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January 31, 2012

House Taxation Committee

Testimony in Support of House Bill 2480

Presented by Richard Cram

Chairman Richard Carlson and Members of the Committee:

The Department of Revenue respectfully submits the following in support of House Bill 2480:

Clarify that Thrift Savings Plan distributions are not exempt from Kansas Income Tax

House Bill 2480 would clarify the subtraction modification at K.S.A. 79-32,117(vii) by amending it as follows:

Amounts received as annuities under the federal civil service retirement system from the civil service retirement and disability fund and other amounts received as retirement benefits ~~in whatever form~~ from a defined benefit plan which were earned for being employed by the federal government or for service in the armed forces of the United States.

Background

Under 4 U.S.C. Section 111, states are authorized to tax federal employees' compensation if the taxation does not discriminate against the employees because of the compensation's source. Prior to 1992, Kansas exempted federal civil servant retirement pay (L. 1966, Ch. 233, Section 3(viii)). Similarly, Kansas also exempted the retirement pay of state and local government employees enrolled in KPERS. However, Kansas taxed military retirement pay.

The U.S. Supreme Court in *Barker v. Kansas, et al.*, 503 U.S. 594 (1992) reversed the Kansas Supreme Court, 249 Kan. 816, 815 P.2d 46 (1991). In *Barker*, several military retirees brought suit to challenge the legality of the taxation of military retirement benefits. The Kansas Supreme Court upheld such taxation, but the U.S. Supreme Court reversed, relying upon 4 U.S.C. Section 111. The Court held that federal law did not permit Kansas to tax military

retirement benefits when Kansas exempted retirement benefits of state and local government retirees under KPERS. The Court found no significant differences between military retirees and state and local government retirees in terms of calculating retirement benefits, which were based on years of service and rank, and considered both to be deferred pay for past services.

The language proposed to be amended above was added in 1992 in Senate Bill 215, L. 1992, Chapter 247, Section 1, in order to codify the *Barker* decision (see Report on Legislative Interim Studies, December 1992, p. 9).

Thrift Savings Plan (TSP) Accounts

TSP accounts, created in 1986, are available to federal government employees, and are similar to a 401(k) plan in the private sector. The TSP is in addition to the federal employee retirement system (FERS) annuity or civil service retirement system (CSRS) annuity received upon retirement from federal civilian service based on grade and years of service, or pay received by retired military based on rank and years of service. The purpose of the TSP is to provide the federal employee the ability to participate in a long-term savings and investment plan. It is a defined contribution plan, whereas the FERS and CSRS annuities, as well as military retirement pay, are defined benefit plans.

For a FERS employee, the employing federal agency makes a contribution to the employee's TSP account equal to 1% of the employee's salary. This is not taken out of salary, and the employee does not become entitled to this amount until a "vesting" period of 2 to 3 years. The employing agency will also match the employee's pre-tax contribution from salary to the TSP, dollar for dollar, up to 3% of salary, and 50% of pre-tax salary contributions from 3% to 5% of salary. The employee can also contribute additional pre-tax amounts above that to the TSP (subject to a maximum imposed by the IRS, \$16,500 for 2011). The federal employee can also rollover amounts from certain other types of retirement accounts to the TSP. For a CSRS employee or member of the military, pre-tax contributions can be made from salary, but they are not matched by the employing agency.

TSP account proceeds are invested in a variety of kinds of funds, from which the employee can choose. Earnings accrue on those investments, and when the employee retires, distributions from the TSP account are then taxed, similar to 401(k) plan distributions.

The TSP account also has certain similarities to the deferred compensation account available to state employees. Both are defined contribution retirement savings plans. The deferred compensation account allows state employees to invest pre-tax salary contributions in a selection of funds, which earn income during the working years. When the state employee retires and takes distributions from the deferred compensation account, those distributions become taxable—both at the federal and state level. The state does not make any contribution to an employee's deferred compensation account, unlike TSP accounts.

KPERS, similar to the FERS and CSRS annuities and military retirement, is a defined benefit plan, providing payments to the retired state worker based on rank and years of service.

