New York State Department of Taxation and Finance
Office of Tax Policy Analysis
Technical Services Division

TSB-A-06(10)I
Income Tax
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STATE OF NEW YORK
COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION PETITION NO. I060920B

On September 20, 2006, a Petition for Advisory Opinion was received from Eric D. Krouse, 5710 Commons Park Drive, East Syracuse, New York 13057.

The issue raised by Petitioner, Eric D. Krouse, is whether retirement benefits received from an Internal Revenue Code (IRC) section 403(b) tax-deferred annuity plan (IRC 403(b) plan) are exempt from New York personal income tax pursuant to section 612(c)(3)(i) of the Tax Law and section 112.3(c)(1)(i) of the New York State personal income tax regulations (Regulations) if an individual directs the custodian of the current New York State-sponsored IRC 403(b) plan to transfer funds from the plan to another IRC 403(b) plan.

Petitioner submits the following facts as the basis for this Advisory Opinion.

Petitioner's client is an individual employed by the state of New York (i.e., State University of New York). New York State sponsors an IRC 403(b) plan for its employees. The individual currently participates in an IRC 403(b) plan with a custodian sponsored by New York State. The IRC 403(b) plan is funded by contributions by New York State or through salary deferrals of the participants, or both.

Upon retirement, the individual may direct the custodian of the New York State-sponsored IRC 403(b) plan to transfer funds from the plan to a custodian of another IRC 403(b) plan. The second IRC 403(b) plan is not sponsored by New York State. After funds are transferred, no further contributions will be made to the second plan.

Applicable law and regulations

Section 401(f) of the IRC provides, in part:

> Certain custodial accounts and contracts. For purposes of this title, a custodial account, an annuity contract, or a contract (other than a life, health or accident, property, casualty, or liability insurance contract) issued by an insurance company qualified to do business in a State shall be treated as a qualified trust under this section if –
>
> (1) the custodial account or contract would, except for the fact that it is not a trust, constitute a qualified trust under this section, and
>
> (2) in the case of a custodial account the assets thereof are held by a bank (as defined in section 408(n)) or another person who demonstrates, to the satisfaction of the

Secretary, that the manner in which he will hold the assets will be consistent with the requirements of this section.

For purposes of this title, in the case of a custodial account or contract treated as a qualified trust under this section by reason of this subsection, the person holding the assets of such account or holding such contract shall be treated as the trustee thereof.

Section 401(g) of the IRC provides:

Annuity defined. For purposes of this section and sections 402, 403, and 404, the term "annuity" includes a face-amount certificate, as defined in section 2(a)(15) of the Investment Company Act of 1940 (15 U.S.C., sec. 80a-2); but does not include any contract or certificate issued after December 31, 1962, which is transferable, if any person other than the trustee of a trust described in section 401(a) which is exempt from tax under section 501(a) is the owner of such contract or certificate.

Section 403(b)(1) of the IRC contains employee annuity provisions for a beneficiary under an annuity purchased by a public school, and provides, in part:

General rule. If –

(A) an annuity contract is purchased -

(i) for an employee by an employer described in section 501(c)(3) which is exempt from tax under section 501(a),

(ii) for an employee (other than an employee described in clause (i)), who performs services for an educational organization described in section 170(b)(1)(A)(ii), by an employer which is a State, a political subdivision of a State, or an agency or instrumentality of any one or more of the foregoing …

* * *

(B) such annuity contract is not subject to subsection (a),

(C) the employee's rights under the contract are nonforfeitable, except for failure to pay future premiums,

* * *

and

(E) in the case of a contract purchased under a salary reduction agreement, the contract meets the requirements of section 401(a)(30),

then contributions and other additions by such employer for such annuity contract shall be excluded from the gross income of the employee for the taxable year to the extent that the aggregate of such contributions and additions (when expressed as an annual addition (within the meaning of section 415(c)(2))) does not exceed the applicable limit under section 415. The amount actually distributed to any distributee under such contract shall be taxable to the distributee (in the year in which so distributed) under section 72 (relating to annuities)....

Section 403(b)(7)(A) of the IRC provides:

Amounts paid treated as contributions. For purposes of this title, amounts paid by an employer described in paragraph (1)(A) to a custodial account which satisfies the requirements of section 401(f)(2) shall be treated as amounts contributed by him for an annuity contract for his employee if –

(i) the amounts are to be invested in regulated investment company stock to be held in that custodial account, and

(ii) under the custodial account no such amounts may be paid or made available to any distributee before the employee dies, attains age 59 ½, has a severance from employment, becomes disabled (within the meaning of section 72(m)(7)), or in the case of contributions made pursuant to a salary reduction agreement (within the meaning of section 3121(a)(5)(D)), encounters financial hardship.

