Financial Security by Design

Investment and Estate Planning

December 17, 2001

Assembly Member Ellen M. Corbett and Senator Jack Scott
Chairs, Assembly and Senate Committees on Revenue and Taxation

Transmitted via e-mail to irene.frausto@asm.ca.gov.

Re: Conforming to Revenue Neutral Retirement Provisions of the 2001 Act

I attach an article which analyzes some effects of non conformity to the new federal pension rules. This article is scheduled to appear in the February 2002 *Journal of Financial Planning.* I thank the *Journal* for permitting distribution of no more than 99 copies to assist in your deliberations.

"Alice" is a retired nurse and my customer. She is concerned that her only option is to convert her 457 pension to a life annuity when it becomes time to take mandatory distributions. She is unhappy with the fees charged by the plan administer and with her limited investment choices and she is disappointed that her plan cannot be converted to a Roth IRA or used to fund her estate plan and that there will be nothing left if she dies prematurely. Alice was therefore delighted to learn that the 2001 Act allows her to roll her account over to an IRA where she will have lower costs and more options.

This rollover would be a non-qualified distribution under current California law, meaning immediate taxation and the potential for a premature distribution penalty. (Fortuitously, this penalty does not apply to 457 distributions.) The non-qualified distribution is an excess contribution to her IRA. It is problematic whether excess contributions have California basis, whether earnings on excess contributions are tax deferred and whether, if earnings are not tax deferred, there is California basis in these earnings. See footnotes 39 -45 in "Pensions, State Taxes and the 2001 Act."

Conforming to the rollover provisions of the 2001 Act is revenue neutral, unless one argues that California should profit by double taxing rollovers which are qualified under federal law. Non-conformity disadvantages all Californians but lower income Californians who do not have access to professional advice will be most affected.

Non-conformity also affects new residents who are often unaware of the California differences since most states routinely conform to changes in the Internal Revenue Code. "Albert" finds that he must pay California tax, a

Certified Financial Planner - Enrolled Agent - Registered Investment Advisor
852 Acampo Drive, Lafayette, CA 94549-5040
(925) 299 - 0472 FAX (925) 299 - 0473 lingane@post.harvard.edu www.lingane.com/tax

premature distribution penalty and federal AMT as a result of a rollover that would have had no tax consequences in his former domicile.

Similar issues of basis and tax deferral crop up if a California resident makes the larger contributions allowed by the 2001 Act.

A favorable legal opinion by the appropriate state agency would put my basis and tax deferral concerns to rest. But if these concerns are justified, or if administrative action is not possible, we need legislation to insure that California does not double tax and penalize non-qualified distributions and excess contributions and that the earnings on excess contributions are tax-deferred.

Non-conformity hurts the California employer. $20,200 worth of payroll deductions are disallowed on "ABC Corporation's" California return simply because this small firm eased pension administration as allowed by the 2001 Act. The denied deduction would increase if ABC Corporation were to let its employees increase contributions as allowed by the 2001 Act.

We need legislative action to guarantee employers a California deduction for pension contributions which are deductible under the 2001 Act. This proposal is revenue neutral since these contributions would be otherwise deductible as wages.

A non increasing life annuity is the only distribution method allowed Alice and other state, county and municipal employees with 457 plans. The 2001 Act makes the 457 distribution rules the same as for IRAs and other pensions. Non-conformity discriminates against these valued employees.

Non-conformity means substantial administrative burdens. Californians, California businesses and pension administrators will have to keep separate books for California purposes.

Non-conformity means that the FTB has to audit additional individual and corporate returns.

There may be intangible benefits from conforming to certain increased contribution limits. It may be, for example, that increasing IRA contribution limits or allowing catch-up contributions has a tolerable fiscal impact while disproportionately benefiting lower income or older taxpayers.

Action is needed in at least the five areas shown below.

1. Insure that excess contributions and earnings are not taxed twice.
2. Insure that earnings on excess contributions grow tax-deferred.
3. Insure that employers a full deduction for pension contributions.
4. Conform rollover opportunities.
5. Conform distribution options for 457 plans.

Action is needed early in the new year because Californians tend to review their financial affairs, and pension decisions, when preparing their tax returns.

Thank you for your consideration of these recommendations. I would be pleased to assist your committees with further analysis. I request an opportunity to participate in the January discussions.

Peter James Lingane

Encl. *Pensions, State Taxes and the 2001 Act.*