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## OVERVIEW

### Gross Income Class

Interest income is a gross taxable income class under Pennsylvania law. Consequently, Pennsylvania law does not permit the deduction of any expenses that a taxpayer incurs to realize ordinary interest income. However, income that can reasonably be classified either as interest or as another taxable class of income may in certain situations be classified into that other class of income.

Interest derived from obligations that are not statutorily free from state or local taxation under any act of the General Assembly or under the laws of the U.S. is subject to taxation under the Pennsylvania personal income tax (PA PIT) statute. Interest on obligations issued by or on behalf of the U.S. government is not subject to Pennsylvania personal income tax.

### Nonresidents and Part-Year Residents

Nonresidents are not subject to Pennsylvania personal income tax on ordinary interest income paid on investments from banks, financial institutions or other payment sources within Pennsylvania. Part-year residents are not subject to Pennsylvania personal income tax on ordinary interest income received while a nonresident of Pennsylvania. Refer to [Table – INTEREST INCOME – RESIDENTS VS. NONRESIDENTS](#)

### Interest Income - Sourcing

Interest income is generally derived from intangible personal property. Therefore, interest income is generally not sourceable to PA (or any other state). Interest income is only sourced to PA if it is from intangible personal property employed in a trade, profession, occupation or business carried on in PA.

### Interest is Classified in a Separate Income Class

Under Pennsylvania law, income and expenses are generally classified according to the activity in which they are earned or incurred. Interest is normally classified as interest income if it is interest generated by investments of an individual such as interest income received during the taxable year from savings and loan associations, credit unions, bank deposits, bonds, certificates of deposit, interest-bearing checking accounts, tax refunds, mortgages or other obligations is classified as interest income. Generally, federal Form 1099-INT, issued by financial institutions, will indicate the amount of interest received or credited from or by such institutions.

In certain situations, interest is classified in another class of income. Instances where interest is classified in another income class are as follows:

- **Interest from Business Accounts**

A taxpayer may classify interest earned in the normal and regular operation of a business, profession or farm as net income (loss) from operation of a business, profession or farm as net income or loss, not as ordinary interest income, in the following situations:

- Interest earned on accounts receivable;
- Interest earned on a business checking account; and
- Interest earned from investment of business working capital.

- **Interest from Installment Sale of Property**

A taxpayer classifies interest that he or she realizes from the sale of property on an installment basis as net gain (loss) on the sale, exchange or disposition of property. Refer to PA Personal Income Tax Guide - Net Gains (Losses) From the Sale, Exchange or Disposition of Property.

- **Interest Earned on the Deposit of Rents**

A taxpayer may classify interest earned on the deposit of rents (i.e. tenant security deposits) as interest income unless the interest earned is used to operate or maintain the rental property. If the interest earned is actually used to operate or maintain the rental property, then such interest is classified as net income (loss)

from rents, royalties, patents and copyrights. Refer to PA Personal Income Tax Guide - Net Income or Loss From Rents, Royalties, Copyrights and Patents.

### **Expenses Incurred to Generate Interest Income**

Pennsylvania law does not permit the deduction of any expenses (including self-charged interest and investment related expenses) that an individual taxpayer incurs to realize ordinary interest income with the following exceptions:

- **Forfeited Interest Penalty**

Pennsylvania considers the premature redemption of a certificate of deposit or a time savings account to be a disposition of property. Any forfeited interest penalty incurred may be used to offset the interest accounts from only the certificate or account that was redeemed (that is, the forfeited interest penalty may not be offset against other interest income). If the penalty exceeds unpaid interest accrued from the certificate or deposit, the excess should be reported on PA-40 Schedule D, Sale, Exchange or Disposition of Property, as a loss from the disposition of property. This loss may be used to offset other gains, if any. If the interest received exceeds the penalty, the excess is reportable as interest income.

Forfeited interest penalty is included as an adjustment to the amount of federal interest income. The forfeited interest penalty amount taken for federal income tax purposes must be added back on Line 3 of PA-40 Schedule A, Interest Income, while the Pennsylvania forfeited interest penalty amount is deducted on Line 8 of PA-40 Schedule A.

