# CHAPTER 12: NET GAINS OR LOSSES FROM THE SALE, EXCHANGE, OR DISPOSITION OF PROPERTY.

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# **OVERVIEW.**

Net gains from the sale, exchange, or other disposition of any kind of property are taxable under Pennsylvania Personal Income Tax law. This includes gain from the sale or disposition of real estate, tangible personal property, and intangible personal property, such as stock or other ownership interests in business enterprises, bonds, annuities, and contracts of insurance with refundable accumulated reserves payable upon lapse or surrender.

#### TABLES.

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Please reference the tables on the following pages.

# Table 12-1. Sale, Exchange, or Disposition of Property - Partnerships and PA S Corporations Pennsylvania Personal Income Tax

# Federal Form Reference

# Federal Form 4797 – Sales or exchange of property

used in a trade or business and involuntary conversions from other than casualty or theft - most property held more than 1 year. Ordinary gains and losses include property held 1 year or less. Enter gain or (loss) on line 18 of the return being filed.

Gain on the sale, exchange, or disposition of property used in a business, profession, or farm and involuntary conversion from other than casualty or theft of business property must be classified by the taxpayer as either:

- (1) Business income and used in determining the net profit (loss) of the partnership or Pennsylvania S corporation, or
- (2) Schedule D gain.

Pennsylvania makes no distinction between longterm and short-term gain. There are no provisions for the carryover of losses from one tax year to another year. Pennsylvania does not allow an offset of loss against gain from one class of income to another or between two taxpayers (i.e. spouses).

Federal Schedule D – Long-term and short-term capital gain and losses. Short-term capital gain or loss is reported on Form 1065, Schedule K, line 4d or 7. Long-term capital gain or loss is reported on Form 1065, Schedule K, line 4e(2) or 7.

Pennsylvania makes no provision for capital gain. Such gain or loss must be classified by the entity as either:

- (1) The net profit (loss) of the partnership or Pennsylvania S corporation, or
- (2) Schedule D gain.

There are no provisions for the carryover of losses from one tax year to another year. Pennsylvania does not allow an offset of loss against gain from one class of income to another or between two taxpayers (i.e. spouses).

Losses are recognized only in the year in which some identifiable event closes and completes the transaction and fixes the amount of loss so there is no possibility of any recovery. Losses are only recognized on transactions entered into for profit, such as investments, business property, and real estate. Losses are not recognized on the sale of property that was not acquired as an investment or for profit.

Capital gain distributions – Even though the taxpayer reports capital gain distributions from mutual funds or other regulated investment companies on Federal Schedule D, this income is reported as Pennsylvania dividend income on the partners'/shareholders' personal return.

"Tax Benefit Rule" applies to all taxpayers and the use of mandatory straight-line depreciation in arriving at Pennsylvania Personal Income Tax basis applies regardless of whether tax benefit was secured for Pennsylvania Personal Income Tax purposes. Refer to the comprehensive example.

As a separate class of income, taxable income includes net income or loss from rents, royalties, patents, and copyrights. In calculating net income or loss from rents, royalties, patents, or copyrights, deductions for depreciation, depletion, repairs, and other expenses may be taken against the rents and royalties received. Rental income is reported on PA Schedule E.

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.

# Table 12-2.

# Rents vs. Net Income or Loss from the Operation of a Business, Profession or Farm

Rents vs. net profits derived from the operation of a business – The leasing of tangible property is a business only when the taxpayer offers the use of the property on a commercial basis to others in a marketplace, and,

- At least one of the following applies:
- The average period of customer use is 30 days or less; or
- The property is customarily made available for use only during defined business hours; or
- In addition to the property, the taxpayer also provides significant services\* to a lessee; or
- The taxpayer incurs significant operating expenses in making the property available for lease; or
- The leasing activity is incidental to a real estate sales business; and
- 2. The taxpayer offers the use of the property intending to realize a profit; and
- 3. The leasing of the property is a regular and continuous activity.

\*Providing housekeeping service, room service, valet parking, decorating assistance, delivery services, transportation services, and concierge services are significant services (i.e. hotel, motel business). Providing heat, lighting, electric service, elevators, cleaning public access and exit areas, collecting trash, and maintaining the property in a usable rental condition are **not** considered significant services.

# Table 12-3.

# Sale, Exchange or Disposition of Property – – Net Income or Loss from Rents, Royalties, Patents or Copyrights (PA Schedule C)

As a separate class of income, taxable income includes net gains or income derived from or in the form of rents, royalties, patents, and copyrights. In calculating net income derived from rents and royalties, deductions for depreciation, depletion, repairs, and other expenses may be taken against the rents and royalties received. Rental income is reported on PA Schedule E.

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.

