

CHAPTER 11: NET INCOME (LOSS) FROM THE OPERATION OF A BUSINESS, PROFESSION OR FARM

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CHAPTER 11: NET INCOME (LOSS) FROM THE OPERATION OF A BUSINESS, PROFESSION OR FARM

I. DIFFERENCES BETWEEN PENNSYLVANIA PERSONAL INCOME TAX AND FEDERAL INCOME TAXATION

A. Commercial Enterprise Test

Under Pennsylvania personal income tax (PA PIT), taxpayers are permitted to deduct ordinary, necessary and reasonable expenses currently paid or incurred during the taxable year which are directly related to and necessary for the production and marketing of their products, goods and services in the marketplace. The requirement that goods or services must be offered to others in a marketplace is referred to as the "commercial enterprise test" under Pennsylvania personal income tax.

B. IRC Section 183 - Hobby Losses

The "hobby loss" rule of IRC section 183 limits the deductions of individuals and certain other taxpayers from activities that are not engaged in for profit. In effect, for federal purposes, a taxpayer may deduct expenses subject to IRC section 183 only to the extent the taxpayer has gross income from the activity during the taxable year.

Pennsylvania personal income tax applies the "commercial enterprise test" which shows whether a taxpayer markets goods or services to others in a marketplace. Although Pennsylvania personal income tax does not strictly follow IRC section 183, Pennsylvania personal income tax does recognize a presumption that if profits occur during at least two years of the last five years the activity will be presumed to be pursued ordinarily for profit.

C. Allocation of Noncommercial Interest, Noncommercial Dividends and Gain to Net Income (Loss) from the Operation of a Business, Profession or Farm

1. Working Capital

a. Overview

Interest earned on deposits, balances, or accounts receivable that are derived in the ordinary course of business or are derived through temporary investment of working capital funds are considered to be part of business income.

b. Definition of the Term "Working Capital"

Accounting Research Bulletin 43 (ARB 43) of the American Institute of Certified Public Accountants (AICPA) states: that "working capital" is "the



excess of current assets over current liabilities and identifies the relatively liquid portion of total enterprise capital which constitutes a margin or buffer for meeting obligations within the ordinary operating cycle of the business."

The American Institute of Certified Public Accountants has defined the term "current assets" as cash and other assets or resources commonly identified as "those which are reasonably expected to be realized in cash or sold or consumed during the normal operating cycle of the business." For convenience, the American Institute of Certified Public Accountants lumps together all assets that are expected to be used or reduced to cash within one year even though "there are several operating cycles occurring within a year."

The primary issue in accounting and reporting for debt and equity investments is the appropriate use of market value. Generally accepted accounting principles (GAAP) require that investments in equity securities that have readily determinable fair market values and all investments in debt securities be classified in three categories (held-to-maturity, trading securities, and available for sale) and be given specific accounting treatments.

See the following chart for examples of debt and equity securities.

| Debt Securities | Equity Securities |
|--|--------------------------|
| | |
| U.S. treasury securities | Common stock |
| U.S. government agency securities | Preferred stock |
| Municipal securities | Warrants |
| Corporate bonds | Rights |
| Convertible debt | Call options |
| Commercial paper | Put options |
| Collateralized mortgage obligations | |
| Preferred stock that must be redeemed | |
| Real estate mortgage investment conduits | |
| Interest-only and principal-only strips | |

Per the American Institute of Certified Public Accountants held-to-maturity securities should be classified as non-current assets until they are within one year of maturity; at that time, they should be classified as current. Trading securities should always be classified as current assets. Available-for-sale securities are classified as current or non-current, as appropriate.



The American Institute of Certified Public Accountants provides for the exclusion of the following from current assets:

- Cash and claims to cash, which are restricted as to withdrawal or use for other than current operations, are designated for the purchase or construction of non-current assets or are segregated for the liquidation of long-term debts;
- Investments in securities, marketable or not, or advances which have been made for the purposes of control, affiliation, or other continuing business advantage;
- Receivables arising from unusual transactions (such as the sale of capital assets or loans or advances to affiliates, officers, or employees) which are not deemed collectible within a year;
- Cash surrender value of life insurance policies;
- Land and other natural resources;
- · Depreciable assets; and
- Long-term prepayments which can be charged fairly to several years'
 operations or deferred charges such as un-amortized debt discount
 and expense, bonus payments under a long-term lease, costs of
 rearrangement of factory layout or removal to a new location, and
 certain research and development costs.

The American Institute of Certified Public Accountants has defined the term "current liabilities" as follows:

The term current liabilities is used principally to designate obligations whose liquidation is reasonably expected to require the use of existing resources properly classifiable as current assets, or the creation of other current liabilities. As a balance sheet category, the classification is intended to include obligations for items which have entered into the operating cycle, such as payables incurred in the acquisition of materials and supplies to be used in the production of goods or in providing services to be offered for sale; collections received in advance of the delivery of goods or performance of services; and debts which arise from operations directly related to the operating cycle, such as accruals for wages, salaries, commissions, rentals, royalties, and income and other taxes. Other liabilities whose regular and ordinary liquidation is expected to occur within a relatively short period of time, usually 12 months, are also



intended for inclusion, such as short-term debts arising from the acquisition of capital assets, serial maturities or long-term obligations, amounts required to be expended within one year under sinking fund provisions, and agency obligations arising from the collection or acceptance of cash or other assets for the account of third persons.

