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OVERVIEW

A sale, exchange or disposition of property is:

- The transfer of property for money;
- The transfer of property for a promise to pay money;
- The transfer of property for other property;
- The charging off a worthless debt;
- A distribution of money or property, other than a dividend to a shareholder with respect to the stock, or in a partial or complete liquidation of a corporation;
- A redemption of stock;
- A grant of an option to purchase property;
- A lessee receiving amounts to cancel a lease;
- A distributor of goods receiving amounts for cancellation of a distributor's agreement;
- The retirement of a debt instrument;
- Any transfer of property where another party assumes a liability of the transferor as part of the consideration;
- The transfer of property for the satisfaction of a claim;
- A transfer of a franchise, trademark, or trade name;
- A surrender, cancellation, termination, rescission, release or other extinguishment of any right under a contract or lease;
- The collection of a previously written off account receivable;
- A partition of a single parcel of property between or among its owners;
- The destruction of property in whole or in part by fire, flood or other casualty;
- A theft or embezzlement;
- The condemnation, confiscation or expropriation of property;
- The foreclosure or other collections of claims;
- A voluntary reconveyance of property to a purchase money mortgagee;
- The abandonment of property including intangible drilling costs for dry-hole wells in oil and gas exploration;
- The retirement of recovery property to personal use;
- Other transactions or occurrences wherein or whereby the rights in, or relationship with, the property is converted into money or other property or terminates, is reduced or becomes worthless.

Gains from the sale, exchange or other disposition of any kind of property are taxable under the Pennsylvania personal income tax (PA PIT) law. This includes gain from the sale or disposition of real estate, tangible personal property, intangible personal property and investments, 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.

Pennsylvania makes no provision for capital gains. There are no provisions for long-term and short-term gains.

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 such as personal use property. Pennsylvania also has no provisions for the carryover of losses from one tax year to another year. Furthermore, Pennsylvania does not allow an offset of loss against gain from one class of income to another or between two taxpayers (i.e., spouses).

Generally, gain (loss) on sales or other dispositions 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 calculation of gain on property acquired before June 1, 1971. Refer to the information below on the Sale of Property Acquired Before June 1, 1971 for additional information.

Ordinarily, your adjusted basis for property for Pennsylvania income tax purposes is the same as your adjusted basis for federal income tax purposes. It is the original (unadjusted) cost for the property (plus allowable expenses of acquisition):

- Adjusted upward by the cost of capital improvements to the property, contributions of capital, and gain incurred, made or recognized during your entire holding period; and
- Adjusted downward by the annual deductions for depreciation, amortization, obsolescence or cost depletion (but not percentage depletion) allowed or allowable and recoveries of capital (such as property damage awards, casualty insurance proceeds, corporate “return of capital” distributions) received during your entire holding period, allowable losses during your entire holding period and other federal and state tax differences. Refer to the section on Depreciation and Basis Adjustment below for additional information.

Adjusted basis for business property or the adjusted basis for investments in partnerships and S corporations are often different for federal and Pennsylvania personal income tax purposes as a result of items 1 and 2 as previously noted. It is recommended that separate Pennsylvania basis calculations be determined annually for these types of investments.

Resident taxpayers must report all gains and losses on the sale, exchange or disposition of property regardless of where the disposition occurred. Therefore, all transactions displaying net gains and losses are reported on PA Schedule D. If a taxpayer has a loss on personal use property or other property where a loss is not permitted, the transaction must still be reported. However, in such situations, the transaction will show the sales price and basis as the same amount for Pennsylvania personal income tax purposes.

Nonresident taxpayers are only taxed on their Pennsylvania-source income. Therefore, only transactions displaying net gains and losses on tangible property located within Pennsylvania are required to be reported on PA Schedule D. Any gain reported on a PA-20S/PA-65 Schedule NRK-1 should be and is presumed to be Pennsylvania-source income. Examples of dispositions of property required to be reported by a nonresident include, but are not limited to: sales of rental property located in Pennsylvania; sales of business or rental tangible personal property located in Pennsylvania; and sales of land and/or buildings located in Pennsylvania held as investment property. Refer to Personal Income Tax Bulletin 2005-02, Gain or Loss Derived from the Disposition of a Going Concern, for additional information regarding the taxability of goodwill for nonresidents.

DIFFERENCES BETWEEN FEDERAL AND PENNSYLVANIA PERSONAL INCOME TAX

There are many differences between the federal tax law treatment and Pennsylvania’s treatment of the gain or loss on the sale, exchange or disposition of property. Many of those differences are discussed in this chapter. Some of the differences include, but are not limited to: sales of business assets; IRC Section 338(h)(10) transactions; like-kind exchanges; wash sales; capital gains distributions; bona fide sales to related parties; and transactions related to fraudulent investment schemes. The following pages discuss Pennsylvania’s treatment of these transactions as well as many others.

