L E G I S L A T I V E

TAXBILLSERVICE

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SUBJECT: INCOME, Taxability of rollovers of state and county employees

BILL NUMBER: HB 1550

INTRODUCED BY: Chong, Say and Yamashita

BRIEF SUMMARY: Amends HRS section 235-2.4 to add a new paragraph (m) to provide that in administering IRC section 403 (with respect to taxation of employee annuities), section 403(b)(8)(A)(ii) shall not be operative for state income tax purposes. Also adds a new paragraph (n) to provide that in administering IRC section 457 (with respect to rollover amounts in deferred compensation plans for state and local governments), section 457(e)(ii) shall not be operative for state income tax purposes.

EFFECTIVE DATE: Tax years beginning after December 31, 2008

STAFF COMMENTS: Under the current law, rollovers made by state and county employees from a deferred compensation plan into eligible state or county retirement plans are not taxed under the federal or state income tax. At retirement, when distributions are made from the state or county retirement plans, the distributions, while taxed for federal income tax purposes, will not be taxed for state income tax purposes.

If enacted, this measure proposes that such rollovers made by state and county employees shall be taxable for state income tax purposes since when distributions are made by the employee upon retirement, such distributions will not be taxable. Thus, this measure attempts to subject what had been tax deferred contributions to a 403(b) compensation plan to the state income tax at the time it is rolled over into a state or county pension plan. This appears to be equitable inasmuch as the distribution from a state or county plan will be tax exempt at the time of retirement.

Digested 2/9/09

LATE

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HOUSE COMMITTEE ON LABOR AND PUBLIC EMPLOYMENT

TESTIMONY REGARDING HB 1550
RELATING TO TAXATION

TESTIFIER: KURT KAWAFUCHI, DIRECTOR OF TAXATION (OR DESIGNEE)
DATE: FEBRUARY 10, 2009
TIME: 9:00 AM
ROOM: 309

This legislation imposes the Hawaii income tax on rollovers made by employees of governmental agencies and nonprofit organizations from qualified deferred compensation and qualified annuity plans to another qualified retirement plan or to an individual retirement (or individual annuity) plan.

The Department offers **comments** to the proposed legislation.

As drafted, this measure would impose an income tax on employees of state and local governments that participate in deferred compensation plans, and employees of 501(c)(3) organizations and public schools with qualified annuity plans, when they rollover amounts in such qualified plans under §§ 403 and 457 of the Internal Revenue Code (the "Code") to another qualified retirement plan or individual retirement account. Both Hawaii and the Federal government do not tax employee- and employer-funded contributions to such qualified plans until the funds are distributed to the individual. Generally, balances in such plans may be rolled over to other qualified retirement plans (and individual retirement accounts) tax-free.

Retirement benefits for certain employees of the State of Hawaii and the City and County of Honolulu, and teachers were affected when the Employee Retirement System changed from a noncontributory pension plan to the "hybrid" plan currently being offered. To maximize their retirement benefits, affected employees may be allowed to use the balances in their §§ 403(b) (qualified annuities for 501(c)(3) organizations and public schools) and 457 (qualified deferred compensation plans for state and local governments) to "purchase" retirement credits for the years in which the plan was "noncontributory" by transferring monies from the §§403 and 457 plans to the hybrid plan. Without any legislation, the transfer would be considered a qualified rollover and the funds would not be subject to Federal or Hawaii income tax at the time of the "rollover."

Pursuant to §88-91, Hawaii Revised Statutes ("HRS"), pension distributions from the hybrid are not subject to income tax. Therefore, any amounts transferred by affected governmental employees from a §§403(b) or 457 plan to the hybrid plan would completely escape Hawaii income taxation.

If the intent of this measure is to impose a tax on individuals who use the funds in their §§403 and 457 plans to "purchase" retirement credits, as noted above, the legislation should be revised to limit taxation to such individuals. As written, any individual who rolls over funds from a §403(b) or §457 plan to another qualified plan or individual retirement account would be subject to income tax.

This measure will result in a revenue increase to the general fund. Assuming $10 million in rollovers are taxed, this measure will result in a revenue gain of $600,000.