

TO: City and Town Treasurers
Regional School District Treasurers
District Treasurers
City Auditors and Town Accountants

FROM: James R. Johnson, Director of Accounts
DATE: November 1998

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SUBJECT: State Tax Status of Retirement Plan Contributions

I Attached for your reference is DOR's Technical Information Release TIR 98-6, which was approved by the Commissioner on October 6, 1998.

Item 11, I on page 4 discusses the state tax status of an employee's contributions to IRC § 403(b) retirement programs. The changes apply to contributions made on or after January 1, 1998.

This information had been requested by several municipal treasurers.

TIR 98-8
Massachusetts
1998 Reducing
Income Taxes
Act ("the Act")

I. Introduction

This Technical Information Release explains the personal income tax provisions contained in St. 1998, c. 175, *An Act Reducing Income Taxes and Unemployment Insurance Rates and Providing for Workforce Training*. The Act was signed into law on June 21, 1998. The pertinent effective dates for the various provisions of the Act are set out below.

On September 3, 1998, St. 1998, c. 319, *An Act Making Appropriations for the Fiscal Year 1998 to Provide for Supplementing Certain Existing Appropriations and for Certain Other Activities and Projects*, was signed into law. Chapter 319 contains a provision amending the Massachusetts personal income tax definition of the Internal Revenue Code to refer to the Code as amended on January 1, 1998. Prior to the amendment, the definition referred to the Code as amended on January 1, 1988. See section IV of this Technical Information Release for further details regarding Chapter 319.

II. Provisions Effective for Tax Years Beginning On or After January 1, 1998

A. Roth and Education IRAs

Under Section 17 of the Act, Massachusetts adopts the federal tax treatment of Roth and Education IRAs under the current internal Revenue Code and automatically adopts any future changes to the federal Roth and Education IRA provisions. This Technical Information Release repeals and replaces Technical Information Release 98-~~M~~*Massachusetts Personal Income Tax Treatment of Roth and Education IRAs*.

1. Roth IRAs

The Roth IRA allows taxpayers with federal adjusted gross income under threshold amounts (\$150,000 to \$160,000 for joint filers and \$95,000 to \$110,000 for single filers) to make nondeductible contributions up to the annual \$2,000 maximum per taxpayer (\$4,000 total for joint filers). IRC § 408A(c). Income accruing in the IRA is exempt. IRC § 408A(a). Distributions are tax-free so long as the taxpayer is at least 59.5 (or disabled or a 'first-time homebuyer') and the account is at least 5 years old.

Effective for 1998 taxable years, Massachusetts will follow the federal Roth IRA rules, including any future changes to those rules. Thus, income accruing in a Roth IRA will be exempt from the Massachusetts personal income tax and distributions from a Roth IRA will be included in Massachusetts gross income only to the extent that such distributions are included in federal gross income.

G.L. c. 62, § 5(c), as added by St. 1998, c. 175, § 17.

The Education IRA allows taxpayers with federal modified adjusted gross income under threshold amounts (\$150,000 to \$160,000 for joint filers and \$95,000 to \$110,000 for single filers) to make nondeductible contributions up to an annual \$500 maximum, per beneficiary under age 18. IRC § 530(c). Income accruing in the IRA is exempt. IRC § 530(a). Distributions are tax-free to the extent they are used to pay "qualified higher education expenses." IRC § 530(d)(2)(A).

Effective for 1998 taxable years, Massachusetts will follow the federal Education IRA rules, including any future changes to those rules. Thus, income accruing in an Education IRA will be exempt from the Massachusetts personal income tax and distributions from an Education IRA will be included in Massachusetts gross income only to the extent that such distributions are included in federal gross income.

G.L. c. 62, § 5(c), as added by St. 1998, c. 175, § 17.

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B. Rollovers¹ from a Traditional IRA to a Roth IRA

1. Federal Provisions

Effective January 1, 1998, taxpayers with \$100,000 or less in federal adjusted gross income, are allowed to make partial or complete rollovers from existing IRAs (deductible and nondeductible) to Roth IRAs. IRC § 408A(c)(3)(B)(i). Generally, the rollover amount is treated as a distribution and included in federal gross income to the extent it is attributable to growth and previously deducted contributions. IRC § 408A(d)(3)(A)(i). A special 4-tax-year averaging rule applies, at the election of the taxpayer, to partial or complete rollovers completed in 1998, whereby the taxable portion of the 1998 rollover amount is included in gross income ratably over four taxable years starting with 1998. IRC § 408A(d)(3)(A)(iii).

