



**PENNSYLVANIA PERSONAL INCOME TAX GUIDE**

**CHAPTER 7 - GROSS COMPENSATION**

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## PENNSYLVANIA PERSONAL INCOME TAX GUIDE

### CHAPTER 7 GROSS COMPENSATION

#### I. OVERVIEW

##### A. Definition of Gross Employee Compensation for Pennsylvania Personal Income Tax

Employee compensation includes salaries, wages, commissions, and every other item of receipt related to an employment, whether received directly, through an agent, in cash, in property or otherwise, unless specifically excepted. It includes:

1. Current, deferred, or prepaid remuneration for services,
2. Remuneration for refraining from services,
3. Amounts paid as a result of an:
  - a. Initiation, modification, rescission or breach of an employment contract,
  - b. Unlawful practice with respect to terms, conditions or privileges of employment, or
  - c. Unlawful discharge, failure, or refusal to hire or deprivation of employment opportunities.

Taxable employee compensation is not limited to remuneration received for positive action, remuneration that is contractually enforceable or remuneration paid directly by the employer. Taxable employee compensation includes:

1. Tips and other amounts, over which the employer does not have the control, receipt, custody, or payment,
2. A sum in excess of salary given an athlete for signing with a team or other bonus,
3. Payments to current and former employees for a covenant not to compete,
4. Back or front pay for a period of time during which an individual was wrongfully separated from his job and front pay paid in lieu of reinstatement.

Compensation includes:

1. Salaries
2. Wages

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3. Commissions
4. Bonuses, and incentive payments, whether based on profits or otherwise
5. Fees
6. Tips and
7. Similar remuneration received for services rendered by an individual whether directly or through an agent and whether in cash or in property.

Compensation paid in any medium other than cash is valued at its fair market value. The term compensation may include:

1. Cash
2. Foreign currency
3. Check or other negotiable instruments
4. Freely transferable readily marketable obligations or other cash equivalents
5. Property interests
6. Below-market-rate loans
7. Discharge of liabilities

Compensation does not include guaranteed payments to a partner even if they are for services.

### **B. Income Items Taxable as Federal Compensation Compared to Income Items Taxable as Pennsylvania Compensation**

There are significant differences between Pennsylvania personal income tax (PA PIT) and federal income tax. Certain income items that are not taxable for federal income tax are taxable for Pennsylvania personal income tax. Certain income items that are taxable for federal income tax are not taxable for Pennsylvania personal income tax.

Please refer to the following tables for differences between federal and Pennsylvania:

1. [Table 7-1, Income Items Always Taxable as Pennsylvania Compensation](#) illustrates what items are included in compensation for Pennsylvania personal income tax purposes.

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2. [Table 7-2, Income Items Never Taxable as Pennsylvania Compensation](#) illustrates what items are not included in compensation for Pennsylvania personal income tax purposes.
3. [Table 7-3, Income Items Taxable as Pennsylvania Compensation Based on Facts and Circumstances on the following pages for descriptions of these items](#) illustrates what items may be taxable based on the facts and circumstances of the item for Pennsylvania personal income tax purposes.

**Table 7-1 Income Items Always Taxable as Pennsylvania Compensation**

<b>Type of Compensation</b>
Salaries
Wages
Tips received directly by the employee or through his or her employer
Gratuities
Commissions
Bonuses
Incentive payments
Vacation/holiday pay
Termination/severance pay
Payment incentives for early retirement
Reimbursements and allowances in excess of allowable business expenses
Directors' fees
Jury fees
Witness fees (will constitute PA-40 Schedule C income if testifying as an expert in a field which is considered one's line of business)
Eligible reimbursed moving expenses in excess of allowable expenses on PA-40 Schedule UE
Honoraria (will constitute PA-40 Schedule C income if one's profession is being a professional speaker)
Executor's or administrator's fees (will constitute PA-40 Schedule C income if one's profession is being an executor or administrator)
Covenant not-to-compete or payments received as consideration for refraining from the performance of services
Proceeds from an employee stock ownership plan to extent of excess computed under cost-recovery method
Cash allowances for rent, utilities, or other expenses received by ministers
Reimbursements made by an employer for dependent care, legal services, or other personal services
National Service Education Awards
Income from Peace Corps, VISTA Job Corps and Americorp
Household employees pay
Employee contributions to an eligible Pennsylvania retirement plan and or contributions to a qualified deferred compensation plan
Distributions from a nonqualified deferred compensation plan (unless the deferral was previously taxed under rules prior to Act 40 of 2005)

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**Table 7-2 Income Items Never Taxable as PA Compensation**

<b>Type of Compensation</b>
Federal active-duty pay earned outside Pennsylvania
GI Bill benefits including tuition and living expenses
Alimony
Child support
Income in respect of a decedent
Inheritance
Social Security
Railroad retirement benefits
Public assistance
Unemployment compensation
Occupational Disease Act benefits (if included on the W-2 form attach explanation)
Meals and lodging provided to an employee by the employer
Personal use of employer-owned or leased property and/or services, at no cost or at a reduced cost. Personal use of company automobile, airplane or other employer-owned or leased property. These amounts are not taxable fringe benefits for Pennsylvania personal income tax
Employer-provided parking facilities. These amounts are nontaxable fringe benefits.
Employer-provided professional services paid for directly by the employer. These are nontaxable fringe benefits.
Premiums paid by an employer for group term life insurance (no limit)
Rental value of parsonage owned by the congregation and required to be occupied by the cleric
Foster care
Employer-paid group term life insurance premiums
Amounts received for permanent loss of body function, disfigurement, or reimbursed medical expense
Disability payments paid by employer arising under occupational disease acts or other legislation
Strike benefits
Life insurance proceeds or settlements
Employee contributions or deferrals to a nonqualified deferred compensation plan (all IRC Section 409A plans and some IRC Section 457b plans where the deferrals made are subject to a substantial risk of forfeiture or the employee deferrals made to the plan are not funded by the employer)
The State Employees' Retirement System, the Pennsylvania School Employees' Retirement System, the Pennsylvania Municipal Employees Retirement System and the U.S. Civil Service Commission Retirement Disability Plan are eligible Pennsylvania retirement plans and all distributions are exempt from Pennsylvania personal income tax. Retired or retainer pay of a member or former member of a uniform service calculated under Chapter 71 of Title 10, U.S. Code as amended is also exempt from Pennsylvania personal income tax
Distributions from eligible Pennsylvania retirement plans after retirement age*

\*Regarding what plans qualify as "eligible Pennsylvania retirement plans," the fact that a plan is a qualified plan for federal income tax is not controlling for personal income tax.

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**Table 7-3 Income Items Taxable as Pennsylvania Compensation Based on Facts and Circumstances**

<b>Type of Compensation</b>	<b>Taxable Description</b>	<b>Non-Taxable Description</b>
Sick pay, sick leave	Sick pay and sick leave are taxable compensation when representing regular wages. The employer must include them as compensation and withhold Pennsylvania tax. Request <i>REV-634, Employee Fringe Benefits and Wage/Salary Supplements</i> .	<p>Payments, not representing regular wages, including payments made by third party insurers for sickness or disability, are not taxable income for Pennsylvania purposes.</p> <p>Your employer should not include periodic payments for sickness or disability in Box 16 of your federal Form W-2.</p> <p>If your employer includes this income and withholds Pennsylvania tax, you must obtain and submit a corrected federal Form W-2 or a statement from your employer explaining the error.</p>
Disability benefit payments, including payments made by third party insurers for sickness or disability	Taxable if paid by employer.	Nontaxable if paid by third-party insurer.
A premature withdrawal from a regular IRA or Roth IRA	A premature withdrawal from a regular IRA or Roth IRA is taxable compensation to the extent that the taxpayer receives an amount that exceeds his or her previously taxed contributions. The cost-recovery method of accounting must be used to determine the taxable portion unless timely rolled over into an eligible Pennsylvania retirement plan. Please consult your summary plan description or plan administrator.	

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**Table 7-3 Income Items Taxable as PA Compensation Based on Facts and Circumstances**

Cont.

<b>Type of Compensation</b>	<b>Taxable Description</b>	<b>Non-Taxable Description</b>
<p>Payments received under worker's compensation acts, occupational disease acts, or similar legislation, including payments for injuries you received while working, and damages received, whether by suit or otherwise, for personal injuries (unless one is required to pay these monies back to the employer and receives regular salary in return)</p>	<p>Taxable when the employee must turn over the worker's compensation payments to the employer in order to receive his or her regular salary in return. The employee does not report the worker's compensation payments, but does report the full amount of his or her regular salary.</p>	<p>All other payments received under workers compensation acts is not taxable compensation.</p> <p>Occupational disease acts are not taxable.</p>
<p>Scholarships or fellowships and stipends</p>	<p>The recipient is required to apply the skill and training to advance research, creative work or some other project or activity.</p>	<p>Made on the basis of need or academic achievement, is not taxable if awarded to encourage or allow the recipient to further his or her academic achievement is not taxable compensation.</p>
<p>Employer-provided fringe benefits</p>	<p>Non-excludible fringes</p> <p>Refer to <a href="#">Pennsylvania Taxation of Fringe Benefits</a> for a list of non-excludable fringes including an option to receive cash or reimbursement.</p>	<p>Excludible fringes (e.g. personal use of an employer's owned or leased property and/or services, at no cost or at a reduced cost, and using your employer's dependent care facilities) is not taxable compensation.</p> <p>Refer to <a href="#">Pennsylvania Taxation of Fringe Benefits</a>.</p>
<p>Damage awards - Delayed damages received in connection with a court judgment or settlement</p>	<p>Delay damages received in connection with a court judgment or settlement is taxable compensation.</p>	

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**Table 7-3 Income Items Taxable as PA Compensation Based on Facts and Circumstances**

Cont.

<b>Type of Compensation</b>	<b>Taxable Description</b>	<b>Non-Taxable Description</b>
Federal-taxable punitive damages awarded and settlements from personal injury		Federal-taxable punitive damages received for personal physical injury or physical sickness, whether received by suit or by settlement is not taxable compensation.
Damages, awards, and settlements from personal injury or sickness		Damage awards and settlements from personal injury or sickness if pain and suffering, emotional distress, or another non-economic element was or would have been a significant evidentiary factor in determining the amount of the taxpayer's damages is not taxable compensation.  Refer to <a href="#">Damage Awards</a> .
All other damage awards	Other damage awards that are also taxable <i>e.g.</i> damage awards and settlements to the extent that the payments represent back wages or other uncollected entitlement to Pennsylvania-taxable incomes, damage awards for lost profits, etc.) is taxable compensation. Report on <i>PA-40 Schedule W-2S, Wage Statement Summary</i> .	

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**Table 7-3 Income Items Taxable as PA Compensation Based on Facts and Circumstances**

Cont.

<b>Type of Compensation</b>	<b>Taxable Description</b>	<b>Non-Taxable Description</b>
Television Show winnings	<p>A prize awarded to a participant in a game or "reality" show is considered non-employee compensation for Pennsylvania personal income tax purposes.</p> <p>The value of the prize should be reported on <i>PA-40 Schedule W-2S, Wage Statement Summary</i>.</p> <p>If the prize is taxed in another state, then the taxpayer can use <i>PA-40 Schedule G-S</i> or <i>PA-40 Schedule G-L</i> to claim the out-of-state tax credit.</p>	
Awards	Awards given in recognition for past or future service are taxable compensation.	All awards not given in recognition for past or future service are not taxable compensation.
Gifts	Taxable if gift is a transfer of cash or property in payment for past or present services or as an inducement to perform future services.	Gifts made from detached or disinterested generosity is not taxable compensation.

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**Table 7-3 Income Items Taxable as Pennsylvania Compensation Based on Facts and Circumstances**

Cont.

<b>Type of Compensation</b>	<b>Taxable Description</b>	<b>Non-Taxable Description</b>
<p>Tuition assistance or educational benefits unless the training or education is either-</p> <ol style="list-style-type: none"> <li>1) Required by law or regulation; or</li> <li>2) Required of the employee by the employer in order for the employee to retain the skills necessary for his or her present position. If the course, degree program, or training is designed to enable the employee to enter a new field or profession or to obtain a promotion, the reimbursement is taxable.</li> </ol>	<p>If employer reimburses employees for education cost then the reimbursement is fully taxable and the employee may deduct only those directly related to business expenses allowed on PA-40 Schedule UE, Allowable Employee Business Expenses is taxable compensation.</p>	<p>Employees of an institution of higher learning that receive free or low-cost education receive the tuition assistance tax free for Pennsylvania personal income tax purposes unless they receive cash grants (for themselves or their children) as reimbursements for the tuition paid at their institution of employment or any other institution of higher learning is not taxable compensation.</p> <p>Since Pennsylvania personal income tax has no distinction regarding taxability with respect to the amount of the benefits received for highly compensated employees, these benefits would also be considered tax free for Pennsylvania personal income tax purposes unless a cash grant is received.</p> <p>An employee's child who receives the cash grants directly instead of the employee receives the tuition benefits tax free as long as there is no requirement for past, present, or future services involved with receiving the grant is not taxable compensation.</p>
<p>Employer contributions to eligible Pennsylvania retirement plans and non-qualifying deferred compensation plans</p>		<p>Not taxable compensation.</p>

**PENNSYLVANIA PERSONAL INCOME TAX GUIDE**

**Table 7-3 Income Items Taxable as Pennsylvania Compensation Based on Facts and Circumstances**

Cont.

<b>Type of Compensation</b>	<b>Taxable Description</b>	<b>Non-Taxable Description</b>
Employee contributions to non-qualifying deferred compensation plans	Refer to PA PIT Bulletin 2005-03 -Deferred Compensation Under Nonqualified Plans.	Refer to PA PIT Bulletin 2005-03 -Deferred Compensation Under Nonqualified Plans.
Distributions from eligible Pennsylvania retirement plans and non-qualifying deferred compensation plans  Refer to PA PIT Bulletin 2005-03 - Deferred Compensation Under Nonqualified Plans and PA PIT Bulletin 2005-05 - Qualified Employer Plans.	Act 2005-40 established the general rule that distributions from plans described in IRC §409A(d)(1) attributable to an elective deferral of income or the income on any elective deferral of income are always taxable, unless the contributions were previously taxed then use the cost recovery method.	

**C. Costs, Expenses, and Deductions Against Gross Compensation**

**1. No Deduction Against Gross Compensation**

For individuals, Pennsylvania law does not exempt, exclude, or allow a deduction for any personal expenses, federal itemized deductions, or federal standard deductions. Pennsylvania only allows direct unreimbursed employee business expenses and other direct costs to earn, receive, or realize income.

**2. Exception - Unreimbursed Employee Expenses**

Allowable employee business expenses for Pennsylvania purposes are similar to, but not exactly the same as, expenses for federal purposes. An allowable Pennsylvania employee business expense must be:

- a. Ordinary, customary, and accepted in the industry or occupation in which the taxpayer works; and
- b. Actually paid while performing the duties of the taxpayer's employment; and

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- c. Reasonable in amount and not excessive; and
- d. Necessary to enable the taxpayer to properly perform the duties of his or her employment; and
- e. Directly related to performing the duties of the taxpayer's occupation or employment.

Unreimbursed employee business expenses are 100 percent allowable. These expenses are reported on *PA-40 Schedule UE, Allowable Employee Business Expenses*.

Pennsylvania law does not have federal expense and percentage accounting limitations and thresholds, such as 50 percent of meal and entertainment expenses and the 2 percent of adjusted gross income limitation.

### **D. Pennsylvania Resident Compensation**

A Pennsylvania resident is taxed on all compensation received regardless of the source.

### **E. Nonresident Pennsylvania Compensation**

A nonresident of Pennsylvania is taxed on Pennsylvania-source income in the same classes as residents.

## **II. PENNSYLVANIA COMPENSATION – GENERAL RULES**

### **A. Pennsylvania Regulations**

The department has issued regulations to interpret the definition of compensation and its exclusions, as follows:

Compensation includes items of remuneration received, directly or through an agent, in cash or in property, based on payroll periods or piecework, for services rendered as an employee or casual employee, agent or officer of an individual, partnership, business or nonprofit corporation, or government agency. These items include salaries; wages; commissions; bonuses; stock options; incentive payments; fees; tips; dismissal; termination or severance payments; early retirement incentive payments; and other additional compensation contingent upon retirement, including - payments in excess of the scheduled or customary salaries provided for those who are not terminating service; rewards; vacation and holiday pay; paid leaves of absence; payments for unused vacation or sick leave; tax assumed by the employer; or casual employer signing bonuses; amounts received under employee benefit plans and deferred compensation arrangements, and other remuneration received for services rendered.

### **B. W-2 Wage and Tax Statement (PA-40 Schedule W2-S, Wage Statement Summary)**

A *W-2 Wage and Tax Statement* (federal Form W-2) or *PA-40 Schedule W2-S, Wage Statement Summary* must be submitted with the PA-40 Individual Income Tax Return,

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as evidence of compensation paid and taxes withheld by an employer. When submitting federal Form W-2, the taxpayer must submit a separate form for each employer. The federal Form W-2 must be submitted with a written explanation if any of the following applies:

1. Federal Form W-2 shows income earned or taxes withheld in another state;
2. Federal Form W-2 shows incorrect income or tax withheld;
3. The federal Form W-2 shows Pennsylvania tax withheld of more than 2.8 percent or 3.07 percent;
4. You were a resident of a reciprocal compensation agreement state and your employer withheld Pennsylvania income tax;
5. You are a Pennsylvania resident, working in another state or country and did not have Pennsylvania income tax withheld by your employer;
6. Your employer gave you a handwritten federal Form W-2;
7. The Medicare wages in Box 5 on federal Form W-2 is greater than Pennsylvania wages in Box 16 or;
8. You have a distribution from a nonqualified deferred compensation plan included in Box 1 of federal Form W-2.

If you receive distributions of previously taxed contributions from a nonqualified deferred compensation plan, you should complete and include with your *PA-40 Individual Income Tax Return* the *PA-40 W-2 RW, Reconciliation Worksheet*.

If submitting *PA-40 Schedule W2-S, Wage Statement Summary*, the taxpayer copies the information from each federal Form W-2 over to the *PA-40 Schedule W2-S*. In addition, the taxpayer must enter the employer identification number (EIN) from Box B, the amount of federal wages from Box 1, the Pennsylvania-taxable wages from Box 16, and Pennsylvania tax withheld from Box 17 for each employer. Federal Form W-2 does not need submitted if using a *PA-40 Schedule W2-S, Wage Statement Summary*, although the department reserves the right to request them if needed. When calculating Pennsylvania compensation from a federal Form W-2, it is important to use state wages from block 16 of federal Form W-2 and not the federal wages. This is a common mistake. The state number is often higher because Pennsylvania taxes the employee's contributions or elective deferrals. If the taxpayer was not furnished with or was unable to obtain a federal Form W-2, a federal Form 4852, *Substitute for Form W-2, Wage and Tax Statement*, must be provided or copies of evidence of compensation paid and tax withheld such as pay stubs. Also, include an explanation.

Use Part B of *PA-40 Schedule W2-S, Wage Statement Summary*, to list all the sources

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of non-employee and other compensation. Report Pennsylvania-taxable compensation and any Pennsylvania tax withheld from that income. Include Pennsylvania-taxable amounts from federal Form 1099 that show pensions, retirement plan distributions, executor fees, jury duty pay and other miscellaneous compensation.

### **C. Withholding Requirements**

Under the Tax Reform Code of 1971, every “employer” who has an office or transacts business within Pennsylvania must deduct and withhold Pennsylvania personal income tax from all wages paid to its resident employees, regardless if the services are performed inside the state or outside. The same is required for all wages paid to nonresidents for services rendered inside Pennsylvania unless the employee is a resident of a reciprocal state. 72 P.S. §7316.

Pursuant to 72 P.S. §§7316 & 7301(h), “employer” means an individual, partnership, association, corporation, governmental body or unit or agency, or any other entity who or that is required under the Internal Revenue Code (IRC) to withhold federal income tax from wages paid to an employee.

The department does not have a form similar to federal Form 1099–MISC. Therefore, Pennsylvania currently does not require an employer party to report payments it makes to an independent subcontractor.

### **D. Reciprocal Compensation Agreements**

Pennsylvania currently has reciprocal agreements with Indiana, Maryland, New Jersey, Ohio, Virginia, and West Virginia. See [Regarding Ohio Reciprocal Compensation Agreement](#).

Under these agreements, one state will not tax a resident of the other state on compensation that is subject to employer withholding. These agreements apply to employee compensation only. They do not apply to income reported as compensation, such as executor fees or director fees, on which there is no federal withholding requirement, nor does it apply to any other class of income.

Residents of these states must file REV-419, Employee’s Non Withholding Application Certificate, so your employer can withhold the correct Pennsylvania personal income tax from your pay. Complete a new REV-419 every year or when your personal or financial situation changes. Photocopies of this form are acceptable.

If you are a Pennsylvania resident working in one of these states and your employer withheld the other state’s income tax, you must file for a refund from that state. File early so you will have your refund before the due date for paying your Pennsylvania tax liability.

If you are a resident of a reciprocal agreement state working or performing services in Pennsylvania and your employer withheld Pennsylvania income tax, you may request a refund of the Pennsylvania tax. You report zero taxable compensation on Line 1a and

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the Pennsylvania tax withheld on Line 13. Submit federal Form W-2 or a photocopy and a signed copy of the resident income tax return that you filed/will file with your resident state and REV-419, Employee's Non Withholding Application Certificate. Also, submit a statement explaining that you are a resident of a reciprocal agreement state.

**Note. Ohio Reciprocal Compensation Agreement:** Commencing Jan. 1, 2004, remuneration paid to a Pennsylvania resident twenty percent shareholder-employee of an Ohio S corporation for services performed in Ohio is not covered by the Pennsylvania/Ohio Reciprocal Compensation Agreement and is (can be) subject to tax in Ohio.

### **E. Federal/Pennsylvania Personal Income Tax Differences in Arriving at Box 16 Wages**

Under Act 2005-40, the federal constructive receipt rules relating to nonqualified deferred compensation plans and unfunded section 457 deferred compensation plans were made applicable for personal income tax purposes. If you receive distributions of previously taxed elective deferrals, complete and include with your return the *PA-40 W-2 RW, Reconciliation Worksheet*. Refer to PIT Guide, Chapter 19, Tax Withholding and Estimated Tax Payments.

### **F. Nonresident Pennsylvania Compensation**

Pennsylvania imposes personal income tax on eight classes of income received by residents of Pennsylvania during each taxable year. Nonresidents are not taxed on interest, dividends or intangible gains. Refer to PA PIT Guide, Chapter 8, Interest; Chapter 9, Dividends and Chapter 12, Net Gains or Losses from the Sale, Exchange, or Disposition of Property. Also, refer to PIT Policy Guidance for PIT Bulletin 2005-02 Gain or Loss Derived From The Disposition Of A Going Concern.

Pursuant to the Tax Reform Code of 1971, a resident individual is "an individual . . . who is not domiciled in this commonwealth but maintains a permanent place of abode in this commonwealth and spends in the aggregate more than one hundred eighty-three days of the taxable year in this commonwealth." (72 P.S. §7301(p).) A permanent place of abode is defined as a "dwelling place maintained by the taxpayer, whether or not owned by him." (61 Pa. Code §101.1.) An abode is not permanent if it is occupied during a fixed or limited period of time for a particular purpose.

#### **1. Nonqualified Deferred Compensation for Payments When Taxpayer Leaves Pennsylvania**

Distributions from nonqualified deferred compensation arrangements, when the income deferred is associated from employment within Pennsylvania, are subject to personal income tax even though the distributions may be made while the individual is a resident of another state, subject to the limitations found in Title 4 of the U. S. Code.

For example, taxpayer was employed as an executive by a corporation for 15 years and had elective deferrals of salary under a nonqualified deferred

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compensation plan during the final 10 years of his employment with the corporation. The taxpayer was employed for the first seven of those final ten years at one of the corporation's Pennsylvania operating facilities and lived in Pennsylvania for those seven years. The taxpayer retired and began taking payments of the amounts deferred while living in Florida. The distributions the taxpayer receives from the nonqualified deferred compensation arrangement are partially taxable to Pennsylvania as they relate to payment for work that was performed in Pennsylvania. If equal amounts were deferred in each of the ten years deferrals were made, seven tenths of each distribution is subject to Pennsylvania personal income tax. The taxpayer's employer should withhold Pennsylvania personal income tax on each distribution made to the taxpayer and the taxpayer should file a PA-40, Individual Income Tax Return to report the income.

### 2. **Stock Options**

Stock options earned while working in Pennsylvania would be subject to personal income tax even though exercised while a resident of another state.

**Examples.** Taxpayer was employed by a corporation for 35 years (July 1974 through September 2009.) He lived and worked in several locations during that time period, including Alabama, Louisiana, Texas, and Pennsylvania. He was awarded stock options in 2007 and 2008, during which time he was a Pennsylvania resident. These options were exercised in 2011. Taxpayer was a Texas resident in 2011 and lived in Texas since his retirement in 2009.

Under Article III of Pennsylvania's Tax Reform Code of 1971, (The Personal Income Tax Act), individuals, trusts and estates are subject to the income tax received in any of the eight separate classes of income. 72 P.S. §7302 and 7303. The tax rate tax year 2011 was 3.07 percent (.0307). Nonresident individuals, estates and trusts are subject to tax on income derived from sources within the commonwealth and the tax rate was also 3.07 percent for 2011. *Id.* at 7301(k).

#### **Pennsylvania defines compensation as follows:**

"Compensation" means and shall include salaries, wages, commissions, bonuses and incentive payments whether based on profits or otherwise, fees, tips and similar remuneration received for services rendered, whether directly or through an agent, and whether in cash or property . . .

#### **72 P.S. §§ 7301(d)**

The department's regulation relating to the tax treatment of stock options under the personal income tax imposed on compensation provides:

(f) Compensation in the form of incentive, qualified, restricted or nonqualified stock options shall be considered to be received:

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- (1) When the option is exercised if the stock subject to the option is free from any restrictions having a significant effect on its market value.
- (2) When the restrictions lapse if the stock subject to the option is subject to restrictions having a significant effect on its market value.
- (3) When exchanged, sold or otherwise converted into cash or other property.

### **61 Pa. Code § 101.6(f).**

For Pennsylvania purposes, a stock option is considered received when the stock option is exercised. The compensation earned would be the difference between the price paid to exercise the option and the fair market value of the stock on that date. Even though the stock option was exercised at the time the taxpayer was a resident of Texas, it is Pennsylvania's position that the stock option was earned for services that were performed partly in Pennsylvania. Because the taxpayer worked in a number of different states during his employment, the taxpayer is entitled to pro-rate the income earned based on the time taxpayer worked in Pennsylvania. Please refer to regulatory section 109.8 for guidance on how to apportion this income. 61 Pa. Code § 109.8.

#### Example 1.

Tom receives a stock option. Tom would be considered an insider under Section 16(b) of the SEC. There are no other limitations on Tom's stock option. The employer is required to withhold taxes on the income from the stock option exercise as it is considered taxable compensation to the recipient employee.

#### Example 2.

Tom receives restricted stock. There is a five-year restriction imposed on the ability to sell the stock. Tom will be taxed on the fair market value of the stock in five years when the stock is no longer subject to substantial restrictions.

