



RECEIVED
2003 NOV -5 AM 8:11
INDEPENDENT REGULATORY REVIEW COMMISSION

November 4, 2003

TAX SECTION

Independent Regulatory Review Commission
Sent by E-Mail

Re: Comments to Proposed Regulation on Employer Withholding Provisions

Dear Commissioners:

The Tax Section of the Philadelphia Bar Association (the "Tax Section") has reviewed the Pennsylvania Department of Revenue's draft of the new Pennsylvania Income Tax Regulations on Employer Withholding Provisions (the "Proposed Regulation"). The Tax Section recommends that Section 113.3(c)(3) of the Proposed Regulation be deleted in its entirety for the following reasons:

- Proposed Regulation Section 113.3(c)(3) is unclear and ambiguous;
- As we interpret Proposed Regulation Section 113.3(c)(3), it is overly broad and contrary to Pennsylvania law on constructive receipt;
- Proposed Regulation Section 113.3(c)(3) (and the rest of Proposed Regulation Section 113.3(c)) goes far beyond the limited purposes set forth in the Preamble to the Proposed Regulations; and
- The substantive issue of when compensation income is deemed received is already addressed in Regulation Sections 101.6 and 101.7. It is inappropriate to have new, and inconsistent, rules dealing with this same issue in a regulation dealing with an employer's obligation to withhold income taxes.

A. The Proposed Regulation is Unclear and Ambiguous.

Proposed Regulation Section 113.3(c)(3) provides:

Any payment made to an employee, third party or fund under a cash or deferred arrangement under which an employee may unilaterally elect to have an employer make payments to the third party or fund for the benefit of the employee or to the employee

directly in cash shall be deemed to be paid to the employee as compensation at the time the payment is made.

The Proposed Regulation is overly broad, does not define key terms, and appears to use terms in a manner inconsistent with their generally accepted meanings. For example, when is an employee deemed to have the power to “unilaterally elect” to have his or her employer make payments to a third party or fund?

Considerable confusion is caused by the use of the term “cash or deferred arrangement.” This is a term of art, and is generally understood to refer to elective employee contributions under a qualified defined contribution pension or profit sharing plan, such as a 401k plan.¹ In draft bulletins promulgated by the Department of Revenue (the “Department”), however, it appears the Department is interpreting this language to imply that any elective deferral of income under any kind of deferred compensation plan (whether funded or unfunded, vested or unvested, qualified or nonqualified) will be compensation to an employee. It is very confusing to take a term of art that has a well understood meaning for federal income tax purposes, and use that term in a much broader manner. In addition, as discussed below, if the Proposed Regulation is interpreted in this broader sense, it is inconsistent with the Pennsylvania law of constructive receipt.

The Proposed Regulation also fails to define the term “the third party or fund for the benefit of the employee.” Based on the recent draft Bulletins prepared by the Department, it appears, but is not entirely clear, that the Department intends the term “fund” to be read very broadly, to include such things as “rabbi trusts.” If this is the case, we believe this Proposed Regulation is contrary to Pennsylvania law.

B. The Proposed Regulation is Contrary to Pennsylvania Law.

As noted above, we believe that the Department intends that Proposed Regulation Section 113.3(c)(3) will be interpreted very broadly, and will apply not only to fully funded arrangements (where the contributions are placed in a fund or trust that is not subject to the claims of the employer’s creditors), but also to arrangements where funds are placed in a “rabbi trust.” The distinguishing feature of a rabbi trust is that the funds remain subject to the claims of the employer’s creditors and are deemed to remain the employer’s funds for tax purposes. This is directly contrary to the Pennsylvania law of constructive receipt and economic benefit.

Existing Regulation Sections 101.6 (Compensation) and 101.7 (Receipt of Income) deal with the issue of when a cash basis taxpayer is deemed to receive compensation income. These regulations incorporate the language of federal income tax regulations dealing with the doctrines

¹ IRC § 401(k) exempts certain employee elective contributions to qualified defined contribution plans (commonly called “401(k) plans”) from normal constructive receipt rules. Absent such statutory exemption, such contributions would be treated as constructively received by the employee for whose benefit the contribution is made because contributions are set aside by an employer (protected from the claims of its general creditors) for the benefit of the employee.

of constructive receipt and economic benefit. In addition, Pennsylvania courts have consistently and uniformly looked to federal cases and rulings to determine when compensation income is deemed to be received by a cash basis taxpayer. Under the federal cases and rulings, it is absolutely clear that deferred compensation put into a rabbi trust is not deemed to have been "received" by the employee. It appears that the Department is trying to reverse this well established rule in Proposed Regulation Section 113.3(c)(3).

