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OVERVIEW

Definition of Gross Compensation for Pennsylvania Personal Income Tax

For Pennsylvania personal income tax (PA PIT) purposes, the term “compensation” includes salaries, wages, commissions, bonuses, and incentive payments whether based on profits or otherwise, fees, tips, and similar remuneration received for services rendered as an employee or casual employee, agent, or officer of an individual, partnership, business or nonprofit corporation, or government agency, whether directly or through an agent, and whether in cash or in property.

Compensation paid in any medium other than cash is valued at its fair market value. Examples of a medium other than cash include, but are not limited to:

- Foreign currency;
- Check or other negotiable instruments;
- Freely transferable readily marketable obligations or other cash equivalents;
- Property interests;
- Below-market-rate loans; or
- Discharge of indebtedness.

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

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

Certain items are excluded from the definition of taxable compensation. These items include, among other things:



- Income received for active duty military service outside the Commonwealth of Pennsylvania;
- Income received for active State duty for emergency within or outside the Commonwealth of Pennsylvania;
- Periodic payments for sickness and disability other than regular wages received during a period of sickness or disability;
- Disability, retirement, or other payments arising under workmen's compensation acts, occupational disease acts and similar legislation by any government;
- Payments commonly recognized as old age or retirement benefits paid to persons retired from service after reaching a specific age or after a stated period of employment;
- Public assistance or unemployment compensation payments by any governmental agency;
- Payments to reimburse actual expenses;
- Personal use of an employer's owned or leased property or of employer-provided services; or
- Compensation does not include guaranteed payments to a partner even if they are for services.

Refer to the sections that follow for detailed rules regarding specific items of compensation.

Income Items Taxable as Federal Compensation Compared to Income Items Taxable as Pennsylvania Compensation

There are significant differences between PA PIT and federal income tax. Certain income items that are not taxable for federal income tax are taxable for PA PIT and vice versa

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

- Income Items Always Taxable as Pennsylvania Compensation illustrates what items are included in compensation for PA PIT purposes.
- Income Items Never Taxable as Pennsylvania Compensation illustrates what items are not included in compensation for PA PIT purposes.
- Income Items Taxable as Pennsylvania Compensation Based on Facts and Circumstances on the following pages for descriptions of these items illustrates what items may be taxable based on the facts and circumstances of the item for PA PIT purposes.



Income Items Always Taxable as Pennsylvania Compensation

Employee earnings: salaries, wages, tips, gratuities, commissions, bonuses, incentive payments, vacation/holiday pay

Severance and termination pay: including front-pay, covenant-not-to-compete payments, early-retirement incentives

Reimbursements and allowances in excess of allowable business expenses on PA-40 Schedule UE

Directors' fees (will constitute PA-40 Schedule C income if one's profession is a director for multiple organizations or corporations)

Jury fees

Witness fees (will constitute PA-40 Schedule C income if testifying as an expert in a field which is considered one's line of business)

Reimbursed moving expenses in excess of allowable expenses on PA-40 Schedule UE

Honoraria (will constitute PA-40 Schedule C income if one's profession is being a professional speaker)

Executor's or administrator's fees (will constitute PA-40 Schedule C income if one's profession is being an executor or administrator)

Covenant not-to-compete or payments received as consideration for refraining from the performance of services

Proceeds from an employee stock ownership plan to extent of excess computed under cost-recovery method

Cash allowances for rent, utilities, or other expenses received by ministers

Reimbursements made by an employer for legal services or other personal services

National Service Education Awards

Income from Peace Corps, VISTA Job Corps and AmeriCorps

Household employees pay

Employee contributions to an eligible Pennsylvania retirement plan and contributions to a qualified deferred compensation plan

Distributions from a nonqualified deferred compensation plan (unless the deferral was previously taxed under rules prior to Act 40 of 2005)

Medicare waiver payments or difficulty of care payments

Student loan debt forgiveness or payment if provided as employment incentive (does not include forgiveness under the Public Service Loan Forgiveness program or a similar program)



Income Items Never Taxable as PA Compensation
Federal active duty pay earned outside Pennsylvania
GI Bill benefits including tuition and living expenses
Alimony
Child support
Income in respect of a decedent (although income classified as IRD at the federal level may be taxable as another class of income in Pennsylvania, such as interest)
Inheritance
Retirement income, such as: distributions from eligible Pennsylvania retirement plans* after retirement age; Social Security payments; railroad retirement benefits
Public assistance
Unemployment compensation
Occupational Disease Act benefits (if included on the W-2 form attach explanation)
Nontaxable fringe benefits for PA PIT purposes, such as: meals and lodging provided to an employee by the employe; personal use of employer-owned or leased property or services, at no cost or at a reduced cost (personal use of company automobile, airplane or other employer-owned or leased property); employer-provided parking facilities; employer-provided professional services paid for directly by the employer
Premiums paid by an employer for group term life insurance
Rental value of parsonage owned by the congregation and required to be occupied by the cleric
Foster care
Amounts received for permanent loss of body function, disfigurement, or reimbursed medical expense
Disability payments paid by employer arising under occupational disease acts or other legislation
Strike benefits
Life insurance proceeds or settlements
Employee contributions or deferrals to a nonqualified deferred compensation plan (all IRC Section 409A plans and some IRC Section 457b plans where the deferrals made are subject to a substantial risk of forfeiture or the employee deferrals made to the plan are not funded by the employer)
The State Employees' Retirement System, the Pennsylvania School Employees' Retirement System, the Pennsylvania Municipal Employees Retirement System and the U.S. Civil Service Commission Retirement Disability Plan are eligible Pennsylvania retirement plans, and all distributions are exempt from PA PIT. Retired or retainer pay of a member or former member of a uniform service calculated under Chapter 71 of Title 10, U.S. Code as amended is also exempt from PA PIT.

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



Income Items Taxable as Pennsylvania Compensation Based on Facts and Circumstances

Type of Compensation	Taxable Description	Non-Taxable Description
Sick pay, sick leave	Sick pay and sick leave are taxable compensation when representing regular wages. The employer must include them as compensation and withhold Pennsylvania tax. Request <i>REV-634, Employee Fringe Benefits and Wage/Salary Supplements</i> .	<p>Payments, not representing regular wages, including payments made by third party insurers for sickness or disability, are not taxable income for Pennsylvania purposes.</p> <p>Your employer should not include periodic payments for sickness or disability in Box 16 of your federal Form W-2.</p> <p>If your employer includes this income and withholds Pennsylvania tax, you must obtain and submit a corrected federal Form W-2 or a statement from your employer explaining the error.</p>
Disability benefit payments, including payments made by third party insurers for sickness or disability	Taxable if paid by employer.	Nontaxable if paid by third-party insurer.



Type of Compensation	Taxable Description	Non-Taxable Description
A premature withdrawal from a regular IRA or Roth IRA	A premature withdrawal from a regular IRA or Roth IRA is taxable compensation to the extent that the taxpayer receives an amount that exceeds his or her previously taxed contributions. The cost-recovery method of accounting must be used to determine the taxable portion unless timely rolled over into an eligible Pennsylvania retirement plan. Please consult your summary plan description or plan administrator.	
Payments received under worker’s compensation acts, occupational disease acts, or similar legislation, including payments for injuries you received while working, and damages received, whether by suit or otherwise, for personal injuries (unless one is required to pay these monies back to the employer and receives regular salary in return)	Taxable when the employee must turn over the worker’s compensation payments to the employer in order to receive his or her regular salary in return. The employee does not report the worker’s compensation payments but does report the full amount of his or her regular salary.	All other payments received under workers compensation acts is not taxable compensation. Occupational disease acts are not taxable.
Scholarships or fellowships and stipends	The recipient is required to apply the skill and training to advance research, creative work or some other project or activity.	Made on the basis of need or academic achievement, is not taxable if awarded to encourage or allow the recipient to further his or her academic achievement is not taxable compensation.



Type of Compensation	Taxable Description	Non-Taxable Description
Employer-provided fringe benefits	Non-excludible fringes	Excludible fringes (e.g. personal use of an employer’s owned or leased property and/or services, at no cost or at a reduced cost, and using your employer’s dependent care facilities) is not taxable compensation.
Damage awards - Delayed damages received in connection with a court judgment or settlement	Delay damages received in connection with a court judgment or settlement is taxable compensation.	Refer to Damage Awards
Federal-taxable punitive damages awarded and settlements from personal injury		Federal-taxable punitive damages received for personal physical injury or physical sickness, whether received by suit or by settlement is not taxable compensation.
Damages, awards, and settlements from personal injury or sickness		Damage awards and settlements from personal injury or sickness if pain and suffering, emotional distress, or another non-economic element was or would have been a significant evidentiary factor in determining the amount of the taxpayer’s damages is not taxable compensation. Refer to Damage Awards.



Type of Compensation	Taxable Description	Non-Taxable Description
All other damage awards	Other damage awards that are also taxable <i>e.g.</i> damage awards and settlements to the extent that the payments represent back wages or other uncollected entitlement to Pennsylvania-taxable incomes, damage awards for lost profits, etc.) is taxable compensation.	
Awards	Awards given in recognition for past or future service are taxable compensation.	All awards not given in recognition for past or future service are not taxable compensation.
Gifts	Taxable if gift is a transfer of cash or property in payment for past or present services or as an inducement to perform future services.	Gifts made from detached or disinterested generosity is not taxable compensation.



