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COMPENSATION & FRINGE BENEFITS

THE CURIOUS CASE OF NEW JERSEY AND MS. DARCEY: NEW JERSEY TAXATION OF NONQUALIFIED DEFERRED COMPENSATION

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'Cause from those total wages earned
Down to that net amount that's due
I feel the painful sense of loss between the two

– After Taxes, Johnny Cash

New Jersey challenges its residents (and their employers) by diverging in significant and meaningful ways from Federal definitions of income. For example, in New Jersey, the employee share of health coverage is generally taxable to employees because New Jersey does not recognize tax-advantaged cafeteria plans under Section 125. Similar complications arise with New Jersey's approach to adoption assistance, dependent care benefits, health flexible spending accounts, qualified transportation fringes, and educational assistance plans. In these ways, New Jersey shares much in common (although not all in common) with its western neighbor, Pennsylvania. Fortunately, New Jersey has entered into a reciprocal agreement with its neighbor Pennsylvania so that a resident of one state who works in the other pays state income tax generally only to his or her state of residence and avoids double taxation on his or her income.

There was no such luck for one Michelle G. Darcey, a resident of New Jersey who seems to have had the bad luck of being required to pay state income tax to both New Jersey and Pennsylvania on income from her employer's nonqualified deferred compensation plan.[1] In the words of Johnny Cash, she must have felt a painful sense of loss.

In 2003 and 2004, Ms. Darcey lived and worked in Pennsylvania. She participated in a nonqualified deferred compensation plan under which the payment of a portion of her compensation was deferred until later years. Until 2005, Pennsylvania taxed elective deferrals under a nonqualified plan at the time of contribution. Consistent with Pennsylvania law at the time, Ms. Darcey's employer subjected her elective deferrals to Pennsylvania state income tax.

In 2005, the Pennsylvania legislature enacted Act 40 of 2005,[2] which prescribed new rules for the tax treatment of elective deferrals of compensation to nonqualified deferred compensation arrangements. Under the new rules, Pennsylvania adopted Federal principles of constructive receipt retroactive to January 1, 2003. Accordingly, elective deferrals to a nonqualified plan in 2003 or later years would no longer be taxed at contribution, but would instead be taxed at distribution.

Notwithstanding the retroactive change in treatment, the Pennsylvania Department of Revenue issued a Tax Bulletin (Personal Income Tax Bulleting 2005-03) providing a special transition rule that would permit employees to claim an "investment in the elective deferral account" to the extent that an employee could document that the elective deferral was included in Pennsylvania income when

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contributed to the account. The rule applied only to deferrals made between 1999 and 2004, although the Department later extended relief to years before 1999 if the taxpayer could demonstrate the deferrals were included in income when made.

By 2013, when the deferred compensation was paid, Ms. Darcey had moved to New Jersey, in what would prove to be an unfortunate choice. Consistent with Federal law, Ms. Darcey's employer reported the entire payment of $1,139,399.12 on her Form W-2 and withheld Federal income taxes. Her employer also reported the entire payment as New Jersey wages, presumably based on Ms. Darcey's New Jersey resident status at the time of payment. Had she remained a Pennsylvania resident, presumably her distribution would have been covered by the relief in the Tax Bulletin, and she would have paid state income tax only on any earnings (and any post-2004 contributions) credited to her account.

When Ms. Darcey prepared her New Jersey tax return, she reported only $999,024 in wages, the portion of the deferred compensation that was not taxed in Pennsylvania at contribution and would have been subject to Pennsylvania tax when paid had she still been a Pennsylvania resident. The New Jersey Division of Taxation audited her individual return and asserted a deficiency of $15,681—the New Jersey tax due on the amount of the distribution that she did not include in New Jersey income. In other words, New Jersey Division of Taxation asserted that the entire distribution was subject to tax by New Jersey when paid.