Assuming that Proposed Regulation Section 113.3(c)(3) is read broadly, as we believe the Department intends, it is inconsistent with Pennsylvania concepts of constructive receipt and economic benefit. The effect of this Proposed Regulation would be to force employees to report compensation income under an accrual method, and pay tax on amounts that they may never receive.

C. The Proposed Regulations Go Far Beyond the Purposes Described in the Preamble.

The Preamble to the Regulations explains the reasons for the changes. The Preamble to the Notice of Final Rulemaking for Employer Withholding states that "Section 113.3 is amended by adding a new subsection (c) that addresses special situations pertaining to the deduction or payment of amounts by an employer for or on behalf of an employee." Moreover, the purpose for the amendment of the regulation is to reflect the changes in the Tax Reform Code passed in the Act of May 7, 1997 (P.L. 85, No. 7) relating to cafeteria plans and other employee compensation arrangements. The 1997 Act amended the Code to exclude from the definition of Compensation payments made pursuant to a cafeteria plan qualifying under Section 125 of the Internal Revenue Code, but did not make any other sweeping changes to eliminate the concept of constructive receipt as would potentially occur if the Proposed Regulation is adopted without amendment.

The best solution is to eliminate Proposed Regulation Section 113.3(c) since it does not conform to the definition of compensation contained in Regulation 101.6 and the Statue as amended by the Act of May 7, 1997. If this solution is adopted, Section (d) would be changed to (c) and the following would be added to the beginning thereof "No withholding shall be made on...." Alternatively, Proposed Regulation Section 113.3(c)(3) should be eliminated and subsection (4) should be renumbered as subsection (3).

D. The Proposed Regulations are Misplaced

The substantive rules dealing with the definition of income and the receipt of income are contained in existing Regulation Sections 101.6 and 101.7. We believe that Proposed Regulation Section 113.3(c)(3), as interpreted by the Department, is inconsistent with these substantive sections of the Regulations, as well as with Pennsylvania case law on constructive receipt and economic benefit. If the Department desires to change substantive rules dealing with the issue of when compensation is deemed received by a cash basis taxpayer (a position we do not support), the proper way to do this is to amend Sections 101.6 and 101.7.

E. The Proposed Regulation Will Implement Bad Tax Policy for Several Reasons.

First, the policy of withholding on all deferred compensation will inevitably lead to harsh and unfair results. If compensation is deferred, it is by definition not paid. Neither can an employee sell or otherwise realize any benefit from the unsecured promise of an employer to pay. Thus, the Department will be in the position of imposing tax on income that has not been received. Worse yet, cases will inevitably occur in which an employer defaults on an obligation to pay, through bankruptcy or other exigencies. How will the Department deal with such cases? It will be patently unfair to tax an individual on income not received, indeed never received, without any compensating loss to offset future income. Pennsylvania has no ability to reduce the employee's income in the year of the employer's bankruptcy. Thus, it will receive tax on income that was never received by the employee which is fundamentally incorrect.

Second, the Proposed Regulation will introduce unnecessary and incorrect differences between Pennsylvania and Federal tax policy. Of course, if there is a statutory difference between the Pennsylvania and Federal tax systems, the distinction must be implemented. However, if there is no such statutory requirement, it is generally a bad idea to create new differences. Such differences are burdensome for employers and employees, are often ignored, and are difficult to enforce. Generally speaking, the Commonwealth is better off having a tax policy that is congruent with Federal policy, assuming again that no different result is required by statute. In the case of unfunded deferred compensation plans, there is no such statutory requirement for the reasons discussed above.

Third, implementation of the Department's policy through a Proposed Regulation will not settle the issue, but is likely to generate substantial litigation. The correct way to implement such a policy would be to enact a statutory change.

Finally, the Legislature's policy decisions in this context should be respected. Income is taxed on receipt and *receipt* is determined under the federal rules except where Pennsylvania law requires otherwise. One example of this is *AMP Products Corp. v. Commonwealth*: Federal statutes explicitly exempt contributions to a 401(k) plan from the constructive receipt rules but there is no corresponding Pennsylvania law. However, the Legislature has not determined that there should be a special exception to the constructive receipt rules for unfunded deferred compensation. The Department should not add one on its own.

The Tax Section is most appreciative of you considering our comments to the Proposed Regulation. We believe that Pennsylvania tax policy is advanced by the cooperative efforts of government, professionals and the private sector.

Very truly yours,



Stanley Kuhl
Chair, Tax Section

Independent Regulatory Review Commission
November 4, 2003
Page 5

cc: Honorable Gregory C. Fajt
Christopher Zettlemoyer, Esquire