Type of Compensation	Taxable Description	Non-Taxable Description
<p>Tuition assistance or educational benefits unless the training or education is either:</p> <ul style="list-style-type: none"> • Required by law or regulation; or • Required of the employee by the employer in order for the employee to retain the skills necessary for his or her present position. If the course, degree program, or training is designed to enable the employee to enter a new field or profession or to obtain a promotion, the reimbursement is taxable. 	<p>If employer reimburses employees for education cost, then the reimbursement is fully taxable and the employee may deduct only those amounts directly related to business expenses allowed on PA-40 Schedule UE, Allowable Employee Business Expenses, to determine taxable compensation.</p>	<p>Employees of an institution of higher learning that receive free or low-cost education receive the tuition assistance tax free for PA PIT purposes unless they receive cash grants (for themselves or their children) as reimbursements for the tuition paid at their institution of employment or any other institution of higher learning.</p> <p>Since PA PIT has no distinction regarding taxability with respect to the amount of the benefits received for highly compensated employees, these benefits would also be considered tax free for PA PIT purposes unless a cash grant is received.</p>
<p>Employee contributions to non-qualifying deferred compensation plans</p>	<p>Refer to PA PIT Bulletin 2005-03 -Deferred Compensation Under Nonqualified Plans.</p>	<p>Refer to PA PIT Bulletin 2005-03 -Deferred Compensation Under Nonqualified Plans.</p>



Type of Compensation	Taxable Description	Non-Taxable Description
<p>Distributions from eligible Pennsylvania retirement plans and non-qualifying deferred compensation plans</p> <p>Refer to PA PIT Bulletin 2005-03 - Deferred Compensation Under Nonqualified Plans and PA PIT Bulletin 2005-05 - Qualified Employer Plans.</p>	<p>Act 2005-40 established the general rule that distributions from plans described in IRC §409A(d)(1) attributable to an elective deferral of income or the income on any elective deferral of income are taxable.</p>	<p>Contributions previously taxed using the cost recovery method are not taxable.</p>
<p>Federal or state active duty pay inside Pennsylvania for armed forces personnel</p>	<p>If related to active duty at a base located in Pennsylvania by Pennsylvania resident military personnel or for non-emergency active duty pay by Pennsylvania National Guard reservists</p>	<p>Active duty pay for nonresident taxpayers Emergency active duty pay under 35 Pa. C.S. §§ 7601-7604.</p>
<p>Federal active duty pay for commissioned corps of the U.S. Public Health Service or the National Oceanic and Atmospheric Administration</p>	<p>Pennsylvania resident taxpayers are subject to tax on their active duty pay regardless of where earned</p>	<p>Active duty pay for nonresident taxpayers</p>

Costs, Expenses, and Deductions Against Gross Compensation

- **No Deduction Against Gross Compensation**

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

- **Exception - Unreimbursed Employee Expenses**

Allowable employee business expenses for Pennsylvania purposes are similar to, but not exactly the same as, expenses for federal purposes. Refer to the section below for guidance regarding unreimbursed employee business expenses. Pennsylvania does not allow amounts of business expenses over and above the amount reimbursed by an



employer if the employer provides a fixed-mileage allowance, daily, weekly, monthly, or yearly reimbursement unless the reimbursement is included in compensation (W-2 wages). These expenses should not be reported on PA Schedule UE and reimbursements should not be included in compensation or on the reimbursement line of PA Schedule UE by the taxpayer.

In addition, business expenses are not to be reported if a taxpayer accounts for allowable business expenses to an employer and the employer reimburses the business expenses in the exact amount of the expenses.

Pennsylvania Resident Compensation

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

Nonresident Pennsylvania Compensation

A nonresident of Pennsylvania is taxed only on Pennsylvania-sourced compensation.

PENNSYLVANIA COMPENSATION – GENERAL RULES

Pennsylvania Statutes, Regulations, and Other Guidance

The sections of the Tax Reform Code of 1971 relating to compensation can be found at 72 P.S. §§ 7301(d), 7303(a)(1). The department has issued regulations to interpret the definition of compensation and its exclusions. The regulations relating to compensation can be found at 61 Pa. Code § 101.6. The department also issues guidance in the form of tax bulletins, letter rulings, and other materials that can be found on the department's pa.gov/agencies/revenue/resources/tax-law-policies-bulletins-notice.

W-2 Wage and Tax Statement

A W-2 Wage and Tax Statement (federal Form W-2) must be submitted with the PA-40 Individual Income Tax Return, as evidence of compensation paid, and taxes withheld by an employer. When submitting federal Form W-2, the taxpayer must submit a separate form for each employer.

Use the REV-1896, 1099 Income Worksheet, to list non-employee and other compensation. Report Pennsylvania-taxable compensation and any Pennsylvania tax withheld from that income. Include Pennsylvania-taxable amounts from federal Form 1099 that show pensions, retirement plan distributions, executor fees, jury duty pay, and other miscellaneous compensation.



Reciprocal Compensation Agreements

Pennsylvania currently has reciprocal agreements with Indiana, Maryland, New Jersey, Ohio, Virginia, and West Virginia. See note: Ohio Reciprocal Compensation Agreement.

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

Residents of these states may file a REV-419, Employee's Nonwithholding Application Certificate, if your employer agrees to withhold and remit your resident state's income tax so your employer can discontinue withholding PA PIT from your pay. Complete a new REV-419 every year or when your personal or financial situation changes. Photocopies of this form are acceptable.

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

If you are a resident of a reciprocal agreement state working or performing services in Pennsylvania and your employer withheld Pennsylvania income tax, you may request a refund of the Pennsylvania tax. You report zero taxable compensation on Line 1a and the Pennsylvania tax withheld on Line 13. Submit federal Form W-2 or a photocopy and a copy of the resident income tax return that you filed/will file with your resident state. Also, submit a statement explaining that you are a resident of a reciprocal agreement state.

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

Federal/Pennsylvania Personal Income Tax Differences in Arriving at Box 16 Wages

Under Act 2005-40, the federal constructive receipt rules relating to nonqualified



deferred compensation plans and unfunded section 457 deferred compensation plans were made applicable for personal income tax purposes. If you receive distributions of previously taxed elective deferrals, complete and include with your return the PA-40 W-2 RW, Reconciliation Worksheet. Refer to Chapter 12 of the PA Personal Income Tax Guide - Tax Income Subject to Withholding, Estimated Payments, Penalties, Interest, and Other Additions.

CURRENT COMPENSATION – PENNSYLVANIA WAGES

Covenants Not-To-Compete or to Surrender a Right to Future Employment and Early Separation Incentive Payments

- **Payments for Covenant Not-To-Compete**

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

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

- **Amounts Paid to Surrender a Right to Future Gainful Employment**

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

- The employment agreement secures for the employee a right to future gainful employment; and
- The only consideration given by the employee to obtain that right is the promise to work in the future.
- "Front pay" paid in lieu of reinstatement also constitutes taxable compensation.

Reduction In Force ("RIF") Entitlements

When reducing their workforces, many employers offer temporary incentives for employees to voluntarily separate from employment, including affording early retirement incentives that are available only for a limited period of time. Many employers also



afford involuntarily terminated employees extra pay. The extra pay may be paid in return for agreements releasing legal claims to avoid the risk of RIF-related litigation. It may also be paid to help workers transition to new employments or simply to part ways with employees on as amicable a basis as possible. Conversely, employers or labor organizations may establish or maintain supplemental unemployment benefit plans ("SUB plan") or early retirement incentives that are not limited or temporary in nature. The taxation of such entitlements is explained below.

- **Limited Plans of Termination**

- **Taxation**

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

- **Limited Plan of Termination Explained**

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

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

- **Supplemental Unemployment Benefits (SUB Plan)**

- **Taxation**

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

- **SUB Plan Explained**

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

- No benefit is payable to, or can be taken, assigned, pledged or otherwise charged or dealt with by, any plan participant except upon lay-off or involuntary separation from the employment of the employer (whether or not the separation is temporary) resulting directly from a reduction in force, plant closing, change in organizational structure, discontinuance of an operation, the participant's failure to meet or



maintain standards of performance for the position due to inability to carry out the responsibilities of the position, health, obsolescence, failure to meet the changed responsibilities of the position or similar circumstance beyond the control of the participant.

- No benefit is payable to, or can be taken, assigned, pledged, or otherwise charged or dealt with by, any plan participant if the participant either voluntarily separates from service or is separated or discharged from service for any of the following reasons:
 - Refusal to accept another position with reasonably comparable compensation.
 - The commission of illegal acts.
 - Insubordination, failure, or refusal to comply with rules or regulations or similar acts within the control of the participant.

- **Voluntary Discontinuance of Plan**

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

- **Early retirement enhancements**

- **General Rule**

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

- **Exceptions**

The added benefits payable to retired persons under Federally qualified defined benefit plans that include:

- Adding additional years to the employee’s actual age and/or actual service to reduce or eliminate the effect of actuarial reductions in benefits on account of early retirement;
- Crediting additional years of service to the employee in calculating benefits under a plan’s benefit formula;
- Offering social security “bridge payments” to plan participants in order to increase benefits under the employer’s retirement benefit plan until they become eligible for social security benefits; or
- Offering subsidized joint and survivor annuities constitute excludible retirement benefits, even if offered only on a temporary or limited basis.



