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What Retirement Income Is Exempt From State Taxes?

by Timothy P. Noonan and Ryan M. Murphy

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As more and more workers move into retirement, we also see them moving to other states. Retirees often like moving to states with nicer weather, a slower pace and — oh yeah — no income taxes. These retirees sometimes learn a painful lesson after moving — that their income could still be taxable in their former state of residence based on state sourcing rules, something that is obvious to all of us practitioners but less noticeable to Joe Retiree.

One issue that always arises in practice involves the federal exclusion for retirement income — one of the few examples in which the federal government has stepped into our fun and exciting state tax world. We often get questions from other lawyers and accountants about the scope of the exemption, and have ourselves spent lots of time in audits trying to figure out how these rules work. And because the rules and definitions in this federal statute are based largely on retirement income as defined in federal law, a working knowledge of those sometimes arcane and difficult federal rules is needed. Or you need to have a guy in your office who knows the stuff.

For this installment of Noonan's Notes, I have pulled in such a guy as coauthor. This article should give you an excellent primer on how this federal "retirement income" exemption works, a topic that rarely is covered in state tax circles.

Background

Let's start with the federal statute. 4 U.S.C. section 114(a) provides that "no State may impose an income tax on any retirement income of an individual who is not a resident or domiciliary of such State (as determined under the laws of such State)." Applicable to amounts received after December 31, 1995, this federal prohibition on state income taxation of a nonresident's retirement income is still relatively unknown and undefined in some circumstances.

The U.S. Supreme Court has long since acknowledged states' power to tax personal income when (i) the taxpayer is a resident of the state or (ii) the taxpayer's income was sourced in the state.[1] Compensation for services is treated as being sourced in the state where the services are performed.[2] So states are constitutionally permitted to tax nonresidents' retirement income, to the extent the retirement income is sourced in that state. That seemingly uncomplicated standard is often difficult in administration, though.

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Consider XYZ Corp., which has an office in New York, Colorado, Oregon, and California. Joe Smith works as an employee of XYZ Corp. for 20 years, during which period he accrues a benefit under XYZ Corp.'s pension plan. Joe spends five years working in each office before retiring, becoming a Florida resident, and beginning receipt of benefits from XYZ Corp.'s pension plan. New York, Colorado, Oregon,

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[1]*See Shafer v. Carter*, 252 U.S. 37 (1920).

[2]*See Zelinsky v. Tax Appeals Tribunal of the State of N.Y.*, 1 N.Y.3d 85 (2003) for a general discussion of the sourcing rules applicable to compensation for services.

and California would be constitutionally permitted to impose income tax on any retirement income properly sourced to their states, and reporting, withholding, and income tax requirements could exist in each of those four jurisdictions.

But with 4 U.S.C. section 114, Congress eliminated states' ability to impose income tax on retirement income solely because the retirement income was sourced within its borders. "Retirement income," though, is a term of art that includes income from arrangements that are commonly thought of as retirement plans, including qualified plans (for example, 401(k) plans, profit-sharing plans, employee stock ownership plans, money purchase plans, and defined benefit pension plans), section 408(k) simplified employee pensions, section 403(a) qualified annuity plans, section 403(b) annuity contracts, individual retirement accounts, individual retirement annuities, section 457(b) plans, governmental plans, and section 501(c)(18) trusts.[3] Application of section 114 in these circumstances is straightforward: If, for example, a nonresident receives a distribution from a 401(k) plan, the distribution is not subject to income tax in any state in which she does not reside.

Because of that, most of the questions we get do not revolve around these more basic definitions. Most or all of the questions and issues in this area revolve around the application of the exemption to deferred compensation arrangements. So we'll spend the rest of our time there.

