New York Tax Treatment of Distributions and Rollovers Relating to Government IRC Section 457 Deferred Compensation Plans

Recent federal legislation has amended Internal Revenue Code (IRC) sections 457 and 3401 to change the characterization of distributions from government section 457 deferred compensation plans. The legislation does not affect the characterization of distributions from the plans of any other exempt organizations. These changes apply to tax years beginning on or after January 1, 2002. The new law provides that distributions from these plans will be characterized as pension or annuity payments. Under prior law, these distributions were characterized as wages. In addition, the new law allows for tax-free transfers, via a trustee-to-trustee transfer, between government section 457 deferred compensation plans and other qualified retirement plans and traditional individual retirement accounts (IRAs). These changes affect the New York tax treatment of distributions from government section 457 plans, effective for tax years beginning on or after January 1, 2002, as described below. Distributions from the section 457 deferred compensation plans of any other tax exempt organization will be addressed in Publication 36, *General Information for Senior Citizens and Retired Persons – For tax year 2002*. When this publication is released, it will be made available on the Tax Department's web site at *www.tax.state.ny.us*.

Pension and Annuity Exclusion

New York State, city of New York and city of Yonkers resident individuals, estates, and trusts

Distributions from government section 457 plans are includible in federal adjusted gross income and therefore are includible in New York adjusted gross income. However, under section 612(c)(3-a) of the New York Tax Law, an individual who has reached the age of 59 ½ may exclude up to $20,000 of certain pension and annuity income included in his or her federal adjusted gross income when computing his or her New York adjusted gross income. Effective for tax years beginning on or after January 1, 2002, distributions from government section 457 deferred compensation plans will qualify for this exclusion, provided the individual is age 59 ½ or older at the time the distribution was received, and the distributions from the plan are being made in periodic payments. *Periodic payments* are a series of payments made over a period of more than one year.

If an individual, estate or trust received pension and annuity income of a decedent, they may also qualify for the up to $20,000 exclusion if the decedent would have been entitled to it, had the decedent continued to live, regardless of the age of the beneficiary.

Important Note: Under the new federal rules, participants in a government section 457 plan may make a tax-free rollover of their section 457 plan funds into an IRA (see *Rollovers to and from Section 457 Plans* on page 5). Taxpayers who wish to withdraw their government section 457 plan funds in a lump-sum or in a series of payments made within one year should note that distributions from an IRA qualify for the $20,000 exclusion even if the payments are not periodic. Accordingly, these taxpayers may wish to first roll-over their government section 457 plan funds into an IRA, thus making them eligible for the exclusion when they withdraw the funds from the IRA (provided they are age 59 ½ or older at the time of the withdrawal).

New York State nonresident individuals

Section 601(e) of the New York State Tax Law imposes a personal income tax on a nonresident individual's taxable income that is derived from New York sources. The tax is equal to the tax computed as if the individual were a New York State resident for the entire year, reduced by certain credits, multiplied by the income percentage.

The numerator of the fraction used to compute the income percentage is the individual's New York source income. The *New York source income* of a nonresident is the sum of the items of income, gain, loss, and deduction entering into federal adjusted gross income derived from or connected with New York sources and any New York additions and subtraction modifications under section 612(b) and 612(c) of the Tax Law that relate to adjusted gross income derived from New York sources. The denominator of the fraction used to compute the income percentage is the nonresident's New York adjusted gross income from all sources for the entire year.

Distributions from a government section 457 plan are included in computing the individual's New York State tax as if a resident and the individual's New York adjusted gross income (the denominator of the income percentage). Therefore, the up to $20,000 pension and annuity exclusion that is allowed to a New York State resident is allowed to a nonresident when computing the nonresident's New York adjusted gross income from all sources for the entire year (the denominator of the income percentage) and the New York State tax as if a resident for the entire year.

Section 114 of Title 4 of the United States Code, effective for tax years beginning after 1995, created a limitation on state income taxation of certain pension income and income from section 457 deferred compensation plans. Under this federal law, distributions from a section 457 deferred compensation plan do not constitute income derived from New York State sources and are not included in New York source income (the numerator of the income percentage). Accordingly, nonresident taxpayers may not claim the up to $20,000 pension and annuity exclusion in computing their New York source income.

New York State nonresident estates and trusts

A nonresident estate or trust computes its New York State personal income tax in the same manner as a nonresident individual. Accordingly, the above rules applicable to nonresident individuals also apply to a nonresident estate or trust in computing the New York source income, New York adjusted gross income, and New York State tax as if a resident for the entire year.