### **G. Apportioning Pennsylvania-Taxable Income**

A nonresident employee who performs services both inside and outside Pennsylvania is subject to Pennsylvania personal income tax on the net compensation for services performed within Pennsylvania. Usually the employer will allocate and separately report on federal Form W-2, Wage and Tax Statement, the Pennsylvania nonresident employee's gross Pennsylvania compensation.

If the employer did not report your Pennsylvania gross compensation on federal Form W-2; or reported an incorrect amount as Pennsylvania gross compensation on federal Form W-2; or the taxpayer incurred unreimbursed employee business expenses in earning or receiving Pennsylvania gross compensation, the *PA-40 Schedule NRH, Apportioning Income by Nonresident Individuals*, must be completed.

A separate *PA-40 Schedule NRH, Apportioning Income by Nonresident Individuals*, must

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be completed for each employer for whom services were performed both within and outside Pennsylvania.

### III. CURRENT COMPENSATION – PENNSYLVANIA WAGES

#### A. Covenants not to compete or to surrender a right to future employment and early separation incentive payments

##### 1. Payments For Covenant Not-To-Compete

A "covenant not-to-compete" is generally treated as compensation if the covenant is a separately negotiable item in the sales contract and it is intended as remuneration for non-competition. If the "covenant not-to-compete" is actually for goodwill, or to insure the goodwill purchased, the covenant is an asset and includable in the sales of business assets on *PA-40 Schedule D, Sale, Exchange, or Disposition of Property*.

Any payment received on account of a covenant not to compete constitutes taxable compensation. The personal deliberate failure to act is expressly what has been bargained for. Such personal refraining to engage in competition constitutes the rendition of personal services. The terminology "services rendered" does not have to involve some positive action; just affirmatively refraining from doing something the person has the right to do (*Snap-Drape v. Commissioner*, 105 T.C. 16, *Ullman v. Commissioner*, 29 T.C. 129).

##### 2. Amounts paid to surrender a right to future gainful employment

Payments constitute taxable compensation for the relinquishment of the right to future employment as opposed to deferred compensation attributable to prior employment if:

- a. The employment agreement secures for the employee a right to future gainful employment; and
- b. The only consideration given by the employee to obtain that right is the promise to work in the future.

"Front pay" paid in lieu of reinstatement also constitutes taxable compensation.

#### B. Reduction In Force ("RIF") Entitlements

##### 1. Introduction

When reducing their workforces, many employers offer temporary incentives for employees voluntarily to separate from employment, including affording early retirement incentives that are available only for a limited period of time. Many employers also afford involuntarily terminated employees extra pay. The extra pay may be paid in return for agreements releasing legal claims to avoid the risk of RIF-related litigation. It may also be paid to help workers transition to new

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employments or simply to part ways with employees on as amicable a basis as possible. Conversely, employers or labor organizations may establish or maintain supplemental unemployment benefit plans ("SUB plan") or early retirement incentives that are not limited or temporary in nature.

The taxation of such entitlements is explained in this subsection. <sup>1</sup>

### 2. Limited plans of termination

(a) TAXATION

All actual or constructive distributions of cash or property upon dismissal, termination or severance of employment (whether by retirement or otherwise) under a limited plan of termination constitutes severance pay for personal income tax purposes.

(b) LIMITED PLAN OF TERMINATION EXPLAINED

A limited plan of termination is an employee benefit plan that has one or more of the following attributes:

- (i) The plan, when begun, is scheduled to be complete on a certain date or upon the occurrence of one or more specified events.
- (ii) The number, percentage or class of employees whose services are to be terminated are specified in advance of the employees' terminations of service.
- (iii) The plan is otherwise temporary or limited.

### 3. Supplemental unemployment benefits

(a) TAXATION

Amounts paid from a supplemental unemployment benefits trust ("SUB trust") that forms part of a permanent, nondiscriminatory supplemental unemployment benefit plan ("SUB plan") are excludible from tax. However, amounts actually or constructively paid by an employer under a temporary, limited, unfunded or discriminatory SUB plan constitute taxable severance pay.

(b) SUB PLAN EXPLAINED

A supplemental unemployment benefit plan is a plan established or maintained by an employer or by an employee organization, or by both, that has all of the following attributes:

- (i) No benefit is payable to, or can be taken, assigned, pledged or otherwise charged or dealt with by, any plan participant except

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<sup>1</sup> 61 PA Code §§ 101.1 ("Limited plan of termination" defined and "Severance Pay" defined), and 101.6 ("Compensation")

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upon lay-off or involuntary separation from the employment of the employer (whether or not the separation is temporary) resulting directly from a reduction in force, plant closing, change in organizational structure, discontinuance of an operation, the participant's failure to meet or maintain standards of performance for the position due to inability to carry out the responsibilities of the position, health, obsolescence, failure to meet the changed responsibilities of the position or similar circumstance beyond the control of the participant.

(ii) No benefit is payable to, or can be taken, assigned, pledged or otherwise charged or dealt with by, any plan participant if the participant either voluntarily separates from service or is separated or discharged from service for any of the following reasons:

- Refusal to accept another position with reasonably comparable compensation.
- The commission of illegal acts.
- Insubordination, failure or refusal to comply with rules or regulations or similar acts within the control of the participant.

(c) **VOLUNTARY DISCONTINUANCE OF PLAN**

The voluntary discontinuance of a SUB plan within 3 years after it has taken effect, for any reason other than business necessity, will be evidence that the plan was temporary and limited.

### **4. Early retirement enhancements**

(a) **GENERAL RULE**

Any portion of a payment that is only available for a limited period of time as an early retirement "window benefit" is taxable as severance pay

(b) **EXCEPTIONS**

The added benefits payable to retired persons under Federally qualified defined benefit plans that are attributable to--

- (i) Adding additional years to the employee's actual age and/or actual service to reduce or eliminate the effect of actuarial reductions in benefits on account of early retirement,
- (ii) Crediting additional years of service to the employee in calculating benefits under a plan's benefit formula,

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- (iii) Offering social security "bridge payments" to plan participants in order to increase benefits under the employer's retirement benefit plan until they become eligible for social security benefits, or
- (iv) Offering subsidized joint and survivor annuities—

constitute excludible retirement benefits, even if offered only on a temporary or limited basis.

### **C. Clergy**

If a member of the clergy is considered a "common law employee," the cleric's occupancy of a parsonage owned by the congregation and provided for the convenience of the congregation is not taxable as compensation. All housing allowances provided to clergy are taxable as compensation.

If a member of the clergy is not a "common law employee" and is a sole proprietor who offers his services in a market place (i.e. to a nonexclusive, indefinite number of individuals or congregations), income is considered to be derived from a business or profession and is reported on *PA-40 Schedule C, Profit or (Loss) From Business or Profession*. Summary:

1. Where the employer provides housing for the clergy, the value of the housing is not taxable;
2. Where the employer pays the costs of housing directly and not as a reimbursement to the clergy, the direct costs are not taxable;
3. Where the employer pays a housing allowance to the clergy for living in provided housing on the employer's property, the payments are taxable – cash is always taxable;
4. Where the employer pays a housing allowance to the clergy for living in housing that the clergy obtains, the housing allowance is fully taxable as Pennsylvania compensation, and the clergy may deduct directly related business expenses allowed on *PA-40 Schedule UE, Allowable Employee Business Expenses*.

### **D. Statutory Employees**

For federal employment tax purposes, a "statutory employee" is defined as an individual that performs services for remuneration for any person:

1. As an agent-driver or commission-driver engaged in distributing meat products, vegetable products, fruit products, bakery products, beverages (other than milk), or laundry or dry-cleaning services, for his principal;
2. As a full-time life insurance salesman;

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3. As a home worker performing work, according to specifications furnished by the person for whom the services are performed, on materials or goods furnished by such person which are required to be returned to such person or a person designated by him; or
4. As a traveling or city salesman, other than as an agent-driver or commission-driver, engaged upon a full-time basis in the solicitation on behalf of, and the transmission to, his principal (except for side-line sales activities on behalf of some other person) of orders from wholesalers, retailers, contractors, or operators of hotels, restaurants, or other similar establishments for merchandise for resale or supplies for use in their business operations; if the contract of service contemplates that substantially all of such services are to be performed personally by such individual; except that an individual shall not be included in the term "employee" under the provisions of this paragraph if such individual has a substantial investment in facilities used in connection with the performance of such services (other than in facilities for transportation), or if the services are in the nature of a single transaction, not part of a continuing relationship with the person for whom the services are performed.

"Statutory employees" are independent contractors who are deemed "employees" for Federal employment tax purposes because of special Federal statutory rules.

For Pennsylvania personal income tax purposes, individuals shall report all taxable remuneration they receive as a statutory employee as non-employee compensation unless their activities constitute a business, profession, or other activity engaged in as a commercial enterprise. See *PA PIT GUIDE Chapter 11: NET INCOME (LOSS) FROM THE OPERATION OF A BUSINESS, PROFESSION OR FARM*. Those of their expenses that are not reported in a specific part of the *PA-40 Schedule UE, Allowable Employee Business Expenses* should be itemized and claimed in Part C, Miscellaneous Expenses.

However, if such expenses are extensive, a *PA-40 Schedule C, Profit or (Loss) From Business or Profession* may be used in lieu of the *PA-40 Schedule UE, Allowable Employee Business Expenses*, provided that the PA wages shown on the W-2 are included on Line 1a, Gross Compensation, and the expenses from Schedule C are included on Line 1b, Unreimbursed Business Expenses.

### **E. Members of the U.S. Armed Forces or Foreign Service**

Unless there is an intention to change his or her domicile by following military procedures to do so, a person generally does not acquire a new domicile by entering the U.S. Armed Forces or lose the domicile that the person had upon entering. A person in the U.S. Armed Forces is not precluded from acquiring a new domicile where his or her family is stationed. A person in the U.S. Armed Forces or Foreign Service, or a person living in a foreign country for other than a temporary or transitory purpose while a lawful permanent resident or citizen of that country, is treated as a domiciliary of that country if the person:

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1. Is not an employee of the U.S., its agencies, or instrumentalities (including members of the Armed Forces and career appointees in the U.S. Foreign Service); and
2. Does not hold an appointive office in the executive branch of the Government of the U.S.

However, special rules may apply if the employee or officer maintains a permanent place or abode there. An individual who has a domicile in Pennsylvania is considered a nonresident if meeting all three of the requirements listed under Pennsylvania Resident in Chapter 4 of the PA PIT Guide.

### **1. Resident Members of the U.S. Armed Forces**

Military pay, including housing allowances, earned or received by a Pennsylvania resident member of the U.S. Armed Forces (Army, Air Force, Navy, Marine Corps, and Coast Guard) while not on federal active duty or not on federal active duty training, is fully taxable regardless of where the military service is performed.

Also, military pay, including housing allowances, earned or received by a Pennsylvania resident for military service on federal active duty in Pennsylvania is subject to the Pennsylvania personal income tax, 72 P.S. § 7303(a)(1).

Full-time federal active duty military pay and federal active duty for training pay, including housing allowances, earned or received by a Pennsylvania resident member of the U.S. Armed Forces while serving outside the state is not taxable for Pennsylvania personal income tax purposes. However, a taxpayer must include such compensation when determining eligibility for tax forgiveness on *PA-40 Schedule SP*.

While on federal active duty or federal active duty for training, any other income that the Pennsylvania resident earns, receives, or realizes remains taxable for Pennsylvania personal income tax purposes.

The taxpayer has the burden of establishing that income received for military service outside the commonwealth was earned while on federal active duty. The Department of Revenue requires a copy of the military orders directing the taxpayer to federal active duty outside the commonwealth. Residents must file a Pennsylvania personal income tax return and include their W-2 form(s) and copies of their military orders as evidence of active duty military pay earned outside Pennsylvania.

Pennsylvania residents in the U.S. Foreign Service are not on active duty for Pennsylvania personal income tax purposes, and his or her compensation is subject to tax.

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### 2. **Nonresident Members of the U.S. Armed Forces**

Nonresident military personnel who are serving in Pennsylvania are exempt from Pennsylvania personal income tax on their federal active duty military pay and housing allowances. They and their families are, however, subject to tax on any other income normally taxable to nonresidents. This includes duty pay that is not active duty pay, such as weekend drills. Refer to [Military Spouses Residency Relief Act](#).

### 3. **Resident Members of the U. S. Armed Forces Reserves or National Guard**

Pennsylvania resident Reservists and National Guardsmen ordered to active duty for training at a two-week summer encampment pursuant to Title 10 or Title 73 of the U.S. Code are presumed to be on federal active duty. For example, all income received for inactive duty while attending weekend drills is taxable.

Military pay, including housing allowances (this includes a reserve unit's two-week summer training) received for service performed while on federal active duty is excludable from taxable compensation provided the active duty training is performed outside the commonwealth. In addition, scholarships or remuneration received by cadets and midshipmen at U.S. military academies are not taxable because none of these academies is within Pennsylvania and such individuals are on federal active duty.

Beginning with tax years after Dec. 31, 2006, compensation earned by National Guard members on active duty and responding to an emergency shall not be considered taxable income. Act 182 of 2006 amended the Tax Reform Code to expand the definition of active duty military income to include income from the U.S. government or the Commonwealth of Pennsylvania for active state duty for emergencies within or outside the commonwealth. This addition includes duty ordered pursuant to 35 PA.C.S. Ch. 76 (relating to the Emergency Management Assistance Compact).

When a civilian employer voluntarily either makes up the difference in a National Guardsman's or U.S. Reservist's regular wages or continues at full pay for the Guardsman or Reservist during the term of their active duty, the differential or full pay continuation will be considered state taxable compensation subject to Pennsylvania personal income tax withholding. The term differential pay includes military continuation pay, active duty differential payments required by state statutes or payments made by certain states or commonwealths that pay a stipend or a set dollar amount to their employees called to military active duty.

Unless otherwise excluded by a preceding section, military differential pay may be taxable non-employee compensation, whether it is subject to withholding or not. Employers should report military differential pay on federal Form 1099-MISC, Box 3 - Other Income.

A full-time Pennsylvania National Guardsman is taxed on all of the following

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components of military compensation:

- a. Inactive State duty pay received for services both within and outside the commonwealth;
- b. Inactive federal duty pay received for services as a member of the U.S. Armed Forces both within and outside the commonwealth;
- c. Active federal duty pay received for services within the commonwealth;
- d. Active State duty pay received for services both within and outside the commonwealth.

### **4. U.S. Foreign Service**

A Pennsylvania resident in the U.S. Foreign Service is not on active duty for Pennsylvania purposes, and his or her compensation is subject to tax.

### **5. Members of the Merchant Marine and Employees of U.S. Public Health Service**

Pennsylvania residents serving in the Merchant Marines, U.S. Public Health Service, the National Oceanic and Atmospheric Administration, or the U.S. Foreign Service are subject to tax on compensation whether earned within or outside Pennsylvania. However, compensation earned by Pennsylvania residents serving in the Merchant Marines or U.S. Public Health Service called to active duty in a combat zone or hazardous duty zone is not subject to tax in Pennsylvania. Copies of executive orders that make the active duty military active duty are required to be included with the Pennsylvania personal income tax return.

### **6. Combat Zone and Hazardous Duty Service**

#### **a. Military Personnel**

Combat zone pay and hazardous duty zone pay received by a member in the U.S. Armed Forces is not taxable for Pennsylvania personal income tax purposes (Refer to Title 72 P.S. §7301(d)(vii)). Combat zone and hazardous duty zone pay received by a member of the U.S. Armed forces is not considered "*poverty income*" for purposes of tax forgiveness (Refer to Title 72 P.S. §7301(o.2)(vii)).

Combat zone for Pennsylvania personal income tax purposes means any area designated by the President of the U.S. by Executive Order as a combat zone for any time period designated by the President by Executive Order as the period of combatant activities. Hazardous duty zone is also designated by Executive Order.

U.S. reservists and Pennsylvania National Guardsmen are members of the U.S. Armed Forces while they are serving in a combat zone for purposes of

## **PENNSYLVANIA PERSONAL INCOME TAX GUIDE**

this exclusion. The \$500 "combat zone" pay exclusion limit for military officers contained in the Internal Revenue Code is not in the state taxing statute.

### **b. Civilians Working in Combat Zones**

The Internal Revenue Service has concluded that no civilian contractor, or other civilian employee, working in a combat zone is eligible for the combat zone exclusion provided by U.S. Code Section 112. Likewise, there exists no comparable exclusion or exemption provided by the Pennsylvania personal income tax statutes or regulations.

## **7. Military Spouses Residency Relief Act**

The Military Spouses Residency Relief Act (MSRRA) affects the treatment of residency and income for spouses of military personnel for state tax purposes for tax years 2009 and after. If a Pennsylvania resident service member is serving outside Pennsylvania and their nonmilitary spouse earns income in that other state – and the spouse claims relief under the MSRRA – the spouse's income is only taxable to Pennsylvania. If a Pennsylvania nonresident service member is serving in Pennsylvania and their nonmilitary spouse earns income in Pennsylvania, the spouse's income is not taxable to Pennsylvania under MSRRA, when the service member and spouse are both residents or domiciliaries of the same other state, and if the spouse is in Pennsylvania solely to be with the service member. Pennsylvania source income, from a business, profession, farm, rental or royalty property, related to a business or property located in Pennsylvania remains taxable to Pennsylvania nonresident military personnel and their spouses and is not covered by the MSRRA. For detailed information on how MSRRA impacts state taxation of income earned by a service member's nonmilitary spouse, please review Personal Income Tax Bulletin 2010-01 Military Spouses Residency Relief Act on the department's website, [www.revenue.state.pa.us](http://www.revenue.state.pa.us).

## **8. Eligibility Income For Tax Forgiveness Purposes**

Active duty pay and active duty for training pay received by a member of the U.S. Armed Forces is not taxable for Pennsylvania personal income tax purposes. A taxpayer must include such compensation when determining eligibility for tax forgiveness on *PA-40 Schedule SP*.

Combat zone pay and hazardous duty zone pay received by a member in the U.S. Armed Forces is not taxable (Refer to Title 72 P.S. §7301(d)(vii)). Combat zone and hazardous duty zone pay received by a member of the U.S. Armed forces is not considered "poverty income" for purposes of tax forgiveness (Refer to Title 72 P.S. §7301(o.2)(vii)).

Combat zone for Pennsylvania personal income tax purposes means any area designated by the President of the United States by Executive Order as a combat zone for any time period designated by the President by Executive Order as the

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period of combatant activities. Hazardous duty zone is also designated by Executive Order.

United States reservists and Pennsylvania National Guardsmen are members of the U.S. Armed Forces while they are serving in a combat zone for purposes of this exclusion. The \$500 "combat zone" pay exclusion limit for military officers contained in the Internal Revenue Code is not in the state taxing statute.

### **9. Military Differential Pay**

Differential pay is defined as payments made voluntarily by an employer to represent the difference between the regular salary of an employee called to military active duty and the amount being paid by the military, if the regular salary was higher. The term differential pay also includes military continuation pay, active duty differential payments required by state statutes or payments made by certain states or commonwealths that pay a stipend or a set dollar amount to their employees called to military active duty.

Unless otherwise excluded by a preceding section, military differential pay may be taxable non-employee compensation, whether it is subject to withholding or not.

Employers should report military differential pay on federal *Form 1099-MISC*, Box 3 - Other Income.

### **10. Personal Income Tax Exemption For Active Duty National Guard Members**

Beginning with tax years after Dec. 31, 2006, compensation earned by National Guard members on active duty and responding to an emergency shall not be considered taxable income. Senate Bill 1139 amended the Tax Reform Code to provide an exemption for personal income tax on compensation earned by National Guard members who respond to active state duty for emergencies within or outside the commonwealth. This includes duty ordered pursuant to Title 35, Chapter 76 (relating to emergency management assistance compact) of the Pennsylvania Consolidated Statutes.

### **11. Combat Zone and Hazardous Duty Service**

Pennsylvanians serving in combat zones or qualified hazardous duty areas designated by the President of the U.S. are given the same additional time to file and pay their Pennsylvania income tax returns and make payments as allowed for federal income tax purposes. The deadline is automatically extended to 180 days from the last day of service or the last day of continuous hospitalization for injury incurred in one of these areas.

Print "COMBAT ZONE" at the top of your return. Mail your return and military orders to:

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**Regarding - COMBAT ZONE**  
PA DEPARTMENT OF REVENUE  
BUREAU OF INDIVIDUAL TAXES  
PO BOX 280600  
HARRISBURG PA 17128-0600

If you are filing your return electronically, you must still fax or mail copies of your orders. Print "COMBAT ZONE" at the top of your orders. Fax your orders to (717) 772-4193 or mail your orders to:

**Regarding - COMBAT ZONE**  
PA DEPARTMENT OF REVENUE  
ELECTRONIC FILING SECTION  
PO BOX 280507  
HARRISBURG PA 17128-0507

### **12. Military Family Relief Assistance Program**

Help those who serve our Nation and commonwealth by making a gift to the Military Family Relief Assistance Program. Your gift will help Pennsylvania service members and their families by providing financial assistance to those with a direct and immediate financial need as a result of military service.

You can also send a direct, tax-deductible, gift to the Military Family Relief Assistance Program, c/o Department of Military and Veterans Affairs, Fort Indiantown Gap, Annville, PA 17003-5002. For more information visit - [www.dmva.state.pa.us](http://www.dmva.state.pa.us) or call toll free 1-866-292-7201.

## **F. Athletes and Entertainers**

### **1. Resident Professional Athletes and Entertainment Performers**

A professional athlete or entertainment performer who is a full-year resident of Pennsylvania must report all the compensation he or she earns, directly or indirectly, from his or her professional sport or professional athletic team, or from professional performances. Such compensation includes, but is not limited to, any prize, contest, tournament or race winnings, and remuneration, such as, but not limited to - the individual's regular wages; any signing bonus; any incentive payments or performance bonuses; any severance or termination payments or any payments received for refraining from performing services (*i.e.*, covenant not-to-compete payment); or any reimbursements for travel expenses except to the extent the reimbursements are for vouchered expenses which do not exceed the federal *per diem* rate for the city in which the player or performer is located. In addition, product endorsement fees, honoraria for public speaking engagements, or fees received for attendance at card shows, autograph signings, or sports memorabilia events, would all have to be reported as Pennsylvania taxable compensation.

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### 2. **Nonresident Professional Athletes and Entertainment Performers**

A nonresident professional athlete or performer is required to pay Pennsylvania personal income tax on wages or compensation received for services rendered within Pennsylvania unless the individual is a resident of one of the reciprocal agreement states.

### 3. **Allocation and Apportionment Rules for Nonresident Professional Athletes and Performers**

Nonresident professional athletes or performers who are not members of professional athletic teams or performing companies and who do not have an established employer-employee relationship with the payer of their remuneration must report all of their remuneration received from professional sporting events or professional performances in which they participate within the commonwealth as "net income from the operation of a trade, profession or business" (*i.e.*, golfers, tennis players, jockeys, race car drivers, boxers, wrestlers, bicyclists, comedians, musicians, *etc.*). Gross receipts and business expenses attributable to such gross receipts must be specifically apportioned on a strict state-by-state accounting basis by such individuals. However, such individual's general overhead expenses (*i.e.*, association dues and fees, traveling manager, booking agent, rehearsal costs, joke writer, *etc.*) may be allocated to Pennsylvania under rules similar to those found below.

Nonresident professional athletes or performers who are members of professional athletic teams or performing companies must apply the following allocation and apportionment rules:

- a. Compensation received by such nonresident employees will not be taxable if the employee is a resident of one of the following states at the time he receives the compensation:
  - New Jersey
  - Ohio
  - Maryland
  - Indiana
  - West Virginia
  - Virginia
- a. Compensation received by nonresident employees of professional teams or performing companies who are residents of states other than those reciprocal compensation states above must use the following apportionment formulas:
  - **Members of professional athletic teams, other than professional football teams**  
Calculate a "total games played within the commonwealth" versus "total games played (including all post-season championship games)"

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fraction. Multiply that fraction against the taxpayer's total apportionable income. In determining "games played," include exhibition games that are officially sanctioned by the team's league office in both the numerator and denominator of this fraction.

- **Members of professional football teams**

Calculate a "total duty days within the commonwealth " versus "total duty days" fraction. Multiply that fraction against the taxpayer's total apportionable compensation. In determining "duty days," include preseason and regular season practice sessions; preseason and regular season games; and post-season practice sessions and games that are officially sanctioned by the team's league office in both the numerator and denominator of this fraction.

- **Members of professional performing companies**

Calculate a "total performances within the commonwealth " versus "total performances" fraction. Multiply this fraction against the taxpayer's total apportionable compensation. For example, if a traveling circus has 200 performances in 2006 and 10 of those performances were in Pennsylvania, then five percent of the lion tamer's total compensation from the traveling circus would be apportionable to Pennsylvania if the lion tamer performed his act at each performance.

#### 4. **Apportionable Income**

"Apportionable income" includes the player's or performer's regular wages received under his or her contract and any incentive payment or performance bonus received, regardless of whether the incentive or performance bonus is based on any single game, season, or career record mark (*i.e.*, doing something specific in a game or a performance, throwing a perfect game, hitting two or more home runs in a game, scoring more than fifty points in a game, selling out the auditorium, *etc.*), being chosen to appear in an all-star game, being chosen as a most valuable player, or whether based on team performance (*i.e.*, making the playoffs, winning the World Series, *etc.*).

"Apportionable income" for a nonresident individual does not include a contract signing bonus if the nonresident was not a resident of Pennsylvania at the time of the signing and the bonus is solely related to the individual's signing of his or her employment contract. "Apportionable income" for a nonresident individual also does not include periodic payments received on account of the nonresident's sickness or disability other than his or her regular wages if such an individual is disabled or injured and cannot play in a game and also cannot practice with his or her team. In such cases, both the numerator and denominator of the "games played," "duty day" or "performance" fraction will have to be modified to reflect these absences.

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### 5. **Classification of Income into Appropriate Income Class**

For Pennsylvania personal income tax purposes, income, profits or gain earned, received, or acquired which fall within the definition of one class of income cannot be offset by losses incurred in another class of taxable income. Therefore, classification of income into its proper class is important. For Pennsylvania personal income tax purposes, income received by professional athletes must be classified under the following guidelines:

- a. Remuneration received by members of professional athletic teams or performing companies – is classified as employee compensation subject to employer withholding.
- b. Remuneration received by professional team athletes for services rendered outside of the contest of their sport (*i.e.*, public speaking functions, attendance at card shows, product endorsements, paid participation in sporting events outside of their sport, *etc.*) – is classified as nonemployee compensation.
- c. Receipts received by professional athletes or performers who are not members of professional athletic teams or performing companies (*i.e.*, golfers, tennis players, boxers, wrestlers, race car drivers, bicyclists, comedians, musicians, *etc.*) must be reported as "net income from the operation of a business or profession" and reported on a strict state-by-state accounting of income and expenses.
- d. Income derived from book or magazine royalties by professional sports or entertainment figures must be reported as "net income derived from rents, royalties, patents and copyrights". Nonresidents would have to report only on the royalties attributable to their Pennsylvania sales.

### G. **PA-40 NRC-AE, Nonresident Consolidated Athletes & Entertainers Only Tax Return**

The purpose of the PA-40 NRC-AE is to simplify filing requirements for athletic and entertainment organizations or entities that have nonresident employees who meet the filing requirements for a PA-40, Individual Income Tax Return.