Type of Gain	Allocation of Gain	
	Gain Treatment	Pennsylvania Form
A lease that contains an option to purchase	Nonresident - Not taxable	PA Resident - Taxable
		Complete PA Schedule D
Transfer of ownership rights to patents or	Nonresident - Not taxable	PA Resident - Taxable
copyrights and other intangibles used in rental		Complete PA Schedule D
or royalty business		
Sale of tangible personal property used in an		PA Resident and nonresident
investment rental activity - For property		<ul> <li>Complete PA Schedule D</li> </ul>
located in Pennsylvania		
Sale of tangible personal property used in an	Nonresident - Not taxable	PA Residents - PA Schedule D
investment rental activity – For property not		
located in Pennsylvania		
Sale of land and buildings held for investment		PA Resident and nonresident
For property located in Pennsylvania		<ul> <li>Complete PA Schedule D</li> </ul>
Sale of land and buildings held for investment	Nonresident - Not taxable	PA Residents - PA Schedule D
<ul> <li>For property not located in Pennsylvania</li> </ul>		
Sale of partnership/PA S corporate interest in	Nonresident - Not taxable	PA Residents - PA Schedule D
an activity involving rents.		

# Sale of Property – Business, Profession, or Farm Table 12-4.

Partnerships must characterize income according to the income class before computing each partner's share. Allowable cost and expenses are deducted when computing net partnership income from a business, profession, or farm. Allowable expenses incurred in the conduct of a business or profession are those ordinary, necessary, and reasonable expenses required for its operation. These include office supplies, employees' salary and

benefits, rental expenses, depreciation, and interest on loans for business purposes.

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.

June 1, 1971.			
Type of Gain	Allocation of Gain		
	Net Income or Loss from a	PA Schedule D	
	business, profession, or farm		
Proceeds from the sale of intangible	Used in determining the net		
personal property used in the trade or	income (loss) of the business,		
business, including goodwill contractually	profession, or farm.		
sold with a business and allocated by the			
parties as to value in the sales			
agreement.			
Proceeds from the sale of intangible		PA Residents - PA Schedule D	
personal property not used in the		Nonresident - Not taxable	
business, including goodwill contractually			
sold with a business and not allocated by			
the parties as to value in the sales			
agreement.			
Proceeds from the sale of tangible	Used in determining the net		
personal property used in the business,	income (loss) of the business,		
profession, or farm and the proceeds	profession, or farm as part of		
reinvested and used to acquire like-kind	working capital.		
property used in the same business,			
profession, or farm.			
Proceeds from the sale of tangible		PA Resident and nonresident –	
personal property used in the business,		Complete PA Schedule D	
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			
Proceeds from the sale of tangible		PA Residents - PA Schedule D	
personal property used in the business,		Nonresident - Not taxable	
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			
Proceeds from the sale of inventory	Used in determining the net		
	income (loss) of the business,		
	profession, or farm.		
Proceeds from the sale of stock in trade	Used in determining the net		
	income (loss) of the business,		
	profession, or farm.		
Proceeds from the sale of other current	Generally used in determining		
assets	the net income or loss of the		
	business, profession, or farm.		
Proceeds from the sale of non-current		Generally PA Residents and	
assets		nonresident – Complete	
		Schedule D	
Proceeds from the sale of land and		PA Resident and nonresident –	
buildings constituting the abandonment of		Complete PA Schedule D	
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.		
Proceeds from the sale of land and buildings constituting the abandonment of business or business segment. For property not located in Pennsylvania.		PA Residents - PA Schedule D Nonresident - Not taxable
i.e., sale of a division or line of business where that division or business activity is not continued by the seller.		
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.		PA Resident and nonresident – Complete PA Schedule D.
Proceeds from the sale of land and/or buildings held for investment regardless of reinvestment of proceeds. Property not located in Pennsylvania.		PA Residents - PA 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 or 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)		PA Residents - PA Schedule D Nonresident - Not taxable
Sale of ownership interests in partnerships and business enterprises		PA Residents - PA Schedule D Nonresident - Not taxable

# PENNSYLVANIA TAXATION OF SPECIFIC TRANSACTIONS.

# Annuities.

Contributions to a retirement annuity that is not employer sponsored or part of an employer's program cannot be excluded or deducted from income even if intended for retirement. When annuity payments are received, the difference between the amount received and the previously taxed contribution is taxable gain reported on a PA Schedule D. Periodic payments received may be reported using the cost-recovery method.

Charitable gift annuities are taxable, as are all taxable annuities, on a cost-recovery basis.

The assignment of a court award is not taxable unless the taxpayer gives up his or her rights to all payments. Court awards of damages are taxable to the extent that they represent back wages, recovered net profits, rents, or another form of taxable income in the year received. This rule applies irrespective of whether they are payable in lump sum form or over time.

For Pennsylvania Personal Income Tax purposes, the entire cash surrender value of an insurance policy or annuity is taxed as gain from the disposition of property.

# **Distributions of Long-Term Care Policies.**

Due to the number of variables in these types of policies, it is necessary that a ruling be obtained from the Department of Revenue, Office of Chief Counsel, as to the taxability of these disbursements.

#### Withdrawals from TAP.

Withdrawals from TAP used for tuition are not reportable as income under Pennsylvania Personal Income Tax law. Withdrawals from a TAP account used for other than tuition purposes, however, are taxable to the extent the withdrawals exceed contributions. These taxable withdrawals are reported as interest or dividend income, as applicable.

A distribution from an education savings program in another state, whether used for education or not, is taxable as gain on sale of property to the extent the withdrawals exceed contributions. Pennsylvania law only provides exclusion for Pennsylvania TAP withdrawals used for education.

