Legislative Fiscal Bureau
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September 21, 2005

TO: Members
Joint Committee on Finance

FROM: Bob Lang, Director

SUBJECT: Senate Bill 140: Elimination of Penalty for Early Withdrawals from an Individual Retirement Account Used to Purchase Long-Term Care Insurance

Senate Bill 140 would eliminate the penalty for early withdrawals from an individual retirement account (IRA) for such withdrawals used to purchase long-term care insurance. SB 140 was introduced on March 29, 2005, and referred to the Senate Committee on Job Creation, Economic Development, and Consumer Affairs. Senate Amendment 1 was introduced on April 21, 2005. On April 22, 2005, the Committee adopted SA 1 to SB 140 and voted to recommend passage of SB 140, as amended, on a vote of four to one. The bill was then referred to the Joint Committee on Finance.

CURRENT LAW

Federal law imposes a 10% penalty tax, in additional to the regular income tax, on distributions from a qualified retirement plan as defined in section 4974 (c) of the Internal Revenue Code (IRC) before an individual has reached age 59½. Such plans include individual retirement accounts and individual retirement annuities, as well as other qualified retirement plans. Federal law provides exceptions to the penalty for certain distributions, such as those made as a result of an employee's total and permanent disability, distributions made to unemployed individuals for health insurance premiums, and distributions made from individual retirement plans for higher education expenses. Under current state law, distributions from qualified retirement plans that are subject to the federal penalty are also subject to a state penalty, equal to 33% of the federal penalty, unless the federal penalty applies to certain retirement income that is exempt from state taxation. At both the federal and state levels, the penalty tax is reported and paid on the individual income tax return.

SUMMARY OF BILL

SB 140 would eliminate the state penalty on early distributions from a qualified retirement plan used solely to purchase a long-term care policy. SB 140 was intended to eliminate the penalty only on such early distributions from IRAs. However, as drafted, the bill would also eliminate the penalty for such distributions from other qualified retirement plans as well. Senate Amendment 1 to SB 140 would modify the bill so that the provisions would apply only in the case of distributions from IRAs.

The bill specifies that the provisions would first apply to distributions from an IRA received on the effective date of the bill. SA 1 would modify the applicability date so that the provisions would first apply to distributions from an IRA received in taxable years beginning on January 1 of the year in which the bill takes effect, unless the bill takes effect after July 31, in which case the provisions would first apply to taxable years beginning on January 1 of the following year. The bill's effective date would be the day after publication.

As stated above, SB 140 would eliminate the state penalty on early distributions used <u>solely</u> to purchase a long-term care policy (underline added for emphasis). In a technical memorandum on SB 140, the Department of Revenue (DOR) indicated that it is unclear whether the bill is intended to: (a) eliminate the penalty on the portion of a distribution used to purchase long-term care insurance, even if the total early IRA distribution exceeds the cost of the insurance, or (b) eliminate the penalty on early IRA distributions only if the entire distribution is used to pay for long-term care insurance. The bill's author has indicated that the intention is to have the penalty eliminated for whatever portion of an early IRA distribution is used to pay for long-term care insurance. Therefore, if the total distribution were to exceed the cost of the long-term care insurance, then the early-withdrawal penalty would apply only to the amount of the distribution that exceeds the amount paid for long-term care insurance. This intention could be clarified by amending the bill to eliminate the penalty for early distributions from IRAs that are not in excess of the amount paid by a taxpayer during the taxable year to purchase a long-term care insurance policy.

FISCAL EFFECT

According to information from the 2003 Wisconsin tax sample, which has data from over 21,000 tax returns, weighted to reflect all taxpayers in 2003, there were 26,700 taxpayers who claimed subtractions for long-term care insurance in tax year 2003. Based on the sample data, only 150 of such taxpayers also paid a penalty for early distributions from qualified retirement plans. Simulations with the tax sample indicate that, for such taxpayers, the average effect of eliminating the penalty on early distributions, based on the amount spent to purchase a long-term care policy, would have been a tax reduction of $28. Therefore, it is estimated that the state fiscal effect of the proposal would be minimal.

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