CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM

BILL ANALYSIS

Assembly Bill 131	**Assembly Member Corbett (As amended 4/4/02)**
Position:	**Support, if amended**
Proponents:	**Association for LA Deputy Sheriffs, CA Independent Public Employees Legislative Council, CA Society of Enrolled Agents, CA State Association of Counties, City of Santa Clara, LA County Probation Union - AFSCME, LA County Sanitation Districts, LA Police Protective League, League of CA Cities, Orange County Board of Supervisors, Orange County ERS, Riverside Sheriff's Association, SACRS, San Francisco City & County ERS**
Opponents:	**None known**

SUMMARY

Assembly Bill 131 conforms state tax law to provisions of the federal Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) concerning rollovers among various types of retirement plans and the purchase of service credit. It also allows members of government defined benefit plans who retired in 2002, but prior to the enactment of state tax conformity, to purchase service credit using rollover funds allowed under EGTRRA.

HISTORY

AB 1122 (Corbett), among other things, conforms California law to the retirement plan provisions of EGTRRA.

AB 1743 (Campbell), among other things, conforms California law to the retirement plan provisions of EGTRRA.

AB 1744 (Corbett) allows members of government defined benefit plans who retired in 2002, but prior to the enactment of state tax conformity, to purchase service credit using rollover funds allowed under EGTRRA.

SB 657 (Scott), among other things, conforms California law to the retirement plan provisions of EGTRRA.

SB 1256 (Brulte), among other things, conforms California law to the retirement plan provisions of EGTRRA.

Chapter 803, Statutes of 2001, (SB 501—Senate PE&R), among other things, authorizes the Teachers' Retirement Board (Board) to establish terms and conditions that permit members of the California State Teachers' Retirement System (CalSTRS) to roll over funds from other traditional defined benefit/defined contribution retirement plans, Section 403(b) plans and Section 457 plans, and any IRAs, either to purchase permissive service credit or to redeposit previously withdrawn contributions to the Defined Benefit (DB) Program.

P.L. 107-16, the Economic Growth and Tax Relief Reconciliation Act of 2001 enacted a number of changes to federal law to enhance the portability of funds among different types of retirement plans, including 401(k), 403(b) and 457 plans, IRAs and 401(a) retirement plans. In addition, it increases the contribution limits to 403(b), 457 and 401(a) plans, and increases the annual allowance limit for defined benefit plans.

CURRENT PRACTICE

The State Teachers' Retirement Plan (Plan) is administered by CalSTRS in accordance with Section 401(a) of the Internal Revenue Code (IRC). The Plan consists of the DB Program, the Defined Benefit Supplement Program and the Cash Balance Benefit Program. In addition, CalSTRS offers school employees a 403(b) deferred compensation retirement savings plan called the Voluntary Investment Program (VIP). The CalSTRS VIP is similar to 401(k) plans available to workers in private industry.

Changes to federal tax law under EGTRRA that became effective January 1, 2002 have a profound effect on administration of Plan assets and the retirement planning options available to CalSTRS members. However, differences between the federal IRC and the California Revenue and Taxation Code currently exist because current state law is based upon the former provisions of the IRC as it was in effect on January 1, 1998. California is among several states that have not changed tax laws to correspond with the more liberal federal law.

CalSTRS is required by the Education Code to administer the Plan in accordance with applicable provisions of the IRC and the state's Revenue and Taxation Code. Due to the conflict between state and federal pension laws, CalSTRS cannot permit its members to take advantage of the pension portability provisions and increased limits contained in EGTRRA. In addition, to do so would potentially jeopardize the tax-qualified status of the Plan.

One difference between current state and federal tax law that is having a significant impact on some CalSTRS members concerns the purchase of service credit. CalSTRS allows members of the DB Program to purchase additional service credit or repay previously refunded contributions, with the purchase fully paid prior to retirement. Under EGTRRA, direct trustee to trustee rollovers are allowed from 403(b), 401(k), 457 or IRAs to 401(a) defined benefit plans to purchase service credit for prior service. However, under state tax law, consistent with prior federal law, use of 403(b) and 457 funds to purchase service credit is not permitted and is treated as a taxable early distribution, subjecting members to a 2½ percent early distribution penalty assessed by the State.

