Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Calderon	Analyst:	Victoria Favorito	Bill Number:	AB 104
Related Bills:	See Legislative History	Telephone:	845-3825	Introduced Date:	January 8, 2009
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Conformity To Federal Pension Protection Act of 2006

SUMMARY

This bill would conform California Personal Income Tax Law (PITL) to select provisions of the federal Pension Protection Act (PPA) of 2006, which provides for a waiver of the 10% additional early withdrawal tax on certain distributions of pension plans.

PURPOSE OF THE BILL

According to the author's office, this bill would help public safety employees defray the cost for health insurance.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment and operative for distributions made after August 17, 2006.

POSITION

Pending.

SUMMARY OF SUGGESTED AMENDMENTS

An amendment is suggested to delete unnecessary language.

Board Position:			Department Director	Date
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_______ N	_______ OUA	___X___ PENDING		

ANALYSIS

FEDERAL/STATE LAW

Federal Law:

Prior to the PPA change, distribution from a qualified retirement plan[1], namely a distribution from a government employee retirement plan, received before age 59½, death, or disability generally was subject to a 10% additional early withdrawal tax. The 10% additional early withdrawal tax is calculated as 10% of the amount of the distribution received that is required to be includible in the employee's income, unless an exception applies.[2] An example of an exception is a distribution rolled over from the government plan to a Roth IRA. Such a distribution would be exempt from the 10% early withdrawal tax.

Act section 828 of the PPA of 2006 amended Internal Revenue Code (IRC) section 72(t) to provide an exception to the 10% additional early withdrawal tax and applies to certain distributions from a governmental plan[3] for public safety employees. The federal provision provides the following:

- the "qualified public safety employee" must have received distribution from a governmental defined benefit plan after separating from service with the employer maintaining the plan.
- the term "qualified public safety employee" means an employee of a state or of a political subdivision of a state (such as a county or city) whose principal duties include services requiring specialized training in the area of police protection, firefighting services, or emergency medical services for any area within the jurisdiction of the state or the political subdivision of the state.
- the exception shall apply for distributions made to an employee who separates from service after attainment of age 50.
- the exception applies to distributions made after August 17, 2006.

Prior to the PPA change, under federal law, a distribution from a governmental plan would generally be included in income for the year distributed (except to the extent the amount received constitutes a return of after tax contributions or a qualified contribution from a Roth IRA).

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[1] Qualified retirement plans include the following: qualified annuity plan, a tax-sheltered annuity, under IRC section 403(b) (a "403(b) annuity"), an eligible deferred compensation plan maintained by a state or local government, under IRC section 457 (a "governmental 457 plan"), or an individual retirement arrangement under IRC section 408 (an "IRA").
[2] IRC section 72(t)(2).
[3] The term "governmental plan" shall have the same meaning given by IRC section 414(d).

Act section 845 of the PPA of 2006 amended IRC section 402 by adding a provision that would provide a tax relief to individuals that use distributions received from governmental plans to pay for health and long-term care insurance. The federal provision provides the following:

- an exclusion from gross income up to $3,000 annually for distributions paid from an Eligible Government Plans[4] that are used to pay qualified health insurance premiums[5] of an eligible retired public safety officer or his or her spouse or dependents.
- an eligible retired public safety officer can make an election to have qualified health insurance premiums deducted from amounts distributed from an Eligible Government Plan and paid directly to the insurer.
- an employee is an eligible retired public safety officer[6] for purposes of the exclusion only if the employee is an individual who separated from service, either by reason of disability or after attainment of normal retirement age, and is a public safety officer with an employer who maintains an Eligible Government Plan.

The amounts used to pay qualified health insurance premiums that are excluded from gross income are not taken into account in determining the itemized deduction for medical care expenses under IRC section 213 or the deduction for health insurance or self-employed individuals under IRC section 162. The provision applies to distribution made after December 31, 2006.

California Law:

Section 828 of the PPA of 2006

California conforms to IRC section 72, relating to the additional early withdrawal tax, as of the "specified date" of January 1, 2005, with modifications to the additional early withdrawal tax to be 2 ½% for California purposes, rather than 10% for federal purposes. Therefore, because the PPA changes were made after the "specified date," this federal change to IRC section 72 does not automatically apply.

Section 845 of the PPA of 2006

California laws specifically provides that federal changes to Part I of Subchapter D of Chapter I of the IRC sections 401 through 420, inclusive, relating to pension, profit-sharing, stock bonus plans, other employee benefit plans, and IRC section 457, relating to deferred compensation plans of state and local governments and tax-exempt organizations, automatically apply without regard to taxable year to the same extent as applicable for federal income tax purposes and adopt all changes made to those IRC sections without regard to the "specified date". Therefore, California is conformed to the federal provision that provides an exclusion from gross income distributions from Eligible Governmental Plans to be used to pay qualified health insurance premiums.

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[4] An "Eligible Government Plan" is a governmental plan described in IRC section 414(d) that are either: IRC sections 401(a), 403(a), or 403(b) plan; or an eligible governmental plan under IRC section 457(b).
[5] The term "qualified health insurance premiums" means premiums for coverage for the eligible retired public safety officer, his spouse, and dependents, by accident or health insurance plan or qualified long-term care insurance contract (as defined in IRC section 7702B(b)).
[6] The term "public safety officer" have the same meaning given by section 1204(9)(A) of the Omnibus Crime Control and Safe Streets Act of 1968 (42 U.S.C. 3796b(9)(A).