- **Bond Premium Amortization**

For Pennsylvania personal income tax purposes, a premium paid on a bond is deemed to be an investment in the bond to obtain the higher bond interest rate. Further, each interest payment on the bond is therefore deemed to be a partial interest payment and a partial return of the bondholder's investment.

Consequently, the basis of a bond (whether the bond interest is taxable or exempt from Pennsylvania personal income tax) includes any premium paid on the bond. For each interest payment, the owner of the bond must amortize the bond premium according to accepted accounting principles and practices consistently used by the taxpayer (such as straight-line, effective interest rate method, constant yield method, etc.) and allocate the amortized amount to each interest payment to reflect the return of bond premium. The taxable bond interest is the difference between the total interest payment and the allocated bond premium amount. Because the allocated bond premium amount is a return of the bond owner's investment, the owner must also reduce his basis in the bond by the amount of the allocated bond premium. The owner must reduce his basis regardless of whether the reduction in the interest payment results in a reduction of tax (in the case of a taxable bond) or does not result in a reduction in tax (in the case of a tax-exempt bond).

Bond premium amortization is included as an adjustment to the amount of federal interest income. The amortization amount taken for federal income tax purposes must be added back on Line 3 of PA-40 Schedule A, Interest Income, while the Pennsylvania amortization amount is deducted on Line 8 of PA-40 Schedule A.

### **Uniform Gifts to Minors Act**

Interest income earned by accounts set up under the Uniform Gifts to Minors Act must be reported on the tax return of the child.

## **PA TAXATION OF SPECIFIC INVESTMENTS AS INTEREST INCOME**

### **Burial Fund Earnings**

Refer to PA Personal Income Tax Guide - Estates, Trusts and Decedents for information regarding the taxation of pre-need funeral trusts or cemetery merchandised trusts regarding burial fund earnings.

### **Insurance Companies**

Interest income on dividends from insurance companies, whether disbursed or not, is taxable as interest income.

**IRA, Keogh Accounts, or Pension Trusts**

Undistributed unearned income accruing in IRA, Keogh Accounts or Pension Trusts is not taxable as interest income.

**Amounts Paid Under Contract of Life Insurance, Endowment or Annuity**

For taxable years beginning after Dec. 31, 2004, income from annuity contracts purchased as retirement annuities that are not from an employer-sponsored retirement annuity or are not part of an employer-sponsored program, are now taxable as interest income. Any income from these types of plans that is taxable for federal income tax purposes is now taxable for Pennsylvania personal income tax purposes as interest income as a result of Act 40 of July 7, 2005. Act 40 also provides that amounts paid under contract of life insurance or endowment, which may be included in gross income for federal income tax purposes, are also subject to Pennsylvania personal income tax as interest income. Previously, the income received from an annuity that you purchased, including a retirement annuity that is not part of an employer-sponsored retirement program was reported as gain on the sale, exchange or disposition of property. Refer to PA Personal Income Tax Guide - Net Gains (Losses) From the Sale, Exchange or Disposition of Property for the old rules for annuities.

**Charitable Gift Annuities**

For taxable years beginning after Dec. 31, 2004, income received from a charitable gift annuity contract is taxable as interest income. Any income from a charitable gift annuity that is taxable for federal income tax purposes is reported as interest income for Pennsylvania personal income tax purposes. Previously, income received from charitable gift annuity contracts was taxable in the same manner as gain on sale, exchange or disposition of property using the cost recovery method to determine the amount taxable for Pennsylvania personal income tax purposes.

**Imputed Interest and Original Issue Discount (OID)**

Imputed interest is taxable under Pennsylvania personal income tax law. Imputed interest is the implied interest on an obligation where the instrument does not provide for interest or the interest rate is below the applicable federal rate (AFR). For example, on an original issue discount bond (OID), a stripped bond, or a certificate of deposit (CD) maturing in several years where interest is received at maturity, the imputed or accrued interest (discount on original issue discount bond) is reported each year for Pennsylvania personal income tax purposes.

