



PENNSYLVANIA PERSONAL INCOME TAX GUIDE

CHAPTER 8: INTEREST

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I. PENNSYLVANIA INTEREST

A. Gross Income Class

Interest income is a gross taxable income class under Pennsylvania law. Consequently, Pennsylvania law does not permit the deduction of any expenses that a taxpayer incurs to realize ordinary interest income. However, income that can reasonably be classified either as interest or as another taxable class of income is to be classified into that other class of income.

Interest derived from obligations that are not statutorily free from state or local taxation under any act of the General Assembly or under the laws of the U.S. is subject to taxation under the Pennsylvania personal income tax (PA PIT) statute. Interest on obligations issued by or on behalf of the U.S. government is not subject to Pennsylvania personal income tax.

B. Nonresidents

Nonresidents are not subject to Pennsylvania personal income tax on ordinary interest income from investments from sources within Pennsylvania.

C. Interest Income - Residents versus Nonresidents

Different types of interest income are classified as taxable as interest income or not taxable for Pennsylvania residents. Generally, nonresidents do not report ordinary interest income from sources within Pennsylvania. Refer to [Table 1](#) on Page 12.

D. Interest is Classified as Income from the Pennsylvania Class in which it was Earned

Under Pennsylvania law, income and expenses are generally classified according to the activity in which they are earned or incurred. Similarly, interest as indicated below is classified as income from the Pennsylvania class in which it is earned:

1. Interest earned from savings accounts, personal checking accounts, bank accounts, bonds, notes and other securities, and other similar type investments is classified as interest income and, as such, no deductions are permitted against such interest income.
2. Interest earned in the normal and regular operation of a business, profession or farm is classified as net income (loss) from operation of a business, profession or farm as net income or loss, not as ordinary interest income. Examples of interest

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which is classified as net income or loss from the operation of a business, profession or farm are as follows:

- Interest earned on accounts receivable;
- Interest earned on a business checking account; and
- Interest earned from investment of business working capital.

Likewise, expenses directly related to the production of this type of “business” interest are deductible against net income (loss) from the operation of a business, profession or farm. Examples of deductible expenses against net income (loss) from the operation of a business, profession or farm are as follows:

- Interest expense incurred with respect to accounts payable;
- Expense directly related to generating interest for working capital, *i.e.* bank fees; and
- Expense on business loans.

Refer to Pennsylvania Personal Income Tax Guide, Chapter 11, Net Income (Loss) From The Operation of a Business, Profession Or Farm Part I, Section C and Part III, Section B.

3. Interest derived by the seller from the sale of property on an installment basis is classified as net gain (loss) from the sale, disposition or exchange of property. Likewise, expenses incurred in holding a mortgage on a property sold by the seller on an installment basis are deductible.

Refer to Pennsylvania Personal Income Tax Guide, Chapter 12, Net Gains (Losses) From the Sale, Exchange, or Disposition of Property and Chapter 30, Pennsylvania Department Of Revenue Personal Income Tax Policy Guidance.

4. Interest earned on the deposit of rents (*i.e.* tenant security deposits) is classified as interest income unless the interest earned is used to operate or maintain the rental property and is not returnable with the return of escrow funds. If the interest earned is actually used to operate or maintain the rental property, then such interest is classified as net income (loss) from rents, royalties, copyrights

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and patents. Likewise, expenses incurred to operate or maintain a rental property are classified as net income (loss) from rents, royalties, copyrights and patents. Refer to Pennsylvania Personal Income Tax Guide, Chapter 13, Net Income or Loss From Rents, Royalties, Copyrights and Patents.

II. INDIVIDUALS

A. Interest Income

An individual taxpayer classifies ordinary interest earned from savings accounts, personal checking accounts, bank accounts and other investments as interest income.

B. Expenses Incurred to Generate Interest Income

Pennsylvania law does not permit the deduction of any expenses that an individual taxpayer incurs to realize ordinary interest income.