Proposed Amendment

The proposed amendment would clarify, consistent with the Department's longstanding interpretation, that the subtraction modification at K.S.A. 79-32,117(vii) exempts federal retirement benefits from defined benefit plans from Kansas income tax, but would not exempt distributions from a defined contribution plan, such as a TSP. This is consistent with the state tax treatment of retirement benefits for state employees in KPERS: retirement benefits from KPERS are exempt from Kansas income tax (although KPERS employees' contributions from salary to their KPERS accounts are subject to state income tax), and distributions to retired state employees from deferred compensation accounts, which are defined contribution plans, are taxable.

The Department seeks this clarification, due a pending administrative appeal challenging the Department's interpretation. Our fiscal note, attached, indicates no fiscal impact to this proposal, since it would codify the Department's current interpretation. Without the clarification in House Bill 2480, should a challenge to the Department's interpretation be successful in the courts (i.e., should TSP account distributions to federal retirees be determined exempt from Kansas income tax), the potential negative fiscal impact would be an estimated \$6 million per fiscal year, plus a 5% annual growth factor.

Correct federal statutory citation in railroad retirement annuities subtraction modification

K.S.A. 79-32,117(c)(viii) provides a subtraction modification for: "(viii) Amounts received by retired railroad employees as a supplemental annuity under the provisions of 45 U.S.C. 228b (a) and 228c (a)(1) et seq." A recently submitted appeal required review of the federal provisions incorporated by reference and it was discovered these provisions were actually repealed in 1974, one year after they were incorporated into Kansas law. The current, equivalent federal provisions that replaced them are 45 U.S.C. 231a(a) and 231b(a)(1). House Bill 2480 would amend this provision to refer to and incorporate the current federal provisions. The proposed amendment is simply a technical correction to update the reference in Kansas law to current, equivalent federal law.

MEMORANDUM

To: Mr. Steve Anderson, Director
Division of Budget

From: Kansas Department of Revenue

Date: 01/23/2012

Subject: House Bill 2480
Introduced as a House Bill

Brief of Bill

House Bill 2480, as introduced, amends K.S.A. 79-32,117 to clarify that the subtraction modification from federal adjusted gross income for amounts received by federal civil service retirees as retirement benefits must be from a defined benefit plan.

The effective date of this bill is on publication in the statute book.

Fiscal Impact

Passage of this bill will not impact state general fund revenues. This bill clarifies the Department's interpretation of K.S.A. 79-32,117(c)(vii) that distributions from Thrift Savings Plan accounts to federal retirees are not exempt from Kansas income tax. Should this bill not be enacted, the Department's interpretation may be challenged, leaving the determination of the correctness of the Department's interpretation up to the courts. If the Department's interpretation is challenged in court, and should the court determine that the Department's interpretation is incorrect, i.e., distributions from Thrift Savings Plan accounts to federal retirees should be treated as exempt from Kansas income tax, then this could result in a negative fiscal impact of \$6 million per fiscal year, plus a 5% annual growth factor.

Administrative Impact

No Impact.

Administrative Problems and Comments

Taxpayer/Customer Impact

Legal Impact

This bill would clarify the Department's longstanding interpretation of K.S.A. 79-32,117(c)(vii) that distributions from Thrift Savings Plan accounts to federal retirees are not exempt from Kansas income tax and do not fall within this subtraction modification provision. This bill is in response to recent claims by taxpayers that distributions from Thrift Savings Plan accounts to federal retirees should be considered exempt, under the provisions of K.S.A. 79-32,117(c)(vii). Enactment of this bill would eliminate any uncertainty as to whether the Department's interpretation is correct. Without enactment of this bill, the Department's interpretation may be challenged through litigation, which may result in the courts making the determination as to whether the Department's interpretation is correct. If the courts were to determine that the Department's interpretation was incorrect and distributions from Thrift Savings Plans to federal retirees are to be treated as exempt from Kansas income tax under K.S.A. 79-32,117(c)(vii), this could have a negative fiscal impact on State General Fund revenues of \$6 million/FY.

Approved By:

A handwritten signature in black ink, appearing to read "Nick Jordan", written in a cursive style.

Nick Jordan
Secretary of Revenue