

TAXABLE INCOME AND DEDUCTIONS

REFERENCE GUIDE

September 1, 2009



The purpose of this Reference Guide is to provide a general guide to the Earned Income Tax provisions of the Pennsylvania Local Tax Enabling Act (Act 511 of 1965), as amended, including amendments under Act 50 of 1998, Act 166 of 2002 and Act 32 of 2008. This Reference Guide is subject to the specific provisions of any earned income tax ordinance or resolution adopted by a municipality, school district or other governmental or taxing authority, and any related regulations, court decisions and other applicable legal authority.

The information and material in this Reference Guide: (1) is general in nature, offered only to inform its readers, and is not intended to be exhaustive; (2) does not constitute any statement of legal opinion or legal authority, and (3) is not binding on Pennsylvania Municipal Service Company or any Pennsylvania municipality, school district or other governmental, taxing or regulatory authority. For specific advice and information, the reader should consult his or her own legal counsel, accountant or other professional advisor.

This Reference Guide may be subject to change.

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PENNSYLVANIA MUNICIPAL SERVICE COMPANY

Pursuant to Act 166 of 2002, definitions as determined by the Department of Revenue under section 303 of the act of March 4, 1971 (P.L.6, No.2), known as the Tax Reform Code of 1971, and rules and regulations promulgated under that section: (1) "Earned Income" and (2) "Net profits" are as required to be reported to or as determined by the PA Department of Revenue.

I. EMPLOYEE EARNINGS

A. TAXABLE EARNED INCOME OF EMPLOYEES

"Earned Income," The compensation as required to be reported to or as determined by the Department of Revenue under section 303 of the act of March 4, 1971 (P.L.6, No.2), known as the Tax Reform Code of 1971, and rules and regulations promulgated under that section. Employee business expenses as reported to or determined by the Department of Revenue under Article III of the Tax Reform Code of 1971 shall constitute allowable deductions in determining earned income. The term does not include offsets for business losses.

The following items of earned income received or constructively received by an employee, whether directly or through an agent, whether in cash or in property and whether based on an hourly, daily, weekly, semi-monthly, monthly, annual, unit of production, or piece work basis, for services rendered as an agent or employee (including as an agent or employee of an S Corporation) are subject to local earned income tax:

- (1) **Salaries.**
- (2) **Wages.**
- (3) **Commissions.**
- (4) **Incentive Payments.**

Incentive payments include, but are not limited to, payments received for purposes of inducing the employee to make a decision - such as moving to another location or accepting an early retirement. Such payments constitute taxable earned income for local earned income purposes. If the payment of such sums is to be made in the future, such sums will be taxed in the year they are received.

- (5) **Bonuses.**
- (6) **Fringe Benefits Taxable for Pennsylvania Personal Income Tax Purposes.**

Fringe benefits (cash and non-cash) taxable for PA Personal Income Tax purposes, including vacation pay, paid leave of absence, holiday pay, signing bonuses, payments for unused vacation or sick leave, termination and separation payments, employer payments for sickness and disability (excluding sickness and disability payments by third party insurers), are taxable earned income for local earned income purposes.

(7) Certain Cafeteria Plan Contributions.

If an employer maintains a Federally qualified Cafeteria Plan pursuant to Section 125 of the Internal Revenue Code (the "Code"), amounts which an employee chooses to have deducted from employee's salary and contributed to the Cafeteria Plan to purchase dependent care benefits and other benefits not excluded from personal income taxation under Pennsylvania law are taxable earned income for local earned income purposes. If an employer maintains an employee benefit plan that is not qualified under Code Section 125, employee contributions are taxable earned income for local earned income purposes.

(8) Non-Qualified Deferred Compensation and Amounts which are Constructively Received.

Generally, taxable earned income for local earned income purposes includes compensation which is deferred through a non-qualified arrangement and amounts which are constructively received. Therefore, if an employee has the option to direct his compensation to be paid or to inure to his benefit in the form of "fringe benefits", certain of those amounts are includable in taxable earned income for local earned income purposes (unless expressly excluded under Pennsylvania law applicable to employee contributions to a qualified Code Section 125 Cafeteria Plan). Where an employee directs the employer to make payments from his earnings for his benefit to the following, such amounts are subject to tax:

- (a) Bank or thrift institutions
- (b) Contributions to group insurance plans for "extra" coverage
- (c) Credit unions
- (d) Deferred compensation programs
- (e) Other payments for life, auto, health and/or home insurance
- (f) Savings bonds programs and other similar payments
- (g) United Way or other charitable contributions
- (h) Dependent care
- (i) Other

(9) Payroll Deductions.

