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109TH CONGRESS
2d Session

HOUSE OF REPRESENTATIVES

REPORT
109–542

STATE TAXATION OF RETIREMENT INCOME

JUNE 29, 2006.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

Mr. SENSENBRENNER, from the Committee on the Judiciary, submitted the following

R E P O R T

[To accompany H.R. 4019]

[Including cost estimate of the Congressional Budget Office]

The Committee on the Judiciary, to whom was referred the bill (H.R. 4019) to amend title 4 of the United States Code to clarify the treatment of self-employment for purposes of the limitation on State taxation of retirement income, having considered the same, report favorably thereon with an amendment and recommend that the bill as amended do pass.

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THE AMENDMENT

The amendment is as follows:

Strike all after the enacting clause and insert the following:

49–006

SECTION 1. CLARIFICATION OF TREATMENT OF SELF-EMPLOYMENT FOR PURPOSES OF THE LIMITATION ON STATE TAXATION OF RETIREMENT INCOME.

(a) IN GENERAL.—Section 114(b)(1)(I) of title 4, United States Code, is amended—

(1) by inserting "(or any plan, program, or arrangement that is in writing, that provides for retirement payments in recognition of prior service to be made to a retired partner, and that is in effect immediately before retirement begins)" after "section 3121(v)(2)(C) of such Code",

(2) by inserting "which may include income described in subparagraphs (A) through (H)" after "(not less frequently than annually",

(3) by adding at the end the following:

"The fact that payments may be adjusted from time to time pursuant to such plan, program, or arrangement to limit total disbursements under a predetermined formula, or to provide cost of living or similar adjustments, will not cause the periodic payments provided under such plan, program, or arrangement to fail the 'substantially equal periodic payments' test.", and

(4) by adding at the end the following:

"(4) For purposes of this section, the term 'retired partner' is an individual who is described as a partner in section 7701(a)(2) of the Internal Revenue Code of 1986 and who is retired under such individual's partnership agreement.".

(b) APPLICATION.—The amendments made by this section apply to amounts received after December 31, 1995.

PURPOSE AND SUMMARY

H.R. 4019 makes technical and clarifying amendments to section 114 of title 4 of the United States Code.

BACKGROUND AND NEED FOR THE LEGISLATION

H.R. 4019 makes technical and clarifying amendments to section 114 of title 4 of the United States Code, which was enacted in 1996 to restrict the ability of States to tax certain types of pension income received by their former residents and nonresidents who earned income in that State.[1] Section 114 exempts from non-resident taxation certain income received from "qualified" pension plans (as defined in the Internal Revenue Code) as well as income received under certain "non-qualified" retirement plans, including liquidation payments paid out of current year profits to retiring partners in a service partnership. Specifically, section 114(a) prohibits a State from taxing "retirement income" of its former residents or nonresidents who earned income within the State, including income from a nonqualified deferred compensation plan, provided it is part of a series of substantially equal periodic payments made (not less frequently than annually) over the life expectancy of the recipient, or for a period of not less than 10 years. Section 114(b)(1)(I) defines nonqualified deferred compensation plans by reference to section 3121(v)(2)(C) of the Internal Revenue Code, which relates to employment taxes.[2]

Questions have arisen as to whether section 114 was intended to apply to nonqualified retirement income paid by a partnership to its retired nonresident partners (including retired partner equivalents, e.g., retired principals). The reference to section 3121(v)(2)(C) is definitional with regard to nonqualified deferred compensation income, irrespective of whether the recipient was subject to the Federal Insurance Contribution Act ("FICA") tax. Nevertheless, the provision's incorporation of the Internal Revenue Code's definition of "nonqualified deferred compensation plans" has been construed

[1] Pub. L. No. 104–95, 109 Stat. 979 (codified at 4 U.S.C. § 114 (2002)).
[2] 26 U.S.C. § 3121(v)(2)(C) (2002).

by at least one State to limit the exemption to payments made only to retired employees (i.e., those individuals subjected to FICA tax), as section 3121(v)(2)(C) is written in the context of employment taxation and there is no specific reference to retired partners in section 114 of title 4 of the United States or in section 3121(v)(2)(C) of the Internal Revenue Code.

