SB 319

Department of Legislative Services

Maryland General Assembly
2000 Session

FISCAL NOTE

Senate Bill 319 (Senators Stone and Della)
Budget and Taxation

Income Tax - Subtraction Modification for Retirement Income - Rollovers to Qualified Retirement Plans

This bill includes income from a qualified retirement plan as defined in the Internal Revenue Code (IRC) within the subtraction modification allowed under the Maryland income tax for retirement income from an employee retirement system to the extent that contributions to the qualified retirement plan consisted of the tax-free rollover of a distribution from an employee retirement system.

The bill takes effect July 1, 2001, and applies to all taxable years beginning after December 31, 1999.

Fiscal Summary

State Effect: The extent of any general fund revenue loss depends on a number of unknown factors which include the number and amount distributed each year from non-taxable rollovers that were formerly distributions from an employee retirement system, and the amount of Social Security received by these individuals. Under one set of assumptions, general fund revenues could decline by approximately $3.1 million annually.

Local Effect: Based on the assumptions above, local government revenues could decrease by approximately $1.7 million.

Small Business Effect: None.

Analysis

Bill Summary: The bill adds the following types of income as qualifying for the existing subtraction for a portion of pensions and annuity income if the contribution was from a tax-free rollover of a distribution from the employer retirement system:

- º pension, profit sharing, stock bonuses
- º nontaxable trusts under IRC section 501(a)
- º employee annuity plans under IRC section 403(c)
- º annuity contracts under IRC section 403(b)
- º annuity purchased by IRC section 501 (c)(3) organization or public school
- º individual retirement account (IRA) under IRC section 408(a)
- º individual retirement annuity under IRC section 408(b)

Current Law: See below.

Background: The current Maryland income tax includes tax relief for elderly individuals in several forms. Social Security benefits and benefits received under the Railroad Retirement Act are exempt from the Maryland income tax, even though they may be partly taxable for federal income tax purposes. The Railroad Retirement Act is the result of railroad pension plans that failed during the 1920s and 1930s and the subsequent bailout of these plans by the federal government. The system operates along the lines of Social Security and functions as a substitute for Social Security for railroad employees.

In addition to the total exemption for Social Security benefits, Maryland law provides a pension exclusion subtraction for individuals who are at least 65 years old or who are totally disabled. As originally enacted in 1968, the pension exclusion was intended to equalize the income tax treatment of individuals covered by Social Security and those not covered by Social Security, such as federal civil service employees.

Under the subtraction modification, some taxable pension income ($16,100 for 1999) may be exempt from tax. The maximum exclusion is the maximum annual benefit under the Social Security Act and is reduced by the amount of any Social Security payments received. Thus, in addition to the total exclusion for Social Security benefits received, a retiree is allowed to deduct the lesser of (1) the amount of pension income actually received; or (2) the maximum Social Security benefit reduced by the amount of Social Security received. For tax year 1995 the average amount excluded under this pension exclusion was just over $6,500. The pension exclusion is estimated to cost the State approximately $55 million a year.
One important feature of the current pension exclusion is that it is limited to income received from an "employee retirement system." Thus, the exclusion does not apply to income from IRAs and Keogh plans. There has been some confusion regarding the scope of the pension

exclusion. A recent Attorney General's letter of advice states that 401(k) and 457 distributions are "employee retirement systems." However, this interpretation is inconsistent with the income tax return instruction's statement that "deferred compensation plans" are not employee retirement systems.

In addition to the treatment of Social Security and other retirement income, each individual age 65 and older is allowed to deduct a $1,000 personal exemption in addition to the regular personal exemptions allowed for individuals ($1,850 per exemption for 1999).

Surrounding States: The variations among the tax structures of different states and the form of tax relief provided for retirement income and senior citizens make interstate comparisons problematic. The table below provides summary information for Maryland and the surrounding jurisdictions for tax year 1999.