Clergy

If a member of the clergy is considered a "common law employee," the cleric's occupancy of a parsonage owned by the congregation and provided for the convenience of the congregation is not taxable as compensation. Likewise, if the congregation pays the costs of housing directly and not as a reimbursement to the clergy, the direct costs are not taxable. All housing allowances provided by the congregation to clergy are taxable as compensation, as cash is always taxable. The clergy may deduct directly related business expenses (such as the business use of the house) allowed on PA-40 Schedule UE, Allowable Employee Business Expenses.

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

Statutory Employees

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

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



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

For PA PIT purposes, individuals shall report all taxable remuneration they receive as a statutory employee as compensation unless their activities constitute a business, profession, or other activity engaged in as a commercial enterprise. See Chapter 5 of the PA Personal Income Tax Guide - Net Income (Loss) from the Operation of a Business, Profession, or Farm. Those expenses that are not reported in a specific part of the PA-40 Schedule UE, Allowable Employee Business Expenses should be itemized and claimed in Part C, Miscellaneous Expenses.

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

Commercial Accident and Health Insurance; Self-Insured Accident and Health Plan Coverage and Benefits

- **Insurance Issued by a Commercial Third-Party Insurance Company**

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

- **Accident or Health Plan**

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

- No program benefits are payable or subject to anticipation, assignment, or pledge until the commencement of a covered sickness or disability or death except:
 - The return of the participant’s own contributions and taxable income or gains thereon;
 - Amounts paid for the prevention of sickness or disability; or
 - Amounts paid for a policy of accident, health, or term life insurance issued by a commercial insurance company.



- The only means of obtaining entitlement to program benefits other than the return of the participant's own contributions and taxable income or gains thereon, or amounts paid for the prevention of sickness or disability, or commercial insurance is proof of hospitalization, sickness, disability, or death.
- The program offers no benefit that defers the receipt of compensation or operates in a manner that enables no participant to defer the receipt of compensation to another taxable year.

- **Discriminatory Programs**

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

- **Disability Annuities**

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

- **Plan Payments**

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

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



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

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

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

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

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

• **Taxable Amounts**

All of the following are taxable:

- Amounts received during a period of sickness or disability for services performed during another period or to which the employee would have been entitled regardless of whether he was sick or disabled;
- Paid leaves of absence due to sickness or disability;
- Payments for unused sick leave.

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



- **Payments for Accident and Health Insurance and Plan Coverage and Disability Annuities**

Except in the case of cafeteria plans:

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

PENNSYLVANIA TAXATION OF STOCK OPTIONS

Pennsylvania follows Internal Revenue Code Section 451 in relation to taxability of stock options for personal income tax.

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

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

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

Federal and Pennsylvania Personal Income Tax Differences Relating to Stock Options

PA PIT, unlike the Internal Revenue Code, does not contain provisions that distinguish between or among various types of stock options. There is no distinction drawn between qualified and nonqualified (sometimes referred to as "statutory" and "non-statutory")



stock options. Moreover, there are no PA provisions that distinguish between qualified stock options and those options granted under employee stock purchase plans.

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

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

Pennsylvania Taxation of Stock Options

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

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

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

Substantial Restrictions/Constructive Receipt for Pennsylvania Income Tax

If the underlying stock can only be sold after a stated period of time, if it cannot be sold to any party other than one's employer and then only at some previously agreed upon price, or it can only be sold or assigned upon termination of one's employment with the company, or is subject to forfeiture if the employee obtains employment with a competitor within a number of years, the department does not consider the employee to be in constructive receipt of the stock. The restrictions imposed upon insider trading by



Section 16(b) of the Securities and Exchange Act is not considered substantial limitations or restrictions. The department also considers the one-year qualification rule imposed by IRC Section 422 on employees' ability to sell their stock not to be a substantial restriction.

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

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

- **Example 1**

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

- **Example 2**

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

Stock Options Earned while a Pennsylvania Resident, but Exercised while a Nonresident

Stock options earned while working in Pennsylvania are subject to personal income tax even though exercised while a resident of another state. If a taxpayer works in multiple states and earns stock options in Pennsylvania and other states during his employment, the taxpayer is entitled to apportion the income earned based on the time taxpayer worked in Pennsylvania. Please refer to regulatory section 109.8 for guidance on how to apportion this income. 61 Pa. Code § 109.8.



Federal Statutory Stock Option (Qualified Stock Option)

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



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

Applicable Option Date	Federal Nonqualified		Pennsylvania	
	Federal Treatment Employee	Federal Treatment Employer	Pennsylvania Personal Income Tax Treatment Employee	Pennsylvania Personal Income Tax Treatment Employer
IRC § 83	Election to include in gross income in year of transfer.		PA PIT was amended to make, with certain exceptions, section 83 of the IRC of 1986 and regulations applicable for taxable years beginning after December 31, 2004, respect to property transferred to a service provider (or beneficiary) in connection with the performance of services.	No tax impact
Option has readily ascertainable fair market value on date of grant (Option fully transferable or not subject to risk of forfeiture)				
Grant Date	The value of the option less any amount paid for the option will be taxed as compensation.	Compensation (ordinary) deduction equal to income subject to withholding or federal Form 1099 issued to employee or	No tax impact	No tax impact



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



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



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

Applicable Option Date	Federal (Nonqualified)		Pennsylvania	
	Federal Treatment Employee	Federal Treatment Employer	Pennsylvania Personal Income Tax Treatment Employee	Pennsylvania Personal Income Tax Treatment Employer
Option has readily ascertainable fair market value on date of grant (Option NOT transferable or subject to risk of forfeiture)				
Grant Date	The value of the option less any amount paid for the option will be taxed as compensation	Compensation (ordinary) deduction equal to income amount recognized by employee	No tax impact	No tax impact
Exercise Date	No tax impact	No tax impact	No tax impact	No tax impact
Lapse Date			The value of the option less any amount paid for the option will be taxed as compensation.	Compensation deduction equal to income subject to withholding or federal Form 1099 issued to employee or independent contractor.



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



Stock Disposition Date	Capital gain equal to difference between sale price and fair market value at the date of exercise option	No tax impact	Gain or loss on the sale of the stock is the difference between the sale price and the taxpayer's basis in the stock which equals the exercise price of the option plus any compensation recognized as a result of exercising the option	No tax impact
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PENNSYLVANIA TAXATION OF CAFETERIA PLANS

Overview – Federal/Pennsylvania Differences

- **Federal**

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

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

- **Pennsylvania**

If a taxpayer's employer maintains a federally qualified cafeteria plan pursuant to IRC Section 125, certain amounts deducted from taxpayer's salary (e.g., health/accident



insurance) are not subject to PA PIT to the extent excluded for federal purposes.

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

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

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

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

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

- Payments made after Dec. 31, 1996, for employee welfare benefit plans under a cafeteria plan will be deemed to be an 'employer contribution' for Pennsylvania Income tax purposes if the following apply:
 - The payments were not actually or constructively received after taking section 125 of the IRC into account.
 - The payments were specified in a written cafeteria plan document as being available to the participant:
 - For the purpose of selecting or purchasing benefits under a plan.
 - As additional cash remuneration received in lieu of coverage under a plan.



- The benefits selected or purchased are nontaxable under the IRC when offered under a cafeteria plan.
- The payments made for the plan would be nontaxable under the PA PIT if made by the employer outside a cafeteria plan.
- If these conditions are satisfied, cafeteria plan contributions are taxed under the rules as applied to employer payments for employee welfare benefit plans . . . See 61 Pa. Code § 101.6(i).

Pennsylvania Taxable Benefits

All benefits other than for death, disability, hospitalization, and sickness are taxable under PA PIT.

Pennsylvania Nontaxable Benefits

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

EMPLOYEE EXPENSES FOR PENNSYLVANIA

Historical Background

The Pennsylvania Tax Reform Code of 1971 does not explicitly address how business expenses are treated. However, the Pennsylvania Supreme Court has interpreted an exclusion for "payments to reimburse actual expenses" to mean that all legitimate business expenses are excludable from compensation. *Commonwealth v. Staley*, 381 A.2d 1280, 1285 (Pa. 1978). Further, the Court has held that amounts reimbursed by an employer for ordinary, actual, reasonable, and necessary business expenses are excluded from compensation. *Ritz v. Commonwealth*, 432 A.2d 169, 171 (Pa. 1981).

If parties to an employment contract recognizes that the employee will pay for some business expenses out of his or her own pocket, these amounts may be excluded from income. *Id.* at 170. However, personal expenses, including daily living expenses of an employee, may not be excluded from compensation. *Williamson v. Commonwealth*, 525 A.2d 475, 477 (Pa. Cmwlth. 1987).

Overview Federal/Pennsylvania Differences

Under federal law prior to the Tax Cuts and Jobs Act of 2017, employee expenses were reported on federal Form 2106. Under PA PIT law, employee expenses are reported accounted for on the PA-40 Schedule UE, Allowable Employee Business Expense. Not all expenses allowed for federal income tax purposes are allowable for PA PIT purposes.



Accountable Plan

Pennsylvania follows federal rules regarding accountable plans. Accordingly, if a plan is properly maintained under federal rules, reimbursed amounts are not included in Pennsylvania wages when the employee submits the expense to the employer for reimbursement and is reimbursed for the exact amount of those expenses. In such cases, the expense should not be reported on PA-40 Schedule UE.