Pennsylvania and federal rules for imputed and accrued interest are the same. Under Pennsylvania law (Act 68 of 1993) for tax years beginning on or after Jan. 1, 1993, original issue discount is calculated in the same manner as it is calculated for federal income tax purposes. For the purpose of determining taxable gain or income from the sale, exchange or disposition of original issue discount bonds, a holder's adjusted basis is increased by the amount of original issue discount bond accrued with respect to such bonds and is adjusted downward, but not below zero, by the amount of payments under the original issue discount bond, other than payments of stated interest.

The applicable Pennsylvania regulations require that unstated or imputed interest be calculated in the same manner as it is calculated for federal income tax purposes. The Pennsylvania Department of Revenue's policy is to look at federal rules regarding the transactions that result in or that are exempt from unstated or imputed interest, how unstated or imputed interest is to be calculated and when it is realized. Consequently, any amount of unstated or imputed interest that is includable in gross income for federal income tax purposes is subject to Pennsylvania personal income tax as interest income.

**Interest from Refunds of Tax Overpayments**

Interest paid to taxpayers on tax overpayments by the Pennsylvania Department of Revenue, the Internal Revenue Service, foreign governments or by local taxing authorities, is no different than any other taxable interest payments. Such interest is derived from "open accounts," not obligations that are statutorily free from state taxation. Therefore, interest paid to taxpayers on tax overpayments by the Internal Revenue Service, Pennsylvania Department of Revenue or any applicable state is taxable interest income in Pennsylvania.

**Tax-Exempt Interest**

Interest is not taxable income if received from direct obligations of the Commonwealth of Pennsylvania, its political subdivisions and authorities or the U.S. government. Likewise, interest from Series E, F, G, H, EE and HH bonds and federal treasury bills and notes are not taxable. Although not taxable, interest income from these obligations is required to be included as adjustments to the amount of interest income taxable for federal income tax purposes. Interest income from direct obligations of the Commonwealth of Pennsylvania, its political subdivisions and authorities

is an adjustment on Line 6 of PA-40 Schedule A, Interest Income. Interest income from the U.S. Government is an adjustment on Line 7 of PA-40 Schedule A.

**Obligations of Federal Agencies, Instrumentalities and Territories Exempt from Pennsylvania Personal Income Tax:**

- Banks for Cooperatives, 12 USC §2134
- Federal District Banks for Cooperatives, 12 USC §2121
- Central Banks for Cooperatives, 12 USC §2121
- Commodity Credit Corporation, 15 USC §713a-5
- Farm Credit System Capital Corporation: Consolidated Obligations, 12 USC §2278a-11 (replaces 12 USC §2216k)
- Farm Credit System Joint Stock Banks, 12 USC §2023 (12 USC §931 replaced by 12 USC §2055, replaced by 12 USC §2023)
- Farm Credit System Land Banks and Land Bank Associations, 12 USC §2023
- Federal Crop Insurance Corporation, 7 USC §1511
- Federal Deposit Insurance Corporation, 12 USC §1825
- Federal Farm Credit Banks (merger of Federal District Intermediate Credit Banks and Federal Land Banks, 12 USC §2011), 12 USC §2023
- Federal Financing Bank, 12 USC §2290(b)
- Federal Home Loan Banks, 12 USC §1433
- Federal Land Bank Associations, 12 USC §2098
- Financing Corporation, 12 USC §1441(e)(7)
- General Insurance Fund, issued under Armed Services Mortgage Insurance, 12 USC §1748(b)(f) National Defense Housing Insurance, 12 USC §1750c(d) Rehabilitation and Neighborhood Conservation Housing Insurance, 12 USC §1715k(h)(7) Rental Housing Insurance Fund, 12 USC §1747(g) Rental Housing Insurance Fund Mortgage Insurance, 12 USC §1713(i) War Housing Insurance law, 12 USC §§1739(d) and 1744(e) Insurance of Loans for Manufacture of Houses, 12 USC §1744(i)(4) (refers to 12 USC §1739) Mortgage Insurance Benefits, 12 USC §1750c
- Government of the Northern Mariana Islands, 48 USC §1801, and Covenant to Establish a Commonwealth of the Northern Mariana Islands in a Political Union with the U.S. States Article IV 607(a)
- Government of Puerto Rico, 48 USC §745
- Government of Virgin Islands, 48 USC §§1403, 1574(b)(iii)(A)
- Government of Guam, 48 U.S.C. §1423a
- Public Building Trust Participation Certificates, 31 USC §3124(a)
- Mutual Mortgage Insurance Fund, 12 USC §1710(d)
- National Credit Union Administration Central Liquidity Facility, 12 USC §1795k(b)
- Production Credit Associations, 12 USC §2077
- Public Housing Agencies, 42 USC §§1437i, 1437c(g)
- Resolution Funding Corporation (REFCORP), 12 USC §1441b(f)(7), 12 USC §1432
- Student Loan Marketing Association, 20 USC §1087-2(l)
- Tennessee Valley Authority, 16 USC §831n-4(d)
- U.S. Postal Service, 39 USC §2005(d)(4)
- U.S. Treasury Bonds, Notes, Bills, Certificates, and Savings Bonds, 31 USC §§3124, 3102-3106, 3109