**Caution.** The PA-40NRC-AE is not intended for use by a resident or nonresident individual filing on their own behalf. A resident or nonresident individual filing on their own behalf must use PA-40, Individual Income Tax Return, to report compensation taxable to Pennsylvania for performances or services completed, or games played, in Pennsylvania.

A professional sports team may file PA-40 NRC-AE on behalf of its qualifying electing nonresident players or qualifying nonresident non-player personnel who receive wages or compensation. A league may also elect to file on behalf of its qualifying nonresident officials or other qualifying nonresident league personnel who receive wages or

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compensation. Professional entertainment entities may also elect to file on behalf of nonresident entertainers who receive wages or compensation. Sports teams, league offices and professional entertainment entities will be known collectively as "entity." Nonresident players and non-player personnel, along with nonresident officials and nonresident entertainers, will be known collectively as "nonresident individuals". Each nonresident individual who wishes to participate in the PA-40 NRC-AE must meet the following requirements:

1. The nonresident individual must be an individual whose tax year is the calendar year.
2. The nonresident individual and the nonresident individual's spouse must each be a domiciliary of a state or country other than Pennsylvania or the reciprocal states of Indiana, Maryland, New Jersey, Ohio, Virginia and West Virginia for the entire taxable year.
3. The nonresident individual must have no Pennsylvania-taxable income derived from or connected with Pennsylvania sources other than his or her apportioned share of compensation for the calendar year.
4. The nonresident individual must elect to join in the filing of the PA-40 NRC-AE.
5. The nonresident individual must not be able, by election or non-election, to participate in the PA-40 NRC-AE filing by any other entity.

**Important.** Nonresident individuals with qualified unreimbursed business expenses may not use PA-40 NRC-AE. Individuals who wish to claim qualified unreimbursed business expenses are required to file their own separate PA-40, Individual Income Tax Return and include PA-40 Schedule UE.

For more detailed information on PA-40 NRC-AE, refer to the instructions on the department's website under Forms and Publications for personal income tax.

### **H. Bonuses**

Bonuses are always taxable as Pennsylvania personal income tax compensation.

### **I. Incentive Pay**

Incentive pay is always taxable as Pennsylvania personal income tax compensation.

### **J. Commissions**

Commissions are always taxable as Pennsylvania personal income tax compensation.

### **K. Tips and Gratuities**

Tips and gratuities are always taxable as Pennsylvania personal income tax compensation.

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### **L. Vacation Pay/Holiday Pay**

Any vacation, holiday, sabbatical, sick leave, or other guaranteed pay an employee receives as an incident or benefit under a work agreement is taxable on the same basis as the base pay the employee receives for periods the employee is not absent from work, provided the payment is:

1. Calculated with reference to the period the employee is absent from work, and
2. Paid in full or partial replacement of the base pay the employee could have earned for such period but for such absence.

Also, note that payments to an employee are not excluded from compensation merely because of a failure to render services during the period covered by the payment.

### **M. Sick Pay**

Regular Wages – Pennsylvania-Taxable

Sick pay and sick leave are taxable compensation when representing the taxpayer's regular wages and his or her employer must include them as compensation and withhold Pennsylvania tax.

Other than Regular Wages – Pennsylvania Nontaxable

Payments, including payments made by third party insurers for sickness or disability, are not taxable income for Pennsylvania purposes. The employer should not include periodic payments for sickness or disability in box 16 of the employee's W-2 form. If the employer includes this income and withholds Pennsylvania tax, the taxpayer must obtain and submit a corrected W-2 form or a statement from the employer explaining the error.

### **N. Commercial Accident and Health Insurance; Self-Insured Accident and Health Plan Coverage and Benefits**

#### **1. Insurance Issued by a Commercial Third Party Insurance Company**

Generally, coverage and amounts paid under policies of accident or health insurance issued by a commercial third party insurance company, including loss of income insurance or accident or health plans, are not taxable. Exceptions apply, however, if the insurance or plan discriminates in favor of highly compensated individuals.

#### **2. Accident or Health Plan**

Any trusted or self-insured arrangement established or maintained by an employer or employee organization in order to provide such care or benefits in the event of sickness, accident, or disability that meets all of the following requirements qualifies as an accident or health plan-

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- a. No program benefits are payable or subject to anticipation, assignment, or pledge until the commencement of a covered sickness or disability or death except:
  - The return of the participant's own contributions and taxable income or gains thereon;
  - Amounts paid for the prevention of sickness or disability; or
  - Amounts paid for a policy of accident, health, or term life insurance issued by a commercial insurance company.
- b. The only means of obtaining entitlement to program benefits other than the return of the participant's own contributions and taxable income or gains thereon, or amounts paid for the prevention of sickness or disability, or commercial insurance is proof of hospitalization, sickness, disability, or death.
- c. The program offers no benefit that defers the receipt of compensation or operates in a manner that enables no participant to defer the receipt of compensation to another taxable year.

### **3. Discriminatory Programs**

Except as provided in "Disability Annuities" below, compensation includes the entire cost of employer-provided coverage provided to a highly compensated participant under a discriminatory program covering hospitalization, sickness, or disability.

### **4. Disability Annuities**

A plan payment that is attributable to the plan participant's becoming sick or injured and is part of a series of substantially equal periodic payments made for the entire period of disability of the participant, or for the life of the participant, or the joint lives of such participant and his designated beneficiary, is not taxable. This exclusion includes disability retirement benefits paid to persons retired from service upon the employee's own application or on application by the employee's employer, for disability retirement and amounts received as a disability pension, disability annuity, or similar allowance for physical injuries or sickness resulting from active service in the armed forces of the United States.

### **5. Plan Payments**

A plan payment that is attributable to the plan participant's becoming sick or injured and is part of a series of substantially equal periodic payments made for less than the entire period of disability to provide participants and their beneficiaries with a substitute source of income during a period of disability is also not taxable unless all of the following conditions apply:

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- a. The periodic payments have some direct relationship to the employee's usual rate of compensation;
- b. The periodic payments are computed without reference to the nature of the disability and with regard to the employee's job classification;
- c. Periodic payments would not be reduced by payments arising under Workmen's Compensation Acts, Occupational Disease Acts, Social Security Disability, or similar legislation by any government;
- d. The periodic payments cannot exceed the employee's usual compensation for the period.

Payments are considered to be computed without reference to the nature of a disability if, under the plan, they can be made for injuries or diseases:

- a. For which the employer, but for his agreement to indemnify his employees against loss arising from such contingencies, would, otherwise, have had no legal or moral duty whatsoever to make payment;
- b. Which did not arise out or in the course of, and were not incidental to, any employment relationship; and
- c. Which may be temporary, non-chronic, and of short duration, with no long-term or permanent impact.

Additionally, payments are considered to be computed without regard to an employee's job classification if:

- a. The amount payable for a period to a participant under the plan may differ from the amount payable to another participant for the period, even if both participants have the same job classification; and
- b. The amount payable for a period to a participant under the plan may be the same as the amount payable to another participant for the period, even if both participants do not have the same job classification.

The disability annuity exclusions apply even if the plan does not qualify as a nondiscriminatory accident or health plan.

### **6. Taxable Amounts**

All of the following are taxable:

- a. Amounts received during a period of sickness or disability for services performed during another period or to which the employee would have

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been entitled regardless of whether he was sick or disabled;

- b. Paid leaves of absence due to sickness or disability;
- c. Payments for unused sick leave.

Also taxable are payments under a wage continuation plan paid in lieu of wages for a period during which the employee is absent from work on account of injury or sickness and computed with reference to the period the employee is absent from work and the employee's regular rate of compensation and without regard to the nature of such injury or sickness. Such payments are taxable even if length of service is not a factor either in determining eligibility for, or the amount of, payment.

### **7. Payments for Accident and Health Insurance and Plan Coverage and Disability Annuities**

Except in the case of cafeteria plans:

- a. Any amount lawfully deducted by an employer from the remuneration of an employee for accident or health insurance or plan coverage or a disability annuity shall be deemed to be a part of the employee's taxable remuneration and to have been paid to the employee as compensation at the time the deduction is made.
- b. Any amount paid for accident or health insurance or plan coverage or a disability annuity by an employer to a third party or fund on behalf of an employee without deduction from the remuneration of, or other reimbursement from, the employee is excludible from the employee's income unless:
  - The payment is made pursuant to a cash or deferred arrangement under which an employee may unilaterally elect to have the employer make payments to such third party or fund for the benefit of the employee or to the employee directly in cash (in this instance, the payment shall be deemed to be paid to the employee as compensation at the time the payment is made).
  - The payment is made pursuant to an arrangement under which an employee may unilaterally choose between accident or health insurance or plan coverage (or a disability annuity) and coverage under another employee benefit plan (in this instance, the payment shall be deemed to be paid to the employee as compensation at the time the payment is made).

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However, amounts specified in a qualifying cafeteria plan document as being available to the employee for the purpose of selecting or purchasing benefits under a plan or as additional cash remuneration received in lieu of coverage under a plan are excludible from tax and withholding if the following apply:

- a. They were not actually or constructively received, after taking IRC Section 125 into account.
- b. The benefits selected or purchased are nontaxable under the Internal Revenue Code when offered under a cafeteria plan described in IRC Section 125.
- c. The payments made for the plan would be nontaxable under Pennsylvania personal income tax if made by the employer outside a cafeteria plan described in IRC Section 125.

### **8. Contributions by, on Behalf of, or Attributable to a Self-Employed Individual are Not Excludible from Income**

Employer payments to reimburse employees for uninsured medical or dental expenses are taxable as compensation if the employee is assured of receiving (in cash or any other benefit) amounts available but unused for covered reimbursement during the year without regard to whether he incurred covered expenses or not.

If the amounts available for covered reimbursement cannot be cashed out or used for any other purpose during the taxable year or be carried over to any other taxable year, normal cash compensation that is forgone by an employee under a spending account or otherwise and credited to a self-insured medical reimbursement account and drawn upon to reimburse the employee for uninsured medical or dental expenses to which Internal Revenue Code Section 105(b) applies is excludable from tax.

### **O. Disability**

#### **1. Regular Wages – Pennsylvania-Taxable**

Payments made by the employer and not a third party insurer for disability amounts are considered regular wages.

#### **2. Other than Regular Wages - Pennsylvania Nontaxable**

Payments not representing regular wages, including payments made by third-party insurers for sickness or disability, are not taxable.

### **P. Strike Benefits**

Strike benefits are not taxable for Pennsylvania personal income tax purposes.

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**Q. Group Term Life Insurance**

Group term life insurance is never taxable for Pennsylvania personal income tax purposes, regardless of the amount.

**R. Unemployment Compensation**

Unemployment compensation is not taxable for Pennsylvania personal income tax purposes.

**S. Workers Compensation**

Workers compensation is never taxable for Pennsylvania personal income tax purposes.

**T. Occupational/Disability Act Benefits**

Occupational/Disability Act Benefits are never taxable for Pennsylvania personal income tax purposes.

**U. Stipends**

**1. Pennsylvania-Taxable**

Stipends paid to medical interns and residents pursuant to an internship or residency program that conforms to the Essentials of an Approved Internship or the Essentials of an Approved Residency as established by the American Medical Association are taxable.

**2. Pennsylvania Nontaxable**

Fellowship awards and stipends do not constitute taxable compensation for services if the recipient is required to apply his skill and training to advance research, creative work, or some other project or activity, and the recipient can show that:

- a. The benefits resulting from the services of the recipient are so minimal, given the actual services performed or expected to be performed, that they constitute no realistic basis for compensation by the institution sponsoring the fellowship or stipend; or
- b. The activities of the recipient are so closely and directly supervised and immediately controlled by regular faculty members so as to constitute a burden on the institution which would offset any benefit it receives from the recipient's activities; or
- c. The recipient is a candidate for a degree and the same activities are required for all candidates for that degree as a condition for receiving such a degree.

**V. Scholarships/Fellowships**

Generally, a scholarship or fellowship award made on the basis of need or academic achievement is not taxable if awarded to encourage or allow the recipient to further his

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or her educational development. If the recipient is required to apply his skill and training to advance creative worth or some other project, the scholarship may be taxable. Refer to above discussion on [stipends](#).

In order to substantiate that a scholarship or fellowship is not taxable, include a letter with an original signature of the department head or other official detailing the description of the program under which the award was received. A form letter is not acceptable.

### **W. Moving Expense Reimbursements**

Moving expense reimbursements for the personal expenses of an employee are considered compensation for personal income tax purposes. Reimbursements for title insurance premiums, notary fees, mortgage service charges, appraisal fees, credit report fees, daily living expenses, etc. are included in compensation even if the reimbursement is a "payment to reimburse actual expenses". See Section VII, Employee Expenses for Pennsylvania, and the Moving Expenses section under letter D.

### **X. Awards/Prizes from Employers**

When an employer rewards an employee in recognition for his or her performance, the cash or value of the award, unless *de minimis* under federal rules under IRC Section 132, is taxable Pennsylvania compensation. However, an award out of detached generosity or in recognition for civic or humanitarian services is not taxable Pennsylvania compensation.

#### **1. National Service Education Awards and Income from Peace Corps**

Such income is taxable for Pennsylvania personal income tax purposes.

### **Y. Golden Parachute Agreement Payments**

#### **1. Explanation**

A golden parachute agreement payment is any payment or property transfer made in addition to the amounts otherwise payable upon termination of employment that is payable on account of a change in ownership or control or change of a significant part of assets of a corporation.

#### **2. Taxation**

Any golden parachute agreement payment to a highly compensated participant is taxable as compensation.

### **Z. Supplemental Wage Payments**

Supplemental wages are compensation paid by or on behalf of a service recipient that are neither regular wages nor planned deferred compensation. Common examples include tips, overtime pay, bonuses, back pay, commissions, wages paid under reimbursement or other expense allowance arrangements, wages paid as noncash fringe benefits, sick pay paid by a third party as an agent of the service recipient, income recognized on the grant or exercise of a nonstatutory stock option, and income

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recognized on the lapse of a restriction on restricted property transferred from an employer to an employee.

### IV. PENNSYLVANIA TAXATION OF STOCK OPTIONS

#### A. Overview

In general, Sections 421, 422 and 423 of the Internal Revenue Code are inapplicable. Section 451 of the Internal Revenue Code, and related rules and regulations govern the taxability for Pennsylvania personal income tax.

Incentive, statutory, and non-statutory stock options are taxable as Pennsylvania compensation on the earliest of the following dates:

1. Date of exercise of the option unless there are substantial restrictions; or
2. Date that substantial restrictions on the option lapse; or
3. Date of sale of the option.

The difference between the fair market value of the stock on the date of exercise or lapse as applicable and the amount paid by the employee to obtain the option, if any, is the amount subject to Pennsylvania tax when sold before lapse or exercise.

See Page 20, Stock Options, for when residency changes during the holding period.

#### B. Federal and Pennsylvania Personal Income Tax Differences Relating to Stock Options

Pennsylvania personal income tax, unlike the Internal Revenue Code, does not contain provisions that distinguish between or among various types of stock options. There is no distinction drawn between qualified and nonqualified (sometimes referred to as "statutory" and "non-statutory") stock options. Moreover, there are no PA provisions that distinguish between qualified stock options and those options granted under employee stock purchase plans.

For federal income tax purposes, nonqualified stock options are taxable in the year they are granted if the option has an ascertainable market value at that time. If the stock is not traded in an established market and the stock's value is not ascertainable under federal regulations, the option is taxed upon exercise for federal purposes.

As a general rule, qualified stock options are subject to a greater number of conditions than other options and they must be satisfied for the employee to receive the favorable tax treatment under the Internal Revenue Code (e.g. the option can only be exercised by the individual to whom granted, options must be exercisable within 10 years of date of grant, option price may not be less than fair market value of stock on date of grant, etc.). A qualified stock option is not taxable under the Internal Revenue Code at the time of its grant or at the time, the employee exercises the option (IRC Section 421);

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rather, the taxation of the stock option is deferred and is imposed as a capital gain when the employee sells the stock.

### **C. Pennsylvania Taxation of Stock Options**

Under Pennsylvania personal income tax law, the exercise of a stock option is “compensation” in the form of intangible property. By regulation, it is taxable and subject to withholding if, the employer is required to withhold tax from the wages of its employee. The difference between the fair market value of the stock on the date of exercise and the amount paid by the employee to obtain the option, if any, is the amount subject to Pennsylvania tax.

Stock options are subject to withholding and reporting in the year that they are exercised unless the underlying stock is subject to substantial limitations or restrictions on its transferability or alienability. The difference between the option cost and the fair market value of the stock at the time the employee exercises the option is the amount subject to withholding and reporting.

There is no Pennsylvania personal income tax provision similar to an IRC Section 83(b) election for federal income tax purposes.

### **D. Substantial Restrictions/Constructive Receipt for Pennsylvania Income Tax**

If the underlying stock can only be sold after a stated period of time, if it cannot be sold to any party other than one’s employer and then only at some previously agreed upon price, or it can only be sold or assigned upon termination of one’s employment with the company, or is subject to forfeiture if the employee obtains employment with a competitor within a number of years, the department does not consider the employee to be in constructive receipt of the stock. The restrictions imposed upon insider trading by Section 16(b) of the Securities and Exchange Act is not considered substantial limitations or restrictions. The department also considers the one-year qualification rule imposed by IRC Section 422 on employees’ ability to sell their stock not to be a substantial restriction.

If there are substantial lapsing restrictions on stock options, they are not considered when determining either the value of the underlying stock or the recipient’s tax liability. If there are some restrictions on the stock that are insubstantial, they will be a factor when determining the value of the option and underlying stock. Restrictions of this nature are one of many factors that may affect a stock's fair market value. Only when one has actual or constructive receipt of his stock options does he have income for purposes of Pennsylvania personal income tax.

The income realized will be the difference between the fair market value of the stock at time the restriction lapses and the fair market value at the time the options are recognized.

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### E. Examples

#### **Example 1.**

Tom receives a stock option. Tom would be considered an insider under Section 16(b) of the Security Exchange Commission (SEC). There are no other limitations on Tom's stock option. The employer is required to withhold taxes on the income from the stock option exercise as it is considered taxable compensation to the recipient employee.

#### **Example 2.**

Tom receives restricted stock. There is a five-year restriction imposed on the ability to sell the stock. Tom will be taxed on the fair market value of the stock in five years when the stock is no longer subject to substantial restrictions.

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**Table 7-4 - Federal Statutory Stock Option (Qualified Stock Option)**

Applicable Option Date	Federal Statutory Stock Option Also Called Incentive Stock Option and Qualified Stock Option		Pennsylvania	
	Federal Treatment Employee	Federal Treatment Employer	Pennsylvania Personal Income Tax Treatment Employee	Pennsylvania Personal Income Tax Treatment Employer
Grant Date	No tax impact	No tax impact	No tax impact	No tax impact
Exercise Date	Alternative minimum tax adjustment equal to the difference between exercise price of stock and fair market value of stock on exercise date	No tax impact	The value of the option less any amount paid for the option will be taxed as compensation	Compensation deduction equal to income withheld as Pennsylvania wages
Lapse Date	No tax impact	No tax impact	No tax impact	No tax impact
Stock Disposition Date	Capital gain equal to difference between sale price of stock and exercise price of option.	No tax impact	Gain or loss on the sale of the stock is the difference between the sale price and the taxpayer's basis in the stock which equals the exercise price of the option plus any compensation recognized as a result of exercising the option	No tax impact

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**Table 7-5 Non-statutory Stock Option (Nonqualified Stock Option) Option Fully Transferable or Not Subject to Risk of Forfeiture**

Applicable Option Date	Federal Nonqualified		Pennsylvania	
	Federal Treatment Employee	Federal Treatment Employer	Pennsylvania Personal Income Tax Treatment Employee	Pennsylvania Personal Income Tax Treatment Employer
IRC § 83	Election to include in gross income in year of transfer.		PA PIT was amended to make, with certain exceptions, section 83 of the IRC of 1986 and regulations applicable for taxable years beginning after December 31, 2004, respect to property transferred to a service provider (or beneficiary) in connection with the performance of services.	No tax impact
<b>Option has readily ascertainable fair market value on date of grant (Option fully transferable or not subject to risk of forfeiture)</b>				
Grant Date	The value of the option less any amount paid for the option will be taxed as compensation.	Compensation (ordinary) deduction equal to income subject to withholding or federal Form 1099 issued to employee or independent contractor.	No tax impact	No tax impact
Exercise Date	No tax impact	No tax impact	The value of the option less any amount paid for the option will be taxed as compensation	Compensation deduction equal to income subject to withholding or federal Form 1099 issued to employee or independent contractor
Stock Disposition Date	Capital gain equal to difference between sale price and fair market value at the date of exercise option	No tax impact	Gain or loss on sale of the stock is the difference between the sale price and the taxpayer's basis in the stock which equals the exercise price of the option plus any compensation recognized as a result of exercising the option	No tax impact

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**Table 7-5 (cont.)**

Applicable Option Date	Federal Nonqualified		Pennsylvania	
	Federal Treatment Employee	Federal Treatment Employer	Pennsylvania Personal Income Tax Treatment Employee	Pennsylvania Personal Income Tax Treatment Employer
<b>Option not publicly traded or does not have readily ascertainable fair market value on date of grant (Option fully transferable or not subject to risk of forfeiture)</b>				
Grant Date	No tax impact	No tax impact	No tax impact	No tax impact
Exercise Date	The fair market value of the stock less any amount paid for the stock will be taxed as compensation	Compensation (ordinary) deduction equal to income amount recognized by employee	The fair market value of the stock less any amount paid for the stock will be taxed as compensation	Compensation deduction equal to income subject to withholding or federal Form 1099 issued to employee or independent contractor
Stock Disposition Date	Capital gain equal to difference between sale price and fair market value at the date of exercise option	No tax impact	Gain or loss on the sale of the stock is the difference between the sale price and the taxpayer's basis in the stock which equals the exercise price of the option plus any compensation recognized as a result of exercising the option	No tax impact

**Table 7-6 Non-statutory Stock Option (Nonqualified Stock Option)  
Option is NOT Fully Transferable or Subject to Risk of Forfeiture**

Applicable Option Date	Federal (Nonqualified)		Pennsylvania	
	Federal Treatment Employee	Federal Treatment Employer	Pennsylvania Personal Income Tax Treatment Employee	Pennsylvania Personal Income Tax Treatment Employer
<b>Option has readily ascertainable fair market value on date of grant (Option NOT transferable or subject to risk of forfeiture)</b>				
Grant Date	The value of the option less any amount paid for the option will be taxed as compensation	Compensation (ordinary) deduction equal to income amount recognized by employee	No tax impact	No tax impact

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**Table 7-6 (cont.)**

Applicable Option Date	Federal (Nonqualified)		Pennsylvania	
	Federal Treatment Employee	Federal Treatment Employer	Pennsylvania Personal Income Tax Treatment Employee	Pennsylvania Personal Income Tax Treatment Employer
Exercise Date	No tax impact	No tax impact	No tax impact	No tax impact
Lapse Date			The value of the option less any amount paid for the option will be taxed as compensation.	Compensation deduction equal to income subject to withholding or federal Form 1099 issued to employee or independent contractor.
Stock Disposition Date	Capital gain equal to difference between sale price and fair market value at the date of exercise option	No tax impact	Gain or loss on the sale of the stock is the difference between the sale price and the taxpayer's basis in the stock which equals the exercise price of the option plus any compensation recognized as a result of exercising the option	No tax impact
<b>Option does not have readily ascertainable fair market value on date of grant (Option not transferable or subject to risk of forfeiture)</b>				
Grant Date	No tax impact	No tax impact	No tax impact	No tax impact
Exercise Date	The value of the option less any amount paid for the option will be taxed as compensation	Compensation (ordinary) deduction equal to income amount recognized by employee	No tax impact	No tax impact

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**Table 7–6 (cont.)**

Applicable Option Date	Federal (Nonqualified)		Pennsylvania	
	Federal Treatment Employee	Federal Treatment Employer	Pennsylvania Personal Income Tax Treatment Employee	Pennsylvania Personal Income Tax Treatment Employer
Lapse Date			The value of the option less any amount paid for the option will be taxed as compensation	Compensation deduction equal to income subject to withholding or federal Form 1099 issued to employee or independent contractor
Stock Disposition Date	Capital gain equal to difference between sale price and fair market value at the date of exercise option	No tax impact	Gain or loss on the sale of the stock is the difference between the sale price and the taxpayer's basis in the stock which equals the exercise price of the option plus any compensation recognized as a result of exercising the option	No tax impact

**V. PENNSYLVANIA TAXATION OF CAFETERIA PLANS**

**A. Overview – Federal/Pennsylvania Differences**

**1. Federal**

Cafeteria plans are federal plans pursuant to Internal Revenue Code Section 125 under which employers sponsor benefit packages that offer employees choices between cash and qualified benefits. If the employees choose cash, the cash amounts are included in taxable compensation. If the employees choose qualified benefits, the values of the benefits are not included in gross income. Qualifying benefits include:

- Accident coverage
- Health coverage
- Group-term life insurance coverage
- Dependent care programs

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- Certain employer payments for educational expenses
- On-site athletic facilities provided and operated by the employer
- A profit-sharing or stock bonus plan or rural cooperative plan as defined in IRC Section 401(k)(7) that includes a qualified cash or deferred arrangement as defined in IRC Section 401(k)(2).

### 2. **Pennsylvania**

If a taxpayer's employer maintains a federally qualified cafeteria plan pursuant to IRC Section 125, certain amounts deducted from taxpayer's salary (*e.g.*, health/accident insurance) are not subject to Pennsylvania personal income tax to the extent excluded for federal purposes.

Employer-provided flex dollars that an employee must use to pay for Pennsylvania-exempt benefits, such as health insurance or life insurance, are excludable from income taxation. Employee contributions to a qualified IRC Section 125 plan for coverage for hospitalization, sickness, disability or death, supplemental unemployment benefits, or strike benefits, like employer contributions, are exempt, but only to the extent they are exempt for federal income tax purposes. If an employer has an employee benefit plan that is not a qualified IRC Section 125 plan, employee contributions, even for the same kinds of coverage, are not excludable from Pennsylvania-taxable compensation.

Employee payments and contributions for other benefits, including dependent care and contributions to an IRC Section 401 plan, are not excludable from Pennsylvania-taxable compensation. If the employer's plan provides life insurance coverage that includes coverage for an employee's spouse and/or dependent child and the employee pays a portion of the premium for that coverage, that portion of the employee's payment is not excludable.

Article III of the Tax Reform Code was amended in 1997 to incorporate some features of federally qualified cafeteria plans. Under the Pennsylvania Income Tax Act:

"Compensation" shall not mean or include . . . payments made by employers or labor unions including payments made pursuant to a cafeteria plan qualifying under section 125 of the Internal Revenue Code of 1986 . . . for employee benefit programs covering hospitalization, sickness, disability or death, supplemental unemployment benefits or strike benefits provided that the program does not discriminate in favor of highly compensated individuals . . . 72 P.S. § 7301(d)(vi).

The department's proposed regulation interprets this statutory exclusion and provides that:

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- a. Payments made after Dec. 31, 1996, for employee welfare benefit plans under a cafeteria plan qualifying under section 125 of the IRC will be deemed to be an 'employer contribution' for Pennsylvania Income tax purposes if the following apply:
- They were not actually or constructively received after taking section 125 of the IRC into account,
  - They were specified in a written cafeteria plan document as being available to the participant:
    - For the purpose of selecting or purchasing benefits under a plan
    - As additional cash remuneration received in lieu of coverage under a plan
    - The benefits selected or purchased are nontaxable under the IRC when offered under a cafeteria plan
- b. If these conditions are satisfied, cafeteria plan contributions are taxed under the rules as applied to employer payments for employee welfare benefit plans . . . Refer to 61 Pa. Code §125.28(a)&(b).

