Department of Legislative Services

Maryland General Assembly
2001 Session

FISCAL NOTE

House Bill 286 (Delegate Howard, *et al.*)
Ways and Means

Income Tax - Subtraction Modification for Retirement Income

This bill alters the State's pension exclusion calculation for retirement income. Specifically, the bill: (1) expands the types of income eligible for the pension exclusion by including income from Individual Retirement Arrangements (IRAs), rollover IRAs, and simplified employee pensions (SEPS); (2) increases the maximum amount of pension exclusion annually so that by 2010 all retirement income is nontaxable; and (3) phases out the Social Security offset through 2010.

The bill takes effect July 1, 2001 and applies to all taxable years beginning after December 31, 2000.

Fiscal Summary

State Effect: General fund revenue decrease of approximately $124.3 million in FY 2002 (one and one-half tax years). Future year decreases reflect a single fiscal year's loss, a new maximum pension exclusion, a reduced Social Security offset, and 4% annual growth in the amount of the pension exclusion. No effect on expenditures.

(in millions)	FY 2002	FY 2003	FY 2004	FY 2005	FY 2006
GF Revenue	($124.3)	($120.9)	($146.7)	($166.4)	($180.9)
Expenditure	$0	$0	$0	$0	$0
Net Effect	($124.3)	($120.9)	($146.7)	($166.4)	($180.9)

Note:() = decrease; GF = general funds; FF = federal funds; SF = special funds; - = indeterminate effect

Local Effect: Local government revenues would decrease by approximately 2.74% of the State pension exclusion subtraction taken. Based on the above estimate, total local revenues would decrease by approximately $71.6 million in FY 2002.

Small Business Effect: None.

Analysis

Bill Summary: **Exhibit 1** illustrates the maximum pension exclusion and the phase-out of the Social Security offset proposed by the bill.

Exhibit 1

Tax Year	Maximum Exclusion	Social Security Offset Required
2001	$18,000	90%
2002	$20,000	80%
2003	$22,000	70%
2004	$24,000	60%
2005	$26,000	50%
2006	$28,000	40%
2007	$30,000	30%
2008	$32,000	20%
2009	$34,000	10%
2010 and late	All income	None

Current Law: See below.

Background: Current Maryland income tax law includes tax relief for elderly individuals in several forms.

Social Security Benefits

Social Security benefits and benefits received under the Railroad Retirement Act are totally exempt from the Maryland income tax, even though they may be partly taxable for federal income tax purposes.

Pension Exclusion

In addition to the total exemption for Social Security benefits, Maryland law provides a special pension exclusion (in the form of a subtraction modification) for individuals who are at least 65 years old or who are totally disabled. Under this subtraction modification, up to a specified maximum amount of taxable pension income ($16,500 for 2000) may be exempt from tax. The maximum exclusion allowed is indexed to the maximum annual benefit payable under the Social Security Act and is reduced by the amount of any Social Security payment received.

The pension exclusion has been a part of the Maryland income tax since 1965. When the pension exclusion was first enacted, it was intended to equalize the income tax treatment of individuals covered by Social Security and those not covered by Social Security, particularly federal government employees. Since the original enactment of the pension exclusion, a new federal government retirement system, the Federal Employees Retirement System, became effective in 1987. Almost all new federal civilian employees hired after 1983 were automatically covered by this new retirement system. Under this new system, employees are eligible to receive Social Security benefits upon retirement.

The current pension exclusion is limited to income received from an "employee retirement system." Chapter 524 of 2000 (SB 401) provides a definition of an "employee retirement system" to clarify the types of retirement income that may be included for purposes of calculating the pension exclusion.

Eligible employee retirement systems are retirement plans established and maintained by an employer for the benefit of its employees and qualified under sections 401(a), 403, or 457 of the IRC. These include defined benefit and defined contribution pension plans, 401(k) plans, 403(b) plans, and 457(b) plans. However, Individual Retirement Arrangements (IRAs), Keogh plans, and simplified employee pension plans (SEPs) are not considered employee retirement systems.

The "Social Security offset" is the reduction in the maximum pension exclusion allowed under current law by the amount of Social Security benefits received by the individual. The Social Security offset was established at the same time as the pension exclusion. The offset works to equalize the tax treatment of individuals who receive their retirement benefits from different sources by reducing the amount of the allowable exclusion by the amount of any Social Security benefits received.

Additional Personal Exemptions for Elderly Individuals

Other income tax relief is provided to senior citizens regardless of the source of their income. In addition to the regular personal exemptions allowed for individuals ($2,100 per exemption for 2001), each individual age 65 and older is allowed to deduct an additional $1,000 personal exemption.

State Fiscal Effect: Based on the 1996 Maryland Statistics of Income data, it is estimated that general fund revenues would decrease by approximately $71.3 million in tax year 2001. Although the changes in the maximum pension exclusion and the Social Security offset take effect in tax year 2001, it is assumed that most taxpayers will not adjust their estimated payments to reflect the increased subtraction until after July 1, 2001. Consequently, general fund revenues are estimated to decrease by $124.3 million in fiscal 2002, reflecting the impact of one and one-half tax years. The estimate is based on the following facts and assumptions:

- For tax year 1996, approximately 83,356 joint returns were filed claiming an average pension exclusion of $7,245; an additional 73,479 returns were filed claiming an average pension exclusion of $5,885.

- The maximum annual benefit under the Social Security Act for tax year 1996 was $14,400 ($16,100 for tax year 1999).

- The average pension exclusion increases by approximately 4% each year.

Future year revenue decreases reflect a single fiscal year's loss and a new maximum pension exclusion, a reduced Social Security offset and 4% annual growth in the amount of the pension exclusion.

Local Revenues: Local revenues would decrease by approximately 2.74% (tax year 2001) to 2.75% (tax year 2005) of the State pension exclusion subtraction taken each year. This results in a loss of approximately $71.6 million in fiscal 2002 (one and one-half tax years) and $70.5 million in fiscal 2003.

Additional Information

Prior Introductions: There have been numerous proposals introduced during the past few sessions dealing with the taxation of retirement income, including several in the 2000 session (SB 285, HB 465, HB 475, HB 629, HB 630 – all failed).

Cross File: None.

Information Source(s): Comptroller of the Treasury (Bureau of Revenue Estimates), Department of Legislative Services

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