PENNSYLVANIA TAXATION OF SPECIFIC TRANSACTIONS

Annuities

For taxable years beginning after Dec. 31, 2004, Act 40 of July 7, 2005 provides that income from a life insurance or endowment contract or annuities such as a charitable gift annuity or an annuity contract purchased as retirement annuity that is not from an employer sponsored retirement annuity, or are not part of an employer sponsored program, are interest income. Any income from these types of investments that is taxable for federal income tax purposes is taxable for Pennsylvania personal income tax purposes as interest income. If a court awards damages in the form of an annuity, the annuity payments are taxable to the beneficiary as interest income as stated above. Refer to the PA Personal Income Tax Guide - Interest, for additional information.

The sale of an annuity contract is taxable as a disposition of property (Schedule D). The assignment of annuity payments is also taxable as a disposition of property if the taxpayer gives up his or her rights to the payments. The mere assignment of annuity payments to another payee is not taxable as Schedule D gain. Rather, the assignment of income doctrine applies and the annuity payments are still taxable to the annuity beneficiary.

The assignment of a PA Lottery prize (including assignments under 72 P.S. § 3761-306) is taxable as Schedule D gain. The basis in the prize is the amount the taxpayer paid for the winning ticket/chance in the PA Lottery game that awarded the prize.

For Pennsylvania personal income tax purposes prior to Jan. 1, 2005, the entire cash surrender value of an insurance policy or annuity less premiums paid (other than the premiums on the coverage on the person's life under the insurance contract) was taxed in the income class "net gains or income from disposition of property", rather than as interest.

Exchange of Insurance Contracts Under IRC Section 1035

For taxable years beginning after Dec. 31, 2004, Act 40 of July 7, 2005 provides that exchanges of insurance contracts under IRC Section 1035 that are tax exempt for federal income tax purposes are also tax exempt for Pennsylvania personal income tax purposes. Therefore, do not report the gain (loss) on the sale, exchange or disposition of any insurance contracts that include:

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

If the exchange of contracts has the effect of transferring property to a non-US person, the gain or loss is not tax exempt. If cash or other boot is involved with the exchange of the contracts, the gain or loss is also not tax exempt. The amount of cash or other boot received will be taxable as interest income. Refer to PA Personal Income Tax Guide - Interest, for additional information.

Sale of an Insurance Contract

For Pennsylvania personal income tax purposes, the basis of a life insurance contract must be adjusted to remove the cost of insurance (that is, any costs related to insurance protection). Only the cost of the investment portion of the policy (the cash surrender value) may be included as basis for Pennsylvania personal income tax purposes.

Gain on Distributions of Long-Term Care Policies

If the long-term care (LTC) insurance contract has a cash surrender value and there is an exchange of one LTC insurance contract for another, any gain on exchange of the contracts must be reported on PA Schedule D.

Withdrawals from Tuition Account Plans (TAP)

For taxable years beginning after Dec. 31, 2005, contributions to any qualified tuition program, including those offered by other states, will be deductible from taxable income. The amount deducted for each designated beneficiary cannot exceed the annual limitation on gifts permitted by the IRC for purposes of federal estate and gift tax. The deduction cannot result in taxable income being less than zero.

Withdrawals or distributions for taxable years beginning after Dec. 31, 2005 used for qualified education expenses, as well as undistributed earnings in the accounts, will not be taxable. Federally qualified rollovers between accounts and beneficiary changes will also not be taxable events for Pennsylvania personal income tax purposes. Distributions of contributions made after Dec. 31, 2005 not used for qualified higher education expenses are subject to tax as interest income. Distributions of contributions made prior to Jan. 1 2006 not used for qualified education purposes are subject to tax to the extent the distributions exceed contributions using the cost-recovery method on a first-in-first-out basis of contributions distribution. Refer to Personal Income Tax Bulletin 2006-04, Qualified Tuition Programs, for additional information.

Medical Savings Account /Archer (MSA) Distributions

Refer to PA Personal Income Tax Guide - Interest, and refer to Personal Income Tax Bulletin 2006-05, Archer Medical Savings Accounts, for additional information.

Health Savings Account/HSA Distributions

Refer to PA Personal Income Tax Guide - Interest, and refer to Personal Income Tax Bulletin 2006-06, Health Savings Accounts, for additional information.

Condemnations

Gain from a condemnation of property is a taxable disposition of property for Pennsylvania purposes. The disposition occurs when the condemnation is filed with the prothonotary's office. 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 PA Schedule 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.