### **B. Pennsylvania Taxable Benefits**

All benefits other than for death, disability, hospitalization, and sickness are taxable under Pennsylvania personal income tax.

### **C. Pennsylvania Nontaxable Benefits**

Hospitalization, sickness, disability, death, supplemental unemployment benefits, or strike benefits are nontaxable under Pennsylvania personal income tax provided that the program does not discriminate. Additionally, Pennsylvania does not tax the employee's use of employer property.

## **VI. PENNSYLVANIA TAXATION OF FRINGE BENEFITS**

### **A. Federal Income Tax – Overview**

While certain benefits can be offered by employers to employees on an income-tax-free basis under Internal Revenue Code Section 125 Cafeteria Plans, the following non-cash benefits qualify for a federal exclusion from an employee's gross income but are specifically excluded from IRC Section 125 plans:

1. No additional cost services (*i.e.* free stand-by flights for airline employees)
2. Qualified employee discounts (*i.e.* reduced prices on goods and services)

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3. Working condition fringe benefits (*i.e.* use of a company car for business purposes)
4. *De minimis* fringe benefits (*i.e.* personal use of a company copy machine)
5. Qualified transportation fringe benefits (*i.e.* commuter highway vehicle, transit passes, and qualified parking)
6. Qualified moving expense reimbursements
7. On-site athletic facilities provided by and operated by the employer
8. Medical Savings Accounts
9. Scholarships and fellowship grants for teaching, research, or other services performed as a condition for receiving the grants
10. Educational assistance provided for graduate teaching and research assistants and excludable fringe benefits (*i.e.*, *de minimis* fringe benefits, no additional cost services, employee discounts, and working condition fringe benefits)
11. Cash and contributions by employers to provide coverage for long-term care services through a flexible spending or similar arrangement.

### **B. Pennsylvania Nontaxable – Overview**

The right to receive cash in lieu of the benefit is always taxable as Pennsylvania compensation. Under Pennsylvania personal income tax law, the following fringe benefits are not taxable:

1. Employer use of property including, but not limited to:
  - a. Employer dependent-care facilities
  - b. Employer office equipment
  - c. Employer-provided aircraft
  - d. Employer-provided vehicles
  - e. Employer recreational facilities
  - f. Employer-provided professional services such as accountants and personal financial planners
  - g. Qualified employee discounts

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- h. Any other *de minimis* fringe benefit defined under IRC Section 132

### C. Tuition Benefits/Educational Assistance Payments – Pennsylvania Rules

#### 1. Direct

If employees (or their dependents) of an institution of education receive free or low-cost education at that institution or at a college or university with which the employer has a reciprocal agreement, then the value of the education is not taxable.

#### 2. Reimbursement

If the employer reimburses an employee for education costs then the reimbursement is fully taxable as compensation and the employee may deduct only those directly related business expenses allowed on *PA-40 Schedule UE, Allowable Employee Business Expenses*. Refer to [Unreimbursed Employee Expenses](#) for discussion of eligible business expenses.

## VII. EMPLOYEE EXPENSES FOR PENNSYLVANIA

### A. Historical Background

The Pennsylvania Tax Reform Code of 1971 does not explicitly address how business expenses are treated. However, the Pennsylvania Supreme Court has interpreted an exclusion for “payments to reimburse actual expenses” to mean that all legitimate business expenses are excludable from compensation. *Commonwealth v. Staley*, 476 Pa. 171, 381 A.2d 1280 (1978). Further, the Court has held that amounts reimbursed by an employer for ordinary, actual, reasonable, and necessary business expenses are excluded from compensation. *Ritz v. Commonwealth*, 495 Pa. 1, 432 A.2d 169 (1981).

If parties to an employment contract recognize that the employee will pay for some business expenses out of his or her own pocket, these amounts may be excluded from income. *Id.* However, personal expenses, including daily living expenses of an employee, may not be excluded from compensation. *Williamson v. Commonwealth*, 525 A.2d 475 (Pa. Cmwlth. 1987).

### B. Overview Federal/Pennsylvania Differences

Under federal law, employee expenses are accounted for on federal Form 2106. Under Pennsylvania personal income tax law, employee expenses are accounted for on *PA-40 Schedule UE, Allowable Employee Business Expense*.

### C. Accountable Plan

Pennsylvania follows federal rules regarding accountable plans. Accordingly, if a plan is properly maintained under federal rules, reimbursed amounts are not included in Pennsylvania wages.

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### **D. Unreimbursed Employee Expenses – PA-40 Schedule UE, Allowable Employee Business Expenses**

Pennsylvania personal income tax law allows a deduction of "allowable employee business expenses" for which the taxpayer was not reimbursed. In order to be claimed as an expense, the item must be ordinary, necessary, reasonable, actually incurred in performing the duties of the job, and directly related to present employment.

The *PA-40 Schedule UE, Allowable Employee Business Expenses* covers these expenses:

1. Travel and mileage
2. Union dues/agency fees (or collective bargaining expenses, both of which are deductible over the life of the contract)/initiation fees
3. Work clothes not suitable for street wear required to be purchased. This includes cleaning, altering, and repairs
4. Small tools and supplies
5. Professional license fees, malpractice insurance, and fidelity bond premiums where required by law or employer
4. Moving expenses – provided the transfer is from one permanent duty station to another and provided that the net distance difference between the residence and the old duty station and the original residence and the new duty station is 35 miles or more. Expenses are limited to those incurred in moving family, self, and household goods from point of departure to point of arrival. Expenses associated with job-hunting trips are not deductible. Personal living expenses and other personal expenses are not deductible even if reimbursed for those expenses.
  - a. *Allowable Expenses* - Expenses a taxpayer pays or incurs in moving himself, his immediate family, his household goods, and his personal effects are an allowable offset against the taxpayer's taxable compensation if the move is made for the benefit of the employer. Allowable moving expenses include the cost of transportation to one's new home. One may use actual out-of-pocket costs or the federal mileage allowance. The expenses for the storage of household goods, for meals and lodging on the way, including such costs on the day you arrive, and parking fees and tolls are also allowable.
  - b. *Nondeductible Expenses* - Pennsylvania personal income tax law does not allow expenses to sell or purchase a home and costs to break a lease. One may not deduct pre-move house hunting expenses, temporary lodging prior to moving, and any costs or expenses not directly related to actually moving. Other nondeductible expenses include title insurance premiums, notary fees, mortgage service



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- c. Blind employees' costs incurred to pay readers
- d. Business gifts
- e. Fees on federal Form W-2 which must be paid back to employer (e.g. Jury duty where employer continues full wages and requires repayment of monies received for jury duty)
- f. Reimbursements not received on federal Form W-2 must be deducted from expenses claimed on *PA-40 Schedule UE, Allowable Employee Business Expenses*.
- g. Depreciation expense
- h. *Per diem* expenses if the taxpayer reports the *per diem* income

The *PA-40 Schedule UE, Allowable Employee Business Expenses* does not cover these expenses:

1. Deductions not allowable as business expenses;
2. Personal, living, or family expenses;
3. Capital expenditures normally are not an allowable business expense except through depreciation. Certain depreciation expense exclusions may be taken. Federal depreciation or cost-recovery deductions are acceptable for Pennsylvania purposes as an administrative convenience to compute allowable business expense deductions;
4. Dues to professional or fraternal societies, Chambers of Commerce, or recreational club memberships;
5. Subscriptions to publications;
6. Campaign or political contributions;
7. Charitable contributions;
8. Commuting expenses;
9. Cost of meals while working late except while traveling away from home overnight;
10. Occupational privilege taxes;
11. Child care and elderly care expenses;

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12. Life, disability income, and health service insurance premiums;
13. Malpractice insurance premiums except where required by law or employer;
14. Pension contributions;
15. Fines, penalties, legal fees (except to recover back wages), and bad debts;
16. Bribes, kickbacks, or other illegal payments;
17. Eligible job-hunting expenses and pre-employment expenses or initial agent's fees;
18. Residential phone service (however, specific charges for telephone calls required to be made for business purposes may be deducted); and
19. Taxpayer's with multiple federal Form W-2, where expenses are greater than the wages from one employer, are not allowed deductions against other compensation from other employers.

### **E. PA-40 Schedule UE, Allowable Employee Business Expenses, Preparation Including the Pennsylvania TeleFile Schedule UE**

A separate PA-40 Schedules UE must be completed for each taxpayer and for each employer and occupation. This means that a separate *PA-40 Schedule UE, Allowable Employee Business Expenses* must be filed for each federal Form W-2 received by the taxpayer. Additionally, the department has the right to request a detailed breakdown of expenses for each employer or occupation. The total amount of unreimbursed expenses must be entered.

An employee cannot deduct expenses if he or she was reimbursed by the employer for the exact amount of the expenses, including a fixed mileage allowance or per diem living expense that the employer did not include in the PA Taxable Compensation in block 16 of the federal Form W-2. However, if the employer did include reimbursements for the employee's expenses in PA Taxable Compensation on the federal Form W-2, the employee may complete the PA-40 Schedule UE to deduct his or her allowable PA business expenses.

If filing by *TeleFile*, use the *UE-TeleFile*. The only expenses allowed using *TeleFile* are union dues/agency fees/initiation fees, work clothes, and small tools/supplies.

**Note:** *TeleFile* will not be available for personal income tax filing for 2013 and beyond; to facilitate the transition to *PA Free File, padirectfile* will be available to file tax year 2013 income tax returns, but the system will be retired following the 2014 income tax filing season.

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Pennsylvania will not consider the stated value or fair market value of an employee's personal use of an employer's owned or leased property or the use of an employer's services at no cost or at reduced cost as Pennsylvania-taxable compensation. The type of property or service and its value or fair market value is not a consideration when determining whether it should or should not be taxable. The employee's personal use is 100 percent excludable.

When an employer rewards an employee in recognition for performance, the cash or value of the award, unless *de minimis* under federal rules, is taxable Pennsylvania compensation. However, an award out of detached generosity or in recognition for civic or humanitarian services is not taxable Pennsylvania compensation.

When an employer reimburses its employees for personal and non-business expenses, the entire reimbursement is taxable Pennsylvania compensation. The employees may take any Pennsylvania-allowable unreimbursed employee business expenses on *PA-40 Schedule UE, Allowable Employee Business Expenses*.

### **F. Allowance for Clothing**

The department has determined that an advance or allowance for clothing is subject to tax unless it represents a reimbursement. The employee must report all reimbursements and allowances as compensation unless:

1. The expenses for which the employee is reimbursed are allowable business expenses; and
2. The employee is required to and does account for the expenses to his employer; and
3. The employee is reimbursed by his employer in the exact amount of the allowable business expenses; and
4. The employee does not report the expenses on *PA-40 Schedule UE, Allowable Employee Business Expenses*.

The costs of purchasing and maintaining uniforms and work clothing to protect you from bodily injury are allowable business expenses under Pennsylvania personal income tax law if the uniforms and clothing are both:

1. Of a type required by the employer to be purchased as a condition of continued employment; and
2. Not adaptable to general usage.

An allowance is considered taxable Pennsylvania income if the employee receiving the allowance can use it at his discretion. An allowance for work clothing is included in Pennsylvania compensation, and, thus, taxed as income. However, a reimbursement paid to the employee for amounts he expended for a particular purpose is not income.

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Reimbursements for the purchase of work clothing are not income and costs in excess of the reimbursement are deductible to the employee.

Compensation does not include benefits payable by an employer or labor union under a supplemental unemployment benefit plan, whether payable on a periodic basis or in the form of cash, services, or property. Refer to 61 Pa. Code §101.6(c)(14).

### G. Examples

**Example 1.** The employer provides leased company cars, each with a value of \$200 per month, to its employees. An employee's use of the car is 75 percent business and 25 percent personal. The personal use of the car (\$50 per month) is not taxable Pennsylvania compensation to the employee.

**Example 2.** The employer provides dependent care for its employees in a facility it leases and pays all the costs. The value of the dependent care is not taxable Pennsylvania compensation to the employees.

**Example 3.** The employer allows its employees to use the company's plane to go to its recreational property. The value of the use of the plane and the recreational facilities is not taxable Pennsylvania compensation to the employees.

**Example 4.** An employee leases her own vehicle for \$200 per month. The employer reimburses the employee for the full value of the lease (\$2,400). The employee's use of the car is 75 percent business and 25 percent personal. The \$2,400 is taxable compensation on the employee's W-2 form. The employee may deduct \$1,800 on PA-40 Schedule UE. Her personal use of the car (\$600) is not deductible.

**Example 5.** The employer reimburses its employees \$50 per month for the dependent care costs they incur. The employer must include \$600 in the employees' W-2 forms as taxable Pennsylvania compensation.

**Example 6.** The employer rewards the 'employee of the year' with a paid vacation. The value of the vacation is taxable Pennsylvania compensation to the employee.

**Example 7.** The employee can elect compensation or to receive reimbursement. The amount is taxable for the employee for Pennsylvania personal income tax.

## VIII. DAMAGE AWARDS

### A. Overview – Federal/Pennsylvania Differences

Federal courts have held that there are no provisions in either Title VII of the Civil Rights Act of 1964 or the ADEA that provide compensatory damages for pain and suffering or for emotional distress. Refer to Supreme Court Decision in *United States v. Burke*, 112 S.Ct. 1867, 119 L.Ed.2d 34 (1992); *Commissioner v. Schlieier*, 515 U.S. 323 (1995). For federal income tax purposes, one could not exclude the settlement

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proceeds unless he could demonstrate that the award represents “damages received on account of personal injury or sickness.” 26 U.S.C. §104(a)(2)

For Pennsylvania personal income tax purposes, damages for personal injury or sickness are excludable from Pennsylvania compensation. This includes emotional distress as well as physical injury.

If a claim was brought under either Title VII of the Civil Rights Act of 1964 or the ADEA, the amounts received are meant to restore the worker to the wage and employment position that the worker would have occupied prior to the unlawful discrimination. Consequently, the sums received from former employers are considered a form of back wages and are taxable as compensation under Pennsylvania’s Tax Reform Code.

As mentioned above, damage awards received for personal injury or sickness are not taxable for Pennsylvania personal income tax. This includes federal taxable punitive damages. Damage award for lost profits or lost capital are taxable for Pennsylvania personal income tax.

### **B. Summary of Pennsylvania Personal Income Tax Treatment of Specific Damage Awards**

#### **1. Personal Injury Damage Awards Received Including Punitive Damage Awards**

Personal injury damage awards, including punitive damages, are not taxable under Pennsylvania personal income tax law.

#### **2. Age Discrimination Under ADEA Damage Awards**

Damage Awards received for age discrimination under ADEA are taxable as compensation.

#### **3. Sex Discrimination and Title VII of the Civil Rights Act**

Damage Awards received for sex discrimination under Title VII of the Civil Rights Act are taxable as compensation.

### **C. Damage Awards for Lost Profits for Pennsylvania Personal Income Tax**

Damage awards for lost profits are taxable under Pennsylvania personal income tax law.

### **D. Damage Awards for Return of Capital for Pennsylvania Personal Income Tax**

Damage awards for return of capital are taxable under Pennsylvania personal income tax law.

### **E. Pennsylvania Treatment of Legal Expenses**

For Pennsylvania personal income tax purposes, legal fees directly associated with the receipt of a damage award or settlement award are offset against the damage award received. The offset occurs only within the class of income.

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### IX. GUARANTEED PAYMENTS TO A RETIRED PARTNER

#### A. **Guaranteed Payments to a Retired Partner – Taxable Compensation**

Guaranteed payments to a retired partner are taxable as compensation on the same basis as deferred compensation is taxed to former employees of a partnership if:

1. Such partner rendered no services with respect to any trade or business carried on by such partnership or its successors during the taxable year of such partnership or its successors, ending within or with his taxable year, in which such amounts were received.
2. No obligations, whether certain in amount or contingent on a subsequent event, exist during the taxable year of such partnership or its successors, ending within or with his taxable year, in which such amounts were received except with respect to retirement payments under such plan.
3. Such partner's share of the capital of the partnership has been paid to him in full before the taxable year of such partnership or its successors, ending within or with his taxable year, in which such amounts were received.

#### B. **Guaranteed payments to a Retired Partner – Non-taxable Retirement Benefits**

However, amounts received by a retiring partner pursuant to a written plan of the partnership that provides for guaranteed payments on account of retirement to partners generally or to a class or classes of partners, such payments to continue at least until such partner's death, are excludible retirement benefits if:

1. The above requirements are met; and
2. The plan otherwise constitutes a qualifying retirement benefit plan.

#### C. **Other Payments Received in Liquidation of the Interest of a Retiring Partner**

Other payments received in liquidation of the interest of a retiring partner shall be considered as:

1. A distributive share of partnership income if the amount thereof is determined with regard to the income of the partnership;
2. A guaranteed payment; or
3. A distribution made in exchange for the interest of such partner in partnership property, including, unless the partnership agreement provides otherwise, unrealized receivables of the partnership and goodwill of the partnership.

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### **D. Federal Limitations on the Taxation of Retirement Income of Nonresident Partners**

Recent federal statutory changes prohibit states from taxing some retirement income of nonresidents. *Public Law 109-264*, signed Aug. 3, 2006, amends *Section 114 of Title 4 of the U. S. Code*. The new law provides that retirement payments made under a nonqualified plan maintained by a partnership and meeting specific criteria are taxable only by a state where the retired partner is a resident or where the retired partner is domiciled at the time the payments are received. To qualify for this tax treatment, the retirement payments must meet all of the following criteria:

1. The payments must be provided for in a written plan, program, or arrangement that was in effect before the partner's retirement;
2. The payments must be in recognition of prior service performed by the partner for the partnership; and
3. The payments must be made over the life or life expectancy of the recipient or over a period of at least 10 years, must be paid at least annually, and must be paid in substantially equal periodic payments.

### **X. PARTNERS AND SELF-EMPLOYED RETIREMENT PLANS – SIMPLIFIED EMPLOYEE PENSION (SEP), KEOGH PLANS**

#### **A. Overview**

Pennsylvania tax law concerning simplified employee plans differs from federal law. For Pennsylvania income tax purposes, employer contributions to a SEP are excludable from the compensation of an employee. However, a self-employed taxpayer cannot deduct payments to his own IRA or Keogh plan.

#### **B. Employer Contributions**

Contributions by a self-employed individual or entity which employs one or more persons for compensation to employee welfare benefit programs on behalf of such employees generally are excludable from the employee's income and are deductible as business expenses to the extent the contributions constitute reasonable compensation for services. Pennsylvania tax law makes no distinction between stockholder-employees or officers of closely held corporations and other employees.

#### **C. Employee Contributions**

When either an employee or self-employed individual invests money in a deferred payment plan, and such individual did so as a result of his unilateral choice, the courts have held that the amounts placed into the plan or forgone as cash-in-hand were either compensation or net profits reportable in the year of deferral or contribution. *Bernknopf v. Commonwealth*, 425 A.2d 880 (Pa. Cmwlth. 1981); *Amp Products Corp. V. Commonwealth*, 593 A.2d 1 (Pa. Cmwlth. 1991) *aff'd. Per curiam*, 530 Pa. 249, 608 A.2d 25 (1992); *Smith v. Commonwealth*, 684 A.2d 647 (Pa. Cmwlth. 1996), *aff'd. Per curiam*, 549 Pa. 578, 701 A.2d 1360 (1997).

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### D. Case Law

In *Kalodner v. Commonwealth of PA*, 150 Pa Commw 248 , 615 a2d A.2d 900 (1992), the commonwealth believed that contributions to a Keogh plan or an IRA by a self-employed individual for his or her own benefit are not ordinary expenses incurred in the conduct of a business and, thus, could not be excluded from net profits. The court stated:

Self-employed persons who contribute to their own retirement plan are investing income they have actually received for their retirement. Refer to *Bernknopf v. Department of Revenue*, 57 Pa. Commonwealth Ct. 57 (1981). On the other hand, in situations where an employee's retirement plan is entirely funded by his or her employer and the contributions are not made by reducing the employee's salary, the employee may not actually or constructively receive income since the receipt of benefits under such a retirement plan could be subject to substantial limitations and restrictions. Refer to 61 Pa. Code § 101.7. Hence, we conclude that the tax code does not offend the federal constitution or the Pennsylvania constitution because there is a rational basis supporting the distinction in the tax code between self-employed persons who make their own contributions to retirement plans and employers who contribute to a retirement plan for their own employees.

## XI. GROSS NON-EMPLOYEE COMPENSATION

Taxable gross compensation is not limited to employee compensation. It also includes:

### A. Honorarium

Honoraria are taxable for Pennsylvania personal income tax purposes.

### B. Executor or Administrator Fees

Executor fees are taxable as compensation. This includes executor's fees paid to nonresident executors and administrators for estates in Pennsylvania. It is presumed that these fees are received for services performed in Pennsylvania by the executor and/or his or her agent (such as an attorney) and the burden of proof falls upon the taxpayer to prove otherwise. Any apportionment must be reported on *PA-40 Schedule NRH, Apportioning Income by Nonresident Individuals*.

An executor or executrix for an estate in Pennsylvania would be required to visit Pennsylvania to complete his or her duties. The fact that the executor or executrix may use an agent to do the duties does not take away the fact that they had a presence in Pennsylvania and are subject to tax on that income. The only apportionment to be done is to exclude that portion of the executor fee that represents the services performed outside of Pennsylvania for the convenience of the estate and by necessity out of Pennsylvania. An example would be an appearance in court outside of Pennsylvania involving the estate. The remainder of the fee would be taxable as compensation for Pennsylvania purposes by non-resident executors. Apportionment can only be done by the number of days required out of Pennsylvania over total days spent working on the

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estate, including the time of the agent. The executor or executrix may be able to get some credit on another state's return for the income taxed by both states.

**C. Witness Fees**

Witness fees are taxable compensation for Pennsylvania personal income tax.

**D. Jury Fees**

Jury fees are taxable compensation for Pennsylvania personal income tax.

**E. Director Fees**

Director fees are taxable compensation for Pennsylvania personal income tax. The taxpayer is entitled to claim unreimbursed employee business expenses that are directly related to that compensation on *PA-40 Schedule UE, Allowable Employee Business Expenses*.

**F. Foster Care**

For taxable years beginning on or after Jan. 1, 1995, remuneration received by a foster care provider for in-home care of foster children received from an agency of the commonwealth or political subdivision or an organization exempt from federal income tax under IRC Section 501(c)(3) are not compensation subject to Pennsylvania personal income tax, unless the taxpayer is in the business of providing foster care.

**G. Miscellaneous Compensation**

Miscellaneous Compensation includes nonemployee compensation from sources other than a federal Form W-2. Enter the payer's EIN and name, Pennsylvania-taxable compensation, Pennsylvania tax withheld, federal taxable income and one of the following codes to identify the type of income:

- Executor fee
- Jury duty pay
- Director fee
- Expert witness fee
- Honorarium
- Covenant not-to-compete
- Damages or settlement for lost wages other than personal injury
- Other nonemployee compensation; describe it on this line
- Early distribution from retirement or pension plan

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- Television Game Show or “Reality” Show winnings

### **H. Federal Form 1099–MISC Income**

Fees, commissions, rewards, golden parachute payments, damage awards, termination payments, fringe benefits or other items of non-employee compensation reported on *federal Form 1099–MISC* are taxable as compensation.

### **I. Pennsylvania Personal Income Tax Treatment of Household Employees**

A household employee, who can include babysitters, caretakers, nannies, health aides, private nurses, housekeepers, cleaning people, drivers, and yard workers, is a person hired to do any sort of household work as long as the employer retains the right to control the details of how the work is done. This differs from house workers obtained through an agency or self-employed workers who retain control of how the work is done. Generally, a self-employed worker provides his or her own tools and offers services to the public as an independent business. These individuals must file and report their income through the appropriate business schedule.

Since household employees are not subject to federal income tax withholding (although they may be subject to Social Security withholding), they are not subject to Pennsylvania income tax withholding.

## **XII. NONRESIDENT – ALLOCATION OF PENNSYLVANIA COMPENSATION**

### **A. Compensation From Sources Within Pennsylvania**

If services are performed within Pennsylvania, the compensation for the services constitutes income from Pennsylvania sources, regardless of the following:

1. Whether the services were performed as an employee
2. Whether the compensation is received in a taxable year after the year in which the services were performed
3. Whether the compensation is received by someone other than the person who performed the services

Some items of compensation may be based upon services relating to a single transaction or piece of work while other items may be based upon multiple transactions or piecework. Some may be based upon services of a continuing nature or services that are frequently recurring; and some constitutes prepaid income. Accordingly, different rules for allocating income to Pennsylvania sources may apply. They are explained below.

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### **B. Commissions**

#### **1. On Sales Of Real Estate**

A commission payable on a sale of real estate must be allocated to Pennsylvania if it is either the place where the real estate is situated or the place where the greater proportion of the income-producing activity is performed, based upon costs of performance and hours of work.

#### **2. On Sales Of Tangible Personal Property**

A commission payable on a sale of tangible personal property must be allocated to Pennsylvania if it is either the place where the property is delivered to the purchaser, regardless of the f.o.b. point or other conditions of the sale, or the place where the greater proportion of the income producing activity is performed, based upon costs of performance and hours of work.

#### **3. On Sales Of Intangible Personal Property**

A commission payable on a sale of intangible personal property must be allocated to Pennsylvania if it is the place where the greater proportion of the income producing activity is performed, based upon costs of performance and hours of work.

### **C. Compensation Based Upon Years Of Continued Service**

If the amount of payment is based upon years of service or the total compensation received by the payee during his years of service, the payment shall be apportioned on the basis of the aggregated total number of working days worked within Pennsylvania during such years. This rule applies where, for example, a plan participant is to receive a severance benefit of 2 percent of his final year's compensation times the years of service performed or a plan participant is to receive a benefit of 2 percent of the total compensation received during the payee's years of service.

### **D. Casual Employments; Compensation Paid On A Daily Basis**

Compensation that is based upon services relating to a single transaction or piece of work must be allocated to Pennsylvania if it is the place where the greatest proportion of the income producing activity is performed, based upon costs of performance and hours of work. The same rule applies to compensation paid—or ordinarily paid—on a daily basis.

### **E. Compensation Paid On A Weekly, Biweekly, Semimonthly, Monthly, Quarterly, Semiannual Or Annual Basis**

Compensation that is earned and paid—or is ordinarily earned and paid—on a weekly, biweekly, semimonthly, monthly, quarterly, semiannual or annual basis shall be allocated to Pennsylvania in the proportion that the total number of working days employed within Pennsylvania during the weekly, biweekly, semimonthly, monthly, quarterly, semiannual or annual period bears to the total number of working days during the period.

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### **F. Miscellaneous Compensation**

Miscellaneous compensation is compensation other than prepaid compensation, commissions, compensation based upon years of continued service, compensation from casual employments or compensation paid on a daily, weekly, biweekly, semimonthly, monthly, quarterly, semiannual or annual basis. If its payment accrual period is determinable, each payment of miscellaneous compensation shall be allocated to Pennsylvania in the proportion that the total number of working days employed within Pennsylvania during the payment's payment accrual period bears to the total number of working days during the payment's payment accrual period.

