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May 23, 2006

Mr. Eric Epstein  
RockTheCapital.org  
4100 Hillisdale Road  
Harrisburg, PA 17112

Re: Pennsylvania Personal Income Tax  
RockTheCapital.org  
Unvouchered expenses

Dear Mr. Epstein:

This letter is in response to your correspondence dated April 13, 2006, which includes a series of questions relating to whether unvouchered expense allowances are subject to Pennsylvania personal income tax. The answers to your questions are as follows:

1. Is compensation delivered through the mechanism of "unvouchered expenses" considered gross wages by the Commonwealth? Does the Department of Revenue's tax definition apply to state taxes?

Yes. When an employer's procedures do not require an employee to substantiate each expense in sufficient detail so that the employer can identify the specific nature of each expense, the employer is required to report the expense reimbursement or allowance as gross wages on the employee's W-2.

Article III of the Tax Reform Code of 1971 (the United State Income Tax Laws) and Chapters 101 - 125 of Title 61 of the Pennsylvania Code contain the law and regulations primarily applicable to the Pennsylvania personal income tax. The State Income Tax Law defines "compensation" to include wages, commissions, bonuses, incentive payments, and similar remuneration received for services rendered and to exclude payments to "reimburse actual expenses."<sup>1</sup> Regulation Section 101.6 explains that actual expenses are limited to ordinary, reasonable and necessary business expenses.<sup>2</sup> Thus, an employer is required to report any reimbursements or payments

<sup>1</sup> 72 P.S. § 7301(d).

<sup>2</sup> 61 Pa. Code § 101.6(c)(5).

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in the employee's gross wages unless the employee has substantiated to the employer that a payment was a reimbursement for an ordinary, reasonable and necessary business expense.

2. "Expenses" for tax purposes imply deductibility. Are "unvouchered expenses" tax deductible?

If an employee uses the payment as a reimbursement for an actual business expense, the recipient can report the expense and deduct it accordingly using PA Schedule UE - 'Allowable Employee Business Expenses.'

3. To be eligible for an unvouchered expense, taxpayers typically carry the burden of substantiating, recording and verifying expense accounts, and showing that the deduction is "ordinary and necessary expenses paid or incurred during the taxable year in carrying on" a trade or business. What accounting or reporting method, if any, might qualify this income as a legitimate expense?

Ordinary, reasonable and necessary business expenses attributable to payments included in gross wages are deductible so long as the employer did not provide the employee a reimbursement for the reported expenses under the employer's accountable expense reimbursement plan, and the employee's records permit identification of the specific nature of each expense.

4. Can an individual who accepts an unvouchered expense allowance avoid state tax liability by donating the income to charitable institutions?

No. An individual's charitable donations are not deductible for state income tax purposes.

5. Can expense "reimbursements" be considered both income for the purposes of a charitable donation and a business expense for the purpose of a state tax deduction?

No. A reimbursement is income; and to the extent that an individual has unreimbursed ordinary, reasonable and necessary business expenses that he or she can substantiate, the expenses can be deducted. No deduction for charitable donations is permitted.

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6. If legislators are paying back the net amount of "unvouchered expenses" over several years, are they in violation of state rules on repayment of overpayment?

The state income tax law has no rules on the repayment of overpayments.

7. Does the Department of Revenue consider repayment plans over a certain period of time a loan? If so, should imputed interest be applied at the applicable state rate even if no interest is actually accruing?

Regulation Section 103.16 defines interest as any charge for the use or detention of money or for a forbearance from enforcement of a debt that is due,<sup>3</sup> and it provides that unstated or imputed interest shall be computed in the same manner as it is required to be computed for federal income tax purposes.<sup>4</sup>

8. Does avoided interest count as income for state tax purposes?

The state income tax law imposes tax on the following eight classes of income: (i) compensation, (ii) net profits, (iii) net gains or income from the disposition of property, (iv) dividends, (v) interest, (vi) net gains or income from trusts or estates, (vii) gambling and lottery winnings other than Pennsylvania State Lottery winnings, and (viii) net gains or income derived from or in the form of rents, royalties, patents, or copyrights. Income that an individual enjoys or acquires from sources other than one of the eight classes subject to tax avoids taxation.

9. Since the enforcement of the tax code generally ignores the legality of an individual's source of income and deductions, does the "public policy" implications of "the instant matter" outweigh the case decisions that support that doctrine?

The Department of Revenue administers the personal income tax pursuant to the state income tax law.

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<sup>3</sup> 61 Pa. Code § 103.16(a).

<sup>4</sup> 61 Pa. Code § 103.16(f).

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10. Does the mischaracterization of prohibited additional compensation as expenses lead to a bizarre result, i.e., that the vary same monies are "expense" for purposes of Pennsylvania law but are "income" for federal tax purposes?

No. See Answer # 1.

11. Can the Department of Revenue offer an Opinion on the implications of an increased pension benefit for those who accepted the increased salary and a repayment system that creates two classes of taxpayers?

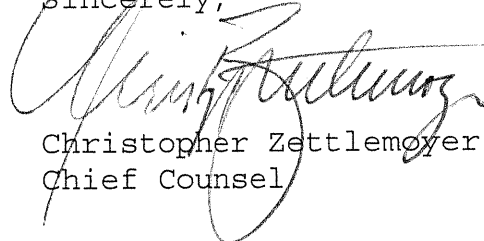
No.

12. Is the Department of Revenue concerned that the mechanism in play creates a disincentive for legislators to pay back the "unvouchered expenses" or provide documentation on how the monies were spent?

The State Income Tax Law requires that gross wages reported on a taxpayer's W-2 include "unvouchered expenses" received during that tax year. The taxpayer must complete schedule UE as described in Answer # 3 to deduct any ordinary, reasonable and necessary business expenses that were not reimbursed under the employer's accountable business expense plan.

I trust that I have answered your inquiry.

Sincerely,



Christopher Zettlemoyer  
Chief Counsel

CZ:jlh