The History of New Jersey's Conflicted Guidance on the Taxation of Nonqualified Deferred Compensation

One must step away from Ms. Darcey's situation and travel 25 years back in time to the Summer of 1995 to appreciate the position of the New Jersey Division of Taxation. In the Division's official publication, *State Tax News*, the Division provided guidance on the consequences to employees who defer a portion of their salary and/or bonus into a nonqualified, unfunded deferred compensation plan. The guidance describes a fairly typical arrangement in which, prior to the plan year, a participant makes certain irrevocable elections to defer of all or part of his or her base salary and prospective bonus compensation. Each participant makes elections as to the date on which the deferrals will be paid from the participant's plan accounts. The Division determined that under the Gross Income Tax Act, a taxpayer's accounting method must be the same as the accounting method for Federal income tax purposes. Accordingly, a cash basis taxpayer must recognize income when it is actually or constructively received. As a result, the Division determined that an employee's deferred compensation is not taxable to an employee until actually received, provided the following conditions are satisfied:

1. The deferral is agreed to before the compensation is earned;
2. The deferred amount is not unconditionally placed in trust or escrow for the benefit of the employee; and
3. The promise to pay the deferred compensation is a contractual obligation not evidenced by notes or is not secured in any way.

If all three conditions are satisfied, the Division advised that the compensation will not be deemed to be constructively received. With respect to a bonus deferral, the Division determined that, as long as the deferral election is made before the amount of the bonus is determined, the amount is not constructively received even if the bonus was earned at the time of the election. The approach taken by the Division is largely consistent with the Federal approach and that of most states.

A mere six months later, in the Winter 95 *State Tax News*, the Division revisited its recently issued guidance to clarify the Division's position with respect to Section 457 plans. The Division advised that, although nonqualified and unfunded, amounts deferred under a Section 457 plan are considered constructively received because "the employee can control the percentage of income being deferred or can eliminate the deferral entirely." This, of course, seems to be a distinction without a difference because the Summer 95 *State Tax News* focused on a plan in which the employee made an election to "defer all or part of their base salary and prospective bonus compensation." That seems like the "employee can control the percentage of income being deferred" under both analyses. Perhaps, the Division was focused on the fact that the Summer 95 plan required an election before the beginning of the

[1] *Darcey v. Dir., Div. of Taxation*, N.J. Tax Ct., Docket No. 001480-2018 (June 19, 2019).

[2] Pa. Act of July 7, 2005 (P.L. 149, No. 40).

plan year, while a Section 457 plan may allow employees to change their election before the beginning of each month (but we will come back to this in a moment).

By 2008, the world of deferred compensation was in a dither due to the enactment of Section 409A as part of the American Jobs Creation Act of 2004. In the Winter 2008 *State Tax News*, the Division again had the opportunity to advise on its approach to the taxation of nonqualified deferred compensation. In response to a taxpayer's inquiry regarding employer withholding on nonqualified deferred compensation paid to a nonresident, the Division advised that "contributions to a nonqualified deferred compensation plan, except as described below, are taxable as wages if they are received for any occupation or from services performed in New Jersey." In describing this exception to the general rule, the Division provided a somewhat expanded list of the criteria identified in the Summer 95 *State Tax News:*

1. the plan must be a nonqualified, unfunded, deferred compensation plan that is set up for the bonuses and compensation of highly compensated employees;
2. the deferral must be agreed to before compensation is earned;
3. the employee cannot control the percentage of income deferred or eliminate deferral entirely;
4. the promise to pay the deferred compensation must be a contractual obligation not evidenced by notes or secured in any way; and
5. the deferral amount cannot be unconditionally placed in trust or escrow for the benefit of the employee (no constructive receipt).

If these requirements are satisfied, the contributions are not taxable. If they are not satisfied, the contributions are subject to New Jersey gross income tax (and employer withholding). If the contributions are included in New Jersey income, the amount of distributions in excess of contributions is taxable when distributed. Most nonqualified deferred compensation plans would seem to satisfy these requirements given general requirements for deferral under Sections 402, 409A, and 451 of the Code.

However, the curious case of New Jersey does not end with its epiphany in the Winter 2008 *State Tax News.* One must consider other guidance from the Division of Taxation. For example, on its website, the Division indicates that "[t]he wages you report for Federal tax purposes may be different than the wages you report for New Jersey purposes. For example, New Jersey does not allow you to exclude from wages amounts you contribute to deferred compensation and retirement plans, other than 401(k) Plans." Similarly, the instructions to Form NJ-1040 state that "[e]mployee contributions to Federal Thrift Savings Funds, 403(b), 457, SEP, or any other type of retirement plan other than 401(k) Plans" are included in New Jersey taxable income. The instructions further provide that "[u]nder New Jersey law, contributions to retirement plans (other than 401(k) Plans) are included in State wages on the W-2 in the year the wages are earned." In its discussion of contributory retirement plans, the instructions provide that "[c]ontributions are usually made through payroll deductions and, in general, are taxed when they are made. Contributions made to a retirement plan (other than a 401(k) Plan) prior to moving to New Jersey are considered to have been previously taxed."