If its payment accrual period is not determinable, each payment of miscellaneous compensation shall be allocated to Pennsylvania in the proportion that the total number of working days employed within Pennsylvania during the last period of continuous employment preceding the payment bears to the total number of working days during such period.

### **G. Prepaid Compensation**

Even when conditioned, directly or indirectly, on the future performance (or refraining from performance) of substantial services, payments for services not yet rendered are taxable to cash method taxpayers unless the possibility of forfeiture is substantial or they are repaid within the refundable period. Amounts paid exclusively to provide reasonable compensation for future services such as a covenant not to compete, however, cannot be allocated on a working days basis unless and until all services fixing the right to retain the payment have occurred. Accordingly, if the evidence shows that substantially all of the future services would have been performed in PA, then the prepayments are allocable to Pennsylvania. Otherwise, such amounts may be allocated only to the employee, director or officer place of residence at the time of payment.

Amounts that substantially exceed the reasonable value of future services or payments that are intended to provide a "stay bonus" or similar incentive, however, must be treated as compensation for prior and current services. Moreover, if there is no way to determine the portion of a payment attributable to prior or current services and the portion attributable to future services, the entire amount is allocable to prior and current services.

### **H. Working Day Explained**

A working day is any calendar day upon which compensable work is done, regardless of how short the time. In determining the number of working days:

1. No account whatsoever may be taken of nonworking days, including Saturdays, Sundays, holidays, days of absence because of illness or personal injury, vacation days, days of leave with pay, days of leave without pay, days where a person is on call if needed or days when work could not reasonably be expected to proceed because of strikes, weather conditions or other cause.
2. The presence within a state or foreign country shall be disregarded if it is solely

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for the purpose of boarding a plane, ship, train or bus for travel to a destination outside such state or country or while traveling by motor, plane, or train through a state or foreign country to a destination outside such state or country.

3. Time spent in commuting or in traveling between work sites shall be disregarded.

### **I. Working Days Employed Within Pennsylvania Explained**

Where a worker is provided with a suitable office or other workplace within Pennsylvania or is maintaining an office-in-home or other workplace within Pennsylvania, a working day is employed within Pennsylvania if either:

1. Some of the compensable work done during the calendar day is done in Pennsylvania; or
2. All of the work done outside Pennsylvania was done there only for the worker's convenience or was not performed there of necessity in the service of the employer.

Conversely, where a worker is provided with a suitable office or workplace outside PA or is maintaining an office-in-home or other workplace outside Pennsylvania, a working day is employed within Pennsylvania only if some of the compensable work done during the calendar day is done in Pennsylvania for the convenience, and of necessity in the service, of the employer.

Time spent in performing the following services shall be disregarded in determining working days employed in Pennsylvania:

1. Services performed by a nonresident individual who performs regularly assigned duties on a railroad in more than one state as an employee of an interstate rail carrier providing transportation.
2. Services performed by a nonresident individual who performs regularly assigned duties with respect to a motor vehicle in more than one state as an employee of an interstate motor carrier or private carrier.
3. Services performed by a nonresident individual who performs regularly assigned duties on an aircraft in more than one state as the employee of an interstate air carrier, unless one-half or more of the employee's time in the employ of the employer in the calendar year is spent in performing services in this commonwealth.

### **J. The Convenience-Of-The-Employer Doctrine**

Pennsylvania, like many other states, follows the "*convenience-of-the-employer*" doctrine. It provides that compensation for services performed by nonresidents cannot be allocated to the services' actual places of performance if they were performed there

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only for the employee's convenience or if they were not performed there "of necessity in the service of the employer". In these instances, the compensation must be allocated only to the state (or among the states) where the employee is of necessity performing actual services in the service, and for the convenience, of the employer.

The only factors considered under this doctrine are:

1. Whether the services performed by an individual outside the taxing jurisdiction were performed in the service, and for the benefit, of the individual's employer and
2. Whether such services were such that they could have been performed at an office of the employer within the taxing jurisdiction (or could have been performed at an office of the employer within the taxing jurisdiction had the employer made suitable accommodations available to the employee)

Consequently, under the "*convenience-of-the-employer*" doctrine, allocation depends upon whether the services in question are of a character required to be performed away from an office of the employer and outside the taxing jurisdiction or require highly specialized facilities not available at or near an office of the employer.

### **K. Payment Accrual Period Explained**

A payment accrual period ends when all services fixing the right to receive, or the duty to pay, the payment have occurred. The period begins when any of the activities that is required to establish that right or duty is begun.

In determining payment accrual periods:

1. The inability to ascertain the amount of payment with reasonable accuracy or doubts as to ability to collect shall be disregarded and
2. It is immaterial whether an immediate right to receive, or duty to pay, has arisen, whether the payment may later be repaid or whether the right to receive payment is subject to forfeiture. It is also immaterial whether the right is enforceable at law or in equity or is unenforceable or the duty is a legal or moral duty

### **L. Retirement Income**

A nonresident's "retirement income" as defined at 4 U.S.C. §114 is not allocable to Pennsylvania if it is part of a series of substantially equal periodic payments made not less frequently than annually for the life or life expectancy of the recipient (or the joint lives or joint life expectancies of the recipient and the designated beneficiary of the recipient), or a period of not less than 10 years.

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### XIII. DISCHARGE OF INDEBTEDNESS.

#### A. **Discharge of Indebtedness Income for Pennsylvania Personal Income Tax**

Refer to the *PENNSYLVANIA PERSONAL INCOME TAX GUIDE, Chapter 24 CANCELLATION OF DEBT*.

##### 1. **Insolvent Individuals**

Insolvent individuals not filing for bankruptcy recognize cancellation of debt as income. The reportable amount is the lesser of:

- a. The amount of indebtedness forgiven or discharged; or
- b. The excess over the taxpayer's net worth as computed using generally accepted accounting principles (GAAP) immediately after the cancellation.

If an insolvent individual is not rendered solvent by the cancellation of debt, no income is recognized.

##### 2. **Solvent Individuals**

Solvent individuals would report the amount of indebtedness forgiven or discharged as income.

##### 3. **Individuals filing for Bankruptcy**

Unless the case is dismissed, an individual bankruptcy filed under Chapter 7, 11, or 12 of the Bankruptcy Act leads to the creation of a bankruptcy estate and no income shall be considered to have been realized by reason of discharge of indebtedness under bankruptcy laws.

#### B. **When Is It Taxable**

Income from cancellation of debt is taxable in Pennsylvania in only two circumstances:

1. Under GAAP, the debt forgiven was considered a liability
2. Where the debt forgiven constitutes a *quid pro quo* or incentive that would be taxable under Pennsylvania personal income tax law if it had been paid to the debtor in cash or in property

#### C. **Class of income**

If the debt forgiveness relates to rent, royalty, patent, or copyright income, it is reported in that class.

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### XIV. ANNUITIES

#### A. Employer Annuity Plan

##### 1. Features

An employer-sponsored plan that provides benefits to employees or their beneficiaries without a trust under annuity or endowment contracts which are held by the employer until such time as the employee separates from service by retirement constitute an employer's annuity plan. Under such plans, contributions are paid toward the purchase of the contracts for the exclusive benefit of the employees or their beneficiaries, and there is a definite written arrangement between the employer and insurer that refunds of premiums, if any, will be applied within the taxable year of the employer in which received or within the next succeeding taxable year toward the purchase of annuities or endowments under the plan.

##### 2. Premium Payments

The following rules apply to premium payments for employees' annuity or endowment plans:

- (a) Amounts voluntarily paid by an employee for an insurance contract forming part of a deferred compensation plan for the exclusive benefit of plan participants and their beneficiaries are not deductible. They constitute the employee's cost of investment in the plan contract.
- (b) Amounts lawfully deducted and withheld from the compensation of an employee and paid for an insurance contract forming part of a deferred compensation plan for the exclusive benefit of plan participants and their beneficiaries are received by the employee as compensation at the time the deduction is made and are treated as amounts voluntarily contributed by the employee.
- (c) Premium payments made under a contributory plan by an employer on behalf of an employee at the election of the employee pursuant to a cash or deferred arrangement or salary reduction agreement are received by the employee as compensation at the time the contribution is made and are treated as amounts voluntarily contributed by the employee.
- (d) Employer premium payments for an insurance contract under a plan are excludible from tax if the plan participant's rights are nontransferable and subject to a substantial risk of forfeiture or penalty.

##### 3. Distributions

- (a) Distributions are excludible from tax if they constitute a qualified annuity. "Qualified annuity" is defined at 61 PA Code § 101.1 to be an

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arrangement under which the payee is entitled to equal, or substantially equal periodic payments, paid at least annually, for any of the following periods:

- The life of the participant, or, if applicable, the joint lives of the recipient and recipient's designated beneficiary,
  - The life expectancy of the participant, or, if applicable, the joint life expectancies of the recipient and recipient's designated beneficiary, or
  - A period of at least 10 years.
- (b) Withdrawals of employee contributions.  
Actual or constructive pre-retirement withdrawals of one's own contributions and accumulated plan earnings are taxable only to the extent allocable to the earnings. The extent to which such withdrawals are taxable as compensation shall be determined using the cost recovery method of accounting.
- (c) Pre-retirement withdrawals of employer contributions.  
Actual or constructive pre-retirement employee withdrawals upon severance of employment without retiring of employer premiums or earnings constitute taxable severance pay.

### **4. Terminated plan annuities**

Annuity contracts that are purchased by an employer upon the termination of a deferred compensation plan are taxed the same as employees' annuity or endowment plans.

#### **B. Nonqualified annuities.**

An annuity that a service provider buys on his own, rather than through a qualified employer sponsored plan or individual retirement arrangement, is a non-qualified annuity. Amounts received under nonqualified annuities are not taxable as compensation. They constitute taxable interest to the extent they are includible in gross income for Federal tax purposes.

#### **C. Non-Employee Benefit Annuities**

If you invested in a retirement annuity that is not part of an employer-sponsored program or a commonly recognized retirement program, you have Pennsylvania-taxable income when you begin receiving annuity payments. You must report the difference between the amount you receive and your previously taxed investment as taxable gain on a *PA-40 Schedule D, Sale, Exchange, or Disposition of Property*. If you receive periodic payments, you use the cost-recovery method to report the taxable gain.

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For taxable years beginning after Dec. 31, 2004, income from annuity contracts purchased as retirement annuities that are not from an employer sponsored retirement annuity, or are not part of an employer sponsored program, are now taxable as interest income. Any income from these types of plans that is taxable for federal income tax purposes is now taxable for Pennsylvania personal income tax purposes as interest income as a result of Act 40 of Jul. 7, 2005. Act 40 also provided that that amounts paid under contract of life insurance or endowment, which may be included in gross income for federal income tax purposes, are also subject to Pennsylvania personal income tax as interest income. Previously, the income received from an annuity that you purchased, including a retirement annuity that is not part of an employer-sponsored retirement program was reported as gain on the sale, exchange, or disposition of property. The old rules for annuities are explained in *Pennsylvania Personal Income Tax Guide, Chapter 8 Interest and Chapter 12, Net Gains (Losses) From the Sale, Exchange or Disposition of Property*.

### **D. Life Insurance Annuity Contracts**

Act 2005–40 provides the taxability of an exchange of life insurance annuity contracts will follow the requirements of Section 1035 of the Internal Revenue Code. Therefore, do not report the gain (loss) on the sale, exchange or disposition of any insurance contracts that include:

1. An exchange of a life insurance contract for another life insurance contract, an endowment contract, or an annuity contract;
2. An exchange of an annuity contract for another annuity contract;
3. An exchange of an endowment contract for an annuity contract;
4. An exchange of one endowment contract for another endowment contract if the dates for payments begin on or before the original contract's payment dates.

If the exchange of contracts has the effect of transferring property to a non-U.S. person, the gain or loss is not tax exempt. If cash or other boot is involved with the exchange of the contracts, the gain or loss is also not tax-exempt.

Under these rules, if there is no cash involved, the exchange will be tax-free. If the exchange involves cash, the amount of cash received will be taxable as interest income. This shall apply to taxable years beginning after Dec. 31, 2004.

## **XV. PLANNED DEFERRED COMPENSATION**

### **A. Overview**

#### **1. Introduction**

A plan provides for the deferral of compensation only if, under the terms of the

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plan and relevant facts and circumstances,--

- The service provider has a legally binding right during a taxable year to compensation that has not been actually or constructively received and included in gross income for Federal tax purposes, and that, pursuant to the terms of the plan, is payable to (or on behalf of) the service provider in a later year, or
- In the case of compensation that is excludible from gross income for Federal tax purposes, the service provider has a legally binding right during a taxable year to compensation that, pursuant to the terms of the plan, is payable to (or on behalf of) the service provider in a later year and is neither actually reduced to possession by nor otherwise made available to the service provider during the taxable year.

A service provider does not have a legally binding right to compensation if that compensation may be unilaterally reduced or eliminated by the service recipient or other person after the services creating the right to the compensation have been performed. However, if the facts and circumstances indicate that the discretion to reduce or eliminate the compensation is available or exercisable only upon a condition that is unlikely to occur, or the discretion to reduce or eliminate the compensation is unlikely to be exercised, a service provider will be considered to have a legally binding right to the compensation. For this purpose, compensation is not considered subject to unilateral reduction or elimination merely because it may be reduced or eliminated by operation of the objective terms of the plan, such as the application of an objective provision creating a substantial risk of forfeiture. Similarly, a service provider does not fail to have a legally binding right to compensation merely because the amount of compensation is determined under a formula that provides for benefits to be offset by benefits provided under a plan that is qualified under IRC § 401(a), or because benefits are reduced due to actual or notional investment losses, or in a final average pay plan, subsequent decreases in compensation.

Planned deferred compensation ordinarily is paid pursuant to a written agreement between an employer and an employee whereby the employee's compensation becomes due and payable, as provided in the plan, within a stated period after one or more of the events or times set forth below transpire—

- The employee's separation from service,
- The employee's becoming disabled,
- The employee's death,
- A time or fixed schedule specified under the plan,
- The completion of a stated period of plan participation or the lapse of a fixed number of years,
- A change in the ownership or effective control of the employer or in the ownership of a substantial portion of the assets of the employer,

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- Financial hardship.

In contrast, an employee's regular compensation is the remuneration that ordinarily is paid on regular paydays designated in advance by the employer for services performed in a preceding pay period. The regular compensation earned in any pay period is due and payable within the number of days after the expiration of the pay period as is provided in the employee's written contract of employment or, if not so specified, within the standard time lapse customary in the employer's trade or business or within the number of days after the expiration of the pay period as is provided by law, whichever is earlier. A pay period may be a daily, weekly, biweekly, semimonthly, monthly, quarterly, semiannual or annual period.<sup>2 3</sup>

### 2. Categories Of Planned Deferred Compensation

Almost all nondiscriminatory deferred compensation plans are designed to satisfy the requirements for a "qualified deferred compensation plan"<sup>4</sup> or other "eligible retirement plan"<sup>5</sup> for Federal income tax purposes. Consistent with the requirements of the *Employee Retirement Income Security Act*, all of such plans provide a secured benefit for plan participants and allow for a deferral of payment and tax for periods extending to the termination of the covered employment. They, however, also allow for deferrals for periods extending *beyond* the termination of the covered employment. Some plans, however,--

- provide no secured benefit for plan participants,
- are maintained by an employer primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees, and
- are designed neither to provide retirement incomes to plan participants nor to result in a deferral of payment for periods extending beyond the termination of the covered employment.

Accordingly, not all planned deferred compensation constitutes excludible old age or retirement benefits.

Deferred compensation plans fall into nine separate categories—

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<sup>2</sup> A deferral of compensation does not occur solely because compensation is paid after the last day of the service provider's taxable year pursuant to the timing arrangement under which the service recipient normally compensates service providers for services performed during a payroll period described in IRC § 3401(b), or with respect to a non-employee service provider, a period not longer than the payroll period described in IRC § 3401(b).

<sup>3</sup> Likewise, planned deferred compensation is to be distinguished from supplemental or other compensation. Supplemental or other compensation includes compensation such as commissions, fees, bonuses or overtime, vacation, holiday or guaranteed pay that is not paid by daily, weekly, biweekly, semimonthly, monthly, quarterly, semiannual or annual pay periods.

<sup>4</sup> Defined Treasury Regulation § 1.402.0(b)(1).

<sup>5</sup> Defined 72 P.S. § 402(c)(8).

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- Short-term deferral plans.
- In-service benefit plans.
- Federally qualified defined benefit plans.
- Federally qualified defined contribution plans.
- Section 409A Supplemental Executive Retirement Plans (SERP).
- Section 409A Voluntary Deferral Plans.
- Section 401(k) Mirror Plans.
- Unfunded Section 457 plans.
- Funded Section 457 plans.

Each category is subject to different rules. They are explained below.

### **B. Short-term deferral plans**

#### **1. Short-term deferral plans explained**

Some Federally nonqualified deferred compensation plans specifically provide for every payment to be made within two-and-a-half months of the end of the taxable year in which the deferred compensation is no longer subject to a substantial risk of forfeiture (or, in the case of an employer that is a fiscal year taxpayer, within two-and-a-half months of the end of the taxable year in which the services are provided or within two-and-a-half months of the end of the calendar year in which the services are provided). Such a plan constitutes a “short-term deferral plan” for Federal and PIT purposes

#### **2. Taxation**

Any amount payable under a short-term deferral plan becomes taxable as compensation when it is no longer subject to a substantial risk of forfeiture.<sup>6</sup>

Short-term planned deferred compensation, however, is not limited to payments under a short-term deferral plan. Notwithstanding that a plan document does not specifically provide for every payment by the relevant two-and-a-half month deadline, so long as a plan payment is actually made by that date, it becomes taxable as compensation when it is no longer subject to a substantial risk of forfeiture.

### **C. In-Service Benefit Plans**

#### **1. In-service benefit plans explained**

An in-service benefit plan is any Federally nonqualified deferred compensation plan (other than a short-term deferral plan) that provides that compensation deferred under the plan may be distributed earlier than separation from service, the date the participant becomes disabled, or death and is neither designed to result nor ordinarily results in deferrals of income by employees for periods extending to or beyond the termination of covered employment. Distributions under such plans typically become due and payable to vested plan participants—

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<sup>6</sup> Such plans and payments are not covered by IRC § 409A.

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- Pursuant to timing arrangements other than the timing arrangement under which the service recipient normally compensates service providers for services performed during a payroll period described in IRC § 3401(b), or
- Within a stated period after a time or fixed schedule specified under the plan other than the specified age or stated period of employment for separation from service by normal or early retirement.

### 2. Taxation

- (a) Effective for taxable years beginning after December 31, 2004, the determination of when compensation is received for personal income tax purposes shall be consistent with the United States Treasury Regulations and revenue and letter rulings under IRC § 409A as they exist as of the time of their application that apply to nonqualified deferred compensation plans.<sup>7</sup>
- (b) Effective for taxable years after December 31, 2004, any part of an amount required to be included in gross income for Federal income tax purposes under IRC § 409A (a) (1) shall be included in compensation. This rule shall apply whether or not the distributee is retired from service at the time of distribution.
- (c) Generally, if at any time during a taxable year an in-service benefit plan fails to meet the requirements of § 409A, or is not operated in accordance with those requirements, all amounts deferred under the plan for the taxable year and all preceding taxable years, by any participant with respect to whom the failure relates, are includible in gross income for Federal tax purposes for the taxable year to the extent not subject to a substantial risk of forfeiture and not previously included in gross income. Any amount required to be included in gross income for Federal income tax purposes under IRC § 409A(a) (1) shall be deemed to have been constructively received as a distribution of deferred compensation, whether or not actually distributed.<sup>8</sup> This rule shall apply whether or not the distributee is retired from service at such time.

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<sup>7</sup> Taxpayers should note that, although the revisions to the Internal Revenue Code under IRC § 409A make significant changes, they do not alter or affect the application of any other provision of the Internal Revenue Code or common law tax doctrine. Accordingly, deferred compensation not required to be included in income under § 409A may nevertheless be required to be included in income under § 451, the constructive receipt doctrine, § 83, the economic benefit doctrine, the assignment of income doctrine or any other applicable provision of the Internal Revenue Code or common law tax doctrine.

<sup>8</sup> Note: If a deferred amount is required to be included in Federal taxable income under IRC § 409A, the amount also is subject to interest and an additional Federal income tax. No interest or additional income tax is imposed for personal income tax purposes.

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### D. Federally qualified defined benefit plans

#### 1. Categories of defined benefit plans

For PIT purposes, federally qualified defined benefit plans fall into three categories:

- Pension benefit plans.
- Mixed-purpose plans.
- Savings pension plans.

The tax treatment of each of these categories is explained in this section.

#### 2. Pension benefit plans

##### (a) FEATURES

A pension benefit plan has two important features:

- (i) The plan is established and maintained by an employer to provide systematically for the payment of definitely determinable benefits to employees over a period of years, usually for life, after retirement; and
- (ii) Since the primary purpose of a pension benefit plan is to provide for retirement benefits, the right of an employee to make withdrawals under the plan before meeting the age or service requirements for acquiring the rights immediately to separate from employment by retirement without the consent of the employer and to begin receiving retirement benefits is restricted to one or more of the following:
  - (A) Incidental benefits due to permanent disability;
  - (B) Incidental death benefits;
  - (C) Distributions required to be made under the minimum distribution rules of IRC § 401(a)(9); or
  - (D) Distributions upon termination of the plan.

##### (b) POST-RETIREMENT BENEFITS

Post-retirement benefits under a pension benefit plan are commonly recognized as nontaxable old age or retirement benefits.

##### (c) DISABILITY BENEFITS

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Any benefit due to permanent disability under a pension benefit plan is taxable deferred compensation unless paid as part of a series of substantially equal periodic payments made for the period of the disability.

- (d) **BENEFITS ON ACCOUNT OF DEATH**  
Amounts paid to the beneficiary of an employee solely by reason of the death of the employee are taxable neither to the employee nor beneficiary.
- (e) **OTHER BENEFITS**  
Pre-severance of employment distributions required to be distributed under the minimum distribution rules of IRC § 401(a)(9) or made upon termination of a plan are taxable deferred compensation.
- (f) **ROLLOVERS**  
Distributions that are transferred into a qualified employer plan or individual retirement account or annuity are not taxable for the year of the transfer where the transferred amounts are not included in income for Federal income tax purposes.

### **3. Mixed-purpose plans**

- (a) **FEATURES**  
A mixed-purpose defined benefit plan is established and maintained by an employer only in part to provide for the payment of retirement benefits. It also is established and maintained in part merely to provide a tax-advantaged deferral of income by employees for periods extending to the termination of covered employment by permitting employee withdrawals of employer contributions or the earnings thereon upon severance of employment without retiring.
- (b) **PRE-RETIREMENT WITHDRAWALS OF EMPLOYER CONTRIBUTIONS**  
Pre-retirement employee withdrawals of employer contributions or plan earnings upon severance of employment without retiring constitute taxable severance pay.
- (c) **POST-RETIREMENT BENEFITS**  
Post-retirement benefits under a mixed purpose plan are commonly recognized as nontaxable old age or retirement benefits.
- (d) **DISABILITY BENEFITS**  
Any benefit due to permanent disability under a pension benefit plan is taxable deferred compensation unless paid as part of a series of substantially equal periodic payments made for the period of the disability.

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- (e) **BENEFITS ON ACCOUNT OF DEATH**  
Amounts paid to the beneficiary of an employee solely by reason of the death of the employee are taxable neither to the employee nor beneficiary.
- (f) **OTHER BENEFITS**  
Pre-severance of employment distributions required to be made under the minimum distribution rules of IRC § 401(a)(9) or made upon termination of the plan are taxable deferred compensation.
- (g) **ROLLOVERS**  
Distributions that are transferred into a qualified employer plan or individual retirement account or annuity are not taxable for the year of the transfer where the transferred amounts are not included in income for Federal income tax purposes.

### **4. Savings pension plans**

- (a) **FEATURES**  
A savings pension plan is a pension benefit plan or mixed-purpose plan that permits an employee to withdraw his own contributions to the plan, together with accumulated interest, prior to retirement or separation.
- (b) **WITHDRAWALS OF EMPLOYEE CONTRIBUTIONS**  
Withdrawals of one's own contributions and accumulated plan earnings prior to retirement or separation are taxable only to the extent allocable to the earnings. The extent to which such withdrawals are taxable as compensation shall be determined using the cost recovery method of accounting.
- (c) **PRE-RETIREMENT WITHDRAWALS OF EMPLOYER CONTRIBUTIONS**  
Pre-retirement employee withdrawals of employer contributions or plan earnings upon severance of employment without retiring constitute taxable severance pay.
- (d) **POST-RETIREMENT BENEFITS**  
Post-retirement benefits under a pension benefit plan are commonly recognized as nontaxable old age or retirement benefits.
- (e) **DISABILITY BENEFITS**  
Any benefit due to permanent disability under a pension benefit plan is taxable deferred compensation unless paid as part of a series of substantially equal periodic payments made for the period of the disability.

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- (f) **BENEFITS ON ACCOUNT OF DEATH**  
Amounts paid to the beneficiary of an employee solely by reason of the death of the employee are taxable neither to the employee nor beneficiary.
- (g) **OTHER DISTRIBUTIONS**  
Pre-severance of employment distributions required to be made under the minimum distribution rules of IRC § 401(a)(9) or made upon termination of the plan are taxable deferred compensation.
- (h) **ROLLOVERS**  
Distributions that are transferred into a qualified employer plan or individual retirement account or annuity are not taxable for the year of the transfer where the transferred amounts are not included in income for Federal income tax purposes.

### **E. Federally qualified defined contribution plans**

#### **1. Categories of qualified defined contribution plans**

For PIT purposes, qualified defined contribution plans fall into three categories:

- Nondiscretionary defined contribution plans.
- Federally qualified stock bonus plans or employee stock ownership plans.
- Discretionary defined contribution plans.

The tax treatment of each of these categories is explained in this section.

#### **2. Nondiscretionary defined contribution plans**

##### **(a) NONDISCRETIONARY DEFINED CONTRIBUTION PLAN EXPLAINED**

A nondiscretionary defined contribution plan is one of the following—

- A Federally qualified profit-sharing plan, stock bonus plan or employee stock ownership plan to which contributions (including employee contributions made as a result of a corresponding reduction in salary pursuant to a cash or deferred arrangement) can be made only to the extent of the employer's current or accumulated earnings and profits for tax accounting or financial accounting purposes, net income, surplus or other measure of employer profitability.<sup>9</sup>

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<sup>9</sup> Until 1986, the unique feature of qualified profit-sharing plans was that contributions thereto could be made only to the extent of the employer's current or accumulated earnings and profits. Earnings and profits for this purpose did not need to be computed in the same manner as for federal income tax purposes. Even if contributions under a CODA that formed part of a profit-sharing plan were made only as a result of a corresponding reduction in salary, the contributions were subject to the general profit-sharing plan requirement that they be limited to the amount of the employer's current or accumulated earnings and profits. IRC § 401(a)(27) eliminated this requirement.

