

## **PERSONAL INCOME TAX BULLETIN 2005-03**

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### **Deferred Compensation Under Nonqualified 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 provisions, cash would become reportable as income only when actually received in hand under the cash receipts and disbursements method of financial accounting or when all the events fixing the right to receive it has occurred under the accrual method of financial accounting.

Examples of where the Internal Revenue Code (“IRC”) sets overriding rules for determining when income is to be reported that operate independently of the taxpayer’s financial accounting method include:

- (1) IRC § 83 (relating to the inclusion in income of beneficial ownership interests acquired in connection with the performance of services).
- (2) IRC § 409A (relating to the inclusion in income of deferred compensation under nonqualified deferred compensation plans).
- (3) IRC § 451 (relating to the general rule for determining the taxable year of inclusion).
- (4) IRC § 457 (relating to the inclusion in income of deferred compensation under deferred compensation plans of governmental and tax exempt entities).

Each of these Code sections supersedes or overrides any otherwise applicable financial accounting principle or practice relating to the recognition of income. Moreover, where inconsistent, IRC §§ 409A, and 457 also supersede or override IRC §§ 83 and 451.

Prior to the enactment of Act 2005-40, the personal income tax had no statutory provisions comparable to these Code sections. Consequently, for personal income tax purposes, there were only a few instances where the determination of when compensation is to be reported operated independently of the taxpayer's financial accounting method. They included instances in which the constructive receipt doctrine, economic benefit doctrine or anticipatory assignment of income doctrine was applicable.

Act 2005-40 incorporates into the personal income tax, where applicable, not only the federal rules and rulings under IRC §§ 83 and 451 but also the specific requirements of IRC §§ 409A and 457 relating to actual or constructive receipt. It, however, also retains some long-standing personal income tax rules relating to the includibility of contributions transferred under a deferred compensation plan for the benefit of the employee to an employees' trust, pooled fund, or other arrangement that is not subject to the claims of creditors of the employer.

*(b) Scope of bulletin.*

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

- Part II. What constitutes a plan?
- Part III. When is an amount subject to a substantial risk of forfeiture?
- Part IV. What constitutes a long-term deferral of compensation?
- Part V. What is a nonqualified deferred compensation plan?
- Part VI. When are amounts deferred under a nonqualified deferred compensation plan currently includible in income?
- Part VII. Distributions attributable to elective deferrals.
- Part VIII. Accounting Methods.
- Part IX. Pennsylvania withholding rules on contributions.
- Part X. Pennsylvania withholding rules on distributions.

This bulletin applies only to "service providers" as defined in Treasury Regulation § 1.409A-1 who are natural persons and 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.

Beyond the scope of this bulletin are retirement benefit plans, arrangements between a partner and a partnership that provide for the deferral of compensation, arrangements between a self-employed individual or director of a corporation and a "service recipient" within the meaning of 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 regulations, instructions, letter rulings, and other published and unpublished statements of policy of the Department of Revenue (“department”) that are inconsistent herewith.

## **Part II. What constitutes a plan?**

Federal rules and rulings shall be determinative of whether an agreement, method or arrangement, including an agreement, method or arrangement that applies to one person, is a plan. Federal rules and rulings shall also be determinative of whether requirements are applied as if:

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

## **Part III. When is an amount subject to a substantial risk of forfeiture?**

Federal rules and rulings shall be determinative of whether compensation is subject to a substantial risk of forfeiture and whether the possibility of forfeiture is substantial.

## **Part IV. What constitutes a long-term deferral of compensation?**

*(a) Deferral of compensation.*

Federal rules and rulings shall be determinative of whether a plan provides for the deferral of compensation.

*(b) “Long-term” deferrals.*

Federal rules and rulings shall be applicable with respect to what constitutes a long-term deferral.

*(c) Earnings.*

References to the deferral of compensation include references to income (whether actual or notional) attributable to such compensation or such income.

## **Part V. What is a nonqualified deferred compensation plan?**

*(a) In general.*

Except as otherwise provided in this part, the term “nonqualified deferred compensation plan” means any plan (within the meaning of Part II) that provides for the long-term deferral of compensation (within the meaning of Part IV). The term does not include qualified employer plans. Accordingly, the term nonqualified deferred compensation plan does not include a qualified retirement plan, tax-deferred annuity, simplified employee pension, SIMPLE or § 501 (c) (18) trust.

(b) *Certain welfare benefits.*

The term nonqualified deferred compensation plan does not include any *bona fide* vacation leave, sick leave, compensatory time, disability pay, or death benefit plan. For these purposes, the term disability pay has the same meaning as provided in § 31.3121 (v) (2)-1 (b) (4) (iv) (C) of the Employment Tax Regulations, and the term death benefit plan refers to a plan providing death benefits as defined in § 31.3121 (v) (2)-1 (b) (4) (iv) (C). The term nonqualified deferred compensation plan also does not include any Archer Medical Savings Account as described in IRC § 220, any Health Savings Account as described in IRC § 223, or any other medical reimbursement arrangement, including a health reimbursement arrangement, that satisfies the requirements of IRC §§ 105 and 106.

