Pennsylvania Department of Revenue

Personal Income Tax

August 3, 2004
Pennsylvania Personal Income Tax
No. PIT-04-020
Compensation/Retirement and Pensions/Rollover of Funds from Retirement Plan to IRA/Withdrawals from IRA

ISSUE

What is the correct tax treatment afforded to amounts distributed from an Individual Retirement Account (IRA) to a Pennsylvania resident before age 59½, given that before becoming a Pennsylvania resident Taxpayer funded the IRA with a combination of funds from a retirement plan and 401(k) savings plan of her former employer.

CONCLUSION

Amounts distributed to the Taxpayer from the IRA before attaining age 59½ are subject to Pennsylvania personal income tax. Taxpayer can, however, use the cost recovery method of accounting, meaning that distributions from this IRA are first deemed non-taxable returns of her own contributions to the 401(k) savings plan and the former employer's retirement plan (if taxpayer made any contributions to the retirement plan).

In the taxable year when Taxpayer begins receiving amounts from the IRA in excess of all of her prior contributions to the 401(k) plan and the pension[1], made while a resident of California, they are subject to Pennsylvania personal income tax until taxpayer attains age 59½.

FACTS

You noted that your wife is the Taxpayer, and she retired from a corporation before she moved to Pennsylvania. You continued by noting that she met the age and length of service criteria for this plan. At the time of her retirement, she elected to take the benefits in the form of a lump sum distribution and she was permitted to transfer the balance to an existing IRC § 401(k) plan, apparently also sponsored by an employer. Thereafter the Taxpayer rolled over the total balance from the 401(k) plan to an IRA, and the assets were invested in several mutual funds. You noted that Taxpayer did not withdraw any sums from the IRA while she resided in California.

Upon moving to Pennsylvania, Taxpayer, although not yet age 59½, began withdrawing funds from the IRA under the exception to the 10 percent additional federal tax imposed on premature withdrawals from retirement plans, which applies when the amounts are withdrawn in substantially equal amounts over the account owner's life expectancy. 26 U.S.C. § 72(t)(2)(A)(iv). The Federal Form 1099R furnished to Taxpayer by the mutual fund company had no state income tax withheld, and it noted in box 7 that the amount was an early distribution but an exception, noted above, applies.

You reviewed the Department's website, including Chapter 07 of the Personal Income Tax Guide, which deals with compensation and the exemption for commonly recognized old age or retirement benefits. You noted that Table 7-8 of this publication states that a distribution from a deferred payment plan is fully taxable if (1) your pension or retirement plan was NOT an eligible plan for Pennsylvania Personal Income Tax purposes or (2) you retired before meeting the age conditions of the plan or years of service conditions of the plan.

You interpret the Personal Income Tax Guide to mean that if Taxpayer's retirement plan was an eligible retirement plan,[2] and she met the age and service requirements for retirement under it, then the early distributions she is receiving from the IRA are not taxable for Pennsylvania purposes.

You are not entirely certain of whether the Department agrees with your analysis. You would like to know if you have interpreted the law correctly, in light of the fact that Taxpayer was not present in Pennsylvania when she retired, she made no contributions to the employer-sponsored retirement plan, 401(k) or IRA from Pennsylvania source income, and all the distributions are from the IRA. You pointed out that in the case of these IRA distributions, the monies are not being distributed directly from a company-sponsored retirement plan.

DISCUSSION

Article III of the Tax Reform Code of 1971 includes the following definition:

> **"Compensation"** means and shall include salaries, wages, commissions, bonuses and incentive payments whether based on profits or otherwise, fees tips and similar remuneration received for services rendered, whether directly or through an agent, or whether in cash or in property.
>
> The term 'compensation' shall not mean or include
> . . . payments commonly recognized as old age or retirement benefits paid to persons retired from service *after reaching a specific age or after a stated period of employment* . . .

72 P.S. § 7301(d)(iii)(emphasis added); *see also* 61 Pa. Code § 101.6(c)(8).[3]

In 2003 the Department issued a number of draft personal income tax bulletins to various bar associations and entities engaged in the accounting profession. These deal with the state tax treatment of pensions, profit sharing plans, defined contribution plans, federally nonqualified deferred compensation plans, IRAs and other deferred payment plans.