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- A noncontributory qualified defined contribution plan where one or more of the following is applicable:
  - (i) The amount of earnings on contributions (or allocations of contributions or earnings) and the amount of benefits are determined with regard to the current or accumulated profits or losses of the employer.
  - (ii) The employer can contribute only in those years when it has current or accumulated profits.
  - (iii) The employer's contributions can fluctuate depending on the level of its profits.
  - (iv) The employer's contributions are made out of current or accumulated profits.
- (b) TAXATION  
Except as provided in (c), all actual or constructive distributions upon dismissal, termination, or severance of employment (whether by retirement or otherwise) under either subcategory of nondiscretionary defined contribution plans constitute severance pay for personal income tax purposes.<sup>10</sup>
- (c) ROLLOVERS  
Distributions that are transferred into a qualified employer plan or individual retirement account or annuity are not taxable for the year of the transfer where the transferred amounts are not included in income for Federal income tax purposes.

### **3. Federally qualified stock bonus plans or employee stock ownership plans**

- (a) TAXATION  
Except as provided in (b) of this section, all distributions of cash or property upon dismissal, termination or severance of employment (whether by retirement or otherwise) under a Federally qualified stock bonus plan or employee stock ownership plan constitute severance pay for personal income tax purposes.<sup>11</sup>
- (b) ROLLOVERS  
Distributions that are transferred into a qualified employer plan or individual retirement account or annuity are not taxable for the year of the transfer where the transferred amounts are not included in income for

<sup>10</sup> 61 PA Code § 101.6(a); 61 PA Code § 101.1.

<sup>11</sup> *Ibid.*

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Federal income tax purposes.

### 4. Discretionary defined contribution plans<sup>12</sup>

#### (a) FEATURES

A discretionary defined contribution plan is a 401(k) plan or other Federally qualified profit-sharing plan that does not limit contributions to the amount of the employer's current or accumulated earnings and profits for tax accounting or financial accounting purposes.<sup>12</sup>

#### (b) DISTRIBUTIONS

The only distribution under a discretionary defined contribution plan that constitutes severance pay is:

(1) A distribution received by an employee before the date he attains age 59½; or

(2) A distribution received by an employee before the date on which he separated from the covered service after attainment of age 59½.

#### (c) ROLLOVERS

Distributions that are transferred into a qualified employer plan or individual retirement account or annuity are not taxable for the year of the transfer where the transferred amounts are not included in income for Federal income tax purposes.

## F. Section 409A Supplemental Executive Retirement Plans (SERP)

### 1. Features

A SERP is a long-term nonqualified deferred compensation plan based solely on notional employer contributions to an account and may be designed along the lines of a Federally qualified defined contribution plan or a Federally qualified defined benefit version. In the defined contribution version, the employer funds the agreement with a pre-determined periodic notional contribution. In the defined benefit version, the business is obligated to provide a pre-determined benefit to the executive on retirement or specified date. SERPs typically include a vesting schedule to encourage executives to remain with the business.

### 2. Taxation of pre-retirement benefits

(a) Federal rules and rulings shall be applicable with respect to what constitutes a long-term deferral;

(b) Effective for taxable years beginning after December 31, 2004, the determination of whether or when long-term deferred compensation is

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<sup>12</sup> CCH-EXP, 2008FED ¶17,509.021

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received for personal income tax purposes shall be consistent with the United States Treasury Regulations and revenue and letter rulings under IRC § 409A applicable thereto as they exist as of the time of their application.<sup>13</sup>

- (c) Effective for taxable years after December 31, 2004, any part of an amount required to be included in gross income for Federal income tax purposes under IRC § 409A (a) (1) shall be included in taxable compensation.
- (d) Generally, if at any time during a taxable year a nonqualified deferred compensation plan fails to meet the requirements of § 409A, or is not operated in accordance with those requirements, all amounts deferred under the plan for the taxable year and all preceding taxable years, by any participant with respect to whom the failure relates, are includible in gross income for Federal tax purposes for the taxable year to the extent not subject to a substantial risk of forfeiture and not previously included in gross income. Any amount required to be included in gross income for Federal income tax purposes under IRC § 409A(a) (1) shall be deemed to have been constructively received as a distribution of deferred compensation, whether or not actually distributed.<sup>14</sup>

### 3. Taxation of post-retirement benefits

- (a) Equal (or substantially equal) periodic payments paid not less frequently than annually to a retired plan participant for the life or life expectancy of the plan participant, the joint lives or joint life expectancies of the plan participant's and recipient's beneficiary, or for a period of not less than 10 years are excludible from tax as old age or retirement benefits.
- (b) If the plan vests a retired plan participant with the right to elect only between payments described in paragraph (a) and a lump sum cash-out or periodic payments of equivalent actuarial value in lieu thereof, such elective benefits are excludible from tax as old age or retirement benefits.
- (c) Other benefits are taxable on the same basis as pre-retirement benefits.

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<sup>13</sup> Taxpayers should note that, although the revisions to the Internal Revenue Code under IRC § 409A make significant changes, they do not alter or affect the application of any other provision of the Internal Revenue Code or common law tax doctrine. Accordingly, deferred compensation not required to be included in income under § 409A may nevertheless be required to be included in income under § 451, the constructive receipt doctrine, § 83, the economic benefit doctrine, the assignment of income doctrine or any other applicable provision of the Internal Revenue Code or common law tax doctrine.

<sup>14</sup> Note: If a deferred amount is required to be included in Federal taxable income under IRC § 409A, the amount also is subject to interest and an additional Federal income tax. No interest or additional income tax is imposed for personal income tax purposes.

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### G. Section 409A Voluntary Deferral Plans

#### 1. Features

Voluntary Deferral Plans are long-term deferred compensation plans that are based solely on deferrals of executive compensation, and accordingly, are structured as defined contribution plans. Benefits are generally determined by using growth factors or an index to an investment asset. The executive typically is immediately vested in all his/her contributions.

#### 2. Taxation

- (a) Federal rules and rulings shall be applicable with respect to what constitutes a long-term deferral;
- (b) Effective for taxable years beginning after December 31, 2004, the determination of whether or when long-term deferred compensation is received for personal income tax purposes shall be consistent with the United States Treasury Regulations and revenue and letter rulings under IRC § 409A applicable thereto as they exist as of the time of their application.<sup>15</sup>
- (c) Effective for taxable years after December 31, 2004, any part of an amount required to be included in gross income for Federal income tax purposes under IRC § 409A (a) (1) shall be included in taxable compensation.
- (d) Generally, if at any time during a taxable year a nonqualified deferred compensation plan fails to meet the requirements of § 409A, or is not operated in accordance with those requirements, all amounts deferred under the plan for the taxable year and all preceding taxable years, by any participant with respect to whom the failure relates, are includible in gross income for Federal tax purposes for the taxable year to the extent not subject to a substantial risk of forfeiture and not previously included in gross income. Any amount required to be included in gross income for Federal income tax purposes under IRC § 409A(a) (1) shall be deemed to have been constructively received as a distribution of deferred compensation, whether or not actually distributed.<sup>16</sup>

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<sup>15</sup> Taxpayers should note that, although the revisions to the Internal Revenue Code under IRC § 409A make significant changes, they do not alter or affect the application of any other provision of the Internal Revenue Code or common law tax doctrine. Accordingly, deferred compensation not required to be included in income under § 409A may nevertheless be required to be included in income under § 451, the constructive receipt doctrine, § 83, the economic benefit doctrine, the assignment of income doctrine or any other applicable provision of the Internal Revenue Code or common law tax doctrine.

<sup>16</sup> Note: If a deferred amount is required to be included in Federal taxable income under IRC § 409A, the amount also is subject to interest and an additional Federal income tax. No interest or additional income tax is imposed for personal income tax purposes.

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- (e) Post-retirement benefits are taxable on the same basis as pre-retirement benefits.

### H. Section 401(k) Mirror Plans

#### 1. Features

401(k) Mirror Plans are hybrids of a defined contribution SERP and a Voluntary Deferral Plan, with the plan participant having the option to defer salary and bonus amounts, and the business making notional matching contributions. The Plan usually includes a vesting schedule for business contributions.

#### 2. Taxation

- (a) Effective for taxable years beginning after December 31, 2004, the determination of whether or when long-term deferred compensation is received for personal income tax purposes shall be consistent with the United States Treasury Regulations and revenue and letter rulings under IRC § 409A applicable thereto as they exist as of the time of their application.<sup>17</sup>
- (b) Except as provided in (d), effective for taxable years after December 31, 2004, any part of an amount required to be included in gross income for Federal income tax purposes under IRC § 409A (a) (1) shall be included in taxable compensation.
- (c) Generally, if at any time during a taxable year a nonqualified deferred compensation plan fails to meet the requirements of § 409A, or is not operated in accordance with those requirements, all amounts deferred under the plan for the taxable year and all preceding taxable years, by any participant with respect to whom the failure relates, are includible in gross income for Federal tax purposes for the taxable year to the extent not subject to a substantial risk of forfeiture and not previously included in gross income. Any amount required to be included in gross income for Federal income tax purposes under IRC § 409A(a) (1) shall be deemed to have been constructively received as a distribution of deferred compensation, whether or not actually distributed.<sup>18</sup>
- (d) Notional matching contributions and the income attributable thereto are

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<sup>17</sup> Taxpayers should note that, although the revisions to the Internal Revenue Code under IRC § 409A make significant changes, they do not alter or affect the application of any other provision of the Internal Revenue Code or common law tax doctrine. Accordingly, deferred compensation not required to be included in income under § 409A may nevertheless be required to be included in income under § 451, the constructive receipt doctrine, § 83, the economic benefit doctrine, the assignment of income doctrine or any other applicable provision of the Internal Revenue Code or common law tax doctrine.

<sup>18</sup> Note: If a deferred amount is required to be included in Federal taxable income under IRC § 409A, the amount also is subject to interest and an additional Federal income tax. No interest or additional income tax is imposed for personal income tax purposes.

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taxable or excludible on the same basis as Section 409A Supplemental Executive Retirement Plan benefits.

### **I. Unfunded Section 457 plans**

Unfunded Section 457 plans of tax exempt organizations other than government units provide that compensation for services performed during a taxable year may be deferred at the plan participant's election on a long-term basis. The following rules apply to all such deferrals --

1. Effective for taxable years beginning after December 31, 2004, the determination of whether and when deferred compensation is received for personal income tax purposes shall be consistent with the United States Treasury Regulations and revenue and letter rulings under IRC § 475 applicable thereto as they exist as of the time of their application.
2. Effective for taxable years beginning after December 31, 2002, any part of a distribution received under a section 457 plan that is attributable to an elective deferral of income or the income on any elective deferral of income shall be included in compensation. This rule shall apply whether or not the distributee is retired from service at the time of distribution.
3. Generally, if at any time during a taxable year a plan fails to meet the requirements of IRC § 457(b), or is not operated in accordance with those requirements, all amounts deferred under the plan for the taxable year and all preceding taxable years, by any participant with respect to whom the failure relates, are includible in gross income for Federal tax purposes for the taxable year to the extent not subject to a substantial risk of forfeiture and not previously included in gross income. Any amount required to be included in gross income for Federal income tax purposes under IRC § 475(f) shall be deemed to have been constructively received as a distribution of deferred compensation, whether or not actually distributed.
4. If the employer makes notional matching contributions, they and the income attributable thereto are taxable or excludible on the same basis as Section 409A Supplemental Executive Retirement Plan benefits.

### **J. Funded Section 457 Plans**

Section 457 plans of government units and tax exempt organizations that maintain set-asides for the exclusive benefit of plan participants provide that compensation for services performed during a taxable year by may be deferred at the plan participant's election on a long-term basis. The following rules apply to such plans --

1. Payments to a set-aside described in section 457(g) of the Internal Revenue Code of 1986 made by an employer on behalf of an employee at the election of the employee pursuant to a cash or deferred arrangement or salary reduction agreement shall be considered to have been received by the employee or

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individual as compensation at the time the payment is made, whether or not such payment is subject to a substantial risk of forfeiture, whether or not the taxation of such payment is deferred under section 457 of the Internal Revenue Code, and regardless of when the election is made or the payment is received. They constitute the employee's cost of investment in the plan contract.

2. The cost-recovery rule shall be used to determine the amount of a distribution under a contributory deferred compensation plan that shall be recognized as compensation. Under the cost-recovery rule, no compensation is recognized with respect to distributions until the distributee has enjoyed a full recovery of his cost of investment in the plan contract. The amount recognized as compensation is *not* determined under IRC § 72.
3. Distributions in excess of unrecovered employee contributions shall be considered to be attributable to contributions by the employer. Such amounts are taxable or excludible on the same basis as Section 409A Supplemental Executive Retirement Plan benefits.
4. **ROLLOVERS**  
Distributions that are transferred into a qualified employer plan or individual retirement account or annuity are not taxable for the year of the transfer where the transferred amounts are not included in income for Federal income tax purposes.

### XVI. PENNSYLVANIA ELIGIBLE RETIREMENT PLANS

#### A. **Criteria for Retirement Plan to Qualify as an Eligible Pennsylvania Retirement Plan**

Under Pennsylvania law, retirement plans are considered eligible Pennsylvania retirement plans if, at a minimum, the plan has four characteristics:

1. The plan is reduced to writing and has been communicated to the participants.
2. The plan establishes eligibility requirements for separation of service or a combination of old age or infirmity, and long-continued service.
3. The plan provides for payments to be made at regularly recurring intervals after their separation from service by retirement which continues at least until death. An option for a lump sum payments or payments does not disqualify the retirement nature of the plan as long as the other provisions are provided.
4. The plan does not permit the distribution of program benefits to any employee until termination of employment except for incidental disability benefits or the return of the employee's previously taxed contributions and income or gains if the employee is required to contribute to the pension plan.

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If the pension program is a SEP, a Keogh, a federally qualified tax sheltered annuity program or a tax deferred custodial account, then an additional provision must be included in the written provisions to be a qualified pension program.

Program benefits cannot be paid before retirement, death, disability, separation from service unforeseeable emergency or attaining the age of 59 ½ without a substantial penalty for early withdrawal.

### **B. Employee Contributions to a Retirement Plan**

Employee contributions to any retirement plan are always taxable as wages. (As indicated below, payments received from eligible Pennsylvania retirement plans are nontaxable retirement income).

### **C. Distributions from an Eligible Pennsylvania Retirement Plan at or After Retirement Age or Years of Service**

All amounts withdrawn from under eligible Pennsylvania retirement plans are taxable in the year received to the extent that contributions and income earned on contributions were not taxed previously, except:

1. Payments from an eligible Pennsylvania retirement plan to a retired employee by reason of his retirement or
2. Payments paid to the estate or designated beneficiary of a participant by reason of the participant's death or
3. Payments received from an eligible Pennsylvania retirement plan which are rolled over into another deferred payment program or IRA, where the transferred amounts are not includable in income for federal income tax purposes

### **D. Treatment of Investment Earnings by an Eligible Pennsylvania Retirement Trust Fund**

Investment earnings on funds deposited into an eligible Pennsylvania retirement trust fund are not taxable to the employee when earned provided that the employee has not constructively received the earnings. Investment earnings on funds held in an eligible PA retirement plan trust fund that are received at retirement age are not taxable retirement income. Investment earnings distributed from a non-qualified deferred compensation plan that is not an eligible PA retirement plan are taxable in the year distributed. *Refer to PIT Bulletin 2005-04 Section 457(b) Eligible Deferred Compensation Plans.*

## **XVII. NONQUALIFIED DEFERRED COMPENSATION PLANS**

Pennsylvania has no provision for the reducing of income being placed in a deferred compensation account under a qualified cash or deferral arrangement. This "deferred" income is taxable compensation in the tax year it is earned.

Deferred compensation is subject to tax as compensation for Pennsylvania residents to the

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extent it was not or would not have been subject to tax. That is, it is subject to tax over and above the amount of the employee's contribution to the plan. The taxable amount is determined by the cost-recovery method.

With certain exceptions, Pennsylvania's constructive receipt rules are now the same as the federal constructive receipt rules to determine when compensation is received by a cash basis taxpayer. Following the federal constructive receipt rule, deferrals to nonqualified deferred compensation plans are not included in compensation. However, compensation now includes distributions from nonqualified deferred compensation plans attributable to an elective deferral of income, regardless of whether the distributions are paid during employment or retirement.

Also, distributions of previously taxed contributions are not taxable. If you receive distributions of previously taxed contributions, complete and include with your return the *PA-40 W-2 Reconciliation Worksheet*. Refer to PIT Bulletin 2005-03, *Deferred Compensation Under Nonqualified Plans*.

### **XVIII. NEW RULES ON NONQUALIFIED DEFERRED COMPENSATION PLANS ADD SPECIAL REQUIREMENTS FOR EMPLOYERS AND TAXPAYERS**

#### **A. General Information**

Act 40 of 2005 changed the definition of constructive receipt for Pennsylvania personal income tax purposes. Specifically, the act's new definition of constructive receipt adopts many of the provisions established by the Internal Revenue Code with respect to what to include and when to include certain deferrals of compensation as income for Pennsylvania personal income tax purposes. The Act also provided that distributions from nonqualified deferred compensation plans attributable to elective deferrals and earnings thereon are taxable at the time of the distributions irrespective of retirement.

#### **B. Employer Requirements**

##### **For Tax Years Before 2005**

Employers who have nonqualified deferred compensation plans that provide for elective deferrals need to provide plan participants with a letter establishing the amount of elective contributions previously included in Pennsylvania-taxable income so that plan participants have an acceptable record of their elective deferrals. The letter should set forth (for each taxable year of elective deferral between July 1, 1971 and Dec. 31, 2004) amounts of elective deferrals of compensation to nonqualified deferred compensation plans that were not taxable for federal income tax purposes (Box 1 of the federal Form W-2), but were included in Medicare Wages (Box 5 of the federal Form W-2) and in Pennsylvania taxable wages (Box 16 of the federal Form W-2) and were subject to withholding.

##### **For Tax Year 2005**

Employers should also provide a letter to their plan participants that outlines amounts included in Box 11 of federal Form W-2 that are attributable to - 1) nonqualified

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deferred compensation plan deferrals that were included in Medicare wages as a result of the amount no longer being subject to a substantial risk of forfeiture for prior year services; or 2) earnings from prior year deferrals not previously included in Medicare wages. The letter should set forth the value of each of these amounts.

### For Tax Years after 2005

Employers that have nonqualified deferred compensation plans for employees and directors must use Box 14 of the federal Form W-2 to indicate additional information regarding these plans in cases where, 1) the employee had a deferred amount of nonqualified deferred compensation that was included in Medicare wages as a result of the amount no longer being subject to a substantial risk of forfeiture (for prior year services); 2) the employee had a distribution from the nonqualified deferred compensation plan; 3) the employee had a distribution from the nonqualified deferred compensation plan when the employee had a deferral for prior year services and a distribution in the same year; or 4) the employee had earnings from prior year deferrals not previously included in Medicare wages. Employees with only a deferral of nonqualified deferred compensation that is included in Medicare wages that are not subject to a substantial risk of forfeiture for current year services are required by the IRS to have this amount shown in Box 12 of the federal Form W-2 with a code Y and do not need to complete Box 14 of the federal Form W-2.

Employees who have a deferral of compensation that is included in Medicare wages as a result of the amount no longer being subject to a substantial risk of forfeiture (for prior year services) should have that amount shown in Box 14 of federal Form W-2 along with the code YN. Employees who have a distribution of nonqualified deferred compensation should have that amount shown in Box 14 of federal Form W-2 along with a code YT. Employees who have had a deferral for prior year services and a distribution in the same year should have both the amounts shown in Box 14 of federal Form W-2. The deferral for prior year services will have a code YN next to that amount and the distribution will have a code YT next to that amount. Employees who have earnings from prior year deferrals not previously included in Medicare wages should have these amounts shown in Box 14 of federal Form W-2 with the code ZN.

**Table 7-7 New Pennsylvania Codes in W-2 Box 14 Nonqualified Deferred Compensation Plans**

<b>Code</b>	<b>When to use</b>
-	Deferrals under a Nonqualified Deferred Compensation (NQDC) Plan (coded as a Y in Box 12 of federal Form W-2).
YN	Deferrals under a NQDC Plan included in social security and Medicare wages as a result of the amount no longer being subject to a substantial risk of forfeiture and are for prior year services.

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- YT Distributions from a NQDC plan included in Box 1 of federal Form W-2.
- ZN Earnings from prior year deferrals now included in social security and Medicare wages.

### C. Withholding Requirements

When distributions exceed the amount of elective deferrals previously taxed by the commonwealth, inclusion of the amounts in PA taxable compensation and withholding on the excess is required. Employers are required to withhold Pennsylvania personal income tax from nonqualified deferred compensation plan distributions when payment is made to employees (except for distributions of deferrals for taxable years prior to Jan. 1, 2005, if the deferrals were previously included in PA taxable compensation).

### D. Taxpayer Requirements

#### Amended returns for tax years between 2003 and 2005

Taxpayers do not have to file amended returns for tax years between 2003 and 2005. Taxpayers who paid tax on elective deferrals of nonqualified deferred compensation for such years will not be subject to tax on such deferrals when such amounts are distributed from the nonqualified deferred compensation plan. However, if a taxpayer elects to do so, amended returns can be filed to remove the elective deferrals of nonqualified deferred compensation plans previously included in Pennsylvania-taxable compensation from such taxable compensation. As a result, special processing procedures and supporting documentation are needed to establish and validate the reduction to compensation. Therefore, the department will require that taxpayers, who amend their returns and remove the deferrals from Line 1a, Gross Compensation, of the *PA-40 Individual Income Tax Return*, write the words "Deferred Compensation" across the top of the amended return. They must also provide a copy of the letter to them from their employer establishing the amount of deferrals previously included in Pennsylvania-taxable compensation for each tax year along with a copy of the original federal Form W-2 from their employer. Taxpayers with distributions and deferrals within the same tax year should also include a worksheet with their amended return reconciling the federal wages (Box 1) shown on federal Form W-2 to the Medicare wages (Box 5) on federal Form W-2 as well as to Pennsylvania wages (Box 16) on federal Form W-2 by clearly indicating on that schedule each category of compensation included in each of the three aforementioned areas. A sample of the worksheet to be provided is included at the end of this article and is available on the department's website at [www.revenue.state.pa.us](http://www.revenue.state.pa.us). Click "Forms and Publications" link. Under "Choose Category to Browse or Search" click Prior Tax Year at the end of "Income Tax." Click 2005 and scroll to PA-40 W-2 Reconciliation Worksheet.

#### For tax year 2005

The *PA-40 W-2 Reconciliation Worksheet* should be included with taxpayers' returns if they have not yet filed their 2005 returns. This worksheet should indicate whether the amount is due to a distribution or as a result of the amount no longer being subject to a

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substantial risk of forfeiture for prior year services and/or from earnings from prior year deferrals. The worksheet will also indicate whether any distributions were previously taxed as Pennsylvania compensation. Taxpayers should also obtain a letter from their employer indicating each of these amounts as previously discussed in the employer section of this article. For taxpayers who have already filed their returns for 2005, the Department will request PA-40 W-2 Reconciliations on an as-needed-basis.

### **For tax years after 2005**

Taxpayers whose employers do not include codes in Box 14 of federal Form W-2 may be requested to provide additional information and reconciliations of PA Gross Compensation if there is an amount reported in Box 11 of federal Form W-2 or if the department is not able to reconcile the Pennsylvania wages with Medicare and/or federal wages from federal Form W-2 forms. If an employer does not provide the new codes in Box 14 of federal Form W-2, the PA-40 W-2 Reconciliation *Worksheet* should be provided with the return.

Any taxpayer who receives distributions from their nonqualified deferred compensation plans must include the distributions from nonqualified deferred compensation plans in their Pennsylvania Gross Compensation to the extent that they have not already paid tax on their deferrals. Taxpayers who have already paid tax on any deferrals should complete the *PA-40 W-2 Reconciliation Worksheet* and include it with their return along with a copy of the letter from their employer indicating the amounts previously taxed.

### **E. Proof Deferrals Were Previously Taxed**

In addition to the letter from their employers showing the amounts previously included in Pennsylvania compensation, taxpayers may also be requested to provide proof that the deferrals were previously taxed. Proof of tax paid may include, but may not necessarily be limited to - copies of federal Form W-2 for the tax years showing the deferrals were included in Pennsylvania compensation; copies of the tax returns for the tax years showing the amount included in the reported gross compensation for those tax years; copies of any departmental assessments showing that the compensation amount reported for the taxpayer was adjusted by the department to include the deferred amount; and copies of any amended returns including or excluding the compensation from taxation.

**Important:** Taxpayers and practitioners should keep the above listed tax records and all other related tax records for deferrals of compensation (or other contributions to retirement plans) indefinitely with their permanent tax records for purposes of documenting their recoverable costs and previously taxed contributions and deferrals.

For additional information regarding the taxation of Deferred Compensation, refer to PA PIT Bulletins 2005-03 and 2005-04 available on the Department's Web site at [www.revenue.state.pa.us](http://www.revenue.state.pa.us).

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### **XIX. EMPLOYEE STOCK OWNERSHIP PLANS (ESOPS)**

Pennsylvania does not follow federal rules on deferral. The fair market value of stock is taxable compensation when constructively received. Any additional appreciation is then taxable Schedule D income when sold. ESOPs are not eligible retirement plans for Pennsylvania personal income tax purposes; therefore, all distributions in excess of previously taxed employee contributions are taxable.

### **XX. PROFIT-SHARING PLANS**

#### **A. Overview**

Under Pennsylvania case law, including *Gosewisch v. Commonwealth*, 40 Pa Commw. 565, 397 A2d 1288 (1979), profit-sharing plans are taxable as Pennsylvania compensation. In *Gosewisch*, a distribution was made to the taxpayer from the "Profit-sharing Trust" and was considered to be remuneration received for services rendered. Since it was a severance, not a retirement benefit, the court held that the payment was compensation as defined in the Code and the regulations.

Pursuant to the *Gosewisch* case, during 2001, the department adopted provisions in Regulation Section 1.101 which provide that "Severance Pay" under Pennsylvania personal income tax law is defined as follows:

#### **Severance pay**

A payment made upon separation from employment under a plan, including a stock bonus or profits sharing plan formed by a trust that meets the requirements for qualification described in section 401 of the IRC (26 U.S.C.A. §401) or employee stock ownership plan, with one or more of the following attributes:

- a. The amount of earnings on contributions or allocations of contributions or earnings and the amount of benefits are determined with regard to the current or accumulated profits or losses of the employer;
- b. The employer can contribute only in those years when it has current or accumulated profits;
- c. The employer's contributions can fluctuate depending on the level of its profits;
- d. The employer's contributions are made out of current or accumulated profits;
- e. Distributions are paid with respect to stock of a corporation that is held by an employee stock ownership plan.

#### **B. Employee Contributions**

Employee contributions are taxable in the year of contributions or deferral.

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### **C. Employer Contributions**

Employee contributions are not taxable if held in trust and no there is constructive receipt.

### **D. Distributions**

All distributions in excess of previously taxed employee contributions are taxable.

## **XXI. IRAs, Roth IRAs, SEPs, and deemed IRAs**

### **A. Definitions**

The following words, terms, and phrases shall have the meaning ascribed to them in this part:

#### *Employer-sponsored IRA*

- (1) Accounts established by employers under Internal Revenue Code § 408(c).
- (2) Any individual retirement plan under which all employer contributions to the account of an employee are determined under a definite written allocation formula which specifies the requirements which the employee must satisfy to share in an allocation and the manner in which the amount allocated is computed.
- (3) Simple retirement accounts or SIMPLE IRAs described in IRC § 408(p).
- (4) Simplified employee pensions or SEPs described in IRC § 408(k).

