STATE OF NEW YORK

COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION PETITION NO. I930823G

On August 23, 1993, a Petition for Advisory Opinion was received from Joseph T. DiGianni, 40 Robert Circle, Syosset, New York 11791.

The issues raised by Petitioner, Joseph T. DiGianni, are:

(1) Whether distributions from the Federal Employees' Thrift Savings Plan (TSP) are tax free at the New York State level.

(2) If not tax free, whether the first $20,000 received is tax free whether taken as a monthly annuity or as a single lump sum payment.

(3) If the TSP distributions are taxable, whether the earnings derived from the "G Fund" (U.S. Bonds) are tax free.

The TSP is a retirement savings and investment plan for Federal employees. The TSP was established in the Federal Employees' Retirement System Act of 1986. Employees covered by the Federal Employees' Retirement System (hereinafter "FERS") and the Civil Service Retirement System (hereinafter "CSRS") can contribute to the TSP. The participation rules are different for FERS and CSRS employees. FERS employees are generally those hired on or after January 1, 1984. CSRS employees are those hired before January 1, 1984.

The provisions of the FERS, which consists of a combination of social security, a defined benefit plan and a defined contribution plan are contained in Chapter 84 of Title 5 of the United States Code (hereinafter "USC"). The defined benefit plan is the "basic annuity" and the defined contribution plan is the TSP and is established by Subchapter III of such Chapter 84.

The provisions of the CSRS, which is a defined benefit plan, are contained in Chapter 83 of Title 5 of the USC. The defined benefit plan is an annuity. In addition, section 8351 of such Chapter 83 provides that an employee covered by the CSRS may elect to contribute to the TSP established by section 8437 of Title 5 of the USC. By making such election, an employee may supplement his/her CSRS annuity.

The FERS basic annuity and the CSRS annuity benefits are based on an employee's years of service and salary, and contributions to these programs are mandatory payroll deductions.

The TSP benefits depend on how much an employee and the employee's agency contribute to the employee's account during working years, and the earnings on such contributions. Where an employee is covered by CSRS, such employee does <u>not</u> receive any agency contributions. However, if an employee covered by CSRS makes the election contained in section 8351 of Title 5 of the USC, such employee may make voluntary contributions to his/her TSP account of up to five percent of the employee's basic pay each pay period not to exceed IRC limits.

Where an employee is covered by FERS, under Chapter 84 of Title 5 of the USC such employee is entitled to receive two different types of contributions to such employee's TSP account from the employee's agency. These contributions are not payroll deductions. When the employee becomes eligible to participate in the TSP the employee's agency will open a TSP account and each pay period the employee's agency will automatically contribute to the account an amount equal to one percent of the employee's basic pay for that period. The employee receives these contributions whether or not the employee contributes his/her own money to his/her TSP account. If the employee does contribute his/her own money to his/her TSP account, the employee's agency makes agency matching contributions to the employee's TSP account up to four percent. These agency matching contributions apply to the first five percent of employee's pay each pay period that the employee contributes. This is in addition to the agency automatic contribution of one percent. An employee's contributions to his/her TSP account are voluntary and the employee may contribute up to 10 percent of his/her basic pay each pay period not to exceed Internal Revenue Code limits.

Employee contributions into his/her TSP account and the earnings on the account are tax-deferred until the funds are withdrawn. An employee cannot withdraw from his/her TSP account while still employed by the Federal government. If the employee is covered by FERS and has not met the TSP vesting requirements when the employee separates from Federal service, the employee is not entitled to the agency automatic one percent contributions in the employee's TSP account (or their earnings). However, employees covered by FERS are always vested in the matching contributions their agencies make, as well as in the earnings on the matching contributions. In addition, employees covered by FERS as well as employees covered by CSRS are always vested in their own contributions and the earnings on such contributions.

Withdrawals may be made from an employee's TSP account after the employee separates from Federal service. When the employee separates from Federal service and the employee's vested TSP account balance is $3,500, or less, such balance will be paid to the employee automatically in a single payment called an "automatic cashout" unless the employee chooses another withdrawal option. If the employee is not eligible for retirement benefits under his/her FERS or CSRS when the employee separates, and the employee does not qualify for the automatic cashout, the employee must transfer the vested account balance to an IRA or other eligible retirement plan (a tax-qualified employee benefit plan, an IRA, an individual retirement annuity, or an annuity plan described in section 403(a) of the Internal Revenue Code). If the employee is eligible for retirement benefits when the employee separates from Federal service, the employee may receive the balance of the employee's TSP account as an automatic cashout, if qualified, or the employee may transfer the account balance to an IRA or other eligible retirement plan, receive the account balance in a single payment, receive the account balance in substantially equal monthly payments or receive a life annuity based on the balance in the account.

Section 7701(j) of the IRC provides that for income tax purposes, the Federal Thrift Savings Fund shall be treated as a trust described in section 401(a) of the IRC which is exempt from taxation under section 501(a) of the IRC, and any contribution to, or distribution from the Thrift Savings Fund shall be treated in the same manner as contributions from such a trust.