**Obligations of Federal Agencies, Instrumentalities and Territories Not Exempt from Pennsylvania Personal Income Tax**

Unless they are issued to the Secretary of the Treasury and all purchases and sales by the Secretary of the Treasury of such obligations is treated as public debt transactions of the U.S., the following obligations of federal agencies, instrumentalities or territories are not exempt from taxation on interest or gain under the Pennsylvania Personal Income Tax Act:

- Agricultural Credit Insurance Fund (Agricultural Credit), 7 USC §1929(c)
- Pacific Northwest Transmission (Bonneville Power Administration), 16 USC §838k(c)
- Electric and Hybrid Vehicle Development Fund, 15 USC §2509(e)(3)(c)

- Export-Import Banks, 12 USC §635b
- Federal Financing Bank, 12 USC §2288
- Federal Home Loan Mortgage Corporation, 12 USC §1455(a)
- Federal National Mortgage Association (Fannie Mae), 12 USC §§1719(e) (see 1723a(c))
- Federal Ship Financing Fund (Merchant Marine Act), 46 USC §53723
- Geothermal Resources Development Fund (Geothermal Research), 30 USC §1144
- Government National Mortgage Association (Ginnie Mae), 12 USC §§1721 and 1723 (see 1721(d), 1721(g), 1723a(c))
- U.S. Housing Authority, Low-rent Housing, 42 USC §1437b
- Pension Benefit Guarantee Corporation, 29 USC §1305(c)
- Rural Development Insurance Fund, 7 USC §1929a(d)
- Rural Housing Insurance Fund, 42 USC §1487(h)
- Rural Telephone Bank, 7 USC §947(b)
- Securities Investor Protection Corporation (Securities Investor Production Fund), 15 USC §78ddd(h)
- Small Business Administration, 15 USC §633(c)(5)(A)
- U.S. States Railway Association, 45 USC §720(e)

### **STRIPS, CATS, ETRS, LIONS, FICOS and Other Stripped-Exempt Bonds**

The federal-taxable income or gain derived from exempt bonds that are issued with interest coupons where there is a separation in ownership between the bond and any coupon that has not yet become payable is taxable as follows:

- The tax-exempt portion of the original issue discount with respect to the stripped coupon or stripped bond, is the excess of the stated redemption price at maturity (or in the case of a coupon, the amount payable on the due date of the coupon), over an issue price that would produce a yield on the maturity as of the purchase date (of the stripped coupon or stripped bond) equal to the lower of the coupon rate of the tax-exempt obligation from which the coupons were separated or the yield to maturity on the basis of the purchase price of the stripped coupon or stripped bond.
- The remaining portion of the discount is treated as original issue discount with respect to an obligation that is not tax-exempt and as imputed interest.

#### **Example:**

A tax-exempt obligation with a face amount of \$100 due Jan. 1, 1990 and with a coupon rate of 10 percent compounded semi-annually is issued for \$100 on Jan. 1, 1987 and is stripped on Jan. 1, 1989. The right to receive the principal amount is sold for \$79.21, reflecting a yield to maturity at the time of the strip of 12 percent compounded semi-annually. The tax-exempt portion of discount on the stripped bond is limited to \$17.73, the difference between the stated redemption price of \$100 and the issue price that would produce a yield to maturity of 10 percent (\$82.27). This portion of the discount on the stripped bond in excess of the tax-exempt portion is \$3.06, equal to the excess of total discount (\$20.79) over the tax-exempt portion. This portion of the discount is treated as original issue discount bond with respect to an obligation that is not tax-exempt.

