PILLSBURY MADISON & SUTRO LLP
STATE & LOCAL TAX BULLETIN
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Federal Statute Now Prohibits State Income Taxation of Certain Pension Income of Nonresidents

On January 10, 1996, President Clinton signed into law H.R. 394, now P.L. 104-95, which prohibits state income taxation of certain pension income of nonresidents received after December 31, 1995.

P.L. 104-95, the text of which follows this article, was a response to the source tax levied by California and New York (and, to a lesser extent, certain other states) on the pension income of former residents now living in other low or no-tax states. A prime example would be a former California resident who retires to Nevada, and receives a pension from his California employer. In fact, the prime mover behind this legislation was the Nevada congressional delegation.

It is estimated that California will lose about $25 million and New York about $10 million annually in state income tax revenues as a result of this legislation. The American Association of Retired Persons (AARP) did not support this law. They were concerned that the affected states could respond by limiting deferred compensation deductions to make up for the lost revenue. For example, California or New York might limit section 401(k) deductions to an amount lower than the federal limit of $9,500, or limit recognition of pretax employee contributions to a governmental plan that are "picked up" under Internal Revenue Code section 414(h). Unless the affected states make up the lost revenue by other adjustments to their income taxes, the IRS actually will receive more federal taxes from those taxpayers who have less itemized state income tax deductions.

The types of pension income covered by the new law include all payments from Internal Revenue Code section 401(a) qualified plans, section 408(k) simplified employee pensions, section 403(a) annuity plans, section 403(b) annuity contracts, section 408 individual retirement accounts, section 457(a) eligible deferred compensation plans, section 414(d) governmental plans, military retired or retainer pay plans, and section 501(c)(18) employee contribution trusts.

However, the law only covers certain payments from nonqualified deferred compensation plans described in Internal Revenue Code section 3121(v), and does not cover any payments from other types of employment-related compensation plans not described in section 3121(v). IRS proposed regulations under section 3121(v) issued January 19, 1996, provide that the types of plans **not** covered by section 3121(v) include stock options, stock appreciation rights, restricted stock, severance, sick leave, compensatory time and vacation pay.

The most common nonqualified deferred compensation plans covered by section 3121(v) (and therefore this new law) include excess plans and deferred bonus plans. Generally payments from section 3121(v) plans are covered by the new law only if they are substantially equal periodic payments made at least annually for the recipient's life or life expectancy (or the joint lives or joint life expectancy of the recipient and the

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For further information on this new federal legislation, please contact employee benefits partner ***William D. Berry*** *or tax partner* ***Jeffrey M. Vesely****, both in the San Francisco office of Pillsbury Madison & Sutro LLP. This bulletin, together with a link to the House Judiciary Committee report for the bill from the GPO Access service, is available on the World Wide Web as part of the Pillsbury Madison & Sutro LLP Tax Page at http://www.pmstax.com/state/bull9602.html.* *© 1996.*

recipient's designated beneficiary), or for a period of at least 10 years. However, this periodic payment rule does not apply if the payments are made from a section 3121(v) plan that is maintained solely to provide benefits in excess of the limitations under Internal Revenue Code section 401(a)(17), 401(k), 401(m), 402(g), 403(b), 408(k) or 415. For example, the new law would cover lump sum payments from these types of excess plans.

Several issues are raised by this new law:

- This new law is not an amendment to the Internal Revenue Code, and it is unclear what, if any, federal agency will interpret it. Accordingly, individual states may take differing positions about what is covered by the law.
- Apparently the prohibition on state income tax applies whenever the individual is a nonresident. For example, if the individual is a resident of California when ten annual installment payments begin, and moves to Nevada after the first three payments are made, the next seven payments will not be subject to California income tax.
- The exception to the periodic payment rule for section 3121(v) plans apparently applies only to plans maintained **solely** to make up benefits limited by the listed Internal Revenue Code sections. Presumably a plan which is more than such an excess plan would be subject to the periodic payment rules. Employers may need to restructure their nonqualified plans to create "pure" excess plans that would be eligible for the periodic payment exception.
- Excess plans that have features not in the underlying qualified plan may not satisfy the exception to the periodic payment rule. A common example would be an excess plan that provides for installment payments rather than the lifetime annuity payments provided under the qualified plan. The technical explanation to the law states that excess plans must provide "...those benefits that would have been provided under the terms of a qualified retirement plan, but for the application of the following limits..."
- Section 3121(v) plans subject to the periodic payment rule presumably can be amended to allow future accruals to be paid over an employee's life expectancy or at least 10 years. However, amending existing payment schedules or the payment rules relating to benefits already accrued could create IRS constructive receipt problems.
- Under the current California rules, section 3121(v) plan payments earned in California payable to nonresidents generally are subject to both California reporting and tax withholding (usually at a 6 percent rate). California presumably will amend these rules in response to this new federal law. However, in the meantime employers should cease withholding on section 3121(v) and other plan payments that meet these new rules.

Text of P.L. 104-95

An Act

To amend title 4 of the United States Code to limit State taxation of certain pension income.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. LIMITATION ON STATE INCOME TAXATION OF CERTAIN PENSION INCOME.

(a) IN GENERAL.–Chapter 4 of title 4, United States Code, is amended by adding at the end the following:

"§ 114. Limitation on State income taxation of certain pension income

"(a) 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).

"(b) For purposes of this section–

"(1) The term 'retirement income' means any income from–

"(A) a qualified trust under section 401(a) of the Internal Revenue Code of 1986 that is exempt under section 501(a) from taxation;

"(B) a simplified employee pension as defined in section 408(k) of such Code;

"(C) an annuity plan described in section 403(a) of such Code;

"(D) an annuity contract described in section 403(b) of such Code;

"(E) an individual retirement plan described in section 7701(a)(37) of such Code;

"(F) an eligible deferred compensation plan (as defined in section 457 of such Code);

"(G) a governmental plan (as defined in section 414(d) of such Code);

"(H) a trust described in section 501(c)(18) of such Code; or

"(I) any plan, program, or arrangement described in section 3121(v)(2)(C) of such Code, if such income–

"(i) is 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, or

"(ii) is a payment received after termination of employment and under a plan, program, or arrangement (to which such employment relates) 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 such Code or any other limitation on contributions or benefits in such Code on plans to which any of such sections apply.

Such term includes any retired or retainer pay of a member or former member of a uniform service computed under chapter 71 of title 10, United States Code.

"(2) The term 'income tax' has the meaning given such term by section 110(c).

"(3) The term 'State' includes any political subdivision of a State, the District of Columbia, and the possessions of the United States.

"(e)[1] Nothing in this section shall be construed as having any effect on the application of section 514 of the Employee Retirement Income Security Act of 1974.".

(b) CONFORMING AMENDMENT.–The table of sections for chapter 4 of title 4, United States Code, is amended by adding at the end the following:

"114. Limitation on State income taxation of certain pension income".

(c) EFFECTIVE DATE.–The amendments made by this section shall apply to amounts received after December 31, 1995.

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1 So in the original; should probably be "(c)".