Washington Report

(December 3, 2013) Ponte Vedra Beach, Florida -Executive benefits consulting firm, Fulcrum Partners LLC, is pleased to distribute this AALU Washington Report to its clients and friends. This continuing series of articles is intended to provide deep insight into trends, events, and issues that impact the design and operation of nonqualified executive benefit plans.

Source Tax Law - Non-Qualified Plan Can Help Protect Retirement Income from Taxation by Former States of Residence

MARKET TREND: A need for more revenue sources has led to a growing trend among states to attempt to tax retirement income paid to current nonresidents based on amounts previously earned in that state. This could create unanticipated tax liabilities, particularly for retirees that choose to relocate to low or no-tax states, such as Florida or Nevada. An understanding of the federal "Source Tax Law" can enable our clients to avoid unexpected taxation of retirement income by states in which they do not live.

SYNOPSIS: Typically, an individual is subject to income taxation by the state in which he or she lives when the income is received. Some states, however, attempt to tax nonresidents on this income on the basis that it was earned, or had its source, in the first state. Retirement income has been a key target of this type of state taxation. Under the federal "Source Tax Law," however, retirement income meeting certain conditions will be taxable only by the recipient's state of residence at the time of payment, regardless of its "source."

TAKE AWAYS: The Source Tax Law generally protects current nonresidents from being taxed on retirement income by states where they previously lived while employed. It covers retirement income paid from tax-favored vehicles such as tax-qualified retirement plans and IRAs. It also protects income from nonqualified deferred compensation arrangements if the income either is paid from a certain type of plan or in substantially equal periodic payments over life or life expectancy or a period of at least ten years. Thus, properly structuring deferred compensation payouts (including compliance with Internal Revenue Code ("Code") § 409A) may provide significant state tax savings, depending on the states involved.

MAJOR REFERENCES: *4 U.S.C. § 114.*

As discussed in a recent series of Washington Reports, income tax planning through the use of deferred compensation vehicles has been growing in popularity and importance. Given the magnitude of the potential tax liabilities, the focus has been primarily on the individual's federal tax exposure. To avoid unexpected tax liabilities, however, individuals also should consider a potentially significant issue involving state tax liabilities related to their retirement income, particularly if an individual plans to move at or after retirement to a state with no personal income tax or a rate much lower than that of his or her current state of residence.

Typically, an individual is subject to tax on income by the state in which he or she resides or is domiciled at the time of receipt. Some states, however, attempt to tax income paid to a nonresident if the income had its "source" in that state. One of the most common types of nonresident income that states attempt to tax is retirement income, which they claim was earned while the individual was a resident or domiciliary of that state. Under federal law (often referred to as the **"Source Tax Law"**), however, states cannot tax certain types of retirement income when paid to nonresidents. Understanding which forms of retirement income are exempt from taxation by another state can be of enormous value in structuring deferred compensation arrangements.

SOURCE TAX LAW

The Source Tax Law is found at 4 U.S.C. § 114. Subsection (a) of that statute articulates the general proposition that "[n]o 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)." The statute enumerates the various types of income that constitute "retirement income" for this purpose, including income from typical tax-favored retirement vehicles, such as:

- Tax-qualified retirement plans, such as defined benefit pension plans and 401(k) plans,
- Tax-sheltered annuities covered by Code §§ 403(a) or 403(b),

- Eligible deferred compensation plans under Code § 457,
- Governmental plans, and
- Individual retirement plans and accounts.

"Retirement income" also includes certain income from nonqualified deferred compensation plans. Specifically, amounts payable from such plans will be protected if either:

- The income is part of a series of substantially equal periodic payments (not less frequently than annually) made for (1) the life or life expectancy of the recipient (or the joint lives or joint life expectancies of the recipient and his or her designated beneficiary), or (2) a period of not less than ten years; or
- The income is a payment made: (1) after termination of employment; and (2) under a plan, program or arrangement maintained solely for the purpose of providing retirement benefits for employees in excess of the limitations imposed by one or more of certain enumerated sections of the Code applicable to tax-qualified retirement plans **("Excess Plans"**).

PLANNING TO ELIMINATE CLAIMS BY THE PRIOR STATE

For individuals whose income tax planning may involve a residency change at or after retirement, deferred compensation planning should address the following three issues to minimize the ability of a former state of residence to tax their retirement benefits:

1. ***Maximize the Extent to Which Amounts Are Deferred Under Tax-Qualified Vehicles.*** Maximizing the amounts an individual defers under tax-qualified arrangements is almost always a sound deferral strategy, because these arrangements generally segregate assets in trusts that provide security for amounts deferred under them. This security is not available in connection with nonqualified deferred compensation, which must remain subject to the claims of the employers general creditors. In the context of an individual who may change his or her state of residence, the benefits of this strategy are enhanced, in that benefits payable under these arrangements are exempt from taxation by states other than the current state of residence under the Source Tax Law.

There are, however, constraints applicable to this strategy. Specifically, the Code severely limits the amounts that can be deferred in any year under these plans. Therefore, significant planning opportunities are usually derived under nonqualified plans.

2. ***Segregate "Excess Plans" from Other Nonqualified Deferred Compensation Plans.*** As noted above, the Source Tax Law prevents a state's taxation of payments made from an Excess Plan to a nonresident after termination of employment. As part of an overall executive retention program, however, employers often will maintain a single nonqualified deferred compensation plan that allows both Excess Plan deferrals and deferrals for benefits based on other factors. Unfortunately, this type of arrangement will not qualify as an Excess Plan for purposes of the Source Tax Law, and thus any protections provided that law for plan distributions made over a period of less than 10 years will be lost.

Accordingly, employers should try and maintain separate plans for Excess Plan deferrals and for deferrals attributable to other factors, so that benefits attributable to Excess Plans remain eligible for payment in, for example, a lump sum without being subject to tax by a state other than the participant's current state of residence.

3. ***Consider Electing Payments from Plans that Are Not Solely Excess Plans Over Life, Life Expectancy or a Period of at Least Ten Years.*** If an individual participates in a plan that is not solely an Excess Plan, the individual should consider setting up account distributions to provide substantially equal periodic installments over a period equal to the individual's life or life expectancy, the joint lives or joint life expectancy of the individual and his or her designated beneficiary, or for a period of at least ten years. This distribution scheme will cause the distributions to fall within the scope of the Source Tax Law and, thus, be exempt from taxation by any state other than the individual's current state of residence.

REMEMBER CODE § 409A COMPLIANCE

It is crucial for plan sponsors to remember that, regardless of state tax planning considerations, distributions from nonqualified deferred compensation arrangements must still comply with the requirements of Code § 409A, as failure to comply can subject the individual to significant tax penalties.

TAKE-AWAYS

The Source Tax Law generally protects current nonresidents from being taxed on retirement income by states where they lived while employed. It covers retirement income paid from tax-favored vehicles such as tax-qualified retirement plans and IRAs. It also protects income from nonqualified deferred compensation arrangements if the income either is paid from a certain type of plan or in substantially equal periodic payments over life or life expectancy or a period of at least ten years. Properly structuring deferred compensation payouts (assuming compliance with Code § 409A) may provide significant state tax savings, depending on the states involved.

For more information about the topic discussed in this Washington Report, please contact press@fulcrumpartnersllc.com.

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