On October 7, 2005, Representative Cannon (R–UT) introduced H.R. 4019 to clarify that this exemption applies to both retired employees and retired partners by specifically including written plans or arrangements for retired partners. A retired partner is defined as a person who is described as a partner in Internal Revenue Code Section 7701(a)(2) and who is retired under the person's partnership agreement. The bill makes clear that any written plan, program, or arrangement in effect at the time of retirement that provides for payments to a retired partner in recognition of prior service may qualify as exempt from nonresident State income taxation as long as such payments are made over 10 years or more and are made in substantially equal periodic payments.

H.R. 4019 also clarifies the definition of substantially equal periodic payments to permit plan caps on retiree payments and cost of living adjustments (COLAs), and clarifies that the substantially equal periodic payments test is satisfied when payments include components from both qualified and nonqualified plans. These modifications are intended to clarify existing law rather than substantively amend it.

H.R. 4019 is intended to make clear Congress's original intent when it passed section 114, i.e. to limit the taxation of retirement income to the State in which the retiree resides, whether the retirement payments are made to a retired employee or a retired partner. H.R. 4019 merely confirms and continues this Congressional intent.

HEARINGS

The House Committee on the Judiciary's Subcommittee on Commercial and Administrative Law held a hearing on H.R. 4019 on December 13, 2005. Testimony was received from the following witnesses: the Honorable George W. Gekas, former United States Representative and former Chairman of the Subcommittee on Commercial and Administrative Law; Lawrence F. Portnoy, retired partner, PricewaterhouseCoopers LLP; Harley T. Duncan, Executive Director, Federation of Tax Administrators; and Stanley R. Arnold, CPA, former Commissioner of New Hampshire's Department of Revenue Administration and former President of the Federation of Tax Administrators.

COMMITTEE CONSIDERATION

On December 13, 2005, the Subcommittee on Commercial and Administrative law met in open session and ordered favorably reported the bill, H.R. 4019, by voice vote, a quorum being present. On June 7, 2006, the full Committee met in open session and ordered favorably reported the bill, H.R. 4019, as amended, by voice vote, a quorum being present.

VOTE OF THE COMMITTEE

In compliance with clause 3(b) of rule XIII of the Rules of the House of Representatives, the Committee notes that there were no recorded votes during the Committee consideration of H.R. 4019.

COMMITTEE OVERSIGHT FINDINGS

In compliance with clause 3(c)(1) of rule XIII of the Rules of the House of Representatives, the Committee reports that the findings and recommendations of the Committee, based on oversight activities under clause 2(b)(1) of rule X of the Rules of the House of Representatives, are incorporated in the descriptive portions of this report.

NEW BUDGET AUTHORITY AND TAX EXPENDITURES

Clause 3(c)(2) of rule XIII of the Rules of the House of Representatives is inapplicable because this legislation does not provide new budgetary authority or increased tax expenditures.

CONGRESSIONAL BUDGET OFFICE COST ESTIMATE

In compliance with clause 3(c)(3) of rule XIII of the Rules of the House of Representatives, the Committee sets forth, with respect to the bill, H.R. 4019, the following estimate and comparison prepared by the Director of the Congressional Budget office under section 402 of the Congressional Budget Act of 1974:

U.S. CONGRESS,
CONGRESSIONAL BUDGET OFFICE,
Washington, DC, June 22, 2006.

Hon. F. JAMES SENSENBRENNER, Jr.,
Chairman, Committee on the Judiciary,
House of Representatives, Washington, DC.

DEAR MR. CHAIRMAN: The Congressional Budget Office has prepared the enclosed cost estimate for H.R. 4019, a bill to amend title 4 of the United States Code to clarify the treatment of self-employment for purposes of the limitation on State taxation of retirement income.

If you wish further details on this estimate, we will be pleased to provide them. The CBO staff contact is Sarah Puro.

Sincerely,

DONALD B. MARRON,
Acting Director.

Enclosure.