Section 35.3405-1,A-18 of the Treasury Regulations provides that the withholding provisions relating to pensions and annuities do not apply to any amounts that are wages without regard to the provisions of section 3405 of the Treasury Regulations. However, wages do not include remuneration paid to, or on behalf of, an employee or beneficiary from or to a trust qualified under section 401(a) of the IRC and tax-exempt under section 501(a) of the IRC.

The United States Supreme Court in Davis v Michigan Department of Treasury, 489 US 803 (1989), held that the state taxation of Federal retirement benefits at a greater rate than the taxation of state retirement benefits is unconstitutional.

Section 612(c)(3) of the Tax Law provides for a modification reducing Federal adjusted gross income for "pensions to officers and employees of the United States of America ... to the extent includible in gross income for federal income tax purposes."

Section 612(c)(3-a) of the Tax Law provides For a modification reducing Federal adjusted gross income for pensions and annuities received by an individual who has attained the age of 59 1/2, not otherwise excluded pursuant to section 612(c)(3), to the extent includible in gross income for Federal income tax purposes, but not in excess of $20,000, which are periodic payments attributable to personal services performed by such individual prior to his or her 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" does not include any lump sum distribution, as defined in section 402(e)(4)(A) of the Internal Revenue Code (hereinafter "IRC") and taxed under section 603 of the Tax Law.

Section 112.3(c)(2) of the Income Tax Regulations provides that:

> (i) For taxable years beginning on or after January 1, 1982, pension and annuity income, not in excess of $20,000, received by an individual not subject to the modification allowed under paragraph (1) of this subdivision, may be subtracted in computing New York adjusted gross income providing the following conditions are met:
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> (a) the pension and annuity income must be included in Federal adjusted gross income;
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> (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 lIRA] or self-employed retirement [Keogh]); and

(d) such individual receiving the pension and annuity income must be 59 1/2 years of age or over.

(ii) Distributions from an individual retirement account (IRA) or a self-employed retirement plan (Keogh) will qualify for the pension and annuity income modification whether such distributions are periodic payments or a lump sum distribution. However, a modification will not be allowed under this paragraph for a lump sum distribution from a self-employed retirement plan (Keogh) if the Federal special 10-year averaging method of determining the Federal income tax due on such lump sum distribution is elected (see section 601-c of the Tax Law for provisions relating to determining the New York State separate tax on the ordinary income portion of a lump sum distribution where the special 10-year averaging method has been elected for Federal income tax purposes).

Herein, with respect to Issue "1", where an employee is covered by FERS, the distributions received by such individual from such employee's TSP account are considered part of such individual's pension and may be allowed as a deduction from Federal adjusted gross income, pursuant to section 612(c)(3) of the Tax Law, to the extent includible in gross income for Federal income tax purposes.

Where an employee is covered by CSRS, the distributions received by such individual from such employee's TSP account are considered as a supplement to such individual's pension and such distributions not allowed as a deduction from Federal adjusted gross income, pursuant to section 612(c)(3) of the Tax Law. However, with respect to Issue "2", such distributions are treated as a retirement benefit, and are not considered wages for purposes of the IRC pursuant to section 35.3405-1,A-18 of Treasury Regulations. Therefore, such distributions may be allowable as a deduction, pursuant to section 612(c)(3-a) of the Tax Law, to the extent such distribution is includible in gross income for Federal income tax purposes, if the individual meets all of the requirements contained in such section 612(c)(3-a) and section 112.3(c)(2) of the Income Tax Regulations.

With respect to Issue "3", section 402(a)(1) of the IRC provides that the amount actually distributed to any distributee by any employees' trust described in section 401(a) of the IRC which is exempt from tax under section 501(a) of the IRC shall be taxable to the distributee, in the taxable year of the distributee in which distributed, under section 72 (relating to annuities) of the IRC. Section 72(a) of the IRC provides that, except as otherwise provided in the income tax provisions of the IRC, gross income includes any amount received as an annuity under an annuity, endowment or life insurance contract. Accordingly, when a taxpayer receives a distribution from an employee's TSP account, no distinction is made between contributions and earnings. Where the contributions into the employees TSP account are invested in the "G Fund" (a U.S. Bond Fund) the interest earned on such investment loses its character as interest income and is treated as annuity income under section 72 of the IRC.

Section 607 of the Tax Law provides that terms used in Article 22 are to be given the same meaning "as when used in a comparable context in the laws of the United States relating to federal income taxes, unless a different meaning is clearly required." Thus, the IRC's exclusion of the income in question from the category of "interest" means that is not to be treated as interest for purposes of Article 22 of the Tax Law, and no modification is allowed under section 612(c)(1) of the Tax Law.

DATED: January 21, 1994

s/PAUL B. COBURN
Deputy Director
Taxpayer Services Division

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