Payroll deductions required by law are includable in the employee's taxable earned income for local earned income purposes, such as the following:

- (a) Court-ordered child support;
- (b) Federal income tax withholding;
- (c) Local tax withholding;
- (d) Employee's share of Social Security taxes withheld;
- (e) State income tax withholding; and
- (f) Other

(10) Car / Travel Allowances.

Car/Travel allowances received (other than employee use of company property which is excluded from taxable earned income). Associated expenses are deductible to the extent allowed on Pennsylvania Form UE-1.

(11) Drawing Accounts.

Draws against commissions, fees, etc., paid to a salesperson and others are taxable earned income in the year received. If the salesperson or other person subsequently repays any amounts not in fact earned, taxable earned income shall be adjusted accordingly, but not below zero.

(12) Executive Compensation Arrangements.

This is a general "catch-all" category. The terms of the compensation arrangement must be reviewed to determine whether payments are subject to local earned income taxation.

(13) Fees and Honorarium.

Fees and honorarium are taxable earned income for local earned income tax purposes. Examples include fees received by a director or officer of a corporation or by an executor or administrator of an estate.

(14) Fellowships, Scholarships, Grants and Stipends.

Payments made to a student under the terms of a fellowship, scholarship or other grant which represents compensation for services required to be performed are taxable earned income subject to local taxation.

(15) Jury Duty & Witness Fees.

(16) Moving Allowances Received.

Associated expenses are deductible to extent allowed on Pennsylvania Form UE-I.

(17) Receipt of Property.

Compensation received in the form of property is taxable earned income for local earned income tax purposes, taxable at its fair market value at the time of receipt.

(18) 401(k) and Other Salary Reduction Plans.

Any plan through which an employee's contribution serves to reduce gross taxable wages for federal income tax purposes is not recognized as an exclusion from taxable earned income for local earned income purposes. For example, an employee's contribution under Section 403(b) or Section 401(k) of the Code will not be recognized as a reduction of taxable earned income for local earned income purposes.

(19) Early Retirement Benefits.

Payments received from certain retirement plans before the taxpayer meets the retirement age or years in service requirements specified under the plan for retirement are taxable earned income for local earned income purposes to the same extent as taxable for Pennsylvania personal income

tax purposes.

- (20) Stock Appreciation Rights.**
- (21) Stock Options.**
- (22) Taxes assumed by an employer.**
- (23) Tips and gratuities received.**
- (24) Adoption assistance benefits.**
- (25) Covenant-Not-To Compete payments and other payments to refrain from performing services.**
- (26) Any other remuneration for services.**

B. EXAMPLES OF TAXABLE EARNINGS:

1. Taxpayer B receives a salary of \$60,000, of which \$10,000 is deferred to a 401(k) Plan for his retirement. His local taxable earned income is \$60,000, not \$50,000. Any plan which serves to reduce gross taxable wages for federal income tax purposes is not recognized as an exclusion for local earned income tax purposes.
2. Taxpayer C receives a salary of \$80,000 He also receives excess life insurance as reported on his W-2 form in the amount of \$265. His total taxable earned income is \$80,265.
3. Taxpayer D is a minister who does not live in a church-provided parsonage. He receives a salary of \$20,000, a housing allowance of \$10,000 and a car/travel allowance of \$2,500. The total taxable earned income is \$22,500 (clergy housing allowance is not taxable, see below.) To claim unreimbursed business expenses, he can file a Pennsylvania Form UE-1 as a deduction from his taxable compensation.
4. Employer X offers to give Employee Y an incentive payment of \$15,000 if Employee Y agrees to retire before his scheduled time. The \$15,000 is to be paid at a rate of \$5,000 per year over a three year period after the retirement takes effect. It will be taxed in the years that it is received by Employee Y. That is to say that Employee will have to include as taxable earned income the extra \$5,000 received for each of the three years following retirement.
5. Taxpayer E has recently moved to the municipality. In addition to his salary of \$45,000, he was given \$10,000 for moving expenses. The total earned income of \$55,000 is taxable by the municipality. Taxpayer E can file a Pennsylvania form UE-1 to claim moving expenses incurred.