2. Massachusetts Provisions

Under Section 9 of the Act, Massachusetts generally adopts the federal rollover rules with certain adjustments explained below. If a taxpayer makes the special 4-tax-year averaging election for federal purposes, the election will also apply for Massachusetts purposes. Conversely, a taxpayer cannot elect the 4-tax-year averaging rule for Massachusetts purposes if he or she does not do so for federal purposes.

G.L. c. 62, §2(a)(3)(A), as added by St. 1998, c. 175, § 9.

3. Massachusetts Adjustments

Section 9 of the Act clarifies that amounts in traditional IRAs previously subject to the Massachusetts personal income tax will not be subject to the tax when the IRA is converted to a Roth IRA.

To illustrate, a taxpayer eligible to make a 1998 rollover, has a \$20,000 traditional IRA, which comprises \$10,000 of contributions which were deducted for federal purposes but subject to

into a Roth IRA, the entire \$20,000 would be included in federal gross income in \$5,000 increments each taxable year, for four tax years beginning in 1998. Section 9 of the Act clarifies that only the portion previously not subject to Massachusetts taxation, in this case the \$10,000 of earnings, will be included in Massachusetts gross income ratably over four tax years (or \$2,500 each year beginning in 1998).

G.L. c. 62, § 2(a)(3)(A), as added by St. 1998, c. 175, § 9.

C. Exclusion for Gain on the Sale of a Principal Residence Under Section 9 of the Act, Massachusetts adopts the federal \$250,000 (\$500,000 for joint filers) exclusion of gain from the sale of a principal residence. This exclusion, which is set forth in IRC § 121, replaces the former rollover and one-time exclusion provisions. Generally, a taxpayer can qualify for this exclusion repeatedly, so long as the sale is for a principal residence owned and used as such by the taxpayer for 2 out of 5 years prior to the sale. IRC § 121 (a).

Therefore, taxpayers that are eligible to exclude any portion of a gain on the sale of a principal residence for federal income tax purposes under IRC § 121, may also exclude the same portion of the gain for Massachusetts purposes. However, the effective date for the Massachusetts adoption of this federal exclusion rule is for tax years beginning on or after January 1, 1998. For federal purposes, the provision was generally effective for sales after May 6, 1997. Therefore, for Massachusetts purposes, sales prior to January 1, 1998, are subject to the former rollover and one time exclusion provisions referenced above.

G.L. c. 62, § 2(a)(3)(B), as added by St. 1998, c. 175, § 9.

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1. *The Code also refers to these rollovers as 'conversions.' See, IRC § 408A(d)(3)(C).*
 2. *Under the previous exclusion rules, a taxpayer had a one-time exclusion, of up to \$125,000 of gain so long as the taxpayer, age 55 or older, had used the property as a principal residence for 3 out of 5 years preceding the sale. Also a taxpayer could exclude all of the gain from the sale of a principal residence if the sale was, within a period 2 years before or after the sale, and he or she rolled over the gain to a residence at least as costly as, the previous residence. IRC § 121 (pre-'97 amendments).*
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D. Trade or Business Expenses - IRC § 162(a)

The Act amends the definition of "Code" in G.L. c. 62, § 1 (c) to adopt the treatment of trade or business expenses under the current Code and automatically adopts any future changes to the federal trade or business expense deduction. Thus, to the extent a taxpayer is allowed to deduct trade or business expenses in Massachusetts, the amount of the Massachusetts deduction will

correspond to the amount of the federal deduction. The following are examples of how certain trade or business expenses allowed for Massachusetts purposes will be updated to the current

- The IRC § 179 expense allowance will increase gradually to \$25,000 by tax year 2003. The allowable amount for tax year 1998 is \$18,500. In addition, the post-1998 federal rules which will now be adopted for Massachusetts purposes, specifically exclude certain property from the IRC § 179 allowance, such as heating and air conditioning equipment and property used outside the U.S.
- The recovery period for the depreciation of nonresidential real property is increased from 31.5 to 39 years.

G.L. c. 62, § 1 (c), as amended by St. 1998, c. 175, § 6.

