

Some State Tax Laws May Conflict with EGTRRA Provisions

One of the more attractive provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) is the opportunity for employees who have reached age 50 to make "catch-up" deferral contributions to 401(k) plans, 403(b) programs, and governmental section 457 plans. Beginning January 1, 2002, eligible employees may be given the opportunity to make \$12,000 of deferral contributions in 2002, instead of being limited to the standard annual deferral limit of \$11,000. These increased deferral limits allow employees to save more money towards their retirement, while also reducing their current federal taxable income.

Most states that impose state income tax use the federal Internal Revenue Code as their basis for determining state taxable income. Some states simply tie their tax laws to the Internal Revenue Code as in effect for the current year. As a result, changes to the federal tax laws (such as the EGTRRA changes) are automatically reflected in the state income tax laws. However, other states tie their tax laws to the Internal Revenue Code as in effect on a specified date. In these situations, changes to the federal tax laws do *not* automatically flow through to the state tax laws. These state tax laws are said to be "nonconforming" because they do not match federal law.

Nonconforming state laws may create significant recordkeeping and participant communication problems. For example, an individual's EGTRRA catch-up deferrals may be considered employee post-tax contributions for state purposes. Therefore, there would be no immediate state tax deferral on these amounts, but later distributions of these contributions should be state tax-free (residents of Pennsylvania are already familiar with such disjointed state and federal tax treatment).

Currently, industry groups have identified the following 20 states as having nonconforming state income tax laws:

- Alabama
- Arizona
- Arkansas
- California
- District of Columbia
- Georgia
- Hawaii
- Idaho
- Indiana
- Iowa
- Kentucky
- Maine
- Massachusetts
- Minnesota
- New Jersey
- North Carolina
- Oregon
- South Carolina
- West Virginia
- Wisconsin

While the federal government has no ability to force states to conform their tax laws to the federal law, states usually do eventually bring their laws into conformance with federal law. These efforts may take some time, but the changes are often made with retroactive effective dates. Prudential will continue to work with industry groups to convince states of the need for conformance with certain EGTRRA provisions. However, many state legislatures have already adjourned for 2001, with no plans to reconvene until 2002. In addition, many of these states (notably, California) are already facing budget deficits, which would only be worsened if conforming changes are made.

*Republished December 2004 to reflect Prudential Financial's acquisition of CIGNA's retirement business.

Plan sponsors with employees in any of the 20 states listed above may want to delay implementation of catch-up provisions until these issues are resolved. Alternatively, they will want to make sure that affected participants are aware of the disjoint between federal and state tax laws. Prudential will keep you informed of future developments in this regard.

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