Federal Emergency Management Agency (FEMA)

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-40 Schedule D. To the extent FEMA money was not used to restore the property, it would be offset by a 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 a 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 consideration 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-40 Schedule D. The gross amount received is the sales price and the cost basis is zero.

For tax years beginning after Dec. 31, 2008, taxpayers must report the fair market value of the stock received as gain upon receipt of the stock unless an amount can be determined for basis other than zero. Refer to Personal Income Tax Bulletin 2009-01, Treatment of Demutualization for Pennsylvania Personal Income Tax (PA PIT) Purposes for additional information regarding the reporting of the transaction and basis determination at time of receipt of the stock. When the sale of stock occurs, the basis is the fair market value of the stock reported as gain in the year of receipt. Gain or loss on any subsequent sale of the stock is computed on the difference between the sales price and the basis. If stock in a demutualization was received in a tax year beginning prior to Jan. 1, 2009, no gain was required to be included when the stock was received. However, when a subsequent sale of the stock received in the demutualization occurred, the taxpayer's basis of such stock would be zero. The sales price less any commissions paid for selling the stock would result in only a gain being reported for such transactions.

Gain from Easements and Right-of-Ways

Easements and right-of-ways represent a transfer of property and, therefore, are reportable on PA-40 Schedule D. The seller must establish the original value of the ceded property in determining the basis. In such cases, the square footage of the easement and the total square footage of the property are used to allocate the cost or adjusted basis. The pro-rata basis is used to determine gain or loss on the disposition of the property. The square footage method for allocating the cost or adjusted basis may only be used if the property is all of a like kind or of equal value.

In the case of a negative easement, where 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), the monies received represent an adjustment to the basis and are taxable as gains to the extent they exceed the basis of the property.

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 and are taxable as gains to the extent they exceed the basis of the property. Refer to 61 Pa. Code § 125.41-125.43 for further information.

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 gain on the sale, exchange or disposition of property.

Timber Sales

For a discussion concerning the proper reporting of gain or loss on timber sales, reference should be made to Private Letter Ruling PIT-08-003 (a copy of which is available on the Department's website).

Repossession of Property

A repossession of property occurs when there is a transfer of property under a deferred payment contract and there is a default under the contract. Many times, the deferred payment contract may span more than one tax year. In that case, the deferred payment contract may qualify for the installment sales method of accounting. In the case of intangible property, the sale will not qualify for the installment sale method of accounting but may qualify for the cost recovery method of reporting the gain on the sale.

- **Tax Treatment of Repossession for Buyer/Debtor**

When property is sold under a deferred payment contract and the seller/creditor repossesses the property upon default of the buyer/debtor, the buyer/debtor experiences a disposition of the property for Pennsylvania Personal Income Tax purposes. The gain or loss to the buyer/debtor is measured by the difference between the amount of indebtedness discharged by the transfer of the repossessed property, and the basis of the transferred property.

For example, a buyer purchases a widget from seller for \$12,000.00, and the buyer agrees to pay the seller \$500.00 per month until the purchase price is paid (i.e., \$500/month for two years). The buyer has a cost basis in the widget of \$12,000.00 because of his obligation to pay the seller. Six months after the sale, the buyer has made 6 payments totaling \$3,000.00. The buyer's remaining debt to the seller is \$9,000.00. At that point, the buyer can no longer afford to repay the seller and the seller repossesses the widget in exchange for a discharge of the remaining debt. In this case, the buyer has a disposition of the widget and experiences a loss of \$3,000.00 (\$9,000.00 discharge of debt - \$12,000.00 basis).

Assume the same facts as above except that deferred payment contract calls for interest to accrue on the principal balance. At the time of the repossession \$4,000 of interest has accrued. The seller takes the widget and discharges the buyer from the principal balance of \$9,000.00 and the accrued interest balance of \$4,000.00. As a result, the buyer experiences a \$1,000.00 gain from the repossession (\$13,000.00 discharge of debt - \$12,000.00 basis.)

Refer to PA Personal Income Tax Guide - Cancellation of Debt, for additional information.

- **Tax Treatment of Repossession for Seller/Creditor**

When property is sold under a deferred payment contract, the seller may incur a bad debt if the buyer/debtor fails to make payments under the contract. Bad debts are recognized when the account becomes uncollectible. The seller/creditor uses either the "direct write-off method" or "allowance method" to account for bad debts.

If the seller/creditor repossesses the property upon default of the buyer/debtor, the seller/creditor will report gain or loss for Pennsylvania Personal Income Tax purposes. In effect, the seller/creditor is exchanging the rights to receive payments from buyer/debtor under the deferred payment contract in exchange for the property. The calculation of the gain or loss depends upon whether the seller/creditor reported the sale on the accrual method of accounting or on the cash basis or installment sales method of accounting.

