

## PERSONAL INCOME TAX BULLETIN 2005-04

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### Section 457(b) Eligible Deferred Compensation plans

#### Part I. Overview.

##### (a) *Receipt of compensation.*

Taxpayers are required to include in the income they report on their tax returns income that is “received” by the taxpayer during the returnable period. The tax accounting rules for determining when income is received and thus must be taken into account for purposes of income tax reporting vary depending upon—

- The method of financial accounting used by the taxpayer.
- Whether overriding rules are set by statute or regulations to operate independently of the taxpayer’s financial accounting method.

For example, in the absence of overriding statutory or regulatory provisions, cash would become reportable as income only when actually received in hand under the cash receipts and disbursements method of financial accounting.

Internal Revenue Code (“IRC”) § 457 (relating to the inclusion in income of deferred compensation under deferred compensation plans of governmental and tax exempt entities) is an example of where the Internal Revenue Code sets overriding rules for determining when income is to be reported that operate independently of the taxpayer’s financial accounting method. IRC § 457 supersedes or overrides any otherwise applicable financial accounting principle or practice relating to the recognition of income. Moreover, where inconsistent, IRC § 457 also supersedes or overrides IRC §§ 83 and 451.

Act 2005-40 incorporates into the personal income tax, where applicable, the specific requirements of IRC § 457 relating to actual or constructive receipt. It, however, also retains long-standing personal income tax rules relating to the includability of contributions set aside in a trust.

##### (b) *Scope of bulletin.*

The taxation of eligible deferred compensation plan contributions, deferrals, income, and benefits is explained in more detail as outlined below:

- Part II. What is an eligible deferred compensation plan?

- Part III. Annual deferrals under eligible deferred compensation plans.
- Part IV. When are amounts deferred under an eligible deferred compensation plan currently includible in income?
- Part V. Accounting methods.
- Part VI. Pennsylvania withholding rules.

This bulletin applies only to “service providers” as defined in Treasury Regulation § 1.409A-1 who are natural persons, use the cash basis method of accounting, and are not actively engaged in the trade or business of providing substantial services other than as an employee. Ineligible deferred compensation plans described in IRC § 457(e) are explained in Personal Income Tax Bulletin 2005-03.

Beyond the scope of this bulletin are retirement benefit plans, arrangements between a self-employed individual and a “service recipient” as defined at Treasury Regulation § 1.409A-1 that provide for the deferral of compensation, qualified employer plans, employees’ welfare benefit plans or vacation leave, sick leave, compensatory time, disability pay, or death benefit plans, IRAs, Roth IRAs, and Coverdell education savings funds, employee stock purchase plans, statutory and non-statutory stock options, stock appreciation rights, and other equity-based compensation, and plans for short-term deferrals of compensation. The taxation of contributions, income, and distributions under such arrangements will be explained in future bulletins.

This bulletin supersedes all instructions, letter rulings, and other published and unpublished statements of policy of the Department of Revenue (“department”) that are inconsistent herewith.

## **Part II. What is an eligible deferred compensation plan?**

### *(a) Compliance in form and operation.*

An eligible deferred compensation plan is a written plan established and maintained by an eligible employer that is maintained, in both form and operation, in accordance with the requirements of Treasury Regulations §§ 1.457-4 through 1.457-10.

### *(b) Treatment as single plan.*

Federal rules and rulings shall be determinative of whether requirements are applied as if:

- A separate plan or plans is maintained for each employee, and
- All compensation deferred with respect to a particular employee is treated as deferred under a single plan.

### **Part III. Annual deferrals under eligible deferred compensation plans.**

#### *(a) General rule.*

Except as provided in Subsection (b) of this Part III, federal rules and rulings shall be determinative of whether annual deferrals are excludable from the personal income of a participant in the year deferred or contributed and are excludable from personal income until paid to the participant in the case of an eligible governmental plan, or until paid or otherwise made available to the participant in the case of an eligible deferred compensation plan of a tax-exempt entity.

#### *(b) Pennsylvania exceptions for contributions set aside in a trust for the exclusive benefit of participants and their beneficiaries.*

##### **(1) Contributions made under wage or salary deduction arrangements.**

Amounts lawfully deducted and withheld from the compensation of an employee and set aside under an eligible deferred compensation plan in a trust for the exclusive benefit of participants and their beneficiaries are received by the employee as compensation at the time the deduction is made. This requirement applies whether or not such amounts are subject to a substantial risk of forfeiture or are available or transferable.

