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[For Local Officials](#)
[For Tax Professionals](#)

[Home](#) > [Businesses](#) > [Help & Resources](#) > [Legal Library](#) > [Directives](#) > [Directives - By Decade](#) > [\(1980-1989\) Directives](#) >

Directive 86-25: State And Municipal Contributory Retirement Plans Pre-Retirement Distributions

Facts: Taxpayer Davis was employed by Massachusetts for six years and was a member of the State Contributory Retirement System established and maintained pursuant to Chapter 32 of the General Laws. While so employed, Davis contributed to the state retirement system by means of deductions automatically taken from his salary. Before he reached retirement, Davis withdrew from state service. In accordance with the provisions of the system, he received a payment reflecting the contributions he made and interest accrued on such amounts.

Issue: To what extent is the pre-retirement distribution received by Davis upon withdrawal from state service subject to Massachusetts taxation?

Discussion: Massachusetts gross income is federal gross income with certain modifications. G.L. c. 62, § 2(a). The portion of a pre-retirement distribution that reflects the return to the taxpayer of previous contributions to the state retirement system is not included in federal gross income. I.R.C. § 61 and cases interpreting that section. Since there is no specific Massachusetts modification to the contrary, these amounts are not included in Massachusetts gross income and are therefore non-taxable.

The portion of the pre-retirement distribution that reflects interest earned on amounts contributed to the system is included in federal gross income. I.R.C. § 61(a). However, as a modification to federal gross income, Massachusetts law provides for the elimination of "income from any contributory annuity, pension, endowment, or retirement fund of . . . the Commonwealth or any political subdivision thereof, to which the employee has contributed." G.L. c. 62, § 2(a)(2)(E). Under this provision, the interest element of the pre-retirement distribution may be eliminated from gross income and is therefore non-taxable.

Chapter 32 of the General Laws, which governs the retirement systems of state and local governments, provides authority for exempting pre-retirement distributions from taxation. Section 19 of that chapter exempts from income taxation the rights of contributors in the various funds of the state and local retirement systems. G.L. c. 32, § 19. Under section 10 of chapter 32, contributors have the right to the return of their contributions plus interest when they withdraw from state service before retirement. Therefore, any amounts received pursuant to section 10 are exempt from taxation. G.L. c. 32, § 10(4).

This tax exemption is not available to the veterans referred to in sections 56 to 60 of chapter 32 of the General Laws who elect to receive a pension in addition to the return of their contributions plus interest. G.L. c. 32, § 25(3). Therefore, section 2(a)(2)(E) of chapter 62 does not apply, and interest earned on their contributions is included in their Part A income, taxed at 10%. G.L. c. 62, § 2(b)(1).

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Directive: The entire pre-retirement distribution to Davis consisting of his prior contributions to the state retirement system plus interest is tax-exempt under Massachusetts law.

Reference: G.L. c. 32, §§ 10(4), 19, 25(3); G.L. c. 62, § 2(a)(2)(E), (b)(1); I.R.C. § 61.

/s/Ira A. Jackson

Ira A. Jackson

Commissioner of Revenue

31 December 1986

DOR-D 86-25

This Directive represents the official position of the Department of Revenue on the application of the law to the facts as stated. The Department and its personnel will follow this Directive, and taxpayers may rely upon it, unless it is revoked or modified pursuant to 830 CMR § 62C.01(5)(e). In applying this Directive, however, the effect of subsequent legislation, regulations, court decisions, Directives, and TIRs must be considered, and Department personnel and taxpayers may rely upon this Directive only if the facts, circumstances and issues presented in other cases are substantially the same as those set forth in this Directive.