# MSA/Archer MSA Distributions.

Withdrawals from MSA for Federally qualified medical expenses are not taxable for Pennsylvania purposes. Withdrawals from a MSA not used for Federally qualified medical expenses are taxable for Pennsylvania purposes to the extent the withdrawals exceed contributions. These taxable withdrawals are reported as interest or dividend income, as applicable. Pennsylvania does not impose the 15% additional tax for non-medical withdrawals.

#### Condemnations.

Condemnation of property is generally not taxable for Federal purposes; however, it is a taxable disposition of property for Pennsylvania purposes. The disposition occurs when the condemnation is filed with the prothonotary's office. Relief may consist of compensation for the value of the property as well as relocation costs. Only the actual compensation for the value of the property itself is taxable for Pennsylvania purposes. The compensation would be the gross sales price and the cost would be the adjusted basis of the property. (For SP purposes, the additional amounts received (relocation costs) are not part of eligibility income). However, if the property is income producing, all monies received are included in the gross sales price on the sale of property.

#### FFMΔ

Generally, FEMA money is not taxable. However, if the monies were not fully reinvested into the damaged property, the excess would be taxable on PA Schedule D. To the extent FEMA money was not used to restore the property, it would be offset by basis reduction.

# Class-Action Life Insurance.

Life insurance settlements for class action cases where stock is given to the policy holder as well as the option for cash settlement upon selling the stock by the company, is reportable as sale of property. The sale of the policy (if canceled) uses the cost-recovery method to determine the gain/loss. If the policy is not sold or canceled, the payments received would adjust the basis of the policy. The stock received would have a basis of zero so that when it is sold, the net sales price is the reportable gain.

#### Conversion of Mutual Insurance.

Demutualization is the conversion of a mutual insurance company to a stock insurance company. By virtue of owning a policy from a mutual insurance company, the policyholder is a part owner of that entity. The policyholder is entitled to receive compensation for giving up membership interests under their policy with the mutual insurance company. Upon conversion to a stock insurance company, the policyholder exchanged his or her ownership in the mutual insurance company for stock or the cash equivalent. The policy itself is not changed by the demutualization.

Where the cash equivalent is received, the policyholder has a disposition of intangible personal property reportable on a PA Schedule D. The gross amount received is the sales price and the cost basis is zero.

If stock is received, no gain is reported until the subsequent sale of said stock occurs. At that point, the sales price is computed as usual and the cost basis is zero.

# Easements and Right-of-Way.

Easements and right-of-ways represent a transfer of property and, therefore, are reportable on PA Schedule D. The seller must establish the original value of the ceded property in determining the basis. Exceptions are negative easements in which no property is transferred but the use of such property is restricted, such as an agreement not to

develop said property but maintain it for agricultural purposes. In these cases, the monies received represent an adjustment to the basis.

# **Holocaust Settlements.**

Awards or settlements received in reparation for the seizure, theft, requisition, or involuntary conversion of the income of victims of Nazi persecution constitute proceeds from the disposition of property.

#### Farmland Preservation.

Income received from placement of farmland into the Farmland Preservation Program, as established by Act 146 of 1988, should be used as an adjustment to the basis of the property. In the event remuneration exceeds the basis, the excess proceeds are reported as a capital gain. Any questions concerning the taxability of the sale of timber should be directed to the Office of Chief Counsel.

# Repossession of Property.

If property is sold on a deferred payment contract and the seller repossesses the property upon default of the buyer in a subsequent tax year, the seller must adjust his basis upward in the property repossessed by the amount of gain previously reported.

Debt forgiveness, pursuant to an obligation to provide payment, is taxable if property is given as consideration.

Where property is sold pursuant to a deferred payment contract and the seller repossesses the property upon default of the buyer in a subsequent tax year, the seller must adjust his basis in the property repossessed by the amount of gain previously reported.

# Capital Gain Distributions from Mutual Funds or Regulated Investment Companies.

Capital gain distributions received from mutual funds or other regulated investment companies are taxable as dividends.

# Tax-exempt Obligations.

Net gains or interest from the sale or disposition (not redemption) of the following obligations are exempt from tax. These obligations include:

- Direct obligations of the United States Government such as Federal Treasury bills and Treasury notes originally issued before February 1, 1994;
- Direct obligations of certain agencies, instrumentalities, or territories of the Federal Government originally issued before February 1, 1994; and
- Direct obligations of the Commonwealth of Pennsylvania and its political subdivisions or authorities originally issued <u>before</u> February 1, 1994.

Losses incurred from the disposition of the above obligations may not be used to reduce other gains.

Under legislation enacted in 1993, if any of the obligations described above were originally issued on or after February 1, 1994, any gain or loss realized on the sale, exchange, or disposition of such obligations must be reported. Gains are taxable and losses may be used to offset other gains.

Net gain or income from the sale of obligations of other states or foreign countries is subject to tax.

# Like-kind Exchanges

The Department of Revenue has indicated that an exchange pursuant to APB Opinion 29 may qualify as a tax-free like-kind exchange under Pennsylvania Personal Income Tax if a taxpayer consistently uses GAAP and follows APB Opinion 29. If the taxpayer follows Federal tax accounting, then no like-kind provisions apply.