C. EXCLUSIONS FROM TAXABLE EARNINGS

The following payments or benefits received by an individual are not subject to local earned income taxation:

(1) Active Duty Military Pay.

Compensation paid by the United States to any person for active duty service in the armed forces of the United States is not taxable. This includes compensation paid to Reserve or National Guard members for active duty service.

(2) Benefits Arising Under Workmen's Compensation Acts, Occupational Disease Acts, and Similar Legislation.

Compensation received by employees under the provisions of workmen's compensation acts, Occupational disease acts, or similar legislation together with any amounts received as damages by suit or agreement on account of any injury or disease are not taxable earned income for local taxation purposes.

(3) Board and Lodging to Employees for Convenience of Employer.

The value of meals and lodging furnished to domestics or other employees by an employer for the latter's convenience is not considered taxable income. Where, however, board or lodging is provided by the employer and the employee is not required to reside on the premises as a condition of employment, the fair market value of the board or lodging shall be included in the employee's taxable earned income.

(4) Fringe benefits not Taxable for Pennsylvania Personal Income Tax Purposes.

(5) Certain Cafeteria Plan Contributions.

If an employer maintains a Federally qualified Code Section 125 Cafeteria Plan, amounts which an employee chooses to have deducted from employee's salary and contributed to the Cafeteria Plan to purchase coverage for hospitalization, sickness, disability or death, supplemental unemployment benefits, or strike benefits are not taxable earned income for local earned income purposes to the extent they are exempt from Pennsylvania personal income tax. Employer provided flex dollars that an employee must use to pay for Pennsylvania personal income tax exempt benefits, such as health insurance or life insurance, are not taxable earned income for local earned income purposes.

(6) Capital Gains.

(7) Death Benefits.

Where an employer makes death benefit payments to the beneficiary of an employee or to his estate, whether payable in a lump sum or otherwise, such payments are not taxable earned income.

(8) Dividends.

Dividends are not subject to tax unless such person is a dealer in securities, in which case the net profits of such business are taxable to such dealer in securities, or unless the dividends are correctly reportable on Pennsylvania Form PA-40 "Gross Compensation" line, or the "State Wages, Tips, etc.." line of form W-2.

(9) Gifts and Bequests.

Cash or property received as a gift or under a will or under statutes of descent and distribution are not taxable earned income.

(10) Interest.

Interest is not taxable earned income unless it is correctly reportable on Pennsylvania Form PA-40 "Gross Compensation" line, or on the "State Wages, Tips, etc." line of Form W-2. Moreover, where a person is engaged in the business of loaning money at interest (i.e., loan or finance companies or private bankers), the net profits of such business are taxable.

(11) Lottery and Gambling Winnings.

Lottery and gambling winnings are unearned income and are not taxable.

(12) Prizes and Awards.

Prizes and Awards are considered unearned income and are not taxable.

(13) Group term life insurance.

(14) Proceeds of Life Insurance Policies.

Proceeds of life insurance policies payable by reason of death of an insured to his estate or to a beneficiary are not taxable earned income.

(15) Public Assistance or Unemployment Compensation Payments.

Payments made under any public assistance or unemployment compensation legislation are not taxable earned income.

(16) Religious Offerings and Housing Allowances.

These items, which are voluntary offerings made by individuals for the performance of baptisms, wedding ceremonies, etc., received by clergymen, evangelists or religious workers, are considered unearned income and are not taxable. Clergy housing allowances are considered unearned income and are not taxable earned income.

(17) Sickness or Disability Benefits.

Payments received by an individual under a third party insured sickness or disability plan are not taxable. Where, however, an employee received a

regular salary from his employer during a period of sickness or disability by virtue of his contract of employment, such compensation shall be fully taxable earned income.

(18) Social Security Benefits

(19) Retirement Benefits.

Payments received from certain retirement plans after the taxpayer meets the retirement age or years in service requirements specified under the plan for retirement are not taxable earned income for local earned income purposes to the extent such payments are not taxable income for Pennsylvania personal income tax purposes. Note that income given to induce early retirement where payment thereof is deferred until after retirement is not excluded and is to be included as taxable earned income in the year received.

(20) Wage and Salary Supplemental Programs.

Payments made by an employer or labor union for certain wage and salary supplemental programs (e.g. hospitalization, sickness, disability or death benefits, supplemental unemployment benefits, strike benefits, social security and retirement benefits) are not taxable earned income for local earned income purposes to the extent such payments are not taxable income for Pennsylvania personal income tax purposes.

