REPORT #854

TAX SECTION

New York State Bar Association

Limitation on state Taxation Of "Retirement Income"

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New York State Bar Association

November 9, 1995

The Honorable Sam M. Gibbons
House of Representatives
Committee on Ways & Means
2204 Rayburn House Office Building
Washington, D.C. 20510

Re: Limitation on state Taxation
<u>Of "Retirement Income"</u>

Dear Mr. Gibbons:

Among the provisions included in the Revenue Reconciliation Provisions of H.R. 2491 as passed by theSenate on October 27, 1995, was an amendment to Title 4of the United States Code (entitled Flag and Seal, Seatof Government, and the States) that would prohibitStates from imposing an income tax on any "retirementincome" of an individual who is not a resident ordomiciliary of the State (as determined under the lawsof the State) . This provision (the "pension, limitation") is substantially the same as H.R. 394,which was favorably reported out of the House JudiciaryCommittee on October 31, 1995[1].

We are writing to comment on the inclusion ofthis rather obscure provision in the Senate version of

[1] Also pending is S. 44, a Senate bill that is similar to H.R. 394; and various other bills along these same lines have been introduced in pas Congresses. See, e.g. , S. 267, 102d Cong., 1s Sess. (1991); H.R. 546, 103d Cong., 2d Sess. (1994) . The substantive differences among thes proposals generally lie in their treatment o distributions from non-gualified plans, and their (non) imposition of caps on the limitation.

the 1995 federal budget legislation, and to note that the pension limitation proposal raises policy issues and technical questions that should be considered in greater detail before such a limitation is imposed onthe States by federal legislation.

The essential issue raised by the pension limitation is whether States should be prohibited fromtaxing income that was earned by their residents, orwithin their borders, because the taxation of that income is deferred under one of the enumerated qualified or nonqualified plans and received in a year when the earner no longer resides or works in the State. The pension limitation would preclude States in which a nonresident individual earned deferred compensation from taxing that income upon its later receipt, and would preclude States from taxing former residents on both deferred compensation and the tax deferredreturn thereon that is earned while a resident. To the extent the pension limitation operates to preclude the later taxation of deferred income, it converts the State's tax deferral of retirement income into an exemption of that income; this creates an opportunity for deliberate tax avoidance.

Where a State could constitutionally taxincome when earned but instead permits a deferral of the type described in the pension limitation, it is not, in our view, inappropriate for that State to collect tax on the income when the deferral period ends. The argument that the pension limitation is necessary to correct unfair State taxation of nonresidents is, therefore, not a persuasive reason for enacting the pension limitation.

The pension limitation may, however, serve other legitimate ends. For example, currently only a few States seek to tax retirement income. In those States, however, taxation of deferred income requires the allocation of pension distributions between deferred compensation and deferred investment income, as well as allocation among the States where income was earned or where an individual resided. The complexities of multistate compliance and the risks of multiple taxation may be factors that warrant federal intervention by enactment of the pension limitation.

We believe, however, that it is very important to evaluate the proposed limitation not on the basis of broad claims about the fairness of taxing nonresidents but instead in terms of the burdens of compliance with the current system, the extent of problems of inefficient or inequitable administration of State laws, and the need for this kind of federal simplification measure. It also might be fruitful to consider more limited forms of restriction, for example federal rules that allocate deferred income among the States in which an individual has lived or worked.

We also are concerned that the ramifications of the pension limitation on State tax policies be fully explored. Currently the State taxation of deferred compensation can best be described as a patchwork. States to whom the eventual taxation of deferred income is important (now or in future) could legitimately avoid the exemption effects of the pension limitation by simply eliminating the deferral of tax on vested deferred compensation. This would be similar to Code section 3121(v), which treats such compensation as paid currently for PICA purposes. States might also consider less drastic measures, like including income currently but permitting a deferral of tax (with or without interest), triggering deferred income immediately before the departure of a resident, or taxing rollovers from qualified plans to IRAs. The extent to which such responses are likely, and the effects such responses might have on individual saving patterns and tax complexity need to be vetted