# **Involuntary Conversions.**

A loss from an involuntary conversion is limited to the smaller of the loss computed by using the value immediately prior to the conversion, or the value immediately after the conversion, taking into account any insurance proceeds or other consideration.

#### Wash Sales.

The Federal wash sale provisions do not apply for Pennsylvania Personal Income Tax purposes. For Pennsylvania purposes, every transaction is considered separate and independent of any subsequent transaction.

#### Bona Fide Sales to Related Parties.

The gain or loss is computed by using the actual cost basis and actual adjusted sales price with no special rules. Pennsylvania Personal Income Tax does not have provision for related party transactions. IRC Section 1239 (regarding gains from the sale of depreciable property between related parties) and IRC Section 267 (regarding treatment of losses, expenses and interest between related parties) are not applicable for Pennsylvania Personal Income Tax purposes.

# Bartering [Reserved].

# SALE OF PRINCIPAL RESIDENCE.

Generally, the gain on the sale of a principal residence occurring on or after January 1, 1998 is exempt from Pennsylvania tax. Likewise, no loss may be taken because such a transaction is not entered into for profit or gain. There is no requirement for any schedule to be filed for informational purposes on an exempt sale of a principle residence.

A residence is a house, lodging, or other place of habitation, including a trailer or condominium, that has independent or self-contained cooking, sleeping, and sanitation facilities.

A principal residence, in order to qualify for exclusion, must meet the following conditions:

- Owned for two of the last five years prior to the date of sale; and
- Physically occupied and personally used the most during two of the last five years prior to the date of sale.
   Moving furniture and personal belongings into a residence does not qualify as use. Even if the taxpayer's family physically occupied the residence, it is not the taxpayer's principal residence if he or she did not occupy it; and
- If the taxpayer has sold a principal residence and claimed the exemption within two years of the date of sale of a second principal residence, the second sale must be reported unless the sale is the result of a change in personal circumstances beyond one's control, such as a change in employment or health; and
- The principal residence was never used for other than residential purposes and was not subject to a depreciation deduction whether taken or not; and
- Was sold on or after January 1, 1998.

If the property is jointly owned and only one spouse fulfills the qualifications and a joint return is filed, the entire transaction is exempt. However, if the husband and wife file separately, only that spouse that fulfills all the qualifications may claim the exemption. The other spouse would be subject to tax on his or her half of the gain.

This exclusion also applies to installment sales.

If the owner has died, the exclusion may not be claimed unless the decedent closed the sale before death. However, a surviving spouse may claim the exclusion if the decedent satisfied both the ownership and use conditions before his or her death and the spouse has not remarried. The exclusion may not be taken on a fiduciary return, PA-41, by the estate.

If a portion of the principal residence has been used for other than residential purposes and eligible for the claiming of depreciation expenses, such as a duplex with one-half as rental, an office in the home, a residence above a retail store, or a farm, the portion of the gain attributable solely to residential purposes may be excluded. The gain attributable to nonresidential purposes does not qualify for the exclusion.

The PA-19 worksheet and instructions should be used in order to properly apportion the percentage of a mixed-use property not eligible for the exclusion.

However, the fact that the residence was rented for a couple of months does not necessarily disqualify the residence from the exclusion. For example, rent paid by the buyer to live in the seller's home prior to the disposition, does not in itself, violate any of the requirements for excluding the gain from the disposition of a principal residence. The

exclusion is allowable as long as the seller is not holding it for the post-conversion appreciation in value and the property is, therefore, not depreciable.

When a taxpayer-seller of a principal residence vacates, offers the residence for sale, and offers the property for rent pending such sale to preserve its value, it will not be disqualified for the exclusion as the property is not being held for the production of income and is not subject to depreciation allowance. The property would only be disqualified if the rental were for the production of income and subject to depreciation and/or the taxpayer held the property for the purpose of seeking profit based on a post-conversion appreciation in value.

The gain or loss on any residence or portion of a residence not eligible for the exclusion is reported on PA Schedule D. If other than the principal residence, it is reported in the line 1 section. If a principal residence, it is reported in the line 7 section.

#### PROPERTY ACQUIRED BEFORE 1971.

Schedule D-71 is used for property other than personal residences acquired before June 1, 1971.

Generally, gain or loss on the sale or other disposition of property is computed by subtracting the adjusted basis of a property from the value of cash and property realized on its sale or disposition. Special tax provisions, however, apply with respect to the computation of gain on property acquired before June 1, 1971. Gain on property acquired before June 1, 1971, is computed by subtracting the adjusted basis of the property or the alternative basis of the property, whichever is greater, from the value of cash or property received on its sale or disposition. In addition, no gain or loss is realized on the sale or disposition of property acquired prior to June 1, 1971, if the value of the cash or property received is greater than the property's adjusted basis but less than its alternative basis.

These special tax provisions apply if the property sold or otherwise disposed of was acquired before June 1, 1971. These provisions also apply if the acquired property was sold or disposed of by gift and the donor acquired the property before June 1, 1971.

#### Schedule D-1.

Part 1 is to be used for all property sold other than installment sales.