All of this guidance seems to be based on N.J. Admin. Code 18:35-2.5, which addresses the state taxation of pensions and annuities. The rule, adopted in 2003, predates the Winter 2008 *State Tax News* and has remained largely unchanged since that time. The preamble to the proposed rule states that the

> rule clarifies N.J.S.A. 54A:6-21 by stating that only the amounts contributed by an employer on behalf of and at the election of an employee to an Internal Revenue Code Section 401(k) plan, and *not to any other Federally qualified deferred compensation or retirement plan*, are excluded from a taxpayer's gross income.[3]

However, when the rule was finalized a few months later, Section 457 had been added to the list without explanation.[4]

Perhaps tellingly, the Winter 2008 *State Tax News* does not appear to consider this rule at all. Instead, it relies on the constructive receipt principles that the Division looked to 13 years earlier. This is true even though the rule was reproposed and readopted in 2008, only months before the *State Tax News* was released. If the rule applies to nonqualified deferred compensation, presumably it would always be taxable at contribution regardless of whether the conditions specified in the 1995 editions of *State Tax News* are satisfied. Accordingly, the guidance in the Winter 2008 *State Tax News* strongly suggests that the rule does not apply to nonqualified deferred compensation because, if it did, the guidance provided would make little sense.

[3] 35 N.J.R. 1384(a) (Mar. 17, 2003) (emphasis added).

[4] 35 N.J.R. 3386(a) (July 21, 2003).

But What of Ms. Darcey?

Having considered over two decades of guidance from the Division, we return to Ms. Darcey in 2013. The Division's litigating position was that her entire deferred compensation benefit was subject to tax when distributed in 2013. This would suggest that the Division believed that the employer's plan satisfied the requirements for deferral when the amounts were contributed. The Tax Court of New Jersey agreed with the Division that

> to the extent that any of the income deferred in 2003 and 2004 was paid pursuant to the [p]lan in 2013, it was taxed to plaintiff for [F]ederal income tax purposes in the year paid. As a result, such income is also subject to New Jersey gross income tax in the year of receipt.

In reaching its conclusion, the court relied on the same provision of the New Jersey Gross Income Tax Act cited by the Division in the Summer 1995 *State Tax News.* Namely, the court relied on the fact that the taxpayer's accounting method was required to be the same as it was for Federal income tax. Tellingly, the decision does not consider N.J. Admin. Code 18:35-2.5 at all.

Ms. Darcey made two arguments for mitigating the court's finding: (1) once the contributions were taxed by Pennsylvania, she established basis in the deferred contribution plan entitling her to reduce the amount subject to New Jersey gross income tax to reflect her basis; and (2) she was entitled to a credit against New Jersey tax for the tax paid to Pennsylvania on the contributions. The court gave short thrift to both arguments. First, the court determined that because she had no basis in the account for Federal income tax purposes, there was no law entitling her to claim basis in her deferred income. Second, it determined that only tax imposed by another state for the same tax year could be credited against New Jersey gross income tax. As a result, Ms. Darcey was left feeling a painful sense of loss as the gap between her deferred compensation account balance and her net income grew twice as wide.

It would be easy enough to chalk up Ms. Darcey's case to an oddity caused by Pennsylvania's old rules for nonqualified deferred compensation. It is an unfortunate case of double taxation for Ms. Darcey, but not of much interest to other taxpayers who, since 2005 at least, have not paid Pennsylvania income tax on contributions to nonqualified deferred compensation plans. Indeed, the decision in *Darcey* would strongly suggest that New Jersey itself follows Federal tax principles for such plans. However, the author's conversations with the New Jersey Division of Taxation indicate that, as the old adage goes, things are not always as they seem.

Confusion Reigns in the Division of Taxation

To confirm the reasonable supposition that N.J. Admin. Code 18:35-2.5 does not apply to nonqualified deferred compensation plans, the author contacted the Division of Taxation Regulatory Services Branch.[5] In an email, the author asked for clarification regarding the proper timing of New Jersey income tax with respect to employee contributions and employee deferrals under a plan that satisfies Section 409A. In a response notable for its swiftness, the Regulatory Services Branch responded that "amounts deferred by an employee under a plan that satisfies the requirements for Code Section 409A are taxable *at contribution.* For the limited exception, see *New Jersey State Tax News*, Vol. 37, No. 4, 01/26/2009. Employer contributions to these plans receive tax-deferred treatment." As support for the Division's position, the email cited, curiously, N.J. Admin. Code 18:35-2.5.