2. Operating Cycle of a Business

The operating cycle of a business is described by the American Institute of Certified Public Accountants as follows:

The ordinary operations of a business involve a circulation of capital within the current asset group. Cash is expended for materials, finished products, operating supplies, labor and other factory services and such expenditures are accumulated as inventory cost. Inventory costs, upon sale of the products to which such costs attach, are converted into trade receivables and ultimately into cash again. The average time intervening between the acquisition of materials or services entering this process and the final cash realization constitutes an operating cycle.

Because a firm must consider its current assets and particularly its monetary ones - cash, marketable securities, and account receivables - for debt-paying ability over the short-term, these relationships are among the most widely used measures of current financial liquidity. Low or declining current and quick ratios may indicate an insufficient margin of safety between the assets that presumably are or will be available to liquidate claims and the obligations to be paid. On the other hand, an extremely high ratio may indicate the presence of excessive or unproductive inventories and receivables.

The current and quick ratios measure the size of the short-term liquidity buffer. A satisfactory ratio means a low risk that the existing short-term creditors could not be paid even if current assets were to shrink in value. As static measures, both the current ratio and the quick ratio must be interpreted in relation to the character of the business and its industry. In industries or firms in which the flow of funds from operations is relatively stable, acceptable liquidity ratios will be lower than in situations characterized by greater uncertainty.

3. Long-Term Investments

Interest, dividends, rents and royalty income not derived in the ordinary course of business also are not reportable as net income (loss) from the operation of a business, profession or farm, and expenses that are attributable to such income are not deductible business expenses.



For Pennsylvania personal income tax purposes, generally accepted accounting principles and practices govern regarding allocation of working capital. See Section C for calculation of net income (loss) from operations.

D. Investment Activities

Section 301(c) of the Tax Reform Code of 1971 defines "business" as an enterprise, activity, profession, vocation, trade, joint venture, commerce, or any other undertaking of any nature when engaged in as commercial enterprise and conducted for profit or ordinarily conducted for profit, whether by an individual, partnership, association, or other unincorporated entity.

A "business, profession, or other activity" must be "engaged in as a commercial enterprise" in order for the income derived from it to be taxable as net profits. The term "commercial enterprise" means the rendering of goods or services to others in a market place.

If a Pennsylvania personal income tax taxpayer has gross taxable classes of income such as interest and dividends, the taxpayer cannot deduct expenses incurred for the production or collection of interest and dividends or for the management of stock and securities, unless the taxpayer employs the stock or securities in a commercial enterprise either as working capital or stock in trade, or the interest is derived from accounts or notes receivable from sales of products or services sold in the ordinary course of business operations. Only then would the interest and dividends be net taxable as net profits from the operation of a commercial enterprise.

Moreover, even with respect to the net taxable classes, not every cost or expense incurred by a Pennsylvania personal income tax taxpayer, other than taxes based on income, would be deductible in determining the taxpayer's personal income. For a cost or expense to be deductible, it must fall into one of the following categories:

- 1. Ordinary and necessary expense incurred in the conduct of a commercial enterprise;
- 2. Ordinary and necessary expense incurred in the production or collection of rents or royalties;
- 3. Ordinary and necessary expense incurred in order to dispose of property;
- 4. Ordinary and necessary expense incurred for the management, conservation, or maintenance of rents, royalties, patents, copyrights, or like property held for the production of personal net taxable income;
- 5. Allowances for exhaustion, wear, tear, and obsolescence of tangible property (net profits and rents and royalties); or



6. Amortizable costs (net profits and rents and royalties).

Investment interest expense may only be deducted if the Pennsylvania personal income tax taxpayer advertises and/or markets their investing services and uses this service to invest for the public as a business and not for themselves.

E. Trading In Securities

For Pennsylvania personal income tax purposes, investing, re-investing, or trading in securities does not cease to be an investment activity solely because of the volume, regularity, and continuity of transactions. A Pennsylvania personal income tax taxpayer's investing, re-investing, or trading in securities constitutes the operation of a business for Pennsylvania personal income tax purposes only if the taxpayer:

- 1. Maintains or provides a marketplace or facilities and charges a negotiated commission for executing transactions and does not take title to the particular positions he buys or sells;
- 2. Acts as his customers' agent and charges a negotiated commission for executing transactions and does not take title to the particular positions he buys or sells;
- 3. Devotes managerial attention to the financial investment products holdings of others or employs other persons to assist him in that management in the capacity of a licensed investment dealer; or
- 4. Is a qualifying licensed dealer or underwriter.

II. DEFINING NET INCOME (LOSS) FROM THE OPERATION OF A BUSINESS, PROFESSION OR FARM

A. What is a Business or Profession

1. Features of a Business or Profession

Not every income-producing activity constitutes a business or profession. A business or profession has certain features, as follows:

a. Commercial Enterprise

A business or profession requires the offering of goods or services to others in the marketplace. For example, income from personal investment activities is not considered business or professional income.

b. Regularity and Continuity

The taxpayer regularly and continuously must conduct his or her commercial activities.



c. Sales are Not Limited or Restricted

The taxpayer does not limit or restrict his or her commercial activities to certain related or unrelated customers.

