HB 646

Department of Legislative Services

Maryland General Assembly
2015 Session

FISCAL AND POLICY NOTE

House Bill 646 (Delegate Gilchrist, *et al.*)
Ways and Means

Income Tax - Subtraction Modification - Retirement Income

This bill allows income from a rollover individual retirement account (IRA) or annuity under Section 408 of the Internal Revenue Code (IRC) to be included within the State income tax subtraction modification allowed for retirement income (pension exclusion) if the contributions to the IRA or annuity consist entirely of the tax-free rollover of distributions from an employee retirement system. The bill also reduces to $28,800 the maximum value of the annual pension exclusion in tax year 2015 and indexes the value thereafter as provided under current law.

The bill takes effect July 1, 2015.

Fiscal Summary

State Effect: General fund revenues increase beginning in FY 2016 due to a reduction in the maximum value of the pension exclusion. General fund revenues decrease beginning in FY 2016 due to eligible rollovers being exempted under the pension exclusion. Overall, the bill is expected to result in a significant decrease in general fund revenues beginning in FY 2016. No effect on expenditures.

Local Effect: Under the assumptions above, local income tax revenues are expected to decrease significantly beginning in FY 2016. No effect on expenditures.

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 age 65 or who are totally disabled. Under this subtraction modification, up to a specified maximum amount of taxable pension income ($29,000 for 2014) 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." Chapter 524 of 2000 clarified the definition of an "employee retirement system" by providing for the types of retirement income that may be included for purposes of calculating the pension exclusion. As defined by Chapter 524, eligible employee retirement systems are retirement plans established and maintained by an employer for the benefit of its employees and qualified under § 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, Chapter 524 also included language clarifying what is not included in an "employee retirement system": (1) an IRA or annuity under § 408 of the IRC; (2) a Roth IRA under § 408A of the IRC; (3) a rollover IRA; (4) a simplified employee pension under § 408(k) of the IRC; or (5) an ineligible deferred compensation plan under § 457(f) of the IRC. Since 2000, there have been no substantive changes to the pension exclusion. **Exhibit 1** shows the eligible and ineligible retirement income under the pension exclusion.

Exhibit 1
Eligible and Ineligible Retirement Plans under the Pension Exclusion

Eligible	**Ineligible**
• 401(k) Cash or Deferred Arrangement (CODA) Plans	• Traditional IRAs
• 403(b) Plans	• Rollover IRAs
• 457(b) Plans	• Roth IRAs
• Thrift Savings Plans	• Keogh Plans
• Savings Incentive Match Plan for Employees (SIMPLE) Retirement Plans Under § 401(k) of the IRC	• Simplified Employee Pensions • SIMPLE Retirement Plans Under § 408 of the IRC

Source: Department of Legislative Services

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. According to the Department of Budget and Management, in fiscal 2014 the State subtraction modification for Social Security benefits reduced State revenues by $165.8 million, the State pension exclusion reduced State revenues by $144.4 million, and the additional personal exemption reduced State revenues by $18.3 million.

IRAs are a significant source of retirement savings, holding more than one-quarter of all U.S. retirement assets. There are several types of IRA accounts – traditional, originating from contributions; traditional, originating from rollovers; Roth IRAs; and Simplified Employee Pensions (SEP) and SIMPLE Plans. Both types of traditional IRAs could have received rollovers or contributions subsequent to their establishment; for example, individuals might make contributions to an IRA originating from a rollover.

According to the Employee Benefit Research Institute, although more IRA accounts received contributions than rollovers in calendar 2010, almost 12 times as much money was rolled over into IRAs than the amount of contributions to new accounts. **Exhibit 2** shows the percentage of IRA accounts by account type and the average balance of these accounts.

Exhibit 2
Percentage of U.S. IRA Accounts and Average Balance
Calendar 2010

Account	% Total	Average Balance
Traditional	39%	$88,403
Roth	21%	22,437
SEP/SIMPLE	6%	55,733
Rollover	18%	123,426
Unknown	16%	96,441
All Accounts		**$91,864**

Note: Average balance is per account holder.