### **Gain (Loss) from the Sale, Exchange or Disposition of Tax-Exempt Obligations**

Gain (loss) on the sale, exchange or disposition of tax-exempt obligations issued by the Commonwealth, a public authority, commission, board or other agency created by the Commonwealth, a political subdivision or obligations exempt from state taxation under the laws of the U.S. only with respect to obligations issued on or after Feb. 1, 1994, is taxable in Pennsylvania.

The tax-exempt portion of the original issue discount bond with respect to a stripped coupon or stripped bond is the excess of the stated redemption price at maturity (or in the case of a coupon, the amount payable on the due date of the coupon), over an issue price that would produce a yield to maturity as of the purchase date equal to the lower of (1) the coupon rate of the tax-exempt obligation from which the coupons were separated, or (2) the yield to maturity (on the basis of the purchase price) of the stripped coupon or stripped bond. The taxpayer can elect to use the original yield to maturity instead of the coupon rate for these purposes.

In addition, the premium paid on a bond is included in the basis of the investment for the bond. The amortization of the premium is a partial return of the investment in that premium and is a reduction to the basis for each interest payment received. See Bond Premium Amortization in this chapter for additional information.

### **Obligations of Other States**

Interest on obligations of other states, territories and their political subdivisions, and instrumentalities is taxable for Pennsylvania personal income tax purposes.

### **Repurchase Agreements**

Interest earned from repurchase agreements (“REPOS”) is not tax-exempt interest income; and interest received on obligations, which are only guaranteed by the federal government, is subject to tax.

### **Distributions from Money Market Funds, Mutual Funds and Other Investment Companies**

Taxable distributions from the earnings and profits of money market or mutual funds, investment trusts and investment companies must be reported as dividend income not interest income. This rule applies even if the company is a fixed portfolio investment trust, separate portfolio trust and other entity whose governing instrument prevents varying the portfolio investments except to:

- Eliminate unsafe investments and investments not consistent with the preservation of the capital or the tax status of the investments of the fund;
- Honor redemption orders, meet anticipated redemption requirements, and negate gains from discount purchases;
- Maintain a constant net asset value per unit pursuant to, and in compliance with, an order or rule of the U.S. Securities and Exchange Commission;
- Reinvest the earnings from securities in like securities, or;
- Defray normal administrative expenses.

### **Nominee Interest**

For federal income tax purposes, a nominee who holds the legal title to an account for another person (principal/beneficiary) and receives notification of the interest income belonging to the principal/beneficiary must include the interest income on the nominee’s return. The income is then removed from the nominee’s return by a reduction entry on the return. Pennsylvania allows the same treatment for personal income tax purposes. However, the Social Security number of the principal/beneficiary must be included on PA-40 Schedule A, Interest Income. Since nominee interest is included as an adjustment to the amount of federal interest income, the nominee amount taken for federal income tax purposes must be added back on Line 3 of PA-40 Schedule A, Interest Income, while the Pennsylvania nominee interest amount is deducted on Line 8 of PA-40 Schedule A.

### **Trust Other than a Business Trust**

For Pennsylvania personal income tax purposes, if a trust, other than a business trust, invests in U.S. government obligations, then all the income from such obligations will retain their exempt status when passed through to the beneficiaries of the trust.

### **Distributions from IRC § 529 Qualified Tuition Programs for Non-Educational Purposes**

If a taxpayer receives a distribution from a 529 plan for non-educational purposes, the distributions may be subject to Pennsylvania personal income tax as interest income. Refer to Personal Income Tax Bulletin 2006-04, Qualified Tuition Programs, for information regarding the taxation of distributions.

### **Distributions from IRC § 529A Achieving a Better Life Experience Savings Program Accounts**

If a taxpayer receives a distribution from a 529A plan for non-qualifying purposes, the distributions may be subject to Pennsylvania personal income tax as interest income.

**Distributions from Health or Medical Savings Accounts**

If a taxpayer receives a distribution from a health or medical savings account that is included in federal taxable income, the amount taxable for federal income tax purposes is subject to tax as interest income for Pennsylvania personal income tax purposes.