H.R. 4019—A bill to amend title 4 of the United States Code to clarify the treatment of self-employment for purposes of the limitation on State taxation of retirement income

H.R. 4019 would amend current law (Public Law 104–95) to prohibit State taxation of certain retirement income of former residents. The legislation would specifically limit the ability of States to tax the retirement income of nonresidents who were partners in firms domiciled within a State. These provisions could result in some individuals having lower itemized deductions of State income

taxes on their federal income tax returns and, therefore, higher federal income taxes. Under the assumption that, in the absence of this legislation, States would continue to tax certain retirement income of former residents, CBO estimates that enacting this bill would result in an increase in federal income taxes of less than $500,000 per year, totaling about $1 million over the 2007–2016 period. CBO estimates that H.R. 4019 would have no significant impact on federal spending.

The prohibition on taxing the income of certain retirees would constitute an intergovernmental mandate as defined in the Unfunded Mandates Reform Act (UMRA) because it would preempt the authority of States to tax. Since UMRA includes in its definition of the direct costs of a mandate amounts that State and local governments would be prohibited from raising in revenues, the cost of this mandate would include the amounts that States are currently collecting but would be precluded from collecting under H.R. 4019. Based on information from the States and some of the affected partnerships, CBO estimates that the net costs to State governments would likely total less than $5 million annually and thus would not exceed the threshold established in UMRA ($64 million in 2006, adjusted annually for inflation) in any of the first five years after enactment.

Under current law, there is some uncertainty as to the taxability of the income of retired partners who do not currently live in the State where they initially earned that income. Only one State, New York, has issued rules that require retired partners to pay such taxes, and those rules are currently being challenged in court. At least 15 other States report that they currently collect tax on such revenues although they are not actively auditing or pursuing partners or companies who are not remitting these taxes. It is unclear if other States currently collect such tax or would do so in the next five years in the absence of legislation.

In total, CBO estimates that actual State tax collections that would be affected by this legislation total less than $10 million annually. Many retired partners who pay taxes to States where they do not currently live receive credit for those taxes in the State where they do live. Such credits would partially offset these losses, resulting in a net impact across all States totaling less than $5 million annually.

The bill contains no private-sector mandates as defined in UMRA.

The CBO staff contacts for this estimate are Barbara Edwards (for federal revenues) and Sarah Puro (for the State and local impact). This estimate was approved by Peter H. Fontaine, Deputy Assistant Director for Budget Analysis, and G. Thomas Woodward, Assistant Director for Tax Analysis.

PERFORMANCE GOALS AND OBJECTIVES

The Committee states, pursuant to clause 3(c)(4) of rule XIII of the Rules of the House of Representatives, that H.R. 4019 will clarify treatment of self-employment for purposes of the limitation on State taxation of retirement income.

CONSTITUTIONAL AUTHORITY STATEMENT

Pursuant to clause 3(d)(1) of rule XIII of the Rules of the House of Representatives, the Committee finds the authority for this legislation in art. I, § 8, cl. 8 of the Constitution.

SECTION-BY-SECTION ANALYSIS AND DISCUSSION

The following discussion describes the bill as reported by the Committee.

Sec. 1. Clarification of treatment of self-employment for purposes of the limitation on State taxation of retirement income

Subsection 1(a) of H.R. 4019 amends section 114 of title 4 of the United States Code to clarify that States may not impose an income tax on non-resident retirement income received under certain nonqualified deferred compensation plans, including written plans, in effect at the time of retirement, providing for payments to a retired partner (as defined in subsection 1(a)) in recognition of prior service, as long as such payments are made over 10 years or more, and are made in substantially equal periodic payments.

Subsection 1(a) of H.R. 4019 also amends section 114 to permit benefit reductions pursuant to a predetermined formula capping total disbursements, or benefit adjustments pursuant to plan provisions providing COLA adjustments, without causing the periodic benefits provided under the plan to fail the "substantially equal periodic payments" test. For example, in order to manage retirement costs, a company might limit aggregate payments to retirees to a certain percentage of its annual income such that benefit reductions would be required if this cap is reached. Subsection 1(a) of H.R. 4019 amends section 114 to clarify that the substantially equal periodic payments test is satisfied when payments include components from both qualified and nonqualified plans. For example, under a pre-determined plan formula, the total annual payments to a retiree may remain the same from year to year, but the payments may be required to come first from a Keogh plan (i.e., qualified plan) until depleted and then from the general assets of the business (i.e., nonqualified plan).