C. Uniform Gifts to Minors Act

Interest, dividends or any other income earned by accounts set up under the Uniform Gifts to Minors Act must be reported on the tax return of the child.

D. Other Income Taxable As Interest

Other income taxable as interest includes:

- Distributions from IRC Section 529 Qualified Tuition Programs for non-educational purposes;
- Distributions from Health/Medical Savings Accounts included in federal taxable income;
- Interest income from PA S corporations and partnership(s), from PA Schedule(s) RK-1.

III. INVESTMENT

A. General

Interest generated by investments of an individual such as interest income received during the taxable year from savings and loan associations, credit unions, bank deposits, bonds, certificates of deposit, interest-bearing checking accounts, tax refunds, mortgages or other obligations is classified as interest income. No deductions are permitted against income classified as interest income. Generally, federal Form 1099-INT, issued by financial institutions, will indicate the amount of interest received or credited from or by such institutions.

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B. Burial Fund Earnings

Burial fund earnings are taxable income for Pennsylvania residents when the funeral home holds the account in the name of the taxpayer to pay the future funeral expenses of the taxpayer. Irrevocable burial funds are not taxable to the taxpayer. The funeral home reports the income as the custodian of the account on the *PA-41, Fiduciary Income Tax* return.

C. Insurance Companies

Interest income on dividends from insurance companies, whether disbursed or not, is taxable as interest income.

D. IRA, Keogh Accounts, or Pension Trusts

Undistributed unearned income accruing in IRA, Keogh Accounts or Pension Trusts is not taxable as interest income.

E. Amounts Paid Under Contract of Life Insurance, Endowment or Annuity

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 July 7, 2005. Act 40 also provides 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. Refer to Pennsylvania Personal Income Tax Guide, Chapter 12, Net Gains (Losses) From the Sale, Exchange or Disposition of Property for the old rules for annuities.

F. Charitable Gift Annuities

Income received from a charitable gift annuity contract for which the annuity was entered into or given for tax years beginning after Dec. 31, 2004 or from which the first payment from such contract to the taxpayer is received in a tax year beginning after Dec. 31, 2004, is calculated in the same manner as it is for federal income tax purposes and reported as interest income for Pennsylvania personal income tax purposes. Income received from charitable gift annuity contracts entered into prior to Jan. 1, 2005, is taxable in the same manner as gain on sale, exchange or disposition of property. Refer to Pennsylvania Personal Income Tax Guide, Chapter 12, Net Gains (Losses) From the Sale, Exchange, or Disposition of Property.

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IV. INTEREST GENERATED FROM RENTS, ROYALTIES, PATENTS AND COPYRIGHTS

A taxpayer classifies interest earned on the deposit of rents (i.e. tenant security deposits) as interest income unless the interest earned is used to operate or maintain the rental property. If the interest earned is actually used to operate or maintain the rental property, then such interest is classified as net income (loss) from rents, royalties, patents and copyrights. Refer to Pennsylvania Personal Income Tax Guide, Chapter 13, Net Income or Loss From Rents, Royalties, Copyrights and Patents.

V. INTEREST FROM INSTALLMENT SALE OF PROPERTY

A taxpayer classifies interest that he or she realizes from the sale of property on an installment basis as net gain (loss) on the sale, exchange or disposition of property. Refer to Pennsylvania Personal Income Tax Guide, Chapter 12, Net Gains (Losses) From the Sale, Exchange or Disposition of Property.

VI. IMPUTED INTEREST AND ORIGINAL ISSUE DISCOUNT (OID)

Imputed interest is taxable under Pennsylvania personal income tax law. Imputed interest is the implied interest on an obligation where the instrument does not provide for interest or the interest rate is below the applicable federal rate (AFR). For example, on an original issue discount bond (OID), a stripped bond, or a certificate of deposit (CD) maturing in several years where interest is received at maturity, the imputed or accrued interest (discount on original issue discount bond) is reported each year for Pennsylvania personal income tax purposes.