#### **Part VI. When are amounts deferred under a nonqualified deferred compensation plan currently includible in income?**

(a) *General rule.*

In general, federal rules and rulings shall be determinative of when amounts deferred under a nonqualified deferred compensation plan are currently includible in income. The general rule and the federal rules relating to trusts and similar arrangements are also applicable for personal income tax purposes as follows:

- (1) Effective for taxable years beginning after December 31, 2004, the determination of whether long-term deferred compensation as defined in Part IV is received for personal income tax purposes shall be consistent with the United States Treasury Regulations and revenue and letter rulings under IRC § 409A applicable thereto as they exist as of the time of their application.
- (2) For taxable years 2003 and 2004, the determination of whether long-term deferred compensation as defined in Part IV is received for personal income tax purposes shall be consistent with the United States Treasury Regulations and revenue and letter rulings under IRC §§ 83 and 451 applicable thereto as they exist as of the time of their application.

Taxpayers should note that, although the revisions to the Internal Revenue Code under IRC § 409A make significant changes, they do not alter or affect the application of any other provision of the Internal Revenue Code or common law tax doctrine. Accordingly,

deferred compensation not required to be included in income under § 409A may nevertheless be required to be included in income under § 451, the constructive receipt doctrine, § 83, the economic benefit doctrine, the assignment of income doctrine or any other applicable provision of the Internal Revenue Code or common law tax doctrine.

*(b) Consequences of a failure to satisfy the requirements of § 409A.*

Generally, if at any time during a taxable year a nonqualified deferred compensation plan fails to meet the requirements of § 409A, or is not operated in accordance with those requirements, all amounts deferred under the plan for the taxable year and all preceding taxable years, by any participant with respect to whom the failure relates, are includible in gross income for federal tax purposes for the taxable year to the extent not subject to a substantial risk of forfeiture and not previously included in gross income. Any amount required to be included in gross income for federal income tax purposes under IRC § 409A(a) (1) shall be deemed to have been constructively received as a distribution of deferred compensation, whether or not actually distributed.

**Note:** If a deferred amount is required to be included in federal taxable income under IRC § 409A, the amount also is subject to interest and an additional federal income tax. No interest or additional income tax is imposed for personal income tax purposes.

*(c) Pennsylvania exceptions for certain contributions to an employees' trust, pooled fund, or other arrangement that is not subject to the claims of creditors of the employer.*

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

Amounts lawfully deducted and withheld from the compensation of an employee and transferred under a deferred compensation plan for the benefit of the employee to an employees' trust, pooled fund, or other arrangement that is not subject to the claims of creditors of the employer 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 under a deferred compensation plan to an employees' trust, pooled fund, or other arrangement which is not subject to the claims of creditors of the employer 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 employee 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.

- (3) A contribution described in (1) or (2) of this Subsection (c) 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. As a consequence, such contributions are deemed to have been contributed by the employee and to constitute a cost of investment.

The rules of IRC § 409A apply to nonqualified deferred compensation plans under IRC § 457 (f) in addition to any requirements already applicable to such plans under IRC § 457 (f). Eligible plans under IRC § 457 (b) are not subject to the requirements of IRC § 409A. However, grandfathered plans under prior IRC § 457 transition rules generally are subject to IRC § 409A.

Accordingly, effective for taxable years beginning on or after January 1, 2005, the determination of whether an item of deferred compensation as defined in Part IV is received for personal income tax purposes shall be consistent with the United States Treasury Regulations and revenue and letter rulings under IRC §§ 457 (f) and 409A applicable thereto as they exist as of the time of their application. However, for taxable years 2003 and 2004, the determination of whether an item of deferred compensation as defined in Part IV is received for personal income tax purposes shall be consistent with the United States Treasury Regulations and revenue and letter rulings under IRC § 457 (f) applicable thereto as they exist as of the time of their application.

#### **Part VII. Distributions attributable to elective deferrals.**

(a) Effective for taxable years beginning after December 31, 2002, any part of a distribution received under a deferred compensation plan that is attributable to an elective deferral of income not specifically described in subsection (b) of Part VI or the income on any elective deferral of income shall be included in compensation. This rule shall apply whether or not the distribution is commonly recognized as a retirement benefit and the distributee is retired from service at the time of distribution.