Nonqualified Deferred Compensation

Indeed, Congress did not exempt merely the straightforward; it also exempted plans described in code section 3121(v)(2)(C).[4] Code section 3121(v)(2)(C) defines "nonqualified deferred compensation plan," for purposes of the special timing rule applicable to the FICA taxes associated with nonqualified deferred compensation plans. Just what is a nonqualified deferred compensation plan requires careful review of the Treasury regulations under code section 3121(v)(2)(C), where what is a nonqualified deferred compensation plan is sometimes defined by what it is not.[5]

Step One: What Type of Plan?

For starters, what is a nonqualified deferred compensation plan? The answer is mostly circular: A nonqualified deferred compensation plan is a plan (other than a plan described in code section 3121(a)(5)) by an employer for one or more of its employees that provides for the deferral of compensation.[6] More instructive is what constitutes a deferral of compensation. In general, a plan is treated as providing for a deferral of compensation if, under the terms of the plan and the relevant facts and circumstances, an employee has a legally binding right during a calendar year to compensation that has not been actually or constructively received and that, under the terms of the plan, is payable to the employee in a later year.[7] An employee is not considered to have a legally binding right to compensation if his employer may unilaterally reduce or eliminate benefits after the employee performs the services creating the right to that compensation.[8]

What types of income do not result in a deferral of compensation? A number of forms of compensation that might frequently be thought of as nonqualified deferred compensation, it turns out.[9] For instance, the grant of stock options, stock appreciation rights, and other stock value rights does not result in a deferral of compensation.[10] Likewise, amounts received on the exercise of a stock option, stock appreciation right, or other stock value right are not considered a deferral of compensation, when those amounts are actually or constructively received in the year of exercise.[11] Because an employee is deemed to be in receipt of income on the date she exercises a stock appreciation right, a stock appreciation right will never constitute a deferral of compensation.[12] So, too, with nonqualified stock options.[13]

Income that would otherwise qualify for the federal exemption will be disqualified when the income is considered as being provided in contemplation of termination of employment. That income is not

[3]4 U.S.C. section 114(b)(1)(A)-(H).

[4]*See* 4 U.S.C. section 114(b)(1)(I).

[5]*See* Treas. Reg. section 31.3121(v)(2)-1.

[6]Treas. Reg. section 31.3121(v)(2)-1(b)(1). Code section 3121(a)(5) describes qualified plans, section 403(a) annuity plans, section 408(k) simplified employee pensions, section 403(b) annuity contracts, certain governmental deferred compensation plans, section 408(p) simple retirement accounts, cafeteria plans, and some plans paying length of service awards.

[7]Treas. Reg. section 31.3121(v)(2)-1(b)(3).

[8]*Id.*

[9]Not discussed at length herein, the regulation treats the following categories of compensation as *not* resulting from a deferral of compensation: excess parachute payments; the transfer of restricted property; compensation paid for current services; and some welfare benefits, including vacation benefits, sick leave, compensatory time, disability pay, severance pay, and death benefits. Treas. Reg. section 31.3121(v)(2)-1(b)(4). Note, though, that benefits payable under a plan *by reason of death or disability* are not necessarily considered death or disability benefits.

[10]Treas. Reg. section 31.3121(v)(2)-1(b)(4)(ii).

[11]*Id.*

[12]Rev. Rul. 80-300, amplified by Rev. Rul. 82-121.

[13]Rev. Rul. 80-244. Note that the exercise of a qualified stock option does not result in any FICA tax owing. *See* IRC section 3121(a)(22). Thus, income from a qualified stock option plan would not be described in code section 3121(v)(2)(C).

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considered as resulting from a deferral of compensation.[14] Thus, a window benefit (that is, a form of benefit made available for no more than one year) providing an early retirement benefit, retirement-type subsidy, Social Security supplement, or similar form of benefit does not result in a deferral of compensation.[15] A benefit is also treated as being provided in contemplation of termination of employment if an employee terminates within 12 months of the plan's establishment, and the facts and circumstances indicate that the plan was established in contemplation of the employee's impending termination of employment.[16] In making that determination, it is important to recognize that a plan is considered to be established on the later of the date (i) it is adopted, (ii) it is effective, and (iii) its material terms are set forth in writing.[17]