Chapter 803, Statutes of 2001, effective January 1, 2002, changed the Teachers' Retirement Law to allow CalSTRS to improve portability of retirement funds by deleting the former prohibition in using 403(b) funds to purchase service credit in the DB Program for out-of-state service. The bill also codifies the Board's existing authority in federal law to accept direct transfers of retirement funds from trustees of other retirement funds. The Board took action at its December 2001 meeting to begin implementation of the rollover provisions of EGTRRA in anticipation of state conformity. CalSTRS, however, will not accept rollovers from 403(b) and 457 plans and non-conduit IRAs until state conformity is achieved. If CalSTRS were to accept rollovers using 403(b) or 457 funds not authorized under the state tax code, members would face potential penalties of 2½ percent plus capital gains and personal income tax on the amount the of the distribution that is allowable under federal law but not California law. In addition, the Plan would face potential disqualification, subjecting the Plan and its members to additional income tax liability.

There are currently over 100 requests pending to transfer 403(b) funds to the DB Program for purposes of redepositing previously refunded contributions and purchasing additional service credit. CalSTRS is receiving about 10 additional requests per week to rollover 403(b) funds into the Plan.

DISCUSSION

If the state does not conform to the changes in federal tax law made last year, CalSTRS members will be unable to take advantage of the EGTRRA provisions and will have significant long-term consequences on their retirement savings and the ability of the System to continue to provide benefits that members are otherwise able to receive.

AB 131 conforms state tax law to new federal tax laws that allow rollovers among governmental 457 plans and 403(b) plans and other qualified plans and rollovers of IRAs to workplace retirement plans, allows rollovers of after-tax retirement plan contributions. In addition, AB 131 allows public retirement system members who retire between 1/1/02 and 120 days after the bill's effective date to purchase service credit using rollover funds allowed under EGTRRA if their purchase is completed by 1/1/03.

Unlike most other state tax conformity bills being considered by the Legislature, AB 131 addresses rollover and service credit purchase issues exclusively, and does not make additional changes to state law concerning increased contributions to 401(k), 403(b) and 457 plans, and IRAs. As a tax levy, AB 131 becomes effective immediately after the Governor's approval. In addition, the tax conformity provisions of AB 131 are retroactive to January 1, 2002, to conform to the effective date of the retirement plan provisions of EGTRRA.

AB 131 requires CalSTRS to allow members of the DB Program that retire between January 1, 2002 and 120 days after the Governor signs the bill, to purchase service credit or redeposit previously withdrawn contributions using rollover funds allowed under EGTRRA, if their service credit purchase is completed by January 1, 2003. This provision allows members that plan to retire in 2002 to purchase service credit with 457 or 403(b) rollover funds without having to wait to retire until after state tax conformity is achieved. In order to further reduce the impact of the state's delay in conforming to federal tax changes, CalSTRS recommends the bill be amended to permit a retirement system to freeze the accrual of interest from the date of retirement until 60 days of the enactment of the state tax conformity legislation.

FISCAL IMPACT

Benefit Program Costs – No significant costs to CalSTRS benefit programs.

Administrative Costs – Minor and absorbable

BOARD POSITION

Support, if amended to permit retirement systems to freeze the accrual of interest between a member's retirement date and 60 days after the enactment of the bill. Members rely on their CalSTRS retirement allowance and individual retirement savings to ensure their income security during retirement. EGTRRA encourages teachers and other school employees to save additional money for retirement through contributions to a 403(b) contribution plan, and makes it easier for them to purchase service credit to boost their pension benefits. The inability of members to take advantage of the EGTRRA provisions will have significant long-term consequences on their retirement savings.