(b) Effective for taxable years after December 31, 2004, any part of an amount required to be included in gross income for federal income tax purposes under IRC § 409A (a) (1) that is attributable to an elective deferral of income or the income on any elective deferral income shall be included in compensation. This rule shall apply whether or not the distribution is commonly recognized as a retirement benefit and the distributee is retired from service at the time of distribution.

#### **Part VIII. Accounting Methods.**

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

The amount of investment in an employee deferred compensation plan is the total amount of the plan participant's contributions, whether through payroll deduction, a salary reduction agreement or otherwise, to an employees' trust, pooled fund, or other

arrangement that forms a part of the plan and is not subject to the claims of creditors of the employer.

Except as provided in subsection (b) (“Special transitional rule for determining the amount of investment”) of Part VIII, none of the following constitute investment in a plan:

- Contributions to an employees’ trust, pooled fund, or other arrangement that is subject to the claims of creditors of the employer.
- Unfunded deferred compensation.
- Payments made by employers or labor unions.

*(b) Special transitional rule for determining the amount of investment.*

Elective deferrals made by employees pursuant to a cash or deferred arrangement or salary reduction agreement under a deferred compensation plan may be considered to have been contributed by the employee and to constitute the employee’s cost of investment in the contract, provided one of the following is applicable:

- (1) The taxpayer can document that the amount deferred was reported (either correctly or incorrectly) as taxable compensation on the taxpayer’s final return for the year in which the deferral occurred, tax was withheld or paid on the amount deferred, and no refund or credit has been made on the ground that the amount deferred is not taxable.
- (2) The taxpayer documents that the amount deferred was assessed by the Department as unreported taxable compensation for a taxable year beginning in 1999, 2000, 2001, or 2002, the assessed liability was paid, and no reassessment is made on the ground that the amount deferred is not taxable.

Taxpayers who use this special transitional rule must maintain sufficient records to substantiate that deferral amounts were taxed. A copy of the assessment or a letter from the employer that corroborates that deferrals were included on Pennsylvania taxable State Wages on the taxpayer’s W-2 and copy of the taxpayer’s tax return will be sufficient.

*(c) Cost recovery method.*

The cost-recovery rule shall be used to determine the amount of a distribution under a 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 investment in a plan. Thus, plan distributions that are not in excess of unrecovered employee contributions to a plan are excludible from tax;



and plan distributions in excess of unrecovered employee contributions are taxable as compensation. The amount recognized as compensation is not determined under IRC § 72.

**Part IX. Pennsylvania withholding rules on contributions.**

Contributions described in Subsection (c) (1) or (2) of Part VI 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").

**Part X. Pennsylvania withholding rules on distributions.**

*(1) Taxable portion.*

Generally, withholding requirements apply only to the taxable portion of a distribution. The taxable portion is the amount, if any, by which the plan distribution exceeds unrecovered employee contributions computed without regard to any deferrals made under the special transitional rules of subsection (b) of Part VIII. For employer withholding tax purposes, elective deferrals shall not be considered employee contributions, and 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. However, the taxable portion of a distribution shall be 100% of the distribution in the absence of cogent evidence presented in advance of the distribution by the employee supporting a finding that withholding tax computed on 100% of the distribution does not yield a withheld tax amount substantially equivalent to the tax reasonably estimated to be due for such year with respect to such distribution, as such is determined within the sole discretion of such person.

*(2) The employer has the control, receipt, custody, disposal, and payment of long-term deferred compensation.*

Where an employer (or an officer or agent of an employer or another employee of the employer) has the duty or power to make the payment of taxable deferred compensation of the employer's employee, the employer, officer, agent or employee is required to deduct and withhold personal income tax from the deferred compensation. This requirement also applies to early retirement benefit plan distributions.

*(3) A fiduciary or other person has the control, receipt, custody, disposal, and payment of long-term deferred compensation.*

A fiduciary of a trust or other person who has the duty or power to make payment of long-term deferred compensation is not required to withhold if:

- (i) All employer contributions to the trust, for Federal income tax purposes, were currently taxable to the employer's employees; or



- (ii) The fiduciary makes no payments attributable to contributions by the employer that were not previously includible in the income of the employer's employee; or
- (iii) 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.

However, withholding on a payment is required if, under Internal Revenue Code § 3402 (relating to income tax collected at source), any of the following is applicable:

- The fiduciary or person is required to withhold federal income tax from the payment to the employee;
- The fiduciary or person previously during the quarter in which the payment is made (or a previous quarter of the calendar year of the payment) was required to withhold federal income tax from another payment to the employee;
- The fiduciary or person would be required to withhold federal income tax from the payment to the employee were the employee entitled to claim no withholding exemptions; or
- The fiduciary or person previously during the quarter in which the payment is made (or a previous quarter of the calendar year of the payment) would have been required to withhold federal income tax from another payment to the employee were the employee entitled to claim no withholding exemptions.

### **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).