The term shall not include inherited IRAs or deemed IRAs described in IRC § 408(q).

#### *Individual retirement investment account*

Any individual retirement plan other than an employer-sponsored IRA.

#### *Individual retirement plan*

An individual retirement account or annuity, section 408(c) IRA, Roth IRA, SEP, SIMPLE IRA or deemed IRA.

#### *Inherited IRA*

- (1) An individual retirement plan that becomes the property of a beneficiary as a result of the death of the original owner. 2
- (2) An inherited IRA beneficiary distribution account or annuity.  
The term shall not include a plan that became the property of the original owner's surviving spouse as a result of the death of the original owner if the surviving spouse elects to treat it as his or her own individual retirement plan.

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### *Participant*

The individual for whom an individual retirement plan is maintained or the owner thereof. The term shall not include a beneficiary or the estate of a participant.

### **B. Employer Contributions**

An employer contribution to an individual retirement plan of an employee and the income attributable thereto shall be considered to be compensation received by the employee only when—

- Distributed (see Sections G and H for taxability of distributions),
- The plan fails to meet Federal requirements, or
- The plan is not operated in accordance with Federal requirements.

### **C. Other Contributions**

#### **1. Employee Contributions**

An employee's receipt of income shall not be tax-deferred by reason of a contribution of that income to an individual retirement plan through payroll deduction, a cash or deferred arrangement or otherwise.

#### **2. Contributions By Or On Behalf Of The Self-Employed**

A self-employed individual's receipt of income shall not be tax-deferred by reason of a contribution of that income directly or indirectly to any individual retirement plan. A self-employed individual includes a partner in a partnership or a member of an LLC.

### **D. Nondeductibility Of Contributions**

No deduction is allowed to a plan participant for --

- The participant's contribution of compensation, whether direct or indirect, or any other asset to an individual retirement plan, or
- Re-contributed or rolled-over amounts.

### **E. Income On Plan Assets**

Income on assets held in an individual retirement plan is not includible in income until—

- Distributed (see Sections G and H for taxability of distributions),
- The plan fails to meet Federal requirements, or
- The plan is not operated in accordance with Federal requirements.

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### **F. Distributions To Plan Participants Under Employer-Sponsored IRAs**

All amounts distributed under an employer-sponsored IRA shall be included in compensation to the extent provided in Section H, "Cost Recovery Method," except--

- Distributions to a former employee made on or after the later of—
  - o The date the former employee attained age 59½, and
  - o The date on which the former employee separated from the service of such employer sponsor, and
- For the year of the transfer, distributions that are transferred into an individual retirement plan or qualified plan where the transferred amounts are not included in income for Federal income tax purposes.

### **G. Distributions To Plan Participants Under Individual Retirement Investment Accounts**

All amounts distributed from an individual retirement investment account shall be included in compensation to the extent provided in Section H, "Cost Recovery Method," except--

- Distributions made to a participant after the participant attains age 59½, and
- For the year of the transfer, distributions that are transferred into an individual retirement plan or qualified plan where the transferred amounts are not included in income for Federal income tax purposes.

### **H. Cost Recovery Method**

The extent to which a distribution is taxable as compensation shall be determined using the cost recovery method of accounting. That accounting method is explained in *Personal Income Tax Bulletin 2005-5* ("Qualified Employer Plans").

### **I. Distributions To The Beneficiaries Or Estate Of A Plan Participant**

#### **1. General Rule**

Except as provided in paragraphs 2 and 3, all amounts paid under an inherited IRA to the estate, or designated beneficiary, of the plan participant after the death of the plan participant are excludible from tax, including amounts attributable to income on plan assets that accrues after the death of the plan participant.

#### **2. Electing Surviving Spouse**

The rules outlined in Section G relating to individual retirement investment accounts apply to distributions from an inherited IRA that a surviving spouse elects to treat as his or her own individual retirement plan.

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### **3. Rollovers Into A Surviving Spouse's Own Individual Retirement Plan**

Any amount rolled over into an individual's own individual retirement plan on a tax free basis from an IRA that became the property of the individual as a result of the death of the individual's spouse shall be treated as the individual's own contribution for tax accounting purposes. The fact or amount of the rollover, however, has no other effect on the taxation of the income on plan assets of, or distributions from, the surviving spouse's own plan. If the surviving spouse's plan is an employer-sponsored IRA, the rules outlined in Section F shall apply to all distributions; and if it is an individual retirement investment account, the rules outlined in Section G shall apply to all distributions.

## **J. Special Rules Relating To Terminations, Conversions, Directors Of Corporations, And Elections**

### **1. Termination Of An Individual Retirement Plan**

- (a) Except as specifically provided in paragraph (b), distributions made upon termination of an individual retirement plan are taxable upon the same basis as other distributions.
- (b) Distributions made upon termination of an arrangement that are transferred into a qualified plan or individual retirement plan are not taxable for the year of the transfer where the transferred amounts are not included in income for Federal tax purposes.

### **2. Conversions**

The conversion of an individual retirement plan (other than a Roth IRA) to a Roth IRA shall be treated as a distribution.

### **3. Directors Of Corporations**

The terms "employee" and "former employee" shall include the directors and former directors of a corporation.

### **4. Election To Treat An Inherited Ira As A Surviving Spouse's Own Individual Retirement Plan**

The Pennsylvania personal income tax rules relating to the election to treat an inherited IRA as a surviving spouse's own individual retirement plan are the same as Federal income tax rules. An election to treat an inherited IRA as a surviving spouse's own individual retirement plan shall be deemed to have been made if—

- (a) The surviving spouse redesignates the account as an account in the name of the surviving spouse as owner rather than as beneficiary; or
- (b) At any time, either of the following occurs --

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- (i) Any amount in the inherited IRA that would be required to be distributed to the surviving spouse as beneficiary is not distributed within the time period required under section IRC § 401(a)(9)(B); or
- (ii) Any additional amount is contributed to the inherited IRA which is subject, or deemed to be subject, to the lifetime distribution requirements of IRC § 401(a)(9)(A).

### K. Regular Individual Retirement Account

#### 1. Treatment of Contributions

No exclusion is provided for contributions to an IRA except:

- a. Direct employer contributions and/or
- b. Amounts rolled over from another IRA or from a qualifying old age or retirement benefit program where the transferred amounts are not includable as income for federal income tax purposes

#### 2. Treatment of Distributions

Amounts withdrawn from an IRA are includable in income to the extent that contributions and income earned on such contributions were not taxed previously except:

- a. Payments, including lump sum distributions, made on or after retirement and reaching the age of 59½ years;
- b. Payments received at regularly recurring intervals during periods of disability by reason of disability;
- c. Payments paid to the estate or designated beneficiary of the participant by reason of the plan participant's death;
- d. Payments that are rolled over into another IRA or into an eligible retirement benefit program where the transferred amounts are not includable in income for federal income tax purposes.

**Note:** Distribution of an IRA or any other retirement plan pursuant to a divorce is taxable to the extent it has not previously been taxed. This income is reported as compensation.

Any amount distributed from an IRA pursuant to a qualified domestic relations order is treated as though distributed to the plan participant.

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### 3. IRA Investment Appreciation

Undistributed income on assets held is not includable in income.

#### L. Roth IRA

##### 1. General Rules

Most of the Pennsylvania personal income tax rules that apply to IRAs or annuities or simplified employee pensions also apply to Roth IRAs. For example:

- a. An exclusion is allowed for payments made by employers directly to Roth IRA trustees or issuers for the benefit of employees.
- b. No exclusion or deduction is allowed for contributions to a Roth IRA made by, on behalf of, or attributable to, an employee or self-employed person, directly or indirectly, whether through payroll deduction, a salary reduction agreement, or otherwise.
- c. Income on assets held in a Roth IRA is not taxable.
- d. Distributions are includable in income to the extent that contributions were not previously included if made before the individual for whom the account is maintained obtains age 59 ½ and retires from service or if the plan makes no provision for payments at regularly recurring intervals continuing at least until the participant's death.
- e. The cost-recovery method is used to determine the portion of a distribution to be included in income.

##### 2. Transfers to Roth IRAs

For federal tax purposes, amounts rolled over into Roth IRAs from regular IRAs are includable in income, but the income from rollovers before Jan. 1, 1999, may be spread out over four tax years beginning with the distribution year. However, for Pennsylvania personal income tax purposes, the following rules apply:

- Amounts rolled over into a Roth IRA from an individual retirement plan other than a Roth IRA are includable in income for the year of distribution to the extent that contributions were not previously included, unless the plan provides that the distributee may elect to have such distribution paid directly to another federally-qualified retirement plan maintained for his benefit and such distribution is made in the form of a direct trustee-to-trustee transfer to the Roth IRA.
- Amounts rolled over into a distributee's Roth IRA from a federally-qualified retirement plan other than an individual retirement plan are includable in income for the year of

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distribution to the extent that contributions were not previously included, unless the entire amount received is paid into the Roth IRA not later than the 60th day after the day on which the distributee receives the payment of distribution.

- If either of the foregoing exceptions applies, the amounts rolled over shall be excludable from federal/Pennsylvania personal income tax.

### **3. Converting Regular IRAs to Roth IRAs**

For Pennsylvania personal income tax purposes, the conversion of an individual retirement plan (other than a Roth IRA) to a Roth IRA shall be treated as a distribution. Any portion of a distribution resulting from a conversion from an individual retirement plan (other than a Roth IRA) to a Roth IRA is exempt from tax to the extent that the distribution is transferred to a Roth IRA. Any distribution that is not transferred is not exempt from tax. For any portion of a distribution that is not transferred, such as the federal income tax withheld, the cost recovery method shall be used to determine the portion of distribution that is subject to tax. This is an exception to the general rule that IRA distributions that are transferred to other types of plans are taxable to the extent taxable for federal income tax purposes.

Inasmuch as financial service companies report only the full amount of the withdrawal on federal Form 1099R they issue to the state without breaking down the contributions that have already been taxed, the department may request proof that the tax has been paid or the IRA has been rolled over.

## **XXII. EMPLOYER WELFARE PLANS**

### **A. Overview**

Employee welfare benefit programs are established by employers to provide welfare benefits to employees or their beneficiaries, such as dependent care assistance; life-; accident- or health insurance coverage; local services; medical benefits; supplemental unemployment compensation (SUB); tuition reductions; disability benefits; strike benefits and dismissal pay.

### **B. Taxation of Certain Benefits for Pennsylvania Personal Income Tax**

#### **1. Employee Welfare Benefit Program Benefits**

All welfare benefit program benefits are taxable in the year received to the extent they are attributable to contributions by the employer that were not includable in the income of the employee or were paid by the employer except:

- a. Amounts received for the permanent loss or loss of use of a part or function of the body or permanent disfigurement or in reimbursement of expenses incurred for medical care; or

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- b. Amounts which are computed with reference to the nature of a sickness or injury and without regard to the period the employee is absent from work; or
- c. Amounts (other than regular wages or sick-leave pay) which are computed with record to the period that the employee is absent from work due to sickness or disability; or
- d. Strike benefits; or
- e. Supplemental Unemployment Compensation (SUB). For a payment to qualify as SUB pay, it must be made periodically during the period of actual unemployment and must continue only for the period of actual unemployment. Lump sum payments are taxable; or
- f. Amounts paid to the beneficiaries or the estate of an employee by reason of the death of the employee; or
- g. The fair market value of employer-provided dependent care facilities.

### **2. Plan Requirements for Qualifying as an Eligible Pennsylvania Welfare and Benefit Plan**

Employers establish and maintain employee welfare benefit plans to provide miscellaneous benefits to eligible employees or their beneficiaries. Unless specifically excluded, Box 16 of federal Form W-2 includes the cost of the Pennsylvania-taxable benefits that your employer provides. Your employer must include the value of these benefits, regardless of the type of plan your employer has.

### **C. Employee Contributions – Taxable**

Deferred-payment program or welfare benefit program contributions deducted from the compensation of an employee; voluntary employee contributions; and contributions made by an employer pursuant to a cash or deferred arrangement under which the employee may unilaterally elect to have the employer either make the payments as contributions to the profit-sharing or stock bonus plan, money purchase plan, Federal Employee's Thrift Savings Plan or 401(k) Plan or 403(b) plan or other program on behalf of the employee or to the employee directly in cash, are not excludable from the employee's Pennsylvania income.

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**Table 7-8 - Pennsylvania Taxation of Contributions to and Distributions from Eligible Pennsylvania Retirement Plans**

<b>Type of Compensation Employer contributions to -</b>	<b>Taxable Description</b>	<b>Nontaxable Description</b>
1) Employer-sponsored eligible Pennsylvania retirement plans; and or	Employer contributions to plans or trusts are taxable if constructive receipt by employee	1) Employer contributions are not taxable when contributed, provided there is no constructive receipt under the <del>PA PIT</del> Pennsylvania personal income tax rules.
2) Nonqualified deferred compensation plans that are non-eligible Pennsylvania retirement plans and/or	Employer contributions to plans or trusts are taxable if constructive receipt by employee	1) Employer contributions are not taxable when contributed, provided there is no constructive receipt under the <del>PA PIT</del> Pennsylvania personal income tax rules.
3) Federal qualified plans that are not eligible Pennsylvania retirement plans	2) Treated as a nonqualified deferred compensation plan	1) Employer contributions are not taxable when contributed, provided there is no constructive receipt under the <del>PA PIT</del> Pennsylvania personal income tax rules
Distributions of employer contributions and investment earnings on non-eligible employer contributions from employer sponsored nonqualified deferred compensation plan.	Always taxable as compensation	
Distributions of employer contributions and investment earnings on employee contributions from employer sponsored nonqualified deferred compensation plan meeting the requirements of an eligible Pennsylvania retirement plan	Any payment of employer contribution and investment earnings prior to retirement age are taxable PA compensation	Not taxable if the amounts are received at or after retirement age.
Distributions of employer contributions from employer-sponsored qualified federal retirement plan that is non-eligible Pennsylvania retirement plan (e.g., profit-sharing plan providing no option to receive an annuity or an employee stock ownership plan)	Taxable as compensation. The fact that the plan is a qualified plan for federal income taxpayers is not controlling.  The plan is not an eligible Pennsylvania retirement plan. ESOPs may be qualified federal plans, but they are non-eligible Pennsylvania retirement plans.	
Distributions of employee contributions and investment earnings on employee contributions	Distributions received before retirement age	
1) Distributions of employee contributions from an eligible Pennsylvania retirement plan	1) Taxable to extent of excess determined under the cost recovery method for amounts received prior to retirement	1) After retirement age, not taxable

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**Table 7-8 - Pennsylvania Taxation of Contributions to and Distributions from Eligible Pennsylvania Retirement Plans**

<b>Type of Compensation Employer contributions to -</b>	<b>Taxable Description</b>	<b>Nontaxable Description</b>
2) Distribution of employee contribution from a nonqualified deferred compensation plan that is not an eligible Pennsylvania retirement plan	2) Taxable to extent of excess determined under the cost recovery method	2) Not taxable - only to extent of amounts previously included in income on prior PA-40 Individual Income Tax Returns and/or amounts contributed
3) Distribution of employee contributions from a qualified federal plan which is not an eligible Pennsylvania retirement plan e.g. profit-sharing plan not providing an option for an annuity of ESOP employee stock ownership plan	3) Taxable to extent of excess determined under the cost recovery method	3) Not taxable - only to extent of amounts previously included in income on prior PA-40 Individual Income Tax Returns and/or amounts contributed
	If you invested in a retirement annuity that is not part of an employer-sponsored program or a commonly recognized retirement program, you have PA-taxable income when you begin receiving annuity payments. You must report the difference between the amount you receive and your previously taxed investment as taxable gain on a <i>PA-40 Schedule D, Sale, Exchange, or Disposition of Property</i> . (If you receive periodic payments, you use the cost-recovery method to report the taxable gain.)	
Annuities (other than employer sponsored retirement plan annuities)		To the extent of previously taxed investment
Roth IRA – Federal	Contributions not deductible	Distributions are includable in income to the extent that contributions were not previously included if made before the individual for whom the account is maintained obtains age 59 ½ and retires from service or if the plan makes no provision for payments at regularly recurring intervals continuing at least until the participant’s death.

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**Table 7-8 - Pennsylvania Taxation of Contributions to and Distributions from Eligible Pennsylvania Retirement Plans**

<b>Type of Compensation Employer contributions to -</b>	<b>Taxable Description</b>	<b>Nontaxable Description</b>
Traditional IRA – Federal	Contributions not deductible	Amounts withdrawn from an IRA are includable in income to the extent that contributions and income earned on such contributions were not taxed previously except -
		1) Payments, including lump sum distributions, made on or after retirement and reaching the age of 59½ years;
		2) Payments received at regularly recurring intervals during periods of disability by reason of disability;
		3) Payments paid to the estate or designated beneficiary of the participant by reason of the participant's death;
		4) Payments that are rolled over into another IRA or into a qualifying old age or retirement benefit program where the transferred amounts are not includable in income for federal income tax purposes.
Nondeductible IRA – Federal		

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### XXIII. FEDERAL FORM 1099R RECONCILIATION FOR PENNSYLVANIA PERSONAL INCOME TAX

Federal Form 1099R is used to report income received from pensions, annuities, profit sharing plans, IRAs, insurance contracts, etc. The 1099R designates the taxable amount for federal purposes but not for Pennsylvania. You have to apply Pennsylvania rules described in [Table 7-9 Form 1099R Reconciliation for Pennsylvania Personal Income Tax](#) to determine what portion, if any, is taxable for Pennsylvania. Pennsylvania law does not follow federal law concerning early retirement options for IRAs, IRC Section 401 plans, 403 plans, and other federally-qualified plans. To determine if the amount you received is taxable in Pennsylvania, review Boxes 1 through 3 (the amount you received or your distributions) and the Pennsylvania tax treatment of Box 7 (the codes that will help determine the taxability of your distribution). The federal codes contained in Box 7 of federal Form 1099R include:

#### A. Code 1 & 2 Early Distribution

This distribution is taxable for Pennsylvania purposes, unless - (1) your pension or retirement plan was an eligible plan for Pennsylvania tax purposes, and (2) you retired after meeting the age conditions of the plan or years of service conditions of the plan. If your plan was not an eligible plan, or if you have not attained the age or years of service required under the plan to retire, you must determine the Pennsylvania taxable amount of your distribution. You must use the cost recovery method to determine this amount.

**Important:** If you are not sure whether your plan was an eligible retirement plan under Pennsylvania tax law, ask your plan administrator.

#### B. Code 3 or 4 Death/Disability Distribution

This is a distribution due to death and/or disability. A distribution due to death is not taxable for Pennsylvania purposes. A distribution due to disability generally is not taxable for Pennsylvania purposes.

#### C. Code 7 Normal Distribution

This distribution from an eligible Pennsylvania retirement plan is not taxable if you met the plan requirements (the age and/or years of service required by the plan) for retirement, and retired after meeting those requirements.

**Caution.** The distributions taken from annuities are taxable for Pennsylvania tax purposes. If taking distributions from annuities for which a federal Form 1099R was received, refer to PA-40IN, Instruction Booklet (no forms included) for reporting Pennsylvania-taxable income.

The State Employees' Retirement System, the Pennsylvania School Employees' Retirement System, the Pennsylvania Municipal Employees Retirement System, and the U.S. Civil Service Commission Retirement Disability Plan are eligible Pennsylvania Retirement Plans and all distributions are exempt from Pennsylvania personal income tax.

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Retired or retainer pay of a member or former member of a uniform service computed under Chapter 71 of Title 10, U.S. Code as amended is also exempt from Pennsylvania personal income tax.

**D. Code G or H Rollover**

This is a rollover from one qualified fund to another and is not taxable for Pennsylvania purposes. Refer to IRA Distributions below.

**E. Boxes 8 or 9b**

Distributions listed in these boxes are distributions from an insurance policy or annuity purchased for retirement. Such distributions are not taxable if:

1. The insurance policy or annuity was from an eligible plan for Pennsylvania tax purposes; and
2. Retired after meeting the age or years of service conditions of such eligible plan.

If these requirements are not met, the taxation of distributions must be determined under the cost recovery method. This distribution is taxable as a gain on a *PA-40 Schedule D, Sale, Exchange, or Disposition of Property*, not as compensation on Line 1a.

**F. Boxes 10 and 11**

If there is state withholding in Box 10 of the federal Form 1099R and the state indicated in Box 11 is Pennsylvania, please include a copy of the federal Form 1099R with the tax return.

**IRA Distributions (60-day rollover rule)**

If a distribution from an IRA was received before age 59 ½ and retiring, and rolled the entire distribution (100 percent) into a Roth IRA directly or within 60 days, the distribution is not taxable income for Pennsylvania purposes. If the entire distribution was not rolled into another IRA, Pennsylvania-taxable income must be reported to the extent the distribution exceeds your contributions.

**Important:** If 59 ½ years of age, but did not retire, IRA distributions must be reported on a cost recovery basis until retirement. If retired, but did not reach age 59 ½, distributions must be reported on a cost recovery basis until age 59 ½ is reached.

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**Table 7–9 Federal Form 1099R Reconciliation for Pennsylvania Personal Income Tax**

Federal Form 1099R Box Number	Federal Treatment	Pennsylvania Personal Income Tax Treatment
<p><b>1</b></p>	<p>Shows the total amount you received this year. The amount may have been a direct rollover, a transfer, or conversion to a Roth IRA, a recharacterized IRA contribution; or you may have received it as periodic payments, as non-periodic payments, or as a total distribution.</p> <p>Unless this amount is from a Coverdell Education Savings Account, report it on Form 1040 or 1040A on the line for "IRA distributions" or "Pensions and annuities" (or the line for "Taxable amount"), and on Form 8606, whichever applies.</p> <p>However, if this is a lump-sum distribution, report it on federal Form 4972, Tax on Lump-Sum Distribution. If you have not reached minimum retirement age, report your disability payments on the line for "Wages, salaries, tips, etc."</p> <p>Also report on that line corrective distribution of excess deferrals, excess contributions, or excess aggregate contributions.</p> <p>If a life insurance, annuity, or endowment contract was transferred tax-free to another trustee or contract issuer, an amount will be shown in this Box and Code 6 will be shown in Box 7. Do not report this on the tax return.</p>	<p>Under Pennsylvania personal income tax law, this distribution is taxable for Pennsylvania purposes if:</p> <ul style="list-style-type: none"> <li>the pension or retirement plan was NOT an eligible plan for Pennsylvania personal income tax purposes; or</li> <li>you retired before meeting the age conditions of the plan or years of service conditions of the plan.</li> </ul> <p>If this distribution is taxable to you under either of the two rules above, then you may use the cost recovery method to determine the taxable portion of this distribution.</p> <p><b>Cost Recovery Method – Residents</b> The "cost recovery method" provides for tax-free distribution of all prior employee contributions (since they were previously taxed) before distribution of employer contributions and investment appreciation (which are subject to tax).</p> <p><b>Cost Recovery Method – Non-Residents</b></p> <ul style="list-style-type: none"> <li>Persons who reside outside of Pennsylvania but have worked in Pennsylvania and receive retirement benefits from such Pennsylvania employer must use the "cost recovery method" as indicated under "Cost Recovery Method – Residents" above.</li> <li>Persons who contributed to a retirement plan while a Pennsylvania resident, but have moved out of Pennsylvania, are subject to tax on the income allocable to Pennsylvania over and above their contributions.</li> <li>Residents who contributed to a retirement plan while a nonresident are subject to tax only on the amount received over and above their contributions, regardless of whether tax was paid to another state on the retirement income.</li> </ul> <p><b>Cost Recovery Method - Annuities and Insurance Contracts</b> To determine prior employee contributions paid on annuities or insurance contracts, consult your plan administrator as to your full cost of the annuity.</p>

**PENNSYLVANIA PERSONAL INCOME TAX GUIDE**

**Table 7–9 Federal Form 1099R Reconciliation for Pennsylvania Personal Income Tax**

<b>Federal Form 1099R Box Number</b>	<b>Federal Treatment</b>	<b>Pennsylvania Personal Income Tax Treatment</b>
<b>2a</b>	<p>This part of the distribution is generally taxable.</p> <p>If there is no entry in this Box, the payer may not have all the facts needed to figure the taxable amount. In that case, the first Box in Box 2b should be checked.</p> <p>You may want to get one of the following publications from the IRS to help you figure the taxable amount - Pub. 560, Pub. 571, Tax-Sheltered Annuity Plans (403(b) Plans) for Employees of Public Schools and Certain Tax-Exempt Organizations, Pub. 575, Pub. 590, Pub. 721, Tax Guide to U.S. Civil Service Retirement Benefits, or Pub. 939, General Rule for Pensions and Annuities.</p> <p>For an IRA distribution, refer to IRAs and Roth IRAs above.</p> <p>For a direct rollover, zero should be shown, and you must enter zero (-0-) on the "Taxable amount" line of your tax return.</p> <p>If this is a total distribution from a qualified plan (other than an IRA or tax-sheltered annuity) and you were born before 1936 (or you are the beneficiary of someone born before 1936), you may be eligible for the 10-year tax option. Refer to the Instructions for federal Form 4972 for more information.</p>	<p>Not applicable to Pennsylvania personal income tax.</p> <p>Refer to Pennsylvania personal income tax treatment in Box 1 above.</p>
<b>2b</b>	<p>If the first checkbox is checked, the payer was unable to determine the taxable amount, and Box 2a should be blank.</p> <p>However, if this is a traditional IRA, SEP, or SIMPLE distribution, then refer to IRAs above.</p> <p>If the second checkbox is checked, the distribution was a total distribution that closed out your account.</p>	<p>Not applicable to Pennsylvania personal income tax.</p> <p>Refer to Pennsylvania personal income tax treatment in Box 1 above.</p>

**PENNSYLVANIA PERSONAL INCOME TAX GUIDE**

**Table 7-9 Federal Form 1099R Reconciliation for Pennsylvania Personal Income Tax**

<b>Federal Form 1099R Box Number</b>	<b>Federal Treatment</b>	<b>Pennsylvania Personal Income Tax Treatment</b>
<b>3</b>	<p>If a lump-sum distribution was received from a qualified plan and the taxpayer was born before 1936 (or is a beneficiary of someone born before 1936), you may be able to elect to treat this amount as a capital gain on federal Form 4972 (not on Schedule D (federal Form 1040)).</p> <p>Refer to the Instructions for federal Form 4972. For a charitable gift annuity, report as a long-term capital gain on Schedule D (federal Form 1040).</p>	<p>Under Pennsylvania personal income tax law, a lump sum distribution is taxable if-</p> <ul style="list-style-type: none"> <li>• Your pension or retirement plan was NOT an "eligible Pennsylvania retirement plan," or</li> <li>• You retired before meeting the age conditions of the plan or years of service conditions of the plan.</li> </ul> <p>If this distribution is taxable under either of the two rules above, then you may use the "cost recovery method" to report the taxable portion of this distribution.</p> <p>For Pennsylvania personal income tax there are no provisions for capital gain. The distribution is reported as gross compensation not as sale, exchange, or disposition of property.</p>
<b>4</b>	<p>This is the amount of federal income tax withheld. Include this on your income tax return as tax withheld, and if Box 4 shows an amount (other than zero), attach Copy B to your return.</p> <p>Generally, if you will receive payments next year that are not eligible rollover distributions, you can change your withholding or elect not to have income tax withheld by giving the payer Form W-4P, Withholding Certificate for Pension or Annuity Payments.</p>	<p>Not applicable to Pennsylvania personal income tax</p> <p>Refer to Pennsylvania personal income tax treatment in Box 1 above</p>