E. Travel Expenses - IRC § 274(m)

The Act amends the definition of 'Code' in G.L. c. 62, § 1 (c) to adopt IRC § 274(m) on a current Code basis. Therefore, Massachusetts will now follow the current restrictions in IRC § 274(m) including the disallowance of travel expenses as business deductions when incurred by a spouse or other family members. Under Section 6, Massachusetts automatically adopts any future changes to IRC § 274(m).'

G.L. c. 62, § 1 (c), as amended by St. 1998, c. 175, § 6.

F. Meals and Entertainment Expenses - IRC § 274(n)

The Act amends the definition of 'Code' in G. L. c. 62, § 1 (c) to adopt IRC § 274(n) on a current Code basis. Therefore, Massachusetts will now follow the current restrictions in IRC § 274(n), including the disallowance of 50% of business meals and entertainment expenses. Under Section 6, Massachusetts automatically adopts any future changes to IRC § 274(n).

G.L. c. 62, § 1 (c), as amended by St. 1998, c. 175, § 6.

G. Capital Gains

The Act amends the definition of 'capital gain income' in G.L. c. 62, § 1 (m), to clarify that Massachusetts follows the restrictions on the deductions of losses from personal use property under IRC §§ 165(c) and 262. The Department had adopted these restrictions in its tax reporting forms and in its proposed capital gains regulation. See proposed regulation 830 CMR 62.4.1.4(3)(b).

G.L.c. 62, § 1(m), as amended by St. 1998, c. 175, § 7.

H. Increases in Personal Exemptions⁴

The Massachusetts personal exemptions for the 1998 tax year are increased as follows⁵

3. *Massachusetts continues to disallow the 'per diem' travel expense for state legislators under IRC § 162(h). G.L.c. 62, § 2(d)(1)(1).*

4. *The Department has updated its Massachusetts, Circular M, Income Tax Withholding Tables to reflect these increases. The Circular M is available through Fax on Demand at (617)887-1900 (document Code 224) and on the Department's website at www.mass.gov/tax.*

5. *Subsequent to the passage of this Act, St. 1998, c. 175, the Legislature passed St. 1998, c. 200, An Act Making Certain Appropriations and Transfers For Fiscal Year, 1998. Section, 7 f c. 260 appropriated a., additional \$200 million for the Tax. Reduction Fund established in, G.L. c. 29, §21. As a result, the personal exemptions for the 1998 tax. year will be increased to amounts higher than shown in this TIR. A final determination, or, the exemption, amounts, will be made later in 1998.*

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- single filers from \$2,200 to \$3,815
- head of households from \$3,400 to \$5,895
- joint filers from \$4,400 to \$7,630

G.L. c. 62, §§ 3(B)(b)(1)-(2), as amended by St. 1998, c. 175, §§ 10,12,14.

I. Voluntary Contributions to IRC § 403(b) Retirement Plans

Under Section 8 of the Act, Massachusetts adopts the federal gross income exclusion for voluntary employee contributions to an IRC § 403(b) annuity under a retirement program of the employer. Previously, only contributions to a § 403(b) retirement plan that were mandated by the plan, were excluded from Massachusetts gross income. Massachusetts had a specific statutory provision, G.L. c. 62, § 2(a)(1)(D), which added back to Massachusetts gross income, voluntary contributions to § 403(b) plans (these contributions are sometimes referred to by the plans as supplemental retirement annuities).

Therefore, all contributions to § 403(b) plans, made on or after January 1, 1998, which are excluded from federal gross income, will also be excluded from Massachusetts gross income regardless of whether they are mandated or voluntary contributions.

G.L. c. 62, § 2(a)(1)(D), repealed by St. 1998, c. 175, § 8.

J. Credit for the Replacement or Repair of Failed Cesspools

The Massachusetts credit for the replacement or repair of failed cesspools has been amended to extend the carryover period for unused credit from three to five years. The current \$6,000 limit on the maximum aggregate amount of the credit remains the same. Taxpayers who took the credit in 1997 will now have until 2002, five years, to carryover any unused credit subject to the maximum \$6,000 aggregate credit amount.

G.L. c. 62, § 6(i), as amended by St. 1998, c. 175, § 18.

K. Massachusetts Government Employees' Deferred Compensation Plan

Massachusetts government employees are allowed to contribute to a deferred compensation plan

allows the maximum employee contribution to these plans to be increased based on increases in the cost-of-living. As a result, the Massachusetts government employees' maximum deferral of salary is increased starting in 1998 from \$7,500 to \$8,000.