- **Accrual Method**

If the accrual method was used then the seller/creditor reported the entire gain/loss from the sale in the year of the sale. Consequently, the gain or loss on the repossession is calculated as follows:

Gain/Loss = the FMV of repossessed property less the seller/creditor's basis in the contract (basis=the contract's full face value less all payments of principal received under the contract. If only part of the payment obligation under the contract is discharged by the repossession, figure the basis using only that amount instead of the full face value of the contract.). If the seller/creditor experiences a gain to the extent that the FMV is greater than the basis or a loss to the extent the FMV is less than the basis.

- **Cash Basis or Installment Sales Method**

If the cash basis or installment sales method was used, then the seller/creditor has reported only a portion of the gain or loss at the time of the repossession. Consequently, the gain or loss on the repossession is calculated as follows:

Gain/Loss = the FMV of repossessed property less the seller/creditor's remaining basis in the contract (basis=accounts receivable balance less unrealized gross profit. If only part of the payment obligation under the contract is discharged by the repossession, figure the basis using only that amount instead of the full face value of the contract.). The seller/creditor experiences a gain to the extent that the FMV is greater than the basis or a loss to the extent the FMV is less than the basis.

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. Refer to PA Personal Income Tax Guide - Dividends, for additional information.

Tax-Exempt Obligations

Net gains from the sale or disposition (not redemption) of the following obligations are taxable to the extent these obligations include:

- Direct obligations of the U.S. government such as federal treasury bills and treasury notes originally issued on or after Feb. 1, 1994;
- Direct obligations of certain agencies, instrumentalities, or territories of the federal government originally issued on or after Feb. 1, 1994; and
- Direct obligations of the Commonwealth of Pennsylvania and its political subdivisions or authorities originally issued on or after Feb. 1, 1994.

Losses incurred from the disposition of the above obligations may be used to reduce other gains.

Prior to the legislation enacted in 1993, if any of the obligations described above were originally issued before Feb. 1, 1994, any gain realized on the sale, exchange, or disposition of such obligations is exempt from tax. Losses incurred from the disposition of obligations issued before Feb. 1, 1994 may not be used to reduce other gains.

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

Like-Kind Exchanges

A like-kind exchange refers to property that has been exchanged for similar property. For example: a taxpayer exchanged land in Pennsylvania for land in Florida. Under the Internal Revenue Code (IRC) a gain (loss) is not recognized and is deferred until the like-kind property is sold. Effective January 1, 2023, the deferral of tax due on gains from like-kind exchanges of property are allowed. Definitions of like-kind properties can be found in IRC Section 1031.

Involuntary Conversions

Pennsylvania PIT law follows the provisions of IRC Section 1033 for property subject to involuntary conversion (destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) after September 11, 2016.

Pennsylvania personal income tax includes a taxable gain from an involuntary conversion of property that occurs prior to September 12, 2016. A loss can occur for property obtained and held for gain, profit or income but is unallowable for personal use property (tangible or intangible).

The basis of property acquired/purchased to replace involuntarily converted property is its cost.

A loss from an involuntary conversion is limited to the smaller of the loss calculated by using the value of the converted property 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 a provision for related party transactions. Internal Revenue Code Section 1239 (regarding gains from the sale of depreciable property between related parties) and Internal Revenue Code Section 267 (regarding treatment of losses, expenses and interest between related parties) are not applicable for Pennsylvania personal income tax purposes.

Bartering

Bartering is a type of sale involving the exchange of property. Gain from bartering is taxable for Pennsylvania personal income tax purposes. Gain from bartering is the difference between the adjusted basis of the relinquished property and the fair market value of the property received. The cost basis in the property received is the fair market value.

Fraudulent Investment Schemes

Investors in fraudulent investment schemes, commonly known as "Ponzi schemes", should refer to Personal Income Tax Bulletin 2010-02, Guidance for Investors in Fraudulent Investment Schemes, for detailed information about how to report losses on any investments in such schemes.

Distributions from C Corporations

A shareholder in a C corporation who receives a distribution other than a dividend must decrease the basis of the C corporation stock or shares, but not below zero, by any such distribution. Any distribution greater than basis is reported as a PA Schedule D Gain.

Gain or Loss on the Sale of a Partnership or S Corporation Ownership Interest

Pennsylvania resident taxpayers with investment in partnerships (including limited liability companies reporting as partnerships on federal Form 1065) and S corporations that sell or exchange their interest or shares in those entities are required to report the gain or loss on those sales on PA Schedule D. Pennsylvania basis in these investments is often different than it is for federal income tax purposes. Refer to PA Personal Income Tax Guide - Pass Through Entities, for additional information on the basis calculations for these entities.