**PENNSYLVANIA PERSONAL INCOME TAX GUIDE**

**Table 7–9 Federal Form 1099R Reconciliation for Pennsylvania Personal Income Tax**

<b>Federal Form 1099R Box Number</b>	<b>Federal Treatment</b>	<b>Pennsylvania Personal Income Tax Treatment</b>
<b>5</b>	<p>Generally, this shows the employee’s investment in contract (after-tax contributions), if any, recovered tax free this year; the part of premiums paid on commercial annuities or insurance contracts recovered tax free; or the nontaxable part of a charitable gift annuity.</p> <p>This Box does not show any IRA contributions.</p>	<p>Generally, this shows the employee’s investment in an annuity contract. Refer below for after-tax contributions. if any, recovered tax free this year; the part of premiums paid on commercial annuities or insurance contracts recovered tax free; or the nontaxable part of a charitable gift annuity.</p> <p>This Box does not show any IRA contributions.</p> <p><b>Cost Recovery Method of Taxation of Retirement Distributions</b> (if applicable) Pennsylvania personal income tax law provides for the cost recovery method of taxation of retirement distributions if such distributions are –</p> <ul style="list-style-type: none"> <li>• From a non-eligible retirement plan, and</li> <li>• Distributed prior to the participant meeting the – <ul style="list-style-type: none"> <li>✓ Retirement age or</li> <li>✓ Years of service, requirements under the plan. The cost recovery method provides for recovery of all prior employee contributions prior to taxation of distributions.</li> </ul> </li> </ul> <p>To determine prior employee contributions consult your plan administrator as to your full cost of the annuity.</p> <p>“After-tax contributions” employee means contributions (usually deducted from pay) that the employee makes to his or her plan, annuity, etc. Since the employee has already been subject to tax on his or her contributions, these contributions are referred to as after tax contributions.</p>
<b>6</b>	<p>If you received a lump-sum distribution from a qualified plan that includes securities of the employer’s company, the net unrealized appreciation (NUA) (any increase in value of such securities while in the trust) is taxed only when you sell the securities unless you choose to include it in your gross income this year. Refer to Pub. 575 and the Instructions for federal Form 4972.</p> <p>If you did not receive a lump-sum distribution, the amount shown is the NUA attributable to employee contributions, which is not taxed until you sell the securities.</p>	<p>Under Pennsylvania personal income tax law, provided there is no constructive receipt, unrealized appreciation from securities held in trust is not taxable unless the securities are sold.</p>

**PENNSYLVANIA PERSONAL INCOME TAX GUIDE**

**Table 7–9 Federal Form 1099R Reconciliation for Pennsylvania Personal Income Tax**

Federal Form 1099R Box Number	Federal Treatment	Pennsylvania Personal Income Tax Treatment
<b>7</b>	<p><b>The following codes identify the distribution you received</b></p>	<p><b>The following codes identify the distribution you received</b></p>
	<p><b>1</b>– Early distribution, no known exception (in most cases, under age 59½).</p> <p>Refer to federal Form 5329, Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts.</p> <p>For a rollover to a traditional IRA of the entire taxable part of the distribution, do not file federal Form 5329. Refer to the federal Form 1040/1040A instructions.</p>	<p><b>1</b>– Under Pennsylvania personal income tax law, this distribution is taxable for PA purposes if –</p> <ul style="list-style-type: none"> <li>• Your pension or retirement plan was not an eligible plan for Pennsylvania personal income tax purposes or</li> <li>• You retired before meeting the age conditions of the plan or years of service conditions of the plan.</li> </ul> <p>If this distribution is taxable to you under either of the two rules above, then you may use the cost recovery method to determine the taxable portion of this distribution.</p> <p><b>Cost Recovery Method – Residents</b> The “cost recovery method” provides for tax-free distribution of all prior employee contributions (since they were previously taxed) before distribution of employer contributions and investment appreciation (which are subject to tax).</p> <p><b>Cost Recovery Method – Non-Residents</b></p> <ul style="list-style-type: none"> <li>• Persons who reside outside of Pennsylvania but have worked in Pennsylvania and receive retirement benefits from such Pennsylvania employer must use the “cost recovery method” as indicated under “Cost Recovery Method – Residents” above.</li> <li>• Persons who contributed to a retirement plan while a Pennsylvania resident, but have moved out of Pennsylvania, are subject to tax on the income allocable to Pennsylvania over and above their contributions.</li> <li>• Residents who contributed to a retirement plan while a nonresident are subject to tax only on the amount received over and above their contributions, regardless of whether tax was paid to another state on the retirement income.</li> </ul> <p><b>Cost Recovery Method - Annuities and Insurance Contracts</b> To determine prior employee contributions or amounts paid on annuities or insurance contracts, consult your plan administrator as to your full cost of the annuity.</p>

**PENNSYLVANIA PERSONAL INCOME TAX GUIDE**

**Table 7–9 Federal Form 1099R Reconciliation for Pennsylvania Personal Income Tax**

<b>Federal Form 1099R Box Number</b>	<b>Federal Treatment</b>	<b>Pennsylvania Personal Income Tax Treatment</b>
<b>7</b>	<b>The following codes identify the distribution you received</b>	<b>The following codes identify the distribution you received</b>
	<b>2</b> – Early distribution, exception applies (under age 59 ½)	<p><b>2</b> – Under Pennsylvania personal income tax law, this distribution is taxable for PA purposes if –</p> <ul style="list-style-type: none"> <li>• Your pension or retirement plan was NOT an eligible plan for Pennsylvania personal income tax purposes or</li> <li>• You retired before meeting the age conditions of the plan or years of service conditions of the plan.</li> </ul> <p>If this distribution is taxable to you under either of the two rules above, then you may use the cost recovery method to determine the taxable portion of this distribution.</p>
	<b>3</b> – Disability	<b>3</b> – Under Pennsylvania personal income tax law, a distribution due to disability generally is not taxable .
	<b>4</b> – Death	<b>4</b> – Under Pennsylvania personal income tax law, a distribution due to death is not taxable
	<b>5</b> - Prohibited transaction	<b>5</b> – Not applicable - Pennsylvania personal income tax has no provisions for prohibited transactions
	<b>6</b> – Section 1035 exchange (a tax-free exchange of life insurance, annuity, or endowment contracts)	<p><b>6</b> – For taxable years beginning after Dec. 31, 2004, Act 40 of Jul. 7, 2005 provides that exchanges of insurance contracts listed under IRC Section 1035 that are tax exempt for federal income tax purposes are also tax exempt for Pennsylvania personal income tax purposes. Therefore, do not report the gain (loss) on the sale, exchange or disposition of any insurance contracts that include</p> <ul style="list-style-type: none"> <li>• An exchange of a life insurance contract for another life insurance contract, an endowment contract, or an annuity contract;</li> <li>• An exchange of an annuity contract for another annuity contract;</li> <li>• An exchange of an endowment contract for an annuity contract;</li> <li>• An exchange of one endowment contract for another endowment contract if the dates for payments begin on or before the original contract’s payment dates.</li> </ul> <p>If the exchange of contracts has the effect of transferring property to a non-US person, the gain or loss is not tax exempt. If cash or other boot is involved with the exchange of the contracts, the gain or loss is also not tax exempt. The amount of cash or other boot received will be taxable as interest income. For additional information, refer to PIT Guide, Chapter 8, Interest .</p>

**PENNSYLVANIA PERSONAL INCOME TAX GUIDE**

**Table 7-9 Federal Form 1099R Reconciliation for Pennsylvania Personal Income Tax**

Federal Form 1099R Box Number	Federal Treatment	Pennsylvania Personal Income Tax Treatment
<b>7</b>	<b>The following codes identify the distribution you received</b>	<b>The following codes identify the distribution you received</b>
	<b>7</b> – Normal Distribution	<b>7</b> – Under Pennsylvania personal income tax law, a normal distribution is not taxable if an only if – <ul style="list-style-type: none"> <li>• Your pension or retirement plan was an “eligible Pennsylvania retirement plan”, and</li> <li>• You have met the retirement age or years of service requirement (as applicable) under such plan. If you or your plan does not meet the two requirements above, the taxation of this distribution is determined under the cost recovery method</li> </ul>
	<b>8</b> – Excess contributions plus earnings/excess deferrals (and/or earnings) taxable in 2002	<b>8</b> – Under Pennsylvania personal income tax law, an excess contribution is taxable (if not already taxed by employer). Employee contributions to an eligible retirement plan are always taxable
	<b>9</b> – PS 58 costs (premiums paid by a trustee or custodian for current insurance protection, taxable to you currently)	<b>9</b> – Under Pennsylvania personal income tax law, PS 58 costs are taxable
	<b>A</b> – May be eligible for 10-year tax option. Refer to federal Form 4972.	<b>A</b> – Under Pennsylvania personal income tax law, there is no provision for 10-year tax options
	<b>D</b> – Excess contributions plus earnings/excess deferrals taxable in 2000	<b>D</b> – Under Pennsylvania personal income tax law, an excess contribution is taxable (if not already taxed by employer). Employee contributions to an eligible retirement plan are always taxable
	<b>E</b> – Excess annual additions under section 415 and certain excess amounts under section 403(b) plans. Report on federal Form 1040/1040A on the line for taxable pension or annuity income	<b>E</b> – Under Pennsylvania personal income tax law, an excess annual addition is taxable (if not already taxed by employer). Employee contributions to an eligible retirement plan are always taxable
	<b>F</b> – Charitable gift annuity	<b>F</b> – Under Pennsylvania personal income tax law, charitable gift annuities from retirement plans are not taxable to the extent that such amounts are distributed after retirement under the retirement plan
	<b>G</b> – Direct rollover to IRA	<b>G</b> – Under Pennsylvania personal income tax law, direct rollovers are not taxable
	<b>H</b> – Direct rollover to qualified plan or tax-sheltered annuity or a transfer from a conduit IRA to a qualified plan	<b>H</b> – Under Pennsylvania personal income tax law, direct rollovers are not taxable

**PENNSYLVANIA PERSONAL INCOME TAX GUIDE**

**Table 7–9 Federal Form 1099R Reconciliation for Pennsylvania Personal Income Tax**

Federal Form 1099R Box Number	Federal Treatment	Pennsylvania Personal Income Tax Treatment
<b>7</b>	<b>The following codes identify the distribution you received</b>	<b>The following codes identify the distribution you received</b>
	<b>J</b> – Early distribution from a Roth IRA, no known exception (in most cases, under age 59 ½). Report on federal Forms 1040 and 8606 and refer to federal Form 5329.	<b>J</b> – Under Pennsylvania personal income tax law, the taxation of a distribution from a Roth IRA prior to reaching 59 ½ is determined under the cost recovery method.
	<b>L</b> – Loans treated as distributions	<p><b>L</b> – Under Pennsylvania personal income tax law, this distribution is taxable for Pennsylvania purposes if-</p> <ul style="list-style-type: none"> <li>• Your pension or retirement plan was not an eligible plan for Pennsylvania personal income tax purposes or</li> <li>• You retired before meeting the age conditions of the plan or years of service conditions of the plan.</li> </ul> <p>If this distribution is taxable to you under either of the two rules above, then you may use the cost recovery method to determine the taxable portion of this distribution.</p>
	<b>M</b> – Distribution from a Coverdell ESA. Report any taxable amount on federal Form 1040. If your education expenses during 2003 were not equal to or more than your distribution, part or all of your distribution may be taxable and subject to an additional 10 percent tax.	<p><b>M</b> – Not applicable to Pennsylvania personal income tax.</p> <p>Under Pennsylvania personal income tax law, there is no provision for Coverdell ESA distributions.</p>
	<b>N</b> – Re-characterized IRA contribution made for 2003 and re-characterized in 2003. Report on 2003 federal Form 1040/1040A and federal Form 8606, if applicable.	<b>N</b> – Under Pennsylvania personal income tax law, employee contributions to an eligible retirement plan are always taxable
	<b>P</b> – Excess contributions plus earnings/excess deferrals taxable in 2002	<p><b>P</b> – Under Pennsylvania personal income tax law, an excess contribution is taxable if not already taxed by employer.</p> <p>Employee contributions to an eligible retirement plan are always taxable.</p>
	<b>R</b> – Re-characterized IRA contribution made for 2002 and re-characterized in 2003. Report on 2002 federal Form 1040/1040A and federal Form 8606, if applicable.	<b>R</b> – Under Pennsylvania personal income tax law, employee contributions to an eligible retirement plan are always taxable.
	<b>S</b> – Early distribution from a SIMPLE IRA in first 2 years, no known exception (under age 59 ½). May be subject to an additional 25 percent tax. Refer to federal Form 5329.	<b>S</b> – Under Pennsylvania personal income tax law, an early distribution from a SIMPLE IRA is taxable under the cost recovery method.

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**Table 7–9 Federal Form 1099R Reconciliation for Pennsylvania Personal Income Tax**

Federal Form 1099R Box Number	Federal Treatment	Pennsylvania Personal Income Tax Treatment
<b>7</b>	<b>The following codes identify the distribution you received</b>	<b>The following codes identify the distribution you received</b>
	<b>T</b> – Roth IRA distribution, exception applies. Report on Forms 1040/1040A and 8606. You are either age 59 ½ or over or an exception (code 2, 3, or 4) applies	<b>T</b> – Under Pennsylvania personal income tax law a Roth IRA distribution is not taxable if you are at least 59 ½ so long as the Roth IRA is considered an “eligible retirement plan.” If you are not 59 ½, the taxation of this distribution is determined under the cost recovery method.
	If the IRA/SEP/SIMPLE Box is checked, you have received a traditional IRA, SEP, or SIMPLE distribution	
<b>8</b>	If you received an annuity contract as part of a distribution, the value of the contract is shown. It is not taxable when you receive it and should not be included in Boxes 1 and 2a. When you receive periodic payments from the annuity contract, they are taxable at that time. If the distribution is made to more than one person, the percentage of the annuity contract distributed to you is also shown. You will need this information if you use the special 10-year tax option (Form 4972).	This is a distribution from an insurance policy or annuity purchased for your retirement. Such distributions are not taxable if- <ul style="list-style-type: none"> <li>• Your insurance policy or annuity was an eligible plan for Pennsylvania personal income tax purposes, and</li> <li>• You retired after meeting the age or years of service conditions of the insurance policy or annuity. If you do not meet these requirements, a distribution may be taxable as a gain on Schedule D, not compensation on Line 1a.</li> </ul> Consult you plan administrator as to your cost in the annuity.
<b>9a</b>	If a total distribution was made to more than one person, the percentage you received is shown.	This box is your percentage of the total distribution listed.
<b>9b</b>	For a life annuity from a qualified plan or from a tax-sheltered annuity (with after-tax contributions), an amount may be shown for the employee’s total investment in the contract. It is used to compute the taxable part of the distribution. Refer to Pub. 575.	Under Pennsylvania personal income tax law, this distribution is taxable for PA purposes if- <ul style="list-style-type: none"> <li>• Your pension or retirement plan was NOT an eligible plan for Pennsylvania personal income tax purposes; or</li> <li>• You retired before meeting the age conditions of the plan or years of service conditions of the plan.</li> </ul> If this distribution is taxable to you under either of the two rules above, then this distribution may be taxable as a gain on Schedule D, not compensation on Line 1a. Consult you plan advisor as to your cost of the annuity.
<b>10</b>	State tax withheld	This box lists the amount of withholdings applicable to Pennsylvania personal income tax. This amount should be added to any other withholdings and listed on your <i>PA-40 Individual Income Tax Return</i> .

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**Table 7–9 Federal Form 1099R Reconciliation for Pennsylvania Personal Income Tax**

<b>Federal Form 1099R Box Number</b>	<b>Federal Treatment</b>	<b>Pennsylvania Personal Income Tax Treatment</b>
<b>11</b>	State/Payer’s state no	Employer identification number or Revenue ID (Box number) of payee
<b>12</b>	State distribution	Not applicable for Pennsylvania personal income tax
<b>13</b>	Local tax withheld	Not applicable for Pennsylvania personal income tax
<b>14</b>	Name of locality	Not applicable for Pennsylvania personal income tax
<b>15</b>	Local distribution	Not applicable for Pennsylvania personal income tax

**XXIV. Property transferred in connection with the performance of services**

**A. Background**

The Pennsylvania personal income tax was amended in order to make, with certain exceptions, section 83 of the Internal Revenue Code of 1986 and the regulations thereunder (“Section 83”) applicable for taxable years beginning after December 31, 2004, with respect to property transferred to a service provider (or beneficiary thereof) in connection with the performance of services by such service provider. Those exceptions to the applicability of Section 83 are explained in this subchapter.

**B. Certain transfers upon death**

For PA PIT purposes, if substantially non-vested property has been transferred in connection with the performance of services and the person who performed such services dies while the property is still substantially non-vested, any income realized on or after such death by reason of such death with respect to such property under IRC §§ 83 and 691 is excludable from tax. The personal income tax has no provisions corresponding to IRC § 691.

**C. Forfeiture after substantial vesting**

For Federal tax purposes, If a person is taxable under IRC § 83(a) when the property transferred becomes substantially vested and thereafter the person’s beneficial interest in such property is nevertheless forfeited pursuant to a lapse restriction, any loss incurred by such person (but not by a beneficiary of such person) upon such forfeiture shall be an ordinary loss. For personal income tax purposes, the loss is reportable as a loss from the disposition of property to the extent the basis in such property has been increased as a result of the recognition of income by such person under IRC § 83(a) with respect to such property.

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### D. Election to include in gross income in year of transfer

#### 1. In general

Under Treasury Regulation §1.83.2, If property is transferred (within the meaning of Section 83(a)) in connection with the performance of services, the person performing such services may elect for Federal tax purposes to include in gross income under IRC § 83(b) the excess (if any) of the fair market value of the property at the time of transfer (determined without regard to any lapse restriction, as defined in Section 4(i)) over the amount (if any) paid for such property, as compensation for services. If this election is made, the substantial vesting rules of section 83(a) and the regulations thereunder do not apply with respect to such property, and except as otherwise provided in section IRC § 83(d)(2) and the regulations thereunder (relating to the cancellation of a non-lapse restriction), any subsequent appreciation in the value of the property is not taxable as compensation to the person who performed the services. Thus, property with respect to which this election is made shall be includible in gross income as of the time of transfer, even though such property is substantially non-vested (as defined in Section 4(b)) at the time of transfer, and no compensation will be includible in gross income when such property becomes substantially vested (as defined in Section 4(b)). In computing the gain or loss from the subsequent sale or exchange of such property, its basis shall be the amount paid for the property increased by the amount included in gross income under IRC § 83(b).

#### 2. Deemed personal income tax election

An election under section 83(b) for Federal tax purposes shall be deemed an election for PA PIT purposes unless revoked with the consent of the Commissioner of the Internal Revenue Service. The PA election is made by making the Federal election. No separate filing of the election is required to be made to the Department. A copy of the election filed with the IRS need not be included with the PA personal income tax return for the person making the election for the period related to the services.

#### 3. No separate PA election

A separate PA election is not permitted if no election is made for Federal tax purposes.

#### 4. Forfeitures

If property for which a section 83(b) election is in effect is forfeited while substantially non-vested, such forfeiture shall be treated as a disposition of property for PA PIT purposes upon which there is realized a loss equal to the excess (if any) of --

- (a) The amount paid (if any) for such property, over,
- (b) The amount realized (if any) upon such forfeiture.

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A sale or other disposition of the property that is in substance a forfeiture, or is made in contemplation of a forfeiture, shall be treated as a forfeiture under the immediately preceding sentence.

### **E. Unstated interest payments**

For Federal tax purposes, the term "amount paid" refers to the value of any money or property paid for the transfer of property to which section 83 applies. Such value does not include any unstated interest payments. For PA PIT rules regarding the calculation of the amount of unstated interest payments, see Treasury Regulation §1.483-1(c).

### **F. Sales which may give rise to suit under section 16(b) of the Securities Exchange Act of 1934**

#### **1. In general**

For Federal tax purposes, when the sale of property at a profit within six months after the purchase of the property could subject a person to suit under section 16(b) of the Securities Exchange Act of 1934, the person's rights in the property are treated as subject to a substantial risk of forfeiture and as not transferable until the earlier of (i) the expiration of such six-month period, or (ii) the first day on which the sale of such property at a profit will not subject the person to suit under section 16(b) of the Securities Exchange Act of 1934.

#### **2. Effective date**

For personal income tax purposes, this paragraph applies to property transferred after December 31, 2004.

### **G. Special rule for certain accounting rules**

#### **1. "Pooling-of-Interests Accounting" rules**

For Federal tax purposes, property is subject to substantial risk of forfeiture and is not transferable so long as the property is subject to a restriction on transfer to comply with the "Pooling-of-Interests Accounting" rules set forth in *Accounting Series Release Numbered 130* ((10/5/72) 37 FR 20937; 17 CFR 211.130) and *Accounting Series Release Numbered 135* ((1/18/73) 38 FR 1734; 17 CFR 211.135).

#### **2. Effective date**

For personal income tax purposes, this paragraph applies to property transferred after December 31, 2004.

### **H. Taxation of nonqualified stock options**

For PA personal income tax purposes, If, after December 31, 2004, there is granted to an employee or independent contractor (or beneficiary thereof) in connection with the performance of services, an option which has a readily ascertainable fair market value at the time the option is granted and to which IRC § 421 (relating generally to certain qualified and other options) does not apply, the person who performed such services

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realizes compensation upon such grant at the time and in the amount determined under section 83(a).

If section 83(a) does not apply to the grant of such an option because the option does not have a readily ascertainable fair market value at the time of grant, sections 83(a) and 83(b) shall apply at the time the option is exercised or otherwise disposed of, even though the fair market value of such option may have become readily ascertainable before such time. If the option is exercised, sections 83(a) and 83(b) apply to the transfer of property pursuant to such exercise, and the employee or independent contractor realizes compensation upon such transfer at the time and in the amount determined under section 83(a) or 83(b).

### **I. Applicability of section and transitional rules**

#### **(1) Scope of section 83**

Section 83 is not applicable to employer payments described in Section 11(b)(1)(B).

#### **(2) Transitional rules**

- (a) In general  
Except as otherwise provided in subsection (b), these rules shall apply to property transferred after December 31, 2004.
- (b) Binding written contracts  
These rules shall not apply to property transferred pursuant to a binding written contract entered into before January 1, 2005. For purposes of this paragraph, a binding written contract means only a written contract under which the employee or independent contractor has an enforceable right to compel the transfer of property or to obtain damages upon the breach of such contract. A contract which provides that a person's right to such property is contingent upon the happening of an event (including the passage of time) may satisfy the requirements of this paragraph. However, if the event itself, or the determination of whether the event has occurred, rests with the board of directors or any other individual or group acting on behalf of the employer (other than an arbitrator), the contract will not be treated as giving the person an enforceable right for purposes of this paragraph. The fact that the board of directors has the power (either expressly or impliedly) to terminate employment of an officer pursuant to a contract that contemplates the completion of services over a fixed or ascertainable period does not negate the existence of a binding written contract. Nor will the binding nature of the contract be negated by a provision in such contract which allows the employee or independent contractor to terminate the contract for any year and receive cash instead of property if such election would cause a substantial penalty, such as a forfeiture of part or all of the property received in

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connection with the performance of services in an earlier year.

### J. Statutory stock options

#### (1) Statutory stock option defined

The term "statutory stock option" describes stock option arrangements with particular Federal tax benefits made available under IRC § 421. Such arrangements include the transfer of a share of stock to an individual pursuant to his exercise of an incentive stock option in respect of which the requirements of IRC § 422(a) are met. It also includes transfers pursuant to the exercise of an option under an employee stock purchase plan in respect of which the requirements of IRC § 423(a) are met.

#### (2) PA PIT treatment

Compensation in the form of statutory stock options is taxable as personal income when –

- (a) The option is exercised if the stock subject to the option is free from any restrictions having a significant effect on its market value,
- (b) The restrictions lapse if the stock subject to the option is subject to restrictions having a significant effect on its market value, or
- (c) Exchanged, sold or otherwise converted into cash or other property.

IRC §§ 421, 421, 422, 423 and 424 have no application for PIT purposes.

### K. Secular trust arrangements

#### (1) Secular trust defined

A secular trust is a nonqualified deferred compensation arrangement that immediately and substantially vests plan participants with a beneficial interest in assets (including money) which are transferred or set aside from the claims of creditors of the transferor and/or service recipient, for example, in a trust, escrow account or other means that is treated as a grantor trust for Federal tax purposes. Accordingly, for Federal tax purposes, the amounts transferred or set aside and trust income are currently taxable to the plan participant.

#### (2) PA PIT taxation of secular trust arrangements

- (a) Amounts transferred or set aside for the benefit of employees
  - (i) General rule  
For taxable years beginning after December 31, 2004, any amount transferred to or set aside in a secular trust for the benefit of a employee (or the employee's beneficiary) and any earnings

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allocable thereto are currently taxable to the employee as compensation.

- (ii) Programs covering retirement  
Notwithstanding the rules of IRC §§ 83 and 402(b), employer payments for programs covering retirement established for the benefit of the employer's employee(s) are excludible from personal income tax until actually or constructively received by the employee. However, for taxable years beginning after December 31, 2004, the earnings on any amounts transferred to or set aside in a secular trust for the benefit of an employee are currently taxable to the employee as compensation.

- (b) Amounts transferred or set aside for the benefit of independent contractors, directors, and similar service providers.

For taxable years beginning after December 31, 2004, any amount transferred or set aside for the benefit of an independent contractor, director or similar service provider and any earnings allocable thereto are currently taxable to the independent contractor, director or service provider as compensation.

- (c) For purposes of this Clause,

- (i) An employee is an individual from whose wages an employer is required under the Internal Revenue Code to withhold Federal income tax.
- (ii) A program covers retirement if it provides a specific distribution rule in the case of an employee's retirement from service such as, for example, where the plan provides for a qualified annuity upon retirement. A program that has substantially the same distribution rules in the case of an employee's voluntary termination of employment before reaching retirement age or service does not qualify.
- (iii) A qualified annuity is defined at 61 PA Code § 101.1 to be an arrangement under which the payee is entitled to equal, or substantially equal periodic payments, paid at least annually, for any of the following periods:
- The life of the participant, or, if applicable, the joint lives of the recipient and recipient's designated beneficiary,
  - The life expectancy of the participant, or, if applicable, the joint life expectancies of the recipient and recipient's

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designated beneficiary, or

- A period of at least 10 years.

### **L Employer annuity plans**

Employer payments for an annuity or endowment contract are taxable unless the plan constitutes an employer annuity plan. See Subchapter XIV (“Annuities”) for an explanation of employer annuity plans.

### **M. Cross Reference**

A qualified annuity is defined at 61 PA Code § 101.1 to be an arrangement under which the payee is entitled to equal, or substantially equal periodic payments, paid at least annually, for any of the following periods:

- The life of the participant, or, if applicable, the joint lives of the recipient and recipient’s designated beneficiary,
- The life expectancy of the participant, or, if applicable, the joint life expectancies of the recipient and recipient’s designated beneficiary, or
- A period of at least 10 years.