State income tax sourcing rules

The general rule for state income taxation of nonqualified deferred compensation is that distributions are taxed by the state where the compensation was **originally earned** (i.e., generally the jurisdiction where the participant resided[1] when income was originally deferred). This is true regardless of where the participant is living at the time of distribution. However, this result could be different in a nonqualified plan if one of two exceptions applies:

1) Periodic payments:
   - The distribution is a payment based on a period of 10 years or more, or
   - The distribution is for the life or life expectancy of the recipient (or the joint lives or joint life expectancies of the recipient and the designated beneficiary of the recipient).
2) Plans designed to restore benefits above the qualified plan limits:
   A nonqualified plan designed specifically to provide retirement benefits that restore benefits lost due to statutory limits on qualified plans. This rule applies only to distributions occurring after termination of employment. The periodic payment rule does not apply.

If the duration of annual (or more frequent) installments is 10 years or more, the participant can be taxed only in their **current** state of residence. If the duration of these installments is less than 10 years, the participant can be taxed by the state where the income was earned and deferred. Consequently, the selected period of distribution (i.e., 10 years or more, or less than 10 years) may provide certain tax advantages.

Coordination of state income tax rules and nonqualified deferred compensation plan design

It's important to understand the variety of issues that determine how state income taxation will affect nonqualified deferred compensation plan distributions.

State income tax considerations

- **Credit**. A participant who has changed a state of residence and now receives a distribution based on the state where the income was earned or reported may be eligible for a credit for taxes paid to the previous state. It's important that participants consult their tax advisor to understand how these laws apply to them.
- **Record retention**. A participant who resided in more than one state while deferring may be subject to tax in each of those states upon distribution. As such, it's important to maintain records as to where a participant earns income.
- **Tax rates**. State tax rates differ significantly (with some as low as 0% and as high as over 13%) and may change over time.
- **Legal domicile**. The definition of domicile varies by state, so it's important that participants with a residence in more than one state consult with local counsel to understand which definition applies.

Nonqualified deferred compensation plan considerations

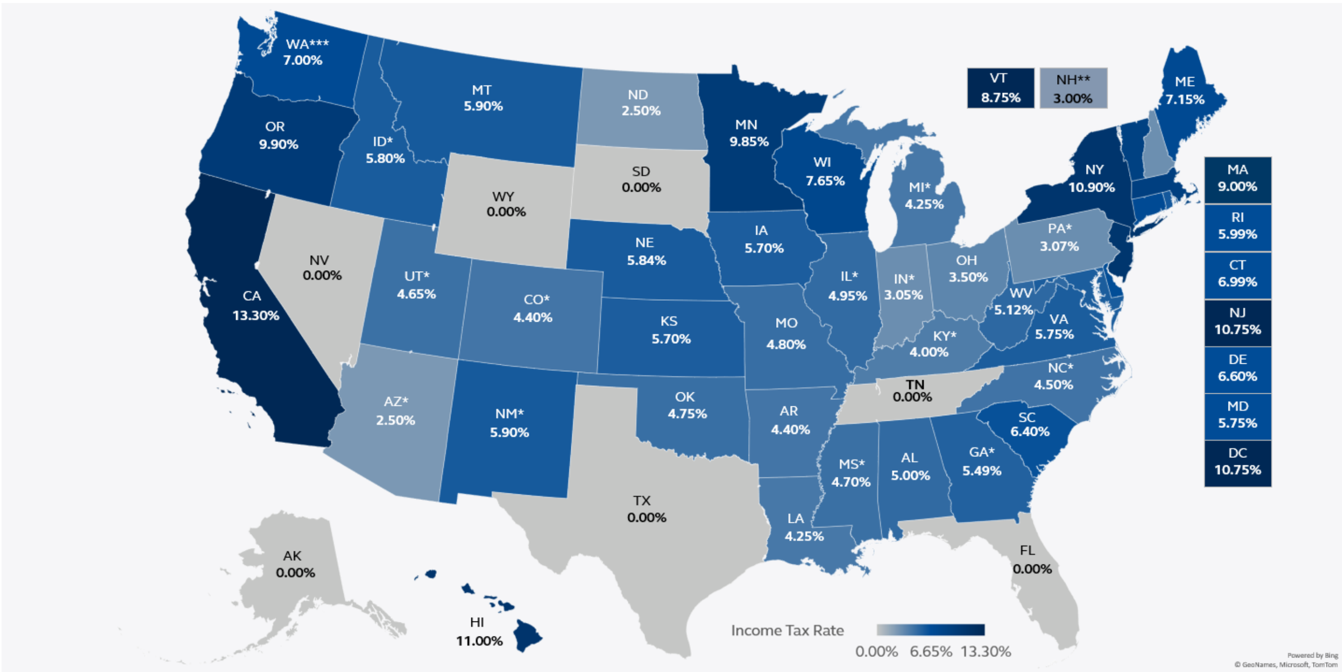
- **Re-deferral and anti-acceleration**. The IRC Section 409A re-deferral rule (i.e., sometimes called the "12 month/5 year" rule) may be used to extend the payout period for 10 or more years (if the plan so provides). However, distributions may not be accelerated after initial deferral.
- **Market fluctuation**. The value of the account balance may change due to market fluctuation of reference investments.

In addition to the state income tax and nonqualified deferred compensation plan considerations, a participant may want to consider the following factors when deciding the duration of the installment payment stream.

Consider a longer payout (10 years or more) if the:	**Consider a shorter payout (less than 10 years) if the:**
State in which a participant anticipates retiring has a lower (or no) income tax rate compared to the state where the contributions were earned	State in which a participant anticipates retiring has a same or higher income tax rate compared to the state where the contributions were earned
Participant wishes to reduce tax liability by spreading it out over more years, especially applicable if anticipated state of retirement has graduated tax rates[2]	Participant is concerned about employer creditor risk
Participant desires to enjoy the benefit of tax deferred growth for a longer period of time	Participant requires access to funds

Please note that retirement income from qualified plans and eligible IRC Section 457 plans is taxed according to the laws of the state in which the recipient resides when the income is received.[3]

Top State Marginal Individual Income Tax Rate, 2024



* State has a flat income tax.
** State only taxes interest and dividend income.
*** State only taxes capital gains income.
Map shows top marginal income tax rate in each state, not effective marginal tax rates, which would include the effects of phase-outs of various tax preferences. Local income taxes are not included. Sources: Tax Foundation; state tax statutes, forms, and instructions; Bloomberg BNA.

[1] Although these materials refer to “residency,” generally it is the individual’s domicile that will dictate which state is entitled to taxation from the distribution. A person’s domicile is their legal residence, determined under rules that vary greatly by state. The determination of “domicile” is especially relevant for participants who have resided in more than one state during the tax year. It is important that participants consult their tax advisor to understand how domicile rules apply to them.
[2] In states that have a graduated tax system, the tax rate goes up as the taxable income amount increases. (Also called a progressive tax.) Other states have a flat tax rate, and all taxpayers pay one rate, regardless of income.
[3] See 4 U.S. Code §114 (as added by P. L. 104-95, §1(a)).

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