2. Example

Charles invests in stock for his personal financial benefit. He does not offer his investment services to others for hire. He derives a substantial income from his investment activities in the form of gains from the sale of stock, dividends, or interest. Charles' income is not net profits from a business or profession. He must report his income as gain from the sale of property, dividend or interest income.

B. What is Not a Business or Profession

The following activities do not constitute the operation of a business, profession or farm and are, therefore, reportable in other classes of Pennsylvania income:

- 1. A sale, discontinuation, or abandonment of a business or segment thereof;
- 2. An isolated or nonrecurring transaction which is not a normal or routine business activity;
- 3. The ownership or disposition of assets which are held for long-term investment purposes;
- 4. Trading in or hedging securities for personal purposes; and
- 5. A non-operating interest in coal, oil, gas, or minerals in place unless they serve an operational function in the operation of the owner's business.

III. CALCULATION OF NET INCOME (LOSS) FROM THE OPERATION OF A BUSINESS, PROFESSION OR FARM

A. Income (Loss) from the Operation of a Business, Profession or Farm

1. Overview

Net income (loss) is computed solely from those items of revenue, cost, expense, or liability that the taxpayer receives from or incurs in:

- a. The ordinary course and operation of the taxpayer's business, profession, or farm activities; or
- b. Securities employed as working capital in the ordinary operation of the taxpayer's business, profession or farm; or



- c. Accounts and notes receivable from the sales of products and/or services in the ordinary operation of the taxpayer's business, profession or farm; or
- d. Assets that serve an operational function in the ordinary operation of the taxpayer's business, profession or farm.

2. Crop Damage Insurance/Drought Relief Grants

Drought relief grants from Pennsylvania and the federal government are part of gross income from operations of a business, profession or farm. The same applies to crop damage insurance as it replaces the gross receipts of the farmer.

3. Forgiveness of Indebtedness Income

Generally, business debt forgiven pursuant to an obligation to provide payment is taxable business income. Refer to Pennsylvania Personal Income Tax Guide, Chapter 24, Cancellation of Debt. Also, refer to Pennsylvania Personal Income Tax Bulletins 2005-02, 2009-03, 2009-04 and 2009-05 on the department's website.

B. Commercial Income Generated by Investment of Working Capital

Interest earned on deposits, balances, or accounts receivable that are derived in the ordinary course of business or are derived through temporary investment of working capital funds are considered to be part of business income. Generally interest and dividends associated with current assets are net profits from a business, profession or farm. If there are excess current assets, attach a computation of the operating cycle of the business showing the percentage allocation of interest and dividends to net profits from a business, profession or farm. Interest and dividends associated with investment in noncurrent assets are classified as respective amounts of interest and dividends and not as net profits from a business, profession or farm.

C. Commercial Income which is not Generated from the Operation of a Business, Profession or Farm

1. Income Generated by Long-Term Investments

Interest, dividends, rents, and royalty income not derived in the ordinary course of business also are not reportable as profits from a business, profession or farm, and expenses, which are attributable to such income, are not deductible business expenses.

2. Other

A taxpayer computes net income (loss) from the operation of a business, profession, or farm without reference to any items he or she derives or incurs in connection with or attributable to:

a. Rendering of services as an employee;



- b. The ownership or disposition of assets that he or she holds for long-term investment purposes or which serve an investment function;
- c. Trading in securities on an established security market for personal purposes and not for the accounts of customers;
- d. A sale, discontinuation, or abandonment of a business or segment thereof;
- e. A non-operating interest in coal, oil, gas, or minerals;
- f. Any event or transaction of a type that would not reasonably be expected to recur in the foreseeable future, and which also possess a high degree of abnormality; or
- g. Any tax imposed on, or measured by, gross or net earned or unearned income.

D. Allowable Expenses Attributable to the Operation of a Business, Profession or Farm

1. Ordinary, Necessary and Reasonable

Allowable expenses must be those ordinary, necessary, and reasonable expenses currently paid or incurred during the taxable year which are directly related to and necessary for the production and marketing of the taxpayer's products, goods, and services.

2. Personal Expenses

Only business expenses are allowable. Personal expenses are not deductible. If some of the expenses incurred in the taxpayer's business are part business and part personal, the taxpayer may deduct only the business portion. For example, if only half of a sole proprietor's car usage is for business, he can deduct only half of the car's operating cost.