The Department is presently reviewing the comments received in relation to these bulletins and it is anticipated that it will change the test(s), on a prospective basis, used to determine which deferred payment plans can make distributions exempt from tax under section 301(d)(iii). Until such time, the Office of Chief Counsel is not issuing private letter rulings on the tax treatment of distributions from pension, profit sharing, deferred compensation and other deferred payment plans. Because your inquiry relates to IRA distributions, however, this office can furnish an opinion to you.

In previous years, the Department interpreted the exemption for retirement pay, in combination with the holding of *Bickford,* to mean that for Pennsylvania Personal Income Tax purposes:

> A deferred payment program constitutes a qualifying retirement program or old age benefit program only if all of the following conditions are met:
>
> 1) The plan is reduced to writing and communicated to the participants;
>
> 2) the plan establishes eligibility requirements for separation from service by retirement on the basis of old age, infirmity, long-continued service or a combination of old age or infirmity and long-continued years of service;
>
> 3) the plan makes provisions for payments based on retirement to be made at regularly recurring intervals to employes after their separation from service by retirement which continue at least until the retired employe's death; and
>
> 4) the plan does not permit the distribution of program benefits to any employe until termination of employment except:
>
> A. incidental disability benefits; or

B. the return of the employe's previously taxed contributions and income or gains thereon, in the case of a contributory retirement benefit plan.

Other deferred payment programs constitute qualifying old age or retirement programs only if all of the following conditions are met:

1. The plan is reduced to writing and communicated to the participants; and

2. Program benefits cannot be paid before retirement, death, disability, separation from service, unforeseeable emergency or the attainment of age 59½, or, if payable before retirement, death, disability, separation from service, unforeseeable emergency or the attainment of age 59½, program benefits are subject to substantial penalty when so paid; and

3. The plan makes provisions for payments to be made at regularly recurring intervals to participants, which continue at least until the participant's death.

If a taxpayer receives a distribution from a deferred payment program that does not meet either of the above criteria, the cost recovery method of accounting must be used to determine the portion of a distribution to be included in income.

Under the present regulation describing the exemption from compensation for old age or retirement benefit plan distributions, amounts distributed from an IRA could be exempt from tax, if the criteria in subparagraph (I) of paragraph (iii)(B) are met. Under this test, which mirrors the statute's rule, an individual must be retired from service after reaching *a specific age* or a *stated period of employment* in order for the plan benefits to be exempt from income tax.

To apply this rule to an IRA exposes one of the weaknesses of the Pennsylvania income tax law, in that an IRA may not necessarily be a plan sponsored by any employer, as in the case of the Taxpayer's IRA account. Thus, when an individual invests funds in an IRA independent of any employer-sponsored retirement plan, there is no "*stated period of employment*",[4] (*see* 72 P.S. § 7301(d)(iii) above) on or after which IRA benefits can qualify for the exemption.

In the absence of receiving guidance from the Pennsylvania General Assembly in relation to IRAs that are not part of any employer-sponsored plan, the Department has interpreted the regulation to mean that age 59½ is the "*specific age*" set forth in the statute's retirement pay exemption (§ 7301(d)(iii) above) which an individual must attain (in combination with terminating employment) in order for the tax exemption to apply. Otherwise, the income or appreciation accumulating on amounts contributed to an IRA would be classified as "interest" under state law. 72 P.S. § 7303(a)(6). Presently there is no retirement exemption in that income class.

In the case of Taxpayer:

1. The amounts rolled over from the employer-sponsored retirement plan and 401(k) savings plan to the IRA would have been exempt from income tax, so long as exempt for federal tax purposes. 61 Pa. Code § 101.6(c)(8)(iii)(A)(II)(*see* above).[5]

2. In making these rollovers, the taxpayer subjected the monies to further transactions. *Willcuts v. Bunn,* 282 U.S. 216, 51 S.Ct. 125 (1931).

3. The Department must rule on the taxability of amounts distributed to Taxpayer from an IRA, and may not analyze the transaction by taking into account whether the taxpayer could have taken distributions directly from an employer sponsored retirement plan or 401(k) plan.[6]

4. Under the exemption from the income class "compensation", the Department interprets the phrase "*benefits paid to persons retired from service after reaching a specific age or a stated period of employment"* 72 P.S. § 7301(d)(iii), to mean that the General Assembly intended IRA distributions to

be entitled to the retirement pay exemption if the individual has terminated his employment (i.e. be "retired", which is one element of the tax exemption in the statute) and attained age 59½.

