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Pennsylvania DOR Reverses Position Regarding Taxation of Deferred Compensation

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On May 12, 2004, the Commonwealth Court of Pennsylvania held in the consolidated cases, *Ignatz v. Commonwealth*, No. 136 F.R. 2003, and *Peabody v. Commonwealth*, No. 397 F.R. 2003, that elective deferrals of compensation by employees under nonqualified deferred compensation plans are constructively received when the compensation is earned and vested, *not* when it is paid, for Pennsylvania personal income tax (PIT) purposes, and are subject to taxation and withholding on the same basis as elective contributions to qualified 401(k) plans. Those decisions are now pending en banc review by the Commonwealth Court, and will likely be appealed to the Supreme Court. The *Peabody* and *Ignatz* cases thereby held that the principles of income deferral and constructive receipt that apply for federal income tax purposes do not apply for Pennsylvania income tax purposes, in spite of the fact that the wording of the Commonwealth's constructive receipt doctrine is virtually identical to the federal constructive receipt doctrine. Under federal tax law, as a general matter, if structured properly, deferred compensation under nonqualified deferred compensation plans is not subject to federal income tax until it is distributed to the participant. For discussions of recent federal law changes in this area, see Treasury Issues Guidance Implementing New Deferred Compensation Rules.

In response to the *Ignatz* and *Peabody* decisions, the Pennsylvania Department of Revenue (DOR) issued PIT Notice #112 on November 9, 2004 (revised on December 2, 2004), stating that withholding requirements for elective deferrals under nonqualified deferred compensation arrangements would become effective April 1, 2005, and that thereafter the DOR would begin auditing employer records to determine whether employers are withholding properly.

On November 19, 2004, the Pennsylvania General Assembly passed House Bill 176, which would effectively reverse the *Ignatz* and *Peabody* decisions by providing that Pennsylvania's definition of constructive receipt would be "defined and construed by the regulations and other federal authority under the Internal Revenue Code of 1986." HB 176 was to apply retroactively to causes of action which arose prior to the effective date of HB 176, indicating the General Assembly's disagreement with the *Ignatz* and *Peabody* decisions. On November 30, 2004, Pennsylvania Governor Rendell vetoed HB 176, stating that the language of HB 176 was too broad, but apparently not disagreeing with the General Assembly's intent to exempt nonqualified deferred compensation plans from the PIT.

Recently, the DOR has withdrawn PIT Notice #112 from its Web site, signaling a possible reversal of the DOR's position with respect to taxation of deferred compensation under nonqualified deferred compensation arrangements. It appears that the DOR may no longer require withholding on elective deferrals under nonqualified deferred compensation plans, pursuant to Governor Rendell's decision to

support appropriately limited legislation adopting federal treatment of nonqualified deferred compensation plans in Pennsylvania. It is anticipated that new legislation will be drafted, most likely for inclusion in the budget package to be submitted in early February 2005, that will clarify that Pennsylvania's constructive receipt doctrine is identical to the federal doctrine for purposes of nonqualified deferred compensation arrangements (presumably as modified by the new federal tax law imposing a variety of restrictions on deferred compensation plans). In addition, it seems likely that the Commonwealth will propose that distributions from deferred compensation plans not be eligible for tax-free treatment under the PIT's exclusion for retirement plans. However, it appears that the new rules will continue to require current taxation of Section 457(b) deferrals (i.e., deferrals under a plan maintained by a state or local government or a tax-exempt entity).

As a result of recent events, it appears that the Commonwealth will settle the *Ignatz* and *Peabody* cases and will no longer require withholding on elective deferrals to nonqualified deferred compensation plans (other than perhaps a Section 457(b) plan). It is anticipated that there will be considerable administrative issues with respect to prior withholdings, and to date, the DOR's approach to resolving such issues is unclear.

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