3. Depreciation

a. MACRS

Deductions allowable under the Federal Modified Accelerated Cost-Recovery System (MACRS), including the IRC section 179 deduction, in effect on Jan. 1, 1986, additional first-year depreciation allowance for small businesses, are acceptable depreciation deductions for Pennsylvania purposes.



b. Thirty Percent or Fifty Percent Or Other Additional First-Year Depreciation is Not Allowed

For federal purposes, Congress enacted legislation during 2002, 2003, 2005 and later that contained provisions providing for additional first-year depreciation on purchases of certain tangible personal property, computer software, and certain leasehold improvements. Pennsylvania personal income tax does not follow these federal provisions. Accordingly, neither the 30 percent additional first-year depreciation deduction for 2002 nor the 50 percent additional first-year depreciation deduction for 2003 and 2005 and later are permitted against net income (loss) from the operation of a business, profession, or farm for Pennsylvania personal income tax purposes. If a taxpayer took the bonus depreciation allowable under federal law for any tax year, they must file an amended *PA-40 Individual Income Tax* return.

c. IRC Section 179

For Pennsylvania personal income tax purposes, IRC section 179 qualifying property is tangible property that is:

- Of a character subject to the allowance of depreciation under IRC section 167 or cost recovery deductions under IRC section 168;
- Either personal property or other property described in IRC section 1245(a)(3);
- Acquired by purchase for use in the active conduct of a trade or business.

The term does not include air conditioning or heating pumps or any other property described in IRC section 50(b).

A taxpayer may elect to treat the cost of any IRC section 179 property as a current expense rather than as an expense that is not chargeable to a capital account.

d. Limitations

Dollar limitation

The aggregate cost that may be taken into account for any taxable year shall not exceed the following applicable amount:

If the taxable year begins:

The applicable amount:

1983 through 1986 \$ 5,000



| 1987 through 1992 | \$10,000 |
|---------------------|----------|
| 1993 through 1996 | \$17,500 |
| 1997 | \$18,000 |
| 1998 | \$18,500 |
| 1999 | \$19,000 |
| 2000 | \$20,000 |
| 2001 | \$24,000 |
| 2002 and thereafter | \$25,000 |

- The limitation under (a) for any taxable year shall be reduced (but not below zero) by the amount by which the cost of IRC section 179 qualifying property placed into service during such taxable year exceeds \$200,000.
- The amount allowed as a deduction for any taxable year (determined after the application of paragraphs <u>a and b</u>) shall not exceed the aggregate amount of federally taxable income (computed without regard to the deduction allowable for the cost of IRC section 179 qualifying property) of the taxpayer for such taxable year that is derived from the active conduct by the taxpayer of any trade or business during such taxable year.
- Carryover of disallowed deduction. The amount allowed under section III.D.(3)(b) above for any taxable year shall be increased for the aggregate amount allowable as a carryover of disallowed deductions for federal income tax purposes for such taxable year. A taxpayer may elect to treat the cost of any IRC section 179 qualifying property as a current expense rather than as an expense that is not chargeable to a capital account.
- (5) If the taxpayer elects to expense IRC section 179 qualifying property, the limitation of a total IRC section 179 deduction is \$25,000 (or the applicable limit for the year the property was acquired) regardless of the number of the taxpayer's business enterprises and income-producing properties. The IRC section 179 property costs may be deducted on the PA-40 Schedule C, Profit (Loss) from Business or Profession or PA-40 Schedule E, Rents and Royalty Income (Loss) but the total of all IRC section 179 expenses on all Pennsylvania schedules may not exceed \$25,000 or the applicable limit.
- (6) Married taxpayers are limited to \$25,000 (or the applicable limit) regardless of ownership interests. If married taxpayers are joint owners, they have a \$25,000 deduction limitation. Pennsylvania personal income tax limitation is based on applicable federal rules.



- Estates or trusts may not elect to currently expense IRC section 179 property costs.
- Beneficiaries of estates or trusts may not elect to currently expense IRC section 179 property costs in respect of estates or trusts.
- Pass through entities. In the case of a partnership, limitations shall apply with respect to the partnership and with respect to each partner. The same rule shall apply in the case of a PA S corporation and each shareholder.

If a partnership elects to expense certain costs under these rules:

- The above limitations apply with respect to the partnership.
- A partner's adjusted basis in his partnership interest is reduced by the
 entire amount of his distributive share of the IRC section 179 expense,
 regardless of whether a portion of the partner's deduction is disallowed
 in the current year by the application of the above limitations.

Refer to the Bureau of National Affairs No. 714, A-9.

e. American Jobs Creation Act of 2004

Many provisions of the federal American Jobs Creation Act of 2004 were not adopted for Pennsylvania personal income tax purposes. Specifically, Pennsylvania personal income tax law does not conform to the following federal provisions—

- Title I, Section 102, Deductions Relating to Income Attributable to Domestic Production Activities, IRC Section 199

 This is a new expense/deduction allowed on qualifying domestic production activities income for taxable years beginning in 2005. Pennsylvania personal income tax law has no such provision and this expense/deduction must be added back into income reported by any individual, partnership or PA S corporation. This amount may not be deducted in calculating Pennsylvania-taxable income by an individual, partnership or PA S corporation.
- Title II, Subtitle A, Section 201, Two-Year Extension of Increased Expensing for Small Business, IRC Section 179
 Certain provisions of IRC section 179 expensing were extended to 2008. Pennsylvania personal income tax law continues to allow a maximum of \$25,000, as previously discussed.



