



## **Pennsylvania Adopts Federal Treatment of Nonqualified Deferred Compensation Plans**

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As reported in a prior LawFlash, the Commonwealth Court of Pennsylvania, in Ignatz v. Commonwealth of Pennsylvania, 849 A.2d 308 (Pa. Commw. Ct. May 12, 2004), upheld assessments of Pennsylvania personal income tax on compensation deferred by employees to unfunded, nonqualified deferred compensation plans. According to the court, for Pennsylvania personal income tax purposes, elective deferrals of compensation by employees under nonqualified deferred compensation plans are currently taxable under the constructive receipt doctrine when such compensation is earned and vested, *not* when it is paid. The court's decision was inconsistent with federal treatment of nonqualified deferred compensation.

However, on July 7, 2005, Governor Edward G. Rendell signed into law House Bill 176, which effectively reverses the court's decision in Ignatz by adopting the federal constructive receipt rule for purposes of computing taxable income in Pennsylvania. Specifically, House Bill 176 revises the definition of "constructive receipt" to provide that compensation will be deemed received when such compensation is actually or constructively received for federal income tax purposes as determined by the rules and regulations under the Internal Revenue Code of 1986, as amended (the "Code"). House Bill 176 also incorporates sections 83, 451, 409A and 457 of the Code, as well as any subsequent revisions to these sections of the Code, in determining when deferred compensation is required to be included in an employee's income. With respect to the treatment of elective deferrals of compensation into nonqualified deferred compensation plans, Pennsylvania law is now consistent with federal law. The transition to the new rules has the potential to pose problematic systems issues. For example, a Pennsylvania employer administering a nonqualified deferred compensation plan may have at least two "buckets" of benefits under the plan: untaxed amounts (either pre-Ignatz or post-House Bill 176) and taxed amounts (post-Ignatz but pre-House Bill 176).

The effective dates of the provisions regarding nonqualified deferred compensation under House Bill 176 are generally favorable to the taxpayer. We would point out that:

- Adoption of the constructive receipt rule following federal law is effective for tax years beginning after December 31, 2002. As a result, employees may pursue a refund of income taxes on prior deferred compensation to the extent their employers withheld

taxes on such amounts in 2003 or thereafter. Please note that refund requests under Pennsylvania law must be made within three (3) years from the date the tax was paid.

- For tax years beginning after December 31, 2004, distributions of elective deferrals and the earnings thereon are taxable as compensation and will not qualify for Pennsylvania's exclusion for "old age or retirement benefits." As a result, employers should withhold income taxes on such distributions (if such amounts have not already been taxed). Please note that House Bill 176 does not define the types of plans that would qualify for Pennsylvania's "old age or retirement benefits" exception. However, the Department of Revenue is expected to clarify this issue in future regulations.
- For tax years beginning after December 31, 2004, section 409A of the Code will apply to all nonqualified deferred compensation plans. Pennsylvania will presumably follow all federal rules and regulations under section 409A, including the rules applicable to grandfathered plans, even though House Bill 176 does not expressly incorporate the IRS's existing guidance under section 409A. For more information about the requirements of section 409A, please [click here](#).
- The new Pennsylvania law applies only to elective deferrals under nonqualified plans and does not affect elective deferrals to 401(k) plans (which remain taxable) or the accrual of nonelective deferred compensation benefits (which remain nontaxable on accrual and may be eligible for nontaxable treatment on distribution as retirement plan benefits).
- The new Pennsylvania law addresses only the Pennsylvania personal income tax, and does not apply to local taxes. As a result, there is uncertainty as to local tax treatment of elective deferrals under nonqualified plans (both pre- and post - House Bill 176). In particular, the City of Philadelphia seems to be taking the view that such elective deferrals remain subject to Philadelphia wage tax unless and until the Philadelphia tax act is amended.

If you have any questions or would like further information about House Bill 176, please contact any one of the following Morgan Lewis attorneys:

### **Harrisburg**

George Bell	717.237.4040	<a href="mailto:gbell@morganlewis.com">gbell@morganlewis.com</a>
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### **Philadelphia**

Robert Abramowitz	215.963.4811	<a href="mailto:r Abramowitz@morganlewis.com">rabramowitz@morganlewis.com</a>
Brian Dougherty	215.963.4833	<a href="mailto:bdougherty@morganlewis.com">bdougherty@morganlewis.com</a>
I. Lee Falk	215.963.5616	<a href="mailto:ilfalk@morganlewis.com">ilfalk@morganlewis.com</a>
Robert Lichtenstein	215.963.5726	<a href="mailto:rlichtenstein@morganlewis.com">rlichtenstein@morganlewis.com</a>
Vivian McCardell	215.963.5810	<a href="mailto:vmccardell@morganlewis.com">vmccardell@morganlewis.com</a>
Joseph Ronan Jr.	215.963.5793	<a href="mailto:jronan@morganlewis.com">jronan@morganlewis.com</a>
Steven Spencer	215.963.5714	<a href="mailto:sspencer@morganlewis.com">sspencer@morganlewis.com</a>

Gary Wilcox  
Mims Zabriskie  
William Zimmerman

215.963.5043  
215.963.5036  
215.963.5023

gwilcox@morganlewis.com  
mzabriskie@morganlewis.com  
wzimmerman@morganlewis.com

## **Pittsburgh**

John Ferreira  
Randall Tracht

412.560.3350  
412.560.3352

jferreira@morganlewis.com  
rtracht@morganlewis.com

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