

PERSONAL INCOME TAX BULLETIN 2005-05

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Qualified Employer 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 § 402 (relating to the taxability of a beneficiary of an employees’ trust).
- (3) IRC § 403 (relating to the taxation of employee annuities).
- (4) IRC § 408(k) (relating to SEPs).
- (5) IRC § 408(p) (relating to SIMPLE plans).
- (6) IRC § 409A (relating to the inclusion in income of deferred compensation under nonqualified deferred compensation plans).

- (7) IRC § 451 (relating to the general rule for determining the taxable year of inclusion).
- (8) 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, they 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 are 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. Act 2005-40 also, however, --

- Explicitly retains long-standing personal income tax rules relating to the includability of contributions transferred under a qualified or nonqualified employer 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, and
- Does not explicitly incorporate the specific requirements of IRC §§ 83, 402, 403, 408 or 451 relating to when amounts deferred under qualified employer plans are currently includible in income.

(b) *Scope of bulletin.*

The taxation of qualified employer plan contributions, income, and benefits are explained in more detail as outlined below:

- Part II. What constitutes a qualified employer plan?
- Part III. When are amounts deferred under a qualified employer plan currently includible in income?
- Part IV. Accounting Methods.
- Part V. Pennsylvania withholding rules.

- Part VI. Reporting requirements.

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. Nonqualified and ineligible deferred compensation plans are explained in PIT Bulletin 2005-3, and eligible deferred compensation plans (within the meaning of IRC § 457(b)) are explained in PIT Bulletin 2005-4.

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” as defined in Treasury Regulation § 1.409A-1 that provide for the deferral of compensation, governmental pension plans, qualified governmental excess benefit arrangements described in IRC § 415(m), employees’ welfare benefit plans or vacation leave, sick leave, compensatory time, disability pay, or death benefit plans, IRAs, Roth IRAs, Roth qualified contribution programs, 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 qualified employer plan?

(a) Qualified employer plan.

Federal rules and rulings under subparagraph (A) of IRC § 409A(d)(2) and subparagraphs (A) and (B) of IRC § 219(g)(5) shall be determinative of what constitutes a qualified employer plan for purposes of this bulletin. Under current federal rules, a qualified retirement plan, tax-deferred annuity, simplified employee pension, SIMPLE plan or § 501(c)(18) trust constitute a qualified employer plan.

(b) Certain welfare benefits.

The term qualified employer 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.

(c) Federal rules and rulings shall also be determinative of whether requirements are applied as if:

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

(d) A plan shall not be disqualified as a qualified employer plan solely by reason of including a qualified Roth contribution program. The included qualified Roth contribution program and the qualified employer plan in which it is included shall be treated as separate plans.

Part III. When are amounts deferred under a qualified employer plan currently includible in income?

(a) General rule.

The provisions of 61 PA Code § 101.6(c)(8) shall be determinative of when amounts deferred under a qualified employer plan are currently includible in income. Federal rules and rulings under IRC §§ 83, 402, 403, 408, and 451 shall be disregarded.

(b) Employee contributions.

An employee's income shall not be reduced for any contribution to a qualified employer plan made directly by the employee.

(c) 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.

(d) 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.

(e) Undistributed contributions and earnings.

Undistributed contributions and income are not includable in income even if made available to a distributee. Amounts deferred under a qualified employer plan are currently includable in income only when actually distributed to a distributee.

Part IV. Accounting Methods.

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

A contribution described in Subsections (b), (c) or (d) 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 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.

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

Part V. Pennsylvania withholding rules.

(a) Contributions described in Subsection (c) or (d) of Part III.

Contributions described in Subsection (c) or (d) 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 a qualified employer plan is not subject to withholding tax.
- (ii) Withholding on compensation paid by an employer under a qualified employer 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).

Part VI. Reporting requirements.

Reporting requirements for persons making distributions to distributees out of qualified employer plans are set forth in 61 Pa. Code § 117.18.