SB 523

Department of Legislative Services

Maryland General Assembly
2018 Session

FISCAL AND POLICY NOTE
First Reader

Senate Bill 523 (Senator Lee)
Budget and Taxation

Income Tax - Subtraction Modification - Foreign Government Employer-Sponsored Retirement Plans

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This bill expands the existing State pension exclusion subtraction modification by including income from an employee retirement system that the Comptroller determines is qualified under a substantially similar provision under the laws of a foreign government. In order to qualify, the income must be attributable to work performed within the United States in collaboration with the U.S. Government. **The bill takes effect July 1, 2018, and applies to tax year 2018 and beyond.**

Fiscal Summary

State Effect: General fund revenues decrease beginning in FY 2019 due to additional pension income being exempted. It is expected that the expansion will apply to a limited number of individuals and revenue losses in each fiscal year will not be significant. Expenditures are not affected.

Local Effect: Local revenues decrease beginning in FY 2019 due to additional pension income being exempted. Local expenditures are not affected.

Small Business Effect: None.

Analysis

Current Law/Background:

Taxation of Foreign Pensions

Income received from foreign pensions or annuities may be taxable or nontaxable for federal income tax purposes. In general, most foreign pensions are not considered to be qualified pensions plans in determining the taxation of contributions, accrual of benefits, and distributions. According to the Internal Revenue Service, whether a foreign pension or annuity is taxable also depends on the provisions of tax treaty provisions related to the foreign pension plans of U.S. participants. The United States currently has tax treaties with about 70 countries, which typically states that each government must respect the tax benefits and structure of the other country's plans, and retirement benefits are taxable by only one country.

As a general rule, the pension/annuity articles of most tax treaties allow the country of residence (as determined by the residency article) to tax the pension or annuity under its domestic laws, unless a treaty provision specifically amends that treatment. Individuals who reside in the United States may be able to claim a foreign tax credit for the foreign income taxes imposed on the pension income.

Maryland 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 ($29,900 for 2017) 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

- 401(k) Cash or Deferred Arrangement Plans
- 403(b) Plans
- 457(b) Plans
- Thrift Savings Plans
- Savings Incentive Match Plan for Employees Retirement Plans under § 401(k) of the IRC

Ineligible

- Traditional IRAs
- Rollover IRAs
- Roth IRAs
- Keogh Plans
- Simplified Employee Pensions
- Savings Incentive Match Plan for Employees Retirement Plans under § 408 of the IRC

IRA: individual retirement accounts
IRC: Internal Revenue Code

Source: Department of Legislative Services

Additional retirement income may be exempted if the individual has qualified U.S. military, fire, rescue, or emergency services personnel retirement income.

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 2018 the State subtraction modification for Social Security benefits reduced State revenues by $212.5 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 $167.5 million, and the additional personal exemption reduced State revenues by $30.6 million.

State/Local Revenues: The bill expands the pension exclusion by allowing additional types of income to be subtracted beginning in tax year 2018. As a result, annual State and local income tax revenues will decrease beginning in fiscal 2019. Revenue losses in each fiscal year are not expected to be significant given the requirements of the bill.

Additional Information

Prior Introductions: None.

Cross File: None.

Information Source(s): Comptroller's Office; Internal Revenue Service; Department of Legislative Services

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