**Interest Income from PA S Corporations and Partnerships**

Interest income reported on PA Schedules RK-1 is also reported as interest income for Pennsylvania personal income tax purposes.

Interest income reported on federal Schedules K-1 may be reported as interest income for Pennsylvania personal income tax purposes if PA Schedules RK-1 are not provided and the amount reported for federal income tax purposes does not include U.S. government interest. Tax-exempt interest income reported on federal Schedules K-1 may also be required to be included if the interest income is from obligations of other states. Refer to Tax-Exempt Interest in this chapter for additional information.

**PA-40 SCHEDULE A – INTEREST INCOME**

**Interest Reported on PA-40 Individual Income Tax Return**

For tax years beginning on or after Jan. 1, 2014, interest income reporting on PA Schedule A will begin by reporting the amount of interest income taxable for federal income tax purposes. Interest income taxable for PA personal income tax purposes will then be ascertained by determining if any adjustments must be made to the federal interest income amount. All Pennsylvania-taxable interest income must be reported on the PA-40, Individual Income Tax return.

**PA-40 Schedule A - Required if Adjustments to Federal Interest Income**

For tax years beginning on or after Jan. 1, 2014, a taxpayer with any adjustments to the interest income reported for federal income tax purposes must complete and file a PA-40 Schedule A, Interest Income, with the PA-40, Individual Income Tax Return. Any adjustments included on Lines 2, 3, 5, 6, 7, 8, 11, 12, 13, 14 and 15 of PA-40 Schedule A, regardless of the amount, triggers the requirement for including the schedule.

For tax years beginning before Jan. 1, 2014, PA-40 Schedule A, Interest Income, is required to be completed and filed when a taxpayer receives taxable interest income of more than \$2,500.

**INTEREST INCOME - RESIDENTS VS. NONRESIDENTS**

<b>Interest Income: Residents vs. Nonresidents</b>		
<b>Type of Interest</b>	<b>Pennsylvania Resident</b>	<b>Pennsylvania Nonresident</b>
Saving or other bank deposits	Taxable as interest income	Not taxable for Pennsylvania personal income tax (1)
Coupon bonds	Taxable as interest income	Not taxable for Pennsylvania personal income tax (1)
Open accounts	Taxable as interest income	Not taxable for Pennsylvania personal income tax (1)
Promissory notes	Taxable as interest income	Not taxable for Pennsylvania personal income tax (1)
Mortgages	Taxable as interest income	Not taxable for Pennsylvania personal income tax (1)
Corporate bonds	Taxable as interest income	Not taxable for Pennsylvania personal income tax (1)
Debentures	Taxable as interest income	Not taxable for Pennsylvania personal income tax (1)

Interest on legacies or life insurance proceeds	Taxable as interest income	Not taxable for Pennsylvania personal income tax (1)
Interest on legacies or life insurance proceeds	Taxable if taxable for federal; however for Pennsylvania personal income tax, taxed as interest income	Not taxable for Pennsylvania personal income tax (1)
Interest on tax refunds	Taxable as interest income	Not taxable for Pennsylvania personal income tax (1)
Interest on U.S. obligations – Direct ownership	Not taxable	Not taxable for Pennsylvania personal income tax (1)
Interest on other states' obligations or political subdivisions	Taxable as interest income	Not taxable for Pennsylvania personal income tax (1)
Unstated or imputed interest, including government obligations (original issue discount)	Taxable as interest income	Not taxable for Pennsylvania personal income tax (1)
Interest income reported as working capital in arriving at or allocated to net profits from a business, profession or farm	Taxable as net profits	Not taxable as interest, however, taxable as net profits
GNMA	Taxable as interest income	Not taxable for Pennsylvania personal income tax (1)
FNMA	Taxable as interest income	Not taxable for Pennsylvania personal income tax (1)

- (1) Interest income for a part-year resident that is received while a nonresident should be adjusted out of the total interest income taxable for PA personal income tax purposes by including the nontaxable amount on Line 8 of PA-40 Schedule A, Interest Income, for tax years beginning on or after Jan. 1, 2014.