It's not unheard of for a plan to provide a variety of benefits. So what if a nonqualified deferred compensation plan provides both benefits that result in a deferral of compensation and benefits that do not result in a deferral of compensation? The benefit that results in a deferral of compensation is viewed separately and still treated as a benefit resulting in a deferral of compensation, even though it is part of a plan providing benefits that do not result in a deferral of compensation.[18]

Step Two(a): Timing and the Annuity Exemption

If a plan constitutes a nonqualified deferred compensation plan described in code section 3121(v)(2)(C), the next step is to determine whether payment is (i) made in the form of an annuity or (ii) from an excess benefit plan following termination of employment.[19] To qualify for the annuity exemption, the income must be part of substantially equal periodic payments (payable not less frequently than annually) over the life or life expectancy of the employee (or the joint lives or joint life expectancies of the employee and the employee's beneficiary), or over a period of at least 10 years.[20] Periodic payments will not fail to be treated as "substantially equal" when payments are adjusted under a plan's predetermined formula, or a cost of living adjustment is provided.[21]

What happens if benefits from a nonqualified deferred compensation plan are paid to a nonresident as both a partial lump sum and a partial annuity? In New York, at least, that benefits are paid as both an annuity and in a lump sum should not cause the annuity to become subject to New York income tax. In the context of New York's own exemption of up to $20,000 for amounts received under a pension or annuity, the New York State Division of Tax Appeals found that a taxpayer who received a lump sum payment of $2,341,504 from a nonqualified deferred compensation plan was entitled to apply New York's exemption to a $5,529.37 monthly life annuity received under the same plan.[22] The holding is particularly relevant because the New York exemption requires that payments be periodic, if made from a nonqualified deferred compensation plan.[23]

To illustrate the annuity exemption, assume that Mike is a participant in a nonqualified deferred compensation plan described in code section 3121(v)(2)(C). Under the plan, Mike may elect to defer a portion of his current compensation. At the time of his retirement, Mike is not a resident of State X, but all payments to be made from the plan were sourced in State X. Mike may choose from four payment options provided under the plan: (i) annual payments over a period of not less than 10 years, (ii) annual payments for life, (iii) annual payments until the amount deferred is fully paid, or (iv) a lump sum payment. If the payments are substantially equal, any annual payments to Mike that are to be made for at least 10 years or for Mike's life are exempt from State X income tax. A lump sum payment to Mike is subject to State X income tax, and annual payments made until the amount deferred is fully paid may or may not be exempt from State X income tax.[24]

Step Two(b): The Excess Benefit Plan Exemption

To qualify for the favorable treatment afforded payments from excess benefit plans, unlike the exemption for annuities, an employee must have

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[14]Treas. Reg. section 31.3121(v)(2)-1(b)(4)(v).

[15]Treas. Reg. section 31.3121(v)(2)-1(b)(4)(v)(A)(1). However, if it is shown that a benefit is recurring, it may not be viewed as a window benefit. Section 31.3121(v)(2)-1(b)(4)(v)(A)(2).

[16]Treas. Reg. section 31.3121(v)(2)-1(b)(4)(v)(C).

[17]Treas. Reg. section 31.3121(v)(2)-1(b)(2)(i).

[18]Treas. Reg. section 31.3121(v)(2)-1(a)(2)(iv).

[19]4 U.S.C. section 114(b)(1)(I)(i) and (ii).

[20]4 U.S.C. section 114(b)(1)(I)(i).

[21]*Id*.

[22]*In re the Petitions of Richard T. & Carol J. Burns for Redetermination of Deficiencies or for Refund of New York State Personal Income Tax under Article 22 of the Tax Law for Years 2001 and 2003*, DTA Nos. 821366 and 821404 (Feb. 21, 2008). For a discussion of 4 U.S.C. section 114 by the New York State Department of Taxation and Finance, see TSB-A-11(10)I (Nov. 17, 2011).