Because the taxpayer is not yet age 59½, amounts distributed to her are subject to Pennsylvania tax as compensation, but she may use the cost recovery method of accounting in reporting such distributions. (*See Example 1,* in regulation section 101.6(c)(8), pp. 4-5 above). This means that she may first recover, as non-taxable, all of the prior contributions she made, as employee contributions, to the pension plan (if any) and the 401(k) plan,[7] which funded this IRA. In the taxable year when taxpayer begins receiving amounts in excess of her contributions, they are taxable, until she attains age 59½. Thereafter, distributions from the IRA are not taxable.

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[1] These amounts funded the IRA account upon the rollover.

[2] You opined that the retirement plan of your wife's former employer met Pennsylvania requirements and you pointed out that an IRA is considered a qualifying plan also for state tax purposes.

[3] The Department's regulations expressly address IRAs and they are deemed to be old age or retirement benefit plans for Pennsylvania tax purposes:

> (c) Compensation does not mean or include any of the following:
>
> * * * *
>
> Old Age or Retirement Benefit Plans.
>
> (i) *Scope.* For the purpose of this section, the term plan includes Individual Retirement plans (IRA), Simplified Employee Pension Plans (SEP), Keogh plans, Federally qualified employe pension plans and similar old age or retirement benefit plans.
>
> (ii) *Contributions.*
>
> (A) Contributions to a plan made by employers or labor unions on behalf of an employe are excludable from the employe's income, except as otherwise provided in this chapter.
>
> (B) Contributions to a plan made by an employe or other individual directly or indirectly, whether through payroll deduction, a salary reduction agreement or otherwise, are not excludable from his income. Contributions by, on behalf of or attributable to a self-employed person are not excludable from either compensation or net profits from a business, profession or other activity.
>
> (iii) *Distributions.*
>
> (A) Amounts distributed to an individual from a plan shall be included in income to the extent that contributions were not previously included in this income except for either of the following:
>
> (I) Distributions made upon or after his retirement from service after reaching *a specific age or after a stated period of employment.*
>
> (II) Distributions transferred into another plan, where the transferred amounts are not included in income for Federal income tax purposes.
>
> (B) To determine the portion of a distribution to be included in income, an

individual shall use the cost recovery method.

Example 1:

John contributed $1,000 to his IRA. He pays tax on the $1,000 contribution. Three years later the account has earned $750 in income. The total balance of the account at that time is ($1,000 + $750 =) $1,750. John receives a distribution of $750 from his IRA. Since the amount of the distribution does not exceed $1,000, the distribution is not includable in income.

Example 2:

Same facts as Example 1, except that John receives a distribution of $1,500. Since the amount of the distribution exceeds $1,000, the excess of the distribution, $500, is includable in his income, as compensation.

(iv) *Income on plan assets.* Income on assets held in a plan is not includable in income.

61 Pa. Code § 101.6(c)(8)(emphasis added).

[4] For example a federally qualified pension or employee savings plan, sponsored by an employer, might contain a term defining retirement to be age 65 or 25 years of service. In the latter instance, a person retiring after 30 years of service would be “retired” and thus benefits could be exempt from state income tax even though not age 65.

[5] This is provided for your information only. The Department recognizes that the Pennsylvania tax law would have no application to you in earlier years when you resided in the State of California.

[6] The Department is not in possession of the terms of either deferred payment plan, nor would it be significant here, because the assets of each deferred payment plan were liquidated and transferred in connection with the rollovers.

[7] Note that although employee contributions to a retirement plan, including employee deferrals under a 401(k) savings plan *are taxable* in the year of deferral under the Pennsylvania statute, because Taxpayer was a nonresident at the time of these transactions, they would not have been subject to Pennsylvania’s rules. That taxpayer may have not paid tax on her own contributions/deferrals as a result of the tax laws of California will not change the character of these monies as employee contributions. Taxpayer may recover them tax-free when distributed from the IRA, notwithstanding that state income tax may not have been imposed on such deferrals/contributions.

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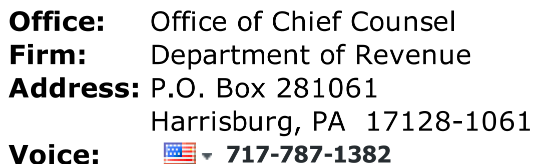

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