HB 422

Department of Legislative Services

2013 Session

FISCAL AND POLICY NOTE

House Bill 422 (Delegate George)
Ways and Means

Income Tax - Subtraction Modification - Individual Retirement Accounts

This bill creates a subtraction modification against the State income tax for retirement income received by a taxpayer from a traditional Individual Retirement Account (IRA) or annuity or a Roth IRA. The subtraction modification may not exceed $8,000 for each individual.

The bill takes effect July 1, 2013, and applies to tax year 2013 and beyond.

Fiscal Summary

State Effect: General fund revenues decrease by about $65.0 million in FY 2014 due to qualified IRA income being exempted against the State income tax. General fund expenditures increase by $32,200 in FY 2014 for one-time tax form changes and computer programming modifications at the Comptroller's Office.

($ in millions)	FY 2014	FY 2015	FY 2016	FY 2017	FY 2018
GF Revenue	($65.0)	($68.3)	($71.7)	($75.3)	($79.0)
GF Expenditure	$.0	$0	$0	$0	$0
Net Effect	($65.1)	($68.3)	($71.7)	($75.3)	($79.0)

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

Local Effect: Local income tax revenues decrease by $41.5 million in FY 2014 and by $50.5 million in FY 2018. Local expenditures are not affected.

Small Business Effect: None.

Analysis

Current Law/Background:

Traditional and Roth IRAs

Individual retirement accounts (IRAs) were created by the Employee Retirement Income Security Act of 1974 in order to provide workers who did not have employment-based pensions an opportunity to save for retirement on a tax-deferred basis. The Economic Recovery Tax Act of 1981 extended the availability of IRAs to all workers with earned income, including those with pension coverage. The Tax Reform Act of 1986 restricted the tax deductibility of IRA contributions to those with incomes below certain levels and created nondeductible IRAs (where contributions are not tax deductible but earnings still accrue tax-deferred), and partially (or wholly) deductible IRAs, depending on income. The Taxpayer Relief Act of 1997 created a new type of nondeductible IRA – the Roth IRA – and allowed nonworking spouses to contribute to IRAs, subject to certain income restrictions. As an account type, IRAs currently hold the largest single share of U.S. retirement plan assets, primarily from rollovers from other types of plans.

There are two basic nonemployment IRAs:

- *Traditional IRAs*: Persons with earned income can contribute, as well as nonearning spouses of earners under certain conditions, to a traditional IRA under Section 408 of the Internal Revenue Code (IRC). Earnings in these IRAs accrue tax-deferred, and withdrawals after age 59½ are taxed as ordinary income with contributions being tax deductible subject to specified income limits and participation in employment-based retirement plans. Minimum withdrawals from traditional IRAs must commence during the year that the individual turns age 70½.

- *Roth IRAs*: A Roth IRA under 408(a) of the IRC offers tax-free investing for retirement – no taxes are paid on investment returns or on withdrawals made after age 59½, as long as the Roth IRA has been held for at least five years. Contributions to Roth IRAs are not tax deductible, but there are no mandatory withdrawals after age 70½. Certain income limits restrict eligibility for contributing to a Roth IRA.

In addition, individuals can in certain situations contribute to two employment-based IRAs – Simplified Employee Pension (SEP) and Savings Incentive Match Plans for Employees (SIMPLE) plans.

State Pension Exclusion

Maryland law provides a 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 ($27,100 for 2012) 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 (Social Security offset).

The "Social Security offset" is the reduction in the maximum pension exclusion allowed under current law for an individual. The Social Security offset was established at the same time as the pension exclusion. Given that Social Security benefits are exempt from Maryland income tax even though benefits are partially taxable for federal purposes, 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.

One significant feature of the current pension exclusion is that it is limited to income received from an "employee retirement system." 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(b) 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 are not considered employee retirement systems.

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

State Revenues: The bill creates a subtraction modification against the State income tax for retirement income resulting from the income received from a traditional IRA or Roth IRA. As a result, general fund revenues will decrease significantly beginning in fiscal 2014. Based on limited data, general fund revenues will decrease by $65.0 million in fiscal 2014. This estimate is based on the following facts and assumptions:

- In tax year 2008, 179,100 Maryland tax returns reported a total of $2.5 billion in distributions from IRAs of all types.
- Each return would have claimed an estimated deduction of $8,600.
- The average IRA balance increased by 23% from 2008 to 2010.

- 70% of the IRA distributions qualify for the subtraction modification or are otherwise reported on a taxable State return.
- Future year revenue losses increase by 5% annually.
- Revenue losses from Roth IRA distributions are negligible.

Legislative Services advises that due to data limitations, the actual revenue loss could be significantly different than estimated. Although the bill specifies that a taxpayer can exempt the retirement income from a Roth IRA or traditional IRA, it does not require that the distribution is a qualified distribution under federal law. Accordingly, the estimate assumes that all Roth and traditional IRA distributions included in Maryland adjusted gross income will qualify for the subtraction modification.

State Expenditures: The Comptroller's Office reports that it will incur a one-time expenditure increase of $32,200 in fiscal 2014 to add the subtraction modification to the personal income tax return. This includes data processing changes to the SMART income tax return processing and imaging systems and system testing.

Local Revenues: Local income tax revenues decrease by about 3% of the total net State subtraction modification claimed. Local income tax revenues decrease by $41.5 million in fiscal 2014, $43.6 million in fiscal 2015, $45.8 million in fiscal 2016, $48.1 million in fiscal 2017, and $50.5 million in fiscal 2018.

Additional Information

Prior Introductions: None.

Cross File: None.

Information Source(s): Comptroller's Office, Congressional Research Service, Employee Benefit Research Institute, U.S. Federal Reserve – *Survey of Consumer Finances*, Department of Legislative Services

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