IRC § 338(h)(10) Sale of Stock Treated as a Sale of Assets

There are no provisions within Pennsylvania personal income tax law that permit the gain on the sale of stock to be treated as a gain on the sale of the assets of the corporation. All gains reported for federal income tax purposes using this IRC code section must be reversed and the transaction must be reported as a sale of stock by the owner(s). As a result, the corporation must keep separate Pennsylvania books and records from the date of the purchase going

forward for all assets held at the time of the purchase to keep the proper basis in the corporation and to calculate the allowable depreciation expense for the entity for Pennsylvania purposes.

Investments in Stocks and Bonds

Any gain or loss on the sale, exchange or disposition of stocks or bonds is reportable for Pennsylvania personal income tax purposes. A taxpayer may report each transaction or use summary information from brokerage accounts or a worksheet to report any net gain or loss amounts if the stocks and bonds are listed on any major exchange.

IRC § 1256 Mark-to-Market Gains and Losses

Mark-to-market gains and losses reported under IRC §1256 gains and losses are reported as Schedule D transactions for Pennsylvania personal income tax purposes.

IRC §§ 987 and 988 Foreign Exchange Gains and Losses

Gains and losses from foreign currency exchange transactions are reported as Schedule D transactions for Pennsylvania personal income tax purposes.

Other Income from Investment Partnerships

Gains and losses (short-term capital gains, long-term capital gains, IRC § 987, IRC § 988, IRC § 1256 and swaps) reported as other income for federal income tax purposes in Box 11 of federal Form 1065 Schedule K-1 are Schedule D gains and losses for Pennsylvania personal income tax purposes.

Sales of Business or Rental Property

Net gains and losses on the sales of tangible and intangible personal property, including the sale of rights, royalties, patents and copyrights, used in a trade or business or that are part of a rental property or royalty business, are required to be reported as gains or losses on PA Schedule D if property of a similar nature is not purchased or obtained to replace the disposed property. In cases where the federal reporting of such transactions also includes an ordinary income component of the gain, the ordinary income reported for federal purposes on such sales must be reclassified as gains from the sale exchange or disposition of property. If the property sold or exchanged for a business (not rental property) is replaced with similar property, the net gain or loss may be classified as business income for Pennsylvania personal income tax purposes. Refer to the information on Classification of Gains (Losses) in this chapter for additional information.

Sales of Land or Buildings Held for Investment

Gain or loss on the sale, exchange or disposition of property such as land or buildings held for investment with the intention of earning a profit is required to be reported on PA Schedule D.

Sales and/or Abandonment of Oil and Gas Wells

Federal sales and/or abandonments of oil and gas wells require the immediate recovery of intangible drilling costs as ordinary business income. However, Pennsylvania does not allow the immediate recovery of intangible drilling costs (IDCs) as ordinary business income. If a well is sold or abandoned for lack of production or insufficient production, the sale and/or abandonment are considered dispositions of property reportable on PA Schedule D. All IDCs not expensed or amortized through the date of disposition are included in the basis of the well being disposed of for purposes of calculating gain/loss. Refer to Personal Income Tax Informational Notice Tax 2013-04, Intangible Drilling and Development Costs, for additional information.

Sales of Property Converted from Business or Rental Property to Personal Use Property

Gain from the sale of property that has been converted from business or rental property (i.e., income producing property) to personal use property (i.e., non-income producing property) is reported on PA Schedule D. Because the property is personal use when sold, any loss from the sale cannot be claimed for PA personal income tax purposes.

Distributions of Stock from Employee Stock Ownership Plans (ESOPs) and Subsequent Sales

If a participant in an employee stock ownership plan (ESOP) receives a distribution from the ESOP, the distribution is reported as compensation to the extent that the distribution is greater than the participant's basis (previously taxed employee contributions). If the employee receives a distribution of stock from the plan, the value of the stock that is taxable as compensation is the fair market value of the stock at the time of the distribution (less the participant's

basis). After the distribution, the participant's basis in the stock is increased to the fair market value of the stock. If the participant later sells the stock back to the ESOP or to another party, the gain or loss from the sale is reported on PA Schedule D. Refer to PA Personal Income Tax Guide - Gross Compensation, for additional information.

Qualified Opportunity Fund Investments

For tax years 2018 and 2019, gains invested in Qualified Opportunity Funds are required to be reported for PA personal income tax purposes even though the gains are deferred for federal income tax purposes. Beginning in tax year 2020, PA follows the rules under IRC § Section 1400Z-2(c) of the Internal Revenue Code of 1986, as amended.