Source: Employee Benefit Research Institute

Rollovers have become more common over time and are now a significant source of IRA assets as companies shift from defined benefit plans to defined contribution systems and as a growing number of Americans enter retirement. Most rollovers occur when people change jobs and wish to move 401(k) or 403(b) assets into an IRA. According to the U.S. Government Accountability Office (GAO), millions of employees change jobs each year and some leave their savings in their former employers' 401(k) plans. If their accounts are small enough and they do not instruct the plan to do otherwise, plans can transfer their savings into an IRA without their consent. When a participant has saved less than $5,000 in a 401(k) plan and changes jobs without indicating what should be done with the money, the plan can transfer the account savings – a forced transfer – into an IRA. The GAO also found that a provision in federal law allows a plan to disregard previous rollovers when determining if a balance is small enough to force out. For example, a plan can force out a participant with a balance of $20,000 if less than $5,000 is attributable to contributions other than rollover contributions.

According to the Investment Company Institute, about two-thirds of newly opened IRAs were opened with just a rollover, with another 8% opened with a contribution only and 2% opened with both a rollover and a contribution. The remaining accounts were transfers from one financial services firm to another (IRA to IRA) and were unlikely to represent new accounts. Although rollovers are a significant source of existing account assets, data is unavailable on the breakdown of IRA distributions. The Internal Revenue Service (IRS) reports only the total amount of taxable IRA distributions. In tax year 2012, a total of 227,100 Maryland resident taxpayers reported a total of $4.2 billion in taxable IRA distributions. In the same year, Maryland residents reported a total of $15.5 billion in pensions and annuities (both qualified and nonqualified employee retirement systems) and $4.6 billion in federally taxable Social Security benefits.

State Revenues: The bill will (1) increase income tax revenues beginning in fiscal 2016 by reducing to $28,800 the maximum value of the pension exclusion in tax year 2015 and (2) decrease income tax revenues beginning in fiscal 2016 by allowing a rollover IRA or annuity to qualify for the pension exclusion if the contributions to the IRA or annuity consist entirely of the tax-free rollover of distributions from an employee retirement system.

Due to taxpayer confidentiality requirements, the Department of Legislative Services (DLS) does not have access to income tax data and is dependent on data from the Comptroller's Office. The Comptroller's Office has advised DLS that it does not have sufficient data to produce a fiscal estimate of various proposals to alter the State pension exclusion. According to the Comptroller's Office, it is in the process of redesigning the personal income tax forms in an effort to overcome the data limitations described above. These changes will occur beginning with tax year 2014 but will not be fully implemented until tax year 2015. If these changes are effectively implemented and the data is accurately captured by the Comptroller's Office, this information will be available for the 2017 legislative session.

Based on limited data from the Comptroller's Office, IRS, and the Current Population Survey, DLS estimates that the bill will likely decrease overall general fund revenues significantly beginning in fiscal 2016.

Decreasing the maximum amount of the pension exclusion will increase general fund revenues by an estimated $6.9 million in fiscal 2016, as shown in **Exhibit 3.** General fund revenues will decrease significantly beginning in fiscal 2016 due to the inclusion of eligible IRA rollover distributions in the pension exclusion amount. Exhibit 3 also shows the estimated loss in general fund revenues from IRA rollovers, based on the percentage of total IRA distributions that would qualify for the exclusion.

Exhibit 3
Projected Fiscal Impact
Fiscal 2016-2020
($ in Millions)

	FY 2016	FY 2017	FY 2018	FY 2019	FY 2020
Pension Exclusion Reduction	$6.9	$7.5	$8.1	$8.2	$8.4
IRA Rollovers					
5%	($10.7)	($11.1)	($11.5)	($12.0)	($12.5)
10%	(21.3)	(22.2)	(23.1)	(24.0)	(25.0)
20%	(42.7)	(44.4)	(46.2)	(48.0)	(49.9)

Local Revenues: Local revenues decrease by approximately 3% of the total net State subtraction modification claimed. Accordingly, local income tax revenues will likely decrease significantly beginning in fiscal 2016.

Additional Information

Prior Introductions: SB 659 of 2013 received a hearing in the Senate Budget and Taxation Committee, but no further action was taken. Its cross file, HB 743, received a favorable report from the House Ways and Means Committee, passed the House, and received a hearing in the Senate Budget and Taxation Committee, but no further action was taken.

Cross File: None.

Information Source(s): Comptroller's Office, Employee Benefit Research Institute, U.S. Federal Reserve, U.S. Government Accountability Office, Investment Company Institute, Internal Revenue Service, Department of Legislative Services

Fiscal Note History: First Reader - February 23, 2015
min/jrb

Analysis by: Robert J. Rehrmann

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