Part 1a Description of the property sold

## Part 1b Cost Method

- A = Bona fide appraisal reflecting the value of the property as of 6-1-71 (must have appraisal attached).
- A = Listed Security generally, the opening price as of 6-1-71. If there have been splits, the number of shares as of 6-1-71 must be determined. The same applies if the stock has been purchased over a period of time.
- P = Proration percentage of gain/loss attributed to period after 6-1-71
- X = Deemed Value In cases where it is impossible to establish 6-1-71 value by any of the above methods, a taxpayer may claim a deemed value for that date. The taxpayer must be able to justify the value used and be able to prove why none of the above methods can be used. Two examples where this type of value may be employed are where a homeowner has built a vacation home over a period of years spanning the period before and after 6-1-71 or where a corporation is a family held business and the stock is not traded so that the 6-1-71 value cannot be established.
- **Part 1c** Date sold goes above the dotted line, and date acquired goes below it (use settlement date for securities and closing date for real estate).
- **Part 1d** Gross sales price less expense of sale. Expense of sale includes closing costs such as brokerage fees, commissions, points, survey(s), loan fees, transfer tax, stamps, legal fees, title registration, termite inspection, advertising, and repairs directly related to the sale.

Non-selling expenses such as real estate taxes, interest, assessments, insurance, and mortgage prepayment penalty are not deducted.

# Part 1e - Costs

Adjusted Costs = Actual Cost + Any capital improvements - Any depreciation/ amortization

Inheritance = fair market value as of date of death Gift = use donor's adjusted base

Alternative basis = used only for property acquired prior to 6-1-71

Determined as follows for the proration method:

Prorated basis + capital improvements after 6-1-71 - depreciation/amortization after 6-1-71

**Part 1f** - Gain or loss

Subtract column E from Column D (D-E) and enter gain or loss.

# Five Rules Regarding Gain/Loss on Property Purchased Prior to 6-1-71:

#### **Income Producing Property:**

- 1. If loss on adjusted basis, use adjusted cost.
- 2. If gain on adjusted basis and gain on alternative basis, use the smaller gain.
- 3. If gain on adjusted basis and loss on alternative basis, use -0- (no gain or loss).

# **Non-income Producing Property:**

- 4. If adjusted basis is a loss, ignore alternative basis; use -0- (no gain or loss).
- 5. If gain on adjusted basis and gain on alternative basis, use the smaller gain.

Line 2 = Subtotal the total gains and losses computed under Part 1 and enter on Schedule "D," Line 5.

# **COMPUTATION OF INSTALLMENT SALES.**

If a sale results in a loss, the installment method cannot be used and the sale must be reported on PA Schedule D. If the installment method is not elected, the taxpayer must report all of the gain on the sale in the year of the sale on his or her PA Schedule D or PA Schedule C. (See Section B.2. as to when installment sales should be reported on Schedule C.)

# Calculation.

If the installment method is elected, the gain on the sale is allocated in equal proportion to the payments received and is reported in the year of the payment. Use PA Schedule D-I to make the calculation of taxable gain.

The installment method of reporting income from the sale of tangible personal property or real estate is permitted beginning with sales made on or after January 1, 1984, whether the sale is an isolated transaction or is from the inventory of a dealer or broker, when at least one payment is to be received in any taxable year following the taxable year of sale. Important: The installment method is not available for:

- Reporting income from sales of intangible personal property; or
- Transactions, the object of which is the lending of money or the rendering of services; or
- Sales where the taxpayer elects to exclude gain from the sale of a principal residence.

# Election.

Taxpayers must make an election if they wish to use the installment method. The Department of Revenue will deem the election to have been made in the following instances:

1. If a taxpayer reports an isolated transaction as an installment sale at the time of filing his or her Form PA-40 by:

- Using PA Schedule D-1 (REV-1689) to calculate the gain to be reported, and
- Including the gain on PA Schedule D, and
- Identifying the transaction on PA Schedule D as an installment sale; or
- 2. If a taxpayer reports other transactions by:
- Using PA Schedule C, and
- Identifying the transaction as an installment sale.

Once the election is made, the taxpayer will not be allowed to change his or her method of reporting in subsequent years.

When real or tangible personal property is sold at a gain and any portion of the payments is received in a tax year after the year of sale, it is an installment sale. The taxpayer has the option to either report the entire proceeds in the year of the sale or report on the installment method. The installment sales method is not permitted for the sale of intangible personal property or transactions, where the objective is the lending of money or the rendering of services. An installment sale election, once made, cannot be revoked. If the installment method of reporting is elected, the taxpayer must use a Schedule D-1 to report the sale. If the property was acquired prior to June 1, 1971, the taxpayer must also obtain Schedule D-71 to determine the adjusted basis or alternative basis.

**Example:** Lawrence Glenn sold his hunting cabin on September 12 of the current year. He purchased it on August 5, 1989. The purchase price was \$10,000 and he made improvements of \$500 for an adjusted basis of \$10,500. He sold the cabin for \$15,000 and closing costs were \$775 for net proceeds of \$14,225. It was sold on the installment plan with payments totaling \$4,383 the first-year, of which \$4,100 was principle. For the second year he collected \$7,124 of which \$5,251 was principal.