Subsection (1)(b) specifies that the amendment applies to amounts received after December 31, 1995. For open years, refunds or credits would be available to the extent allowed under applicable state law.

CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED

In compliance with clause 3(e) of rule XIII of the Rules of the House of Representatives, changes in existing law made by the bill, as reported, are shown as follows (new matter is printed in italic and existing law in which no change is proposed is shown in roman):

SECTION 114 OF TITLE 4, UNITED STATES CODE

§ 114. Limitation on State income taxation of certain pension income

(a) * * *

(b) For purposes of this section—

(1) The term "retirement income" means any income from—
(A) * * *

* * * * * * *

(I) any plan, program, or arrangement described in section 3121(v)(2)(C) of such Code *(or any plan, program, or arrangement that is in writing, that provides for retirement payments in recognition of prior service to be made to a retired partner, and that is in effect immediately before retirement begins)*, if such income—

(i) is part of a series of substantially equal periodic payments (not less frequently than annually *which may include income described in subparagraphs (A) through (H)*) made for—

(I) * * *

* * * * * * *

Such term includes any retired or retainer pay of a member or former member of a uniform service computed under chapter 71 of title 10, United States Code. *The fact that payments may be adjusted from time to time pursuant to such plan, program, or arrangement to limit total disbursements under a predetermined formula, or to provide cost of living or similar adjustments, will not cause the periodic payments provided under such plan, program, or arrangement to fail the "substantially equal periodic payments" test.*

* * * * * * *

(4) For purposes of this section, the term "retired partner" is an individual who is described as a partner in section 7701(a)(2) of the Internal Revenue Code of 1986 and who is retired under such individual's partnership agreement.

* * * * * * *

MARKUP TRANSCRIPT

BUSINESS MEETING

WEDNESDAY, JUNE 7, 2006

HOUSE OF REPRESENTATIVES,
COMMITTEE ON THE JUDICIARY,
Washington, DC.

The Committee met, pursuant to notice, at 1:10 p.m., in Room 2141, Rayburn House Office Building, the Honorable F. James Sensenbrenner, Jr. (Chairman of the Committee) presiding.

[Intervening business.]

Chairman SENSENBRENNER. The next item on the agenda is the adoption of H.R. 4019 to amend title 4 of the United States Code to clarify the treatment of self-employment for purposes of the limitation of State taxation on retirement income.

The Chair recognizes the gentleman from Utah, Mr. Cannon, the Chairman of the Subcommittee on Commercial and Administrative Law for a motion.

Mr. CANNON. Thank you, Mr. Chairman. The Subcommittee on Commercial and Administrative Law reports favorably the bill H.R. 4019 and moves its favorable recommendation to the full House.

[The bill, H.R. 4019, follows:]

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109TH CONGRESS
1ST SESSION

H. R. 4019

To amend title 4 of the United States Code to clarify the treatment of self-employment for purposes of the limitation on State taxation of retirement income.

IN THE HOUSE OF REPRESENTATIVES

OCTOBER 7, 2005

Mr. CANNON introduced the following bill; which was referred to the Committee on the Judiciary

---

A BILL

To amend title 4 of the United States Code to clarify the treatment of self-employment for purposes of the limitation on State taxation of retirement income.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. CLARIFICATION OF TREATMENT OF SELF-EMPLOYMENT FOR PURPOSES OF THE LIMITATION ON STATE TAXATION OF RETIREMENT INCOME.

