

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

CHAPTER 16: PASS THROUGH ENTITIES

TABLE OF CONTENTS

I. PARTNERSHIPS.....	5
A. Definition of a Partnership	5
1. Partnership For Pennsylvania Personal Income Tax Purposes	5
2. Organizations Not Treated as a Partnership.....	5
B. Differences Between Federal Tax Law and Pennsylvania Tax Law.....	5
C. PA-20S/PA-65 PA S Corporation/Partnership Information Return and Schedules	6
1. Filing Requirements – Partnership.....	6
2. PA-65 Corp – Directory of Corporate Partners.....	7
D. Processible Returns.....	8
E. Withholding of Estimated Quarterly Pennsylvania Personal Income Tax on the Distributable Income of a Resident Individual	8
F. Withholding of Quarterly Pennsylvania Personal Income Tax on the Distributable Income of a Nonresident Individual, Estate or Trust.....	8
G. Final/Catch-Up Payment of Nonresident Withholding Tax	9
H. Mailing Address for the Nonresident Withholding Payment	10
I. Operations of a Partnership	11
1. Elections	11
2. Federal Optional Adjustments to Basis.....	11
3. Determining a Partner’s Distributive Share.....	11
4. Guaranteed Payments to Partners	11
5. Guaranteed Payments Example	12
6. Guaranteed Payments to a Retired Partner	13
7. Federal Limitations on the Taxation of Retirement Income of Nonresident Partners	13
8. Cancellation of Indebtedness Income	14
9. Allocation of Partnership Income and Losses	14
J. Formation and Termination of a Partnership.....	14
1. Tax Free Formation of a Partnership.....	14
2. Contributions in Exchange for an Interest in a Partnership.....	14
3. Partnership Distributions in Complete Liquidation.....	15
4. Dissolving a Partnership	15
K. Basis of a Partner’s Interest in a Partnership	16
1. Definition of Outside Basis	16
2. Definition of Inside Basis	17
3. General Rules – Resident Partner.....	17
4. Examples	18
5. Basis Calculation	19
6. Increase in Basis.....	19
7. Decrease in Basis.....	20

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

8. Basis - Ordering Rules	20
9. No Carry-Forward or Carry-Back of Losses	20
10. No Offsetting Income (Loss) in More than One Class of Income	20
11. General Rules – Nonresident Partner	20
12. PA-20S/PA-65 Schedules RK-1 and NRK-1	21
L. Distributions of Cash, Property and Marketable Securities	21
1. Income to Partner	21
2. Non-liquidating Distributions from Partnership to Partner	22
3. General Rules Regarding the Treatment of Partner or Partnership Liabilities	22
M. Debt Limitation	24
N. IRS Investment Tax Credits	24
O. Tax Benefit Rules	24
1. Sole Proprietor	25
2. Partner	25
II. PENNSYLVANIA S Corporations	25
A. Definition of a PA S Corporation	25
1. Statutory Definition	25
2. Small Corporation	25
B. Differences Between Federal Tax Law and Pennsylvania Tax Law	26
C. PA-20S/PA-65 PA S Corporation/Partnership Information Return and Schedules	26
1. Filing Requirements – PA S Corporation	26
D. Processible Returns	27
E. Withholding of Estimated Quarterly Pennsylvania Personal Income Tax on the Distributable Income of a Resident Individual, Estate or Trust	27
F. Withholding of Quarterly Pennsylvania Personal Income Tax on the Distributable Income of a Nonresident Individual, Estate or Trust	28
G. Final/Catch-Up Payment of Nonresident Withholding Tax	28
H. Mailing Address for the Nonresident Withholding Payment	29
I. Operations of a PA S Corporation	30
1. How Does a Corporation Become a PA S Corporation	30
2. Effect of PA S Corporation Status	30
3. Election Not to Be Taxed as a PA S Corporation	31
4. Pennsylvania Resident Shareholders of S Corporations in Another State	31
5. Revocation of Election Not To Be Taxed as a PA S Corporation	31
6. Qualified Subchapter S Subsidiaries (QSSS)	32
J. Termination of a PA S Corporation	34
1. Corporate Distributions in Complete Liquidation	34
K. Termination of PA S Corporation Status	34
L. PA S Corporation Revocation or Termination Year	34
1. PA-20S/PA-65 Information Return Short Taxable Year Return	35
2. RCT-101, PA Corporate	35
3. Division of Income	35
M. Allocation of Income	36
1. Cancellation of Debt Income	36
2. Built-In Gains	36
3. Gain Rules	37

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

N. Basis of a Shareholder's Interest in a PA S Corporation	37
1. Figuring Shareholder Taxable Income (Loss)	37
2. Pennsylvania Does Not Permit Offsetting Between the Classes of Income (Losses).....	37
3. Adjustments to Basis of Stock (Shareholders' Capital Investment)	37
O. Shareholder Adjustments to Basis of Indebtedness (Shareholder's Loans to PA S Corporations)	39
1. Reduction in Basis of Indebtedness.....	39
2. Restoring Basis.....	39
P. Adjustments to Basis for PA S Corporation Distribution.....	39
1. Determine Stock and Loan Basis	39
Q. PA S Corporation Distributions	40
1. Distributions to Residents.....	40
2. Distributions to Nonresidents	41
3. Distribution of Appreciated Property.....	41
4. PA-20S/PA-65 Schedule RK-1 and NRK-1	41
R. Accumulated Adjustments Account	41
1. Pennsylvania Personal Income Tax Accumulated Adjustments Account.....	41
2. Distributions from Pennsylvania Accumulated Adjustments Account.....	42
3. Distributions of Cash, Marketable Securities, and Property (other than distribution from Pennsylvania Accumulated Earnings and Profits)	42
4. Accumulated Adjustments Account Distributions May Exceed Shareholder Basis	42
5. Negative Accumulated Adjustments Account	42
S. Accumulated Earnings and Profits	43
T. IRC Section 338(h)(10) Elections Not Permitted	44
U. Treatment of Life Insurance Proceeds Received by a PA S Corporation Where S Corporation Paid Premiums	45
1. Proceeds Used to Fund a Buy or Sell Arrangement	45
2. Proceeds Used to Buy-Out a Decedent's Interest	45
3. Proceeds Used to Continue Business or Secure Loans	45
III. Bonus Depreciation.....	45
A. Other Depreciation Expense Difference	45
B. IRC Section 179 Property Deductions.....	46
IV. Apportionment.....	46
A. How to Apportion Income From a Business, Profession or Farm Derived From Sources within Pennsylvania, Wholly Outside Pennsylvania, or Partly Within Pennsylvania..	46
1. Operation Wholly Within Pennsylvania.....	46
2. Operation Wholly Outside Pennsylvania	47
3. Operation Partly Within Pennsylvania	48
B. Real Estate and Tangible Property (Property Factor)	48
C. Wages, Salaries, Commissions, and Other Compensation (Payroll Factor)	49
D. Sales (Sales Factor)	50
E. Allocating Gains or Losses from the Disposition of Tangible Property	51
F. Gains or Losses from the Disposition of Intangible Personal Property.....	51
G. Interest Income.....	52
H. Dividend Income	52
I. Rental Income From Real Estate	53
J. Rental Income From Tangible Personal Property.....	53
K. Royalties from Real Property	53

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

L. Royalties From Patents and Copyrights	53
M. Allocating Income from Estates and Trusts	53
V. LIMITED LIABILITY COMPANY (LLC).....	54
VI. PA-20S/PA-65 SCHEDULE M.....	55
A. Reconciliation of Federal Taxable Income to Pennsylvania-Taxable Income.....	55
B. PA-20S/PA-65 Schedule M, Part A	55
1. Classifying Federal Income (Loss) for Pennsylvania Personal Income Tax Purposes	55
2. Pass Through Income from Another Pass Through Entity.....	56
3. Partnership Example.....	56
4. PA-20S/PA-65 Schedule M, Part B	56
VII. PENALTIES, ADDITIONS AND FEES.....	56
VIII. FRAUDULENT INVESTMENT SCHEMES	57
IX. TABLES.....	59
Table 16-1- Schedule of Differences Between Federal Tax Law and Pennsylvania Personal Income Tax Law for Partnerships	59
Table 16-2- Schedule of Differences Between Federal Tax Law and Pennsylvania Personal Income Tax Law for Partner’s Outside Basis Calculation	62
Table 16-3- Schedule of Differences Between Federal Tax Law and Pennsylvania Personal Income Tax Law for PA S Corporations	63
Table 16-4- Schedule of Differences Between Federal Tax Law and Pennsylvania Personal Income Tax Law for S Corporation’s Outside Basis Calculation	66
Table 16-5- PA Filing Requirements for Corporate Net Income Tax and Personal Income Tax Purposes.....	67
Table 16-6- Reporting Gain (Loss) For Pennsylvania Personal Income Tax Purposes.....	69
Table 16-7- PA Partnerships and PA S Corporations Entity Distinctions	71
Table 16-8- Classified Federal Schedule K Lines for Pennsylvania Personal Income Tax Purposes	72
X. BASIS Worksheets.....	73
REV-998 – Shareholder Tax Basis in PA S Corporation Stock Worksheet and REV-999 – Partner PA Outside Tax Benefit in a Partnership Worksheet	
XI. TAX WORKSHEET FOR NON PENNSYLVANIA TAXES PAID ON INCOME (SCHEDULE M).....	71
REV-1190, Tax Worksheet for PA-20S/PA-65 Schedule M, Part B, Section E, Line a	

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

CHAPTER 16: PASS THROUGH ENTITIES

I. PARTNERSHIPS

A. Definition of a Partnership

A partnership, for Pennsylvania personal income tax purposes, is any unincorporated entity that is classified as a “partnership” for federal income tax purposes, such as:

1. Partnership For Pennsylvania Personal Income Tax Purposes

A domestic or foreign general partnership, joint venture, limited partnership (LP), limited liability partnership (LLP), limited liability company (LLC), business trust, investment club or other unincorporated entity that for federal income tax purposes is classified as a partnership.

2. Organizations Not Treated as a Partnership

The term “partnership” does not include the following kinds of organizations:

- a. Condominium management associations, residential real estate management associations, or similar organizations provided that no part of the income inures, other than by enhancing the value of the property of the association or its members, to the benefit of any member,
- b. Political organizations, or
- c. Organizations described in IRC §501(c).

Note. For tax year 2005 and forward, an investment club that derives all of its receipts for the taxable year from either federally taxable portfolio interest income or dividends or from the sale and exchange of securities, is considered a partnership for Pennsylvania purposes and is required to file a PA-20S/PA-65 Information Return.

B. Differences Between Federal Tax Law and Pennsylvania Tax Law

For each class of income there are differences in reporting requirements for federal income tax and Pennsylvania personal income tax.

Within each class of income there are certain IRC sections, including elections for federal income tax, that are not allowed in arriving at reportable income for Pennsylvania personal income tax purposes.

Within each class of income there are specific rules for Pennsylvania personal income tax purposes that differ from federal income tax rules.

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

Within each class of income there are circumstances where Pennsylvania will accept the use of federal tax accounting rules provided they are consistently used and applied. See [Table 16-1–Schedule of Differences Between Federal Tax Law and PA PIT Tax Law for Partnerships](#) in Part VI - TABLES, for specific circumstances where Pennsylvania may accept the use of consistently applied federal treatment.

C. PA–20S/PA–65 PA S Corporation/Partnership Information Return and Schedules

1. Filing Requirements – Partnership

Every domestic or foreign partnership (72 P.S. § 7335(c)) or an entity formed as a limited liability company that is classified as a partnership for federal income tax purposes must file the *PA-20S/PA-65 PA S Corporation/Partnership Information Return (PA-20S/PA-65 Information Return)* if either of the following apply:

- a. During the taxable year, the partnership earned, received, or acquired any gross taxable income (loss) allocable or apportionable to Pennsylvania, regardless of the amount of its income (loss) and/or whether or not the income was distributed.
- b. The partnership, at year end, had at least one partner that was a Pennsylvania resident individual, estate, trust, or disregarded entity owned by a resident individual or another pass through entity such as a partnership, PA S corporation or limited liability company.

A partnership must file a PA-20S/PA-65 Information Return to report the income, deductions, gains, losses etc. from their operations. The partnership passes through any profits (losses) to the resident and nonresident partners. Partners include their share of the income (loss) on form *PA-40 Individual Income Tax Return*, *PA-41 Fiduciary Income Tax Return*, or other Pennsylvania returns.

A partnership with operations within Pennsylvania whose partners are all C corporations must provide to the department a complete copy of its federal Form 1065. Such a partnership must submit a *PA-65 Corp, Directory of Corporate Partners*, and **does not** complete a PA-20S/PA-65 Information Return. See [PA-65 Corp.](#)

Each partnership must submit with the PA-20S/PA-65 Information Return a complete copy of its federal income tax return including all schedules, statements, federal Schedules K-1, and PA-20S/PA-65 Schedules RK-1 and NRK-1 received as an owner in other pass through entities such as a partnership, PA S corporation or limited liability company. With the PA-20S/PA-65 Information Return, the partnership must also submit copies of the PA-20S/PA-65 Schedules RK-1 that it provides to resident partners and copies of the PA-20S/PA-65 Schedules NRK-1 that it provides to nonresident partners. If the entity is a

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

limited liability company, filing as a partnership, and the limited liability company has already forwarded a complete copy of its federal return to the Bureau of Corporation Taxes, with the RCT-101, PA Corporate Tax Report, do not send another copy.

A partnership or limited liability partnership (LLP), jointly owned by husband and wife that elects to file on federal Form Schedule C, E or F with the Internal Revenue Service (IRS) files PA-40 Schedule C, E, or F with the *PA-40 Individual Income Tax Return* for Pennsylvania.

Partners are not employees and are not issued a W-2 form. The partnership must furnish copies of PA-20S/PA-65 Schedule RK-1 and/or NRK-1 to the partners before the PA-20S/PA-65 Information Return is required to be filed, including extensions.

The taxable year of a partnership with respect to a partner ends at the close of business on the day of:

- a. Disposition, when the partner sells his or her entire interest in the partnership;
- b. Redemption, when the partner liquidates his or her entire interest in the partnership; or
- c. The date of death of the partner.

The partnership apportions items of income, gain and expense or loss to a partner only for that portion of the partnership-year when the partner was a member. It may be necessary to divide the partnership-year into daily or other segments and treat each such segment as a separate accounting period in order to satisfy this rule.

2. PA-65 Corp – Directory of Corporate Partners

A partnership or limited liability company filing as a partnership must complete the PA-65 Corp - Directory of Corporate Partners if the partnership has income (loss) from operating a business, profession or farm within Pennsylvania, and/or income (loss) from the ownership of property within Pennsylvania and either of the following applies:

- a. If the entity has any partner that is a nonfiling corporation subject to corporate net income tax, and the partnership is making corporate net income tax withholding payments on behalf of its nonfiling corporate partner, or
- b. All of its partners are corporations.

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

Refer to the *PA-65 Corp* instructions on the department's website.

The PA-65 Corp, Directory of Corporate Partners, must be mailed separate from all other PA returns. Do not send corporate net income tax withholding payments to the Bureau of Corporation Taxes. See **Where To File** in the instructions for the PA-65 Corp, Directory of Corporate Partner on the department's website.

Any excess withholding will be refunded when the corporation's RCT-101, PA Corporate Tax Report, is filed and processed. The refund will be sent to the corporate partner and not the partnership submitting the payment.

D. Processible Returns

The PA-20S/PA-65 Information Return for a partnership must satisfy all requirements found in the PA-20S/PA-65 instructions. The applicable PA-20S/PA-65 Schedules RK-1 and NRK-1 are required attachments for resident and nonresident owners' share of income, deductions, credits, etc. The partnership must also submit the PA-20S/PA-65 Schedules RK-1 and NRK-1 that it received as an owner in other entities. Refer to *Miscellaneous Tax Bulletin 2008-02 Reproduced Forms and Substitute Forms*.

E. Withholding of Estimated Quarterly Pennsylvania Personal Income Tax on the Distributable Income of a Resident Individual, Estate or Trust

Individual resident partners are subject to the estimated quarterly tax provisions under the Pennsylvania Personal Income Tax Act. Resident partners must make declarations and estimated quarterly Pennsylvania tax payments if they reasonably expect income, other than compensation on which Pennsylvania tax is withheld, to exceed \$8,000. Individual partners should refer to *REV-413I, Instructions for Estimating PA Personal Income Tax for Individuals Only*.

F. Withholding of Quarterly Pennsylvania Personal Income Tax on the Distributable Income of a Nonresident Individual, Estate or Trust

Under Act 22 of 1991, a partnership with partners or members who are nonresident individuals, nonresident estates, or nonresident trusts (owners) must withhold and pay Pennsylvania personal income tax on each owner's expected share of distributable Pennsylvania-source taxable income. If making a quarterly withholding payment for the first time, use *PA-40 ESR (F/C,) Declaration of Estimated or Estimated Withholding Income Tax For Fiduciary or Partnerships*. The partnership makes the initial quarterly withholding payment and all future quarterly withholding payments under the employer identification number, name and address of the partnership.

The entity should refer to *REV-413P/S, Instructions for Withholding PA Personal Income Tax from Nonresident Owners by Partnerships and PA S corporations*.

Note. An entity may not withhold Pennsylvania personal income tax for another entity or a Pennsylvania resident individual, and should not withhold Pennsylvania personal income tax on income from intangibles such as interest, dividends, or sale of stock.