CLASSIFICATION OF GAINS (LOSSES)

The following table describes various types of gains or losses and the classification of the gain or loss as well as whether the income is taxable for a resident or nonresident taxpayer.

TYPE OF GAIN(LOSS)	CLASSIFICATION
<p>Proceeds from the sale of intangible personal property used in the trade or business, excluding goodwill.</p>	<p>PA resident – taxable Nonresident – taxable if PA source</p> <p>Used to determine the net income (loss) of the business, profession or farm if the proceeds are used to acquire like-kind property used in the same business, profession or farm. Report on Schedule C or Page 1 of the PA-20S/PA-65.</p> <p>If the proceeds are not used to acquire like-kind property used in the same business, profession or farm, report on Schedule D. Refer to Personal Income Tax Bulletin 2005-02, Gain or Loss Derived from the Disposition of a Going Concern.</p>
<p>Proceeds from the sale of goodwill.</p>	<p>PA resident – taxable Nonresident – taxable if PA source</p> <p>Report on Schedule D.</p> <p>Refer to Personal Income Tax Bulletin 2005-02, Gain or Loss Derived from the Disposition of a Going Concern.</p>
<p>Proceeds from the sale of tangible personal property used in the business, profession, or farm and the proceeds are used to acquire like-kind property used in the same business, profession or farm.</p>	<p>PA resident - taxable Nonresident – taxable if PA source</p> <p>Used to determine the net income (loss) of the business, profession or farm. Report on Schedule C or Page 1 of the PA-20S/PA-65.</p>
<p>Proceeds from the sale of tangible personal property used in the business, profession, or farm and the proceeds are not used to acquire like-kind property and/or not used in the same business, profession or farm.</p>	<p>PA resident - taxable Nonresident – taxable if PA source</p> <p>Report on Schedule D</p>
<p>Proceeds from the sale of inventory/stock-in-trade.</p>	<p>PA resident/nonresident – taxable</p>

	Used to determine the net income (loss) of the business, profession or farm. Report on Schedule C or Page 1 of the PA-20S/PA-65.
Proceeds from the sale of tangible assets held for investment.	PA resident - taxable Nonresident – taxable if PA source Report on Schedule D.
Proceeds from the sale of intangible assets.	PA resident – taxable. Report on Schedule D. Nonresident – not taxable
Proceeds from the sale of land and/or building constituting the abandonment of a business or business segment. Example. Sale of a division or line of business where that division or business activity is not continued by the seller.	PA resident - taxable Nonresident – taxable if PA source Report on Schedule D.
Proceeds from the sale of land and/or building used to generate rental income.	PA resident– taxable Nonresident – taxable if PA source Report on Schedule D.
Proceeds from the sale of land and/or buildings held for investment regardless of reinvestment of proceeds.	PA resident – taxable Nonresident – taxable if PA source Report on Schedule D.
Sale of stocks and bonds other than federal obligations or Pennsylvania obligations used in the operating cycle of the business activity.	PA resident/nonresident – taxable Used to determine the net income (loss) of the business, profession or farm. Report on Schedule C or Page 1 of the PA-20S/PA-65.
Sale of stocks and bonds other than federal obligations or Pennsylvania obligations not used in the operating cycle of the business activity.	PA resident – taxable Report on Schedule D. Nonresident – not taxable
Sale of ownership interest in partnerships and business enterprises.	PA resident – taxable Report on Schedule D. Nonresident – not taxable Refer to Personal Income Tax Bulletin 2005-02, Gain or Loss Derived from the Disposition of a Going Concern.
IRC § 1035 - exchange of insurance policy	

With boot	With boot: PA resident- taxable. Report on Schedule D. Nonresident- not taxable
Without boot	Without boot: nontaxable

SALE OF PRINCIPAL RESIDENCE

Generally, the gain on the sale of a principal residence occurring on or after Jan. 1, 1998 is exempt from Pennsylvania personal income 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 principal residence. However, if any portion of the gain is taxable due to nonresidential (business/rental) use of the property, the worksheet included with PA Schedule 19 must be included with the return.

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 all of the following conditions:

- Was sold on or after Jan. 1, 1998; and
- 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.

If a principal residence includes business or rental premises, the exemption does not apply to the portion of the property used for business or rental purposes. Examples include a sole proprietor's residence above the sole proprietor's store, an office in home and a duplex where one unit is rented. A principal residence used for rental purposes while the owner is attempting to sell the property is subject to a depreciation deduction, whether taken or not, and is therefore, not eligible for the exclusion.

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

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 PA-41, Fiduciary Income Tax Return by the estate.

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 gain (loss) on any residence or portion of a residence not eligible for the exclusion is reported on PA-40 Schedule D. The gain (loss) on any residence not eligible for total or partial exclusion is reported on line 1 of Schedule D. The gain excluded from taxation for any principal residence or the partial gain excluded from taxation on any principal residence is included in eligibility income on Line 8 of PA Schedule SP.