[23]N.Y. Tax section 612(c)(3-a).

[24]This example is loosely based on Situation 3 to California Franchise Tax Board Legal Ruling 2011-02. The FTB there fails to indicate how annual payments made under the plan's "exhaustion" method should be treated before the time payments are established as being exempt from California income tax. Presumably, payments would become exempt only after the right to exemption is established.

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terminated employment.[25] However, there is no requirement that benefits be paid from an excess benefit plan in the form of an annuity — that is, they may be paid in a lump sum. An excess benefit plan under 4 U.S.C. section 114 is a nonqualified deferred compensation plan "maintained *solely* for the purpose of providing retirement benefits for employees in excess of the limitations imposed by 1 or more of sections 401(a)(17), 401(k), 401(m), 402(g), 403(b), 408(k), or 415 of [the] Code or any other limitation on contributions or benefits in [the] Code on plans to which any such sections apply."[26]

For example, Sue is a participant in her employer's profit-sharing plan. She is also a participant in a nonqualified deferred compensation plan described in section 3121(v)(2)(C) that supplements the profit-sharing plan and incorporates some definitions from the profit-sharing plan. The nonqualified deferred compensation plan provides deferred compensation that is payable in a lump sum following termination of employment, and the plan is designed to provide retirement income in excess of the limits imposed by section 401(a)(17). Sue receives compensation of $500,000 in 2011. Sue's employer makes a profit-sharing contribution to the profit-sharing plan equal to 12 percent of Sue's compensation. All amounts are sourced in State X. Because only $245,000 of compensation may be taken into account under section 401(a)(17) in 2011, Sue may receive only a profit-sharing contribution of $29,400 ($245,000 * 12 percent). Then, $30,600 (($500,000 - $245,000) * 12 percent) is credited to Sue's account in the nonqualified deferred compensation plan. The nonqualified deferred compensation plan is an excess benefit plan. If Sue is a nonresident of State X when payment from the excess benefit plan is made, no amount will be subject to State X income tax. Of course, that would also be true of distributions from the profit-sharing plan.[27]

Final Note: Extension to Former Partners

Because of the requirement that a nonqualified deferred compensation plan be described in code section 3121(v)(2)(C), which relates to FICA tax, questions arose over whether payments by a partnership to a retired partner would be covered by 4 U.S.C. section 114.[28] In 2006, 4 U.S.C. section 114 was amended retroactively to include payments made to a retired partner on or after January 1, 1996. In passing the amendment, Congress sought to make "clear that any written plan, program, or arrangement in effect at the time of retirement that provides for payments to a retired partner in recognition of prior service may qualify as exempt from nonresident State income taxation as long as such payments are made over 10 years or more and are made in substantially equal periodic payments."[29] The term "retired partner" is defined as an individual who is described as a partner in code section 7701(a)(2) and who is retired under the individual's partnership agreement.[30]

Conclusion

I know, this is a lot to take in. Thanks for staying until the end.

In determining in what jurisdictions retirement benefits are taxable, the answer for income from qualified plans, simplified employee pensions, section 403(a) qualified annuity plans, section 403(b) annuity contracts, IRAs, individual retirement annuities, section 457(b) plans, governmental plans, and section 501(c)(18) trusts is simple: The individual is taxable only in the state where he resides. Conversely, when dealing with retirement benefits from any other deferred compensation plan, the plan must be placed under a microscope when benefits are sourced in a state other than the retiree's current state of residence.

Although the analysis may sometimes be painstaking to review (and even harder to write — trust us), if 4 U.S.C. section 114 is applicable to the plan, other headaches may avoided, including the migraine caused by writing a check to a state where you do not reside. ✰

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[25] 4 U.S.C. section 114(b)(1)(I)(ii).

[26] *Id*. Emphasis added.

[27] This example is loosely based on Massachusetts Department of Revenue Letter Ruling 00-1.

[28] H.R. 109-542.

[29] *Id*.

[30] 4 U.S.C. section 114(b)(4).

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