



eBenefits Alert: Minnesota Income Tax Amendment Repeals Exemption for Some Non-Qualified Plan Distributions to Former Residents

March 1, 2008

A recent amendment to Minnesota tax law may affect the treatment of some distributions from non-qualified retirement plans. The amendment, approved by the governor on March 7, 2008, eliminates a tax exemption for certain types of retirement plan distributions related to services performed in Minnesota. The amendment requires that employers withhold Minnesota income tax on these retirement plan distributions after April 1, 2008.

Prior Minnesota tax law included an exemption for wages earned in Minnesota if the wages were paid after the end of the taxable year that the recipient ceased being a Minnesota resident. Accordingly, under prior law, virtually all retirement payments made to a former employee who moved from Minnesota could escape Minnesota income tax as long as the payment was made in the year after the move. This exemption was particularly meaningful to employees who moved to a low- or no-income tax state, such as South Dakota or Florida, because their retirement payments could, for the most part, escape state income tax altogether.

The recent law change eliminated this exemption. However, the change affects only some types of retirement distributions. Minnesota law continues to comply with federal law which exempts certain types of retirement plan payments from state income tax. Under this exemption, any income that is classified as "retirement income" is exempt from Minnesota income tax if it is paid to an individual who is no longer a resident of Minnesota. "Retirement income" consists, generally, of: (1) qualified plan distributions; and (2) nonqualified plan distributions that are: (a) paid out over at least a ten-year period; or (b) paid under a pure excess benefit plan. Specifically, Minnesota law provides an exemption for qualified and other similar plan distributions and for income from any nonqualified deferred compensation plan that:

- (i) is part of a series of substantially equal periodic payments... made for... a period of not less than ten years, or
- (ii) is a payment received after termination of employment and under a plan, program, or arrangement (to which such employment relates) maintained solely for the purpose of providing retirement benefits for employees in excess of the limitations imposed by 1 or more sections 401(a)(17), 401(k), 401(m), 402(g), 403(b), 408(k) or 415 of [the Internal Revenue Code] or any other limitation on contributions or benefits in



such Code on plans to which any other such sections apply.

Thus, distribution from nonqualified plans made over a period of ten years or more continue to be exempt, as are distributions from nonqualified plans that are pure "excess" plans. Distributions from nonqualified plans made over a shorter period that are not from pure "excess" plans will not be exempt. Special attention should be paid to plans that provide excess benefits since these plans sometimes provide benefits in addition to those intended to compensate for the Internal Revenue Code limits. In this case, the "excess benefit" exemption will probably not apply.

Note that the above exemption for "retirement income" applies only if a plan participant moves out of state. It will have no effect on participants who remain Minnesota residents. These participants will be subject to Minnesota income tax on all their retirement plan distributions.

Note also that Minnesota income tax applies only to income for "the work of the employee performed within [Minnesota]." Thus if any portion of a distribution is attributable to service performed outside of Minnesota, it is not subject to Minnesota income tax. This creates complexity for employers who must try to allocate distributions among states. In addition, the law does not provide any specifics on exactly how to determine what income is for work performed in Minnesota, which creates some ambiguity when it comes to plan features like satisfaction of vesting requirements.

Immediate Action

Since the change in the withholding requirement is effective April 1, employers will want to take immediate action to determine whether plan distributions are affected. Generally, this will be limited to payments after April 1, 2008 from non-qualified plans to non-Minnesota residents that are neither from an "excess plan" nor to be paid over a period of more than 10 years. Only distributions attributable to work performed in Minnesota will be subject to Minnesota income tax. Thus, employers will need to determine if any portion of a distribution is for work performed outside Minnesota and withhold on only the remaining portion of the distribution. As a final observation, while the withholding requirement is effective for distributions made after April 1, 2008, the change in the law is technically effective January 1, 2008. The amendment to the law does not address how the law change is to apply to payments made between January 1 and April 2, 2008, but presumably affected participants are liable for the Minnesota income tax on those payments.

Employers should also be aware that the law change may affect other payments, such as severance payments and payments under stock plans, which will likely not qualify for any exemption. Minnesota employers are encouraged to seek legal advice and evaluation of their retirement plans to assess the full impact of this recent amendment on their particular plans and needs.



The full text of the amendment can be found on the Minnesota State Legislature website, or by clicking here:
<https://www.revisor.leg.state.mn.us/laws/?id=154&year=2008&type=0>

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