We also note some technical issues raised by the pension limitation. The limitation does not apply to individuals who are residents or domiciliaries of the taxing State, as defined in that State's laws. Obviously, some kind of exception along these lines must be included in any limitation. However, I leaving the definition of residence and domicile to each State the pension limitation fails to address the problems presented by conflicting and overlapping determinations of residence and domicile. Currently, if an individual is considered to be a resident or domiciliary of more than one State, he or she can be subjected to multiple taxation, and State credit mechanisms can be inadequate to alleviate that burden. The pension limitation does not recognize this problem of multistate residency, and indeed could exacerbate it if States responded to the pension limitation by expanding their definitions of residence and domicile. Similarly, the pension limitation does not address the allocation issues noted above, which continue to be relevant with respect to retirement income not covered by the pension limitation. The pension limitation also fails to address the thorny issues presented by deferred compensation vehicles such as stock options, stock appreciation rights and restricted stock. Assuming there is sufficient federal interest in the State taxation of deferred compensation to warrant enactment of the pension limitation, consideration also should be given to these other forms of deferral, and whether the differing State taxation of these vehicles should be rationalized.

Some versions of the pension limitation limit its application to nonqualified plans to distributions that are "part of a series of substantially equal periodic payments (not less frequently than annually) made for (i) the life or life expectancy of the recipient (or the joint lives or joint life expectancies of the recipient and the designated beneficiary of the recipient), or (ii) a period of not less than 10 years). See §114(b)(1)(I) of the Senate's version in H.R. 2491. In other versions of the pension limitation a dollar amount cap is imposed on the amount of retirement income from nonqualified plans that is eligible for exemption. New York State has similar limitations on the types of distributions subject to State income tax, and the interpretation of New York's rule has spawned some issues that could be relevant to the pension limitation. For example, New York has held that each plan of an employer is evaluated separately, so if different plans pay differing amounts to an individual in each year the exemption is not applicable, even if the aggregate amount received in each year is substantially the same[2] As we noted in our report on the proposed legislation regarding interstate mail order sales (the "Bumpers Bill"),[3] federal legislation affecting State

[2] See Philip H. Trout, New York TSB-H-81 (397) I, November 6, 1981.
[3] New York State Bar Association Tax Section Report on Proposed "Consumer and Main Street Protection Act of 1995, submitted April 5, 1995. (Tax Report

taxation is not subject to uniform federal interpretation — there is, for example, no federal agency to write regulations under the pension limitation. In enacting such federal legislation, therefore, it is important to flush out and address as many technical issues as possible, for after the bill is enacted its interpretation will largely fall to the separate jurisdictions of the fifty States.

This letter is intended simply to highlight the issues presented by the pension limitation. A number of thoughtful analyses of these issues have been published over the last few years[4], which analyze in greater detail issues that range from the macro-problem of Constitutional limits on State taxation to the micro-problems of State tax withholding responsibilities. We urge that Congress take the time to explore the pension limitation in greater detail to ensure that the federal interest in this issue merits enactment of a limitation on State taxation of nonresidents' retirement income, and that Congress defer consideration of these proposals until this has been done. We are, as always, interested and available to assist in this process.

Very truly yours,

Carolyn joy Lee
Chair

- Identical letters have been sent to:

The Honorable William V. Roth, Jr.
Chairman, Committee on Finance
United States Senate

The Honorable Daniel P. Moynihan
United States Senate
Committee on Finance

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[4] Note, Take the Money and Run! Source Taxation of Pension Plan Distributions to Nonresidents,. 14 Virginia Tax Review No. 3, 645 (Winter, 1995); Richard Reichler, State Taxation of Executive and Employee Compensation, Tax Management Memorandum, June 16, 1994; Walter Hellerstein and James Charles Smith, State Taxation of Nonresidents1 Pension Income 56 Tax Notes 221 (July 13, 1992).

The Honorable Bill Archer
Chairman, Committee on Ways and Means
House of Representatives
The Honorable Leslie B. Samuels
Assistant Secretary (Tax Policy)
Department of the Treasury

The Honorable Margaret M. Richardson
Commissioner
Internal Revenue Service

Mr. Kenneth J. Kies
Chief of Staff
Joint Committee on Taxation