Pennsylvania and federal rules for imputed and accrued interest are the same. Under Pennsylvania law (Act 68 of 1993) for tax years beginning on or after Jan. 1, 1993, original issue discount is calculated in the same manner as it is calculated for federal income tax purposes. For the purpose of determining taxable gain or income from the sale, exchange or disposition of original issue discount bonds, a holder's adjusted basis is increased by the amount of original issue discount bond accrued with respect to such bonds and is adjusted downward, but not below zero, by the amount of payments under the original issue discount bond, other than payments of stated interest.

The applicable Pennsylvania regulations require that unstated or imputed interest be calculated in the same manner as it is calculated for federal income tax purposes. The Pennsylvania Department of Revenue's policy is to look at federal rules regarding the transactions that result in or that are exempt from unstated or imputed interest, how unstated or imputed interest is to be calculated and when it is realized. Consequently, any amount of unstated or imputed interest that includable in gross income for federal income tax purposes is subject to Pennsylvania personal income tax as interest income.

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VII. INTEREST FROM REFUNDS OF TAX OVERPAYMENTS

Interest paid to taxpayers on tax overpayments by the Pennsylvania Department of Revenue, the Internal Revenue Service or by local taxing authorities, is no different than any other taxable interest payments. Such interest is derived from "open accounts," not obligations that are statutorily free from state taxation. Therefore, interest paid to taxpayers on tax overpayments by the Internal Revenue Service, Pennsylvania Department of Revenue or any applicable state is taxable interest income in Pennsylvania.

VIII. TAX-EXEMPT INTEREST

Interest is not taxable income if received from direct obligations of the Commonwealth of Pennsylvania, its political subdivisions and authorities or the U.S. government and should not be reported on the *PA-40, Individual Income Tax* return. Likewise, interest from Series E, F, G, H, EE and HH bonds and federal treasury bills and notes are not taxable.

A. Obligations of Federal Agencies, Instrumentalities and Territories Exempt from Pennsylvania Personal Income Tax:

- Banks for Cooperatives, 12 USC §2134
- Federal District Banks for Cooperatives, 12 USC §2121
- Central Banks for Cooperatives, 12 USC §2121
- Commodity Credit Corporation, 15 USC §713a-5
- Farm Credit System Capital Corporation: Consolidated Obligations, 12 USC §2278a-11 (replaces 12 USC §2216k)
- Farm Credit System Joint Stock Banks, 12 USC §2023 (12 USC §931 replaced by 12 USC §2055, replaced by 12 USC §2023)
- Farm Credit System Land Banks and Land Bank Associations, 12 USC §2023
- Federal Crop Insurance Corporation, 7 USC §1511
- Federal Deposit Insurance Corporation, 12 USC §1825
- Federal Farm Credit Banks (merger of Federal District Intermediate Credit Banks and Federal Land Banks, 12 USC §2011), 12 USC §2023
- Federal Financing Bank, 12 USC §2290(b)
- Federal Home Loan Banks, 12 USC §1433
- Federal Land Bank Associations, 12 USC §2098
- Financing Corporation, 12 USC §1441(e)(8)
- General Insurance Fund, issued under Armed Services Mortgage Insurance, 12 USC §1748(b)(f) National Defense Housing Insurance, 12 USC §1750c(d) Rehabilitation and Neighborhood Conservation Housing Insurance, 12 USC §1715k(h)(7) Rental Housing Insurance Fund, 12 USC §1747 Rental Housing Insurance Fund Mortgage Insurance, 12 USC §1713(i) War Housing Insurance law, 12 USC

