Beware of double taxation on distributions: Wagner Law

By Wagner Law Group *Tue, Apr 5, 2022*

If your clients live in Massachusetts, Pennsylvania or New Jersey, they might inadvertently and erroneously pay significant additional state income taxes, according to the attorneys at Wagner Law Group in Boston.

Due to an arcane mismatch in rules, you might inadvertently pay too much tax on distributions from your retirement accounts. Most states follow the federal rules so this may be a problem in only a few states. In those few, however, the mismatch could inadvertently result in you erroneously paying significant additional state income taxes. Massachusetts is an outlier, along with Pennsylvania and New Jersey.

Your state might not permit a 401k/IRA deduction

Withdrawals from retirement accounts are taxable for both federal and state purposes to the extent they are determined to consist of contributions that were not previously subject to tax. This makes sense. If you received a deduction for a contribution, such as to an IRA, or were not taxed on a contribution, such as to a 401(k) plan, the contribution, along with tax-deferred earnings on that contribution, become taxable when they are distributed. On the other hand, if you make a non-deductible contribution to an IRA you have a “basis” in that contribution and need not be taxed when that basis is returned to you.

Most states follow the federal income tax rules so the return of basis is the same for purposes of determining your federal income tax and state income tax. Massachusetts, Pennsylvania and New Jersey are the contrarians. In those states, any contribution that was not tax deductible when it was made should be withdrawn as a “return of basis” and not taxed. If you are not aware of this, you might report a distribution in the same amount on both your federal and state income tax returns. This would result in your paying tax twice: once when you made the contribution, and again when you withdraw it.

The Massachusetts mismatch

Since Massachusetts does not allow a deduction for amounts originally contributed to an IRA, the distributions are not taxable until the full amount of your contributions which were previously subject to Massachusetts taxes are recovered.

As an example, assume that in 2010 you made a $5,000 contribution to your IRA. If you met the income limitations for a deductible IRA for that year, you could have deducted the contribution on your federal income tax return. If you lived in Massachusetts, however, you could not have deducted the contribution on your state income tax return.

Assume that in 2021, the account has grown to $8,000 and you withdraw the entire account value. For federal tax purposes, you have no basis in the account because none of it has been previously taxed. You should add the entire $8,000 as ordinary income to your federal income tax return ($8,000 gross ordinary income equals $5,000 contribution that was previously deducted plus $3,000 gain that was tax deferred while accumulating in the IRA). For your Massachusetts return, you have already been taxed on the $5,000 contribution but the $3,000 gain has not yet been included in income. You therefore should add only $3,000 as ordinary income to your Massachusetts return ($8,000 less $5,000 return of basis equals $3,000 gross ordinary income).

Avoid overpaying state income tax

Taxpayers who are unaware of this disparate treatment may pay too much state income tax. It is critical, therefore, to know your state's rules, or work with a competent tax adviser who does. It is also important to keep clear records of your non-deductible contributions throughout the years.

Nondeductible IRA contributions are recorded each year via IRS Form 8606. That form is also used to report distributions from traditional, SEP or SIMPLE IRAs (if you have a basis in them), as well as conversions to or distributions from Roth IRAs. These forms are important to have on hand as you prepare your returns for years in which you receive distributions. But Form 8606 does not report amounts that are not deductible in your state.

For added protection, we suggest that you also maintain a spreadsheet that records all of your IRA contributions, deductions claimed for contributions (state and federal), all distributions from those accounts, and related dates.

State rules vary significantly

Currently, eight states—Alaska, Florida, Nevada, South Dakota, Tennessee, Texas, Washington, and Wyoming—have no state income tax at all. If you are lucky enough to live in one of those states, mismatched basis is not an issue for you. Some states have income taxes but exclude distributions from employer-based plans and IRAs. Others exempt distributions but impose age or other limitations. Still others may pro-rate distributions so that each payment is partially taxable and partially a return of basis. As the example above illustrates, Massachusetts is among those that permit previously taxed contributions to be returned tax-free first.

Further complications arise when you move. If you lived in a state that follows the federal rules when you made a distribution but lived in a state where you could not deduct your contribution when it was made, the second state may or may not have a mechanism by which your basis can be recognized and be reduced from taxable income. Massachusetts considers the contribution to be a return of basis only if it was previously taxed by Massachusetts.

Vigilant taxpayers must become well-informed to navigate these complex rules. Once again, adequate records and professional advice are key to your success.