GAIN or LOSS on Property Acquired Prior to June 1, 1971

Refer to PA Schedule D-71 (REV-1742), Sale or Exchange of Property Acquired Prior to June 1, 1971, for detailed rules on how to report gain (loss) on property acquired before June 1, 1971.

CALCULATION OF INSTALLMENT SALES Gain

When real or 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. For sales of real or tangible personal property, a cash basis taxpayer has the option to either report the entire gain in the year of the sale or report the gain using the installment sales method of accounting. An accrual basis taxpayer may not use the installment sale method of accounting. Under the installment sales method of accounting, the gain from each installment payment is reported when received and the taxpayer's basis is allocated proportionally over all of the installment payments.

Although intangible personal property may be sold under an installment sales agreement, for Pennsylvania personal income tax purposes a cash basis taxpayer may not elect to use the installment sale method of accounting for an installment sale of intangible personal property or transactions where the objective is the lending of money or rendering of services. Rather, the cash basis taxpayer may report the entire gain in the year of the sale or use the cost recovery method of accounting (each installment payment is attributable to basis until fully recovered) to determine the gain on each installment payment. However, if the promise to pay the future installments is secured by a note that is assignable, the taxpayer may not use the cost recovery method and must report the entire gain during the year of the sale.

In addition, if a sale results in a loss, the installment method cannot be used and the sale must be reported on PA-40 Schedule D. The installment sales method also cannot be used where the taxpayer elects to exclude the gain from the sale of a principal residence.

If the installment method of reporting is elected, the taxpayer must use *REV-1689, PA Schedule D-1*, to report the sale. If the property was acquired prior to June 1, 1971, the taxpayer must also obtain *REV-1742, PA Schedule D-71*, to determine the adjusted basis or alternative basis.

If the installment method is not elected or permitted or the cost recovery method cannot be used, the taxpayer must report all of the gain on the sale in the year of the sale on his or her PA-40 Schedule D or PA Schedule C.

Election

Taxpayers must make an election if they wish to use the installment method. An installment sale election, once made, cannot be revoked. Pennsylvania will deem the election to have been made in the following instances:

If a taxpayer reports an isolated transaction as an installment sale at the time of filing the PA-40 Individual Income Tax Return by:

- Using *REV-1689, PA Schedule D-1* to calculate the gain to be reported, and
- Including the gain on PA-40 Schedule D, and
- Identifying the transaction on PA-40 Schedule D as an installment sale.

Once the election is made, the taxpayer will not be allowed to change the method of reporting in subsequent years. For example:

- Jane sold her hunting cabin on Sept. 12 of the current year.
- She purchased it on Aug. 5, 1989.

- The purchase price was \$10,000.
- She made improvements of \$500 for an adjusted basis of \$10,500.
- She sold the cabin for \$15,000.
- 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 principal.
- For the second year she collected \$7,124 of which \$5,251 was principal.

Since Jane chooses the installment sale method to report this sale:

- REV-1689, 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 calculation of the taxable part of the 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 a taxable gain of \$1,304.

For the following year:

- Complete Part 1 with the same amounts from the first year.
- 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 Jane 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 Jane was a nonresident and reported the entire gain in the year of sale, she would not report any interest income to Pennsylvania.

Defaults and Repossessions

Refer to Repossession of Property in this chapter for additional information.

DEPRECIATION AND BASIS ADJUSTMENT

Depreciation

In computing income, a depreciation deduction shall be allowed for the exhaustion, wear and tear and obsolescence of property being employed in the operation of a business or held for the production of income. The deduction must be reasonable and shall be computed in accordance with the property's adjusted basis at the time placed in service, reasonably estimated useful life and net salvage value at the end of its reasonably estimated useful economic life. A taxpayer must consistently use the same depreciation method over the life of the asset

Acceptable methods of depreciation are:

- The straight-line method; or

- Any depreciation method, recovery method or convention that is also used by the taxpayer in determining Federal net taxable income. This includes such methods as Modified Accelerated Cost Recovery System (MACRS). Such a method may only be used if the property, when placed in service, has the same adjusted basis for Federal income tax purposes and the method or convention is allowable for Federal income tax purposes at the time the property is placed in service or under the Internal Revenue Code of 1986, whichever is earlier.

Federal Bonus Depreciation

Pennsylvania personal income tax does **not** follow the federal provisions for the allowance of bonus depreciation. No bonus depreciation may be taken for Pennsylvania personal income tax purposes.