Since Lawrence Glenn chooses the installment sale method to report this sale, Schedule D-1 must be used. For the year of the sale, the Schedule D-1 shows a net profit in Part 1 of \$3,725 (\$14,225 - \$10,500), and part 2 shows the computation of taxable part of installment sale for the first-year. First the proportional gain ratio must be determined, by dividing the net profit by the gross sales price. In this example, it is .249 ( $\$3,725 \div \$15,000$ ). Apply the ratio to the principal payments received during the year ( $\$4,100 \times .249 = \$1,021$ ). Add to this figure any interest payments received during the year, which total \$283 (\$4,383 - \$4,100). The resulting figure is the taxable gain of \$1,304.

For the following year, Part 1 does not have to be completed on the Schedule D-1. Part 2 starts with the same ratio as in the prior year of .249. This is applied to the principal payments received in the second year ( $$5,251 \times .249 = $1,308$ ). Add to this figure the amount of interest payments received during the second year of \$1,873 (\$7,124 - \$5,251). The resulting figure is the taxable gain of \$3,181 (\$1,308 + \$1,873).

Subsequent years would be done the same as the second year. If Mr. Glenn had decided not to use the installment method, Schedule D would have been utilized and the entire amount of gain would have been reported in the first-year. Each year's interest on the installment sale would have been reported as interest income on Schedule A. If Mr. Glenn was a nonresident and reported the entire gain in the year of sale, he would not report any interest income to Pennsylvania.

# DEPRECIATION.

# **Depreciation Recapture.**

Pennsylvania's rule for adjustment of basis for depreciation expense requires that a minimum amount of depreciation must be recognized by the taxpayer on depreciable property in the amount of depreciation expense that would be allowed under the straight-line method. To the extent the taxpayer uses a different method to calculate depreciation and receives a tax benefit for some amount of depreciation expense greater than straight-line, that increased amount must be recognized. If, however, the taxpayer did not receive a tax benefit of the amount in excess of the straight-line amount, that excess does not have to be recognized. The taxpayers must reduce their basis by at least the straight-line depreciation expense even if they received no tax benefit.

Depreciation is the expensing of the cost of a depreciable asset employed in the operation of a business or in the production of rents or royalties over its useful life. The depreciation method chosen must be a method of accounting that reflects the consistent application of generally accepted accounting principles (GAAP) in a particular trade or business in accordance with prevailing conditions or practices in that trade or business. It shall be presumed to clearly reflect income if the method is used for Federal income tax purposes. Such accounting method can be

employed in calculating net profits or loss unless it is inconsistent with Departmental regulations. Generally, this is straight-line method of depreciation that evenly divides the basis in the asset by its useful life. The Department of Revenue permits as a convenience the use of Federal income tax depreciation methods such as MACRS, which is an accelerated method. Anytime an accelerated depreciation method is used and it creates a tax benefit, the taxpayer will have to reduce the basis in the asset to reflect the tax benefit realized.

For purposes of calculating the basis in assets for Pennsylvania tax purposes, the taxpayer must aggregate all taxable years under a single method of depreciation and should not use different depreciation methods from year to year, depending on whether a profit/gain or loss was realized.

For Federal and Pennsylvania purposes, when calculating the income for each year, the taxpayer must consistently use the same depreciation method over the life of the asset. When analyzing the gain or loss on sale, liquidation, or other disposition, the taxpayer must adjust basis in the asset downward by the greater of: 1) the total state tax benefit received over all years the asset was held by taxpayer (i.e. reductions in Pennsylvania taxable income or the income tax of another state) under whatever method was used, which could be the accelerated (MACRS) method of depreciation; or 2) the amount of total deductions for all years the asset is held by taxpayer that would be allowable under the straight line method, irrespective of whether a state tax benefit was received.

No 30% or 50% Additional First-Year Depreciation. For Federal purposes, Congress enacted legislation during 2002 and 2003 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% additional first-year depreciation deduction for 2002 nor the 50% additional first-year depreciation deduction for 2003 is permitted for Pennsylvania Personal Income Tax purposes.

# RETURN OF CAPITAL DISTRIBUTIONS.

A resident shareholder must report as taxable gain for the tax year in which it was received or credited, the excess of the fair market value of any "return of capital" distribution over the adjusted basis of the stock on the PA Schedule D. A "return of capital" distribution is any distribution that is not made or credited by a business corporation or association out of its earnings and profits.

# **BOOT RECEIVED ON NON-PENNSYLVANIA REORGANIZATIONS.**

Definition of "sale or exchange or other disposition" under Pennsylvania Law:

Pennsylvania Tax Reform Code Section 303(a)(2)(iv) provides:

The term "sale, exchange or other disposition" shall not include the exchange of stock or securities in a corporation a party to a reorganization in pursuance of a plan of reorganization, **solely for stock or securities in such corporation** or in another corporation a party to the reorganization and the transfer of property to a corporation by one or more persons **solely in exchange for stock or securities** in such corporation if immediately after the exchange such person or persons are in control of the corporation.

