

## ICI Comments on Pennsylvania Tax Reform Legislation, June 2005

June 15, 2005

Hon. Gregory C. Fajt Mr. Christopher Zettlemoyer  
Secretary of Revenue Chief Counsel  
Pennsylvania Department of Revenue Pennsylvania Department of Revenue  
Executive Office 1032 Strawberry Square  
1133 Strawberry Square Harrisburg, PA 17128-1100  
Harrisburg, PA 17128-1100

### **RE: Withholding on Early Distributions Under Section 324.8 of H.B. 1557**

Dear Secretary Fajt and Chief Counsel Zettlemoyer:

The Investment Company Institute<sup>1</sup> (the "Institute") is extremely concerned about the impact that section 324.8 of H.B. 1557 would have on Pennsylvania residents participating in qualified plans. This provision would require all payors to withhold Pennsylvania state tax on early distributions from an employee benefit plan to any Pennsylvania resident—except to the extent the payor reasonably believes the distribution is excludable from Pennsylvania tax. Under the bill, the early distribution would be excludable to the extent of contributions to the plan.<sup>2</sup>

Section 324.8 apparently would require payors to choose either to track Pennsylvania taxable basis (i.e., contributions) for early distribution purposes or to withhold on 100% of the amount distributed. Current reporting and withholding systems generally do not track basis for qualified plans because all distributions either are fully exempt from tax (in Pennsylvania) or fully taxable (in every other income tax jurisdiction).

If section 324.8 were enacted, Pennsylvania plan participants would be taxed twice on qualified plan contributions unless Pennsylvania taxable basis is determined. As the bill would apply to future early distributions, it would apply retroactively to contributions already made. Existing systems do not have contribution data and there is little ability to reconstruct this data at reasonable cost, if at all. Changing existing systems to capture future contributions would be costly and time-consuming.

Any payor not tracking basis would withhold 100% on early distributions from qualified plans to Pennsylvania residents—thus taxing Pennsylvania residents twice on their qualified plan contributions. Pennsylvania currently does not provide a form (e.g., a form similar to federal Form 8606) that Pennsylvania taxpayers can use to identify and recover the portion of an early distribution that has already been taxed. Even if Pennsylvania were to develop a mechanism for recovering over-withheld amounts, it would take some time to educate Pennsylvania residents regarding the new law and the fact that if they fail to track their Pennsylvania taxable basis, they will be taxed twice by Pennsylvania on their qualified plan contributions.

## Recommendations

Section 324.8 should be stricken from H.B. 1557. If this provision is enacted, its effective date should be delayed until the Department of Revenue develops a form or other mechanism for Pennsylvania residents to identify and recover over-withheld amounts and educates Pennsylvania residents about the benefits of seeking a refund of over-withheld amounts.

\* \* \*

We appreciate the opportunity to comment on H.B. 1557. We would be pleased to speak with the Department of Revenue regarding section 324.8 and to provide additional information or assistance.

Sincerely,

Lisa Robinson  
Associate Counsel

cc: Hon. H. William DeWeese  
Hon. David K. Levdansky

#### ENDNOTES

<sup>1</sup> The Institute is the national association of the American mutual fund industry. Institute members provide the investment vehicles through which many families save for retirement and also serve as program managers, custodians, trustees, record keepers and service providers for retirement savings vehicles. ICI members include 8,541 open-end investment companies (mutual funds), 653 closed-end investment companies, 143 exchange-traded funds, and 5 sponsors of unit investment trusts. Mutual fund members of the ICI have total assets of approximately \$7.838 trillion (representing more than 95 percent of all assets of US mutual funds); these funds serve approximately 87.7 million shareholders in more than 51.2 million households.

<sup>2</sup> Pennsylvania, uniquely, does not provide a tax deduction for contributions to qualified plans. Instead, Pennsylvania exempts retirement plan distributions from state tax.