Title VIII, Subtitle D, Section 902, Consistent Amortization of Periods for Intangibles

Allows for the immediate expensing of intangible costs for start-up expenses, organizational expenses and syndication fees of an amount up to \$5,000, reduces the amount of \$5,000 for amounts over \$50,000, and establishes a 180 months period for amortizing amounts over \$5,000. Pennsylvania personal income tax law has no such immediate expensing provisions. However, amortization is an allowable expense according to accepted accounting principles. Therefore, the Pennsylvania Department of Revenue has adopted a rule for administrative convenience. Intangible costs for start-up expenses, organizational expenses and syndication fees must be amortized ratably over a 180-month period.

4. Taxes

A taxpayer may deduct all state, local and federal taxes other than taxes based on income that can be deducted as expenses from gross income to arrive at the taxpayer's adjusted gross income for federal tax purposes. However, the taxpayer may not deduct the one-half of self-employment tax (which the IRS allows) for Pennsylvania purposes. The taxpayer also may deduct the amount of sales tax paid on acquired property, which for federal tax purposes must be treated as part of the cost of the acquired property for depreciation purposes.

5. Nondeductible Contributions to Retirement Plans by Partners and Other Self-Employed Individuals

Contributions made by a self-employed individual to his own pension plan such as an IRA or Keogh or welfare benefit program, are not deductible as a business expense in determining the self-employed individual's net income (loss) from the operation of a business or profession; nor are such contributions otherwise excludable from taxable income. Contributions made by a self-employed individual to his employees' retirement plans and welfare benefit programs are deductible as an ordinary, necessary business expense in determining the self-employed individual's net profits from operation of a business or profession. Contributions by partners or made on behalf of partners to their retirement plans are not deductible. Contributions by shareholders of PA S corporations or on behalf of such shareholders to their retirement plans are not deductible for Pennsylvania purposes unless the shareholder is an employee of the PA S corporation.

6. Federal Labor Hired Deduction or Federal Wage Deduction

For federal income tax purposes, a taxpayer's federal labor-hired deduction and federal wage deduction must be reduced by the amount of his or her federal jobs credit. That reduction is not applicable for Pennsylvania tax purposes. However, if you are involved in Pennsylvania's Employment Incentive Payment Program,



wages for which an employment incentive payment (EIP) credit is claimed cannot be claimed as an expense.

7. Meals and Entertainment

The 50 percent federal limit on the deductibility of meals and entertainment expenses does not apply for Pennsylvania purposes. However, the taxpayer must be able to show that the expenses claimed are ordinary, actual, reasonable and necessary.

8. Donations to Charitable Organizations

Payments to charitable organizations made from business funds for business purposes are allowable expenses for Pennsylvania to the extent the payment is for an ordinary, necessary, and reasonable expense currently paid or incurred during the taxable year and to the extent the payment is directly related to and necessary for the production and marketing of the taxpayer's products, goods, and services.

For federal income tax purposes, if a taxpayer receives or expects to receive a financial or economic benefit as a result of making a contribution to a qualified organization, the taxpayer cannot deduct the part of the contribution that represents the value of the benefit received.

Therefore, to the extent taxpayer makes a donation to a qualified organization and claims any portion of the donation as a federal income tax charitable deduction, the taxpayer has taken the position for federal income tax purposes that taxpayer received no financial or economic benefit for the payment.

A taxpayer is required to maintain a consistent position for both federal income tax and Pennsylvania personal income tax purposes. If a taxpayer has taken the position for federal income tax purposes that the taxpayer received no financial or economic benefit for a payment to a qualified organization, then for Pennsylvania personal income tax purposes the payment is not an ordinary, necessary, and reasonable expense and the taxpayer may not claim an expense deduction against net profits for the payment.

Following are examples that illustrate application of this standard:

a. Taxpayer operates a restaurant. A local charity asks a taxpayer to purchase a block of advertising space in a flyer it intends to distribute at an upcoming charity function. The taxpayer purchases advertising space and the taxpayer's restaurant is featured in the flyer. The taxpayer does not take a charitable deduction for Federal income tax purposes for any of the amount paid to purchase advertising space. Taxpayer may deduct the payment to the charity against net profits for Pennsylvania personal income tax purposes to the extent the payment for the advertising space is reasonable in amount.



- b. Taxpayer operates a transportation business and owns a fleet of small vans that he uses in the business. A local charity is in need of a small van for use in operation of the charity, and solicits donations from the public. The taxpayer donates one of the new vans used in the business to the local charity. In return, the local charity mentions the taxpayer's name and transportation business in an annual newsletter mailed to the public. The taxpayer deducts the entire amount of the donation as a charitable contribution on taxpayer's Federal income tax return, and does not report any portion of the donation as a contribution from which taxpayer's business benefited. Taxpayer may not deduct any portion of the donation of the van as a business expense for Pennsylvania personal income tax purposes.
- E. Gain (Loss) on the Sale, Exchange or Disposition of Property Used in the Production of Net Income (Loss) from the Operation of a Business, Profession or Farm