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

G. Final/Catch-Up Payment of Nonresident Withholding Tax

If the Pennsylvania personal income tax due on the taxable income allocable to nonresidents exceeds the tax withheld, the final payment is due on the date prescribed for the filing of the PA-20S/PA-65 Information Return, PA-40 Nonresident Consolidated Income Tax Return or with an extension request.

If the tax of the nonresident owners exceeds the nonresident withholding tax payments, the partnership must pay the deficiency by the date prescribed for filing the entity's PA-20S/PA-65 Information Return or if the nonresident owners elect to file a PA-40 Nonresident Consolidated Income Tax Return, the entity may make the final/catch-up payment with the PA-20S/PA-65 Information Return, PA-40 Nonresident Consolidated Income Tax Return or with an extension request.

There are three ways to make a final withholding tax payment or final catch-up payment for nonresident owners that are individuals, estates, or trusts. Follow these instructions:

1. With Approved Software Form

If using approved software, submit payment along with the 20XX Nonresident Withholding Payment substitute voucher in the same envelope with the PA-20S/PA-65 Information Return, PA-40 Nonresident Consolidated Income Tax Return. Do not staple payment to your return or the substitute voucher.

2. Without Approved Software Form

- a. Submit payment with the PA-20S/PA-65 Information Return, PA-40 Nonresident Consolidated Income Tax Return. Print the entity's federal employer identification number (FEIN) and 20XX Final Nonresident Withholding on the check or money order made payable to the PA Dept. of Revenue.
- b. Submit payment in the same envelope with the PA-20S/PA-65 Information Return, PA-40 Nonresident Consolidated Income Tax Return or extension request. Do not staple payment to your return.

3. Fed/State e-File

The only acceptable electronic payment method for fed/state partnership e-file is electronic funds withdrawal which is part of the current tax year return submission and is automatically and electronically transferred from taxpayers' bank accounts.

The following types of payments can be electronically transferred with the PA-20S/PA-65 Information Return:

- a. final nonresident individual withholding tax "catch-up" payment submitted with the current tax year return; and

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

- b. the next tax year's (future) estimated payments for nonresident individual quarterly withholding tax submitted with the current tax year return.

These future estimated nonresident individual withholding tax payments for the next tax year will be stored in the system as separate electronic transaction payments until the specified due date.

Important. The nonresident individual quarterly withholding tax payment may not be submitted through Electronic Funds Transfer (EFT), credit/debit cards or e-TIDES.

H. Mailing Address for the Nonresident Withholding Payment

When submitting the final withholding payment or final "catch-up" payment with the PA-20S/PA-65 Information Return, with or without the 20XX Nonresident Withholding Payment substitute voucher, send to:

PA DEPARTMENT OF REVENUE
BUREAU OF INDIVIDUAL TAXES
PO BOX 280502
HARRISBURG PA 17128-0502

When submitting the final withholding payment or final "catch-up" payment with the PA-40 Nonresident Consolidated Income Tax Return, with or without the 20XX Nonresident Withholding Payment substitute voucher, send to:

PA DEPARTMENT OF REVENUE
CONSOLIDATED RETURN
PO BOX 280418
HARRISBURG PA 17128-0418

When submitting the final withholding payment or final "catch-up" payment with an extension request for any Pennsylvania tax return, send form REV-276 to:

PA DEPARTMENT OF REVENUE
BUREAU OF INDIVIDUAL TAXES
PO BOX 280504
HARRISBURG PA 17128-0504

Follow the instructions above, [With Approved Software Form](#) or [Without Approved Software Form](#).

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

I. Operations of a Partnership

1. Elections

Pennsylvania law determines income (loss) under accepted accounting principles and practices. The partnership, not the partners, makes the choices for calculating income (loss) from the partnership's activities. The partnership chooses the recognized methods of accounting, methods of calculating depreciation, capitalization of organizational fees, and the use of the installment sales provisions. All partnership elections are applicable equally to all partners but any election made by the partnership will not apply to any partner's other income or gain outside the partnership. Pennsylvania law does not provide for all the elections that partnerships and partners may make for federal purposes, including the elections under IRC § 614; 1031; 1033; 732(d); 734(b); 754; 743(b); 59(e); 108; 617; 901, and 6222(b).

2. Federal Optional Adjustments to Basis

For Pennsylvania purposes, the partnership may **not** adjust the basis of its property in the manner provided in IRC § 734(b) or IRC § 743(b). Pennsylvania does not permit the IRC § 732(d) or IRC § 754 election.

3. Determining a Partner's Distributive Share

The partnership may allocate each item of income (loss) by class to the partners in the same proportion that it uses for federal purposes. The partnership must submit a statement with its PA-20S/PA-65 Information Return explaining the reason for a different allocation method.

4. Guaranteed Payments to Partners

There are differences between federal tax law and Pennsylvania tax law for reporting guaranteed payments to partners. The partnership characterizes guaranteed payments to partners in the following manner:

- a. To the extent paid for services rendered directly in the production of income from a business, profession or farm, the guaranteed payments to the recipient are gross income from that specific income class. If the partnership does not deduct these guaranteed payments on its federal return, it may deduct them to determine net profits on the PA20-S/PA-65 Information Return, Part I.
 - For nonresidents a guaranteed payment is allocable or apportionable to Pennsylvania to the same extent as the net profits are allocable or apportionable to Pennsylvania.
- b. To the extent paid for services rendered directly in the production of rental or royalty income, the guaranteed payments are gross income from that income class to the recipient. If the partnership does not deduct

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

these guaranteed payments to determine rental income and royalty income on its federal return it may deduct them to determine rental and royalty income on the PA20-S/PA-65 Information Return, Part III.

- For nonresidents a guaranteed payment is allocable to Pennsylvania to the same extent as the rental and royalty income is allocable to Pennsylvania.
- c. To the extent paid for other services or for the use of capital, Pennsylvania classifies such distributions as:
- A withdrawal proportionately from the capital of all partners.
 - A return of capital by the recipient to the extent derived from his/her own capital. The distributions that the partnership makes that represent repayments of the partner's own capital are not income for Pennsylvania personal income tax purposes.
 - A gain from the disposition of the recipient's partnership interest and a loss from the disposition of the other partners' partnership interests, to the extent derived from the capital of the other partners.
 - Residents are taxed on 100 percent of their taxable gain.
 - For nonresidents a guaranteed payment for other services or for the use of capital is allocable to their state of residence. Nonresidents are not taxed on a guaranteed payment for the use of capital for Pennsylvania personal income tax purposes.
 - The partnership does not receive a deduction for a guaranteed payment if the guaranteed payment is for capital or other services.

5. **Guaranteed Payments Example**

Andy, Betty, and Carl are equal partners in ABC partnership. Andy manages the rental activities of the partnership and receives an annual guaranteed payment of \$5,000 for such services. Betty contributed the rental property to the partnership. She receives an annual guaranteed payment of \$15,000 for its use. ABC partnership received net rents of \$80,000 for the taxable year. The \$5,000 guaranteed payment to Andy is an allowable deduction from the net rents of the partnership and is taxable to Andy as gross rents. The partnership calculates Andy's total rental income as follows:

Guaranteed payment	\$ 5,000
Share of partnership net rents $(\$80,000 - 5,000) \div 3 =$	<u>\$25,000</u>
Total	\$30,000

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

Betty and Carl each have total rental income of \$25,000 ($\$80,000 - 5,000 \div 3$).

The guaranteed payment to Betty is a gain on the disposition of her partnership interest to the extent it is from Andy and Carl's capital. To the extent that the guaranteed payment is a return of Betty's own investment, it is a return of capital distribution. The partnership reflects this amount as guaranteed payments for capital on the *PA-20S/PA-65 Schedules RK-1 and NRK-1*. The return of capital distribution is not taxable if it does not exceed Betty's basis in the partnership.

6. **Guaranteed Payments to a Retired Partner**

If the Guaranteed payments to a retired partner meet the requirements of IRC § 1402 then the guaranteed payments to a retired partner may constitute nontaxable retirement benefits. 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:

- a. The above requirements are met, and
- b. The plan otherwise constitutes a qualifying retirement benefit plan.

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

- a. A distributive share of partnership income if the amount thereof is determined with regard to the income of the partnership,
- b. A guaranteed payment, or
- c. 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.

7. **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 § 114 of Title 4 of the U.S. Code. The 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:

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

- a. The payments must be provided for in a written plan, program, or arrangement that was in effect before the partner's retirement,
- b. The payments must be in recognition of prior service performed by the partner for the partnership, and
- c. 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.

8. Cancellation of Indebtedness Income

For additional information concerning cancellation of indebtedness, please refer to Pennsylvania Personal Income Tax Guide Chapter 24, Cancellation of Debt for Pennsylvania Personal Income Tax Purposes and related PIT Tax Bulletins 2009-02 through 2009-07.

9. Allocation of Partnership Income and Losses

A partner is taxed on " . . . his share, whether or not distributed, of the income or gain received by the partnership ", 72 P.S. § 7306. The partner's share of income (loss) is the same percentage as for federal income tax purposes. Because Pennsylvania does not have special partnership and partner rules or definitions, the department relies on the federal definition of "substantial economic effect." Where the allocation is consistent with the underlying economic arrangement of the partners and the allocation will substantially affect the dollar amount to be received by the partners, independent of any tax consequences, it is used or accepted. Absent such an effect, the department uses the partner's ownership interest for the allocation of income (loss).

J. Formation and Termination of a Partnership

1. Tax Free Formation of a Partnership

Federal law permits the tax-free formation of a partnership under IRC § 721. IRC § 721 is generally followed for Pennsylvania tax purposes.

2. Contributions in Exchange for an Interest in a Partnership

Neither the partnership nor its partners or members recognize gain or loss in the case of a contribution in exchange for an interest in the partnership, unless:

- a. The purpose of the contribution was to affect an exchange of property between two or more partners, or
- b. The contributing partner receives, in exchange for its contribution, an interest in the partnership plus other property or cash.

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

3. Partnership Distributions in Complete Liquidation

Generally the amounts received by a partner in the complete actual winding up of a partnership and distribution of its assets (or the proceeds from the sale of its assets) shall be treated as in full payment in exchange for the partner's interest in the partnership. Accordingly, if property is received in such a distribution, generally, the basis of the property in the hands of the distributee shall be the fair market value of such property at the time of the distribution.

However, if the amounts are received pursuant to a tax-free liquidation made in connection with the transfer of a partnership interest in exchange for an interest in another partnership, no sale, exchange or other disposition is recognized, and the basis of the property in the hands of the distributee shall be the partnership's adjusted basis at the time of the distribution.

If a complete liquidation results in a loss to a partner on the partner's investment in the partnership, the loss is sourced to the partner's state of residence. The loss is classified as a net loss from a disposition of property.

A non-resident partner may not offset this non-Pennsylvania-source loss against Pennsylvania-source net gain or loss from dispositions of property. For example, if the partnership recognizes partnership cancellation of indebtedness income in a foreclosure on partnership property, the non-resident partner may not apply the loss from liquidation of his or her investment against the gain resulting from the foreclosure on partnership property.

The amounts received in a complete liquidation are taxed under the above rules even if the distributions are not made in connection with settling the accounts and liquidating the assets of a partnership for the purpose of dissolving the partnership. The concept of an actual distribution of assets to its partners in the course of complete liquidation is distinct from the legal termination of the partnership.

An existing partnership continues until it terminates. A partnership terminates only when:

- a. Neither the partnership nor any of its partners continue the business, financial operation, or venture of the partnership, or
- b. Within a 12-month period, the partners sell or exchange 50 percent or more of their ownership interest.

4. Dissolving a Partnership

General partnerships and sole proprietors that are not required to withhold tax at the source (*e.g.* employer withholding and sales tax) are not required to obtain clearance certificates if they are merely ceasing to do business within Pennsylvania or selling their assets in a bulk or auction sale.

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

However, limited partnerships or general partnerships that withhold at the source must obtain a tax clearance certificate before filing required documents with the Department of State. Limited partnerships not general partnerships file a certificate of termination with the Department of State in addition to the REV-181. If you are a general partner in a limited partnership and want to withdraw from the limited partnership, a *Withdrawal by Limited/General Partner* would be filed with the Department of State.

To obtain a tax clearance certificate from the Department of Revenue, the entity must complete Form *REV-181, Application for Tax Clearance Certificate* available on the department's website. Be sure to read the instructions on *Form REV-181-I*

K. Basis of a Partner's Interest in a Partnership

To determine the basis of a partner's interest in a partnership, there are certain federal IRC sections, relating to basis adjustments that Pennsylvania personal income tax law does not allow. In addition, there are certain rules for Pennsylvania personal income tax purposes that are exclusive to Pennsylvania.

Note. A nonresident partner does not adjust basis, however he must determine whether he has sufficient economic investment to be able to utilize losses. [Refer to General Rules -Nonresident Partner.](#)

1. Definition of Outside Basis

a. Partner's Outside Basis

The purpose of outside tax basis is to keep track of the partner's adjusted basis in his or her partnership interest. It is the partner's after tax investment. It is also used to determine gain (loss) on the sale or other disposition of a partnership interest.

Outside basis is the individual partner's adjusted basis in his or her partnership interest. In general, a partner's outside basis is his or her separate tax capital account, which reflects adjusted basis, plus his or her share of the partnership's debt.

Initially, outside basis is determined by including the amount of the adjusted basis in the property contributed plus any cash contributed by the partner. If there are liabilities, outside basis includes the partner's share of all liabilities. In subsequent years, the outside basis is increased and decreased by partnership operations.

Outside basis is maintained by each individual partner outside of the partnership books. Outside basis is the calculation that most partners are concerned with because it is the basis that the taxpayer uses to limit losses, determine the taxability of partnership distributions, and calculate gain (loss) on the disposition of their partnership interest. Outside basis is calculated at the end of each partnership tax year.

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

The following is the calculation of a partner's outside basis based on IRC § 722 and IRC § 705(a).

b. **Outside Basis – Adjusted Basis of a Partner's Interest**

Adjusted basis in asset or cash contributed by the partner
- Liabilities of the partner assumed by the partnership
+ Partner's share of partnership liabilities
+ Any gain recognized by the partner on the contribution of assets to the partnership
= Beginning Tax Basis

Then partnership operations during the year,

+ Taxable Income
+ Tax exempt Income
- Distributions from the partnership of cash or property
- Partnership expenditures that are neither deductible or capitalized by the partnership
- Oil and gas depletion, calculated at the partner's level
- Losses
+/- Change in partner's share of partnership's liabilities
= Tax Basis at year-end

The year ending tax basis cannot be a negative balance.

2. **Definition of Inside Basis**

a. **Partner's Inside Basis**

Inside basis is the partnership's tax basis in its assets. For tax purposes, a partnership takes a carryover basis in the contributed property equal to the contributing partners' adjusted basis in the property at the time of the contribution. Inside basis is the aggregate adjusted basis of all property contributed by all partners.

There is a close relationship between inside and outside basis. They both reflect the adjusted basis of the assets versus the fair market value. However, outside basis deals with each partner's interest in the partnership assets they contributed and inside basis deals with all partners' interests in the partnership assets aggregated together.

3. **General Rules – Resident Partner**

Generally the initial outside basis of a resident partner's interest in the partnership is the amount of cash and the adjusted basis of property that the partner contributes.

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

If a partner contributes property that is subject to indebtedness or if the partnership assumes a partner's debt, the contributing partner must reduce basis by the amount of the debt assumed by the other partners. The partnership's assumption of the debt is a distribution of money to the contributing partner.

The assumption by the other partners of a portion of the contributing partner's debt is a contribution to the partnership, and therefore, increases their basis.

If a partner's interest in the partnership's capital is for rendering past, present, or future service, the partner's basis equals the income for those services. The partner recognizes that income when the partner performs the services and the partnership removes any restrictions on withdrawal or disposition of the income.

A partner's outside basis in a partnership can never be less than zero.

A partner that acquires a partnership interest, other than by contributing money, property, or both, determines his or her basis in the partnership under general basis rules.

Important. The basis of a partnership interest acquired by purchase is the purchase price paid. The basis of a partnership interest acquired by inheritance is the fair market value on the decedent's date of death. The basis of a partnership interest acquired by gift or otherwise, such as a joint tenant with right of survivorship, is the donor's basis.

4. Examples

Example 1

Tim acquired a 20 percent interest in a partnership by contributing property. At the time of Tim's contribution, the property had a fair market value of \$10,000 and an adjusted basis of \$4,000. The property was subject to a mortgage of \$2,000. The partnership assumed payment of the mortgage. Tim's basis in the partnership is \$2,400, calculated as follows:

Adjusted basis of the property contributed		\$4,000
Less the portion of the mortgage assumed by the other partners that must be treated as a distribution to Tim	(\$2,000 x 80%)	(\$1,600)
Basis of Tim's partnership interest		<u>\$2,400</u>

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

Example 2

Use the facts from Example 1 above except that the mortgage on the property was \$6,000. Tim's basis in the partnership would be zero, calculated as follows:

Adjusted basis of the property contributed		\$4,000
Less the portion of the mortgage assumed by the other partners that must be treated as a distribution to Tim	(\$6,000 x 80%)	(\$4,800)
Basis of Tim's partnership interest		(\$800)

Since Tim's basis cannot be less than zero, the \$800 in excess of basis is a distribution of money and a gain from the sale or exchange of Tim's partnership interest in excess of basis.