(21) Railroad retirement benefits.

(22) Alimony and child support.

(23) Fellowships and Scholarships.

Payments made to a student under the terms of a fellowship, scholarship or other grant which do not require service to be performed are not subject to local earned income taxation.

(24) Settlements or damages received for personal injury.

(25) Employee use of company property.

Employee use of company property is not taxable earned income (other than car/travel allowances received which are included in taxable earnings). Examples include the use of employer provided vehicles, aircraft, recreational or daycare facilities and office equipment.

II. ALLOWABLE EMPLOYEE EXPENSES

A. BUSINESS EXPENSES

Business expenses as documented on Pennsylvania Department of Revenue Form UE-1 and to the extent not reimbursed are allowable deductions from taxable earned income for local earned income purposes. If employee business expenses are claimed, a copy of Federal Form 2106 must be provided. If moving expenses are claimed, a copy of Federal Form 3903 must be provided. A general summary of deductible and nondeductible

expenses is as follows:

(1) Employees' Deduction for Expenses Directly Connected with Employment.

Business expenses for which an employee has not been reimbursed are allowed as a deduction from gross wages provided such expenses are necessary (required by the employer) in order for the employee to keep his/her present job and provided they are recognized as deductions for state or federal income tax purposes. Examples include, but are not limited to:

(a) Education.

Allowable education expenses must meet the express requirements of the employer or laws or regulations for keeping a job or position. Tuition, books, supplies, laboratory fees and similar items and certain related travel and transportation costs may be deducted from income.

(b) Office Rental or Office-In-Home.

An exclusion for an office in the home may be taken if the following requirements are met:

- (i) A suitable work space is not provided by the employer, and
- (ii) The nature of the work is such that it requires a work area for its performance or for the storage of goods and wares on premises other than that of the employer. A letter must be submitted on employer's letterhead stating in detail that the office is necessary in order to work for the employer. Letter must be signed by an appropriate representative of the company.

(c) Other Expenses.

- (i) Union dues and initiation fees.
- (ii) Professional dues and subscriptions to professional journals.
- (iii) Small tools and supplies.
- (iv) Uniforms, not suitable for everyday use, and protective clothing required by an employer.

(d) Transportation-Daily Expenses.

Transportation expenses incurred by the employee as a condition of employment and required by the employer are allowed as deductions, less the amount of any reimbursement the employee receives. Neither the cost of commuting to and from one's job site nor the cost of commuting to and from a secondary place of employment are allowed as deductions.

(e) Transportation-Overnight Expenses.

Transportation and expenses incurred by an employee while away from home overnight (meals and lodging, etc.) as a condition of employment and required by the employer are allowed as a deduction, less the amount of any reimbursement the employee receives.

Examples:

- (i) Air, rail and bus fares.
- (ii) Operation and maintenance of an automobile.
- (iii) Taxi fares or other transportation, such as trips between airport or station and hotel; from one place of business to another; or from where employee sleeps to temporary work assignment.
- (iv) Meals and lodging when away from home on business.
- (v) Tips that are incidental to any of the above.

(2) Nondeductible Expenses.

The following items are examples of non-deductible employee expenses:

- (a) Commuting to and from work;
- (b) Hospitalization payments;
- (c) Insurance payments;
- (d) Pension plan (e.g., 401 (k)) and IRA payments;
- (e) Personal, family or living expenses; and
- (f) Taxes based on income.

III. NET PROFITS OF BUSINESSES, PROFESSIONS AND OTHER ACTIVITIES

A. COMPUTATION OF NET PROFITS.

"Net Profits" The net income from the operation of a business, other than a corporation, as required to be reported to or as determined by the Department of Revenue under section 303 of the act of March 4, 1971 (P.L.6, No.2), known as the Tax Reform Code of 1971, and rules and regulations promulgated under that section. The term does not include income under any of the following paragraphs:

- 1 - Income which:
 - (i) Is not paid for services provided; and
 - (ii) Is in the nature of earnings from an investment.
- 2 - Income which represents:
 - (i) Any gain on the sale of farm machinery;
 - (ii) Any gain on the sale of livestock held 12 months or more for draft, breeding or dairy purposes; or
 - (iii) Any gain on the sale of other capital assets of a farm.

B. PERSONS, ENTITIES, ACTIVITIES AND PROPERTY SUBJECT TO LOCAL TAXATION ON NET PROFITS.

(1) Individuals.