Section 403(b)(8)(A) of the IRC provides:

General rule. If

(i) any portion of the balance to the credit of an employee in an annuity contract described in paragraph (1) is paid to him in an eligible rollover distribution (within the meaning of section 402(c)(4)),

(ii) the employee transfers any portion of the property he receives in such distribution to an eligible retirement plan described in section 402(c)(8)(B), and

(iii) in the case of a distribution of property other than money, the property so transferred consists of the property distributed,

then such distribution (to the extent so transferred) shall not be includible in gross income for the taxable year in which paid.

Section 403(b)(11) of the IRC provides:

Requirement that distributions not begin before age 59½, severance from employment, death, or disability. This subsection shall not apply to any annuity contract unless under such contract distributions attributable to contributions made pursuant to a salary reduction agreement (within the meaning of section 402(g)(3)(C)) may be paid only –

(A) when the employee attains age 59 ½, has a severance from employment, dies, or becomes disabled (within the meaning of section 72(m)(7)), or

(B) in the case of hardship.

Such contract may not provide for the distribution of any income attributable to such contributions in the case of hardship.

Section 501(c)(3) of the IRC provides:

Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

Section 612(a) of the Tax Law provides:

General. The New York adjusted gross income of a resident individual means his federal adjusted gross income as defined in the laws of the United States for the taxable year, with the modifications specified in this section.

Section 612(c) of the Tax Law provides, in part:

Modifications reducing federal adjusted gross income. There shall be subtracted from federal adjusted gross income:

* * *

(3)(i) Pensions to officers and employees of this state, its subdivisions and agencies, to the extent includible in gross income for federal income tax purposes;

* * *

(3-a) Pensions and annuities received by an individual who has attained the age of fifty-nine and one-half, not otherwise excluded pursuant to paragraph three of this subsection, to the extent includible in gross income for federal income tax purposes, but not in excess of twenty thousand dollars, which are periodic payments attributable to personal services performed by such individual prior to his retirement from employment, which arise (i) from an employer-employee relationship or (ii) from contributions to a retirement plan which are deductible for federal income tax purposes. However, the term "pensions and annuities" shall also include distributions received by an individual who has attained the age of fifty-nine and one-half from an individual retirement account or an individual retirement annuity, as defined in section four hundred eight of the internal revenue code, and distributions received by an individual who has attained the age of fifty-nine and one-half from self-employed individual and owner-employee retirement plans which qualify under section four hundred one of the internal revenue code, whether or not the payments are periodic in nature. Nevertheless, the term "pensions and annuities" shall not include any lump sum distribution, as defined in subparagraph (A) of paragraph four of subsection (e) of section four hundred two of the internal revenue code and taxed under section six hundred three of this article. Where a husband and wife file a joint state personal income tax return, the modification provided for in this paragraph shall be computed as if they were filing separate state personal income tax returns. Where a payment would otherwise come within the meaning of the term "pensions and annuities" as set forth in this paragraph, except that such individual is deceased, such payment shall, nevertheless, be treated as a pension or annuity for purposes of this paragraph if such payment is received by such individual's beneficiary.

Section 112.3(c)(1) of the Regulations provides:

Pensions and other retirement benefits paid to public officers and public employees of New York State, its political subdivisions or agencies or the Federal government (Tax Law, §612(c)(3)).

(i) Retirement benefits provided for in clauses *(a)* and *(b)* of this subparagraph which are included in Federal adjusted gross income, relate to services performed as public officers or public employees and all or a portion of which are actually contributed to (rather than merely being deemed contributed to) by New York State, its political subdivisions or agencies or the Federal government, shall be subtracted in computing New York adjusted gross income:

(a) pensions and other retirement benefits (including, but not limited to, annuities, interest and lump sum payments) paid to a public officer or public employee or the beneficiary of a deceased public officer or deceased public employee of New York State, its political subdivisions or agencies;

(b) pensions and other retirement benefits (including but not limited to annuities, interest and lump sum payments) paid to a public officer or public employee or the beneficiary of a deceased public officer or deceased public employee of the United States, its territories or possessions, or political subdivisions of such territories or possessions, the District of Columbia, or any agency or instrumentality of any one of the foregoing.

(ii) This paragraph shall also apply to distributions paid in a taxable year prior to retirement to public officers and public employees which represent a return of contributions to the applicable public retirement program.

(iii) The provisions of this paragraph can be illustrated by the following examples:

Example 1: A retired employee of New York State receives a pension which is taxed under the Internal Revenue Code as annuity income. Since the pension of a retired New York State employee is exempt from New York State personal income tax under New York State law, the amount included in Federal adjusted gross income on account of this pension is subtracted in determining such employee's New York adjusted gross income.