Example 3

Facts: ABC partnership is formed. "A" contributes land with a basis of \$200. "B" contributes a building with a basis of \$300. "C" contributes \$400 cash. "A's" outside basis is \$200. "B's" outside basis is \$300. "C's" outside basis is \$400. ABC has an inside basis in the partnership assets of \$900 (\$200 in the land, \$300 in the building, and \$400 in cash).

5. Basis Calculation

A partnership ordinarily determines its outside basis at the end of each taxable year. A partner must separately determine their outside basis. This amount may differ from the amount shown in the partnership's books as the partner's capital, equity, or similar account, or the partner's outside basis for federal income tax purposes.

The department requires the partnership to provide each partner with the information that each partner needs to calculate the Pennsylvania personal income tax outside basis of their partnership interest. Pennsylvania does not require partnerships to account for each partner's Pennsylvania personal income tax basis. Each partner must determine their Pennsylvania personal income tax basis, appropriately applying the Pennsylvania tax rules. The partner is responsible for tracking Pennsylvania personal income tax outside basis. The department requires *PA-40 Schedules RK-1* and/or *NRK-1* and a *PA-40 Individual Income Tax Return* be submitted for all years in which they were a partner.

6. Increase in Basis

The original basis of a resident partner's interest increases by:

- a. Additional contributions to the partnership, and
- b. The partner's distributive share of:
 - The accumulated partnership taxable income,

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

- The partnership's accumulated tax-exempt gross income (such as, permanent items having a nontaxable difference between book income and taxable income; interest on PA municipal bonds; or life insurance proceeds), and
- Basis is increased when the partner's share of partnership liabilities is increased.

7. Decrease in Basis

The basis of a partner's interest decreases, but not below zero, by:

- a. Distributions by the partnership, which is the amount of money and the adjusted basis of property distributed to a partner. In computing the partner's adjusted basis, the partnership takes into account all distributions to a partner before any losses,
- b. The sum of the partner's distributive share of partnership losses if the losses enabled the partner to reduce their Pennsylvania-taxable income or income tax liability to another state,
- c. Nondeductible partnership expenditures that are not capital expenditures, i.e., partner's retirement contributions and partner's life and health insurance premiums, and
- d. Basis is decreased when the partner's share of partnership liabilities is decreased.

8. Basis - Ordering Rules

In calculating the partner's adjusted basis, the partner takes into account all distributions before any losses.

9. No Carry-Forward or Carry-Back of Losses

For Pennsylvania purposes, neither the partnership nor the partners may carry-forward or carry-back any losses to other tax years.

10. No Offsetting Income (Loss) in More than One Class of Income

Per Reg. 121.13 (a), "a person shall not be allowed to offset a gain in one class of income with a loss in another class of income".

Therefore neither the partnership nor the partner may offset income or gain in one class of income with a loss in another class of income.

11. General Rules – Nonresident Partner

To determine the economic interest of a nonresident partner's interest in a partnership, there are certain rules for Pennsylvania personal income tax purposes that are specific and exclusive to the Pennsylvania nonresidents.

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

- a. The economic investment of a nonresident partner's interest in the partnership is the amount of cash and the adjusted basis of property that the nonresident partner contributes.
- b. If a nonresident partner contributes property that is subject to indebtedness or if the partnership assumes a nonresident partner's debt, the contributing nonresident partner must reduce economic investment by the amount of the debt assumed by the other partners. The partnership's assumption of the debt is a distribution of money to the contributing nonresident partner. The assumption by the other partners of a portion of the contributing nonresident partner's debt is a contribution to the partnership, and therefore, increases their basis or economic investment.
- c. If a nonresident partner's interest in the partnership's capital is for rendering past, present, or future service, the partner's economic investment equals the income for those services. The partner recognizes that income when the nonresident partner performs the services and the partnership removes any restrictions on withdrawal or disposition of the income.
- d. All distributions to nonresident partners reduce the nonresident partners' economic investment in the partnership.
- e. A nonresident partner cannot utilize losses of a partnership against other income in the same class of income if the nonresident partners' economic investment in the partnership is less than zero.

12. PA-20S/PA-65 Schedules RK-1 and NRK-1

A partnership reports distributions on the partner's PA-20S/PA-65 Schedules RK-1 and/or NRK-1. Each resident partner must reflect distributions from the PA-20S/PA-65 Schedules RK-1 on the form [REV-999, Partner PA Outside Tax Basis in a Partnership Worksheet](#) to determine whether such distributions are taxable.

Important. The partnership must provide information to the partner on straight-line depreciation so the partner can calculate basis in accordance with 72 P.S. § 7303(a.2).

L. Distributions of Cash, Property and Marketable Securities

1. Income to Partner

Distributions that the partnership makes that represent cash, marketable securities, and other property that are not guaranteed payments may represent Pennsylvania-taxable income to the extent the distributions exceed the resident partner's adjusted outside basis.

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

2. **Non-liquidating Distributions from Partnership to Partner**

With respect to non-liquidating distributions from a partnership to a resident partner, the partner's outside basis in their partnership interest is decreased to the extent of the partnership's Pennsylvania personal income tax adjusted basis in the property distributed to the partner. In non-liquidating distributions, a resident partner will recognize taxable income to the extent that the partnership's adjusted basis in the property distributed exceeds the resident partner's outside basis in the owner's partnership interest. Although not taxable to a nonresident partner, the nonresident partner reduces his or her economic investment by the partnership's adjusted basis in the property distributed. Refer to section H part 3 of this chapter for partnership distributions in complete liquidation.

3. **General Rules Regarding the Treatment of Partner or Partnership Liabilities**

Pennsylvania law generally follows IRC § 752:

- a. If the liabilities of a partnership increase, then each partner's share of the liabilities increases. Each partner's share of the increase is treated as a contribution of money to the partnership.

Example: Amy and Bob are equal partners in AB partnership. The partnership borrows \$1,000. Each partner's interest in the partnership increases by \$500. The partnership uses this rule regardless of its method of accounting.

- b. If the liabilities of a partnership decrease, then each partner's share of the liabilities decreases. Each partner's share of the decrease is treated as a distribution of money to the partners by the partnership. The partnership's distributions decrease the economic interest of the non resident partners in the partnership.
- c. If a decrease in liabilities exceeds the resident partner's basis in their partnership interest, then the excess constitutes a gain.
- d. A partner's percentage share of partnership liabilities ordinarily is the same as their percentage share of losses, unless the partnership agreement establishes otherwise, or by an express undertaking of a liability, such as a note.
- e. A decrease in a partner's personal liabilities, because the partnership assumes a portion of them, is a distribution of money to the partner. The contributing partner's basis decreases and the assuming partner's basis increases.

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

- f. When a partner contributes encumbered property, the corresponding decrease in the contributing partner's liability is a distribution of money to such partner. In addition, the liability attributable to the other partners is an increase in each other partner's basis.

Example. Ed, a resident partner, contributes property with a basis of \$10,000 in exchange for a one-third interest in a partnership. The property has a mortgage of \$1,500. Ed reduces the \$10,000 basis for the contributed property by \$1,000; two-thirds of his original liability of \$1,500 attributable to the other partners which reduces his basis in the partnership to \$9,000. The liability attributable to each of the other partners increases their basis.

- g. When a partner receives a non-liquidating distribution of partnership property subject to liability:
- the receiving partner is treated as if he/she contributed money to the partnership by reason of the partner's assumption of the liability, and
 - all partners are treated as if they received money because of a decrease in the partner's share of partnership liabilities that occurred when the recipient partner assumed the debt from the partnership.
 - When a partner sells or exchanges their partnership interest, the general rule for the treatment of liabilities applies.

Example. Alice, a resident partner, sells her partnership interest for \$750. At the same time she transfers to the buyer her pro rata share of the partnership's recourse liabilities of \$250 and the partnership's non-recourse liabilities of \$500. Alice's sale price is \$1,500. This is the amount she applies against the outside basis of her partnership interest to determine her gain (loss).

- h. A partnership's obligations for the payment of its outstanding trade accounts, notes, and accrued expenses are liabilities whether or not recorded on the partnership books under its method of accounting. Contingent liabilities, however, are not liabilities until they become fixed or liquidated.

Important. Take into account distributions and decreases in basis, before losses, in determining a resident partner's outside basis. Partners may not reduce their outside basis below zero for Pennsylvania personal income tax purposes.

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

- i. A partnership determines a partner's share of its partnership liabilities in accordance with the partner's ratio for sharing losses under the partnership agreement. However, where none of the partners have any personal liability with respect to a partnership non-recourse liability (as in the case of a mortgage on real estate acquired by the partnership without the assumption by the partnership or any of the partners of any liability on the mortgage) then all partners, including limited partners, share this liability in the same ratio as they share the profits.

Example. In the GL partnership, Gene is a general partner, and Larry is a limited partner. Each made equal contributions of \$20,000 to the partnership upon its formation. Under the terms of the partnership agreement, they are to share profits equally. The partnership agreement limits Larry's liabilities to the extent of his contributions. The partnership pays \$10,000 for real property that is subject to a \$5,000 mortgage. Neither the partnership nor either partner assumes any liability for the mortgage. Gene and Larry increase their partnership interests by \$2,500 each, since each partner's share of the \$5,000 mortgage partnership liability increased by that amount. However, if the partnership assumed the mortgage so that Gene was personally liable, Gene's basis increases by \$5,000, and Larry's basis remains unchanged.

M. Debt Limitation

The partnership may take an amount of indebtedness into account only once. This rule applies even though the partner, in addition to being liable for the indebtedness as a partner, may be liable in a capacity other than as a partner.

N. IRS Investment Tax Credits

For Pennsylvania personal income tax purposes, a partnership need not reduce the basis of an asset by that percentage of the federal investment tax credit taken as required under the IRC.

O. Tax Benefit Rules

The PA Department of Revenue does not follow the federal tax benefit rules. 72 P.S. § 7303(a.2) states that the basis in property shall be reduced, but not below zero, for depreciation by the greater of:

1. The amount deducted on the return and not disallowed, but only to the extent the deduction results in a reduction of income, or
2. The amount allowable, using the straight-line method of depreciation, regardless of whether the deduction results in a reduction of income.

This adjustment is applied at the Pennsylvania personal income tax taxpayer level (*PA-40 Individual Income Tax Return, PA-41 Fiduciary Income Tax Return*).

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

1. **Sole Proprietor**

The individual sole proprietor is required to reduce his basis in the assets used in the business by the amount deducted on the tax return. However, if the business incurs a loss in which the individual owner has no other income to offset, he is only required to reduce his basis in the assets by straight-line depreciation.

2. **Partner**

For Pennsylvania personal income tax purposes, a partner must reduce his outside basis in the partnership by losses, but only to the extent that the losses reduce either the income subject to Pennsylvania tax or the income subject to the tax of another state or country. If the partner does not get the benefit of the losses from the partnership, the statute still requires him to reduce his outside basis in the partnership by his share of straight-line depreciation in the assets of the partnership.

The Pennsylvania tax benefit rule applies to nonresident partners only to the extent to verify that they have sufficient basis to reduce their PA-source income by their share of partnership loss. It does not apply to nonresident partners upon disposal of the partnership interest. Nonresidents are not taxed on the gain from the sale of intangibles nor allowed the loss. A partnership interest is an intangible asset. Losses from the sale of a partnership interest are not sourced to Pennsylvania for nonresidents.

This issue is addressed in *Legal Letter Ruling No. PIT-05-003 and PIT Tax Bulletin 2005-02, Section 2.*

The partnership must provide the amount of straight-line depreciation on the PA-20S/PA-65 Schedules RK-1 and/or NRK-1.

See [Table 16-2 – Schedule of Differences Between Federal Tax Law and PA PIT Tax Law for Partners Outside Basis Calculation](#) in Part IX - TABLES.

II. PENNSYLVANIA S CORPORATIONS

A. **Definition of a PA S Corporation**

1. **Statutory Definition**

72 P.S. § 7301(n.1) states a "Pennsylvania S Corporation means any small corporation as defined in § 301(s.2) which does not have a valid election under § 307 in effect."

2. **Small Corporation**

Per 72 P.S. § 7301(s.2), "Small corporation means any corporation which has a valid election in effect under subchapter S of chapter 1 of the IRC of 1986, as amended to January 1, 2005."

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

For purposes of determining whether a corporation qualifies as a small corporation:

- a. A qualified subchapter S subsidiary (QSSS) owned by a small corporation shall not be treated as a separate corporation, and all gross receipts and passive investment income of such qualified subchapter S subsidiary shall be treated as earned by the parent corporation, and
- b. All inter-corporate payments or distributions between the parent corporation and any qualified subchapter S subsidiary owned by such corporation shall be disregarded.

Note. A corporation includes a business trust or limited liability company that the IRS classifies as a corporation for federal purposes except a business trust that qualifies as a real estate investment trust or a regulated investment company.

B. Differences Between Federal Tax Law and Pennsylvania Tax Law

For each class of income there are differences in reporting for federal income tax and Pennsylvania personal income tax. Within each class of income there are certain IRC sections including elections for federal income tax, which are not allowed in arriving at reportable income for Pennsylvania personal income tax purposes.

Within each class of income there are specific rules for Pennsylvania personal income tax purposes.

Within each class of income there are circumstances where Pennsylvania will accept the use of federal tax accounting rules provided they are consistently used and applied.

See [Table 16-3 - Schedule of Differences Between Federal Tax Law and PA PIT Tax Law for PA S Corporations](#) in Part IX - TABLES.

C. PA-20S/PA-65 PA S Corporation/Partnership Information Return and Schedules

1. Filing Requirements – PA S Corporation

Every domestic or foreign PA S corporation (72 P.S. § 7330.1) or an entity formed as a limited liability company that is classified as a PA S corporation for federal income tax purposes must file the *PA-20S/PA-65 PA S Corporation/Partnership Information Return (PA-20S/PA-65 Information Return)* if either of the following apply:

- a. During the taxable year, the PA S corporation or its qualified subchapter S subsidiary earned, received, or acquired any gross taxable income (loss) allocable or apportionable to Pennsylvania, regardless of the amount of its income (loss) and/or whether or not the income was distributed; and/or

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

- c. During the taxable year, the PA S corporation had at least one shareholder that was a Pennsylvania resident individual, estate, trust, disregarded entity owned by a resident individual or another pass through entity such as a PA S corporation or limited liability company.

PA S corporations must file a PA-20S/PA-65 Information Return to report the income, deductions, gains, losses etc. from its operations. The PA S corporation passes through any profits (losses) to the resident and nonresident shareholders. Shareholders include their share of the income (loss) on the *PA-40 Individual Income Tax Return*, *PA-41 Fiduciary Income Tax Return*, or other Pennsylvania returns.

Each PA S corporation must submit with the PA-20S/PA-65 Information Return a complete copy of its federal income tax return including all schedules, statements, federal Form 1120S Schedules K-1, along with the PA-20S/PA-65 Schedules RK-1 and NRK-1 that it received as an owner in other pass through entities, such as a partnership or limited liability company. With the PA-20S/PA-65 Information Return, the entity must also submit copies of the *PA-20S/PA-65 Schedule RK-1* that it provides to resident shareholders and copies of the *PA-20S/PA-65 Schedule NRK-1* that it provides to nonresident shareholders.

If the entity has already forwarded a complete copy of its federal return to the Bureau of Corporation Taxes with the RCT-101, PA Corporate Tax Report, do not send another copy.

All PA S corporations that conduct business in Pennsylvania must file the *RCT-101, PA Corporate Tax Report*, for the capital stock/foreign franchise tax.

A PA S corporation, incorporated in another state with a Pennsylvania resident shareholder having no PA-source income or Pennsylvania activity is not required to file the *RCT-101, PA Corporate Tax Report*.

D. Processible Returns

The PA-20S/PA-65 Information Return for an S corporation must satisfy all requirements found in the PA-20S/PA-65 instructions. The applicable PA-20S/PA-65 Schedules RK-1 and NRK-1 are required attachments for resident and nonresident owners' share of income, deductions, credits, etc. The S corporation must also submit the PA-20S/PA-65 Schedules RK-1 and NRK-1 that it received as an owner in other entities. Refer to *Miscellaneous Tax Bulletin 2008-02 Reproduced Forms and Substitute Forms*.

E. Withholding of Estimated Quarterly Pennsylvania Personal Income Tax on the Distributable Income of a Resident Individual, Estate or Trust

Individual resident shareholders are subject to the estimated quarterly tax provisions under the Pennsylvania Personal Income Tax Act. Resident shareholders must make declarations and estimated quarterly Pennsylvania tax payments if they reasonably

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

expect income, other than compensation on which Pennsylvania tax is withheld, to exceed \$8,000. Individual shareholders should refer to *REV-413I, Instructions for Estimating PA Personal Income Tax for Individuals Only*.

F. Withholding of Quarterly Pennsylvania Personal Income Tax on the Distributable Income of a Nonresident Individual, Estate or Trust

Under Act 22 of 1991, a PA S corporation with shareholders who are nonresident individuals, nonresident estates, and nonresident trusts (owners) must withhold and pay Pennsylvania personal income tax on each owner's expected share of distributable Pennsylvania-source taxable income. If making a quarterly withholding payment for the first time, use *PA-40 ESR (F/C,) Declaration of Estimated or Estimated Withholding Income Tax for Fiduciary or Partnerships*. Associations and PA S corporations may also use this form. The PA S corporation makes the initial quarterly withholding payment and all future quarterly withholding payments under the employer identification number, name, and address of the PA S corporation.

The entity should refer to *REV-413P/S, Instructions for Withholding PA Personal Income Tax from Nonresident Owners by Partnerships and PA S Corporations*.