Table 11

Sale of Property – Business, Profession or Farm

| | cation of Gain | |
|---|--|--|
| Type of Gain | Net Income (Loss) from a Business, Profession or Farm | PA-40 Schedule D |
| Proceeds from the sale of intangible personal property used in the trade or business, including goodwill contractually sold with a business and allocated by the parties as to value in the sales agreement. Refer to Personal Income Tax Bulletin 2005-02 Gain (Loss) Derived From the Disposition Of a | If Proceeds from sale are reinvested in a similar business unit, then the gain is business income. Pennsylvania Resident – Taxable on all income of the business entity. See | If Proceeds from the sale of a business unit are not reinvested in a similar business unit, then the gain is reported as Taxable PA-40 Schedule D. |
| Going Concern, and Classification between Net Profits and Schedule D Gains and Losses in PA PIT Guide Chapter 12. | PA-40 Line 4. Nonresident – taxable based upon proportion to the average of the property, payroll, and sales percentages of the trade or business as determined under 61 PA Code § 109.5(c) for the 365-day period preceding the disposition. | |



Table 11 (con'd)

Sale of Property - Business, Profession or Farm

| | Allocation of Gain | | |
|--|---|--|--|
| Type of Gain | Net Income (Loss) from a Business, Profession or Farm | PA-40 Schedule D | |
| Proceeds from the sale of intangible personal property not used in the business, including goodwill contractually sold with a business and not allocated by the parties as to value in the sales agreement. Refer to Personal Income Tax Bulletin 2005-02 Gain (Loss) Derived From the Disposition Of a Going Concern in PA PIT Guide Chapter 30. | | Pennsylvania Resident – Taxable PA-40 Schedule D Nonresident – Not Taxable | |
| Proceeds from the sale of tangible personal property used in the business, profession or farm and the proceeds reinvested and used to acquire like-kind property used in the same business, profession, or farm. | If used in determining the net income (loss) of the business, profession, or farm as part of working capital. | | |
| Proceeds from the sale of tangible personal property used in the business, profession or farm and the proceeds not reinvested and used to acquire like-kind property used in the same business, profession or farm. (For property located in Pennsylvania.) | | Pennsylvania Resident and Nonresident - Taxable PA-40 Schedule D | |
| Proceeds from the sale of tangible personal property used in the business, profession or farm and the proceeds not reinvested and used to acquire like-kind property used in the same business, profession, or farm. (For property not located in Pennsylvania.) | | Pennsylvania Resident – Taxable PA-40 Schedule D Nonresident – Not Taxable | |



Table 11 (con'd)

Sale of Property - Business, Profession or Farm

| | Allo | cation of Gain |
|--|---|--|
| Type of Gain | Net Income (Loss) from a Business, Profession or Farm | PA-40 Schedule D |
| Proceeds from the sale of inventory | If used in determining the net income (loss) of the business, profession or farm. | |
| Proceeds from the sale of stock in trade | If used in determining the net income (loss) of the business, profession or farm. | |
| Proceeds from the sale of other current assets | Generally if used in determining the net income (loss) of the business, profession or farm. | |
| Proceeds from the sale of non-current assets | | Pennsylvania Resident and Nonresident - Taxable PA-40 Schedule D |
| Proceeds from the sale of land and buildings constituting the abandonment of a business or business segment. For property located in Pennsylvania. (i.e., sale of a division or line of business where that division or business activity is not continued by the seller.) | | Pennsylvania Resident and Nonresident - Taxable PA-40 Schedule D |
| Proceeds from the sale of land and buildings constituting the abandonment of business or business segment. For property not located in Pennsylvania. (i.e., sale of a division or line of business where that division or business activity is not continued by the seller.) | | Pennsylvania Resident – Taxable PA-40 Schedule D Nonresident – Not Taxable |



Table 11 (con'd)

Sale of Property - Business, Profession or Farm

| | Allo | |
|--|---|--|
| Type of Gain | Net Income (Loss) from a Business, Profession or Farm | PA-40 Schedule D |
| Proceeds from the sale of land and building used as a facility in the operation of the business, profession, or farm for reinvestment in a like-kind facility used in the same business, profession or farm. | Used in determining the net income (loss) of the business, profession or farm. | |
| Proceeds from the sale of land and/or buildings held for investment regardless of reinvestment of proceeds. Property located in Pennsylvania. | | Pennsylvania Resident and Nonresident - Taxable PA-40 Schedule D |
| Proceeds from the sale of land and/or buildings held for investment regardless of reinvestment of proceeds. Property not located in Pennsylvania. | | Pennsylvania Resident – Taxable PA-40 Schedule D Nonresident – Not Taxable |
| Proceeds from the sale of stocks and bonds other than federal obligations or Pennsylvania obligations used in the operating cycle of the business activity (generally current assets). | Used in determining the net income (loss) of the business profession or taken as part of working capital. | |
| Sale of stocks and bonds other than federal obligations or Pennsylvania obligations not used in the operating cycle of the business activity (generally long-term assets). | | Pennsylvania Resident – Taxable PA-40 Schedule D Nonresident – Not Taxable |



Table 11 (con'd)

Sale of Property - Business, Profession or Farm

Basis – The basis of any property, real or personal, tangible or intangible, acquired on or after June 1, 1971, is determined on the date of acquisition. The basis of property, acquired before June 1, 1971, is adjusted to reflect its value as of that date. The basis as of June 1, 1971, for purposes of determining gain is the greater of (1) its cost or other basis, as adjusted, or (2) its fair market value on June 1, 1971. The basis as of June 1, 1971, for purposes of determining loss is its cost or other basis, as adjusted, without reference to its fair market value as of June 1, 1971.

