Department of Legislative Services

Maryland General Assembly
2001 Session

FISCAL NOTE

House Bill 735 (Delegate Ports, *et al.*)
Ways and Means

Income Tax - Subtraction for Retirement Income

This bill adds income received from an Individual Retirement Arrangement (IRA), a rollover IRA, or a simplified employee pension (SEP) to the types of income that are considered "qualified retirement plans" and are eligible for inclusion in the State's pension exclusion subtraction modification.

The bill takes effect July 1, 2001 and applies to all taxable years beginning after December 31, 2000.

Fiscal Summary

State Effect: General fund revenues would decrease by $10.1 million in FY 2002, which represents the impact of one and one-half tax years. Future year revenue decreases reflect a single fiscal year's loss and 4% growth. Expenditures would not be affected.

(in dollars)	FY 2002	FY 2003	FY 2004	FY 2005	FY 2006
GF Revenue	($10,145,700)	($7,111,100)	($7,466,700)	($7,840,000)	($8,232,000)
Expenditure	$0	$0	$0	$0	$0
Net Effect	($10,145,700)	($7,111,100)	($7,466,700)	($7,840,000)	($8,232,000)

Note:() = decrease; GF = general funds; FF = federal funds; SF = special funds; - = indeterminate effect

Local Effect: Local revenues would decrease by $5.8 million in FY 2002, which represents the impact of one and one-half tax years and $4.1 million in FY 2003. Expenditures would not be affected.

Small Business Effect: None.

Analysis

Current Law: The pension exclusion applies to individuals who are at least 65 years of age or who are totally disabled. The pension exclusion is limited to income received from an employee retirement system qualified under sections 401(a), 403, or 457(b) of the Internal Revenue Code (IRC).

Background: Current Maryland income tax law includes tax relief for elderly individuals in several forms.

Social Security Benefits

Social Security benefits and benefits received under the Railroad Retirement Act are totally exempt from the Maryland income tax, even though they may be partly taxable for federal income tax purposes.

Pension Exclusion

Maryland law provides a special 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 ($16,500 for 2000) 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 payment received.

The pension exclusion has been a part of the Maryland income tax since 1965. When the pension exclusion was first enacted, it was intended to equalize the income tax treatment of individuals covered by Social Security and those not covered by Social Security, particularly federal government employees.

Since the original enactment of the pension exclusion, a new federal government retirement system, the Federal Employees Retirement System, became effective in 1987. Almost all new federal civilian employees hired after 1983 were automatically covered by this new retirement system. Under this new system, employees are eligible to receive Social Security benefits upon retirement.

The current pension exclusion is limited to income received from an "employee retirement system." Chapter 524 of 2000 (SB 401) provides a definition of an "employee retirement system" to clarify the types of retirement income that may be included for purposes of calculating the pension exclusion.

Eligible employee retirement systems are retirement plans established and maintained by an employer for the benefit of its employees and qualified under sections 401(a), 403, or 457 of the IRC. These include defined benefit and defined contribution pension plans, 401(k) plans, 403(b) plans, and 457(b) plans. However, Individual Retirement Arrangements (IRAs), Keogh plans, and simplified employee pension plans (SEPs) are not considered employee retirement systems.

The "Social Security offset" is the reduction in the maximum pension exclusion allowed under current law by the amount of Social Security benefits received by the individual. The Social Security offset was established at the same time as the pension exclusion. 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.

Additional Personal Exemptions for Elderly Individuals

Other income tax relief is provided to senior citizens regardless of the source of their income. In addition to the regular personal exemptions allowed for individuals ($2,100 per exemption for 2001), each individual age 65 and older is allowed to deduct an additional $1,000 personal exemption.

State Fiscal Effect: Exhibit 1 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 $144

Exhibit 1

State Tax Savings to Retirees from the Pension Exclusion in 2001						
	Current Law			HB 735		
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 2001 is $17,200)						
	Take lesser of:			Take lesser of:		
	$13,000 or ($17,200 - $0)			$16,000 or ($17,200)		
Pension Exclusion	$13,000			$16,000		
State Tax Savings	$624			$768		

Based on the 1996 Maryland Statistics of Income data, it is estimated that general fund revenues would decrease by about $6.6 million in tax year 2001. Although the pension exclusion is expanded for tax year 2001, it is assumed that most taxpayers will not adjust their estimated payments to reflect the increased subtraction until after July 1, 2001. Consequently, general fund revenues are estimated to decrease by $10.1 million in fiscal 2002, reflecting the impact of one and one-half tax years. 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 ($16,500 for tax year 2000).

- All returns with an IRA distribution, and no pension exclusion, would receive the average pension of $6,500.

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

Future year revenue decreases reflect a single fiscal year's loss and grow by about 4% annually.

The estimate reflects the cost of adding only taxable IRAs to the current pension exclusion.

Local Revenues: Local revenues would decrease by approximately 2.74% of the total State subtraction taken in fiscal 2002. This results in a loss of approximately $5.8 million in fiscal 2002 (one and one-half tax years) and $4.1 million in fiscal 2003. Future year revenue losses increase by about 4% annually.

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 2000 session (SB 285, HB 465, HB 475, HB 629, and HB 630 – all failed).

Cross File: None.

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

Fiscal Note History: First Reader – February 27, 2001
ncs/jr

Analysis by: Michael Sanelli

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