Confused by the Division's response, the author asked for an explanation of the decision in *Darcey* which concluded that "New Jersey law requires that [nonqualified deferred compensation] be included in income in the year paid." The Regulatory Services Branch again, to its credit, responded quickly. The Branch indicated that

> [p]ursuant to an agreement with her Pennsylvania employer, the Pennsylvania resident plaintiff had a portion of her 2003 and 2004 compensation state tax deferred at the contribution level .... The court held that she should have reported the portion of the deferred compensation contributions not taxed by Pennsylvania to New Jersey at distribution. Otherwise, that portion of her contributions *would never be subject to state income tax in Pennsylvania or New Jersey.* (Emphasis added.)

This response is perplexing given that the plaintiff's litigating position was primarily based on the fact that the amount she did not include in New Jersey income in 2013 *was taxed* by Pennsylvania when deferred in 2003

[5] The Regulatory Services Branch is responsible for "providing advice, information, and written guidance . . . providing administrative and enforcement advice to the Division on all tax laws, drafting potential new legislation, reviewing proposed legislation, providing technical assistance in the implementation of new tax laws, responding to taxpayers' questions and requests for advice, and issuing technical bulletins, technical advice memorandums . . . [and] publications."

and 2004. She argued that Pennsylvania's taxation of the contributions established basis in her plan benefit. She further argued that she was entitled to a credit against New Jersey tax for tax paid on the contributions in 2003 and 2004 to Pennsylvania. Moreover, Pennsylvania law (setting aside the retroactive law change in 2005) *required* the contributions to be taxed in 2003 and 2004. Indeed, the Division's own filings in the case included copies of Ms. Darcey's 2003 and 2004 Forms W-2 that show her contributions were taxed by Pennsylvania in 2003 and 2004, respectively.

One might assume that Ms. Darcey availed herself of the retroactive law change and filed amended Pennsylvania returns to exclude the contributions from her Pennsylvania gross income. However, neither the court's decision nor any filings in the case mention any such fact and according to the decision, the "plaintiff maintain[ed], and the Director concede[d], that a portion of the income paid to her by her employer in 2013 was previously taxed by ... Pennsylvania." That the only portion of the income paid to her by her employer in 2013 subject to Pennsylvania tax in 2003 and 2004 would have been her contributions strongly suggests that Ms. Darcey did not take advantage of the relief.

In a follow-up response, the author questioned the Branch's contention that the contributions would have escaped state taxation entirely. As a result, the correspondence with the Division of Taxation only got stranger. The Branch's response indicated that "only a portion of the taxpayer's contributions were taxed by Pennsylvania" and "New Jersey sought to impose tax on the deferrals when paid because they were not taxed at the contribution level in [Pennsylvania]." The Branch did not explain why New Jersey sought to impose tax on the entire amount distributed from the plan in 2013 nor did it explain why the court made no mention of any untaxed contributions. Given the information contained in the Division's filings, it seems doubtful that New Jersey was merely asserting its right to tax contributions (such as those made after 2004) that escaped Pennsylvania taxation when deferred. Indeed, the Division's filings strongly suggest that Ms. Darcey reported those amounts on her New Jersey return and paid the tax due.

In his follow-up response, the author also asked for clarification of the scope of the exemption that the Branch referred to in the Winter 2008 *State Tax News*, thinking that maybe the exception was not so "limited." Perhaps, if the exception would have applied to the plan in which Ms. Darcey participated (had she been a New Jersey resident at the time of contribution), it would make New Jersey's position that the distribution was fully taxable consistent with its own laws, and Ms. Darcey's double taxation a case of bad luck. Specifically, the author asked whether a binding and irrevocable election made in 2019 to defer 10% of salary earned in 2020 until retirement would satisfy the requirements for the exception.

Somewhat unhelpfully, the Regulatory Services Branch responded to the inquiry by listing out the criteria specified in the Winter 2008 *State Tax News* without addressing the specific question asked. The Branch indicated that the plan must meet the following criteria:

1. nonqualified,
2. unfunded,
3. set up for the bonuses and compensation of highly compensated employees,
4. the deferral is agreed to before compensation is earned in that the employee cannot control the percentage of income deferred or eliminate the deferral entirely,
5. the promise to pay the deferred compensation is a contractual obligation not evidenced by notes or secured in any way,
6. the deferral amount is not unconditionally placed in trust or escrow for the benefit of the employee; i.e. no constructive receipt, and
7. prior to the date of actual distribution, contributions are subject to substantial limitations and restrictions.