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- §§1739(d) and 1744(e) Insurance of Loans for Manufacture of Houses, 12 USC §1739 Mortgage Insurance Benefits, 12 USC §1750c
- Government of the Northern Mariana Islands, 48 USC §1801, and Covenant to Establish a Commonwealth of the Northern Mariana Islands in a Political Union with the U.S. States Article IV 607(a)
- Government of Puerto Rico, 48 USC §745
- Government of Virgin Islands, 48 USC §§1403, 1574(b)(iii)(A)
- Government of Guam, 48 U.S.C. §1423a
- Public Building Trust Participation Certificates, 31 USC §3124(e)
- Mutual Mortgage Insurance Fund, 12 USC §1710(d)
- National Credit Union Administration Central Liquidity Facility, 12 USC §1795k(b)
- Production Credit Associations, 12 USC §2077
- Public Housing Agencies, 42 USC §§1437i, 1437c(g)
- Resolution Funding Corporation (REFCORP), 12 USC §1441b(f)(7)
- Student Loan Marketing Association, 20 USC §1087-2(l)
- Tennessee Valley Authority, 16 USC §831n-4(d)
- U.S. Postal Service, 39 USC §2005(d)(4)
- U.S. Treasury Bonds, Notes, Bills, Certificates, and Savings Bonds, 31 USC §§3124, 3102-3106, 3109

B. Obligations of Federal Agencies, Instrumentalities and Territories Not Exempt from Pennsylvania Personal Income Tax

Unless they are issued to the Secretary of the Treasury and all purchases and sales by the Secretary of the Treasury of such obligations is treated as public debt transactions of the U.S., the following obligations of federal agencies, instrumentalities or territories are not exempt from taxation on interest or gain under the Pennsylvania Personal Income Tax Act:

- Agricultural Credit Insurance Fund (Agricultural Credit), 7 USC §1929(c)
- Pacific Northwest Transmission (Bonneville Power Administration), 16 USC §838k(c)
- Electric and Hybrid Vehicle Development Fund, 15 USC §2509(e)(3)(c)
- Export-Import Banks, 12 USC §635b
- Federal Financing Bank, 12 USC §2288
- Federal Home Loan Mortgage Corporation, 12 USC §1455(g)
- Federal National Mortgage Association, 12 USC §§1719(e), see 1723a(c) (Fannie Mae)
- Federal Ship Financing Fund (Merchant Marine Act), 46 USC §1275(d)
- Geothermal Resources Development Fund (Geothermal Research), 30 USC §1144
- Government National Mortgage Association, 12 USC §§1723(c); see 1723a(c) (Ginnie Mae)

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- Merchant Marine Obligations (Maritime Administration), 46 USC §1271
- U.S. Housing Authority, Low-rent Housing, 42 USC §1437b
- Pension Benefit Guarantee Corporation, 29 USC §1305(c)
- Rural Development Insurance Fund, 7 USC §1929a(d)
- Rural Housing Insurance Fund, 42 USC §1487(h)
- Rural Telephone Bank, 7 USC §947(b)
- Securities Investor Protection Corporation (Securities Investor Production Fund), 15 USC §78ddd(h)
- Small Business Administration, 15 USC §633(c)(5)(A)
- Synthetic Fuels Corporation, 42 USC §8795(c)
- U.S. States Railway Association, 45 USC §720(e)

C. STRIPS, CATS, ETRS, LIONS, FICOS and Other Stripped-Exempt Bonds

The federal-taxable income or gain derived from exempt bonds that are issued with interest coupons where there is a separation in ownership between the bond and any coupon that has not yet become payable is taxable as follows:

1. The tax-exempt portion of the original issue discount with respect to the stripped coupon or stripped bond is the excess of the stated redemption price at maturity (or in the case of a coupon, the amount payable on the due date of the coupon), over an issue price that would produce a yield on the maturity as of the purchase date (of the stripped coupon or stripped bond) equal to the lower of the coupon rate of the tax-exempt obligation from which the coupons were separated or the yield to maturity on the basis of the purchase price of the stripped coupon or stripped bond.
2. The remaining portion of the discount is treated as original issue discount with respect to an obligation that is not tax-exempt and as imputed interest.