# Calculation of Pennsylvania Reorganizations with Gain (Boot) Computation Worksheet.

<ol> <li>Consideration received b</li> </ol>	y taxpayer:	1.	
	ue) non-PA reorganization	a.	
b. Securities <sup>2</sup> (fair marke	t value) non-PA reorganization	b.	
c. Money <sup>2</sup>		C.	
TOTAL			
2. Less: PA Basis of stock s	surrendered	2	
3. PA Gain realized on exch	ange	3	

# Treatment of Stock and Securities for Pennsylvania Personal Income Tax.

# Federal Income Tax Treatment of Securities Received in a Reorganization:

Surrender	Receive	Taxability
Stock & securities	Stock only	Nontaxable
Securities only	Securities of equal or less value	Nontaxable
Securities only	Stock or securities in an equal or less principal amount	Nontaxable
Securities only	Securities exceeding principal amount of securities surrendered	Taxable
Stock only	Securities	Taxable

# Pennsylvania Personal Income Tax Treatment of Securities Received in a Pennsylvania Reorganization:

Surrender	Receive	Reportable
Stock & securities	Stock & securities in the same proportion	Nonreportable
Stock & securities	Stock & securities in different proportion	Reportable
Stock only	Stock only	Nonreportable
Securities only	Securities only in an equal or lesser principal amount	Nonreportable
Stock only	Securities only	Reportable
Securities only	Stock only	Reportable

# (See Notes regarding Pennsylvania reorganization gain computation on next page.)

# Notes: Pennsylvania Reorganizations with Gain (Boot) Computation Worksheet:

- 1. If taxpayer received solely stock, then no gain recognized for Pennsylvania Personal Income Tax in the exchange transaction provided the requirements are met for the respective Pennsylvania reorganization.
- 2. Securities are gain (boot) for Pennsylvania Personal Income Tax purposes in a non-Pennsylvania reorganization.
- 3. Pennsylvania statutory reorganization provisions included in Section 303(a)(3)(iv)(b):
- i. A statutory merger or consolidation.
- ii. The acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation) of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition).
- iii. The acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of substantially all of the properties of another corporation, but in determining whether the exchange is solely for stock the assumption by the acquiring corporation of a liability of the other, or the fact that property acquired is subject to a liability, shall be disregarded.
- iv. A transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred.
- v. A recapitalization.
- vi. A mere change in identity, form, or place of organization however effected.
- 4. Pennsylvania statutory reorganization provisions included in Section 303(a)(3)(iv):
- (c) The acquisition by one corporation, in exchange for stock of a corporation (referred to in this clause (c) as "controlling corporation") which is in control of the acquiring corporation, of substantially all of the properties of another corporation which in the transaction is merged into the acquiring corporation, shall not disqualify a transaction under clause (b)(i) if such transaction would have qualified under clause (b)(i) if the merger had been into the controlling corporation, and no stock of the acquiring corporation is used in the transaction.
- (d) A transaction otherwise qualifying under clause (b)(i) shall not be disqualified by reason of the fact that stock of a corporation (referred to in this clause (d) as the "controlling corporation") which, before the merger was in control of the merged corporation, is used in the transaction; if after the transaction, the corporation surviving the merger holds substantially all of its properties and the properties of the merged corporation (other than stock

of the controlling corporation distributed in the transaction); and in the transaction, former shareholders of the surviving corporation exchanged, for an amount of voting stock of the controlling corporation, an amount of stock in the surviving corporation which constitutes control of such corporation.

# BASIS OF INHERITED PROPERTY.

A person who inherits property has as his or her basis the fair market value of the property as of the date of death of the decedent. Additionally, the following rules apply to inherited property:

- The basis of property acquired through inheritance, other than between a husband and wife, is that established at the time of death. Pennsylvania does not recognize the alternative "six months after death window" under Federal law.
- There is no stepped-up basis for property acquired as a surviving joint tenant with right of survivorship for state purposes. Property acquired by inheritance of intestate succession does produce a stepped-up basis for state purposes however.
- Basis does not have to be reduced for state purposes merely because the taxpayer utilized a Federal tax credit in conjunction with the depreciable asset.

## TRANSFERS OF PROPERTY INCIDENT TO DIVORCE.

There is no adjustment of the value to the party receiving the property. When the acquiring party disposes of the property, the original cost basis will be used. In addition, the relinquishing party will report no gain or loss on the sale or disposition of the property.

# **EXAMPLES.**

**Example 1:** A taxpayer moves from outside the state into Pennsylvania and establishes residency here and then sells his house in the other state for a substantial gain. Since the taxpayer has established his or her residency in Pennsylvania, he or she is subject to Pennsylvania tax on all income earned or received regardless of the source. If the taxpayer had to pay tax on the gain to the other state, a credit would be given, not to exceed the Pennsylvania tax due on the gain. If the taxpayer was not liable for tax on the gain to the other state because of Federal or state provisions, the gain is fully taxable in Pennsylvania and no credit would be allowed.

**Example 2:** If an individual sells stock that is traded on the open market, must the taxpayer use the June 1, 1971, traded value or can he use the prorated method to determine basis? If property was acquired prior to June 1, 1971, and it is listed on an established market or exchange on June 1, 1971, or the week preceding June 1, 1971, the listed security method of determining fair market value must be used.

If the taxpayer listed the fair market value on June 1, 1971, is it a) the opening price on June 1, 1971, or b) the price of the last sale during the preceding week if not traded on June 1, 1971, or c) the average of the high and low price or the average of the bid and asked quotations on June 1, 1971, whichever is appropriate, if not traded on or during the week preceding June 1, 1971. These rules are in Personal Income Tax Pamphlet Number 3, "Gain or Loss on Property acquired Prior to June 1, 1971."