(a) IN GENERAL.—Section 114(b)(1)(i) of title 4, United States Code, is amended by—

1 (1) inserting "and any plan, program, or ar-
2 rangement providing for retirement benefits to a re-
3 tired partner (treated as such under applicable tax
4 laws)" after "section 3121(v)(2)(C) of such Code",
5 (2) inserting "which may include income de-
6 scribed in subparagraphs (A) through (H)" after
7 "(not less frequently than annually", and
8 (3) adding at the end the following: "The fact
9 that benefits may be adjusted from time to time
10 pursuant to the plan to limit total disbursements
11 under a predetermined formula, or to provide cost of
12 living or similar adjustments, will not cause the pe-
13 riod benefits provided under the plan to fail the
14 'substantially equal period payments' test.".
15 (b) APPLICATION.—The amendments made by this
16 section apply to amounts received after December 31,
17 1995.

Chairman SENSENBRENNER. Without objection, H.R. 4019 will be considered as read and open for amendment at any point. The Chair recognizes Mr. Cannon to strike the last word, and recognizes him for 5 minutes.

Mr. CANNON. I thank the Chairman.

H.R. 4019 is a technical amendment to Public Law 104–95. This legislation clarifies that all retirees should be treated the same with regard to how States may tax retirement payments.

In 1996, Congress passed Public Law 104–95 to prohibit States from taxing the retirement income of nonresident retirees. Essentially, when retirees, most of whom are on fixed incomes, are not living in the State, then no State except the State where the individual resides should tax the retiree's income.

After passage of the 1996 law, most States interpreted the law as it was intended to apply to all retirees, including employees and partners. One State, however, has recently taken the position that it can treat retired employees of a company and retired partners from partnerships differently.

The State's interpretation is contrary to the original intent of the law and would allow for a State to tax retirement payments of a person who retires from a partnership no matter where the retiree is living. This was not the intent of Congress when the bill was passed, as was emphasized at our hearing by our former colleague, who was chair of the Subcommittee when Public Law 104–95 was enacted. Congress intended for all retirees to be treated the same under the law, and H.R. 4019 simply clarifies that intent. States must treat all retirees similarly.

I worked with the State tax administrators to craft a manager's amendment to alleviate some of their initial concerns, and I appreciate their efforts in coming to the table to reach an agreement.

I urge all of my colleagues to support H.R. 4019 and I yield back.

Chairman SENSENBRENNER. In the absence of the gentleman from North Carolina, the gentleman from Michigan is recognized for 5 minutes for an opening statement.

Mr. CONYERS. Thank you, Mr. Chairman. I appreciate the work of the Subcommittee Chairman, and I speak on behalf of the gentleman from North Carolina, Mr. Watt.

We do not oppose H.R. 4019, which is intended to clarify Public Law 104–95 by prohibiting States from taxing the retirement income of any nonresident whether the individual is a retired employee, partner or principal, and that benefit reduction calculations under the bill include components from both qualified and nonqualified plans.

One thing that I had originally opposed has been corrected. Since 1996, States have adjusted their tax system to reflect the policy, and to allow several different interpretations of the policy would upset expectations and reliance on the law and would further confuse the tax system and certainly lead to litigation.

This clarification is a needed measure to protect the current State taxation policies, and I urge my colleagues not to oppose it and to support the measure and I ask unanimous consent to include my further statement in the record.

Chairman SENSENBRENNER. Without objection, so ordered.

Without objection, all Members may introduce opening statements into the record at this point.

The Chair recognizes the gentleman from Utah, Mr. Cannon, to offer an amendment in the nature of a substitute.

Mr. CANNON. Thank you, Mr. Chairman. I have an amendment in the nature of a substitute at the desk.

[The amendment follows:]

AMENDMENT IN THE NATURE OF A SUBSTITUTE TO H.R. 4019 OFFERED BY MR. CANNON,

Strike all after the enacting clause and insert the following:

1 **SECTION 1. CLARIFICATION OF TREATMENT OF SELF-EM-**
2 **PLOYMENT FOR PURPOSES OF THE LIMITA-**
3 **TION ON STATE TAXATION OF RETIREMENT**
4 **INCOME.**

5 (a) IN GENERAL.—Section 114(b)(1)(I) of title 4,
6 United States Code, is amended—

