

PA Governor Proposes Federal Treatment of Non-Qualified Deferred Compensation

Governor Ed Rendell has recently proposed legislation that may make the Commonwealth Court's 2004 decision in *Ignatz v. Commonwealth* moot by explicitly excluding compensation deferred under certain types of arrangements from Pennsylvania personal income taxation in the year in which the deferred compensation is earned. If enacted, Pennsylvania's taxation of nonqualified deferred compensation would be more in line with federal and other states' tax practices. The proposed legislation would also impose withholding requirements on payers of early distributions from certain qualified employee benefit plans, individual retirement plans, and commercial annuities.

In *Ignatz*, the Commonwealth Court ruled that voluntary employee contributions to an unfunded, nonqualified deferred compensation plan are taxable in Pennsylvania as personal income in the year that the services relating to the compensation were performed and not in the year that the amounts are actually distributed or paid to the employee. The court's decision is notable because it potentially can apply to a broad range of deferred compensation arrangements and makes Pennsylvania one of only a handful of states that differ from federal tax law in this area.

Governor Rendell vetoed the first attempt at legislation aimed at correcting the problem but has included as part of his 2005-06 budget tax package a narrower proposal that would treat compensation deferred under nonqualified deferred compensation plans (other than eligible excess benefit plans) in the manner set forth in the Internal Revenue Code, most significantly as provided under the recently enacted Code § 409A. In general, § 409A provides that, for federal income tax purposes, compensation deferred under nonqualified deferred compensation arrangements is not taxable until the compensation is distributed, if the following conditions are satisfied:

- (1) the deferred compensation must not be distributed earlier than, in general, upon the taxpayer's separation from service (or six months from separation, if the taxpayer is a key employee), a change in control of the employer, or the death or disability of the taxpayer,
- (2) the taxpayer makes an irrevocable election to defer the compensation during a taxable year prior to the taxable year in which the compensation is earned, and
- (3) the compensation plan must be unfunded, that is, the deferred funds must be subject to the employer's creditors.

In light of these developments, Pennsylvania employers should consider taking the following actions:

- Notify employees who may have paid tax on amounts deferred under unfunded deferred compensation plans that they should consider filing a petition for a refund before the applicable statute of limitations expires.
- Take a pro-active stance by closely monitoring developments in Harrisburg for any change in the law with respect to reporting and withholding obligations regarding compensation earned under these types of plans.

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