



# Alert

## Employee Benefits & Executive Compensation Client Service Group

To: Our Clients and Friends

December 28, 2011

### State Taxation of Former Residents' Retirement Income

Recently, the New York State Department of Taxation and Finance issued an Advisory Opinion (TSB-A-11(10)I) regarding whether New York State may impose income tax on distributions from a nonqualified deferred compensation plan made to a former resident. The opinion, consistent with federal law, concluded that New York State may not impose income tax on these retirement payments. Similar reasoning should apply to other states. Plan sponsors and former New York State residents that participate in nonqualified deferred compensation plans should be aware of the tax implications of this law.

**Background.** Since 1996, federal law prohibits states from imposing income tax on any "retirement income" of plan participants who no longer reside in the state, even if the participants earned the benefits while they were residents of that state and income taxes were deferred on the contributions. "Retirement income" for this purpose includes income from qualified plans and certain payments from nonqualified plans. Payments from a nonqualified plan are considered "retirement income" only if (i) the plan is a restoration plan (i.e. a plan that restores benefits that cannot be provided under the company's qualified plans due to Internal Revenue Code qualified plan limits), or (ii) the payments are made for the life expectancy of the recipient or a period of at least ten years.

**Tax Implications.** Plan sponsors have the ability to help plan participants avoid the inconvenience and/or tax liability of having more than one state impose tax on their benefit payments. Depending on the type of nonqualified plan, the options for plan sponsors differ. Nonqualified plans are typically categorized as either restoration plans or supplemental executive retirement plans (SERPs). Restoration plans are intended to provide executives with the same benefit as an associated qualified plan but without regard the qualified plan limits. As noted above, any payment from a restoration plan qualifies as "retirement income" under the federal law and therefore is only taxed in the state where the participant is a resident.

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On the other hand, a SERP is a more flexible nonqualified plan and typically provides greater benefits than those provided under a restoration plan. SERP payments may qualify as “retirement income” under federal law but only if paid out over a long-term period (*i.e.*, at least 10 years or the participant’s life expectancy). In order to allow those plan participants who may wish to change their state of residence post-retirement to avoid taxation in both their current and former states of residence, plan sponsors should structure their SERPs to have at least one long-term payout option. Under this arrangement, for example, if a New York resident participant becomes entitled to a SERP benefit while residing and working in New York State, such participant may avoid New York State income tax on the benefit if he elects a ten-year payout period and subsequently moves to a different state before payments commence. This federal law may help plan participants eliminate state income taxes on the SERP benefit altogether if the participant moves post-retirement to a state that does not impose income taxes (*e.g.*, Florida).

Plan sponsors should also be aware of how this law affects their withholding and other administrative obligations. For example, for payments that qualify as “retirement income,” plan sponsors generally need to track only the state in which a participant currently resides. Implementing these suggestions may allow plan participants to reduce their state tax liabilities and also ease the plan sponsor’s administration burdens.

If you have any questions regarding anything discussed in this Alert, the attorneys and other professionals of the [Employee Benefits and Executive Compensation](#) group of Bryan Cave LLP are available to answer your questions.

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