##### **(2) Contributions made under cash or deferred arrangements or salary reduction plans.**

Contributions set aside in a trust for the exclusive benefit of participants and their beneficiaries under an eligible deferred compensation plan that are made by an employer on behalf of an employee at the election of the employee pursuant to a cash or deferred arrangement or salary reduction agreement are received by the plan participant as compensation at the time the contribution is made. This requirement applies whether or not such contributions are subject to a substantial risk of forfeiture or are available or transferable and regardless of when the election is made or a payment is received.

### **Part IV. When are amounts previously deferred under an eligible deferred compensation plan currently includible in income?**

Except as provided in Subsection (b)(1) or (2) of Part III, federal regulations and rulings under IRC § 457 are determinative of whether an amount deferred under an eligible deferred compensation plan from a prior taxable year is includible in the personal income of a participant or beneficiary.

### **Part V. Accounting Methods.**

#### *(a) General rule for determining the amount of investment.*

A contribution described in Subsection (b)(1) or (2) of Part III is not deductible in computing the income of the employee. This rule shall apply whether or not such amounts may be subject to the claims of creditors or to a substantial risk of forfeiture or are transferable. It shall be considered to have been contributed by the employee and to constitute the employee's cost of investment in the contract.

(b) *Cost-recovery method.*

The cost-recovery rule shall be used to determine the amount of a distribution under an eligible deferred compensation plan that shall be recognized as compensation. Under the cost-recovery rule, no income is recognized with respect to distributions until the distributee has enjoyed a full recovery of his contributions. Distributions in excess of unrecovered employee contributions are taxable as compensation. The amount recognized as compensation is not determined under IRC § 72.

**Part VI. Pennsylvania withholding rules.**

(a) *Contributions described in Subsection (b)(1) or (2) of Part III.*

Contributions described in Subsection (b)(1) or (2) of Part III constitute supplemental or other compensation that is subject to withholding. An employer shall determine the tax to be withheld by adding the contributions to the supplemental or other compensation for the current payroll period and multiplying the amount by the rate prescribed in Article III of the Tax Reform Code ("TRC").

(b) *Distributions.*

(1) "Net" Distributions.

Generally, withholding requirements apply only to the taxable portion of a distribution. The taxable portion is the amount, if any, by which the distribution exceeds unrecovered employee contributions. For employer withholding tax purposes, the burden of proof regarding the amount of unrecovered employee contributions shall be on the person having the duty or power to make the payment of the distribution.

(2) The employer has the control, receipt, custody, disposal or payment.

(i) Except as provided in Subsection (b)(2)(ii) of this Part or Subsection (a) of this Part, remuneration paid under or to an eligible deferred compensation plan which, at the time of such payment, is a plan described in IRC § 457(b) which is maintained by an eligible employer described in IRC § 457(e)(1)(A) is not subject to withholding tax.

(ii) Withholding on compensation paid by an employer under an eligible deferred compensation plan is required if, under Internal Revenue Code

§ 3402 (relating to income tax collected at source), –

(A) The employer during the quarter in which the payment is made (or a previous quarter of the same calendar year) was required to withhold Federal income tax from another payment to the employee; or

(B) The employer during the quarter in which the payment is made (or a previous quarter of the same calendar year) would have been required to withhold federal income tax from another payment to the employee were the employee entitled to claim no withholding exemptions.

- (3) A fiduciary or other person has the control, receipt, custody, disposal, and payment.

A fiduciary of a trust is not required to withhold if the fiduciary pays no amount to an employer's employee that is "wages" for federal income tax purposes without regard to Internal Revenue Code § 3405. This rule also applies to early retirement benefit plan distributions.

(c) *Rolled-over employee contributions.*

For withholding and reporting purposes, if there has been a roll-over into an eligible deferred compensation plan from another plan, --

- (1) The payor shall treat rollover distributions as not being attributable to amounts contributed to the other plan by the plan participant, and
- (2) The plan participant has the burden of proof respecting the amounts contributed to the other plan by the plan participant.

### **Cross References**

The requirements relating to computing withholding of Pennsylvania Personal Income Tax on supplemental or other compensation are set forth in 61 PA Code § 113.3(a)(2).