D. Example

A tax-exempt obligation with a face amount of \$100 due Jan. 1, 1990 and with a coupon rate of 10 percent compounded semi-annually is issued for \$100 on Jan. 1, 1987 and is stripped on Jan. 1, 1989. The right to receive the principal amount is sold for \$79.21, reflecting a yield to maturity at the time of the strip of 12 percent compounded semi-annually. The tax-exempt portion of discount on the stripped bond is limited to \$17.73, the difference between the stated redemption price of \$100 and the issue price that would produce a yield to maturity of 10 percent (\$82.27). This portion of the discount on the stripped bond in excess of the tax-exempt portion is \$3.06, equal to the excess of total discount (\$20.79) over the tax-exempt portion. This portion of the discount is treated as original issue discount bond with respect to an obligation that is not tax-exempt.

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- E. Gain (Loss) from the Sale, Exchange or Disposition of Tax-Exempt Obligations**
Gain (loss) on the sale, exchange or disposition of tax-exempt obligations issued by the Commonwealth, a public authority, commission, board or other agency created by the Commonwealth, a political subdivision or obligations exempt from state taxation under the laws of the U.S. only with respect to obligations issued on or after Feb. 1, 1994, is taxable in Pennsylvania.

The tax-exempt portion of the original issue discount bond with respect to a stripped coupon or stripped bond is the excess of the stated redemption price at maturity (or in the case of a coupon, the amount payable on the due date of the coupon), over an issue price that would produce a yield to maturity as of the purchase date equal to the lower of (1) the coupon rate of the tax-exempt obligation from which the coupons were separated, or (2) the yield to maturity (on the basis of the purchase price) of the stripped coupon or stripped bond. The taxpayer can elect to use the original yield to maturity instead of the coupon rate for these purposes.

For Pennsylvania personal income tax purposes, a premium paid on a bond is deemed to be an investment in the bond to obtain the higher bond interest rate. Further, each interest payment on the bond is deemed to be a partial interest payment and a partial return of the bondholder's investment.

Consequently, the basis of a bond (whether the bond interest is taxable or exempt from Pennsylvania personal income tax) includes any premium paid on the bond. For each interest payment, the owner of the bond must amortize the bond premium according to the accepted accounting principles and practices consistently used by the taxpayer (such as straight-line, effective interest rate method, constant yield method, etc.) Further, the taxpayer must allocate the amortized amount to each interest payment to reflect the return of bond premium. The taxable bond interest is the difference between the total interest payment and the allocated bond premium amount. Because the allocated bond premium amount is a return of the bond owner's investment, the owner must also reduce his basis in the bond by the amount of the allocated bond premium. The owner must reduce his basis regardless of whether the reduction in the interest payment results in a reduction of tax (in the case of a taxable bond) or does not result in a reduction in tax (in the case of a tax-exempt bond).

- F. Other States**
Interest on obligations of other states, territories and their political subdivisions, and instrumentalities is taxable for Pennsylvania personal income tax purposes.
- G. Repurchase Agreements**
Interest earned from repurchase agreements ("REPOS") is not tax-exempt interest income; and interest received on obligations, which are only guaranteed by the federal government, is subject to tax.

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IX. DISTRIBUTIONS FROM MONEY MARKET FUNDS, MUTUAL FUNDS AND OTHER INVESTMENT COMPANIES

Taxable distributions from the earnings and profits of money market or mutual funds, investment trusts and investment companies must be reported as dividend income not interest income. This rule applies even if the company is a fixed portfolio investment trust, separate portfolio trust and other entity whose governing instrument prevents varying the portfolio investments except to:

1. Eliminate unsafe investments and investments not consistent with the preservation of the capital or the tax status of the investments of the fund;
2. Honor redemption orders, meet anticipated redemption requirements, and negate gains from discount purchases;
3. Maintain a constant net asset value per unit pursuant to, and in compliance with, an order or rule of the U.S. Securities and Exchange Commission;
4. Reinvest the earnings from securities in like securities, or;
5. Defray normal administrative expenses.