Any individual engaged in a business, trade, profession or other commercial activity or enterprise for profit (whether as a sole proprietor or otherwise) shall pay a local earned income tax on the net profits therefrom. Such net profits shall be the same as reported on the individual's Pennsylvania Personal Income Tax Return as "Net Income or Loss from the Operation of a Business, Profession or Farm", and copies of supporting Pennsylvania Schedules C or F (or other forms or schedules accepted by the Commonwealth for Personal Income Tax purposes) shall be attached to the local earned income tax return. "Net Profits" does not include income which is not paid for services provided and which is in the nature of earnings from an investment.

(2) Partnerships and Unincorporated Entities Taxed as a Partnership.

A partner or member of a general or limited partnership, limited liability company or limited liability partnership taxed as a partnership, or other unincorporated entity taxed as a partnership, engaged in a business, trade, profession or other commercial activity or enterprise for profit shall be required to pay tax on his share of the total net profits therefrom, regardless of whether the net profits actually are distributed. "Net profits" does not include income which is not paid for services provided and which is in the nature of earnings from an investment. Such partner or member's share of taxable net profits shall be as reported on the partner's or member's Pennsylvania Personal Income Tax Return as "Net Income or Loss from the Operation of a Business, Profession or Farm", and copies of supporting Pennsylvania Schedules RK-1 and NRK-1 (or other forms or schedules accepted by the Commonwealth for Personal Income Tax purposes) shall be attached to the local earned income tax return.

(3) S Corporations

A shareholder of an S Corporation engaged in a business, trade, profession or other commercial activity or enterprise for profit shall not be required to pay local earned income tax on his share of the net profits therefrom, whether or not the net profits are actually distributed. A resident S Corporation shareholder shall be required to pay local earned income tax on any "earned income" (e.g. salaries, wages, commissions, bonuses, etc) for services rendered to or on behalf of the S Corporation.

(4) Rental Activities.

A. Taxable Rental Activities

The net profits received from the renting or leasing of any commercial or residential property is a business activity taxable as net profits for local earned income tax purposes when such rental activity is required to be reported as "Net Income or Loss from the Operation of a Business, Profession, or Farm" for Pennsylvania personal income tax purposes. In general, under Pennsylvania Personal Income Tax law rental activities are

a business activity taxable as net profits for Pennsylvania and local earned income tax purposes when (i) the use of such property is offered on a commercial basis to others in a marketplace, (ii) significant services (e.g. housekeeping services, room service, valet parking, decorating assistance, delivery services, transportation services, etc.) are provided to the lessee primarily for the lessee's convenience, and not customarily provided in connection with renting property, and (iii) at least one of the following three conditions applies: (1) the average period of customer use is 30 days or less, (2) the property is leased intending to realize a profit, or (3) the leasing of the property is a regular and continuous activity. The income received from the rental or sale of real estate by Licensed Realtors in the Commonwealth of Pennsylvania is subject to local earned income taxation.

B. Non-taxable Rental Activities

"Net profits" does not include income from a rental activity which is not paid for services provided and which is in the nature of earnings from an investment. In general, if the rental activity does not constitute a business activity as described in "Taxable Rental Activities", or is not otherwise reported as "Net Income or Loss from the Operation of a Business, Profession or Farm" for Pennsylvania personal income tax purposes, it will be a non-taxable rental activity for local earned income tax purposes.

(5) Royalties.

The net profits received from royalties is taxable as net profits for local earned income tax purposes when such royalties are required to be reported as "Net Income or Loss from the Operation of a Business, Profession, or Farm" for Pennsylvania personal income tax. "Net profits" does not include income which is not paid for services provided and which is in the nature of earnings from an investment.

(6) Trusts or Estates.

Every estate or trust must pay the tax (i) on the net profits resulting from its engagement in any business, trade or other activity, and (ii) on income which would be subject to the tax if received by an individual or partnership. "Net profits" does not include income which is not paid for services provided and which is in the nature of earnings from an investment.

C. DEDUCTIONS FROM GROSS PROFITS

Taxpayers are permitted to deduct ordinary, necessary and reasonable expenses currently paid or incurred during the taxable year which are directly related to and necessary for the production and marketing of their products, goods, and services in the marketplace, as determined for Pennsylvania Personal Income Tax purposes. The following deductions are generally allowable:

(1) Ordinary and Necessary Business Expenses.

