HB 33

Department of Legislative Services

Maryland General Assembly
2016 Session

FISCAL AND POLICY NOTE
First Reader

House Bill 33 (Delegate Arentz)
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 or sources to be included within the subtraction modification: (1) individual retirement accounts and annuities under Section 408 of the Internal Revenue Code (IRC); (2) Roth individual retirement accounts under Section 408(a) of the IRC; (3) simplified employee pensions under Section 408(k) of the IRC; and (4) ineligible deferred compensation plans under Section 457(f) of the IRC. The bill also alters the method of calculating the maximum amount of the pension exclusion, thereby increasing its maximum benefit.

The bill takes effect July 1, 2016, and applies to tax year 2016 and beyond.

Fiscal Summary

State Effect: General fund revenues will decrease significantly beginning in FY 2017 as a result of additional income being exempted under the pension exclusion. The revenue loss will likely exceed $83.0 million annually. Expenditures are not affected.

Local Effect: Local revenues will decrease significantly beginning in FY 2017 as a result of additional income being exempted under the pension exclusion. The revenue loss will likely exceed $54.0 million annually. Local expenditures are not affected.

Small Business Effect: None.

Analysis

Bill Summary: Under current law, the Comptroller calculates the maximum benefit of the pension exclusion based on the maximum annual benefit for an individual who retired at age 65 for the prior calendar year. The bill alters the method of calculating the maximum benefit by specifying the maximum value is based on the maximum benefit for an individual regardless of age. Federal law currently provides a greater maximum annual benefit to those who retire at age 70.

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 ($29,200 for 2015) 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 individual retirement account (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 2016 the State subtraction modification for Social Security benefits reduced State revenues by $210.5 million (this is in addition to the revenue loss resulting from the partial federal exemption of social security benefits), the State pension exclusion reduced State revenues by $166.0 million, and the additional personal exemption reduced State revenues by $30.3 million.

State/Local Revenues: The bill expands the pension exclusion by allowing additional types and amounts of income to be subtracted beginning in tax year 2016. As a result, annual State and local income tax revenues will decrease significantly beginning in fiscal 2017.

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 an accurate 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.

Based on limited data on the additional amount of eligible retirement income reported on Maryland federal income tax returns relative to the amount claimed under the current pension exclusion, the Comptroller estimates that revenue losses resulting from the bill would have totaled $48.5 million in tax year 2012, the last year of available data. This estimate is increased by 6% annually based on recent and projected growth in taxable pension and annuity income. Increasing the maximum value of the pension exclusion is estimated to increase revenue losses by an additional 35%. As a result, general fund revenue losses will likely exceed $83.0 million annually beginning in fiscal 2017.

Under the assumptions above, local income tax revenues would decrease by about $54.0 million annually beginning in fiscal 2017.

This estimate does not include revenue losses resulting from additional income exempted (1) under ineligible Section 457(f) deferred compensation plans, Roth IRAs, and Simplified Employee Pensions; (2) by individuals with disabilities (under all eligible sources); and (3) by individuals who only receive pension income that is qualified under current law and would be able to exempt additional income due to the increased maximum value of the pension exclusion. This additional revenue loss is expected to be significant.

Additional Information

Prior Introductions: SB 406 of 2010 received a hearing in the Senate Budget and Taxation Committee, but no further action was taken. Its cross file, HB 300, 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, U.S. Social Security Administration, Department of Legislative Services

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md/jrb

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