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Opinion No. 02-045

Proposed Income Tax effect on Retirement Plans

QUESTIONS

1. Under the income tax proposed by Senator Robert Rochelle and Representative Tommy Head (SB 3136, HB 3115), would withdrawals from an individual's 401(k) or Individual Retirement Arrangement (IRA) be subject to tax?

2. If the answer to the first question is "yes," compare the tax implications of:

(a) for years before the state income tax goes into effect, an individual saves from his earned income a set amount per year, and then, after the state income tax goes into effect, begins withdrawing (spending) a portion of the savings each year thereafter; and

(b) for years before the state income tax goes into effect, an individual contributes a set amount from his earned income each year to a 401(k) plan or an IRA, and then, after the state income tax goes into effect, begins withdrawing a portion of the plan each year thereafter.

OPINIONS

1. Withdrawals from a 401(k) plan or an IRA would be subject to the proposed state income tax. Both plans essentially define Tennessee taxable income as federal adjusted gross income with certain further adjustments. Since withdrawals from a 401(k) or an IRA are subject to federal income taxation in the year of withdrawal, and thus would be included in the individual's federal adjusted gross income, they would be subject to the state tax.

2. (a) Withdrawing (spending) funds from a savings account would have no tax consequences since the proposed state income tax would apply only to income and not to consumption. Generally, federal income tax would have been due on the income earned and saved, in the year earned, and on the interest received by the savings account, in the year received.

(b) Withdrawals from a 401(k) plan or an IRA would be subject to federal income tax in the year withdrawn and thus subject to the proposed state income tax. In contrast to the savings scenario, no federal income tax would have been due on earned income used to make contributions to the 401(k) plan and the IRA, and the earnings of either plan would have been exempt from federal tax until the owner's retirement age. Thus, as the funds are withdrawn from either the 401(k) or IRA, tax would be paid on those funds, both on the contributions and on the earnings on the contributions, for the first time.

ANALYSIS

Section 20 of SB 3136, HB 3115, sponsored by Senator Rochelle and Representative Head, would levy a broad-based state income tax and would codify it in title 67, chapter 2, part 2. Section 67-2-204 would impose a tax at varying rates on "Tennessee taxable income." Section 67-2-206 would define Tennessee taxable income as the individual's "Tennessee adjusted gross income" reduced by an exemption based on filing status (single, married, etc.). Tennessee adjusted gross income is in turn defined as federal adjusted gross income after certain adjustments. Section 67-2-207. None of the adjustments or exemptions are relevant to the questions presented here. Therefore, whether withdrawals from a 401(k) plan or an IRA would be subject to the proposed state income tax depends on whether the withdrawals would be includable in the taxpayer's federal adjusted gross income.

Both a 401(k) plan and an IRA are vehicles by which an individual may save and invest earned income while postponing the federal income tax on the income until retirement age is reached. (This opinion does not address Roth IRA's.) Thus, subject to limitations on dollar amounts of contributions, an individual with earned income may contribute to a 401(k) or IRA each year and pay no federal income tax on the amount contributed. In addition, any investment income generated by the 401(k) or IRA is exempt from tax so long as it is left in the plan. However, once the taxpayer reaches age 70½, federal law requires that he (or she) begin making annual withdrawals from the plan and include the full amount withdrawn in federal adjusted gross income. IRC §§ 408(a)(6) and 401(a)(9)(C). Since the amount withdrawn would be included in federal adjusted gross income, it would in turn be subject to the proposed state income tax.

Your question assumes that the 401(k)/IRA contributions are made before the effective date of the proposed state income tax and that the withdrawals are made after the effective date. The tax result is as described in the preceding paragraph: The withdrawn amounts would be subject to federal and state tax in the year withdrawn.

The second scenario presented assumes the individual merely saves money in years prior to the effective date of a state income tax and then withdraws the money from savings (spends the money) in years after the state income tax goes into effect. The assumption is also made that the source of the savings is earned income subject to federal income tax in the year earned. In this situation, federal income tax has already been paid on the amounts saved, and therefore when savings are withdrawn (spent), they are not includable in federal adjusted gross income. Since not subject to federal tax, the withdrawals

(expenditures) would not be subject to the proposed state income tax.

Assuming the amounts saved are invested in a way that earns interest, the interest would be subject to federal income tax in the year received and thus includable in federal adjusted gross income. Any interest received after the proposed state income tax goes into effect would also be subject to the state tax.

The actual results of the 401(k)/ IRA scenario, as compared to the savings scenario, when the contributions or savings are made before the state tax goes into effect, and the withdrawals are made after the effective date, depends of course on the actual earnings, number of years of contributions and savings, and the tax rates involved. However, certain generalizations can be made.

First, contributions to the 401(k)/ IRA could be made with pre-tax dollars, while traditional savings must come from post-tax dollars. Thus, if the federal tax rate is 20%, then in order to make a 401(k)/IRA contribution of $1000, one must contribute $1000 in earned income. To save an equal amount after tax has been paid, however, would require $1250 of earned income (because tax at 20% is $250).

Second, if one can earn 5% on investments or savings, the 401(k)/IRA would actually bring a return of 5% per annum, because the earnings within the plan are tax deferred. However, the effective, after-tax earnings rate of the savings account would be 4% (5% reduced by the 20% tax rate is 4%).

Third, because the effective growth rate of the amounts invested in the 401(k)/IRA is greater than the effective growth rate of the amounts saved, the 401(k)/IRA would grow faster than the traditional savings account even if the same amount, each year, were contributed to each. The effect of this difference in growth rates would grow progressively larger each year.

Fourth, in the particular scenario you propose, the growth advantage of the 401(k)/IRA would be to some extent canceled because of the different tax treatment of the withdrawals when actually made. The 401(k)/IRA withdrawals would be subject to both federal tax and the new state income tax. The withdrawals from traditional savings, on the other hand, would be subject to neither tax.

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