July 8, 2016

NYS Dept Of Taxation and Finance Advisory Opinion Addresses State Taxation of Lump Sum NQDCP Payment to Former Residents

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During the first quarter of 2016, the New York State Department of Taxation and Finance issued three Advisory Opinions on the application of federal law (4 USC 114) to the issue of whether New York State income tax can be imposed on payments of nonqualified deferred compensation earned by a former New York resident. Each Advisory Opinion concluded no. The Advisory Opinions are referenced as TSB-A-16(1)I (dated March 15, 2016), TSB-A-16(3)I (dated April 22, 2016), and TSB-A-16(4)I (dated April 29, 2016).

The March Advisory Opinion (TSB-A-16(1)I) is the most interesting of the group. It involves the State taxation of a lump sum payment from a voluntary deferred compensation arrangement. The Opinion provides a favorable result and some clarification to a common nonqualified deferred compensation arrangement but, on closer review, the availability of the result could be limited.

FACTS. The March Advisory Opinion addresses the New York taxation of a lump sum payment of voluntary employee contributions to a nonqualified deferred compensation arrangement. As is typical, the deferred amount earned a return from a selected group of investments. The employee retired during August 2014 and ceased being a New York resident on December 31, 2014. Pursuant to the plan, the deferred compensation was paid during early 2015, within the first 90 days of the year following employment termination. The employee selected to receive the nonqualified deferred compensation as a lump sum payment. Between employment termination and the payment date, the aggregate deferred compensation amount continued to fluctuate based on the employee's investment selection.

CONCLUSION AND CRITICAL FACTS. The Opinion concludes that the lump sum payment to the former resident is not subject to New York State income tax. The critical facts that allow for this favorable conclusion are (A) employees can elect to defer portions of salary and bonus compensation only after contributing the maximum amount to the employer's 401(k) plan, (B) only employees whose annual base salary equals or exceeds the Section 401(a)(17) compensation amount (with cost of living adjustments) are eligible to participate, and (C) the investment options subjects the deferred amount to a positive or negative adjustment through the payment date. As discussed below, the second fact is specifically referenced as the basis for the conclusion, which is interesting.

Two main issues are analyzed in reaching the conclusion.

1. FEDERAL SOURCE RULE. 4 USC 114 prevents a State from imposing an income tax on a former resident's nonqualified deferred compensation lump sum payment "if such income is a payment received after termination of employment and under a plan, program, or arrangement (to which the 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 the Code or any other limitation on contributions or benefits in such Code on plans to which any of such sections apply."

Nonqualified deferred compensation arrangements that satisfy this test avoid income taxation by the State where the compensation was deemed earned, even though the amount is paid in a lump sum. If applicable, this exemption avoids having to pay the deferred compensation over at least ten years or over the employee's life expectancy in order to meet a second exemption under the federal source rule.

a. Critical Fact #1. The critical fact towards satisfying this test would seem to be that the employees could elect to defer portions of salary and bonus compensation only after contributing the maximum amount to the employer's 401(k) plan.** Note that this fact is not a required element of nonqualified deferred compensation arrangements, and many arrangements do not have this feature. For those arrangements that contain this feature, this Advisory Opinion seems to clarify that consideration should certainly be given to the availability of the special federal exemption to lump sum payments from nonqualified deferred compensation arrangements.

b. Critical Fact #2. The Opinion does not reference critical fact #1 above as the basis for applying the federal exemption. Instead, the fact that only employees whose annual base salary equals or exceeds the Section 401(a)(17) compensation amount (with cost of living adjustments) are eligible participants is stated as the basis for the application of the federal exemption***. This is somewhat of a surprise in this context. Note that this second feature could be a common element of these arrangements in order to qualify as a "top-hat plan" for ERISA purposes, which means that the arrangement is maintained primarily to provide deferred compensation to a "select group of management or highly compensated employees."

Commentary: Consider Extension to Other States. Arrangements that include this second critical fact should consider the availability of the federal exemption.*** While the Advisory Opinion is issued by the New York State Department of Taxation and Finance on the New York position, consideration should be given to whether the same position could be accepted in other States.**** For arrangements that do not include critical fact #2 and use an alternative method to satisfying "top-hat plan" status, consideration should also be given to whether it is worthwhile to apply the Section 401(a)(17) limitation, which would also allow the federal exemption to apply to lump sum payouts going forward.

2. NEW YORK ACCELERATION OF COMPENSATION INCOME FOR EMPLOYEES WHO CHANGE RESIDENCY. A second issue is very relevant to whether New York can tax the payment of nonqualified deferred compensation to former residents. New York has a special statute (Tax Law Section 639) that requires New York residents who change their status to nonresidents to report and pay tax on compensation that accrues during the residency period. This rule places affected employees on the accrual method of accounting, rather than the cash method. According to the NYS Dept of Taxation and Finance Publication 88 and Instructions to IT-260-I (Change of Resident Status—Special Accruals), compensation is includible in income prior to the change in residency if the employee has a fixed right without restriction or contingencies to the payment and the amount is fixed and determinable with reasonable accuracy before such change of residence.

The Advisory Opinion addresses whether the nonqualified deferred compensation was required to be accrued and taxed in 2014 before the change in residency. The conclusion was no.

Critical Fact #3. The critical facts supporting this conclusion were that (a) the employee did not have a fixed right in 2014 to receive any nonqualified deferred compensation and (b) the deferred compensation amount would fluctuate through the 2015 payment date pursuant to the investment options. The second fact seems the more critical fact, which is commonly found in many deferred compensation arrangements.

Query whether the same favorable conclusion on this point would be reached if the nonqualified arrangement provides only a flat interest rate on the deferred compensation or if the interest ceases to accrue on employment termination.

For possible additional guidance and interpretation on this point, the same issue of immediate taxation of certain amounts when a person's status changes from resident to nonresident arises when an individual leaves the United States. In States that have adopted the same approach, a review of the interpretation given by federal law could be useful. The special New York statute is also found in some other States (e.g., Connecticut, California) and similar consideration would need to be given where an individual leaves those States.

**When certain benefits are contingent on electing to make or not make 401(k) contributions, consideration must be given to whether the contingent benefit prohibition of Reg. 1.401(k)-1(e)(6) applies. A violation can impair the benefits available under the Section 401(k) plan.

***Advisory Opinions are binding only with respect to the person to whom issued.

****A 2000 Massachusetts Department of Revenue ruling (00-1) has broad language that would also allow a lump sum payment from a nonqualified plan that is limited to employees whose compensation exceed the Section 401(a)(17) limit.

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