Example 2: A New York State employee leaves state service prior to vesting in the New York State Employee's Retirement System. Contributions made by or on behalf of such employee, as well as all investment earnings accumulated thereon, are to be subtracted in determining such employee's New York adjusted gross income.

Example 3: A retired Federal employee receives a pension which is taxed under the Internal Revenue Code as annuity income. Since the pension of a retired Federal employee is exempt from New York State personal income tax under New York State law, the amount included in Federal adjusted gross income on account of this pension is subtracted in determining such employee's New York adjusted gross income.

Example 4: A retired employee of the State University of New York who elected to participate in the applicable Optional Retirement Program authorized under the Education Law receives a pension, based upon such employee's public service, which is taxed under the Internal Revenue Code as annuity income. Since such pension income is exempt from New York State personal income tax under New York State law because such pension was actually contributed to by New York State, the amount included in

Federal adjusted gross income on account of this pension is subtracted in determining such employee's New York adjusted gross income.

Example 5: A retired employee of a public benefit corporation receives a pension from a fund which was not contributed to by New York State, any of its political subdivisions or agencies or the Federal government and which is taxed under the Internal Revenue Code as annuity income. Since such pension income is not exempt from New York State personal income tax under New York State law because such pension was not actually contributed to by New York State, any of its political subdivisions or agencies or the Federal government, the amount included in Federal adjusted gross income on account of this pension is not subtracted in determining such employee's New York adjusted gross income and is therefore included in such employee's New York adjusted gross income.

Section 112.3(c)(2)(i) of the Regulations provides, in part:

Pension and annuity income not subject to the modification referred to in paragraph (1) of this subdivision and not in excess of $20,000, received by an individual may be subtracted in determining New York adjusted gross income providing the following conditions are met:

(a) the pension and annuity income must be included in Federal adjusted gross income;

(b) the pension and annuity income must be received in periodic payments (except where otherwise provided in this paragraph);

(c) the pension and annuity income must be attributable to personal services performed by such individual, prior to such individual's retirement from employment, which arises from either an employer-employee relationship or from contributions to a retirement plan which are tax deductible under the Internal Revenue Code (e.g., individual retirement account [IRA] or self-employed retirement [Keogh]); and

(d) such individual receiving the pension and annuity income must be 59 ½ years of age or over.

Opinion

Section 5 of Article 16 of the New York State Constitution provides that "all salaries, wages and other compensation, except pensions, paid to officers and employees of the state and its subdivisions and agencies shall be subject to taxation."

Section 612(c)(3)(i) of the Tax Law exempts from New York State personal income tax pensions paid to officers and employees of New York State, its subdivisions, and agencies. The United States Supreme Court in *Davis v Michigan Department of Treasury*, 489 US 803 (1989), extended the exemption to employees of the United States, its territories or possessions, or political subdivisions of such territories or possessions, the District of Columbia, or any agency or instrumentality of any one of the foregoing. Section 112.3(c)(1) of the Regulations relates to the subtraction modification for pensions paid to public officers and public employees of New York State, its political subdivisions, its agencies, or the federal government. On August 1, 1994, section 112.3(c)(1) of the Regulations was amended to clarify that pensions and other retirement benefits paid would qualify for the modification if they relate to services performed as a public officer or public employee of, and include amounts actually contributed by, the State, its political subdivisions, its agencies, or the federal government.

Retirement benefits received that are not attributable to amounts actually contributed by the State, its political subdivisions, its agencies, or the federal government do not constitute a pension or retirement benefit exempt from New York personal income tax pursuant to section 612(c)(3)(i) of the Tax Law and section 112.3(c)(1)(i) of the Regulations.

In *Joseph W. Martiney*, Adv Op St Tax Comm, November 24, 1980, TSB-H-80-(523)I, it was held that the distributions from an IRA established by means of a tax-free rollover of amounts received in the form of a pension from New York State, or a subdivision or agency thereof, represents a nontaxable return of principal to the extent that the distribution represents a return of the pension funds "rolled over" into the IRA. To the extent that the distribution represents interest or any other type of gain earned in the account, such portion would be subject to tax.

In a related issue, in *Richard Epstein*, Adv Op Comm T&F, November 19, 2003, TSB-A-03(5)I, the petitioner was a pension member of the Board of Education of the City of New York. It was held that a portion of the distributions received by the petitioner from an IRA established by means of a tax-free rollover or direct transfer of amounts from petitioner's IRC 403(b) plan, represented an amount of the IRC 403(b) plan. The return of the IRC 403(b) plan contribution was exempt for New York State personal income tax purposes. Since petitioner was more than 59½ years old, the balance of the distribution from the IRA that represented other contributions, interest, dividends, net gains, etc. was eligible for the New York State pension and annuity exclusion of $20,000 under section 612(c)(3-a) of the Tax Law.

