HB 1002

Department of Legislative Services

2013 Session

FISCAL AND POLICY NOTE

House Bill 1002 (Delegate Krebs, *et al.*)
Ways and Means

Fairness in Taxation for Retirees Act

This bill expands the existing State pension exclusion subtraction modification by allowing income from the following plans to be included within the subtraction modification: individual retirement accounts and annuities under Section 408 of the Internal Revenue Code (IRC); Roth individual retirement accounts under Section 408(a) of the IRC; simplified employee pensions under Section 408(k) of the IRC; and ineligible deferred compensation plans under Section 457(f) of the IRC.

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

Fiscal Summary

State Effect: General fund revenues decrease by at least $24.1 million in FY 2014, which represents the impact of one and one-half tax years. Future year revenue estimates reflect annualization, the estimated number of eligible taxpayers, and additional income subtracted as provided by the bill. Expenditures are not affected.

($ in millions)	FY 2014	FY 2015	FY 2016	FY 2017	FY 2018
GF Revenue	($24.1)	($16.7)	($17.2)	($17.7)	($18.2)
Expenditure	0	0	0	0	0
Net Effect	($24.1)	($16.7)	($17.2)	($17.7)	($18.2)

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

Local Effect: Local income tax revenues decrease by at least $15.8 million in FY 2014 and by $11.9 million in FY 2018. Expenditures are not affected.

Small Business Effect: None.

Analysis

Current Law/Background: 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 (SEP) 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.

In tax year 2008, a total of 236,500 resident returns claimed the pension exclusion. The average amount of pension income excluded was $11,100, or a little less than one-half of the average taxable pension income reported by all returns, including those that did not claim the exclusion. Lower-income returns excluded a higher percentage of pension income; the average pension exclusion was equal to two-thirds of the average pension reported by taxpayers with income less than $25,000 while taxpayers with incomes over $150,000 had average pension income excluded of about one-quarter of the average pension. The Department of Budget and Management estimates that the pension exclusion reduced State revenues by $103.4 million and local income tax revenues by $64.1 million in fiscal 2012. Exempting Social Security benefits is estimated to reduce State income tax revenues by $139.8 million and local income tax revenues by $86.7 million in fiscal 2012.

State Fiscal Effect: Under the bill, additional types and amounts of income may be subtracted beginning in tax year 2013. It is assumed that most taxpayers will adjust withholdings and estimated payments. As a result, fiscal 2014 revenues will decrease by the change in tax year 2013 revenues and also by one-half of the change in tax year 2014 revenues, resulting in a decrease of $24.1 million in fiscal 2014. This estimate is based on the following assumptions:

- in tax year 2005, approximately 24,000 taxable returns filed by individuals over 65 years old had taxable distributions from an IRA/SEP but no pension income, with an average distribution of $18,000; and
- the average amount excluded under the pension exclusion in tax year 2008 was $11,160, which was about 47% of the maximum exclusion.

This estimate does not include revenue losses from distributions from Section 457(f) deferred compensation plans, distributions to individuals with disabilities, annuities, and individuals who already receive a pension and could subtract more income under the pension exclusion due to the additional types of qualifying retirement income provided by the bill. This additional revenue loss is likely to be significant. Revenue losses from Roth individual retirement accounts would be minimal, as qualified distributions are not taxable for federal and State income tax purposes. Based on the additional amount of retirement income reported on Maryland federal income tax returns relative to the amount claimed under the pension exclusion and the assumption that the all of the additional amounts will be exempted under the bill, the Comptroller estimates that revenue losses could total $262.0 million in fiscal 2014.

Local Fiscal Effect: Local government revenues decrease by 3% of the net State subtraction modification claimed. Accordingly, local government revenues decrease by $15.8 million in fiscal 2014, $10.9 million in fiscal 2015, $11.2 million in fiscal 2016, $11.5 million in fiscal 2017, and by $11.9 million in fiscal 2018.

Additional Information

Prior Introductions: Legislation proposing to expand the State pension exclusion have been introduced since the 2005 session. HB 1129 of 2012 received a hearing in the House Ways and Means Committee, but no further action was taken. HB 622 of 2011 received an unfavorable report from the House Ways and Means Committee. HB 300 of 2010 received a hearing in the House Ways and Means Committee, but no further action was taken. Its cross file, SB 406, received a hearing in the Senate Budget and Taxation Committee, but no further action was taken. SB 527 of 2009 received a hearing in the Senate Budget and Taxation Committee, but no further action was taken. HB 158 of 2009, HB 999 of 2008, HB 1162 of 2007, and HB 151 of 2005 received a hearing in the House Ways and Means Committee, but no further action was taken.

Cross File: None.

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

Fiscal Note History: First Reader - March 7, 2013
ncs/jrb

Analysis by: Robert J. Rehrmann

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