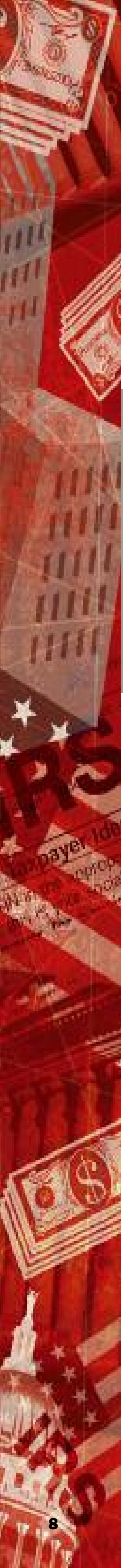

State Income Tax and IRAs

Just as state income tax rates vary from state to state, so do the treatment and rules for taxing distributions from a retirement plan. When researching places to live during retirement, individuals (and their tax advisors) should remember to consider how a particular state taxes retirement income.

Retirement is commonly thought of as the golden years when a person gets to relax and enjoy life without the hassle of work. It might be referred to as the "Me" or "Our" years. Often, a retired person or couple elects to move to another part of the United States to enjoy this period of their lives in a milder climate, an area with less congestion, or simply a new environment. Regardless of the reason, it's always wise to research the prospective areas to learn about the positive and negative attributes before making a final decision on where to relocate.

Most retirees understand that their retirement income is subject to federal income tax regardless of where they move in the U.S. Because this tax system is a national tax, it will be the same in whichever state they live. The same can't be said about state income taxes, however, which vary across the different states from zero to double-digit tax rates. When considering a move for retirement, many individuals fail to recognize or consider that their retirement income can be taxed differently in each state.

Presently, 43 states and the District of Columbia have a state income tax system. But within these states, many have special rules for taxing distributions from a retirement plan based on the plan itself or the manner in which the income is received. For instance, the tax can vary if the retirement income comes from a qualified retirement plan, a traditional IRA, or a nonqualified retirement plan, and it can treat an annuity differently from a lump sum payout. Further complicating things, states differ on whether or not they recognize the basis of an IRA established by the taxpayer while residing in another state. This article highlights some of the state-related issues an individual with an IRA should investigate when considering a move or remaining in a state during retirement.

State Tax Basis of an IRA

Not all states with a state income tax permit a taxpayer to deduct his or her contributions to an IRA. For example, Massachusetts, New Jersey, and Pennsylvania don't permit a deduction for contributions to an IRA. Likewise, some taxpayers may have made nondeductible contributions to their IRA, which may or may not have been deductible for state income tax purposes. As a result, these taxpayers have established a state tax basis in their IRA that wouldn't be included in gross state income when the taxpayer takes a distribution from the IRA. If the taxpayer relocates to another state during his or her career or after retiring, however, the question is whether the basis in the state where the contributions were initially made carries over to the new state where the withdrawal occurs. In general, the answer is, no, which means the taxpayer could actually pay tax on the nondeducted contributions to both states. The taxpayer pays state income taxes to the state where he or she resides when the amount is contributed to the IRA and then again on the same amount to the new state of residence where the distribution is received. There are a few exceptions to this general rule. Oregon and Virginia, for example, permit a resident taxpayer an adjustment to the distribution from a traditional IRA, Keogh plan, or a simplified employee pension (SEP) plan for the contributions that have been previously taxed by another state. For those resident taxpayers in Oregon, there are some conditions that need to be satisfied to employ this adjustment (see 1999 Ore. Laws 746, §316.680(1)(g)).

