Lump-Sum Payments From Nonqualified Deferred Compensation Plans To Nonresident of New York Are Exempt From New York Income Tax

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A recent advisory opinion from the New York State Department of Taxation and Finance concludes that payments received by an individual nonresident of New York in settlement of his benefits under two nonqualified deferred compensation plans of his former employer are exempt from New York State and local income tax, even though he performed services for his former employer in New York and each payment was made in a single lump-sum.

Source tax law

The federal "source tax" law, 4 U.S.C. § 114 (Pub. L. No. 104-95), enacted in 1996, essentially provides that only the state of which an individual is a resident or domiciliary may tax the individual on his or her retirement income. So, for example, if an employee participates in a tax-deferred retirement plan covered by the source tax law while working in New York and retires to a state with no income tax before receiving distributions from the plan, those distributions will escape state income tax, in New York or any other state. If, instead, the source tax exemption does not apply to such a former employee's distributions, all or a portion of those distributions would be includible in the former employee's New York source income and subject to New York income tax.

Only "retirement income" that satisfies certain requirements is protected by the source tax law. Retirement income is income from:

- a tax-qualified plan (such as a 401(k) plan) or certain other types of tax-favored retirement plans and arrangements, including individual retirement accounts, or
- (a) a "nonqualified deferred compensation plan" described in § 3121(v)(2)(C) of the Internal Revenue Code of 1986, as amended (the "Code") (essentially, a deferred compensation plan that is not tax-qualified or otherwise tax-favored under a particular provision of the Code), or (b) any plan, program or arrangement that is in writing, that provides for retirement payments in recognition of prior service to be made to a retired partner and that is in effect immediately before retirement begins, in each case, that satisfies the additional requirements described below.

To constitute retirement income, distributions from a nonqualified deferred compensation plan or other plan for retired partners must either be:

- made in a series of substantially equal periodic payments (made not less frequently than annually) for:

  —the life or life expectancy of the recipient (or the joint lives or joint life expectancy of the recipient and the recipient's designated beneficiary), or

  —a period of at least 10 years; or

- payments received after termination of employment under a nonqualified deferred compensation plan "maintained solely for the purpose of providing retirement

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benefits to 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 [the] Code on plans to which any of such sections apply."

Facts

A recently issued advisory opinion of the NY State Department of Taxation and Finance[1] concerns an individual who participated in a supplemental employee retirement plan ("SERP") and a deferred compensation plan of Dime Savings Bank of New York. The individual asserts that both plans were nonqualified deferred compensation plans, as described above. The individual was an executive vice president of Dime, which was headquartered in New York City; however, the individual was never a resident of New York. Dime was acquired by Washington Mutual Bank ("WMB") in January 2002. The individual retired from Dime at the time of the acquisition. Shortly thereafter, he began receiving monthly payments under the SERP and in the year following retirement, he began receiving quarterly payments under the deferred compensation plan. The payments under the SERP were in a fixed amount for life and the quarterly payments under the deferred compensation plan varied on the basis of the earnings from the assets in the individual's account under the plan for a term of 12 years.

In 2008, WMB filed for bankruptcy, was seized by the FDIC and its assets were sold to JPMorgan Chase ("JPMC"). Pursuant to a Global Settlement Agreement, JPMC did not assume the SERP or the deferred compensation plan but was required to "satisfy the obligations to pay or provide any and all benefits with respect to the arrangements" in those plans. Further, JPMC was expressly authorized "to the extent of applicable laws, [to] change the manner and form of those payments."

In May 2012, JPMC disbursed to the individual a lump-sum distribution that represented the present value of the SERP annuity, the balance of the deferred compensation plan and interest during the period of bankruptcy when payments were suspended.

1. TSB-A-13(5)I (April 8, 2013).

Analysis

The advisory opinion notes that both the SERP and the deferred compensation plan are nonqualified deferred compensation plans within the meaning of the source tax law and payments made under those plans would have constituted retirement income exempt from New York income tax pursuant to the source tax law had WMB not commenced bankruptcy proceedings.

The advisory opinion concludes that the fact that the WMB bankruptcy caused the individual to accept a lump-sum payment in settlement of payments that would have constituted retirement income under the source tax law does not change the tax characterization of the payments. The advisory opinion explains that settlement amounts received by compromise or judgment should have the same income tax treatment as the underlying item that was the basis for the settlement. In this case, the unforeseeable act of WMB filing for bankruptcy should not change the income tax treatment of the individual's SERP or deferred compensation plan payments.

Accordingly, the advisory opinion concludes that for New York State and local person income tax purposes, the lump-sum payment received by the individual in settlement of his SERP and deferred compensation plan benefits will be treated as nontaxable retirement income of a person who is not a resident or domiciliary under the source tax law.

Note that an earlier advisory opinion from the NY State Department of Taxation and Finance[2] concluded that even though a participant in a nonqualified deferred compensation plan has the right to elect to receive retirement distributions under the plan in a single lump-sum, where the participant in fact elects to receive his or her distributions in 10 annual installments (and such election becomes irrevocable after retirement), those distributions constitute "retirement income" under the source tax law. Accordingly, since the participants described in this opinion established their domiciles outside New York upon retiring, their distributions from the plan were not subject to New York state income taxes.

2. TSB-A-11(10)I (Nov. 17, 2011).

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