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RE: Taxation of Pensions Under the Hawaii Net Income Tax Law: Deferred Compensation Arrangements: Rollover IRAs: Sub-Accounts of Pension Plans; Social Security and Railroad Retirement Act Benefits: Limitation on Deductions for Contributions to a Nonqualified Plan

This Tax Information Release (TIR) answers questions that have arisen since adoption of new Hawaii Administrative Rules (HAR) sections 18-235-7-02 and 18-235-7-03, regarding treatment under the Net Income Tax Law of public and private retirement benefits.

A. What Are Some Examples of Elective Arrangements that Are Not Eligible for the Pension Exclusion?

Section 235-7(a)(2) and (3), Hawaii Revised Statutes (HRS), states that certain kinds of pensions, whether paid by public or private employers, are not subject to the Hawaii income tax.

TIR No. 53-77, issued in January 1978, stated that not all retirement benefits are eligible for this tax exclusion. If an employee invests his or her money in a tax-deferred annuity or an individual retirement account (IRA), a distribution from the annuity or from the IRA is considered to be a return from an individual investment and is not considered to be an excluded pension.

Sections 18-235-7-02(e) and 18-235-7-03(c), HAR, clarified that if an employee has made contributions under an elective right to a plan (sometimes known as a “deferred compensation plan”), distributions from the plan are considered to be returns from an individual investment and do not qualify as an excluded pension. Generally, a deferred compensation plan is any plan in which the employee has a choice of whether to contribute money into the plan or to take that amount in cash or property.

This section provides examples of deferred compensation plans that are not eligible for the exclusion.

1. **Cash or deferred arrangements,** popularly known as **“401(k) plans”** (section 401(k), Internal Revenue Code (IRC)), are generally funded by way of an election an employee makes to have the employer make payments to the plan on behalf of the employee, or to the employee directly in cash. To that extent, such plans are not eligible for the exclusion and distributions from such plans are taxable.

In some 401(k) plans, the employer makes **matching contributions** to the plan (section 401(m)(4)(A), IRC). If a 401(k) plan is funded by this type of contribution, part of the plan will be considered to be employer-funded. An exclusion ratio will be used to determine that part of the distribution that is excluded. Section 18-235-7-03(e), HAR, prescribes the procedure to compute the exclusion ratio.

In other plans, the employee is required to make a nonelective contribution (section 1.401(k)-l(g)(10), Treasury Regulations, including a nonelective contribution under section 401(m)(4)(C), IRC). Under such nonelective contribution provisions, the employee does not have the right to have the contributions paid to the employee in cash. Accordingly, contributions of this nature shall be considered employer-funded as well.

2. **Salary reduction simplified employee pension (SARSEP) plans** (section 408(k)(6), IRC) are generally funded through salary reduction arrangements through which an employee may elect to have the employer make a contribution to an employee's IRA, or make the payment to the employee directly in cash. To that extent, such plans are not eligible for the exclusion and distributions from such plans are taxable.

In contrast, **simplified employee pension (SEP) plans** (section 408(k)(l), IRC) are generally considered to be employer-funded pension plans. Distributions from a SEP plan are, generally, excluded.

3. **IRAs** that are funded by an individual employee (rather than by a rollover from an employer plan) are, in general, deferred compensation plans the distributions from which are fully taxable.

If, however, the contributing individual's IRA deduction is **disallowed** in whole or in part, the disallowed amount is treated as a contribution of previously taxed income. When the IRA makes a distribution, part of the money is treated as money on which the recipient has already paid tax, and that part is not taxed again.

4. In **teachers' tax sheltered annuity plans,** or similar arrangements in which an employee of a charitable organization or a public school purchases an annuity through a salary reduction arrangement (sections 403(b) and 3121 (a)(5)(D), IRC), the employee may elect to have the employer contribute to an annuity arrangement or make the payment to the employee directly in cash. To the extent of the amounts subject to the election, such plans are not eligible for the exclusion and distributions from such plans are taxable.

If, however, the deferral was not allowed under Hawaii law and the individual paid Hawaii income tax on the gross salary amount (for example, if contributions were made in calendar year 1981 or earlier, before Hawaii's adoption of section 403(b), IRC), the disallowed amount is treated as a contribution of previously taxed income. When the plan makes a distribution, part of the money is treated as money on which the recipient has already paid tax, and that part is not taxed again.

Pension trusts created before June 25, 1959, that are exempt from federal taxation (section 501(c)(18), IRC, to the extent that the employee is allowed a deduction under sections 219(b)(3) and 501(c)(18)(D), IRC) are not eligible for the exclusion and distributions from such plans are taxable.

If the employee was not allowed a deduction for the contribution, the disallowed amount is treated as a contribution of previously taxed income, and that amount is not taxed again.

6. The **State** of **Hawaii Deferred Compensation Plan** established by chapter 88E, HRS, or other deferred compensation plans of tax-exempt organizations or state or local governments (section 457, IRC) are not eligible for the exclusion. The **Federal Thrift Savings Fund** is treated the same as a cash or deferred arrangement (section 7701(j), IRC) and also not eligible for the exclusion.

7. If **the employer and the employee are the same individual** (i.e., the person involved is self-employed), any plan of any type (whether or not any of the above paragraphs apply) is considered a deferred compensation plan and distributions to <u>that particular employee</u> are not eligible for the exclusion. If the plan benefits other employees of the same employer, distributions from the plan to the other employees are not disqualified because of this paragraph. Those distributions may or may not be taxable. For more information, see TIR No. 53-77.