7 (1) by inserting "(or any plan, program, or ar-
8 rangement that is in writing, that provides for re-
9 tirement payments in recognition of prior service to
10 be made to a retired partner, and that is in effect
11 immediately before retirement begins)" after "sec-
12 tion 3121(v)(2)(C) of such Code",

13 (2) by inserting "which may include income de-
14 scribed in subparagraphs (A) through (H)" after
15 "(not less frequently than annually",

16 (3) by adding at the end the following:

17 "The fact that payments may be adjusted from
18 time to time pursuant to such plan, program, or

1 arrangement to limit total disbursements under
2 a predetermined formula, or to provide cost of
3 living or similar adjustments, will not cause the
4 periodic payments provided under such plan,
5 program, or arrangement to fail the 'substan-
6 tially equal periodic payments' test.", and
7 (4) by adding at the end the following:
8 "(4) For purposes of this section, the term 're-
9 tired partner' is an individual who is described as a
10 partner in section 7701(a)(2) of the Internal Rev-
11 enue Code of 1986 and who is retired under such in-
12 dividual's partnership agreement. ".
13 (b) APPLICATION.—The amendments made by this
14 section apply to amounts received after December 31,
15 1995.

Chairman SENSENBRENNER. The Clerk will report the amendment.

The CLERK. Amendment in the nature of a substitute to H.R. 4019, offered by Mr. Cannon. Strike all after the enacting clause and insert the following——

Chairman SENSENBRENNER. Without objection, the amendment in the nature of a substitute is considered as read and open for amendment at any point, and the Chair recognizes the gentleman from Utah, Mr. Cannon, for 5 brief minutes.

Mr. CANNON. Thank you, Mr. Chairman. If you can speed up your clock, I think I can still beat it.

This amendment perfects the underlying legislation during the hearing on H.R. 4019 held by the Subcommittee on Commercial and Administrative Law. Mr. Harley Duncan from the Federation of Tax Administrators had a few reservations and some suggestions which we have incorporated so that the bill would clarify the language of Public Law 104–95 and not extend the 1996 law into new areas.

This amendment refines the language of the bill to correspond to the current statute in a manner acceptable to all interested parties. I urge my colleagues to support this amendment and I yield back the many minutes that remain of my time.

Chairman SENSENBRENNER. Are there any second degree amendments to the amendment in the nature of a substitute?

For what purpose does the gentleman from Michigan seek recognition?

Mr. CONYERS. To strike the requisite number of words.

Chairman SENSENBRENNER. The gentleman is recognized for 5 minutes.

Mr. CONYERS. I am pleased to rise in support of the amendment in the nature of a substitute offered by our colleague, Mr. Cannon, and comment favorably as well on the remarks of Mr. Harley Duncan.

This amendment in the nature of a substitute reflects those definitions that have been referred to and fully complies with the intent of the Federation of Tax Administrators' suggestion. And so I think we on this side have no objection to this substitute and urge its passage.

And I return the time.

Chairman SENSENBRENNER. Are there any second degree amendments to the amendment in the nature of a substitute offered by the gentleman from Utah?

If there are none, the question occurs on the amendment in the nature of a substitute offered by the gentleman from Utah, Mr. Cannon. Those in favor will say aye.

Opposed, no.

The ayes appear to have it. The ayes have it. The amendment in the nature of a substitute is agreed to.

A reporting quorum is not present. Without objection, the previous question is ordered on the motion to report H.R. 4019 favorably as amended.

[Intervening business.]

Chairman SENSENBRENNER.The unfinished business is the motion to report the bill H.R. 4019 favorably, as amended, on which

the previous question has been ordered. A reporting quorum is present.

All those in favor, signify by saying aye.

Opposed, no.

The ayes appear to have it. The ayes have it. The motion to report the bill favorably, as amended, is agreed to.

Without objection, the bill will be reported favorably to the House in the form of a single amendment in the nature of a substitute incorporating the amendments adopted here today.

Without objection, the staff is directed to make any technical and conforming changes and all Members will be given 2 days, as provided by the House rules, in which to submit additional dissenting supplemental or minority views.

○