**Example 3:** Husband and wife jointly own house. Husband dies. Pennsylvania's position is that no gain or loss is recognized on the exchange of jointly owned property between spouses. Each spouse owns the property in its entirety, subject only to each other's survivorship rights. When one spouse dies, the basis of the property does not change. Pennsylvania does not permit a stepped-up basis.

**Example 4:** Stock of a privately held corporation was acquired 6 months prior to 06/0l/1971. Corporation merged with public corporation under a tax-free organization. For Pennsylvania purposes, the basis of the stock is the 06/0l/1971 value of the public stock.

#### GAINS AND LOSSES FROM PARTNERSHIPS AND PENNSYLVANIA S CORPORATIONS.

See Chapter 16 for information regarding gains and losses from partnerships and Pennsylvania S corporations.

#### DISTRIBUTIONS FROM PARTNERSHIPS.

See Chapter 16 for information regarding distributions from partnerships.

# DISTRIBUTIONS FROM PENNSYLVANIA S CORPORATIONS.

See Chapter 16 of the *PA PIT Guide* for information regarding distributions from Pennsylvania S Corporations.

# Classification between Net Profits and Schedule D Gains and Losses - Overview

All gains and losses from the Federal Schedule K are first summarized. Gains and losses from Federal Form 4797 are included in arriving at this summarized total. Gains and losses are then classified between the following net classes of income: net profits from a business, profession or farm, or PA Schedule D gains and losses.

Federal gains and losses are classified as net profits if the funds are reinvested in the same line of business. For purposes of this classification. A "line of business" is defined by the North American Inventory Classification System. If the funds are not reinvested in the same line of business, then the gains and losses are reported on PA Schedule D.

The first four digits of North American Industry Classification System are considered for this purpose as the same line of business. As an example the North American Industry Classification System code of <u>3363</u>40 would be considered for this purpose as the same line of business as <u>3363</u>12.

# Classification between Net Profits and Schedule D Gains and Losses for PMI - Example

When PMI sold its Bethlehem plant, it did not reinvest the funds in that same line of business that was manufacturing air conditioning condensers. The North American Industry Classification System Code for manufacturing air conditioning and warm air heating equipment is 333415. Part of the proceeds was included in the distribution to the shareholders. The remaining proceeds were invested in non-current assets.

Alternatively, if the proceeds from the Bethlehem sale were invested in either a new business at the Pittsburgh or Philadelphia plant, or a different business at a new location, the gains and losses would also be included in arriving at PA Schedule D gains or losses. The classification of gains depends on the reinvestment of the proceeds from the sale. Proceeds not reinvested within the same line of business are PA Schedule D Gains. In contrast interest and dividend classification depends on whether the funds are included in working capital for any business.

The Pittsburgh facility is in the same line of business as defined under the North American Industry Classification System as the Scranton plant. The North American Industry Classification System Code for industrial mold manufacturing, (except steel ingot), is 333511. When the Scranton plant was sold the funds were reinvested in an attached production facility to the existing Pittsburgh plant. Because the proceeds were reinvested in the same line of business as the Scranton plant within first four digits of the North American Industry Classification System Code of 3335, the gain associated with the Scranton plant is classified and included in arriving at the computation of net profits.

If 10% part of the proceeds of the Scranton plant were invested in either a contiguous land investment surrounding the Pittsburgh plant or a new line of business at the Pittsburgh plant, then 10% of the associated gain would be included in PA Schedule D gains and losses.

#### Classification between Rental Income and PA Schedule D Gains - Overview

When property used in a rental activity is sold the gain or loss is a PA Schedule D gain. This rule applies to both real and personal property used in the rental business. Such gain is PA Schedule D gain regardless of whether the property is reinvested in a new building or similar type of building.

However, when a dealer in real property sells real property the gain is classified under the net profit rules. Such gain is classified depending on how and where the proceeds are reinvested. If the proceeds are reinvested in the same type of net profits activity, the gains are included in arriving at a net income or loss of such profits activity. In applying this classification rule, consideration is given whether that new real property is geographically located near the dealer's old property. If the proceeds are invested in new real property located outside of Pennsylvania, the gain is generally PA Schedule D gain. That new net profits activity is servicing new customers. This only applies to dealers in real property. Pennsylvania will follow the Federal dealer classification rules in administrating these rules.

As discussed above, when a dealer in real property sells real or personal property the gain generally is classified under the Net profit rules. Gain is classified depending on how and where the proceeds are reinvested by the dealer in real property. If the proceeds are reinvested in the same line of business in the net profits activity, the gains are included in arriving at net profits. The same line of business is defined under the five-digit North American Industry classification system as distinguished from four digits. E.g. <u>533110</u>. In applying this classification rule, consideration is given whether the real property acquired or exchanged is geographically located within Pennsylvania to the dealer's old property. If the proceeds are invested in real property located outside of Pennsylvania, the associated gain is

generally schedule D gain. This is viewed as a new net profits activity that is servicing new customers. This rule only applies to dealers in real property. Pennsylvania Department of Revenue will follow the Federal dealer classification rules in administrating these rules.