Note. An entity may not withhold Pennsylvania personal income tax for another entity or a Pennsylvania resident individual, and should not withhold Pennsylvania personal income tax on income from intangibles such as interest, dividends, or sale of stock.

G. Final/Catch-Up Payment of Nonresident Withholding Tax

If the Pennsylvania personal income tax due on the taxable income allocable to nonresidents exceeds the tax withheld, the final payment is due on the date prescribed for the filing of the PA-20S/PA-65 Information Return, PA-40 Nonresident Consolidated Income Tax Return or with an extension request.

If the tax of the nonresident owners exceeds the nonresident withholding tax payments, the PA S corporation must pay the deficiency by the date prescribed for filing the entity's PA-20S/PA-65 Information Return or if the nonresident owners elect to file on a PA-40 Nonresident Consolidated Income Tax Return, the entity may make the final/catch-up payment with the PA-20S/PA-65 Information Return, PA-40 Nonresident Consolidated Income Tax Return or with an extension request.

There are three ways to make a final tax withholding payment or final catch-up payment for nonresident owners that are individuals, estates, or trusts. Follow these instructions:

1. With Approved Software Form

If using approved software, submit payment along with the 20XX Nonresident Withholding Payment substitute voucher in the same envelope with the PA-20S/PA-65 Information Return, PA-40 Nonresident Consolidated Income Tax Return or extension request. Do not staple payment to your return or the substitute voucher.

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

2. Without Approved Software Form

- a. Submit payment with the PA-20S/PA-65 Information Return, PA-40 Nonresident Consolidated Income Tax Return or extension request. Print the entity's federal employer identification number (FEIN) and 20XX Final Nonresident Withholding on the check or money order made payable to the PA Dept. of Revenue.
- b. Submit payment in the same envelope with the PA-20S/PA-65 Information Return, PA-40 Nonresident Consolidated Income Tax Return or extension request. Do not staple payment to your return.

3. Fed/State e-File

The only acceptable electronic payment method for fed/state partnership e-file is electronic funds withdrawal which is part of the current tax year return submission and is automatically and electronically transferred from taxpayers' bank accounts.

The following types of payments can be electronically transferred with the PA-20S/PA-65 Information Return:

- a. The final nonresident individual tax withholding "catch-up" payment submitted with the current tax year return; and
- b. The next tax year's (future) estimated payments for nonresident individual quarterly tax withholding submitted with the current tax year return.

These future estimated nonresident individual tax withholding payments for the next tax year will be stored in the system as separate electronic transaction payments until the specified due date.

Important. The nonresident individual quarterly tax withholding payment may not be submitted through Electronic Funds Transfer (EFT), credit/debit cards or e-TIDES.

H. Mailing Address for the Nonresident Withholding Payment

When submitting the final withholding payment or final "catch-up" payment with the PA-20S/PA-65 Information Return, with or without the 20XX Nonresident Withholding Payment substitute voucher, send to:

PA DEPARTMENT OF REVENUE
BUREAU OF INDIVIDUAL TAXES
PO BOX 280502
HARRISBURG PA 17128-0502

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

When submitting the final withholding payment or final “catch-up” payment with the PA-40 Nonresident Consolidated Income Tax Return, with or without 20XX Nonresident Withholding Payment substitute voucher, send to:

PA DEPARTMENT OF REVENUE
CONSOLIDATED RETURN
PO BOX 280418
HARRISBURG PA 17128-0418

When submitting the final withholding payment or final “catch-up” payment with an extension request for any Pennsylvania tax return, send form REV-276 to-

PA DEPARTMENT OF REVENUE
BUREAU OF INDIVIDUAL TAXES
PO BOX 280504
HARRISBURG PA 17128-0504

Follow the instructions above, [With Approved Software Form](#) or [Without Approved Software Form](#).

I. Operations of a PA S Corporation

1. How Does a Corporation Become a PA S Corporation

Effective for tax years beginning on or after Dec. 31, 2005, any corporation with a valid federal S corporation election is automatically a PA S Corporation.

2. Effect of PA S Corporation Status

S corporation shareholders include their share of the corporation's separately stated items of income, deduction, loss, and credit, and their share of non-separately stated income (loss) on their tax returns.

A PA S corporation will only be subject to the corporate net income tax on its net recognized built-in gain reported on federal Schedule D, federal Form 1120S. If any tax is imposed on a PA S corporation (or any qualified subchapter S subsidiary owned by such PA S corporation) pursuant to § 1374 of the IRC of 1986, the amount of tax so imposed shall be treated as a loss sustained by such PA S corporation during such years. The character of such loss shall be determined by allocating the loss proportionately among the recognized built-in gains giving rise to such tax.

A PA S corporation will remain subject to all other Pennsylvania corporate taxes including capital stock (CS) or foreign franchise (FF) tax.

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

The PA S corporation passes its income (loss), and credits to its shareholders in the applicable class of income taxable under the Pennsylvania personal income tax rules and regulations.

3. **Election Not to Be Taxed as a PA S Corporation**

Starting with tax years beginning on or after Jan. 1, 2006, a corporation with a valid federal S election is no longer required to file *REV-1640, PA S Corporation Election and Shareholders' Consent* in order to be a PA S corporation. Under Act 67 of 2006, Senate Bill 300 PN 1986, all federal S corporations are PA S corporations. Act 67 also includes a provision for federal S corporations to make an election NOT to be taxed as a PA S corporation. To make this election, the taxpayer is required to file *REV-976, Election Not to be Taxed as a Pennsylvania S Corporation* on or before the due date or extended due date of the report for the first period in which the election is to be in effect.

Example: A federal S corporation that does not want to be a PA S corporation for the tax year ending Dec. 31, 20X1 must file *REV-976, Election Not to be Taxed as a Pennsylvania S Corporation* on or before April 15. If the taxpayer has a valid extension to file the *RCT-101, PA Corporate Tax Report*, then REV-976 would be due on or before Oct. 15.

Note. REV-1640, PA S Corporation Election and Shareholders' Consent, became an obsolete form as of Dec. 31, 2005.

4. **Pennsylvania Resident Shareholders of S Corporations in Another State**

Any federal S corporation that does not make this election and is an S corporation in another state that has a Pennsylvania resident shareholder will be taxed as a PA S corporation and is required to file a PA-20S/PA-65 Information Return. The entity is not required to file the *RCT-101, PA Corporate Tax Report* as was previously reported in June/July 2006, *PA Tax Update #121*. In addition, each shareholder will be subject to Pennsylvania personal income tax on each shareholder's pro rata share of the S corporation income, whether distributed or not.

5. **Revocation of Election Not To Be Taxed as a PA S Corporation**

First, it is important to remember the election to not be taxed as a Pennsylvania S corporation may not be revoked for five years from the date it went into effect. A revocation received within this five year period will be effective for the first tax period for which the taxpayer is eligible to revoke the election.

Elections which first went in effect in 2006 may be revoked for 2011. To revoke the election the corporation must send a letter signed by shareholders holding more than one-half of the shares of stock of the corporation on the day on which the revocation is made. This letter must contain the name of the corporation, the federal employer identification number (FEIN), the PA corporate tax account number and the effective date of the revocation. If no effective date is provided

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

the revocation will be effective for the first tax period for which the revocation was timely submitted. In the case of a corporation with qualified subchapter S subsidiaries, the letter must include the names and PA corporate tax account numbers of all qualified subchapter S subsidiaries doing business in Pennsylvania. Mail the letter to:

PA DEPARTMENT OF REVENUE
BUREAU OF CORPORATION TAXES
PROCESSING DIVISION
PO BOX 280705
HARRISBURG PA 17128-0705

The deadline for revocation of an election not to be taxed as a Pennsylvania S corporation is the 15th day of the third month of the year in which the revocation is to be in effect. A revocation submitted after the due date will be in effect for the next tax period.

6. **Qualified Subchapter S Subsidiaries (QSSS)**

Pennsylvania personal income law does not treat a qualified subchapter S subsidiary (QSSS) owned by a PA S corporation (parent) as a separate corporation for personal income tax.

However for corporation tax, Pennsylvania law does treat a QSSS owned by a PA S corporation as two separate corporations.

Consequently a QSSS may not have a personal income tax filing obligation but may have a corporation tax filing obligation.

Pennsylvania personal income tax law treats all assets, liabilities, and items of income, deduction, and credit of a qualified subchapter S subsidiary as assets, liabilities, and items of income, deduction, and credit of the parent PA S corporation for income tax purposes.

The parent PA S corporation must report the assets, liabilities, and items of income, deduction, and credit of the qualified subchapter S subsidiary on the parent's PA-20S/PA-65 Information Return.

Note. Shareholders receive the income distribution from the parent corporation not from each qualified subchapter S subsidiary.

The following provisions apply only to a qualified subchapter S subsidiary in Pennsylvania:

- a. A qualified subchapter S subsidiary cannot elect corporation treatment independent of its parent corporation.

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

If a qualified subchapter S subsidiary and/or parent of a qualified subchapter S subsidiary does not desire to be taxed as a PA S corporation, the parent must file form REV-976, Election Not to be Taxed as a Pennsylvania S Corporation, for itself and all qualified subchapter S subsidiary (s). The parent corporation submits a schedule with the election, identifying the name, address, Revenue ID, and federal employer identification number (FEIN) of each qualified subchapter S subsidiary owned by the corporation and doing business in Pennsylvania.

- b. The parent corporation is not required to register with the Department of State if its only activity in Pennsylvania is its investment in the qualified subchapter S subsidiary that is registered in Pennsylvania.

Therefore, the parent corporation is not required to file the RCT-101, PA Corporate Tax Report. If the qualified subchapter S subsidiary is not registered, then either the parent or the qualified subchapter S subsidiary must register.

Additionally, the parent is required to file a PA-20S/PA-65 Information Return and list the qualified subchapter S subsidiary(s) on Part IX and include all qualified subchapter S subsidiaries' items of income, deduction and credit on the return. There is no ownership percentage for the qualified subchapter S subsidiary because it is a division of the parent company.

Since the qualified subchapter S subsidiary is a division of the parent company, the qualified subchapter S subsidiary is not included on the Partner/Member/Shareholder Directory. Only the owners of the parent company are listed on the directory.

- c. For Pennsylvania corporation tax purposes (capital stock and foreign franchise tax) the parent corporation and each qualified subchapter S subsidiary is a separate entity with its own Revenue ID.

Each entity must file an RCT-101, PA Corporate Tax Report, on a separate company basis. On a separate company basis, each entity submits with its RCT-101, PA Corporate Tax Report, its individual income statement, beginning and ending balance sheet and statement of retained earnings (or a pro-forma federal Form 1120S).

- d. If the parent corporation must file the RCT-101, PA Corporate Tax Report, the parent must also submit a consolidated beginning and ending balance sheet that includes all foreign and domestic qualified subchapter s subsidiaries. Please refer to REV-1200, CT-1 PA Corporation Tax Booklet, on the department's website for additional guidelines.

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

Note. The parent PA S corporation may also file the PA-40 Nonresident Consolidated Income Tax Return, for its nonresident individual owners if the nonresident individual owners meet the parameters. Refer to the PA-40 NRC instructions on the department's website for further information.

J. Termination of a PA S Corporation

1. Corporate Distributions in Complete Liquidation

Generally, the amounts received by a shareholder in the complete actual winding up of a PA S corporation and distribution of its assets (or the proceeds from the sale of its assets) shall be treated as a full payment in exchange for the shareholder's stock. Accordingly, if property is received in such a distribution, generally, the basis of the property in the hands of the distributee shall be the fair market value of such property at the time of the distribution. However, if the amounts are received pursuant to a tax-free reorganization to which the PA S corporation is a party, no sale, exchange or other disposition is recognized, and the basis of the property in the hands of the distributee shall be the corporation's adjusted basis at the time of the distribution.

The amounts received in a complete liquidation are taxed under the above rules even if the distributions are not made in connection with settling the accounts and liquidating the assets of a corporation for the purpose of dissolving the corporation. The concept of an actual distribution of assets to its shareholders in the course of complete liquidation is distinct from the legal termination of the entity.

K. Termination of PA S Corporation Status

A corporation's PA S corporation status remains effective until it is terminated by the IRS or the federal election was revoked. If the corporation is no longer a federal S corporation, the PA S status is automatically terminated. No separate revocation of the PA S status is required.

L. PA S Corporation Revocation or Termination Year

A PA S corporation revocation or termination year is the tax year of a PA corporation in which the corporation is treated as a PA S corporation for part of the tax year and a corporation subject to corporate net income tax for the balance of the tax year.

The PA S corporation revocation or termination year is divided into two periods for filing tax returns. These periods are known as:

1. The PA-20S/PA-65 Information Return short taxable year, and
2. The RCT-101, PA Corporate Tax Report short taxable year.

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

The corporation must file two returns to cover the revocation or termination year; one that covers the PA-20S/PA-65 Information Return short taxable year and one that covers the RCT-101, PA Corporate Tax Report short taxable year and includes:

1. PA-20S/PA-65 Information Return Short Taxable Year Return

The *PA-20S/PA-65 Information Return* short taxable year is the part of the termination year that begins on the first day of the corporation's tax year and ends the day before the termination is effective.

The PA-20S/PA-65 Information Return that is due for the corporate net income tax short year is due 3½ months after the last day of the tax year.

2. RCT-101, PA Corporate Tax Report Short Taxable Year Return

The RCT-101, PA Corporate Tax Report, short taxable year is the part of the PA S corporation revocation year that begins on the day the termination is effective and ends on the last day of the corporation's tax year. The *RCT-101, PA Corporate Tax Report*, is due for the corporate net income tax short year. The *RCT-101, PA Corporate Tax Report*, for the short taxable year is due 30 days after the date on which the corporation's federal tax return is due.

3. Division of Income

After the PA S corporation termination year is divided into two periods, the separately stated items of income, loss and credit, and the amount of the non-separately calculated income or loss must be divided between the periods. There are two methods that can be used to make this division:

a. Pro Rata Allocation

This method of allocation must be used unless the shareholders and the PA S corporation specifically choose the other allocation method discussed under [Allocating Based on Normal Accounting Rules](#).

The pro rata allocation is made as follows:

- First determine the amount of each separately stated item of income, deduction, loss or credit, and the amount of the non-separately calculated income or loss.
- Then divide each amount by the number of days in the PA S corporation revocation or termination year (total tax year).
- Multiply the amounts from the second step above by the number of days in the S corporation's short taxable year. Use
 - these amounts to file the PA-20S/PA-65 Information Return for the revocation or termination year.

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

- Multiply the amounts from second step above by the number of days in the *RCT-101, PA Corporate Tax Report* short taxable year. Use these amounts to file the RCT-101, PA Corporate Tax Report for the PA S revocation or termination year.

b. Allocation Based on Normal Accounting Rules

A normal accounting rules basis is the alternate method of allocation. The corporation must choose this method and all persons who are shareholders during the PA S corporation revocation or termination year must consent to the choice. The corporation will then report all items of income, loss, or credit based on the corporation's books and records (including worksheets). Therefore, the items will be split between the PA-20S/PA-65 Information Return short taxable year and the RCT-101, PA Corporate Tax Report short taxable year according to the time they were realized or incurred based on the books and records of the corporation.

M. Allocation of Income

Shareholders who are nonresident individuals, estates, or trusts are taxed only on taxable income allocable or apportionable to Pennsylvania. Items of income (loss), cost, expense, and liability not allocable to Pennsylvania are ignored in computing the PA-taxable income of such shareholders.

Special allocation rules apply to each of the following:

- a. Net income or loss from trusts, estates, partnerships, and other PA S corporations,
- b. Net income or loss from business, profession or farm activities,
- c. Net gains or losses from the sale, exchange or disposition of tangible or real property,
- d. Net gains or losses from the sale, exchange or disposition of intangible personal property,
- e. Net rental income or loss from ownership of property.

1. Cancellation of Debt Income

For additional information concerning cancellation of indebtedness income, please refer to the Pennsylvania Personal Income Tax Guide, Chapter 24, Cancellation of Debt for Pennsylvania Personal Income Tax Purposes and PIT Tax Bulletins 2009-02 through 2009-07.

2. Built-In Gains

If any tax is imposed on a PA S corporation (or any qualified subchapter S subsidiary owned by such PA S corporation) pursuant to § 1374 of the IRC of

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

1986, the amount of tax so imposed shall be treated as a loss sustained by such PA S corporation during such years. The character of such loss shall be determined by allocating the loss proportionately among the recognized built-in gains giving rise to such tax. The built-in gains taxes imposed on the PA S corporation are treated as losses to be reported to the shareholders. The losses are allocated to the class of income that gave rise to the built-in gain and may be deducted by the shareholders. Tax for built-in gains is reported on the *RCT-101, PA Corporate Tax Report*.

3. Gain Rules

There are differences between federal income tax reporting and Pennsylvania personal income tax reporting. Refer to the *PA-20S/PA-65 Schedule D instructions* on the department's website.

N. Basis of a Shareholder's Interest in a PA S Corporation

There are differences between federal income tax and Pennsylvania personal income tax reporting at the entity level. IRC rules for determining basis, adjustments to basis and gains by the corporation generally are to be followed with these exceptions:

- For business assets placed into service after 1982, their basis will not have to be reduced by a percentage of the federal income tax credit for which the asset qualifies.
- Losses realized by a PA S corporation on bona fide sales or exchanges of property with related taxpayers may be offset against any gains received from other sales or exchanges.