G.L. c. 29, §§ 64, 64B, as amended by St. 1998, c. 175, §§ 4, 5.

III. Provisions Effective for Tax Years Beginning On or After January 1, 1999

A. Increases in Personal Exemptions

The Massachusetts personal exemptions for the 1999 tax year will be as follows:

- single filers from \$3,815 to \$4,400
- head of households \$5,895 to \$6,800
- joint filers from \$7,630 to \$8,800

G.L. c. 62, §§ 3(B)(b)(1)-(2), as amended by St. 1998, c. 175, §§ 11, 13, 1 S.

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B. Decrease in Tax Rate for Interest and Dividends

The Massachusetts tax rate for interest and dividend income will be reduced from 12% to 5.95%, for tax years beginning on or after January 1, 1999. The rate for short-term capital gains will remain at 12%.

Part A gross income consists of interest, dividends, short-term capital gains and gains on the sale of collectibles. Certain deductions, such as the deduction for short-term losses under G.L.c. 62, § 2(c)(2), reduce Part A gross income in determining Part A adjusted gross income. Other deductions, such as the excess exemptions deduction under G.L.c. 62, § 3(A)(b), reduce Part A adjusted gross income to arrive at Part A taxable income. These deductions apply to Part A income in the aggregate, with no differentiation between interest, dividends, short-term capital gains or gains on collectibles.

The new 5.95% tax rate is imposed on Part A taxable income consisting of interest and dividends. The Act does not specify how the Part A deductions and exemptions should be allocated between the 5.95% Part A Income and the 12% Part A income. The Commissioner will

require Part A exemptions and deductions to be allocated on a prorated basis. Part A taxable income will be multiplied by a ratio of gross interest and dividend income over gross interest, dividends, short-term capital gains and gains on the sale of collectibles. The resulting amount will

consisting of short-term capital gains or gains on the sale of collectibles (net of the long-term gain deduction if applicable), and will be subject to the 12% tax rate.

G.L. c. 62, § 4(a), as amended by St. 1998, c. 175, § 16.

IV. Chapter 319 and Code Update

Chapter 319 updates the Massachusetts personal income tax references to the Internal Revenue Code from January 1, 1988 to January 1, 1998. As a result, any changes to the definition of federal gross income or other specific Code provisions which Massachusetts has adopted, are now adopted for Massachusetts personal income tax purposes, so long as these federal tax law changes are part of the Code as amended and in effect on January 1, 1998. Later this year a more detailed Technical Information Release will be issued regarding general Code update and Chapter 319.

G.L.c. 62, § 1 (c), as amended by St. 1998, c. 319, § 6.

A. Dual Adoption Dates - Current versus Static Code Update This Technical Information Release explains the automatic Code update provisions of Chapter 175. As discussed above, these Code update provisions require the use of the current Code in all future taxable years. Thus, any federal tax law changes after January 1, 1998, affecting Roth and Education IRAs, the exclusion for gain on the sale of a principal residence, trade or business expenses, travel expenses, meal and entertainment expenses and the maximum deferral amount of government employees' deferred compensation plans, will automatically be incorporated into the Massachusetts personal income tax law. In contrast, the Code update provision of Chapter 319 is static. Any federal tax law changes after January 1, 1998, affecting provisions other than those set forth above are not incorporated into the Massachusetts personal income tax law. These provisions will be discussed in a subsequent Technical Information Release.

For example, under Chapter 175, Massachusetts has adopted the federal treatment of Roth and Education IRAs, on a current Code basis. Chapter 319 also adopts the federal treatment of Roth and Education IRAs, but only as of January 1, 1998. In such instances of dual adoption dates for provisions affected by both Chapters 175 and 319 Code update, the Chapter 175 current Code adoption will control. Therefore, in the example above, any future changes to Roth and Education IRAs will be adopted by Massachusetts.

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B. Effective Date for Chapter 319 General Code Update

The effective date for Chapter 319 is June 30, 1998. The Department will apply the Code update provision of Chapter 319 to all returns due on or after July 1, 1998 without regard to extensions. The Department will not require any taxpayers that filed a return based on the 1988 Code on or after July 1, 1998 and before the date of this Technical Information Release, to file an amended

already filed their returns based on the 1988 Code, may amend their returns on the basis of the 1998 Code, subject to the statute of limitations for amending personal income tax returns.

St. 1998, c. 319, § 45.

October 6, 1998

Mitchell Adams, Commissioner of Revenue