THE NONQUALIFIED ADVISOR

An Independent Resource for Plan Sponsors and Participants of Nonqualified Plans

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Managing State Taxation of Deferred Compensation

Executives planning to save income tax by retiring to Florida or other no tax or low tax jurisdiction may be surprised to find that they may not be able to escape taxation on nonqualified benefits and other forms of deferred compensation. In fact without proper planning, an individual could be subject to state income tax twice on the same retirement income.

The taxation of deferred compensation is not new; however, state taxation has received more attention in recent years as states have grown more aggressive taxing nonresidents on compensation that was technically "earned" their state.

The most common targets for unreported income are nonresident professional athletes, doctors, actors and musicians that perform in the state; however, with the increasing number of former residents that are receiving deferred compensation out of state, nonresident retirees with deferred compensation are likely to be the next target.

Background

For purposes of state taxation, federal law requires a state to have a definite connection or "nexus" with the individual to source income to that state. The most obvious form of nexus is "physical presence," which applies to residents of the state. However, nexus may also apply to nonresidents on income that was "earned" in the state or derived from employment within the state, such as deferred compensation.

The sourcing of state income and state withholding requirements for nonresidents varies by state; however, given that nexus can be established in more than one state, an individual could be subject to state income tax in more than one state. Most states offer residents a tax credit for taxes paid to another state; however, the credit is generally limited to the amount of tax paid to the resident state. Consequently, if there is little or no tax paid to the resident state, there is little or no tax credit available to the individual.

Tax Planning

Before reviewing state regulations for the tax treatment of deferred compensation, one should first consider whether an individual is likely to incur state tax in more than one state. If an employee never plans to reside in another state, state tax planning is probably a waste of time.

When determining if state tax issues exist, an executive will want to consider his or her intended state of residence, state income tax rates of the resident state and the intended state of residence, and whether there are state income exemptions and/or tax credits for nonresidents who pay taxes in other states. If state taxes are still an issue, planning should take place before plan agreements are executed.

Under federal source taxation law, deferred compensation earned by an employee or former employee while a resident but paid when the individual is a nonresident, cannot be subject to that state's income tax if:

i) compensation is payable over the individual's life or life expectancy or is paid in installments scheduled over 10 or more years; or

ii) the compensation is paid under certain qualified retirement plans or "excess plans".

While the definition of "deferred compensation" applies to both qualified and nonqualified plans, nonqualified plans tend to provide a better opportunity for tax planning because benefits are negotiated individually.

State taxation can generally be managed by adjusting the timing and structure of benefit payments to fall within federal regulations and re-balancing the benefit. As a result, taxation is limited to the individual's state of residence and employers are relieved from the administrative burden of monitoring state withholding requirements for multiple states.

For executives and employers who want to modify the terms of an existing nonqualified deferred compensation plan, immediate action is required to meet the deadline for Section 409A transition relief. Under Section 409A, all arrangements providing for nonqualified deferred compensation must be brought into documentary and operational compliance by December 31, 2008. Accordingly, any changes to the payment terms of a benefit plan will need to be executed prior to year end.

As states face looming budget deficits and underfunded pension plans for state employees, states will continue to seek other sources of revenue they may be entitled to. With a little extra planning, executives can minimize their tax liability and avoid being a target of nonresident income tax audits and other state filings.

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