1. Figuring Shareholder Taxable Income (Loss)

Each shareholder reports the applicable pro rata share of each item of income (loss) or credit from business, profession or farm reported to them on the PA-20S/PA-65 RK-1 and/or NRK-1 on their *PA-40 Individual Income Tax Return*, or the *PA-41 Fiduciary Income Tax Return*. Refer to the PA-40 or PA-41 tax forms and instructions for this reporting.

2. Pennsylvania Does Not Permit Offsetting Between the Classes of Income (Losses)

Pennsylvania does not permit offsetting between the classes of income (loss) that the PA S corporation passes through to its shareholder. The character of any PA S corporation item included in the shareholder's pro rata share is determined as if the item were realized directly by the shareholder. For more information, refer to the PA-20S/PA-65 Information Return instructions on the department's website.

3. Adjustments to Basis of Stock (Shareholders' Capital Investment)

Each shareholder must adjust the basis of stock in the PA S corporation as indicated below:

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

a. **Increases**

Each shareholder's pro rata share of the following items increases the basis of stock:

- Non separately stated net profits from business, profession, and farm that are passed through to the shareholder,
- Separately stated other personal income items passed through to the shareholder, and
- Nontaxable income.

b. **Decreases**

Each shareholder's pro rata share of the following items decreases the basis of stock, but not below zero:

- Non separately stated losses from business, profession or farm activities that are passed through to the shareholder,
- Separately stated other personal loss items that are passed through to the shareholder,
- Distributions other than dividend distributions, and
- Nondeductible expenses.

Basis is reduced only to the extent that the losses reduce the shareholder's income subject to Pennsylvania personal income tax or a tax on or measured by income imposed on the shareholder by any other state.

If losses are not used, basis must be reduced by the shareholder's share of straight-line depreciation. Percentage of unused loss is multiplied by the shareholder's share of straight-line depreciation.

c. **Limitation on Losses and Loss Carryovers**

The aggregate amount of losses taken into account by a shareholder is limited to the sum of the adjusted basis of the shareholder's stock for the tax year and the shareholder's adjusted basis of any indebtedness of the corporation to the shareholder figured before any adjustments for the tax year.

There is no provision allowing for carryover of losses by the shareholders of the corporation.

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

d. No Carry-Forward or Carry-Back of Losses

For Pennsylvania purposes, neither the S corporation nor the shareholders may carry-forward or carry-back any losses to other tax years.

e. No Offsetting Income or Losses in More than One Class of Income

Per Reg. 121.13 (a), "a person shall not be allowed to offset a gain in one class of income with a loss in another class of income".

Therefore neither the S corporation nor the shareholders may offset income or gain in one class of income with a loss in another class of income.

O. Shareholder Adjustments to Basis of Indebtedness (Shareholder's Loans to PA S Corporations)

1. Reduction in Basis of Indebtedness

If the shareholder's basis of stock in a PA S corporation is decreased to zero, any amount of excess losses shall be used to reduce the shareholder's basis of indebtedness of the PA S corporation to the shareholder, but not below zero.

2. Restoring Basis

If the shareholder's basis in indebtedness is reduced under "1" above, the reduction shall be restored before the shareholder's basis in the stock of the PA S corporation is increased.

P. Adjustments to Basis for PA S Corporation Distribution

1. Determine Stock and Loan Basis

Determine the year-end stock basis excluding all tax year distributions. This is the adjusted basis figure used in the determination of the tax treatment of any distributions during the tax year.

a. PA S Corporations with no Pennsylvania Personal Income Tax Accumulated Earnings and Profits (AE&P)

Distributions from a corporation with no accumulated earnings and profits for Pennsylvania personal income tax purposes are a nontaxable reduction to the stock basis.

b. PA S Corporations with C Corporation Accumulated Earnings and Profits

Distributions from a corporation in excess of accumulated adjustments account (AAA) with earnings and profits for Pennsylvania personal income tax purposes is handled as follows:

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

- Reduce the distribution by the pro rata share of the accumulated adjustments account. If the distribution is not pro rata for any given year, a resident shareholder cannot receive tax-free distributions in excess of what the resident previously reported in prior years for Pennsylvania personal income tax. Nonresidents are not taxed on distributions from the PA S corporation. Consequently, when distributions are made which are not pro rata in any given year, adjustments are required for either the resident and or nonresident to properly reflect the appropriate treatment for Pennsylvania personal income tax purposes.
- The excess of the distribution over the members share of accumulated adjustments account is a taxable dividend to the extent of the shareholder's pro rata share of the accumulated earnings and profits of the corporation.
- The excess of the distribution beyond accumulated adjustments account and accumulated earnings and profits is a nontaxable reduction to the basis. (Cannot go below zero.)
- Any distributions in excess of basis calculated above are treated as gain from the sale, exchange or disposition of property.

For a nonresident, all distributions are nontaxable. The nonresident's economic investment is reduced by the fair market value of the distribution. A nonresident cannot deduct losses in excess of his/her/its economic investment.

In summary, distributions are:

- Nontaxable to the extent of the accumulated adjustments account to the extent of basis,
- Taxable as dividends to the extent of corporate accumulated earnings and profits,
- Nontaxable return of capital to the extent of basis,
- Taxable as a gain from the sale, exchange or distribution of property.

Q. PA S Corporation Distributions

1. Distributions to Residents

A distribution that a PA S corporation pays from the accumulated earnings and profits of the corporation before it elected PA S status is dividend income to its resident shareholders. All other distributions represent a nontaxable return of the resident shareholders' basis in its stock.

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

Nontaxable return of basis distributions will reduce each resident shareholder's basis in the stock first. If the nontaxable return of basis distribution exceeds the shareholder's basis in his/her/its stock holdings, the shareholder can apply the excess against the basis of any indebtedness of the PA S corporation to that shareholder. If the distribution exceeds the shareholder's basis in the stock and the PA S corporation's indebtedness, the resident shareholder must report a gain from the disposition of property.

2. **Distributions to Nonresidents**

All distributions to nonresident shareholders reduce the nonresidents' economic investment in the PA S corporation. Distributions are nontaxable.

3. **Distribution of Appreciated Property**

If the PA S corporation distributes appreciated property, it must treat the distribution as if it had sold the property to the shareholders at fair market value. Such a distribution will produce a gain from the sale of property that the PA S corporation will have to report as net gain (loss) from the sale, exchange, or disposition of property.

4. **PA-20S/PA-65 Schedule RK-1 and NRK-1**

A PA S corporation must report distributions on the shareholder's *PA-20S/PA-65 Schedules RK- 1 and NRK- 1*.

a. **Residents**

Each resident shareholder must reflect distributions on the *PA-20S/PA-65 Schedule RK-1* and on form [REV-998 Shareholder Tax Basis in PA S Corporation Stock Worksheet](#) to determine whether such distributions are taxable.

b. **Nonresidents**

Distributions to nonresidents are not taxable.

R. **Accumulated Adjustments Account**

1. **Pennsylvania Personal Income Tax Accumulated Adjustments Account**

Pennsylvania accumulated adjustments account should not usually equal the federal accumulated adjustments account because of the differences between the federal tax law and Pennsylvania personal income tax law. Pennsylvania generally parallels federal rules for the PA S corporation's accumulated adjustments account with these significant differences:

- a. The PA S corporation accumulated adjustments account only reflects the income (loss) or distribution from the inception of PA S corporation status.

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

- b. The PA S corporation does not make an adjustment for any income (loss) that is not enumerated in Pennsylvania personal income tax law or any nondeductible expense. For example, for Pennsylvania personal income tax purposes, tax-exempt income is not added to the Pennsylvania personal income tax accumulated adjustments account.
- c. The Pennsylvania accumulated adjustments account is based on the Pennsylvania personal income tax income (loss) or distributions.

2. **Distributions from Pennsylvania Accumulated Adjustments Account**

Distributions to a resident shareholder from Pennsylvania accumulated adjustments account are tax free to the resident shareholder unless the Pennsylvania accumulated adjustments account exceeds the resident shareholder's basis in his/her/its stock.

The resident shareholder will recognize taxable income to the extent that the Pennsylvania accumulated adjustments account distribution exceeds the shareholder's basis in his/her/its stock. Although not taxable to a nonresident shareholder, the nonresident shareholder reduces his/her/its economic investment by the fair market value of the property distributed.

3. **Distributions of Cash, Marketable Securities, and Property (other than distribution from Pennsylvania Accumulated Earnings and Profits)**

Distributions of cash, marketable securities and property (in excess of Pennsylvania accumulated adjustments account) are considered a tax-free return of investment to the extent of the resident shareholder's basis in his/her/its stock. The resident shareholder will recognize taxable income to the extent that the fair market value of such distribution exceeds the shareholder's basis in his/her/its stock. Although not taxable to a nonresident shareholder, the nonresident shareholder reduces their economic investment by the fair market value of the property distributed.

4. **Accumulated Adjustments Account Distributions May Exceed Shareholder Basis**

Distributions that the PA S corporation makes that represent cash, marketable securities, and other property may represent Pennsylvania-taxable income to the extent the distributions exceed the resident shareholder's personal basis.

5. **Negative Accumulated Adjustments Account**

Pennsylvania follows the federal rule in that the PA S corporation's accumulated adjustments account may become negative because of losses not distributions.

The accumulated adjustments account is a corporate account. Future income must be used to restore the negative closing balance of Pennsylvania accumulated adjustments account before the PA S corporation can make PA tax-free distributions.

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

S. Accumulated Earnings and Profits

Pennsylvania follows the federal tax laws regarding the calculation of accumulated earnings and profits. Accumulated earnings and profits is a measure of the undistributed earnings of a C corporation, but from a tax point of view. C corporations generate positive or negative accumulated earnings and profits each year, calculated by making annual adjustments to taxable income.

When a C corporation becomes a PA S corporation, the accumulated earnings and profits retains its character. The PA C corporation's accumulated earnings and profits is frozen on the date the corporation converts to PA S status. The accumulated earnings and profits generally will not increase except when the corporation acquires another corporation with accumulated earnings and profits. However, it can be reduced by distributions from accumulated earnings and profits and the payment by the PA S corporation of C corporation period tax.

The tax treatment of distributions made by an S corporation is partially determined based on whether the corporation has accumulated earnings and profits. The shareholder's stock basis must also be considered because distributions in excess of basis always result in taxable income to the shareholder.

Federal subchapter S corporations that have been Pennsylvania S corporations throughout their corporate existence always should have tracked their Pennsylvania adjustments account and Pennsylvania accumulated earnings and profits, if applicable, to provide the information required for resident shareholders to correctly report distributions.

Federal subchapter S corporations that have become Pennsylvania S corporations by the operation of Act 67 of 2006 similarly should track Pennsylvania accumulated adjustments account and Pennsylvania accumulated earnings and profits. However, it may be extremely difficult to obtain the necessary information to calculate the initial Pennsylvania accumulated earnings and profits.

There are significant differences among the federal accumulated adjustments account, Pennsylvania accumulated adjustments account and Pennsylvania accumulated earnings and profits calculations.

The Pennsylvania Department of Revenue will allow a transitional election by federal subchapter S corporations that have become Pennsylvania S corporations by the operation of Act 67 of 2006. The department may allow a "new" Pennsylvania S corporation taxpayer to elect to use its federal accumulated adjustments account as the functional equivalent of its Pennsylvania accumulated earnings and profits.

This election may be filed with the *PA-20S/PA-65 PA S Corporation/Partnership Information Return*. Attach a statement indicating the PA S corporation elects to use its

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

federal accumulated adjustments account to calculate the amounts reported as dividends from accumulated earnings and profits. Report those amounts on PA-20S/PA-65 Schedule RK-1, Line 15 and PA-20S/PA-65 Schedule NRK-1, Line 13.

Both C corporations and PA S corporations can distribute taxable dividends to the extent they have accumulated earnings and profits. Although PA S corporations do not generate accumulated earnings and profits, they can have accumulated earnings and profits from:

1. C corporation operations during any period in which the corporation did not have a valid S corporation election in effect, or
2. Being a party to a reorganization whereby the S corporation acquires the assets of another corporation that has accumulated earnings and profits.

Accordingly, a PA S corporation will not have accumulated earnings and profits if it:

1. Was never a C corporation, or
2. Has not acquired another corporation with accumulated earnings and profits.

See [Table 16-4 - Schedule of Differences Between Federal Tax Law and PA PIT Tax Law for PA S Corporations Outside Basis Calculation](#) in Part IX - TABLES.

T. IRC Section 338(h)(10) Elections Not Permitted

IRC § 338(h)(10) election is an election whereby a selling group and buying corporation can elect jointly to have the selling group recognize gain or loss as if the target corporation sold its assets while still a member of the selling group. There is no income tax on the sale of the stock to the acquiring company. The income tax attributes of the target company stay with the selling parent company, which is responsible for taxes on the deemed sale of asset. The deemed sales price is determined under the modified aggregate deemed sales price method, which depends on the actual purchase price of the stock, adjusted for liabilities and other relevant items.

Pennsylvania personal income tax law does not recognize IRC § 338(h)(10) elections. Accordingly, the sale of a share of stock in a PA S corporation is never treated as a sale of the shareholder's proportionate interest in each asset of that corporation; nor is there any basis under Pennsylvania personal income tax law for treating a target PA S corporation as if it had sold all of its assets at the close of the acquisition date at fair market value in a single transaction and then repurchased all of the assets at the beginning of the day after the acquisition date if no such sale and repurchase actually occurred.

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

For Pennsylvania personal income tax purposes, gain recognized by shareholders under IRC § 338 is “deemed gain” from the sale of assets that is not to be taken into account.

However, the resident shareholders must report their gain or loss on the sale of stock on *PA-40 Schedule D, Sale, Exchange, or Disposition of Property*.

A resident shareholder may claim a resident credit for taxes paid to another state on Schedule D gain resulting from an IRC § 338(h)(10) transaction. Refer to PA PIT Guide Chapter 17, Credits.

U. Treatment of Life Insurance Proceeds Received by a PA S Corporation Where S Corporation Paid Premiums

1. Proceeds Used to Fund a Buy or Sell Arrangement

No expense deduction is allowed for life insurance premiums if the life insurance proceeds are to be used to fund a buy or sell arrangement. The proceeds payable upon death are not taxable at the shareholder level.

2. Proceeds Used to Buy-Out a Decedent’s Interest

No expense deduction is allowed to free up funds to buy-out a decedent’s interest. The proceeds are not taxable at the shareholder level.

3. Proceeds Used to Continue Business or Secure Loans

72 P.S. § 7303(a)(6) defines interest income as any amount paid under contract of life insurance..., which is includable for federal income tax purposes. However, if the exclusive purpose of the policy is to keep the business going, including the use of the insurance policy to secure business loans, the insurance premiums are deductible by the PA S Corporation and the life insurance proceeds are taxable. These proceeds are included in the PA S Corporation’s business income from operations.

III. BONUS DEPRECIATION

Under Pennsylvania personal income tax law, a PA S corporation or partnership may not use any of the bonus depreciation elections enacted for federal purposes.

Many provisions of the 2004 American Jobs Creation Act were not adopted for Pennsylvania personal income tax purposes. Specifically, the provisions regarding Internal Revenue Code (IRC) § 199 domestic production activities expense deduction and immediate expensing of intangible costs for start-up expenses, organizational expenses, and syndication fees may not be used in the calculation of Pennsylvania personal income tax liabilities.

A. OTHER DEPRECIATION EXPENSE DIFFERENCE

Pennsylvania tax law allows ACRS or MACRS only when:

1. They are also used for federal tax purposes, and

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

2. The property, when placed in service, has the same adjusted basis for Pennsylvania and federal tax purposes.

Moreover, deductions under ACRS and MACRS are allowable only to the extent allowable under the version of the IRC in effect as amended to Jan. 1, 1997.

Additionally, for any year in which an ACRS or MACRS deduction is allowed or allowable and regardless of the method of accounting:

1. The S corporation or partnership must reduce its basis in the depreciable property by the amount by which the deduction reduced its net income; and
2. Each owner must reduce outside basis by the owner's share of net loss or the amount of the owner's share of depreciation allowed or allowable using the straight-line method of depreciation.

B. IRC SECTION 179 PROPERTY DEDUCTIONS

Pennsylvania tax law allows IRC § 179 property deductions on a limited basis. They are allowable with respect to the entity and each owner only to the extent allowable under the Internal Revenue Code in effect on Jan. 1, 1997. For example, the aggregate dollar limitation is \$25,000 less the amount by which the cost of IRC § 179 property placed in service during the taxable year exceeds \$200,000. Federal increases enacted after 1997 are disregarded for personal income tax purposes.

The deduction limits apply both the business entity and the owner. Each entity calculates its 179 expenses and applies the limit. The expenses (subject to the limit) are then passed through to the owner. The owner then adds up all 179 expenses passed through to him/her from all business entities. The owner then applies the 179 limit to the sum. The result is the owner's allowable 179 deduction.

Additionally, for any year in which an IRC § 179 property deduction is claimed, basis must be reduced by the amount of the deduction, regardless of whether the deduction results in a reduction of net income.

IV. APPORTIONMENT

A. How to Apportion Income From a Business, Profession or Farm Derived From Sources within Pennsylvania, Wholly Outside Pennsylvania, or Partly Within Pennsylvania

1. Operation Wholly Within Pennsylvania

If the operation of the business is wholly within Pennsylvania, the entity allocates income (loss) exclusively to Pennsylvania. The operation of a business is wholly within Pennsylvania if, during the entire taxable year:

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

- a. The entity, or its representative, maintained or operated within Pennsylvania an office, shop, store, warehouse, factory, agency, or
- b. Commercial establishment where it systematically and regularly conducted or managed such business; and
- c. The entity, or its representative, did not maintain and operate outside Pennsylvania any office, shop, store, warehouse, factory, agency, or commercial establishment where it systematically and regularly conducted or managed such business.