Unreimbursed Employee Expenses on PA-40 Schedule UE, Allowable Employee Business Expenses

For PA PIT purposes, allowable employee business expenses are similar to, but not the same as, expenses for federal purposes. Pennsylvania law only permits expenses required to perform the duties of a job or profession. An allowable Pennsylvania employee business expense must be all of the following:

- Ordinary, customary, and accepted in the industry or occupation;
- Actually paid while performing the duties of the employment;
- Reasonable in amount and not excessive;
- Necessary to enable the proper performance of the duties of the employment; and
- Directly related to performing the duties of the occupation or employment.

A taxpayer may deduct 100 percent of the Pennsylvania-allowable unreimbursed employee business expenses unless a specific provision or limitation applies. Unlike federal rules and limitations for percentage and accounting of the expenses, Pennsylvania law contains no such provisions.

Allowable expense do not include expenses where the taxpayer:

- Received a fixed-mileage allowance or a per-diem allowance for the allowable business expense, and neither the employee, nor the employer, included the allowance in compensation; or
- Accounted for the allowable expenses to an employer and the employer reimbursed the expenses in the exact amount of the expenses.

Do not include such reimbursements in gross compensation. Do not claim such expenses on a PA Schedule UE.

Note: Expenses may not be deducted based upon federal per-diem allowances. Only those expenses actually paid while performing the duties of employment may be deducted.



Examples of Allowable Expenses and the Limitations on Those Expenses

Refer to the PA Schedule UE for more information regarding expenses that qualify as allowable employee business expenses and how to report the expenses. You may also refer to the Department publication *Tips for Successfully Filing PA Schedule UE (REV-489)*, which is available on the Department's website, for assistance in completing the PA Schedule UE.

Nonallowable Expenses

Pennsylvania does not allow the following business expenses, even if allowed for federal purposes:

- Personal, living, or family expenses;
- Dues to fraternal organizations, professional societies, Chambers of Commerce, or recreational club memberships;
- Dues and subscriptions to publications, including trade and professional publications;
- Political candidate or campaign contributions;
- Charitable contributions;
- Commuting expenses –the costs of public transportation or driving a car between a taxpayer's home and place of work or between different jobs for different employers are personal commuting expenses no matter how far the home is from the workplace;
- Cost of meals while working late, unless while traveling away from home overnight on business;
- Childcare or elderly care expenses;
- Occupational privilege taxes:
- Life, disability income, and health insurance premiums;
- Contributions to deferred compensation plans or other pension or retirement plans;
- Legal fees (except to recover back wages), fines, penalties, and bad debts;
- Bribes, kickbacks, or other illegal payments;
- Job hunting or other pursuit of employment expenses;
- Malpractice insurance premiums, except when allowed in Part E, 1, d;
- Moving expenses, except when allowed in Part E, 6;
- Educational expenses, except as allowed in Part E, 5;
- Capital expenditures, except as allowed in Part E, 7;
- Expenses calculated at federal per-diem rates;
- Expenses where the employer reimburses an employee at a fixed-mileage allowance, daily, weekly, monthly, or yearly amount where the reimbursement amount is less than the federal mileage allowance or the actual expense and the reimbursement is NOT included in the employee's wages reported on federal Form W-2 by the employer; and /or
- Expenses reimbursed 100% by the employer.



Nonresidents and Part-Year Residents

Nonresidents must use PA Schedule NRH to apportion expenses for PA personal income tax purposes. A taxpayer may use the working day or business volume method to determine their apportionable expenses for PA personal income tax purposes. Part-year residents may only claim 100 percent of unreimbursed business expenses if the expenses were incurred only while providing services in Pennsylvania or while a PA resident. Include a statement indicating the method used to determine the expenses for the period of residency

Multiple Employers

A separate PA Schedule UE must be filed for each employer. Spouses may not report joint expenses on a PA Schedule UE, even if filing jointly. The excess of expenses over compensation for one employer or taxpayer may not be deducted from the compensation earned from another employer or taxpayer.

Reimbursements

If an employer does not provide reimbursement, an employee may reduce compensation by the allowable expenses actually incurred. If a reimbursement is more than the allowable expenses, the excess must be reported as taxable compensation on Line 1a of the PA-40, Personal Income Tax Return.

Example: Dave earned compensation of \$30,000. He incurred allowable vehicle and travel employee business expenses of \$3,000 and was reimbursed \$3,500. He must complete a PA Schedule UE. He includes the excess \$500 as compensation. His total net taxable compensation is \$30,500.

Statutory Employees

Pennsylvania generally does not recognize statutory employee income as business income if the income is reported on a W-2. A statutory employee must report the income from a W-2 as compensation for PA personal income tax purposes and the business expenses must be included on PA Schedule UE. While most expenses are allowable for reporting purposes on PA Schedule UE, the business expenses included on a federal Schedule C must be examined to determine if there are any nonallowable expenses for PA Schedule UE purposes. For example, dues to fraternal organizations, professional societies, Chambers of commerce or recreational club memberships and dues and subscriptions to publication including trade, and professional must be removed from federal expenses. The allowable expenses may then be claimed on PA Schedule UE.



To claim the allowable expenses, it is suggested that the total amount of allowable expenses be claimed as Miscellaneous Expenses in Part C of PA Schedule UE. A breakdown of the expenses must be included by a separate statement showing the description and amount of the expenses or by including a separate PA Schedule C to report the expenses. The description, "See PA Schedule C for List of Expenses" should be included on the Miscellaneous Expenses line in Part C of PA Schedule UE.

If using a PA Schedule C to report the expenses, the PA Schedule C should be completed with the name of the taxpayer in the name of the owner space, the taxpayer's Social Security number and "Statutory Employee Schedule UE Expenses" on Line A. All other information requested on Lines C through I and 1 through 5 in Section I is not required.

Typically, with statutory employees, income is reported to them via two methods or documents - a federal Form W-2 and a federal Form 1099-MISC. In some cases, a portion of the income not included on a W-2 is also not reported on a 1099-MISC when the income is below the required federal reporting threshold. However, such income is still required to be included by a taxpayer. If the income is reported to the taxpayer using both methods, the taxpayer may elect to include the income not reported on a W-2 as business income on PA-40 Schedule C or as compensation on Part B of PA Schedule W-2S.

If the income not reported on a W-2 is elected to be reported as business income, the expenses must be reported on a pro-rata basis between the PA Schedule UE (usually on a PA Schedule C) and on a separate PA Schedule C that reports the income not included on the W-2. If the income and expenses for each are not determined using separate accounting, the expenses may be allocated based upon the percentage of the income for each method of income reported to the taxpayer to the total income. In such cases, all expenses included on a federal Schedule C must be allocated between the two reporting methods. If an expense is nonallowable for PA Schedule UE purposes, it must still be allocated to that portion of the income. However, the expense is not to be included with the total expenses for the income reported as compensation.

The PA Schedule C reporting the income not reported as compensation (and all its related expenses) should have all the lines completed at the top of the schedule (Lines A through I and 1 through 5, Section I). The main business activity would be included as the type of business, such as Insurance Sales.

Allowance for Clothing

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

- The expenses for which the employee is reimbursed are allowable business expenses;



and

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

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

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

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

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

Examples

- **Example 1:** The employer provides leased company cars, each with a value of \$200 per month, to its employees. An employee's use of the car is 75 percent business and 25 percent personal. The personal use of the car (\$50 per month) is not taxable Pennsylvania compensation to the employee.
- **Example 2:** The employer provides dependent care for its employees in a facility it leases and pays all the costs. The value of the dependent care is not taxable Pennsylvania compensation to the employees.
- **Example 3:** The employer allows its employees to use the company's plane to go to its recreational property. The value of the use of the plane and the recreational facilities is not taxable Pennsylvania compensation to the employees.
- **Example 4:** An employee leases their own vehicle for \$200 per month. The employer reimburses the employee for the full value of the lease (\$2,400). The employee's use of the car is 75 percent business and 25 percent personal. The \$2,400 is taxable



compensation on the employee's W-2 form. The employee may deduct \$1,800 on PA-40 Schedule UE. The personal use of the car (\$600) is not deductible.

- **Example 5:** The employer reimburses its employees \$50 per month for the dependent care costs they incur. The employer must include \$600 in the employees' W-2 forms as taxable Pennsylvania compensation.
- **Example 6:** The employer rewards the 'employee of the year' with a paid vacation. The value of the vacation is taxable Pennsylvania compensation to the employee.
- **Example 7:** The employee can elect compensation or to receive reimbursement. The amount is taxable for the employee for PA PIT.

DAMAGE AWARDS

Overview – Federal/Pennsylvania Differences

Federal courts have held that there are no provisions in either Title VII of the Civil Rights Act of 1964 or the Age Discrimination in Employment Act of 1967 ("ADEA") that provide compensatory damages for pain and suffering or for emotional distress. Refer to Supreme Court Decision in *United States v. Burke*, 112 S.Ct. 1867, 119 L.Ed.2d 34 (1992); *Commissioner v. Schlieier*, 515 U.S. 323 (1995). For federal income tax purposes, one could not exclude the settlement proceeds unless he could demonstrate that the award represents "damages received on account of personal injury or sickness." 26 U.S.C. § 104(a)(2).

Pennsylvania Treatment of Legal Expenses

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

GUARANTEED PAYMENTS

Refer to Chapter 10 of the PA Personal Income Tax Guide - Pass Through Entities.

GROSS NON-EMPLOYEE COMPENSATION

Taxable gross compensation is not limited to employee compensation. It also includes items of non-employee compensation. Please refer to the charts above for examples of taxable non-employee compensation.