| | Allocation of Gain | |
|---|---|---|
| Type of Gain | Net Income (Loss) from a Business, Profession or Farm | PA-40 Schedule D |
| Sale of ownership interests in partnerships and business enterprises. | | Pennsylvania Resident – Taxable PA-40 Schedule D |
| Refer to Personal Income Tax Bulletin 2005-02 Gain (Loss) Derived From the Disposition Of a Going Concern in PA PIT Guide Chapter 30. | | Nonresident – Not Taxable |

IV. REPORTING

A. PA-40 Schedule C - Profit (Loss) From Business or Profession

Sole proprietors having net income (loss) from the operation of a business or profession other than a farm must file *PA-40 Schedule C*. If a taxpayer had more than one business or if a taxpayer and spouse each had separate businesses, submit a separate PA-40 Schedule C for each business.

B. PA-40 Schedule F - Farm Income and Expenses

Sole proprietors having net income (loss) from a farm must file *PA-40 Schedule F*. If a taxpayer had more than one farm or if a taxpayer and *spouse each had separate farms, submit a separate PA-40 Schedule F for each farm.*

C. Federal Schedule C or Federal Schedule F

1. When Can Federal Schedules C or F be Used

Federal Schedules C or F may be used with the following exceptions:

- Taxpayer is a nonresident or part-year resident, or
- Taxpayer and spouse filed jointly for federal and separately for Pennsylvania.



2. Taxpayer Must Adjust Federal Schedules for Pennsylvania Personal Income Tax Rules

Taxpayer must adjust for the differences between the federal Schedules C or F and Pennsylvania personal income tax Schedules C or F for the following items:

a. Business Meals and Entertainment Expenses

Pennsylvania allows 100 percent of customary and reasonable amounts expensed on business meals and entertainment as opposed to the federal limit of 50 percent.

b. Sales Tax on Acquired Property

Sales tax on acquired property may be expensed currently rather than added to the basis of the property as required by the IRS. If sales tax is expensed, the basis of that property will differ from the federal basis. If sales tax is expensed for Pennsylvania purposes, depreciation must be adjusted accordingly. The taxpayer cannot expense sales tax and still take depreciation on the sales tax.

c. Charitable Contributions

Charitable contributions made from business funds for business purposes and publicly acknowledged by the charity are allowable expenses for Pennsylvania.

d. Amortization

Any generally acceptable amortization method may be used.

e. Depreciation

Any depreciation method may be used as long as it is generally accepted and consistently used. Taxpayer must use straight-line depreciation if the federal basis is different from Pennsylvania personal income tax basis.

f. IRC Section 179

Pennsylvania law allows IRC section 179 expenses, in effect on Jan. 1, 1986, up to a maximum of \$25,000. The federal limitation does not apply for Pennsylvania personal income tax purposes. Taxpayer may use any acceptable method of depreciation if the federal basis and Pennsylvania personal income tax basis are the same.

See the instructions for Depreciation above.

g. Intangible Drilling Costs

Current expensing of intangible drilling costs associated with the creation of wells, as permitted in IRC section 59(e)(2), is not allowable or deductible. As long as the taxpayer or entity is engaged in the active conduct of a business and business activities have begun (beyond the



exploration stage), and the drilling costs are reasonable in amount, the direct expenses may be amortized over the life of the wells.

h. Depletion

With the exception of start-up expenses, depletion is an allowable deduction against income.

Refer to Personal Income Tax Statement of Policy 2004-01 Depletion as published in Section 125 of Title 61 of the Pennsylvania Code.

Also refer to Pennsylvania Personal Income Tax Guide, Chapter 23, Natural Resource and Chapter 30, Pennsylvania Department of Revenue Personal Income Tax Policy Guidance.

i. Bonus Depreciation elections enacted by the U.S. Congress in 2002, 2003, 2005, and later

The federal elections for 30 percent and 50 percent bonus depreciation do not apply for Pennsylvania personal income tax purposes.

j. Federal Jobs Credits

Federal jobs credits should not be deducted from Pennsylvania wages.

k. Employment Incentive Payment/Jobs Creation Tax Credit

The total Pennsylvania wages must be reduced by the amount of employment incentive payment (EIP) and/or credit to the Jobs Creation Tax Credit that the taxpayer is entitled.

I. Pension and Profit-Sharing Plans

The taxpayer, if he or she is a sole proprietor or partner, cannot deduct his or her own contributions to such plans; only that portion contributed for the employees is deductible.

m. Taxes

A taxpayer may not deduct taxes based on net income. A taxpayer may not deduct taxes paid to other states or foreign countries based on income. A taxpayer may not deduct estate taxes and inheritance, legacy, succession and gift taxes. Assessments for betterment and improvements are not allowable.

The **Philadelphia Business Privilege Tax** includes two components:

- Gross receipts tax based on revenue; and
- Net income tax based on net income.



Pennsylvania personal income tax law does not allow deductions for taxes based on net income. Only the gross receipts portion of the Philadelphia Business Privilege tax is deductible for Pennsylvania personal income taxes. You may not take a deduction for the net income tax portion.