State Exclusion Amounts

The basis of an IRA isn't relevant in those cases where a person relocates to a state that doesn't have an income tax or doesn't tax a retiree's retirement income, such as Pennsylvania, Illinois, and Mississippi. Other states might provide a retiree the opportunity to exclude a portion of the taxable distribution. The exclusion amount varies among these states and in some cases may depend on some other aspect of the retiree, such as age and marital status. For example, South Carolina provides a $3,000 annual deduction per spouse for retirement income received before age 65 and a $10,000 annual deduction per spouse at age 65 or over (S.C. Code Ann. §12-6-1170). Wisconsin provides up to $5,000 of certain retirement income if the taxpayer (or spouse, if married filing jointly) is age 65 or older on December 31 and the taxpayer's federal adjusted gross income (AGI) is less than $15,000 (or $30,000, if married filing jointly). Delaware provides a pension exclusion of up to $12,500 per person for taxpayers who are age 60 or older and up to $2,000 per person for taxpayers who are under age 60 (Del. Code Ann. tit. 30, § 1106). One way to learn the provisions of a state is to check out its website, many of which have actually gotten pretty sophisticated. This provision varies among the states, and some states have provided specific information for retirement income on the Web (see, for example, N.Y. State Department of Taxation and Finance's Publication 36, "General Information for Senior Citizens and Retired Persons").

An interesting question arises for those taxpayers with a January 1 birthday: When does the retiree satisfy the age requirement for the exclusion provision, December 31 or January 1? Some states specifically address this issue, but not all. Colorado residents qualify if they're over age 55 as of December 31 of the taxable year. Delaware and South Carolina, on the other hand, don't stipulate the date, and, as a result, the taxpayer's age is presumably determined on December 31 of the taxable year.

IRA to Roth IRA Conversions

The ability to convert assets held in a traditional IRA to a Roth IRA became attractive to many higher-income taxpayers beginning in 2010 when the $100,000 threshold limitation was repealed. For conversions made in 2010, taxpayers were able to split the tax amount and allocate the two portions on their conversion to 2011 and 2012. But the taxable amount associated with any conversions made after 2010 are included in the year of conversion.

At the state income tax level, there are a number of oddities. Most states follow the federal income tax rules on a conversion with a few exceptions. Massachusetts and New Jersey include in state gross income only the state-taxable portion of the conversion distribution, which in general differs from the federal taxable portion. Illinois and Pennsylvania don't include the taxable portion of a qualified conversion in state gross income. The position of both states is consistent with the fact that distributions from qualified traditional IRAs are excluded from state gross income in both states.

As previously mentioned, many states have exclusion rules for some portion of taxable retirement income. Thus, the natural issue is whether these rules apply to the taxable portion of the conversion. The solution is that you need to check out the state's rules in this area. Iowa, Kentucky, and North Carolina, for example, permit taxpayers who are eligible to elect retirement exclusion to apply the exclusion to all or part of the taxable portion of a conversion rollover. Colorado provides in "FYI—Pension/Annuity Subtraction (updated November 2007)" that the rollover amount included in federal AGI as an IRA distribution qualifies for the pension subtraction in the year the amount is received in gross income if the taxpayer is age 55 or older as of December 31 of that year. This provision applies whether the rollover is reported in full in the year of the conversion or reported over a four-year period, which was an option for conversions in the 1990s. In light of this provision, one can only conclude that the two-year carryover provision for conversions will receive similar treatment in Colorado.

The real challenge to a conversion is determining the state income tax action that applies when a taxpayer moves during the same year in which the conversion is made. The solution depends on the state as well as when the conversion occurred. Oregon, for example, requires the entire taxable amount of a conversion to a Roth IRA to be included in state gross income if the taxpayer is a resident of Oregon at the time of the conversion (see Publication 17½, "Oregon Individual Income Tax Guide," 150-101-431, rev. December 2011). Kentucky requires that the entire taxable amount be included in state gross income in the case of an "inbound" taxpayer who has already moved into the state—or an "outbound" taxpayer who hasn't yet left the state—at the time of the conversion. Iowa requires a taxpayer who resides in the state for part of the year to include only the portion of the taxable amount of the conversion attributable to the months of residence. For this purpose, a month is a period longer than half a month spent in Iowa. Thus, a taxpayer who spends 16 or more days of the month (15 days for February) in Iowa is credited with being a resident of Iowa for that month. California, like Iowa, taxes the portion of the current year's taxable income based on the taxpayer's residency in the state, but California's allocation is based on residency days, not residency months.

As one might suspect, these are but a few of the state income tax pits out there for retirees or even those moving around the country for career advancement. The best advice for those individuals and their tax advisors is to check out the state's website or the latest edition of *Individual Retirement Account Answer Book*, edited by Martin Fleisher and JoAnn Lippe and published by Aspen Publishers, from which much of this material has been drawn. **SF**

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