All ordinary and necessary expenses of doing business, including reasonable compensation paid employees, shall be allowed. (No deduction may be claimed for "salary" or withdrawals of a sole proprietor or of the partners or members of an unincorporated business or enterprise.)

(2) Rentals.

Rentals or other payments required to be made as a condition of the continued use or possession, for purposes of the trade or business, of which property to which the taxpayer has not taken or is not taking title or in which he has no equity, shall be allowed as deductions.

(3) Interest.

Interest on indebtedness incurred by the business, including mortgage interest (where proprietor also owns the building) and interest payments on loans made for use in the business, shall be allowed as deductions.

(4) Taxes.

Taxes directly connected with the operation of the business and on business property shall be allowed.

Examples Of Deductible Taxes Include: (i) employer's contributions to Pennsylvania Unemployment Compensation Funds; (ii) employer's portion of Social Security tax payments; (iii) real estate taxes where the business owns the building in which the business is located.

Examples of Non-Deductible Taxes: (i) the tax under the earned income tax resolution or ordinance; (ii) any federal, state or local taxes based on income; (iii) any gift, estate, or inheritance taxes; and (iv) taxes or assessments for local benefits or improvements to property which tend to increase the value thereof.

(5) Casualty Losses.

Casualty losses sustained during the taxable period and not fully compensated for by insurance or otherwise shall be allowed, if incurred in conducting the trade or business subject to tax. Where such a loss is claimed, there must be attached to the return a schedule showing in detail the nature of the loss of the property damaged, destroyed, or stolen; its cost or other valuation, the depreciation sustained prior to the time of the damage, destruction or theft; the measure of loss, and any recovery through insurance or otherwise. In any event, the amount of the loss to be recognized shall not exceed the amount allowed by the federal government.

(6) Bad Debts.

Bad debts, in a reasonable amount, may be allowed in the year ascertained worthless and charged off, or at the discretion of the tax collector (if the 'reserve method is used).

(7) Depreciation.

Depreciation may be claimed and allowed in a reasonable amount for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) of property used in the trade or business. The amount so allowed, however, may not exceed that recognized for Pennsylvania income tax purposes. The Accelerated Recovery System (MACRS or ACRS) is an acceptable method of depreciation.

D. ITEMS NOT DEDUCTIBLE

In computing net profits for earned income tax purposes, no deduction shall be allowed in respect to the following:

- (1) Any amount otherwise allowable as a deduction which is allocable to one or more classes of income wholly exempt from local tax.
- (2) Any amount otherwise allowable as an ordinary and necessary expense of doing business which is allocable to interest wholly exempt from the tax imposed herein.
- (3) Any loss resulting from an activity which in the case of a profit would not be considered earned income or a net profit taxable hereunder.
- (4) Contributions by an individual to any Individual Retirement Account, a Keogh/HR10 Plan, a tax deferred annuity, a 401(k) Plan or a Simplified Employee Pension Plan (SEP).
- (5) Gifts of any kind, regardless of character or purposes of recipient or donor.
- (6) Personal taxes, including taxes on real estate occupied as taxpayer's residence, personal property taxes, and per capita, occupation and poll taxes.
- (7) Premiums paid on any life insurance policy covering the life of any employee or of any person financially interested in any trade or business carried, on by the taxpayer, when the taxpayer is directly or indirectly a beneficiary under such policy.

IV. NET LOSSES

A net loss incurred in a business activity can be used to offset the net profits of another business activity. Business net losses may not be used to offset the earned income received by a taxpayer from an employer. Net losses incurred in any year may not be carried over to any other year.

V. CREDITS FOR PAYMENT OF EARNED INCOME TAXES OR NET PROFITS TAXES TO OTHER TAXING BODIES

A. CREDIT FOR TAXES PAID TO PHILADELPHIA.

If an individual works in Philadelphia and pays the Philadelphia earned income tax or net profits tax, the individual is entitled to claim a credit of the earned income or net profits taxes paid to Philadelphia against the tax assessed by the municipality/school district in which the individual resides. Please note that some "home rule" municipalities may limit the credit to 1%; please refer to each municipality's tax ordinance and regulations.

Example:

Taxpayer works in Philadelphia and earns \$20,000.00 with Philadelphia tax paid of \$800.00 (a tax rate of 4%). Taxpayer resides in the Township of Edgewood, a home rule municipality, which imposes a 1.3% wage tax. Edgewood will allow a credit of 1% (i.e., \$200.00) against its tax. The taxpayer must still pay to Edgewood a .3% wage tax, which represents the "home rule" tax component. Note that some home rule municipalities would allow the credit to be applied against the home rule tax component as well (i.e., total credit-\$260.00).