Pennsylvania Personal Income Tax Treatment of Household Employees

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

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

NONRESIDENT – ALLOCATION OF PENNSYLVANIA COMPENSATION

Compensation from Sources within Pennsylvania

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

- Whether the services were performed as an employee;
- Whether the compensation is received in a taxable year after the year in which the services were performed; and/or
- Whether the compensation is received by someone other than the person who performed the services.

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

Commissions

If a nonresident traveling salesperson, agent or other employee receives a commission for sales made or the performance of other services based upon the volume of business transacted by him or her, his or her items of income derived from or connected with Commonwealth sources include that proportion of the amount of the items attributable to the business which the volume of business transacted by him within this Commonwealth bears to the total volume of business transacted by him within and



without this Commonwealth.

Compensation Based Upon Years of Continued Service

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

Compensation Paid on a Daily, Weekly, Biweekly, Semimonthly, Monthly, Quarterly, Semiannual, or Annual Basis

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

Miscellaneous Compensation

Miscellaneous compensation is compensation other than prepaid compensation, commissions, compensation based upon years of continued service, compensation from casual employments or compensation paid on a daily, weekly, biweekly, semimonthly, monthly, quarterly, semiannual, or annual basis. If its payment accrual period is not determinable, each payment of miscellaneous compensation shall be allocated to Pennsylvania in the proportion that the total number of working days employed within Pennsylvania during the last period of continuous employment preceding the payment bears to the total number of working days during such period.

Prepaid Compensation

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



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

Working Day Explained

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

- No account whatsoever may be taken of nonworking days, including Saturdays, Sundays, holidays, days of absence because of illness or personal injury, vacation days, days of leave with pay, days of leave without pay, days where a person is on call if needed or days when work could not reasonably be expected to proceed because of strikes, weather conditions or other cause;
- The presence within a state or foreign country shall be disregarded if it is solely for the purpose of boarding a plane, ship, train, or bus for travel to a destination outside such state or country or while traveling by motor, plane, or train through a state or foreign country to a destination outside such state or country; and
- Time spent in commuting or in traveling between work sites shall be disregarded.

Working Days Employed within Pennsylvania Explained

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

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

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

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



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

The Convenience of the Employer Doctrine

Pennsylvania, like many other states, follows the "*convenience-of-the-employer*" doctrine. It provides that compensation for services performed by nonresidents cannot be allocated to the services' actual places of performance if they were performed there only for the employee's convenience or if they were not performed there "of necessity in the service of the employer". In these instances, the compensation must be allocated only to the state (or among the states) where the employee is of necessity performing actual services in the service, and for the convenience, of the employer. The only factors considered under this doctrine are:

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

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

Payment Accrual Period Explained

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



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

Retirement Income

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

CANCELLATION OF DEBT

Cancellation of Debt Income for Pennsylvania Personal Income Tax

Refer to Chapter 15 of the PA Personal Income Tax Guide - Cancellation of Debt and Bankruptcy Considerations for PA PIT Purposes.

ANNUITIES

Employer Annuity Plan

- **Features**

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

- **Premium Payments**

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

- Amounts voluntarily paid by an employee for an insurance contract forming part of a deferred compensation plan for the exclusive benefit of plan participants and their



beneficiaries are not deductible. They constitute the employee's cost of investment in the plan contract.

- Amounts lawfully deducted and withheld from the compensation of an employee and paid for an insurance contract forming part of a deferred compensation plan for the exclusive benefit of plan participants and their beneficiaries are received by the employee as compensation at the time the deduction is made and are treated as amounts voluntarily contributed by the employee.
- Premium payments made under a contributory plan by an employer on behalf of an employee at the election of the employee pursuant to a cash or deferred arrangement or salary reduction agreement are received by the employee as compensation at the time the contribution is made and are treated as amounts voluntarily contributed by the employee.
- Employer premium payments for an insurance contract under a plan are excludible from tax if the plan participant's rights are nontransferable and subject to a substantial risk of forfeiture or penalty.

• **Distributions**

- Distributions are excludible from tax if they constitute a qualified annuity. "Qualified annuity" is defined at 61 Pa. Code § 101.1 to be an arrangement under which the payee is entitled to equal, or substantially equal periodic payments, paid at least annually, for any of the following periods:
 - The life of the participant, or, if applicable, the joint lives of the recipient and recipient's designated beneficiary;
 - The life expectancy of the participant, or, if applicable, the joint life expectancies of the recipient and recipient's designated beneficiary; or
 - A period of at least 10 years.
- Withdrawals of employee contributions.
Actual or constructive pre-retirement withdrawals of one's own contributions and accumulated plan earnings are taxable only to the extent allocable to the earnings. The extent to which such withdrawals are taxable as compensation shall be determined using the cost recovery method of accounting.
- Pre-retirement withdrawals of employer contributions.
Actual or constructive pre-retirement employee withdrawals upon severance of employment without retiring of employer premiums or earnings constitute taxable severance pay.



- **Terminated Plan Annuities**

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

- **Nonqualified Annuities**

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

- **Non-Employee Benefit Annuities**

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

Income from annuity contracts purchased as retirement annuities that are not from an employer sponsored retirement annuity, or are not part of an employer sponsored program, are now taxable as interest income. Any income from these types of plans that is taxable for federal income tax purposes is now taxable for PA PIT purposes as interest income as a result of Act 40 of Jul. 7, 2005. Act 40 also provides that amounts paid under contract of life insurance or endowment, which may be included in gross income for federal income tax purposes, are also subject to PA PIT as interest income. Previously, the income received from an annuity that you purchased, including a retirement annuity that is not part of an employer-sponsored retirement program was reported as gain on the sale, exchange, or disposition of property. The rules for annuities are explained in Chapter 3 of the PA Personal Income Tax Guide – Interest and Chapter 6 of the PA Personal Income Tax Guide - Net Gains (Losses) From the Sale, Exchange, or Disposition of Property under "Classification of Gains (Losses)" section.

- **Life Insurance Annuity Contracts**

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

- An exchange of a life insurance contract for another life insurance contract, an endowment contract, or an annuity contract;
- An exchange of an annuity contract for another annuity contract;



- An exchange of an endowment contract for an annuity contract; or
- An exchange of one endowment contract for another endowment contract if the dates for payments begin on or before the original contract's payment dates.

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

Under these rules, if there is no cash involved, the exchange will be tax-free. If the exchange involves cash, the amount of cash received will be taxable as interest income.

PENNSYLVANIA ELIGIBLE RETIREMENT PLANS

Criteria for A Plan to Qualify as an Eligible Pennsylvania Retirement Plan

A plan is considered an eligible Pennsylvania retirement plan if, at a minimum, the plan has the following four characteristics:

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

Generally, eligible Pennsylvania retirement plans include qualified pension plans under Section 401(a) of the Internal Revenue Code (defined benefit plans and defined contributions plans), IRAs (individual retirement accounts and annuities), Roth IRAs, Simplified Employee Pension Plans (SEPs), and Keogh plans.

For a plan that is not an employer provided plan and has no specific retirement criteria, such as an IRA, the qualifying retirement age is the period after which a distribution will not be subject to penalty for early withdrawal for Federal Income tax purposes (such as age 59½, death, disability).



Contributions to a Retirement Plan

Employee contributions to any retirement plan are always taxable as compensation.

Employer contributions on behalf of an employee to a retirement plan are not considered received at the time of contribution and are not included in the employee's compensation at the time of contribution.

A self-employed individual or a partner in a partnership is not an employee. Therefore, contributions to a retirement plan by a self-employed individual or by a partnership on behalf of a partner are included in the individual or partner's income and are not deductible as a business expense.

Exempt Distributions from an Employer Provided Retirement Plan

Under Pennsylvania law, payments commonly recognized as old age or retirement benefits are not subject to tax. In order to be considered exempt retirement benefits, the payments must come from an eligible Pennsylvania retirement plan and must be paid to persons retired from service after reaching a specific age or after a stated period of employment.

Plan other than Employer Provided Retirement Plan

If a taxpayer receives distributions from a plan that is not an employer provided plan, such as an Individual Retirement Arrangement (IRA), the department will consider the distributions exempt retirement income so long as the taxpayer is not required to pay a penalty for early withdrawal. For example, if a taxpayer received a distribution from an IRA after retirement, death, disability, separation from service unforeseeable emergency or attaining the age of 59½ and a penalty is not paid, the distribution is not included in the taxpayer's compensation.

For additional information regarding IRAs, refer to Personal Income Tax Bulletin 2008-01.

Early Distributions from an Eligible Pennsylvania Retirement Plan

Distributions from an eligible Pennsylvania retirement plan before retirement age or years of service are taxable in the year received to the extent that the distributions exceed previously taxed contributions. Early distributions are deemed to come from previously taxed contributions first (cost recovery method).

Distributions to Beneficiaries and Rollovers

Payments paid to the estate or designated beneficiary of a participant by reason of the participant's death are not included as taxable compensation.

Payments received from an eligible Pennsylvania retirement plan which are rolled over



into another plan, where the transferred amounts are not includable in income for federal income tax purposes are not included in the plan participant's taxable compensation.

TREATMENT OF INVESTMENT EARNINGS BY AN ELIGIBLE PENNSYLVANIA RETIREMENT TRUST FUND

Investment earnings on funds deposited into an eligible Pennsylvania retirement trust fund are not taxable to the employee when earned provided that the employee has not constructively received the earnings. Investment earnings on funds held in an eligible PA retirement plan trust fund that are received at retirement age are not taxable retirement income.

