Moving Out of State? Don't Forget about the Source Tax

One well known, yet unexpected result of the COVID-19 pandemic was the mass exodus of individuals out of city centers. For many, that exodus extended to moving out of state, particularly for those seeking to move from high to low income tax states. Open any news site over the last year and there is a good chance you will see an article about people leaving California, New York and New Jersey. For many, particularly those in or close to retirement, the cost of high taxes has outweighed the benefits of living in those states.

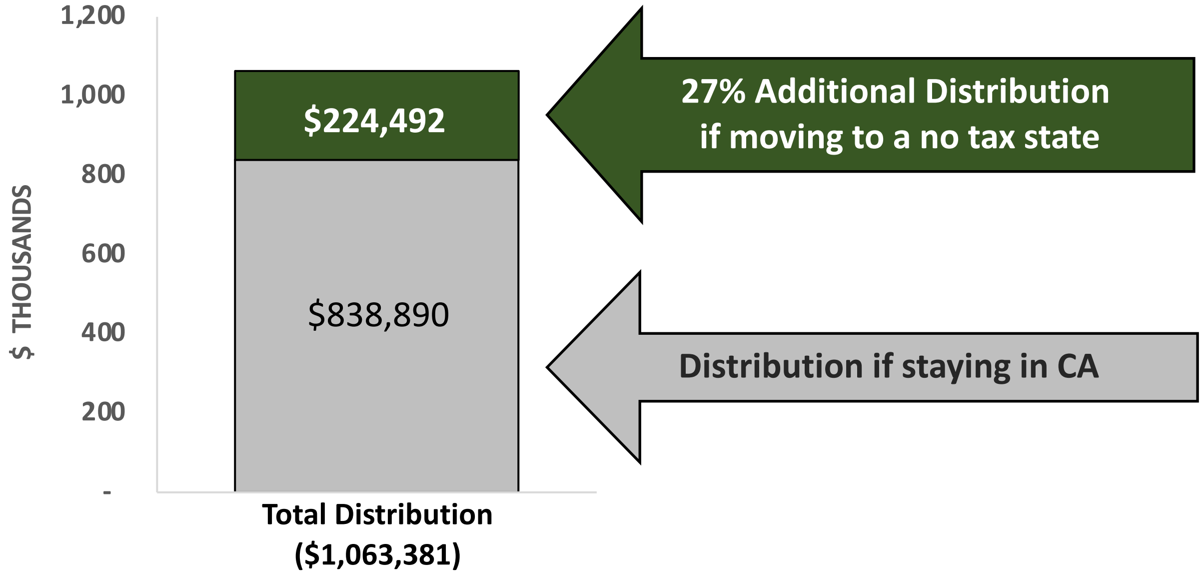
What some retirees do not realize, is that the state where they earned their money will assess taxes on their 401(k)s and IRAs, unless they take at least a 10-year distribution[1]. The problem is, many 401(k) and IRAs do not provide investors with a 10 (or more) year distribution option necessary to get the benefit of lower tax rates in the new state.

However, most **non-qualified deferred compensation plans** have the ability to schedule distribution payments of 10 years or more. A properly designed plan allows participants to save a large portion of their compensation pre-tax and take 10 or more years of annual installments in retirement, exempting them from the source tax. By deferring compensation in high tax states and retiring in a low tax state, those retirees can save a significant amount of tax.

The graph below illustrates a 45-year-old saving $25,000 per year for 20 years, then moving from CA with a 13.3% top tax rate to a 0% income tax state in retirement. Model assumes a 7% pretax growth rate, benefits distributed over 15 years and a 37% ordinary federal income tax rate.

[1]4 U.S.C. 114 subsection (a)

Cumulative After-Tax Benefit Payments from Deferred Compensation Plan



For more information regarding the potential impacts of these proposals, please contact your Mullin Barens Sanford Associate.

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