B. CREDIT FOR TAXES PAID TO OTHER PENNSYLVANIA POLITICAL SUBDIVISIONS.

Except in the case of work conducted in Philadelphia, the individual is required to pay earned income or net profits taxes to the municipality/school district in which he or she resides, not the Pennsylvania political subdivision where he or she works. However, if the tax assessed by the municipality/school district in which an individual resides is less than 1%, he or she may also be required to pay tax (up to 1%) to the Pennsylvania political subdivision where he or she works. If an individual works in a different political subdivision and such Pennsylvania political subdivision's taxes are withheld by the individual's employer, the individual must apply for a refund directly from such Pennsylvania political subdivision for any tax which was properly payable to the municipality/school district in which the individual resides. Credit will not be given for any taxes paid to other Pennsylvania political subdivisions, excepting Philadelphia.

Example:

Tax payer is a resident of Franklin Township and pays a 1/2% earned income tax there. The taxpayer works in the City of Pittsburgh which imposes a 1% earned income tax on non-residents. The taxpayer must pay a 1/2 % tax to the City of Pittsburgh.

C. PAYMENT OF A TAX ON INCOME TO STATES OTHER THAN PENNSYLVANIA OR TO POLITICAL SUBDIVISIONS LOCATED OUTSIDE OF PENNSYLVANIA.

If an individual is legally required to pay tax to a state other than Pennsylvania or to a political subdivision located outside of Pennsylvania on his or her earned income or net profits, a credit will be allowed against the tax imposed on such income by the municipality/school district in which the individual resides. In no event may an individual take the same credit against both the tax imposed by the municipality/school district in which he or she resides and against the Pennsylvania personal income tax. Please note that some "home rule" municipalities may limit the credit to 1%; please refer to each

municipality's tax ordinance and regulations.

Example:

Taxpayer is a resident of Penn Township and is a partner in a national accounting firm with offices in New York City and Chicago. Taxpayer pays taxes on income earned in each one of these cities, as well as to the State of New York. Penn Township imposes a 1% earned income tax. The credit which the taxpayer may claim is computed as follows:

- (a) Determine amount of income earned in each state/city:

\$ 15,000	State/City of New York
\$ 15,000	City of Chicago
<u>\$ 85,000</u>	Penn Township
\$115,000	Total Income

- (b) Calculate maximum local credit available for taxes paid to the other state/cities.

\$15,000 x 1%	\$150.00	State of New York
\$15,000 x 1%	\$150.00	City of New York
<u>\$15,000 x 1%</u>	<u>\$150.00</u>	City of Chicago
	\$450.00	Max. Local Credit

- (c) Find out amount of tax paid to other state/cities.

\$ 600.00	State of New York
\$ 750.00	City of New York
<u>\$ 300.00</u>	City of Chicago
\$1,650.00	Total

- (d) Find out the total amount of state taxes paid listed in (c) above, which were claimed on Pennsylvania tax return (PA-40R).

\$600.00	Total other state taxes paid (i.e. NY).
<u>\$420.00</u>	Credit taken on PA-40R
\$180.00	Balance
	(\$150.00 credit allowable for local tax purposes)

- (e) \$450.00 - Local credit available (i.e., \$150.00 City of New York; \$150.00 City of Chicago; \$150.00 State of New York)

D. CREDIT FOR TAXES PAID TO RECIPROCAL STATES.

No credit may be taken by an individual for state income taxes paid to states which reciprocate with Pennsylvania. These states are: Indiana, Maryland, New Jersey, Ohio, Virginia and West Virginia.

E. FOREIGN TAXES PAID.

No credit is allowed for foreign taxes paid by an individual.

Example:

Taxpayer works in Germany and pays \$500.00 in German income taxes.
No credit may be taken against his local taxes for the \$500.00 paid.

F. LIMITATION / DOCUMENTATION.

The amount of credit an individual is entitled to claim cannot exceed the amount of the tax liability assessed by the municipality/school district in which the individual resides on such earned income or net profits. If an individual claims a credit for taxes paid to another state or political subdivision, the individual must provide a copy of his or her W-2 and/or other appropriate verification of taxes paid or the individual's credit will be disallowed.