B. <u>How Do the New Rules Treat Rollover IRAs and Other Trustee-to-Trustee Transfers?</u>

Section 18-235-7-03(d)(2), HAR, states that when amounts are transferred directly between plans, such as when money is paid into a rollover IRA, the recipient plan is, in essence, treated as a continuation of the original plan. Tax Information Release No. 63-79, which stated that earnings in a rollover account are treated differently from earnings in the original plan, is superseded by the rule in section 18-235-7-03(d)(2), HAR.

The new rule will be applied to amounts that are earned on or after January 1, 1995.

A question has been asked about amounts in an employer-funded qualified plan that are rolled over into an **IRA for a surviving spouse** when the participant spouse dies (section 402(c)(9), IRC). As discussed above, a rollover account is treated as a continuation of the original plan. Hence, a distribution from the rollover IRA that is paid to the surviving spouse, or a beneficiary that had been designated by the participant (now deceased) spouse, qualifies as a pension. Where the surviving spouse designates a beneficiary who was **not** designated by the participant spouse, the distribution shall **not** qualify as a pension.

C. <u>Can Sub-Accounts of Pension Plans Be Used to Keep Deferred Compensation Plans Separate from Qualifying Employer-Funded Pensions?</u>

Pension plans sometimes keep sub-accounts for their beneficiaries corresponding to different plan features. For example, a plan may keep a separate sub-account for rollover contributions that it accepts, or for 401(k) contributions, in order to keep them separate from employer contributions (which may be subject to a different vesting schedule). If a plan keeps records in sufficient detail to segregate a participant's sub-accounts, then the sub-accounts may be treated as separate plans for purposes of computing the applicable exclusion ratios. Often, this method will result in one sub-account having an exclusion ratio of zero and another having an exclusion ratio of one, which may greatly simplify the process of computing how much is taxable under state law.

Example: Employer A has a qualified profit sharing plan, P, which allows employees to contribute to it under a section 401(k), IRC, cash or deferred arrangement. P's plan administrator keeps participant sub-accounts for 401 (k) contributions and the profit sharing contributions. There are no section 401(m)(4), IRC, qualified nonelective contributions or employer matching contributions.

In 1994, P distributes $1000 to employee E, who retired in 1993. P's plan administrator determines that of the $1000, $750 came from the profit sharing sub-account and $250 came from the 401(k) sub-account. E may treat the sub-accounts as different plans, namely: (1) a profit sharing plan which is fully employer-funded, and (2) a 401(k) plan. The profit sharing plan has an exclusion ratio of one. The 401(k) plan has an exclusion ratio of zero. E may exclude $750 from taxable income under section 235-7(a)(3), HRS. The $250, however, is taxable income to E.

D. Are Social Security and Railroad Retirement Act Benefits Affected?

Social Security Act and first tier Railroad Retirement Act benefits continue to be exempt from the net income tax. These benefits are exempt under Act 99, SLH 1984, which added section 235-2.3(b)(3), HRS. Thus, although Social Security and Railroad Retirement Act benefits are not mentioned in the new pension rules, there is no change in Hawaii's net income tax treatment of those benefits.

E. How Are Deductions for *Contributions* to a Nonqualified Plan Treated Under Hawaii Law?

Some employers have retirement plans that are not "qualified plans" (as defined in section 401, IRC). For those kinds of plans, section 83 or 404(a)(5), IRC, governs when an employer may deduct contributions to the plan and when an employee includes distributions from the plan in gross income. (This discussion uses the terms "employer" and "employee", but the same principles apply when the service provider is an independent contractor.)

Section 83(h) and 404(a)(5), IRC, both state that an employer may deduct an amount contributed to a nonqualified plan as a business expense for the taxable year in which the amount is included in the gross income of the employee.

Section 1.404(a)-12(b)(l), Treasury Regulations, states that an employer may take a deduction under section 404(a)(5), IRC, when a distribution is made to an employee under the plan, whether or not the employee is able to exclude the payment from the employee's gross income under section 101(b) or subchapter N, IRC.

Section 235-7(a)(3), HRS, provides that a qualifying distribution is excluded from gross income, adjusted gross income, and taxable income of the employee. Consistent with the Treasury Regulation mentioned above, the Department shall interpret section 83(h) and 404(a)(5), IRC, to permit the deduction whether or not the pension exclusion applies to the employee to whom the distribution is made. Thus, an employer may deduct an amount contributed to a nonqualified plan at the same time the deduction is allowed under federal rules. The Department shall apply this reasoning to nonqualified plans described in either section 83 or 404(a)(5), IRC.

Section 83(b), IRC, allows an employee to **elect to include an amount in gross income** when the amount is contributed to the nonqualified plan instead of when the employee receives the distribution from the plan. Under Treasury Regulation section 1.83-2, the election is made by preparing and filing a signed written statement with the Internal Revenue Service. If an employee makes a proper section 83(b) election, the amount in question will not qualify for the pension exclusion because it is considered to have been received by the employee prior to retirement, disability or death. See section 18-235-7-03(c), HAR. Thus, if the election is made, the amount will be deductible by the employer, and will be included in the gross income of the employee, at the time of contribution. In this situation, the tax treatment of the employer and employee will be the same under state and federal rules.

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HRS Sections Explained: HRS §§235-2.3(b)(3), 235-7(a)(2), 235-7(a)(3)

Rules Sections Explained: §§18-235-7-02, 18-235-7-03