Application of Pennsylvania Basis Adjustment Rules for Depreciation

Personal income tax law in 72 P.S. §7303(a.2) states that the basis in property shall be reduced, but not below zero, for depreciation by the greater of:

- The amount deducted on the return and not disallowed, but only to the extent the deduction results in a reduction of income; and
- The amount allowable using the straight-line method of depreciation computed on the basis of the property's adjusted basis at the time placed in service, reasonably estimated useful life and net salvage value at the end of its reasonably estimated useful economic life, regardless of whether the deduction results in a reduction of income.

RETURN-OF-CAPITAL DISTRIBUTIONS

A resident shareholder or partner 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 or partnership interest on the PA-40 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. Refer to the PA Personal Income Tax Guide - Pass Through Entities, for additional information.

REORGANIZATIONS

Definition of Sale or Exchange or Other Disposition Under Pennsylvania Law

Pennsylvania treatment is similar to Internal Revenue Code Section 368(a)(1). Refer to Pennsylvania Tax Reform Code Section 303(a)(3)(iv) for additional information.

PA Personal Income Tax Treatment of Stock and Securities Received in a Reorganization

Securities are considered to be boot in reorganizations. The following chart provides when the boot received results in a taxable or nontaxable transaction for PA personal income tax purposes:

Surrender	Receive	PA Taxability
Stock and Securities	Stock and securities in same proportion	Nontaxable
Stock and Securities	Stock and securities in different proportions	Taxable
Stock Only	Stock only	Nontaxable
Securities Only	Securities only in an equal or lesser principal amount	Nontaxable
Stock Only	Securities only	Taxable
Securities Only	Stock only	Taxable

Calculation of Gain or Loss for Taxable Reorganizations

Gain or loss on a taxable reorganization for PA personal income tax purposes is calculated in the same manner as for federal income tax purposes.

BASIS OF INHERITED PROPERTY

A person including the estate of a decedent 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 (“stepped-up basis”). Additionally, the following rules apply to inherited property:

- The basis of property acquired through inheritance, whether by testate or intestate succession, is established at the time of death. Pennsylvania does not recognize the alternative “six months after death window” under federal law.
- There is no Pennsylvania personal income tax stepped-up basis for property acquired as a surviving joint tenant with right of survivorship or by a surviving spouse for property owned as tenants by the entirety.
- 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.

GAINS AND LOSSES FROM PARTNERSHIPS AND PA S CORPORATIONS

Refer to the PA Personal Income Tax Guide - Pass Through Entities for information regarding gains and losses from partnerships and Pennsylvania S corporations.

DISTRIBUTIONS FROM PARTNERSHIPS

Refer to the PA Personal Income Tax Guide - Pass Through Entities, for information regarding distributions from partnerships.

DISTRIBUTIONS FROM PA S CORPORATIONS

Refer to the PA Personal Income Tax Guide - Pass Through Entities, for information regarding distributions from Pennsylvania S Corporations.

CLASSIFICATION BETWEEN NET PROFITS AND SCHEDULE D GAINS (LOSSES)

Gains and losses are classified as net profits for Pennsylvania if the funds are reinvested in the same line of business within the same entity. Funds are reinvested in the same line of business within the same entity only if the funds are used to acquire like-kind property used in the same business, profession or farm. If the funds are not reinvested then the gains are reported on PA-40 Schedule D. If the gains are reported as ordinary income on federal Form 4797, it is not necessarily reported as net profits for Pennsylvania personal income tax purposes. For purposes of this classification, “Line of business” is defined by the North American Inventory Classification System (NAICS). If the funds are not reinvested in the same line of business, then the gains (losses) are reported on PA-40 Schedule D.

NAICS is a two- through six-digit hierarchical classification system, offering five levels of detail. Each digit in the code is part of a series of progressively narrower categories, and the more digits in the code signify greater classification detail. A complete and valid NAICS code contains six digits that consist of:

- The first two digits designate the economic sector;
- The third digit designates the subsector;
- The fourth digit designates the industry group;
- The fifth digit designates the NAICS industry; and

- The sixth digit designates the national industry.

As it relates to classification between net profits and PA-40 Schedule D gains (losses), the first four digits of NAICS are considered as the same line of business. For example, the NAICS code of **336340** would be considered for this purpose as the same line of business as **336312**.

CLASSIFICATION BETWEEN RENTAL INCOME AND PA SCHEDULE D GAINS (LOSSES)

When property used in a rental activity is sold, the gain or loss is a PA-40 Schedule D gain. This rule applies to both real and personal property used in the rental business. Such gain is PA-40 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-40 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 NAICS as distinguished from four digits.

Example:

In applying this classification rule, consideration is given to 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 PA-40 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 will follow the federal dealer classification rules in administrating these rules.