A single-member limited liability company (SMLLC) that files as a sole proprietor, a limited liability company that files as a partnership or PA S corporation may deduct the Pennsylvania capital stock/franchise tax paid. Other federal, state and local taxes are allowable deductions.

n. Contributions to Benefit Plans

Contributions to benefit plans established for sole proprietors and partners cannot be deducted.

o. Pennsylvania Research and Development Credit

Expenses for Pennsylvania research and development tax credit must be reduced by expenses incurred that qualify the claim for the credit.

p. Other Adjustments

Other adjustments for differences between Pennsylvania and federal expenses should be itemized and explained in detail on the *PA-40*, *Individual Income Tax* return.

See instructions for PA-40 Schedules C or F as to required increases in income to arrive at Pennsylvania personal income tax. Rental losses are disallowed. IRC section 1031 and 1033 exchanges are taxable for Pennsylvania personal income tax. Defined income for advance payments of goods and services are taxable. The entire IRC section 481(a) adjustment in the year of change is taxable.

The Pennsylvania Department of Revenue does not follow the federal tax benefit rule. For tax benefit rules, Pennsylvania law requires depreciation to be computed under the straight-line method even if the depreciation did not provide any tax benefit. If a taxpayer does not utilize the loss from the PA-40 Schedules C or F, then the assets of the business must be depreciated using straight-line depreciation. There are no carryovers of losses.

D. Married Filing Jointly

If the taxpayers are married and they elect to file a joint return, each spouse must separately determine his or her own net income (loss).

E. Nonresidents

Nonresidents reporting net income (loss) from the operation of a business, profession, or farm must allocate business activity.



1. Allocation of Net Profits

Nonresidents reporting net income (loss) from the operation of a business, profession, or farm must allocate business activity in accordance with the following rules:

a. Operation Wholly Within Pennsylvania

The operation of a business, profession or farm is wholly within Pennsylvania if during the entire taxable year the taxpayer or the taxpayer's representative:

- Maintained or operated a commercial establishment (office, shop, store, warehouse, farm, factory, agency, etc.) within Pennsylvania where the business was systematically and regularly conducted or managed; and
- Did not maintain and operate a commercial establishment outside Pennsylvania where the business was systematically and regularly conducted or managed.

If the taxpayer's representative operated as an independent contractor, the business activity will not be taken into account.

b. Operation Wholly Outside Pennsylvania

The operation of a business, profession, or farm is wholly outside Pennsylvania if during the taxable year the taxpayer or the taxpayer's representative:

- In the ordinary course of business, did not transact any business in Pennsylvania or only transacted business in Pennsylvania on a sporadic or temporary basis; or
- In the ordinary course of business, the only business transacted with any permanency or continuity was either or both of the following:
 - (1) Soliciting orders for, or sales of, property or services when such orders were sent outside Pennsylvania for approval or rejection and, if approved, are filled by shipment or delivery of goods or services from a point outside Pennsylvania; or
 - (2) Soliciting orders in Pennsylvania in the name of, or for the benefit of, a prospective customer when the orders resulting from such solicitation enable your customer to fill orders of the type described in paragraph (1) above.



c. Operation Partly Within Pennsylvania

If a taxpayer's business, profession, or farm is not wholly within or outside Pennsylvania as described above, allocation shall be made by separate accounting if:

- The business, profession or farm operation within and outside Pennsylvania constitutes independent profit centers (i.e. there are no transfers of finished goods, raw materials, supplies, services or operational assets inter se and each is free to buy outside, and because of geographical location, neither is in competition with the other); and
- The taxpayer's books are kept so as to properly disclose the amounts of revenues, costs, expenses and liabilities attributable to Pennsylvania operations.

2. Three-Factor Allocation

If the taxpayer does not allocate as indicated in the previous section, then the taxpayer must allocate using a three-factor (property, sales and payroll) formula. Use *PA-40 Schedule NRH* for this purpose.

F. Records Maintained

All amounts reported on PA-40, Individual Income Tax returns and accompanying schedules are subject to verification and audit by the Pennsylvania Department of Revenue. Books and records must be maintained to verify all information reported. These records should be retained for at least four years after filing.

G. Reporting Investment Income

1. Income from the Operation of a Business, Profession or Farm Interest earned on deposits, balances, or accounts receivable would be part of business income as well as gain (loss) on sale of business assets and trade-ins and would be reported on *PA-40 Schedule C*.

2. Income which is not Generated from Operation of a Business, Profession or Farm

Income such as earnings on investments held or other income (loss) not derived in the ordinary course of business must be recorded on the appropriate schedules, such as in the following examples:



| Type of Income: | Reported on: |
|---|---------------------|
| Gain (Loss) on Sale or Disposition of the Business or a Portion thereof | PA-40 Schedule D |
| Rent or Royalty Income (Loss) | PA-40 Schedule E |
| Interest/Dividends | PA-40 Schedules A/B |

3. Pass Through from Partnerships and PA S Corporations

For further information about partnerships and PAS corporations, refer to Pennsylvania Personal Income Tax Guide, Chapter 16, Pass Through Entities.