THIS BILL

This bill would conform California law to section 828 of the PPA that provides an exception to the 10% additional early withdrawal tax for distributions from a governmental plan for public qualified public safety employees.

This bill seeks to conform California law to section 845 of the PPA; however, California already automatically conforms to the section 845 provisions that exclude up to $3,000 annually from gross income distributions from Eligible Governmental Plans used to pay qualified health insurance premiums.

IMPLEMENTATION CONSIDERATIONS

Implementing this bill would not significantly impact the department's programs and operations.

TECHNICAL CONSIDERATIONS

California already conforms to section 845 of the PPA provision that provides an exclusion from gross income distributions from Eligible Governmental Plans to be used to pay qualified health insurance premiums. The author may wish to consider deleting sections 2 and 3 of the bill.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York.* These states were selected due to their similarities to California's economy, business entity types, and tax laws.

Illinois State Constitution allows the Income Tax Act to adopt by reference federal laws and regulations as they then exist or thereafter may be changed, for the purpose of arriving at the amount of income on which tax is imposed, except as otherwise expressly provided. In addition, under current *Illinois* law any federal rules taken into account when calculating federal taxable income will be followed when calculating *Illinois* taxable income. A cursory review of *Illinois* state law was performed and no provisions were found relating to the exclusion from gross income distributions from Eligible Governmental Plans to be used to pay qualified health insurance premiums and to the provision for the exception to the 10% early withdrawal distribution rule. Thus, *Illinois* applies these items in calculating taxable income.

Massachusetts follows the federal treatment of deferred compensation plans as *Massachusetts* incorporates the IRC by reference as of January 1, 2005, with certain exceptions. Thus, *Massachusetts* has not conformed to the federal provisions that provide exclusion from gross income distributions from Eligible Governmental Plans to be used to pay qualified health insurance premiums and to the provision relating to the 10% additional early withdrawal tax exception that applies to certain distributions from a governmental plan for public safety employees because these changes were made after January 1, 2005.

Michigan law conforms to federal law as amended and in effect on January 1, 1996 or at the option of the taxpayer the IRC in effect for the tax year. Thus, the federal provisions relating to the exclusion from gross income distributions from Eligible Governmental Plans to be used to pay qualified health insurance premiums and the provision relating to the 10% additional early withdrawal tax exception that applies to certain distributions from a governmental plan for public safety employees do no apply unless the taxpayer choose to apply the federal provisions when calculating *Michigan* personal income tax.

Minnesota law adopts the IRC as amended through February 13, 2008. Thus, *Minnesota* law applies the federal provisions relating to the exclusion from gross income distributions from Eligible Governmental Plans to be used to pay qualified health insurance premiums and to the provision that provides an exception to the 10% additional early withdrawal tax for distributions from a governmental plan for public qualified public safety employees.

New York law does not conform to the federal provision pertaining to the exclusion from gross income distributions from Eligible Governmental Plans to be used to pay qualified health insurance premiums. However, under *New York* law, pensions and other retirement benefits (including but not limited to annuities, interest and lump sum payments) paid to a public officer or public employee or the beneficiary of a deceased public officer or deceased public employee of the United States are deducted from gross income and distributions paid in a taxable year prior to retirement to public officers and public employees which represent a return of contributions to the applicable public retirement program are also excluded from income.

New York uses an individual's adjusted gross income as the computational starting point for its tax and any deduction or exclusion from gross income must specifically be stated under *New York* law. A cursory review of *New York* law was performed and no provision was found that excluded the federal provision relating to the 10% additional early withdrawal tax exception that applies to certain distributions from a governmental plan for public safety employees. Thus, *New York* would apply the provision in calculating *New York* taxable income.

Florida only has a corporation income tax therefore the federal provisions relating to the exclusion from gross income distributions from Eligible Governmental Plans to be used to pay qualified health insurance premiums and to the provision relating to the 10% additional early withdrawal tax exception that applies to certain distributions from a governmental plan for public safety employees are not applicable.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

Based on data and assumptions discussed below, this bill would result in the following revenue losses. The bill would be effective for taxable years beginning on or after January 1, 2009, and operative for the waiver of early withdrawal penalties for distributions made after August 17, 2006.

Estimated Revenue Impact of AB104 Operative with Penalties for Distributions Made After 8/17/06 Enactment Assumed After 6/30/09				
	2008/09	2009/10	2010/11	2011/12
Waive Penalty (conform to 828 PPA 2006)	-$300,000	-$300,000	-$200,000	-$200,000

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this bill.

Revenue Discussion

Estimates are based on a proration of federal revenue projections developed for the Pension Protection Act of 2006, adjusted to reflect California differences.

The revenue impact of waiving the early withdrawal penalty would be determined by the following:

- the amount of early withdrawal penalties previously paid on applicable distributions between 8/17/06 and 6/30/09, that would be refunded; and
- the amount of penalties forgone on applicable distributions that would be taken annually after 7/1/09 and before 6/30/12.

California data regarding eligible distributions is not readily available; however, eligible distributions would be treated the same for both federal and California tax purposes, except for the amount of the penalty. Federal revenue projections are prorated to California and adjusted for the difference in penalty percentages. Amounts prorated to California are adjusted to reflect that the California penalty is 25% of the federal penalty (California 2.5% penalty divided by the federal 10% penalty equals 25%). It is assumed that California's share of eligible distributions is approximately 13%.

Approximately 65% of the 2009-10 revenue loss accrues back to fiscal year 2008-09 because it is attributed to distributions for prior taxable years.

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