X. FORFEITED INTEREST PENALTY

Pennsylvania considers the premature redemption of a certificate of deposit or a time savings account to be a disposition of property. Any forfeited interest penalty incurred may be used to offset the interest accounts from only the certificate or account that was redeemed (that is, the forfeited interest penalty may not be offset against other interest income). If the penalty exceeds unpaid interest accrued from the certificate or deposit, the excess should be reported on *PA-40 Schedule D Sale, Exchange or Disposition of Property* as a loss from the disposition of property. This loss may be used to offset other gains, if any. If the interest paid exceeds the penalty, the excess is reportable as interest income.

XI. TRUST OTHER THAN A BUSINESS TRUST

For Pennsylvania personal income tax purposes, if a trust other than a business trust invests in U.S. government obligations, then all the income from such obligations will retain their exempt status when passed through to the owners of the trust.

XII. PA-40 SCHEDULE A – PENNSYLVANIA-TAXABLE INTEREST INCOME

A. Interest Reported on PA-40 Individual Income Tax Return

All interest income must be reported on the *PA-40 Individual Income Tax* return.

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B. PA-40 Schedule A - Required if Interest Exceeds \$2,500

If a taxpayer receives interest income of more than \$2,500, a *PA-40 Schedule A, PA Taxable Interest Income* must be completed and filed.

C. Report All Interest Received

Taxpayers should include all interest income received during the taxable year from savings and loan associations, credit unions, bank deposits, bonds, certificates of deposit, interest-bearing checking accounts, tax refunds, mortgages or other obligations. Generally, federal Form 1099-INT, issued by financial institutions, will indicate the amount of interest received or credited from or by such institutions. Interest received on obligations, which are only guaranteed by the federal government, is subject to tax.

XIII. TABLE 1 INTEREST INCOME - RESIDENTS VS. NONRESIDENTS

Interest Income: Residents vs. Nonresidents		
Type of Interest	Pennsylvania Resident	Pennsylvania Nonresident
Saving or other bank deposits	Taxable as interest income	Not reportable for Pennsylvania personal income tax
Coupon bonds	Taxable as interest income	Not reportable for Pennsylvania personal income tax
Open accounts	Taxable as interest income	Not reportable for Pennsylvania personal income tax
Promissory notes	Taxable as interest income	Not reportable for Pennsylvania personal income tax
Mortgages	Taxable as interest income	Not reportable for Pennsylvania personal income tax
Corporate bonds	Taxable as interest income	Not reportable for Pennsylvania personal income tax
Debentures	Taxable as interest income	Not reportable for Pennsylvania personal income tax
Interest on legacies or life insurance proceeds	Taxable as interest income	Not reportable for Pennsylvania personal income tax

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Table 1 (con'd)

Interest Income: Residents vs. Nonresidents		
Type of Interest	Pennsylvania Resident	Pennsylvania Nonresident
Interest on legacies or life insurance proceeds* Refer to Act 40–2005 changes discussed in Part III C. above.	Taxable if taxable for federal; however for Pennsylvania personal income tax, taxed as interest income	Not reportable for Pennsylvania personal income tax
Interest on tax refunds	Taxable as interest income	Not reportable for Pennsylvania Personal Income Tax
Interest on U.S. obligations – Direct ownership	Not taxable	Not reportable for Pennsylvania Personal Income Tax
Interest on other states' obligations or political subdivisions	Taxable as interest income	Not reportable for Pennsylvania Personal Income Tax
Unstated or imputed interest, including government obligations (original issue discount)	Taxable as interest income	Not reportable for Pennsylvania Personal Income Tax
GNMA	Taxable as interest income	Not reportable for Pennsylvania Personal Income Tax
FNMA	Taxable as interest income	Not reportable for Pennsylvania Personal Income Tax