ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author:	Portantino	Analyst:	Scott McFarlane	Bill Number:	AB 558
Related Bills:	See Legislative History	Telephone:	845- 4372	Introduced Date:	February 16, 2011
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Economic Hardship Exception to the Additional Tax on Early Distributions from Certain Retirement Plans

SUMMARY

This bill would provide an exception to the 2½-percent additional tax imposed on early distributions from qualified retirement plans under Internal Revenue Code (IRC) section 401 for distributions that do not exceed $25,000 and that are received by individuals who exhaust their unemployment benefits or who are ineligible for unemployment benefits.

RECOMMENDATION AND SUPPORTING ARGUMENTS

No position.

Summary of Suggested Amendments

Amendment one is suggested to make a technical modification.

PURPOSE OF THE BILL

According to the author's office, the purpose of the bill is to provide tax relief to individuals who take early distributions from their retirement plans because their unemployment insurance benefits have ended.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately and specifically operative for taxable years beginning on or after January 1, 2011, and before January 1, 2013.

ANALYSIS

FEDERAL/STATE LAW

A distribution from a qualified retirement plan under IRC section 401(a), a qualified annuity plan under IRC section 403(a), 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

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section 408 (an “IRA”) generally is included in income for the year distributed.[1] These plans are referred to collectively as “eligible retirement plans.” In addition, a distribution from a qualified retirement or annuity plan, a 403(b) annuity, or an IRA received before age 59½, death, or disability generally is subject to a 10-percent early-withdrawal tax on the amount includible in income, unless an exception applies under IRC section 72(t). Such exceptions apply to distributions that are: (1) used for the health insurance premiums of an unemployed individual; (2) used for medical expenses; (3) made to a beneficiary (or to the estate of the employee) on or after the date of the death of the employee; (4) made to an employee who separates from service at age 55 or older; (5) made to individuals called to active duty; or, (6) used for first-time home purchases.

A special rule applies to simple retirement accounts under IRC section 408(p). In the case of a distribution from a simple retirement that does not meet one of the IRC section 72(t) exceptions, and that is made within two years of the date an individual first participates in a qualified salary-reduction arrangement maintained by an employer, the early-withdrawal tax is 25 percent of any amount includible in income, instead of 10 percent of such amount.

An eligible rollover distribution from a qualified retirement or annuity plan, a 403(b) annuity, a governmental 457 plan, or a distribution from an IRA generally can be rolled over within 60 days to another plan, annuity, or IRA. The IRS has the authority to waive the 60-day requirement if failure to waive the requirement would be against equity or good conscience, including cases of casualty, disaster, or other events beyond the reasonable control of the individual. Any amount rolled over is not includible in income (and thus not subject to the 10-percent early-withdrawal tax).

Distributions from a qualified retirement or annuity plan, 403(b) annuity, a governmental 457 plan, or an IRA are generally subject to income tax withholding unless the recipient elects otherwise. An eligible rollover distribution from a qualified retirement or annuity plan, 403(b) annuity, or governmental 457 plan is subject to income tax withholding unless the distribution is rolled over to another plan, annuity or IRA by means of a direct transfer.

Certain amounts held in a qualified retirement plan that includes a qualified cash-or-deferred arrangement (a 401(k) plan) or in a 403(b) annuity may not be distributed before severance from employment, age 59½, death, disability, or financial hardship of the employee. Amounts deferred under a governmental 457 plan may not be distributed before severance from employment, age 70½, or an unforeseeable emergency of the employee.

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[1] IRC sections 402(a), 403(a), 403(b), 408(d), and 457(a).

State Law

California generally conforms to the federal eligible-retirement-plan rules,[2] including the additional tax on early distributions;[3] however, the additional tax on early distributions is generally modified to be 2½ percent of any amount includible in income for California purposes rather than the federal rate of 10 percent. For simple retirement plans, the early-distribution tax is modified to be 6 percent of any amount includible in income rather than the federal rate of 25 percent.

