Department of Legislative Services
Maryland General Assembly
2005 Session

FISCAL AND POLICY NOTE

House Bill 151 (Delegates Bromwell and Cardin)
Ways and Means

Income Tax - Subtraction Modification for Retirement Income

This bill expands the existing State pension exclusion subtraction modification by allowing income from the following plans to be included within the subtraction modification allowed for retirement income: (1) Individual Retirement Accounts (IRAs) and annuities under Section 408 of the Internal Revenue Code (IRC); (2) rollover IRAs; and (3) Simplified Employee Pension (SEPs) under Section 408 of the IRC.

The bill takes effect July 1, 2005 and applies to tax year 2005 and beyond.

Fiscal Summary

State Effect: The extent of any general fund revenue decrease depends on several unknown factors, including the number and amount distributed each year from qualifying plans and the amount of Social Security received by the individuals utilizing these rollovers. Under one set of assumptions, general fund revenues could decrease by approximately $7.4 million annually beginning in FY 2006.

Local Effect: Based on the assumptions above, local government revenues could decrease by approximately $4.8 million annually beginning in FY 2006.

Small Business Effect: None.

Analysis

Current Law: 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 ($20,700 for 2004) 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 payments received. The pension exclusion has been a part of the Maryland income tax since 1965.

Background: One important feature of the current pension exclusion is that it is limited to income received from an "employee retirement system." Chapter 524 of 2000 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, IRAs, Keogh plans, and 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 Income Tax Treatment for Elderly Individuals

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. In addition to the special treatment of Social Security and other retirement income, other income tax relief is provided to senior citizens regardless of the source of their income. Each individual age 65 and older: (1) is allowed a $1,000 personal exemption in addition to the regular personal exemption of $2,400 allowed for all individuals; and (2) can earn more income without being required to file taxes.

State Revenue Effect: The actual cost of the bill, which cannot be reliably estimated at this time, depends on the number of eligible plans and amount distributed each year by these plans and the amount of Social Security benefits received by these individuals.

However, *for illustrative purposes only*, based on the tax year 1997 and 2003 income tax return data, it is estimated that general fund revenues would decrease by about $7.4 million in fiscal 2006. Although the pension exclusion is expanded for tax year 2005, it is assumed that most taxpayers will not adjust their estimated payments to reflect the increased subtraction until after July 1, 2005. The estimate is based on the following facts and assumptions:

- for tax year 2003, approximately 19,217 returns were filed with IRA distributions totaling approximately $294.1 million, but no pension income; the average distribution was $15,306;

- the average pension exclusion in tax year 1997 was $7,207;

- the annual growth in the pension exclusion amount is 4%;

- 25% of IRA distributions resulted from Roth IRAs that do not qualify for the increased subtraction modification;

- each taxpayer qualifies for an estimated average pension exclusion of $9,863 in tax year 2005; and

- the maximum annual benefit under the Social Security Act for tax year 1996 was $14,400 ($20,700 for tax year 2004).

Local Revenues: Local government revenues would decrease by approximately 3.1% of the total State subtraction taken in tax year 2005. Based on the estimate above, this would result in a loss of approximately $4.8 million in fiscal 2006.

Additional Information

Prior Introductions: None.

Cross File: None.

Information Source(s): Comptroller's Office, Department of Legislative Services

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Analysis by: Robert J. Rehrmann

Direct Inquiries to:
(410) 946-5510
(301) 970-5510