For purposes of this rule, do not take into account any establishment maintained or operated by a representative of a PA S corporation or partnership if the representative acted as an independent contractor.

2. Operation Wholly Outside Pennsylvania

If the operation of the business is wholly outside Pennsylvania, the entity cannot allocate to Pennsylvania any item of income (loss), cost, or expense that it derives or incurs. The operation of a business is wholly outside Pennsylvania if, during the taxable year:

- a. The entity does not conduct in Pennsylvania any acts or transactions in the ordinary course of operating its business, or
- b. The entity only conducts in Pennsylvania acts or transactions in the ordinary course of operating its business that, with a fair measure of permanency or continuity, are either or both of the following—
 - The solicitation of orders or sales of tangible personal property which are sent outside Pennsylvania for approval or rejection and, if approved, are filled by shipment or delivery of goods or services from a point outside Pennsylvania, or
 - The solicitation of orders in Pennsylvania by the entity or entity representative, to a prospective customer, and such customer sells entity's product to its customers via solicitation as described in bullet point above.

For purposes of the above, an entity is not engaged in business activities within Pennsylvania during a taxable year merely by reason of sales of tangible personal property in Pennsylvania or the solicitation of orders for sales of tangible personal property in Pennsylvania on behalf of the entity by one or more independent contractors that maintain an office in Pennsylvania solely for making sales or soliciting orders for sales.

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

3. Operation Partly Within Pennsylvania

When an entity operates a business that is neither wholly within nor wholly outside Pennsylvania under the above definitions, it allocates by separate accounting if:

- a. The business operations within Pennsylvania and the business operations outside Pennsylvania constitute independent profit centers. This means there are no transfers of finished or partly finished goods, raw materials, supplies, services, or operational assets interspersed; and each center is free to buy outside; and because of geographical location, no center is in direct competition with another, and
- b. The entity keeps its books so that the amounts of revenues, costs, and expenses attributable to Pennsylvania operations can be properly disclosed.

Otherwise, the entity must complete a *PA-20S/PA-65 Schedule H*.

Submit a statement that lists all places both within and outside Pennsylvania where the PA S corporation or partnership conducts business activity or farming. Include the street address, city, state, and the type of business, profession or farm.

B. Real Estate and Tangible Property (Property Factor)

The property factor is a fraction. The numerator is the average value of real and tangible personal property employed in the business and located in Pennsylvania. The denominator is the average value of the real and tangible property employed in the business everywhere. For purposes of calculating the property factor:

1. The PA S corporation or partnership values owned property at its original cost.
2. Real property includes real property the entity rents and uses in the business.
3. The entity values rental property by multiplying the gross rents paid during the taxable year by eight.
4. If the values of the Pennsylvania real or tangible personal property that the entity employs in its business are zero at the beginning of any calendar month during its taxable year, the entity determines its average value of property by averaging the values at the beginning and ending of the taxable year. Otherwise, the entity determines its average value of property by averaging the monthly values.
5. Gross rents are the actual sum of money or other consideration paid directly or indirectly by the PA S corporation or partnership or for its benefit for the use or possession of the property. Gross rents include:

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

- a. The amount paid for the use or possession of real property or any part thereof, whether designated as a fixed sum of money or a percentage of sales, profits, or otherwise.
 - b. The amount paid as additional rent, or instead of rent, the amount the entity paid in interest, taxes, insurance, repairs, or other amounts under the terms of a lease or other arrangement.
 - c. The portion of the cost of any improvement to real estate made by or on behalf of the taxpayer which reverts to the owner or the lessor upon termination of the lease or other arrangement based on the unexpired term of the lease commencing with the completion date of the improvement, or the life of improvement, if its life expectancy is less than the unexpired term of the lease. If the entity erects, or another entity erects on behalf of the entity, a building on leased land, the entity determines the value of the land by multiplying the gross rent by eight and the value of the building in the same manner as if owned by the PA S corporation or partnership. The proportional part of the cost to an improvement (other than the building on leased land) is generally equal to the amount of allowable amortization in calculating Pennsylvania net income, whether the lease does or does not contain an option of renewal.
6. Gross rents shall not include:
- a. Any portion of a payment or credit to the proprietor of the business, or to a shareholder in a PA S corporation or partner in a partnership conducting the business for the use of real property,
 - b. Amounts payable for separate charges for water and electric service furnished by the lessor,
 - c. Amounts payable for storage if no designated space under the control of the taxpayer as a tenant is rented for storage purposes,
 - d. That portion of any rental payment that, in the discretion of the department, is applicable to property subleased by the taxpayer and not used by him or her in the carrying on of the business.
- C. Wages, Salaries, Commissions, and Other Compensation (Payroll Factor)**
The payroll factor is a fraction. The numerator is the total current employee wage and salary expense for the taxable year the PA S corporation or partnership incurs in connection with its business activity within Pennsylvania. The denominator is the total current employee wage and salary expense the entity incurs in connection with its business everywhere.

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

The entity incurs employee wage and salary expense in connection with its business activity in Pennsylvania if one of the following applies:

1. The employee performs personal services entirely within Pennsylvania, or
2. The employee performs personal services outside Pennsylvania that are incidental to the usual services the employee performs in Pennsylvania, or
3. The employee performs some personal services in Pennsylvania, and at least one of the following applies:
 - a. The employee's base of operations is in Pennsylvania.
 - b. The place from which the employee receives direction or control is in Pennsylvania.
 - c. The employee is a resident of Pennsylvania.

The term base of operations refers to the place or fixed center from which the individual works. An individual's base of operations may be their business office, or a place at which the employee is to receive their directions and instructions if their contract of employment so specifies. In the absence of more controlling factors, an individual's base of operations may be the place to which they have their business mail, supplies, and equipment sent, or the place where they maintain their business records.

D. Sales (Sales Factor)

The sales factor is a fraction. The numerator is total gross receipts derived from sales in Pennsylvania during the taxable year. The denominator is total gross receipts derived from all sales during the taxable year.

For purposes of calculating the sales factor, only sales of stock in trade or inventory held primarily for sale to customers in the ordinary course of the business, sales of services to customers, and sales of operational assets shall be taken into account. A sale of stock in trade or inventory is in Pennsylvania if:

1. The seller delivers or ships the property from outside Pennsylvania into Pennsylvania to any purchaser other than the federal government.
2. The seller delivers or ships the property from Pennsylvania and the purchaser is the federal government.
3. The seller delivers or ships the property from Pennsylvania to another state or country, and the other state or country has no jurisdiction to tax the net income of the business derived from such sales.

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

4. The seller delivers or ships the property from a point within Pennsylvania to a purchaser in Pennsylvania. A sale of services is in if the seller performs the services wholly within Pennsylvania.

A sale of services is in Pennsylvania if the seller performs a greater portion of the services in Pennsylvania than outside Pennsylvania, based on costs of performance. A sale of an operational asset that is in Pennsylvania is a sale of property within Pennsylvania.

E. Allocating Gains or Losses from the Disposition of Tangible Property

Generally, the revenues, costs, expenses, and liabilities that a PA S corporation or partnership derives from, or incurs in, the sale, exchange, or other disposition of real property or tangible personal property are entirely derived from or incurred in the state or country in which the property is physically located. Special rules, however, apply with respect to the following:

1. Stock in trade or other property of a kind that the entity includes in its inventory if on hand at the close of the taxable year.
2. Property the entity holds primarily for sale to customers in the ordinary course of its business operations.
3. Assets that the entity employs in and serves as an operational function in the operation of the business.

The general rule for apportionment applies with respect to such assets if:

1. The entity disposes of the assets pursuant to the sale, discontinuation, or abandonment of a business, or segment thereof, or
2. The sale or other disposition is of a type that the entity does not reasonably expect to recur in the near future and possesses a high degree of abnormality.

Otherwise, the PA S corporation or partnership allocates the gain (loss) under the rules applicable to allocating income (loss). See [Table 16-6 Reporting Gain \(Loss\) For Pennsylvania Personal Income Tax Purposes](#).

The entity may not take into account any item of revenue, cost, expense, or liability allocable to a state or country other than Pennsylvania, under these rules, in computing its income from PA sources.

F. Gains or Losses from the Disposition of Intangible Personal Property

Generally, the revenues, costs, expenses, and liabilities that the PA S corporation or partnership derives from, or incurs in, the sale, exchange, or other disposition of

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

intangible personal property are entirely derived from or incurred in the state or country in which the property is physically located. The general rule for apportionment applies with respect to assets if:

1. The entity disposes of the asset pursuant to the sale, discontinuation, or abandonment of that business or segment thereof, or
2. The sale or other disposition is of a type that the entity does not reasonably expect to recur in the near future and possesses a high degree of abnormality.

Otherwise, the entity allocates gains or losses under the rules applicable to allocating income and loss.

Please refer to *PA PIT Bulletin 2005 -02 Gain or Loss Derived from the Disposition of a Going Concern* contained in the *Pennsylvania Personal Income Tax Guide, Chapter 30*.

G. Interest Income

Generally, the PA S corporation or partnership allocates any item of interest, cost, expense, or liability incurred in the production of interest to Pennsylvania.

However, special rules apply with respect to the following:

1. Interest the PA S corporation or partnership derives from, and costs, expenses, or liabilities the PA S corporation or partnership incurs in connection with, purchase money mortgages on real estate or land contracts,
2. Interest the PA S corporation or partnership derives from, and costs, expenses, or liabilities the PA S corporation or partnership incurs in connection with, assets that it employs as working capital (generally current assets) in its business and from accounts and notes receivable from sales or products or services it sells in the ordinary course of business, and
3. Interest incidental to the production or collection of rental or royalty income.

The PA S corporation or partnership apportions such items under the rules applicable to apportioning net profits (losses). Therefore, classify interest income associated with current assets as net profits from a business, profession or farm.

H. Dividend Income

Generally, the PA S corporation or partnership allocates any item of dividend, cost, expense, or liability incurred in the production of dividends to Pennsylvania. The special rules for allocating interest income, described above, also apply to dividend income. Therefore, generally classify dividend income associated with current assets as net profits from a business, profession or farm.

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

I. Rental Income From Real Estate

Rent that the PA S corporation or partnership derives from real estate, and costs, expenses, and liabilities the entity incurs in the production or collection of such rents are allocable to Pennsylvania only if the rental property is in Pennsylvania.

J. Rental Income From Tangible Personal Property

The PA S corporation or partnership allocates the rent it derives from tangible personal property that it does not employ in its business operation, and costs, expenses and liabilities that it incurs in the production or collection of such rents, by multiplying the net rent by a fraction. The numerator is the number of days the property is physically in Pennsylvania during the rental period. The denominator is the number of days for all rental periods in the taxable year.

If the physical location of the property during the rental period is unknown, the entity allocates it to the state or country in which the property was located at the time the rental payer obtained possession.

K. Royalties from Real Property

Proceeds derived from non-operating interests in coal, oil, gas, or other minerals in place and costs, expenses, and liabilities incurred in the production of such receipts are allocable to Pennsylvania only if the property from which the operating interests serves is located in Pennsylvania.

L. Royalties From Patents and Copyrights

The PA S corporation or partnership allocates patent and copyright royalties that are not includable in the calculation of net profits from the operation of a business, and the costs, expenses, and liabilities incurred in the production and collection of such royalties to Pennsylvania only if and to the extent that:

1. The payer employed the patent in the production, fabrication, manufacturing, or other processing in Pennsylvania, or
2. The payer produced the patented products in Pennsylvania, or
3. The payer originates the printing or publication in Pennsylvania.

M. Allocating Income from Estates and Trusts

Estate or trusts must provide to each beneficiary a *PA-41 Schedules RK-1 and NRK-1*, detailing the beneficiary's share of income, credits and distributions during the taxable year. The *PA-41 Schedules RK-1 and NRK-1* lists each beneficiary's resident taxable income or nonresident taxable income (respectively). The nonresident taxable income represents the beneficiary's total net income or gain derived through the estate or trust which the beneficiary must allocate to Pennsylvania.

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

V. LIMITED LIABILITY COMPANY (LLC)

A. Filing Requirements

1. Regardless of how a **limited liability company** is classified for federal income tax purposes, the limited liability company is subject to capital stock/foreign franchise tax, reported on the RCT-101, PA Corporate Tax Report. A limited liability company that meets the de minimis standards as outlined in Corporation Tax Bulletin 2004-01 may file the RCT-101D, Declaration of de minimis PA Activity, in lieu of the RCT-101, affirming the Pennsylvania activity during that period is de minimis.
2. A limited liability company that elects to file as a **C corporation** for federal income tax purposes files as a C corporation for Pennsylvania and is subject to Pennsylvania corporate net income tax, reported on the RCT-101, PA Corporate Tax Report. A limited liability company that files as a C corporation with the IRS does not file the PA-20S/PA-65 Information Return.
3. A limited liability company that elects to file as an **S corporation** for federal income tax purposes and has not elected out of PA Subchapter S status for Pennsylvania by filing REV-976, Election Not To Be Taxed as A Pennsylvania S Corporation, must file as an S corporation for Pennsylvania using the PA-20S/PA-65 Information Return. The members are subject to personal income tax.
4. A limited liability company that elects to file as a **partnership** for federal income tax purposes files as a partnership for Pennsylvania using the PA-20S/PA-65 Information Return. The partners are subject to personal income tax.
5. **Income Reported on Federal Tax Return of an Individual**
A single member limited liability company (SMLLC) owned by an individual or a limited liability company jointly owned by husband and wife that files as a disregarded entity for federal income tax purposes is an entity separate from its owner for corporation tax purposes and is liable for capital stock/foreign franchise tax but not for Pennsylvania corporate net income tax.

For personal income tax purposes, a SMLLC owned by an individual or a limited liability company jointly owned by husband and wife is a disregarded entity. The income of the limited liability company is reported on PA-40 Schedule C, Profit or Loss from Business or Profession, or PA-40 Schedule E, Rent and Royalty Income (Loss), of the member's PA-40, Individual Income Tax Return, and the single-member limited liability company does not file a PA-20S/PA-65 Information Return. Examples include rental property or partnership interest held by a limited liability company.

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

6. **Income Reported on Federal Tax Return of another Business Entity**
The income of a SMLLC owned by another entity is reported on the tax return of the member as if earned by the member. The limited liability company is an entity separate from its owner for corporation tax purposes and is liable for capital stock/foreign franchise tax. It is prohibited to combine the activity of the limited liability company with the activity of the member when reporting capital stock/foreign franchise tax.

See [Table 16-5 – PA Filing Requirements for Corporate Net Income Tax and Personal Income Tax Purposes](#) in Part IX - TABLES.

VI. PA-20S/PA-65 SCHEDULE M

- A. **Reconciliation of Federal Taxable Income to Pennsylvania-Taxable Income**
Use Part A to classify taxable income (loss) as shown on federal Form 1120S or the federal Form 1065 for Pennsylvania purposes. The entity must classify its federal amounts using Pennsylvania personal income tax rules.

Use Part B to reconcile from the entity's federal business income (loss) and rental/royalty income (loss) to its Pennsylvania income (loss). If the entity is separately allocating its income, keeps separate books and records for financial statement purposes, and there are no business transactions between multiple businesses, the "PA Allocated Income (loss)" column, and the "Total Income (loss) Total Business Income (loss) before Apportionment" column will be completed. If the entity is apportioning its income, only the Total column will be completed.

Important. Use *PA-20S/PA-65 Schedule M* for business income (loss) or rental/royalty income (loss). The entity should complete the appropriate PA-20S/PA-65 Schedules A, B, and D for all other income classes. Use of PA-20S/PA-65 Schedule M for the other income classes' results in the improper classification of income and reporting errors.

See [Table 16-6 – Reporting Gain \(Loss\) For PA PIT Purposes](#) in Part IX - TABLES.

See [Table 16-7 – PA Partnerships and PA S Corporations Entity Distinctions](#) in Part IX - TABLES.

- B. **PA-20S/PA-65 Schedule M, Part A**

1. **Classifying Federal Income (Loss) for Pennsylvania Personal Income Tax Purposes**

Use Part A to classify the federal amounts from federal Form 1120S, Schedule K or federal Form 1065, Schedule K.

For each line, analyze the components of the federal amounts. Then, classify the federal amounts to the applicable Pennsylvania income class in its entirety, or the appropriate portion of each amount, without adjustment for Pennsylvania

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

personal income tax rules. If the entity does not have to allocate an income (loss) amount, place that amount in the appropriate column for the Pennsylvania income class. The partnership or PA S corporation should transfer amounts from columns (c) through (e) to the corresponding PA Schedules. Columns (b) and (f) are reported on PA-20S/PA-65 Schedule M, Part B, for further adjustment as required.

2. **Pass Through Income from Another Pass Through Entity**

If the partnership or PA S corporation completing this PA-20S/PA-65 Information Return received a PA-20S/PA-65 Schedule RK-1 and/or NRK-1 from the other entity on which it is a member, it already has the classified income (loss) amount for completing PA-20S/PA-64 Schedule M, Part A.

