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Explanation of Tax

The personal income tax is levied against the taxable income of resident and nonresident individuals, estates and trusts, partnerships, S corporations, business trusts and limited liability companies that are not taxed as corporations for federal purposes.

Pennsylvania taxes eight classes of income: (1) compensation; (2) interest; (3) dividends; (4) net profits from the operation of a business, profession or farm; (5) net gains or income from the dispositions of property; (6) net gains or income from rents, royalties, patents and copyrights; (7) income derived through estates or trusts; and (8) gambling and lottery winnings (except Pennsylvania Lottery winnings won on or after July 21, 1983). A loss in one class of income may not be offset against income in another class, nor may gains or losses be carried backward or forward from year to year.

Act 4–1999 eliminated the 25% passive income test. A corporation with a valid S election under the Internal Revenue Code is allowed to have passive income in excess of 25% of total income and still qualify as a PA S corporation. The five year waiting period for corporations whose S election was terminated for exceeding the passive income limitation is repealed.

The Pennsylvania personal income tax does not provide for a standard deduction or personal exemption. However, individuals are able to reduce their tax liabilities through allowable deductions, credits and exclusions.

Deductions:

- Taxpayers may reduce taxable compensation for allowable unreimbursed expenses that are ordinary, actual, reasonable, necessary and directly related to the taxpayer's occupation or employment.
- Act 179–1996 allows taxpayers with qualified federal Medical Savings Accounts to deduct no more than 65% of their deductible if single and no more than 75% if married filing jointly. Contributions to, interest earned on, and reimbursement for qualified expenses are exempted from the personal income tax effective January 1, 1997.

Credits:

- A credit against tax is allowed for gross or net income taxes paid to other states or foreign countries by Pennsylvania residents.
- Enacted in 1974, a credit is available to those individuals receiving tax forgiveness under the Special Provisions for Poverty. For the 2005 tax year, the eligibility income allowance is $6,500 for a claimant. If married, there is also an income allowance of $6,500 for the spouse. Married couples, filing a joint return, are given a claimant allowance of $13,500. The income bracket increment used to determine partial forgiveness is $250. The dependent allowance is $9,500 for each dependent. For a married couple with 2 children, the income allowance for 100% tax forgiveness would be $32,000. For a single parent with 2 children, the income allowance for 100% tax forgiveness is $25,500.
- Taxpayers may use employment incentive payment credits, job creation tax credits, research and development credits, or film production tax credits to offset personal income tax liabilities.

Exclusions:

- Act 7–1997 allows taxpayers to exclude from compensation qualified payments made under a cafeteria plan, qualifying under Section 125 of the Internal Revenue Code, for programs covering hospitalization, sickness, disability or death.
- Effective January 1, 1998, Act 45–1998 exempts the capital gain from the sale of a principal residence for all taxpayers who satisfy ownership and use requirements. Previously, a one-time exclusion of up to $100,000 of gain from the sale of a taxpayer's principal residence was

allowed for persons 55 years of age or older (for sales made after July 1, 1987) who satisfied ownership and use requirements.
- Act 45–1998 provides an exclusion for personal use of employer-owned property.

The Commonwealth employs three primary methods for collecting personal income taxes:(1) estimated and final payments from individuals; (2) employer withholding; and (3) estimated withholding from nonresident partners or shareholders by partnerships and S corporations.

1. Individuals, estates and trusts must file annual returns on or before April 15th for the previous year's income. Individuals, estates and trusts with non-withheld income in excess of $8,000 annually must file and remit estimated payments by the 15th day of April, June, September and January for the preceding calendar quarter. There are special estimated tax provisions for farm income.

2. Employers withhold and remit employees' taxes on wage and salary income according to the following schedule:

   a. Quarterly - If total withholding tax is under $300 per quarter, due the last day of April, July, October and January for the preceding calendar quarter.
   b. Monthly - If $300 to $1,000 of tax is withheld per quarter, due the 15 th day of the following month.
   c. Semi-Monthly - If $1,000 or more in tax is withheld per quarter, due within three banking days of the close of the semi-monthly period.

   Employers receive coupon books containing a year's supply of deposit and quarterly reconciliation forms, which must be filed by the last day of the month following the end of each quarter.

   An employer reconciliation statement must be filed by January 31st following the calendar year for which taxes were withheld or within 30 days after the termination of a business.

3. Partnerships and S corporations with nonresident partners or shareholders must remit tax on income from sources within this Commonwealth which is allocable to a nonresident. The nonresident partner or shareholder may take a credit on their

annual return for the tax remitted by the partnership or S corporation.

The income tax was first imposed in 1971 but was declared unconstitutional because of its graduated structure. The tax was modified to a flat rate tax on the eight separate classes of income described above, effective June 1, 1971.

The tax is imposed at the following rates:

Year	Rate
1971-1973	2.30%
1974- 1977	2.00%
1978-1982	2.20%
1983	2.45%
1984[1]	2.40%
1985	2.35%
1986[2]	2.16%
1987-1990	2.10%
1991[3]	2.60%
1992[4]	2.95%
1993-2003	2.80%
2004-2006	3.07%

[1] Effective tax rate after midyear rate change. Rate was 2.45% for the first half of the year and 2.35% for the second half of the year.

[2] Effective tax rate after midyear rate change. The rate for the first eight months of the tax year commencing on or after January 1, 1986 was 2.2% and for the final four months was 2.1%, for an effective rate of 2.16%.

[3] Effective tax rate after midyear rate change. Rate was 2.1% for first half of the year and 3.1% for second half of the year.

[4] Effective tax rate after midyear rate change. Rate was 3.1% for first half of the year and 2.8% for second half of the year.

The enabling legislation is Article III of the Tax Reform Code of 1971 (P.L. 6, No. 2) as amended.

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