State	Full Exclusion for Social Security Benefits	Maximum Pension Exclusion	Additional Deductions or Exemptions for Elderly	Comments
Maryland	Yes	$16,100	$1,000 additional exemption	Maximum pension exclusion is reduced by social security benefits received
Virginia	Yes	n/a	$800 additional exemption; $6,000 to $12,000 elderly deduction	Elderly deduction is $6,000 for-ages 62 to 64, $12,000 for 65+
West Virginia	No	n/a	$8,000 max. deduction for 65+	WVa police/fire exempt; other state and fed.: $2,000; $8,000 max for 65+
D.C.	Yes	$3,000	$1,375 extra exemption	Pension exclusion for public pensions only
Delaware	Yes	$2,000-$5,000	Additional standard deduction allowed for 65 and over (not for itemizers) $2,500	Pension exclusion includes deferred compensation plans and interest, dividends, rental income; $2,000 for less than 60, $5,000 for 60+
Pennsylvania	Yes	No maximum	None	Employee contributions to a retirement plan are taxed

Fully exempting all retirement income from the State and local income tax could result in an annual State general fund loss of approximately $260 million and a corresponding loss in county income tax revenue of a little over half that amount.

State Fiscal Effect: The exhibit below presents the savings to a retiree under current law and under the bill. The retiree is assumed to receive $13,000 in annual pension income through an employer retirement plan, $3,000 in distributions from an IRA, and $0 in Social

Security (SS) payments. As the exhibit indicates, the additional State tax savings to the retiree as a result of the bill is $146.

State Tax Savings to Retirees from the Pension Exclusion in 2000						
	Current Law			SB 319		
Types of Income	Retirement Income	IRA	SS Payment Received	Retirement Income	IRA	SS Payment Received
Amount of Income	$13,000	$3,000	$0	$13,000	$3,000	$0
Pension Exclusion Calculation (assume max. SS benefit allowed in 2000 is $16,500)						
	Take lesser of:			Take lesser of:		
	$13,000 or ($16,500 - $0)			$16,000 or ($16,500)		
Pension Exclusion	$13,000			$16,000		
State Tax Savings	$630			$776		

The actual cost of the bill, which cannot be reliably estimated at this time, depends on the number of rollovers and the amount distributed each year from rollovers that were formerly distributed from an employee retirement system and the amount of Social Security benefits received by these individuals.

However, for illustrative purposes only, based on the 1996 Maryland Statistics of Income data, it is estimated that general fund revenues would decrease by about $3.1 million in tax year 2000. Although the pension exclusion is expanded for tax year 2000, it is assumed that most taxpayers will not adjust their estimated payments to reflect the increased subtraction until after July 1, 2000. The estimate is based on the following facts and assumptions:

- For tax year 1996, approximately 15,700 returns were filed with an IRA distribution, but no pension income; the average distribution was $30,000; the average pension exclusion was $6,500.

- The maximum annual benefit under the Social Security Act for tax year 1996 was $14,400 ($16,100 for tax year 1999).

- º One-half of the IRA distributions resulted from the non-taxable rollover of a distribution from an employee retirement system and each taxpayer qualifies for the average pension exclusion.

- º The maximum annual growth in the pension exclusion amount increases by 4% annually.

Local Revenues: Local revenues would decrease by approximately 55% (tax year 2001) to 57.7% (tax year 2005) of the State revenue each year. Based on the estimate above, this would result in a loss of approximately $1.7 million in tax year 2000.

Additional Information

Prior Introductions: There have been numerous proposals over the past few sessions dealing with the income tax treatment of retirement income, including several bills introduced during the 1999 session.

HB 365 (failed) and HB 839 (failed) would have expanded the existing subtraction modification for retirement income. HB 365 would have expanded the subtraction to include income from all qualified retirement plans (including IRAs, 401ks, etc., currently not covered) and would have eliminated the "Social Security offset;" i.e., the reduction in the maximum subtraction modification under the current law for Social Security payments received by the individual.

Like HB 365, HB 839 would have expanded the existing subtraction modification to include income from all qualified retirement plans and would have eliminated the Social Security offset to determine the maximum subtraction allowed. In addition, HB 839 would have specified in the statute the maximum subtraction allowed. Under current law, the maximum subtraction allowed is determined based on the maximum annual benefit for the prior calendar year under the Social Security Act ($16,100 for 1999). Under HB 839, the maximum subtraction would have been set at $19,120 for 1999 and would be increased over time to $32,000 for tax year 2003 and beyond.

SB 183 (failed) would have lowered from 65 to 62 the age at which an individual qualifies for the income tax subtraction modification for retirement income.

Cross File: None.

Information Source(s): Comptroller of the Treasury (Bureau of Revenue Estimates), Department of Legislative Services

Fiscal Note History: First Reader - February 14, 2000

cm/jr

Analysis by: Mike Sanelli

Direct Inquiries to:
John Rixey, Coordinating Analyst
(410) 946-5510
(301) 970-5510