Yonkers nonresident individuals, estates, or trusts

- **Yonkers nonresidents who are full-year New York State residents**

  Generally, a Yonkers nonresident individual, estate, or trust is subject to the Yonkers nonresident earnings tax on wages earned or net earnings from self-employment within that city. For tax years beginning on or after January 1, 2002, distributions from a government section 457 deferred compensation plan received by a Yonkers nonresident who is a New York State resident, do not constitute wages or net earnings from self-employment derived from Yonkers sources and, therefore, are not subject to the nonresident earnings tax.

- **Yonkers nonresidents who are full-year New York State nonresidents**

  In the case of a Yonkers nonresident who is a New York State nonresident, distributions received from a government section 457 plan received in tax years beginning after 1995 are exempt from the Yonkers nonresident earnings tax pursuant to section 114 of Title 4 of the United States Code.

New York State part-year resident individuals

A New York State part-year resident individual computes his or her New York State personal income tax in the same manner as a nonresident individual. However, the New York source income of a part-year resident (the numerator of the income percentage) is the sum of the following:

(1) the individual's New York adjusted gross income from all sources for the resident period, determined as if the individual's tax year for federal income tax purposes were limited to the resident period;

(2) the individual's New York adjusted gross income derived from New York sources for the nonresident period, determined as if the individual's tax year for federal income tax purposes were limited to the nonresident period; and

(3) the special accruals required under section 639 of the Tax Law that relate to adjusted gross income. (If a part-year resident had a right to receive income without restrictions or contingencies at or before the date of the change of residence, that income is accruable at the time of the change of residence, even if the income is actually received after the date of change.)

Under the above rule, the New York source income of a part-year resident individual (the numerator of the income percentage) includes distributions from government section 457 deferred compensation plans received or accrued during his or her resident period. However, if the individual and payment qualify, the individual may exclude from New York source income, under the pension and annuity exclusion, up to $20,000 of government section 457 payments received or accrued during the resident period. Under section 114 of Title 4 of the United States Code, section 457 payments received during the nonresident period are not includible in New York source income, and no pension and annuity exclusion is allowed for those payments.

New York State part-year resident trusts

A part-year resident trust computes its New York State personal income tax in the same manner as a part-year resident individual. Accordingly, the same rules that apply to pension and deferred compensation income received by part-year resident individuals apply to part-year resident trusts.

New York City part-year resident individuals or trusts

A New York City part-year resident individual or trust is subject to the New York City personal income tax for his or her period of residence. For a part-year resident, the New York City personal income tax is computed based on all items of income, gain, loss and deduction received or accrued during the period of residence. Therefore, distributions from a government section 457 plan received or accrued during the period of residence, less the pension and annuity income exclusion of up to $20,000, are subject to the New York City personal income tax.

Yonkers part-year resident individuals or trusts

A Yonkers part-year resident individual or trust is subject to the Yonkers income tax surcharge for the period of residence and, if applicable, the Yonkers nonresident earnings tax for the period of nonresidence. The Yonkers income tax surcharge for the period of residence is equal to the allocated net New York State personal income tax multiplied by the Yonkers income tax surcharge rate. The allocated net New York State tax is equal to the net New York State tax[1] for the entire year multiplied by a fraction. The numerator of the fraction is the individual's or trust's New York adjusted gross income for the period of residence. The denominator of the fraction is the individual's or trust's New York adjusted gross income for the entire year. The nonresident earnings tax, if applicable, is based on wages or net earnings from self-employment derived from Yonkers sources for the period of nonresidence.

If an individual or trust has a change of Yonkers resident status during the tax year, distributions from a government section 457 deferred compensation plan received or accrued during the period of residence, less the pension and annuity income exclusion of up to $20,000, if applicable, would be included in the numerator of the fraction used to compute the allocated net

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[1]*Net New York State tax* is the individual's New York State tax computed as if the individual were a resident for the entire year, reduced by any New York State credits, and increased by any other New York State taxes.

New York State tax. For the treatment of distributions received during the nonresident period, see *Yonkers nonresident individuals, estates or trusts*, on page 3.

Rollovers to and from Section 457 Plans

After December 31, 2001, participants of a government section 457 plan can rollover their funds tax-free for federal income tax purposes to other government section 457 plans, individual retirement accounts (IRAs) or other qualified plans. Since the New York State income tax conforms to the federal income tax, these tax-free rollovers are not included in New York adjusted gross income, and will not be subject to New York State, New York City, or Yonkers resident income taxes. In the case of nonresidents and part-year residents, these rollovers are not included in the numerator or denominator of the income percentage, and are not included in the computation of the individual's or trust's tax as if a resident for the entire year.