THIS BILL

This bill would provide an exception to the 2½-percent additional tax imposed on early distributions from a qualified retirement plan under IRC section 401 for distributions that do not exceed $25,000 and that are received by individuals who exhaust their unemployment benefits or who are ineligible for unemployment benefits.

TECHNICAL CONSIDERATIONS

Amendment one is suggested to provide that Section Two of the bill would be operative for taxable years beginning on or after January 1, 2013.

LEGISLATIVE HISTORY

None.

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.

A review of these states' laws found that *Illinois* generally exempts retirement plan contributions and distributions from gross income, and does not impose an additional tax on early distributions. *Massachusetts* does not allow tax-deferred retirement plan contributions, thus such distributions are not taxable until the full amount of the taxpayer's contributions that were previously subject to *Massachusetts* taxes are recovered, and there is no additional tax on early distributions. *Michigan* and *Minnesota* generally follow the federal rules that apply to retirement plan contributions and distributions, but do not impose an additional tax on early distributions.

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[2] R&TC section 17501 conforms to Subchapter D of Chapter 1 of Subtitle A of the IRC, relating to deferred compensation, etc., as of the specified date of January 1, 2009, with modifications—but conforms to certain IRC sections within that subchapter without regard to taxable year, including IRC sections 401, 403, and 408; thus, California automatically conforms to any federal changes to these sections. Similarly, R&TC section 17551 conforms to Subchapter E of Chapter 1 of Subtitle A of the IRC, relating accounting periods and methods of accounting, as of the specified date of January 1, 2009, with modifications—but conforms to IRC section 457 without regard to taxable year, except for allowable elective deferrals; thus, except for elective deferrals, California automatically conforms to federal changes made to IRC section 457.

[3] R&TC section 17081 conforms to Part II of Subchapter B of Chapter 1 of Subtitle A of the IRC, as of the "specified date" of January 1, 2009, with modifications to IRC section 72(t) under R&TC section 17085(c).

New York generally follows the federal rules that apply to retirement plan contributions and distributions, except that an individual who has reached the age of 59½ may exclude up to $20,000 of certain pension distributions to the extent the payments are includible in federal gross income and not otherwise excluded as government pension payments, and there is no additional tax on early distributions. *Florida* does not impose personal income tax: thus, this provision is not applicable to *Florida*.

FISCAL IMPACT

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

ECONOMIC IMPACT

Estimated Revenue Impact of AB 558 As Introduced February 16, 2011 Assumed Enactment After June 30, 2011 $ in Millions		
2011-12	2012-13	2013-14
-$18	-$4.7	$0

SUPPORT/OPPOSITION

Support: None on file.

Opposition: None on file.

ARGUMENTS

Pro: Proponents would argue that this bill would provide tax relief to individuals who take early distributions from their IRC section 401 retirement accounts.

Con: Opponents would argue that this bill would not provide tax relief to individuals who take early distributions from retirement accounts that are generally similar IRC section 401 accounts, except that they're allowed under a different section of the IRC.

POLICY CONCERNS

This bill would provide an exception to the additional tax on early distributions from a qualified retirement plan under IRC section 401, but would not provide an exception to the additional tax on early distributions from any other type of retirement annuity or arrangement, including an IRA under IRC section 408. The author may want to consider amending the bill to provide an additional-tax exception for other types of annuity plans and retirement arrangements that similarly allow early distributions.

The early-distribution additional-tax exception would apply to “an individual who has either exhausted his or her unemployment benefits or who is ineligible for unemployment benefits.” That definition could be interpreted to apply to any individual who is not currently receiving unemployment benefits, including an individual who is employed full time; thus, the author may want to consider amending the bill to more specifically define who would be eligible for the economic-hardship additional-tax exception.

This bill would have a cliff effect; that is, the early-distribution additional-tax exception would apply to any distribution that does not exceed $25,000, but no exception would be provided for any distribution that exceeds $25,000. The author may want to consider amending the bill to except the additional tax on the first $25,000 of an economic-hardship early distribution.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 558
As Introduced February 16, 2011

AMENDMENT 1

On page 4, line 18, after "operative", strikeout "on", and insert:

for taxable years beginning on or after