With Apologies to Billy Joel, We're in a New York State of Distributions

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An Article discussing the exemption of certain amounts of taxable retirement income from New York state and local taxes.

New York taxpayers who are at least age 59 1/2 should take notice of a somewhat under-the-radar New York tax rule. The first $20,000 of a taxpayer's taxable retirement income in each year is exempt from New York State and City income taxation. (N.Y. Tax Law § 612(c)(3-a); see New York State Department of Taxation and Finance: Publication 36.)

Accordingly, a New Yorker who takes a $20,000 distribution annually after reaching age 59 1/2 saves as much as $2,500 annually in otherwise eventually payable New York taxes. Note that this is not a deferral but rather complete tax-exemption on these amounts.

To illustrate, let's assume a 10% combined state and local tax rate and a $100,000 account balance in an IRA or tax-qualified plan. If the entire $100,000 account balance is deferred for five years and then distributed, the taxpayer owes $8,000 in state and local taxes (($100,000 - $20,000) x 10%). But if $20,000 is distributed in each of those five years, no tax is paid to New York. That's a potentially significant impact on net after-tax returns.

This result, while seductive, is questionable financial planning. The cost of employing this technique is losing the not-to-be-underestimated value of continuing federal income-tax deferral. It's not impossible that the lost deferral opportunity could overwhelm the state and local tax exemption, depending on the length of the deferral and a variety of other factors.

But there's another approach. What if a taxpayer accomplishes this not with a taxable distribution but with a Roth conversion? Now, he or she gets something for paying taxes up front, which is complete tax-exemption on future earnings. A Roth conversion occurs when an individual converts a traditional IRA to a Roth IRA or a 401(k) plan participant transfers his or her eligible non-Roth accounts to a Roth option within the same 401(k) plan without removing funds from the plan. At the time of conversion, the converted amount is included in the individual's taxable income and taxed at ordinary income tax rates. However, the amounts in the Roth account then grow entirely tax-free and are distributed (assuming certain requirements are satisfied) without triggering any future income tax liability.

The value of a Roth IRA (or Roth 401(k) plan) versus a traditional IRA (or 401(k) plan) can certainly be debated and depends upon a host of factors (although, in the interest of full disclosure, the authors are generally fans of the Roth conversion even without this extra tax break). But by adding into the mix the exemption from New York income taxes as an additional carrot, the Roth-conversion approach of at least $20,000 annually becomes effectively supercharged, making a Roth account preferable in an even wider variety of circumstances.

Using the same $100,000 example, if that amount were converted into a Roth account, the account owner would owe the same $8,000 in taxes (($100,000 - $20,000) x 10%). However, the remaining funds in the account would grow tax-free and would not be subject to future tax liability when withdrawn.

To be sure, no one should act on the foregoing without confirming with an independent tax advisor that the law is as suggested above and consulting with a financial advisor to ensure that the technique suggested here makes financial and economic sense in any particular case. But it sure seems enticing in principle.

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It's possible that this strategy could work in other states as well. For example, it appears that South Carolina taxpayers who have reached age 65 may deduct up to $10,000 of retirement income from their state taxable income (S.C. Code Ann. § 12-6-1170(A)(1)). For Delaware taxpayers who are at least age 60, the first $12,500 of annual retirement income is exempt from state taxes (30 Del. C. § 1106(b)(3)(b)(2)(A)). In Colorado, taxpayers age 55 and older may deduct up to $20,000 annually from their state taxable income (this amount increases to $24,000 for taxpayers who are at least age 65) (Colo. Rev. Stat. Ann. § 39-22-104(4)(f)(iii)).