Employee Stock Ownership Plans

Employee Stock Ownership Plans are not eligible retirement plans for PA PIT tax purposes; therefore, all distributions in excess of previously taxed employee contributions are taxable.

NONQUALIFIED DEFERRED COMPENSATION PLANS

Pennsylvania follows many of the provisions established by the Internal Revenue Code with respect to when to include certain deferrals of compensation as income for PA PIT purposes. For purposes of determining when deferred compensation of employees (other than employees of exempt organizations and State and local governments) is required to be included in income, the rules of sections 83, 409A, and 451 of the Internal Revenue Code apply. Distributions from nonqualified deferred compensation plans attributable to elective deferrals and earnings thereon are taxable at the time of the distributions irrespective of retirement.

For additional information regarding nonqualified deferred compensation plans, refer to Personal Income Tax Bulletin 2005-03.

PROFIT-SHARING PLANS

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

Pursuant to the *Gosewisch* case, during 2001, the department adopted provisions in



Section 1.101 of its Regulations which provide that "Severance Pay" under PA PIT tax law is defined as follows:

Severance Pay

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

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

Taxable Employee Contributions

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

Non-Taxable Employer Contributions

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

Distributions

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

EMPLOYER WELFARE PLANS

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

Taxation of Certain Benefits for Pennsylvania Personal Income Tax

• Employee Welfare Benefit Program Benefits

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



- Amounts received for the permanent loss or loss of use of a part or function of the body or permanent disfigurement or in reimbursement of expenses incurred for medical care;
 - Amounts which are computed with reference to the nature of a sickness or injury and without regard to the period the employee is absent from work;
 - Amounts (other than regular wages or sick-leave pay) which are computed with record to the period that the employee is absent from work due to sickness or disability;
 - Strike benefits;
 - Supplemental Unemployment Compensation (SUB). For a payment to qualify as SUB pay, it must be made periodically during the period of actual unemployment and must continue only for the period of actual unemployment. Lump sum payments are taxable;
 - Amounts paid to the beneficiaries or the estate of an employee by reason of the death of the employee; or
 - The fair market value of employer-provided dependent care facilities.
- **Plan Requirements for Qualifying as an Eligible Pennsylvania Welfare and Benefit Plan**

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

Employee Contributions – Taxable

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



Pennsylvania Taxation of Contributions to and Distributions from Eligible Pennsylvania Retirement Plans

Type of Compensation Employer contributions to -	Taxable Description	Nontaxable Description
Employer-sponsored eligible Pennsylvania retirement plans; and/or	Employer contributions to plans or trusts are taxable if constructive receipt by employee	Employer contributions are not taxable when contributed, provided there is no constructive receipt under PA PIT rules.
Nonqualified deferred compensation plans that are non-eligible Pennsylvania retirement plans and/or	Employer contributions to plans or trusts are taxable if constructive receipt by employee	Employer contributions are not taxable when contributed, provided there is no constructive receipt under the PA PIT rules.
Federal qualified plans that are not eligible Pennsylvania retirement plans	Treated as a nonqualified deferred compensation plan	Employer contributions are not taxable when contributed, provided there is no constructive receipt under the PA PIT rules
Distributions of employer contributions and investment earnings on non-eligible employer contributions from employer sponsored nonqualified deferred compensation plan	Always taxable as compensation	
Distributions of employer contributions and investment earnings on employee contributions from employer sponsored nonqualified deferred compensation plan meeting the requirements of an eligible Pennsylvania retirement plan	Any payment of employer contribution and investment earnings prior to retirement age are taxable PA compensation	Not taxable if the amounts are received at or after retirement age and after retirement from service with the employer.



<p>Distributions of employer contributions from employer-sponsored qualified federal retirement plan that is non-eligible Pennsylvania retirement plan (e.g., profit-sharing plan providing no option to receive an annuity or an employee stock ownership plan)</p>	<p>Taxable as compensation. The fact that the plan is a qualified plan for federal income taxpayers is not controlling.</p> <p>The plan is not an eligible Pennsylvania retirement plan. ESOPs may be qualified federal plans, but they are non-eligible Pennsylvania retirement plans.</p>	
<p>Distributions of employee contributions and investment earnings on employee contributions</p>	<p>Distributions received before retirement age</p>	
<p>Distributions of employee contributions from an eligible Pennsylvania retirement plan</p>	<p>Taxable to extent of excess determined under the cost recovery method for amounts received prior to retirement</p>	<p>After retirement age, not taxable</p>
<p>Distribution of employee contribution from a nonqualified deferred compensation plan that is not an eligible Pennsylvania retirement plan</p>	<p>Taxable to extent of excess determined under the cost recovery method</p>	<p>Not taxable - only to extent of amounts previously included in income on prior PA-40, Individual Income Tax Returns and/or amounts contributed</p>
<p>Distribution of employee contributions from a qualified federal plan which is not an eligible Pennsylvania retirement plan e.g. profit-sharing plan not providing an option for an annuity of ESOP employee stock ownership plan</p>	<p>Taxable to extent of excess determined under the cost recovery method</p>	<p>Not taxable - only to extent of amounts previously included in income on prior PA-40, Individual Income Tax Returns and/or amounts contributed</p>



	<p>If you invested in a retirement annuity that is not part of an employer-sponsored program or a commonly recognized retirement program, you have PA-taxable income when you begin receiving annuity payments. You must report the difference between the amount you receive and your previously taxed investment as taxable gain on a PA-40 Schedule D, Sale, Exchange, or Disposition of Property. (If you receive periodic payments, you use the cost-recovery method to report the taxable gain.)</p>	
<p>Annuities (other than employer sponsored retirement plan annuities)</p>		<p>To the extent of previously taxed investment</p>
<p>Roth IRA – Federal</p>	<p>Contributions not deductible</p>	<p>Distributions are includable in income to the extent that contributions were not previously included if made before the individual for whom the account is maintained obtains age 59½ and retires from service or if the plan makes no provision for payments at regularly recurring intervals continuing at least until the participant’s death.</p>



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

FEDERAL FORM 1099-R RECONCILIATION FOR PENNSYLVANIA PERSONAL INCOME TAX

Federal Form 1099R is used to report income received from pensions, annuities, profit sharing plans, IRAs, insurance contracts, *etc.* The 1099R designates the taxable amount for federal purposes but not for Pennsylvania. You have to apply Pennsylvania rules described in Table - Form 1099R Reconciliation for PA PIT to determine what portion, if any, is taxable for Pennsylvania. Pennsylvania law does not follow federal law concerning early retirement options for IRAs, IRC Section 401 plans, 403 plans, and other federally qualified plans. To determine if the amount you received is taxable in Pennsylvania, review Boxes 1 through 3 (the amount you received or your distributions) and the



Pennsylvania tax treatment of Box 7 (the codes that will help determine the taxability of your distribution). The federal codes contained in Box 7 of federal Form 1099R include:

Federal Form 1099-R Reconciliation for Pennsylvania Personal Income Tax

Federal Form 1099R Box Number	Federal Treatment	Pennsylvania Personal Income Tax Treatment
<p>1</p>	<p>Shows the total amount you received this year. The amount may have been a direct rollover, a transfer, or conversion to a Roth IRA, a recharacterized IRA contribution; or you may have received it as periodic payments, as non-periodic payments, or as a total distribution.</p> <p>Unless this amount is from a Coverdell Education Savings Account, report it on Form 1040 or 1040A on the line for "IRA distributions" or "Pensions and annuities" (or the line for "Taxable amount"), and on Form 8606, whichever applies.</p> <p>However, if this is a lump-sum distribution, report it on federal Form 4972, Tax on Lump-Sum Distribution. If you have not reached minimum retirement age, report your disability payments on the line for "Wages, salaries, tips, etc."</p> <p>Also report on that line</p>	<p>Under PA PIT law, this distribution is taxable for Pennsylvania purposes if:</p> <ul style="list-style-type: none"> • the pension or retirement plan was NOT an eligible plan for PA PIT purposes; or • you retired before meeting the age conditions of the plan or years of service conditions of the plan. <p>If this distribution is taxable to you under either of the two rules above, then you may use the cost recovery method to determine the taxable portion of this distribution.</p> <p>Cost Recovery Method – Residents The "cost recovery method" provides for tax-free distribution of all prior employee contributions (since they were previously taxed) before distribution of employer contributions and investment appreciation (which are subject to tax).</p> <p>Cost Recovery Method – Non-Residents</p> <ul style="list-style-type: none"> • Persons who reside outside of Pennsylvania but have worked in Pennsylvania and receive retirement benefits from such Pennsylvania employer must use the "cost recovery method" as indicated under