The present case is distinguishable from *Epstein, supra*. When there is a transfer from an IRC 403(b) plan to an IRA, the transfer is considered a distribution and subsequent rollover (see IRC section 403(b)(8)(A) and Internal Revenue Service Revenue Ruling 89-50). However, in the present case, the individual is considering a direct transfer from one IRC 403(b) plan to another IRC 403(b) plan. A direct transfer between IRC 403(b) plans does not constitute an actual distribution under IRC section 403(b)(1) if the transferred funds continue to be subject to the same or more stringent distribution restrictions imposed on such funds by IRC section

403(b)(11) or IRC section 403(b)(7)(A)(ii). See Internal Revenue Service Revenue Ruling 90-24, 1990-1 CB 97.

IRC section 403(b)(7)(A) provides that amounts paid by a qualifying employer to a custodial account that satisfies the requirements of IRC section 401(f)(2) are treated as amounts contributed by the employer to an annuity contract for an employee provided the amounts are to be invested in regulated investment company stock to be held in that custodial account. IRC section 403(b)(7)(A)(ii) provides that amounts paid by an employer to a custodial account are treated as amounts contributed by the employer to an annuity contract for an employee only if no amounts may be paid or made available to any distributee before the employee dies, attains age 59½, separates from service, becomes disabled, or, in the case of contributions made pursuant to a salary reduction agreement, encounters financial hardship. Similarly, IRC section 403(b)(11) provides that a distribution from an IRC section 403(b) plan attributable to salary reduction contributions may be paid only when the employee attains age 59½, separates from service, dies, or becomes disabled. Distributions attributable to those contributions may also be paid in the case of hardship, but the distributions may not include income attributable to those contributions. IRC section 403(b)(11) is effective for years beginning after December 31, 1988, but only with respect to distributions attributable to assets other than assets held as of the close of the last year beginning before January 1, 1989. See Internal Revenue Service Revenue Ruling 90-24, *supra*.

It appears that in this case, because the individual will merely transfer an interest in one IRC 403(b) plan to another IRC 403(b) plan, the transfer will not violate the early distribution restrictions of IRC section 403(b)(11) or IRC section 403(b)(7)(A)(ii). Because the individual will not receive an actual distribution within the meaning of IRC section 403(b)(1), the transfer is not taxable for federal income tax purposes. Also, because the individual will retain an annuity interest throughout the transaction, the direct transfer between IRC 403(b) plans is a mere change in issuers that does not violate the nontransferability requirement of IRC section 401(g).

Accordingly, when all or a portion of the amounts were actually contributed (rather than merely being deemed to be contributed) to the first IRC 403(b) plan by New York State, regardless of the age of the individual at the time of distribution, the retirement benefits received from the second IRC 403(b) plan established by direct transfer of funds from the first IRC 403(b) plan relating to services performed as a public officer or public employee, the amount transferred, and any subsequent interest, dividends, net gains, etc. earned in the second IRC 403(b) plan are exempt from New York personal income tax pursuant to section 612(c)(3)(i) of the Tax Law and section 112.3(c)(1)(i) of the Regulations.

When no amounts were actually contributed (rather than merely being deemed to be contributed) to the first IRC 403(b) plan by New York State, the retirement benefits received from the second IRC 403(b) plan established by direct transfer of funds from the first IRC 403(b) plan, the amount transferred, and any subsequent interest, dividends, net gains, etc. earned in the second IRC 403(b) plan are not exempt from New York personal income tax pursuant to section 612(c)(3)(i) of the Tax Law and section 112.3(c)(1)(i) of the Regulations. However, pursuant to

section 612(c)(3-a) of the Tax Law and section 112.3(c)(2)(i) of the Regulations, when an individual reaches 59½ years of age, pensions and annuities received by an individual from the second IRC 403(b) plan not otherwise excluded under section 612(c)(3)(i) of the Tax Law and section 112.3(c)(1)(i) of the Regulations may be added to the individual's other pension and annuity income, if any, that meets the conditions of sections 612(c)(3-a) and 112.3(c)(2)(i) for purposes of computing the $20,000 pension and annuity income modification. The total, but not in excess of $20,000, may be subtracted from federal adjusted gross income when computing New York adjusted gross income.

DATED: December 29, 2006

/s/
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NOTE: The opinions expressed in Advisory Opinions are limited to the facts set forth therein.