3. **Partnership Example**

The ABC partnership is a partner in the XYZ partnership. The ABC partnership receives an RK-1 from the XYZ partnership that includes Pennsylvania-taxable business income (loss) from operations in the amount of \$1,000, interest income in the amount of \$500, net gain (loss) from the sale, exchange or disposition of property in the amount of \$10,000, and net income (loss) from rents, royalties, patents, and copyrights in the amount of \$3,000. The ABC partnership will classify on Line 1b of their PA-20S/PA-65 Information Return the \$1,000 of PA-taxable business income (loss) from operations as share of income from all other entities. The \$500 of interest income will be classified on PA-20S/PA-65 Schedule A, Line 1. The \$10,000 of net gain (loss) from the sale, exchange, or disposition of property will be classified on PA-20S/PA-65 Schedule D, Line 9, or Line 19.

The \$3,000 of net income (loss) from rents, royalties, patents and copyrights will be classified on their PA-20S/PA-65 Schedule E, Line 23, or Line 24.

4. **PA-20S/PA-65 Schedule M, Part B**

Part B is similar to, but more specific than the PA Schedule C that individuals, estates, and trusts use to reconcile federal income (loss) for Pennsylvania personal income tax purposes.

For line-by-line instructions for PA-20S/PA-65 Schedule M, Part A and Part B, please see *PA-20S/PA-65 Schedule M Instructions* on the department's website.

VII. PENALTIES, ADDITIONS AND FEES

If a taxpayer fails to include in taxable income an amount more than 25 percent of the taxable income that was reported by reason of negligence or intentional disregard of rules and regulations but without intention to defraud, there shall be added an amount equal to 25 percent of the amount of underpayment. See Section 352(b)(2).

Any partnership required to furnish an information return who furnishes a false or fraudulent return shall be subject to a penalty of \$50.00 for each failure.

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

A partnership that did not file a return and did not request an extension would be penalized \$50 for each non filed year. If the partnership files the required returns, the \$50 penalty per return will not be imposed. However, if the partnership has nonresident withholding tax and or corporate net income tax withholding due with the nonfiled returns, interest and penalty will be applied.

Every PA S Corporation required to file a return that furnishes a false or fraudulent return or fails to file a return shall be subject to a \$250 penalty for each failure. See Section 352(f).

If any individual, estate or trust files a return which does not contain sufficient information to determine the correct liability or which contains information which indicates the liability is significantly incorrect and the return is filed frivolously or to delay or impede the administration of the tax law, the filer shall pay a \$500 penalty. See Section 342(l).

VIII. FRAUDULENT INVESTMENT SCHEMES

In response to taxpayer inquiries regarding fraudulent investment schemes and losses as they relate to Pennsylvania personal income tax, the Department of Revenue provides the following guidance.

Pennsylvania's treatment of losses from such schemes, often referred to as "Ponzi" schemes, differs from federal income tax treatment.

The Internal Revenue Service (IRS) recently published guidance on the application of federal income tax to losses from fraudulent investment schemes. See Rev. Proc. 2009-20, 2009-14 IRB; and Rev. Rul. 2009-9, 2009-14 IRB (3/17/2009). The IRS determined that a loss from a fraudulent investment scheme is treated as a theft loss under IRC § 165 rather than a capital loss. The loss is an itemized deduction that is taken in the year the loss is discovered, and the loss is not subject to the deduction limitations of IRC §§ 67, 68 or 156(h). Further, the IRS will allow the taxpayer to carry the loss forward and backward under certain circumstances.

Pennsylvania personal income tax law does not have a corresponding provision to IRC § 165. Consequently, the department does not follow the federal income tax treatment of losses from fraudulent investment schemes.

For Pennsylvania personal income tax purposes, a loss from a fraudulent investment scheme must be reported as a loss from the sale, exchange or disposition of property on the PA-40 Schedule D.

This rule applies to both direct and indirect investors in S corporations and partnerships. A direct investor is one whose investment was an ownership interest in the fraudulent investment scheme or in the assets purportedly to be purchased in the investor's name by the perpetrator of the investment fraud. An indirect investor is one who was exposed through fund investments diversified in some of the fraudulent investment scheme or who was exposed through investments in third party funds (such as "funds of funds") with unreported investments in the fraudulent investment scheme.

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

An Investor experiences a loss upon a disposition of their direct or indirect investment to the extent that the taxpayer's basis in the investment is greater than the amount recovered from the investment. The investor's basis in the investment is the initial investment and any subsequent actual or fictitious income from the investment – reported by the investor and on which Pennsylvania personal income tax was paid – less any distributions and any losses utilized by the taxpayer in Pennsylvania or any other state. If the investment is in a partnership, the basis would be determined using Pennsylvania personal income tax rules. For calculation of the basis of a partner's interest in a partnership refer to the Part I of this chapter.

If a taxpayer reported fictitious income from a fraudulent investment scheme in a prior tax year, the department will not accept an amended return to remove such income from the prior tax year. Rather, such income increases the taxpayer's basis in the investment. Consequently, upon final disposition of the investment, any loss will be greater because of the basis increase from the fictitious income reported in prior years.

A loss from a direct or indirect investment in a fraudulent investment scheme can only be reported in the year in which some identifiable event closed and completed the transaction and fixed the loss amount so there is no possibility of any eventual recoupment. Any actual recovery from a direct or indirect investment is considered a distribution and reduces taxpayers' basis in the investment. Any recovery in excess of basis is reported as gain from the disposition of property and is reported on PA-40 Schedule D. The recovery period is considered final at the conclusion of all court and legal action to obtain a recovery on the investment, when the taxpayer receives notification that all proceeds have been paid out of existing funds, and/or when any other legal or final acts to dissolve the investment.

Losses are only recognized on transactions entered into for profit, such as investments, business property, and real estate. Losses are not recognized on the sale of property that was not acquired as an investment or for profit. Carry-forward or carry-back of any unused losses on the sale, exchange or disposition of property is not permitted.

If your investment was held in any entity other than a pass-through (i.e., partnership or S-corporation), please contact the department for further guidance.

Questions on reporting or calculating losses from fraudulent investment schemes may be directed to 717-787-8201.

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

IX. TABLES

Table 16-1 Schedule of Differences Between Federal Tax Law and Pennsylvania Personal Income Tax Law for Partnerships

Table 16-1

IRC Code Section	Description of Federal Tax Treatment	Pennsylvania Tax Treatment
§ 108	Exclusion of cancellation of indebtedness (COD) income	Pennsylvania does not follow federal treatment. Refer to Chapter 24: Cancellation of Debt for Pennsylvania Personal Income Tax Purposes
§ 179	Federal law extends and expands the IRC § 179 enhanced expensing provisions beginning in 2002 through year 2011. It provides an increase in the expensing limit from \$125,000 to \$500,000 with phase-out beginning at \$2,000,000 for 2010 and 2011.	Pennsylvania follows federal treatment. However, any changes made to IRC § 179 after Jan. 1, 1997 are not applicable to Pennsylvania. The Pennsylvania § 179 expense is limited to \$25,000 and will be phased out for purchases in excess of \$200,000. Pennsylvania allows a carry-over of the excess. Refer to PA PIT Tax Bulletin 2009-08.
§ 469	Passive or portfolio income	Pennsylvania does not follow federal treatment.
§ 704(b)	Special allocations with substantial economic effect	Pennsylvania follows federal treatment.
§ 704(c)	Allocations with respect to pre-contribution gain inherent in contributed assets	Pennsylvania follows federal treatment.
§ 704(d)	Limitation of losses to the extent of adjusted basis	Pennsylvania follows federal treatment; however, there is no provision for carryover of losses. For Pennsylvania personal income tax, a partner must reduce their basis in their partnership interest by losses, but only to the extent that the losses reduce either the income subject to Pennsylvania tax or the income tax of another state or country. If losses are not used, the basis must be reduced by the partner's share of straight-line depreciation
§ 705(a)	Determination of basis of partner's interest (general rule)	Pennsylvania follows federal treatment.
§ 706(c)	Federal closing of the books	Pennsylvania follows federal treatment.
§ 707(a)	Federal disguised sale rules	Pennsylvania follows federal treatment.
§ 707(c)	Guaranteed payments for the use of capital – unreasonable guaranteed payments	Pennsylvania follows federal treatment.

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

Table 16-1

IRC Code Section	Description of Federal Tax Treatment	Pennsylvania Tax Treatment
§ 707(c)	Guaranteed payments for the use of capital or other services	<p>Pennsylvania does not follow federal treatment for guaranteed payments for services. Under Pennsylvania tax law, to the extent paid for other services or for the use of capital, a guaranteed payment is:</p> <p>a. A withdrawal proportionately from the capital of all partners;</p> <p>b. A gain from the disposition of the recipient's partnership interest and a loss from the disposition of the other partners' partnership interests, to the extent derived from the capital of the other partners; and</p> <p>c. A return of capital by the recipient to the extent derived from his/her own capital.</p> <p>Pennsylvania allows the deduction</p>
§ 708	Technical termination of a partnership (involves greater than 50% change in ownership)	Pennsylvania follows federal treatment.
§ 709(a)	Treatment of organization and syndication fees (general rule)	Pennsylvania follows federal treatment.
§ 722	Basis of Contributing Partner's Interest	Pennsylvania follows federal treatment.
§ 721	Contribution of property to a partnership on a tax-free basis	<p>Pennsylvania generally follows federal treatment.</p> <p>Neither the partnership nor the partners, recognize gain or loss in the case of a contribution of property in exchange for an interest in the partnership.</p> <p>The partners recognize gain or loss in the following circumstances:</p> <ul style="list-style-type: none"> • The purpose of the contribution was to affect an exchange of property between two or more partners; or • The contributing partner receives, in exchange for his or her contribution, an interest in the partnership plus other property or cash.
§ 731		<p>Pennsylvania has not adopted the following concepts: 731(c)(3)(C)(iv) – Look-Thru of Partnership Tiers, 731(c)(5) – Subsection Disregarded in Determining Basis of Partner's Interest in Partnership and of Basis of Partnership Property.</p>
§ 733		<p>Pennsylvania has not adopted the following concepts: 732(d) – Special Partnership Basis to Transferee, 732(f) – Corresponding Adjustment to Basis of Assets of a Distributed Corporation Controlled by a Corporate Partner.</p>

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

Table 16-1

IRC Code Section	Description of Federal Tax Treatment	Pennsylvania Tax Treatment
§ 752	Increases or decreases in liabilities create deemed cash contribution or distributions to partner	Pennsylvania follows federal treatment.
§ 732(d) § 734(b) § 743(b) § 754	Election to step-up or down basis upon certain events	Pennsylvania does not follow federal treatment.
§ 1031	No gain (loss) recognized on any like-kind exchange transactions.	Pennsylvania does not follow federal treatment.
NA	Tax benefit rule (requirement to adjust basis)	For Pennsylvania personal income tax, a partner must reduce their basis in their partnership interest by losses, but only to the extent that the losses reduce either the income subject to PA tax or the income tax of another state or country. If losses are not used, the basis must be reduced, but not below zero, by the partner's share of straight-line depreciation.

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

Table 16-2 Schedule of Differences Between Federal Tax Law and Pennsylvania Personal Income Tax Law for Partner's Outside Basis Calculation

Table 16-2

IRC Code Section	Description of Federal Tax Treatment	Pennsylvania Personal Income Tax Treatment	Pennsylvania Tax Benefit Rule
§ 465	Federal loss not allowed due to federal-at-risk limitations	Pennsylvania personal income tax loss allowed to extent of Pennsylvania personal income tax basis and income in class. There is no carryover of a loss.	Basis is reduced by amount of loss offset by income. Percentage of unused loss is multiplied by partner's share of straight-line depreciation. Basis is reduced by the result.
	Federal loss for year higher than Pennsylvania loss as a result of federal-at-risk carryover	There is no carryover of a loss for Pennsylvania personal income tax purposes.	Loss was incurred in prior year. Any unused Pennsylvania personal income tax loss in prior year is forgone.
§ 469	Federal loss not allowed due to federal passive loss limitations	Pennsylvania personal income tax loss allowed to extent of Pennsylvania personal income tax basis and income in class. There is no carryover of a loss.	Basis is reduced by amount of loss offset by income. Percentage of unused loss is multiplied by partner's share of straight-line depreciation. Basis is reduced by the result.
	Federal loss for year higher than Pennsylvania loss as a result of federal passive loss carryover	There is no carryover of a loss for Pennsylvania personal income tax purposes.	Loss was incurred in prior year. Any unused Pennsylvania personal income tax loss in prior year is forgone.
§ 704	Federal loss not allowed due to federal basis limitations	Pennsylvania personal income tax loss allowed to extent of Pennsylvania personal income tax basis and income in class. The loss is only allowed if the partner is responsible for making up losses to the partnership. There is no carryover of a loss.	Basis is reduced by amount of loss offset by income. Percentage of unused loss is multiplied by partner's share of straight-line depreciation. Basis is reduced by the result.
	Federal loss for year higher than Pennsylvania loss as a result of federal loss carryover	There is no carryover of a loss for Pennsylvania personal income tax.	Loss was incurred in prior year. Any unused Pennsylvania personal income tax loss in prior year is forgone.
	Federal loss allowed because of federal basis. For Pennsylvania personal income tax no income to offset in class	No loss allowed for Pennsylvania personal income tax against any other class of income. There is no carryover of a loss.	Basis is reduced by amount of loss offset by income. Percentage of unused loss is multiplied by partner's share of straight-line depreciation. Basis is reduced by the result.
	Federal loss for year higher than Pennsylvania loss as a result of Pennsylvania personal income tax adjustments	Pennsylvania personal income tax loss allowed to extent of Pennsylvania personal income tax basis and income in class. There is no carryover of a loss. Do not use federal loss.	Loss was incurred in prior year. Any unused Pennsylvania personal income tax loss in prior year is forgone.

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

Table 16-3 Schedule of Differences Between Federal Tax Law and Pennsylvania Personal Income Tax Law for PA S Corporations

Reconciliation of Federal-Taxable Income to Pennsylvania-Taxable Income

The PA S corporation should use the PA-20S/PA-65 Schedule M, Reconciliation of Federal-Taxable Income to Pennsylvania-taxable Income to reconcile from federal ordinary income (loss) to Pennsylvania-taxable income (loss) from business, profession, or farm operations, and from rental or royalty income (loss).

In many instances, Pennsylvania personal income tax law and regulations do not provide specific treatment similar to federal tax laws. This is especially true with regard to federal elections concerning the timing of income and expense items. Taxpayers should not use federal elections to determine Pennsylvania personal income tax income (loss).

Table 16-3

IRC Code Section	Description of Federal Tax Treatment	Pennsylvania Tax Treatment
§ 108	Exclusion of cancellation of indebtedness (COD) income	Pennsylvania does not follow federal treatment. See new Chapter 24: Cancellation of Debt for Pennsylvania Personal Income Tax Purposes
§ 179	Federal law extends and expands the IRC § 179 enhanced expensing provisions beginning in 2002 through year 2011. It provides an increase in the expensing limit from \$125,000 to \$500,000 with phase-out beginning at \$2,000,000 for 2010 and 2011.	Pennsylvania follows federal treatment. However, any changes made to IRC § 179 after Jan. 1, 1997 are not applicable to Pennsylvania, including the PA § 179 expense is \$25,000 and will be phased out for purchases in excess of \$200,000.
§ 338(h)(10)	Election to treat a stock as an asset sale	Pennsylvania does not follow federal treatment.
§ 351	Contribution of property to a corporation on a tax-free basis	Pennsylvania follows federal treatment.
§ 465	Federal loss not allowed due to federal at risk limitations Federal loss for year higher than Pennsylvania loss as a result of federal at risk carryover	Pennsylvania personal income tax loss allowed to extent of Pennsylvania personal income tax basis and income in class. There is no carryover of a loss. Basis is reduced by amount of loss offset by income. Percentage of unused loss is multiplied by shareholder's share of straight-line depreciation. Basis is reduced by the result. There is no carryover of a loss for Pennsylvania personal income tax purposes. Loss was incurred in prior year. Any unused Pennsylvania personal income tax loss in prior year is forgone.