Federal Form 1099R Box Number	Federal Treatment	Pennsylvania Personal Income Tax Treatment
	<p>corrective distribution of excess deferrals, excess contributions, or excess aggregate contributions.</p> <p>If a life insurance, annuity, or endowment contract was transferred tax-free to another trustee or contract issuer, an amount will be shown in this Box and Code 6 will be shown in Box 7. Do not report this on the tax return.</p>	<p>“Cost Recovery Method – Residents” above.</p> <ul style="list-style-type: none"> • Persons who contributed to a retirement plan while a Pennsylvania resident, but have moved out of Pennsylvania, are subject to tax on the income allocable to Pennsylvania over and above their contributions. • Residents who contributed to a retirement plan while a nonresident are subject to tax only on the amount received over and above their contributions, regardless of whether tax was paid to another state on the retirement income. <p>Cost Recovery Method - Annuities and Insurance Contracts To determine prior employee contributions paid on annuities or insurance contracts, consult your plan administrator as to your full cost of the annuity.</p>
2a	<p>This part of the distribution is generally taxable.</p> <p>If there is no entry in this Box, the payer may not have all the facts needed to figure the taxable amount. In that case, the first Box in Box 2b should be checked.</p> <p>You may want to get one of the following publications from the IRS to help you figure the</p>	<p>Not applicable to PA PIT.</p> <p>Refer to PA PIT treatment in Box 1 above.</p>



Federal Form 1099R Box Number	Federal Treatment	Pennsylvania Personal Income Tax Treatment
	<p>taxable amount - Pub. 560, Pub. 571, Tax-Sheltered Annuity Plans (403(b) Plans) for Employees of Public Schools and Certain Tax-Exempt Organizations, Pub. 575, Pub. 590, Pub. 721, Tax Guide to U.S. Civil Service Retirement Benefits, or Pub. 939, General Rule for Pensions and Annuities.</p> <p>For an IRA distribution, refer to IRAs and Roth IRAs above.</p> <p>For a direct rollover, zero should be shown, and you must enter zero (-0-) on the "Taxable amount" line of your tax return.</p> <p>If this is a total distribution from a qualified plan (other than an IRA or tax-sheltered annuity) and you were born before 1936 (or you are the beneficiary of someone born before 1936), you may be eligible for the 10-year tax option. Refer to the Instructions for federal Form 4972 for more information.</p>	
2b	<p>If the first checkbox is checked, the payer was unable to determine the taxable amount, and Box 2a should be blank.</p> <p>However, if this is a traditional IRA, SEP, or SIMPLE</p>	<p>Not applicable to PA PIT.</p> <p>Refer to PA PIT treatment in Box 1 above.</p>



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



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	distributions, you can change your withholding or elect not to have income tax withheld by giving the payer Form W-4P, Withholding Certificate for Pension or Annuity Payments.	
5	<p>Generally, this shows the employee’s investment in contract (after-tax contributions), if any, recovered tax free this year; the part of premiums paid on commercial annuities or insurance contracts recovered tax free; or the nontaxable part of a charitable gift annuity.</p> <p>This Box does not show any IRA contributions.</p>	<p>Generally, this shows the employee’s investment in an annuity contract. Refer below for after-tax contributions, if any, recovered tax free this year; the part of premiums paid on commercial annuities or insurance contracts recovered tax free; or the nontaxable part of a charitable gift annuity. This Box does not show any IRA contributions.</p> <p>Cost Recovery Method of Taxation of Retirement Distributions (if applicable) PA PIT law provides for the cost recovery method of taxation of retirement distributions if such distributions are –</p> <ul style="list-style-type: none"> • From a non-eligible retirement plan, and • Distributed prior to the participant meeting the: <ul style="list-style-type: none"> ○ Retirement age or ○ Years of service, requirements under the plan. The cost recovery method provides for recovery of all prior employee contributions prior to taxation of distributions. <p>To determine prior employee contributions, consult your plan administrator as to your full cost of the annuity.</p>



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		<p>“After-tax contributions” employee means contributions (usually deducted from pay) that the employee makes to his or her plan, annuity, etc. Since the employee has already been subject to tax on their contributions, these contributions are referred to as after-tax contributions.</p>
6	<p>If you received a lump-sum distribution from a qualified plan that includes securities of the employer’s company, the net unrealized appreciation (NUA) (any increase in value of such securities while in the trust) is taxed only when you sell the securities unless you choose to include it in your gross income this year. Refer to Pub. 575 and the Instructions for federal Form 4972.</p> <p>If you did not receive a lump-sum distribution, the amount shown is the NUA attributable to employee contributions, which is not taxed until you sell the securities.</p>	<p>Under PA PIT law, provided there is no constructive receipt, unrealized appreciation from securities held in trust is not taxable unless the securities are sold.</p>
7	<p>The following codes identify the distribution you received</p>	<p>The following codes identify the distribution you received</p>
	<p>1– Early distribution, no known exception (in most cases, under age 59½).</p> <p>Refer to federal Form 5329, Additional Taxes on Qualified</p>	<p>1– Under PA PIT law, this distribution is taxable for PA purposes if –</p> <ul style="list-style-type: none"> • Your pension or retirement plan was not an eligible plan for PA PIT purposes or • You retired before meeting the age



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	<p>Plans (Including IRAs) and Other Tax-Favored Accounts.</p> <p>For a rollover to a traditional IRA of the entire taxable part of the distribution, do not file federal Form 5329. Refer to the federal Form 1040/1040A instructions.</p>	<p>conditions of the plan or years of service conditions of the plan.</p> <p>If this distribution is taxable to you under either of the two rules above, then you may use the cost recovery method to determine the taxable portion of this distribution.</p> <p>Please refer to the Cost Recovery Method information above for more information.</p>
	<p>2 – Early distribution, exception applies (under age 59½).</p>	<p>2 – Under PA PIT law, this distribution is taxable for PA purposes if –</p> <ul style="list-style-type: none"> • Your pension or retirement plan was NOT an eligible plan for PA PIT purposes or • You retired before meeting the age conditions of the plan or years of service conditions of the plan. <p>If this distribution is taxable to you under either of the two rules above, then you may use the cost recovery method to determine the taxable portion of this distribution.</p>
	<p>3 – Disability.</p>	<p>3 – Under PA PIT law, a distribution due to disability generally is not taxable.</p>
	<p>4 – Death.</p>	<p>4 – Under PA PIT law, a distribution due to death is not taxable.</p>
	<p>5 - Prohibited transaction.</p>	<p>5 – Not applicable - PA PIT has no provisions for prohibited transactions.</p>
	<p>6 – Section 1035 exchange (a tax-free exchange of life insurance, annuity, or endowment contracts).</p>	<p>6 – For taxable years beginning after Dec. 31, 2004, Act 40 of Jul. 7, 2005 provides that exchanges of insurance contracts listed under IRC Section 1035 that are tax exempt for federal income tax purposes are also tax exempt for PA</p>



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		<p>PIT purposes. Therefore, do not report the gain (loss) on the sale, exchange, or disposition of any insurance contracts that include:</p> <ul style="list-style-type: none"> • An exchange of a life insurance contract for another life insurance contract, an endowment contract, or an annuity contract; • An exchange of an annuity contract for another annuity contract; • An exchange of an endowment contract for an annuity contract; • An exchange of one endowment contract for another endowment contract if the dates for payments begin on or before the original contract’s payment dates. <p>If the exchange of contracts has the effect of transferring property to a non-US person, the gain or loss is not tax exempt. If cash or other boot is involved with the exchange of the contracts, the gain or loss is also not tax exempt. The amount of cash or other boot received will be taxable as interest income. For additional information, refer to PA Personal Income Tax Guide - Interest.</p>
	<p>7 – Normal Distribution.</p>	<p>7 – Under PA PIT law, a normal distribution is not taxable if an only if –</p> <ul style="list-style-type: none"> • Your pension or retirement plan was an “eligible Pennsylvania retirement plan”; • You have met the retirement age or years of service requirement (as applicable) under such plan; and • You have retired from service with



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		<p>that employer. If you or your plan does not meet the three requirements above, the taxation of this distribution is determined under the cost recovery method.</p>
	<p>8 – Excess contributions plus earnings/excess deferrals (and/or earnings) taxable in 20XX.</p>	<p>8 – Under PA PIT law, an excess contribution is taxable to the extent there are any earnings on the excess contributions, or the employer did not include the contributions in taxable compensation. Otherwise, not taxable.</p>
	<p>9 – Cost of current life insurance protections (PS 58 costs/premiums paid by a trustee or custodian for current insurance protection, taxable to you currently).</p>	<p>9 – Under PA PIT law, PS 58 costs are taxable.</p>
	<p>A – May be eligible for 10-year tax option.</p>	<p>A – Under P PA PIT law, there is no provision for 10-year tax options.</p>
	<p>D – Annuity payments from nonqualified annuities and distributions from life insurance contracts that may be subject to tax under section 1411.</p>	<p>D – Under PA PIT law, taxable to the extent distributions exceed contributions as determined using the cost recovery method.</p>
	<p>E – Distributions under Employee Plans Compliance Resolution System (EPCRS).</p>	<p>E – Under PA PIT law, not taxable.</p>
	<p>F – Charitable gift annuity.</p>	<p>F – Under PA PIT law, charitable gift annuities from retirement plans are not taxable to the extent that such amounts are distributed after retirement under the retirement plan.</p>
	<p>G – Direct rollover and direct payment.</p>	<p>G – Under PA PIT law, direct rollovers are not taxable.</p>
	<p>H – Direct rollover of a designated ROTH account distribution to a ROTH IRA.</p>	<p>H – Under PA PIT law, direct rollovers are not taxable.</p>



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	J – Early distribution from a Roth IRA, no known exception (in most cases, under age 59½). Report on federal Forms 1040 and 8606 and refer to federal Form 5329.	J – Under PA PIT law, the taxation of a distribution from a Roth IRA prior to reaching 59½ is determined under the cost recovery method.
	L – Loans treated as distributions	L – Under PA PIT law, this distribution is taxable for Pennsylvania purposes if- <ul style="list-style-type: none"> • Your pension or retirement plan was not an eligible plan for PA PIT purposes or • You retired before meeting the age conditions of the plan or years of service conditions of the plan. If this distribution is taxable to you under either of the two rules above, then you may use the cost recovery method to determine the taxable portion of this distribution.
	K – Distribution of traditional IRA assets not having a readily available FMV.	K – Under PA PIT law, this distribution is taxable for Pennsylvania purposes if included with Code 1 or 2 when those distributions are taxable.
	N – Re-characterized IRA contribution made for current tax year (20XX). Report on 20XX federal Form 1040/1040A and federal Form 8606, if applicable.	N – Under PA PIT law, not taxable.
	P – Excess contributions plus earnings/excess deferrals taxable in 20XX	P – Under PA PIT law, an excess contribution is taxable if not already taxed by employer. Employee contributions to an eligible retirement plan are always taxable.
	R – Re-characterized IRA contribution made for previous	R – Under PA PIT law, not taxable.



