

MEMO# 18985

June 29, 2005

INSTITUTE FOLLOW-UP LETTER TO PENNSYLVANIA DEPARTMENT OF REVENUE REGARDING PROPOSED WITHHOLDING PROVISION

©2005 Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice. [18985] June 29, 2005 TO: PENSION COMMITTEE No. 24-05 PENSION OPERATIONS ADVISORY COMMITTEE No. 22-05 RE: INSTITUTE FOLLOW-UP LETTER TO PENNSYLVANIA DEPARTMENT OF REVENUE REGARDING PROPOSED WITHHOLDING PROVISION The Pennsylvania General Assembly is considering H.B. 1557, comprehensive tax reform legislative that includes section 324.81, which would require withholding on early distributions (defined the same as under federal law) from qualified plans, IRAs and commercial annuities. Withholding would be required except to the extent the payor reasonably believes the distribution is excludable from Pennsylvania tax. Under the bill, an early distribution would be excludable to the extent of contributions to the plan. Federal law and every state except Pennsylvania defer taxation on contributions to a qualified plan. If section 324.8 were enacted, Pennsylvania plan participants would be taxed twice on qualified plan contributions unless Pennsylvania taxable basis is tracked. Pennsylvania does not have a system established for Pennsylvania taxpayers to recover over- withheld amounts. The Institute submitted a letter to the Pennsylvania Department of Revenue ("DOR") to urge that section 324.8 be removed from H.B. 1557 because it would require that payors either make costly modifications to their systems in order to track Pennsylvania taxable basis or withhold on 100% of early distributions.² In the alternative, the letter proposed delaying enactment of section 324.8 until Pennsylvania has established a mechanism for Pennsylvania taxpayers to recover over-withheld amounts and to educate taxpayers regarding the implications of the new withholding rules. DOR is considering proposing an amendment to section 324.8 to add a safe harbor withholding rule for payors that are unable to accurately track Pennsylvania basis. The safe harbor would require payors to withhold at the applicable Pennsylvania rate on 25% of the total amount of an early distribution (existing bill language would require these payors to withhold on 100% of an early distribution) beginning with distributions made on or after July 1, 2006. 1 Go to <http://www2.legis.state.pa.us/WU01/LI/BI/BT/2005/0/HB1557P1932.pdf> to see HB 1557. Section 324.8 begins on page 15 of the bill. 2 See Institute Memorandum (18954) to Pension Members No. 30-05 and Tax Members No. 17-05, dated June 17, 2005. 2 In the attached letter, the Institute states that while most payors would likely be able to amend their systems to comply with a safe harbor withholding rule by July 1, 2006, we continue to

urge striking section 324.8 from H.B. 1557 because of the continuing likelihood of double taxation of Pennsylvania residents under the safe harbor rule and the costs to payors to modify existing systems. There is likely to be a House vote on this language, which is strongly supported by DOR, during the first week of July. Please contact me at 202-326-5835 or lrobinson@ici.org with any comments regarding the attached letter by close of business on Friday, July 1, 2005. In particular, please provide comments regarding whether it is possible to modify systems to comply with the safe harbor withholding rule by the proposed effective date of July 1, 2006. Lisa Robinson Associate Counsel Attachment (in .pdf format)

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