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

Table 16-3

§ 469	<p>Federal loss not allowed due to federal passive loss limitations</p> <p>Federal loss for year higher than Pennsylvania loss as a result of federal passive loss carryover</p>	<p>Pennsylvania personal income tax loss allowed to extent of Pennsylvania personal income tax basis and income in class. There is no carryover of a loss. Basis is reduced by amount of loss offset by income. Percentage of unused loss is multiplied by shareholder's share of straight-line depreciation. Basis is reduced by the result.</p> <p>There is no carryover of a loss for Pennsylvania personal income tax purposes. Loss was incurred in prior year. Any unused Pennsylvania personal income tax loss in prior year is forgone.</p>
§ 1031	No gain (loss) recognized on any like-kind exchange transactions.	Pennsylvania does not follow federal treatment.
§ 1361	<p>One class of stock requirement</p> <p>Qualified Subchapter S Subsidiaries (QSSS)</p>	<p>Pennsylvania follows federal treatment.</p> <p>Pennsylvania permits qualified subchapter S subsidiaries; however, each qualified subchapter S subsidiaries is considered a separate corporation for purposes of the capital stock / foreign franchise tax. See Act 2006–67.</p>
IRC Code Section	Description of Federal Tax Treatment	Pennsylvania Tax Treatment
§ 1362	Election of S corporation	Pennsylvania follows federal treatment for tax years beginning Jan. 1, 2006.
§ 1362(d)	Passive income test	Pennsylvania does not follow federal treatment.
§ 1368	Accumulated Adjustments Account (AAA)	<p>Calculation required for years when PA S status is in place.</p> <p>Federal subchapter S corporations that have been Pennsylvania S corporations throughout their corporate existence always should have tracked their Pennsylvania adjustments account and Pennsylvania accumulated earnings and profits, if applicable, to provide the information required for resident shareholders to correctly report distributions.</p> <p>Federal subchapter S corporations that have become Pennsylvania S corporations by the operation of Act 67 of 2006 similarly should track Pennsylvania accumulated adjustments account and Pennsylvania accumulated earnings and profits. However, it may be extremely difficult to obtain the necessary information to calculate the initial Pennsylvania accumulated earnings and profits.</p> <p>The Pennsylvania Department of Revenue will allow a transitional election by federal subchapter S corporations that have become Pennsylvania S corporations by the operation of Act 67 of 2006. The department may allow such a "new" Pennsylvania S corporation taxpayer to elect to use its federal accumulated adjustments account as the functional equivalent of its Pennsylvania accumulated earnings and profits.</p>

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

Table 16-3

§ 1374	Built-in-gains tax	Pennsylvania generally follows federal treatment. Pennsylvania does not follow federal for 25 percent passive income test. If any built-in-gains tax is imposed on a PA S corporation (or any qualified subchapter S subsidiary owned by such PA S corporation), the amount of tax so imposed shall be treated as a loss sustained by such PA S corporation during such years. The character of such loss shall be determined by allocating the loss proportionately among the recognized built-in gains giving rise to such tax.
§ 1377	Election to terminate year	Pennsylvania follows federal treatment.
NA	Tax Benefit Rule	For Pennsylvania purposes, a shareholder must reduce basis in the S corporation by losses but only to the extent that the losses reduce either the income subject to Pennsylvania tax or the income tax of another state or country. If losses are not utilized, the basis must be reduced by the shareholder's share of straight-line depreciation.

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

Table 16-4 Schedule of Differences Between Federal Tax Law and Pennsylvania Personal Income Tax Law for S Corporation's Outside Basis Calculation

Table 16-4

IRC Code Section	Description of Federal Tax Treatment	Pennsylvania Personal Income Tax Treatment	Pennsylvania Tax Benefit Rule
§ 465	Federal loss not allowed due to federal at risk limitations	Pennsylvania personal income tax loss allowed to extent of Pennsylvania personal income tax basis and income in class. There is no carryover of a loss.	Basis is reduced by amount of loss offset by income. Percentage of unused loss is multiplied by shareholder's share of straight-line depreciation. Basis is reduced by the result.
	Federal loss for year higher than Pennsylvania loss as a result of federal at risk carryover	There is no carryover of a loss for Pennsylvania personal income tax purposes.	Loss was incurred in prior year. Any unused Pennsylvania personal income tax loss in prior year is forgone.
§ 469	Federal loss not allowed due to federal passive loss limitations	Pennsylvania personal income tax loss allowed to extent of Pennsylvania personal income tax basis and income in class. There is no carryover of a loss.	Basis is reduced by amount of loss offset by income. Percentage of unused loss is multiplied by shareholder's share of straight-line depreciation. Basis is reduced by the result.
	Federal loss for year higher than Pennsylvania loss as a result of federal passive loss carryover	There is no carryover of a loss for Pennsylvania personal income tax purposes.	Loss was incurred in prior year. Any unused Pennsylvania personal income tax loss in prior year is forgone.
§ 1367	Federal loss not allowed due to federal basis limitations	Pennsylvania personal income tax loss allowed to extent of Pennsylvania personal income tax basis and income in class. There is no carryover of a loss.	Basis is reduced by amount of loss offset by income. Percentage of unused loss is multiplied by shareholder's share of straight-line depreciation. Basis is reduced by the result.
	Federal loss for year higher than Pennsylvania loss as a result of federal loss carryover	There is no carryover of a loss for Pennsylvania personal income tax.	Loss was incurred in prior year. Any unused Pennsylvania personal income tax loss in prior year is forgone.
	Federal loss allowed because of federal basis. For Pennsylvania personal income tax no income to offset in class	No loss allowed for Pennsylvania personal income tax against any other class of income. There is no carryover of a loss.	Basis is reduced by amount of loss offset by income. Percentage of unused loss is multiplied by shareholder's share of straight-line depreciation. Basis is reduced by the result.
	Federal loss for year higher than Pennsylvania loss as a result of Pennsylvania personal income tax adjustments.	Pennsylvania personal income tax loss allowed to extent of Pennsylvania personal income tax basis and income in class. There is no carryover of a loss. Do not use federal loss.	Basis is reduced by amount of loss offset by income. Percentage of unused loss is multiplied by shareholder's share of straight-line depreciation. Basis is reduced by the result.

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

Table 16-5 PA Filing Requirements for Corporate Net Income Tax and Personal Income Tax Purposes

LLC Type	Federal Classification:	CNI Tax	CSF Tax	Loans Tax	PIT
Multiple members • 72 P.S. § 7401(1) • 72 P.S. § 7601(a) • 15 Pa. C.S. § 8925	Regular corporation Submit RCT-101 and federal Form 1120	YES	YES	YES	NO
	Subchapter S corporation federal ONLY REV-976 filed with Pennsylvania Submit RCT-101 and: • Federal Form 1120S • Schedule of net book income supported by change in net worth from the beginning to the end of the tax year (PA Schedule A-2)	YES	YES	YES	NO
	Subchapter S corporation Federal & Pennsylvania Submit RCT-101 and: • Federal Form 1120S • Schedule of net book income supported by change in net worth from the beginning to the end of the tax year (PA Schedule A-2) Submit PA-20S/PA-65 Information Return	YES (for net recognized built-in gains only)	YES	YES	YES
	Partnership Submit RCT-101 and : • Federal Form 1065 Submit PA-20S/PA-65 Information Return	NO	YES	YES	YES
Single member • 72 P.S. § 7401(1) • 72 P.S. § 7601(a) • 15 Pa. C.S. § 8925	Regular corporation Submit RCT -101 and: • Federal Form 1120	YES	YES	YES	NO
	Subchapter S corporation federal ONLY REV-976 filed with Pennsylvania Submit RCT-101 and: • Federal Form 1120S • Schedule of net book income supported by change in net worth from the beginning to the end of the tax year (PA Schedule A-2)	YES	YES	YES	NO
	Subchapter S corporation Federal & Pennsylvania Submit RCT-101 and: • Federal Form 1120S • Schedule of net book income supported by change in net worth from the beginning to the end of the tax year (PA Schedule A-2) Submit PA-20S/PA-65 Information Return	YES (for net recognized built-in gains only)	YES	YES	YES
	Disregarded entity (sole proprietorship owned by a natural person) Submit RCT-101 and: • Balance sheet (PA Schedule L) • Reconciliation of book income to income reported on federal Schedule C, E, or F (PA Schedule M-2) Submit PA-40 & required schedules	NO	YES	YES	YES
	Disregarded entity (a branch or division) - Submit RCT-101 and: • Pro Forma Separate Company • Federal Form 1120S or 1065 Income for the disregarded entity is filed with parent RCT-101 or PA-20S/PA-65 Information Return	NO	YES	YES	YES

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

LLC Type	Federal Classification:	CNI Tax	CSF Tax	Loans Tax	PIT
Restricted Professional Company (RPC) * <ul style="list-style-type: none"> • 72 P.S. § 7401(1) • 72 P.S. § 7601(a) • 15 Pa. C.S. § 8925 • 15 Pa. C.S. § 8997 	Regular corporation Submit RCT-101 and federal Form 1120	YES	YES	YES	NO
	Subchapter S corporation federal ONLY REV-976 filed with Pennsylvania Submit RCT-101 and: <ul style="list-style-type: none"> • Federal Form 1120S • Schedule of net book income supported by change in net worth from the beginning to the end of the tax year 	YES	YES	YES	NO
	Subchapter S corporation federal & Pennsylvania Submit RCT-101 and: <ul style="list-style-type: none"> • Federal Form 1120S • Schedule of net book income supported by change in net worth from the beginning to the end of the tax year Submit PA-20S/PA-65 Information Return	YES (for net recognized built-in gains only)	YES	YES	YES
	Partnership Submit PA-20S/PA-65 Information Return Not required to file RCT-101	NO	NO	NO	YES
	Disregarded entity (sole proprietorship owned by a natural person) Prior to Jan. 1, 2006: Submit RCT-101 and: <ul style="list-style-type: none"> • Balance sheet • Schedule of net book income supported by change in net worth from the beginning to the end of the tax year Submit PA-40 & required schedules	NO	YES	YES	YES
	Disregarded entity (sole proprietorship owned by a natural person) Beginning Jan. 1, 2006: Submit PA-40 & required schedules Not required to file RCT-101	NO	NO	NO	YES

* A Restricted Professional Company (RPC) engaged in activities other than activities authorized for an RPC is subject to corporation taxes and required to file the RCT-101 in the same manner as any other Limited Liability Company.

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

Table 16-6 Reporting Gain (Loss) For Pennsylvania Personal Income Tax Purposes

Table 16-6

Classified Gains (Losses) for PA-20S/PA-65 and Reporting Gains (Losses) for Pennsylvania Personal Income Tax			
Type of Gain	Classification	Gain Treatment	
		Pennsylvania Resident	Nonresident
Sale of intangible personal property used in a business, profession or farm, including goodwill contractually sold with the business and allocated by the parties as to value in the sales agreement	Used in determining the net income (loss) of the business, profession or farm PA-20S/PA-65, Part I or Part II	Taxable	Taxable
Sale of intangible personal property not used in a business, profession or farm, including goodwill contractually sold with the business and allocated by the parties as to value in the sales agreement	PA-20/PA-65 Schedule D	Taxable	Not Taxable
Sale of tangible personal property used in a business, profession or farm - proceeds reinvested and used to acquire similar property used in the same kind of business, profession or farm	Used in determining the net income (loss) of the business, profession or farm PA-20S/PA-65, Part I or Part II	Taxable	Taxable
Sale of tangible personal property used in a business, profession or farm - proceeds not reinvested and used to acquire similar property used in the same kind of business, profession or farm	PA-20S/PA-65 Schedule D	Taxable	Taxable (If property is located in Pennsylvania)
Sale of inventory	Used in determining the net income (loss) of the business, profession or farm PA-20S/PA-65, Part I or Part II	Taxable	Taxable
Sale of stock in trade	Used in determining the net income (loss) of the business, profession or farm PA-20S/PA-65, Part I or Part II	Taxable	Taxable
Sale of other current assets	Used in determining the net income (loss) of the business, profession or farm PA-20S/PA-65, Part I or Part II	Taxable	Taxable
Sale of tangible non-current assets and intangible non-current assets used in operating a business, profession or farm	PA-20S/PA-65 Schedule D	Taxable	Taxable

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

Table 16-6

Sale of tangible non-current assets and intangible non-current assets held for investment not used in operating a business, profession or farm	PA-20S/PA-65, Schedule D	Taxable	Taxable (If property is located in Pennsylvania)
Sale of land and/or buildings constituting the abandonment of a business or business segment i.e. sale of a division or line of business where the seller does not continue the division or business activity	PA-20S/PA-65 Schedule D	Taxable	Taxable (If property is located in Pennsylvania)
Sale of land and/or buildings used as a facility in the operation of a business, profession or farm - proceeds reinvested in a similar facility and used in the same kind of business, profession or farm	Used in determining the net income (loss) of the business, profession or farm PA-20S/PA-65, Part I or Part II	Taxable	Taxable
Sale of land and/or buildings held for investment regardless of reinvestment of proceeds	PA-20S/PA-65 Schedule D	Taxable	Taxable (If property is located in Pennsylvania)
Sale of stocks and bonds, other than federal or Pennsylvania obligations, and used in the operating cycle of the business, profession or farm	Used in determining the net income (loss) of the business, profession or farm PA-20S/PA-65, Part I or Part II	Taxable	Taxable
Sale of stocks and bonds, other than federal or Pennsylvania obligations, and not used in the operating cycle of the business, profession or farm	PA-20S/PA-65 Schedule D	Taxable	Not taxable
IRC § 1035 - exchange of insurance policy			
With boot		Taxable	Not Taxable
Without boot	PA-20S/PA-65 Schedule D	Not Taxable	Not Taxable
Sale of ownership interests in partnerships and business enterprises	PA-20S/PA-65 Schedule D	Taxable	Not taxable

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

Table 16-7 PA Partnerships and PA S Corporations Entity Distinctions

Table 16-7

PA PARTNERSHIPS AND PA S CORPORATIONS ENTITY DISTINCTIONS		
Description	PA Partnerships	PA S Corporations
Capital Stock Tax or Foreign Franchise Tax	Not applicable, except in the case of an LLC or business trust.	Applicable
Entity Election	Not applicable	Follows federal treatment.
Built-In Gains Tax	Not applicable	Follows federal treatment.
Share of liabilities as part of basis	Liabilities included in basis.	Liabilities not included in basis, unless shareholder lends directly to PA S corporation.
Contribution To Owner's Retirement	Not deductible for partners.	Deductible for shareholder/employees only per plan.
Corporate Net Income Tax	Not applicable to partnerships, unless filing as a corporation for federal purposes.	Only if built-in gains tax applies.
Corporate Net Income Tax	Corporate partners will reflect their allocable share of partnership income (loss) on their respective RCT-101, PA Corporate Tax Return.	If the S corporation has built-in gains tax it is required to file a RCT-101, PA Corporate Tax Return and a PA-20S/PA-65 Information Return.
Health Insurance Premiums	Not deductible for premiums paid to partners. Not included as guaranteed payments.	Entity can deduct premiums paid for shareholder employees if it is a non-discriminatory plan. Not included as wages for shareholder.

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

Table 16- 8 Classified Federal Schedule K Lines for Pennsylvania Personal Income Tax Purposes

Table 16-8

Classified Federal Schedule K Lines for Pennsylvania Personal Income Tax Purposes	
Net income (loss) from rental real estate activities	<ul style="list-style-type: none"> • If the rental activity includes providing significant services (e.g. hotel) - Part I, Line 1a and/or Part II, Line 2a and/or Line 2e. • If the rental activity does not include providing significant services - Part III, Line 6. • If the rental activity includes providing significant services (e.g. rental of tangible personal property) - Part I, Line 1a and/or Part II, Line 2a and/or Line 2e. • If the rental activity is an investment property and does not include providing significant services - Part III, Line 6.
Interest income	<ul style="list-style-type: none"> • If derived from assets employed as working capital in a business, profession, or farm or from accounts and notes receivable from sales of products or services sold in the ordinary course of business, generally current assets - Part I, Line 1a and/or Part II, Line 2a and/or Line 2e. • If derived from assets that are held for long-term investment purposes or otherwise serve an investment function, generally long-term assets - Part III, Line 3.
Dividend income	<ul style="list-style-type: none"> • If derived from assets employed as working capital in a business, profession or farm, or from accounts and notes receivable from sales of products or services sold in the ordinary course of business, generally current assets - Part I, Line 1a and/or Part II, Line 2a and/or Line 2e. • If derived from assets that are held for long-term investment purposes or otherwise serve an investment function, generally long-term assets - Part III, Line 4.
Sale of property federal Form 4797 Net IRC § 1231 gain (loss) other than due to casualty or theft	<ul style="list-style-type: none"> • If from a sale, exchange, or disposition of property used in the business, profession, or farm, and the proceeds reinvested and used to acquire similar property used in the same kind of business - Part I, Line 1a and/or Part II, Line 2a and/or Line 2e. • If from a sale, exchange, or disposition of property NOT USED in the ordinary course of operating the business, profession, or farm as described above - Part III, Line 5.
Guaranteed payments to partners	<ul style="list-style-type: none"> • Guaranteed payment treatment for partners (partnerships only)
Other income (loss)	<ul style="list-style-type: none"> • Determine the appropriate Pennsylvania income class from the activity, operation, and transactions (and purpose) that generated the income (loss). Include the amount on the applicable line of the PA-20S/PA-65 Information Return.

PENNSYLVANIA PERSONAL INCOME TAX GUIDE

X. BASIS WORKSHEETS

REV-998 – Shareholder Tax Basis in PA S Corporation Stock Worksheet and REV-999 – Partner PA Outside Tax Benefit in a Partnership Worksheet

REV-998 is used by owners in a PA S corporation and the REV-999 is used by partnerships to calculate each owner's basis in that entity. Both forms are available on the department's website.

Pennsylvania law requires an entity to depreciate property by a minimum amount it determines using the straight-line method even if the depreciation calculated under this method does not provide any tax benefit. A tax benefit means that the owner reduces the Pennsylvania tax liability or the tax liability to another state. Therefore, if an owner receives a distributable share of a loss and does not receive a benefit from the loss, the owner must still reduce the basis by their share of straight-line depreciation. However, if the owner only received a partial benefit from the loss, the owner must reduce the basis by (1) the loss utilized and (2) a portion of the owner's share of straight-line depreciation. This is calculated by the unutilized loss divided by the total loss multiplied by the owner's share of straight-line depreciation. If the owner receives full benefit of the loss then the maximum amount the taxpayer must reduce their basis by is the total loss.

XI. TAX WORKSHEET FOR NON PENNSYLVANIA TAXES PAID ON INCOME (SCHEDULE M)

REV-1190, Tax Worksheet for PA-20S/PA-65 Schedule M, Part B, Section E, Line a

For tax year 2012, the tax worksheet for PA-20S/PA-65 Schedule M, Part B, Section E, Line a has been change to REV-1190. REV-1190 must be attached to PA-20S/PA-65 Schedule M when reporting non-Pennsylvania taxes paid on income. REV-1190 is available on the department's website.