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	tax year (20XX). Report on 20XX federal Form 1040/1040A and federal Form 8606, if applicable.	
	S – Early distribution from a SIMPLE IRA in first 2 years, no known exception (under age 59½). May be subject to an additional 25 percent tax. Refer to federal Form 5329.	S – Under PA PIT law, an early distribution from a SIMPLE IRA is taxable under the cost recovery method.
	T - Roth IRA distribution, exception applies.	T - Under PA PIT law, not taxable to the extent you are over 59½. Taxable if under 59½.to the extent using the cost recovery method.
	U – Dividends distributed from and ESOP under section 404(k).	U - Under PA PIT law, taxable. If the stock in the ESOP has not been allocated to the participants, the distribution is taxable as compensation. If the stock in the ESOP has been allocated to the participants, the distribution is taxable as dividend income.
	W - Charges or payments for purchasing qualified long-term care insurance contracts under combined arrangements.	Under PA PIT taxable to the extent using the cost recovery method.
	T – Roth IRA distribution, exception applies. Report on Forms 1040/1040A and 8606. You are either age 59½ or over or an exception (code 2, 3, or 4) applies	T – Under PA PIT a Roth IRA distribution is not taxable if you are at least 59½ so long as the Roth IRA is considered an “eligible retirement plan.” If you are not 59 ½, the taxation of this distribution is determined under the cost recovery method.
	If the IRA/SEP/SIMPLE Box is checked, you have received a traditional IRA, SEP, or SIMPLE distribution	



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8	If you received an annuity contract as part of a distribution, the value of the contract is shown. It is not taxable when you receive it and should not be included in Boxes 1 and 2a. When you receive periodic payments from the annuity contract, they are taxable at that time. If the distribution is made to more than one person, the percentage of the annuity contract distributed to you is also shown. You will need this information if you use the special 10-year tax option (Form 4972).	This is a distribution from an insurance policy or annuity purchased for your retirement. Such distributions are not taxable if- <ul style="list-style-type: none"> Your insurance policy or annuity was an eligible plan for PA PIT purposes, and You retired after meeting the age or years of service conditions of the insurance policy or annuity. If you do not meet these requirements, a distribution may be taxable as a gain on Schedule D, not compensation on Line 1a. Consult you plan administrator as to your cost in the annuity.
9a	If a total distribution was made to more than one person, the percentage you received is shown.	This box is your percentage of the total distribution listed.
9b	For a life annuity from a qualified plan or from a tax-sheltered annuity (with after-tax contributions), an amount may be shown for the employee's total investment in the contract. It is used to compute the taxable part of the distribution. Refer to Pub. 575.	Under PA PIT law, this distribution is taxable for PA purposes if- <ul style="list-style-type: none"> Your pension or retirement plan was NOT an eligible plan for PA PIT purposes; or You retired before meeting the age conditions of the plan or years of service conditions of the plan. If this distribution is taxable to you under either of the two rules above, then this distribution may be taxable as a gain on Schedule D, not compensation on Line 1a. Consult you plan advisor as to your cost of the annuity.
17	State tax withheld	This box lists the amount of withholdings



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		applicable to PA PIT. This amount should be added to any other withholdings and listed on your PA-40, Individual Income Tax Return. A copy of the 1099-R must be included with the return.
15	State/Payer's state no.	Employer identification number or Revenue ID (Box number) of payee.
16	State distribution	Not applicable for PA PIT.
19	Local tax withheld	Not applicable for PA PIT.
20	Name of locality	Not applicable for PA PIT.
18	Local distribution	Not applicable for PA PIT.

PROPERTY TRANSFERRED IN CONNECTION WITH THE PERFORMANCE OF SERVICES

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

Certain Transfers upon Death

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

Forfeiture after Substantial Vesting

For Federal tax purposes, if a person is taxable under IRC § 83(a) when the property



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

Election to Include in Gross Income in Year of Transfer

• In General

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

• Deemed Personal Income Tax Election

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

• No Separate PA Election

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

• Forfeitures

If property for which a Section 83(b) election is in effect is forfeited while substantially non-vested, such forfeiture shall be treated as a disposition of property for PA PIT



purposes upon which there is realized a loss equal to the excess (if any) of:

- The amount paid (if any) for such property, over,
- The amount realized (if any) upon such forfeiture.
A sale or other disposition of the property that is in substance a forfeiture, or is made in contemplation of a forfeiture, shall be treated as a forfeiture under the immediately preceding sentence.

Unstated Interest Payments

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

Sales which May Give Rise to Suit under Section 16(b) of the Securities Exchange Act of 1934

• In General

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

• Effective Date

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

Special Rule for Certain Accounting Rules

• "Pooling-of-Interests Accounting" Rules

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

• Effective Date

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



Taxation of Nonqualified Stock Options

For PA PIT purposes, If, after December 31, 2004, there is granted to an employee or independent contractor (or beneficiary thereof) in connection with the performance of services, an option which has a readily ascertainable fair market value at the time the option is granted and to which IRC § 421 (relating generally to certain qualified and other options) does not apply, the person who performed such services realizes compensation upon such grant at the time and in the amount determined under Section 83(a).

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

Applicability of Section and Transitional Rules

- **Scope of Section 83**

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

- **Transitional Rules**

- **In General**

Except as otherwise provided in subsection (b), these rules shall apply to property transferred after December 31, 2004.

- **Binding written contracts**

These rules shall not apply to property transferred pursuant to a binding written contract entered into before January 1, 2005. For purposes of this paragraph, a binding written contract means only a written contract under which the employee or independent contractor has an enforceable right to compel the transfer of property or to obtain damages upon the breach of such contract. A contract which provides that a person's right to such property is contingent upon the happening of an event (including the passage of time) may satisfy the requirements of this paragraph. However, if the event itself, or the determination of whether the event has occurred, rests with the board of directors or any other individual or group acting on behalf of the employer (other than an arbitrator), the contract will not be treated as giving the person an enforceable right for purposes of this paragraph. The fact that the board of directors has the power (either expressly or impliedly) to terminate employment of an officer pursuant to a contract that contemplates the completion of services over a fixed or ascertainable period does not negate the existence of a binding written



contract. Nor will the binding nature of the contract be negated by a provision in such contract which allows the employee or independent contractor to terminate the contract for any year and receive cash instead of property if such election would cause a substantial penalty, such as a forfeiture of part or all of the property received in connection with the performance of services in an earlier year.

Statutory Stock Options

• Statutory Stock Option Defined

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

• PA PIT Treatment

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

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

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

Secular Trust Arrangements

• Secular Trust Defined

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

• PA PIT Taxation of Secular Trust Arrangements

- Amounts transferred or set aside for the benefit of employees.

- General rule:



For taxable years beginning after December 31, 2004, any amount transferred to or set aside in a secular trust for the benefit of an employee (or the employee's beneficiary) and any earnings allocable thereto are currently taxable to the employee as compensation.

- Programs covering retirement.
Notwithstanding the rules of IRC §§ 83 and 402(b), employer payments for programs covering retirement established for the benefit of the employer's employee(s) are excludible from personal income tax until actually or constructively received by the employee. However, for taxable years beginning after December 31, 2004, the earnings on any amounts transferred to or set aside in a secular trust for the benefit of an employee are currently taxable to the employee as compensation.
- Amounts transferred or set aside for the benefit of independent contractors, directors, and similar service providers. For taxable years beginning after December 31, 2004, any amount transferred or set aside for the benefit of an independent contractor, director, or similar service provider and any earnings allocable thereto are currently taxable to the independent contractor, director, or service provider as compensation.
- For purposes of this Clause:
 - An employee is an individual from whose wages an employer is required under the Internal Revenue Code to withhold Federal income tax.
 - A program covers retirement if it provides a specific distribution rule in the case of an employee's retirement from service such as, for example, where the plan provides for a qualified annuity upon retirement. A program that has substantially the same distribution rules in the case of an employee's voluntary termination of employment before reaching retirement age or service does not qualify.
 - A qualified annuity is defined at 61 Pa. Code § 101.1 to be an arrangement under which the payee is entitled to equal, or substantially equal periodic payments, paid at least annually, for any of the following periods:
 - The life of the participant, or, if applicable, the joint lives of the recipient and recipient's designated beneficiary;
 - The life expectancy of the participant, or, if applicable, the joint life expectancies of the recipient and recipient's designated beneficiary; or
 - A period of at least 10 years.



Employer Annuity Plans

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