



June 15, 2006
Pennsylvania Personal Income Tax
No. PIT-06-009
Distributions from Nonqualified
Deferred Compensation Plan

ISSUE

Are distributions from a nonqualified deferred compensation plan that are attributable to elective deferrals subject to Pennsylvania Personal Income Tax and employer withholding at the time the deferrals are distributed?

CONCLUSION

Distributions from a nonqualified deferred compensation plan that are attributable to elective deferrals are subject to Pennsylvania Personal Income Tax. However, distributions that are attributable to previously taxed elective deferrals are not subject to Pennsylvania Personal Income Tax or employer withholding at the time they are distributed from the plan under the rules outlined below. The cost recovery method is used to account for deferrals that were previously subject to tax.

FACTS

Taxpayer's spouse ("Spouse"), was an employee of the ABC Company ("Employer"). Spouse was a participant in Employer's nonqualified deferred compensation plan ("Plan"). Although it is not entirely clear from the documentation that Taxpayer supplied to this Office, it appears (and it is assumed) that Spouse's account under the Plan consists solely of elective deferrals and income accrued and credited to the account in respect of the deferrals.

Spouse retired from service in 1998 and began receiving monthly distributions from the Plan in January 2001. Although not specifically provided in the documents that Taxpayer supplied, it is assumed that the Plan provides for equal, monthly payments to the Plan beneficiary.

Spouse died in August 2003. Taxpayer became the Plan beneficiary and recipient of the remaining distributions under the Plan after Spouse's death.

Taxpayer has supplied documentation that suggests Employer withheld Pennsylvania Personal Income Tax from Spouse's elective deferrals to the Plan. The documentation consists of tax-related documents for tax years 1993 and after. Taxpayer also submitted correspondence from Employer indicating that as of October 2005, the account consisted of previously taxed deferrals.

DISCUSSION

In light of the enactment of Act 40 of 2005, Act of July 7, 2005 (P.L. 149, No. 40), which prescribed new Pennsylvania Personal Income Tax rules related to, among other things, the tax treatment of elective deferrals of compensation to nonqualified deferred compensation

arrangements, the Department issued Personal Income Tax Bulletin 2005-03 to address the new income tax rules.

Part VII of the Tax Bulletin provides that for taxable years beginning after December 31, 2002, any part of a distribution received from a nonqualified deferred compensation plan that is attributable to an elective deferral of income and the income attributable to any elective deferral shall be included in compensation at the time of the distribution. PIT Tax Bulletin, Part VII(a). This rule is based upon specific statutory provisions that Act 40 added to the Tax Reform Code of 1971. Act 40 did not provide a statutory exception to this rule, and it applies whether the distribution is made during employment or on or after retirement. 72 P.S. § 7301(d) (as amended by Act 40). It also applies even if a taxpayer paid tax on elective deferrals at the time of the deferral. Act 40 does not contain any provisions that would allow for a tax exclusion for a distribution of a previously taxed elective deferral.^[1]

Nevertheless, the Department recognizes that circumstances may exist for some taxpayers in which tax was paid on deferrals to non-qualified deferred compensation plans. Therefore, the Department, as a matter of administrative discretion, has established special transition rules to account for elective deferrals that were previously subject to tax prior to the enactment of Act 40. Those rules are contained in the Tax Bulletin and provide that for tax years beginning in calendar years 1999-2004, if a taxpayer can provide documentation that an elective deferral was reported on the taxpayer's final return and tax was paid on the deferral, either through employer withholding, estimated payments, or as a tax payment made with the final return, and no refund or credit is made on the basis that the amount deferred is not taxable, then the deferral that was subject to tax will be considered the taxpayer's investment in the elective deferral account (i.e., taxpayer's basis in the account). Taxpayers who use the special transition rules must maintain sufficient records to substantiate the above requirements. A copy of the Department's assessment or a letter or documentation from the taxpayer's employer that corroborates the previously taxed deferrals and amounts, and a copy of the taxpayer's tax return showing the taxation of the deferrals are sufficient documentation for this purpose.

As a result of the special transition rules, any distribution from a non-qualified deferred compensation plan attributable to a previously taxed elective deferral made during tax years beginning in calendar years 1999-2004 (not including income attributable to the elective deferral) that a taxpayer can substantiate with appropriate documentation is not subject to tax. All distributions from a plan are deemed to be a distribution of such previously taxed deferrals before any distribution of income attributable to the deferral. In other words, the cost recovery accounting method is applicable to distributions of elective deferrals from a nonqualified plan. PIT Tax Bulletin 2005-03, Part VIII.

The Tax Bulletin provides that the special transition rules are applicable to elective deferrals made in tax years beginning in calendar years 1999-2004. The Department limited the transition rules to those tax years because, in the Department's experience, employers were not withholding and taxpayers were not reporting or paying tax on elective deferrals to nonqualified plans prior to 1999.

However, the Department, in its administrative discretion, has decided to extend the special transition rules to elective deferrals made in tax years beginning prior to 1999, upon which tax was paid, provided the taxpayer can substantiate the elective deferrals and the amount

of tax paid thereon. In a recent *Pennsylvania Tax Update* article^[2], the Department outlined the documentation that is necessary to establish previously taxed elective deferrals. Employers with nonqualified deferred compensation plans are required to provide plan participants with a letter establishing the amount of elective deferrals previously included in Pennsylvania taxable income. In addition to a letter from the employer, taxpayers may also be requested to provide proof that the deferrals were previously taxed, such as: copies of tax returns for the tax years showing the amount included in the reported gross compensation for those tax years, copies of any Department assessments showing that the compensation amount reported for the taxpayer was adjusted by the Department to be included in the deferred amount, and copies of any amended returns including or excluding the compensation from taxation.

In this case, Taxpayer asserts that all of Spouse's elective deferrals were made in tax years beginning prior to 1999. Because the Department has extended the special transition rules to elective deferrals made in tax years prior to 1999, Taxpayer is not required to report distributions from the Plan as taxable compensation to the extent that the distributions are attributable to previously taxed elective deferrals. Taxpayer is permitted to use the cost recovery method to account for deferrals that were previously subject to tax. However, Taxpayer should obtain a copy of the letter from Employer, outlining the previously taxed deferrals and keep all tax records and returns to substantiate the amount of previously taxed deferrals.

^[1] The only mechanism available to a taxpayer under Act 40 that will prevent the double taxation of a previously taxed elective deferral is a petition for a refund of tax paid on the elective deferral. Act 40 provided that the application of Federal constructive receipt rules to elective deferrals to nonqualified deferred compensation plans was retroactive to tax years beginning after December 31, 2002. Therefore, a taxpayer is entitled to file a petition for a refund of tax paid on an elective deferral to a nonqualified deferred compensation plan if the deferral was made for a taxable year beginning after December 31, 2002.

^[2] "New Rules on Nonqualified Deferred Compensation Plans Add Special Requirements for Employers and Taxpayers," *Pennsylvania Tax Update*, Number 120 (April/May 2006).