



MASSACHUSETTS WILL TAX UNINCORPORATED OWNERS AND PARTNERS ON 401(K)

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1. DIRECTIVE 08-3

The Department of Revenue ("DOR") just confirmed that it wants current taxes from the self-employed and partners ("Unincorporated Owners") on their 401(k) deferrals and matches. For a 50 year old who saves \$20,000, that's \$1,060 up front to the Commonwealth at the 5.3% rate.

Conceding that this is a change in position for 401(k) deferrals, DOR will take no action with respect to 401(k) deferrals in 2007 or earlier years. The Directive applies retroactively to January 1, 2008. When DOR issued a draft of this Directive earlier this year, I submitted comments requesting that it defer the change until 2009. That reasonable request was rejected.

However, there is some IMPORTANT GOOD NEWS in the Directive.

Some Unincorporated Owners may not have realized that DOR had a non-enforcement position prior to 2008. Accordingly, Unincorporated Owners who did pay taxes on 401(k) deferrals for years prior to 2008 may file for rebates with respect to open years.

Dave Grasso of McDermott Will & Emery called a few days after I wrote this to point out that DOR extends this treatment only for deferrals and not for matches. Dave's right on that and it's a great point. The abatements will only be good for deferrals up to the 402(g) limit -- \$15,500 in 2007 -- plus catchups for those age 50 or more. DOR will not allow an abatement request for matches.

2. IS THE DRAFT DIRECTIVE CORRECT?

Frankly, the Directive is a correct interpretation of a very unfair Massachusetts statute, M.G.L. c. 62 § 2(d)(1)(D) (the "Unfair Law"), which the DOR had not enforced for years in the case of 401(k) savings. (See earlier Directives 00-5 and 01-7, and TIR 02-18, all of which are now superseded.)

For those not familiar with the Unfair Law (my term, not theirs):

- ▶ it singles out owners and partners of unincorporated businesses and partnerships, and LLC members who are taxed as owners or partners;
- ▶ it applies to employer contributions to all types of qualified plans, not just 401(k) plans;
- ▶ it does not penalize the workers who get contributions, only the Unincorporated Owners;
- ▶ it does not penalize shareholder-employees who own incorporated businesses, only Unincorporated Owners;
- ▶ it allows basis recovery when taxable amounts are eventually paid. However, that's wasted if the owner lives in a different state during retirement and does not owe Massachusetts taxes on the payment. And, if taxable payments are less than the amount contributed (i.e. if the plan lost money), the basis cannot be applied against other Massachusetts taxable income.

DOR says that the Directive corrects a long-standing misinterpretation of the Unfair Law. They say the Unfair Law was meant to tax Unincorporated Owners on contributions to all types of qualified plans, and there is no exception for 401(k)s. As a technical matter, that's probably correct. The Unfair Law "disallows contributions made on behalf of...(Unincorporated Owners)." A voluntary 401(k) deferral of earnings is characterized in the Internal Revenue Code as an employer profit sharing contribution. DOR reasons that the Unfair Law does not distinguish one type of employer profit sharing contribution from another. Correct or not, the new Directive reverses a long-standing policy which simply treated Unincorporated Owners the same as the people who worked for them, and the same as those who own incorporated businesses.

3. WHY DID THIS HAPPEN IN 2008?

To my knowledge, there was no groundswell from the Legislature urging a change in enforcement position. This decision was approved by a new Administration, which apparently begrudges any retirement saving by unincorporated business owners.

How irksome.

These same bureaucrats are fully exempt from MA tax on their own State pensions, which can be as high as 80% of the best three year earnings average. They also get MA tax breaks for voluntary savings through the State's 457(b) programs.

In Massachusetts, decision-makers get a better set of rules. Surprised?

4. IS THIS GOOD POLICY FOR MASSACHUSETTS?

Of course not. Why should an Unincorporated Owner be singled out for taxation on retirement savings? The new Directive will add to the State's reputation as "Taxachusetts", and a place which is unfriendly to business.

The previous DOR policy prudently distinguished 401(k)s from other qualified plans governed by the Unfair Law. It gave Unincorporated Owners an incentive to sponsor 401(k)s, so that they, and their employees, would save for retirement.

With the added prospect of higher federal tax rates in future years, Unincorporated Owners may reconsider whether it's worthwhile for them to sponsor 401(k) plans at all. Why should an Unincorporated Owner in Massachusetts have the expense and bother of a plan for others when he or she is the only one not to get a tax break?

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