Perhaps the most perplexing statement in the Branch's response, however, is that "[t]he *only* deferred compensation New Jersey has seen that meets this exception are Rabbi Trust arrangements where plan participants have no rights, conditional or unconditional, to amounts placed in trust or escrow for the purpose of providing plan benefits." (Emphasis in original.) A rabbi trust is a trust set aside to fund nonqualified deferred compensation benefits, but the assets in the trust remain subject to the claims of the employer's creditors. The IRS has ruled that such a trust does not result in the plan being funded or the deferred amounts being included in the employee's income under Section 402 of the Code. The only criteria for the New Jersey exception that a rabbi trust would seem to address is that the deferral amount is not unconditionally placed

in trust, as the assets are available to satisfy claims of the employer's creditors. It is unclear why the establishment of such a trust would make it *less* likely that contributions would be taxable when made. Indeed, the setting aside of funds in such a trust would generally make such a result *more* likely.

The Branch helpfully suggested that if the author had additional questions, he should seek independent counsel. Undeterred by the suggestion, the author sent another email to the Branch promising it was his final question. Specifically, he asked whether the exception's requirement that "the employee cannot control the percentage of income deferred or eliminate [the] deferral entirely" applied only before the amount was earned such that an employee could make an election to defer a percentage of compensation in the year prior to which it is earned, as generally required by Section 409A. In less than 30 minutes, the Branch dutifully responded:

> To qualify for deferral from NJ gross income taxation, there should be no agreement between the employer and employee about the deferral percentage before or after the compensation is earned. That is implied constructive receipt to the employee and it is taxable.

Implied constructive receipt? The author has found no reference to such Federal or state income tax concept in any source, in any state. For a taxpayer to be in constructive receipt of income, the income must be available to the taxpayer without substantial limitation or restriction. An election to defer income in advance of any right to the income would not ordinarily give rise to constructive receipt especially if, once deferred, the time for payment is fixed such that the taxpayer cannot receive it before the specified time. It is not clear what "implied constructive receipt" is, but perhaps it suggests taxpayers should be taxed on income which they will never receive in case they might, someday, receive it.

It is the rare nonqualified deferred compensation plan that provides the employee with no control over the deferral percentage. Indeed, beyond a supplemental executive retirement plan ("SERP"), or perhaps a plan that mandates an executive to defer all base salary over $1 million to avoid the application of Section 162(m), it is hard to imagine such a plan. The Branch's interpretation of an exception rooted in 25 years of, albeit informal, official guidance would limit its application in such a way as to make employee contributions to the majority of modern nonqualified deferred compensation plans subject to tax when made.

What to Do?

Despite his robust back-and-forth exchange with the Division, the author maintains that the Regulatory Services Branch is simply wrong. None of the three *State Tax News* discussions governing New Jersey taxation of nonqualified deferred compensation nor the decision in *Darcey* rely on N.J. Admin. Code 18:35-2.5 for the position that elective deferrals to such plans are subject to tax when contributed. Instead, they are all based on Federal principles of constructive receipt. Indeed, the Tax Court of New Jersey's decision in *Darcey* explicitly determines that distributions from nonqualified deferred compensation plans are taxable at distribution under the New Jersey Gross Income Tax Act. The Regulatory Services Branch's contention that the employee cannot control the deferral percentage when making a deferral election is puzzling in light of the express facts addressed in the Summer 1995 *State Tax News*, which the Division has never withdrawn or expressly overruled, other than in the context of Section 457 plans. Setting aside the Branch's position in its email to the author, the "limited exception" in the Winter 2008 *State Tax News* will be satisfied by almost every plan that satisfies Section 409A.

Nonetheless, employers in New Jersey should be aware that the Division appears poised to challenge any failure to treat such contributions as income subject to withholding and reporting for New Jersey tax purposes based on its erroneous belief that N.J. Admin. Code 18:35-2.5, which does not reference nonqualified deferred compensation plans other than Section 457 plans and does not contain the "limited exception" referenced in three editions of *State Tax News*, requires that employers treat such contributions as taxable and withhold on them. ■