HB 1645

Department of Legislative Services

Maryland General Assembly
2018 Session

FISCAL AND POLICY NOTE
First Reader

House Bill 1645 (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 $29,700 the maximum value of the annual pension exclusion in tax year 2018 and indexes the value thereafter as provided under current law. **The bill takes effect July 1, 2018.**

Fiscal Summary

State Effect: General fund revenues increase beginning in FY 2019 due to a reduction in the maximum value of the pension exclusion. General fund revenues decrease beginning in FY 2019 due to eligible rollovers being exempted under the pension exclusion. Based on information provided by the Comptroller's Office, the bill is not expected to significantly impact general fund revenues. No effect on expenditures.

Local Effect: Local income tax revenues are not expected to be significantly impacted. No effect on expenditures.

Small Business Effect: None.

Analysis

Current Law/Background:

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 ($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	Ineligible
• 401(k) Cash or Deferred Arrangement Plans	• Traditional IRAs
• 403(b) Plans	• Rollover IRAs
• 457(b) Plans	• Roth IRAs
• Thrift Savings Plans	• Keogh Plans
• Savings Incentive Match Plan for Employees Retirement Plans under § 401(k) of the IRC	• 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

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.

Rollover IRAs and Retirement Income

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 and SIMPLE Plans. Both types of traditional IRAs can receive rollovers or contributions subsequent to their establishment; for example, individuals might make contributions to an IRA originating from a rollover.

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, 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 – a forced transfer – into an IRA without their consent.

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. As required by Chapter 648 of 2016, the Comptroller's Office altered the personal income tax form to capture additional data on the pension exclusion by adding Form 502R. In tax year 2016, 705,360 taxpayers filed Form 502R and reported $21.7 billion in retirement income (of all sources). A total of 227,900 of these taxpayers reported $3.8 billion in IRA retirement income. Of the taxpayers reporting IRA retirement income, about 2% reported that the IRA consisted entirely of the tax-free rollover of distributions from an employee retirement system.

State/Local Revenues: The bill will (1) increase income tax revenues beginning in fiscal 2019 by reducing to $29,700 the maximum value of the pension exclusion and (2) decrease income tax revenues beginning in fiscal 2019 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.

The Comptroller's Office estimates that the bill's fiscal impacts described above will largely offset and State and local revenues will not be significantly impacted.

DLS notes that the percentage of IRA income reported by taxpayers who filed Form 502R is lower than national estimates. In addition, approximately 108,000 taxpayers who reported $3.3 billion in retirement income (of all sources) did not file Form 502R. Revenue losses could also be greater due to tax compliance issues as there may be difficulty in determining whether all, part, or none of an IRA consists of a rollover contribution.

Additional Information

Prior Introductions: Similar legislation was introduced in the 2015 and 2013 sessions. HB 646 of 2015 received a hearing in the House Ways and Means Committee, but no further action was taken. 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; Department of Legislative Services

Fiscal Note History: First Reader - March 5, 2018
md/hlb

Analysis by: Robert J. Rehrmann

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