SB 488

Department of Legislative Services

Maryland General Assembly
2002 Session

FISCAL NOTE

Senate Bill 488 (Senator Neall)
Budget and Taxation

Income Tax - Retirement Income and Charitable Contributions

This bill alters the computation of the State's pension exclusion subtraction modification beginning in tax year 2004. Under current law, the maximum pension exclusion is reduced by the amount of Social Security benefits received. The bill provides that the maximum pension exclusion is reduced by: 75% of Social Security benefits received for tax year 2004; 50% in tax year 2005; 25% in 2006; and 0% for tax years 2007 and thereafter.

This bill takes effect July 1, 2003 and applies to all taxable years beginning after December 31, 2003.

Fiscal Summary

State Effect: General fund revenues would decrease by $45.5 million in FY 2004, which includes the impact of one-half of tax year 2004, from altering the computation of the pension exclusion. Future year revenue decreases reflect a single fiscal year's loss and 4% growth. The extent of the revenue loss associated with the provision dealing with charitable contributions depends on the number of individuals who report a qualified capital gain, the amount of their unrestricted charitable contributions, and their income tax liability in the taxable year in which the contribution was made. Information upon which to base a reliable estimate is not available.

($ in millions)	FY 2003	FY 2004	FY 2005	FY 2006	FY 2007
GF Revenue	$0	($45.5)	($105.7)	($132.0)	($151.8)
Expenditure	$0	$0	$0	$0	$0
Net Effect	$0	($45.5)	($105.7)	($132.0)	($151.8)

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

Local Effect: Local government revenues would decrease by approximately $26.8 million in FY 2004 (one-half tax years) and $62.3 million in FY 2005. Future year revenue losses increase by about 4% annually. To the extent the bill encourages charitable contributions, local government revenues would decrease.

Small Business Effect: Minimal. However, small nonprofits could benefit significantly if they qualify as community foundations and are the recipients of charitable contributions.

Analysis

Bill Summary: The bill also creates a credit against the State income tax in an amount equal to 100% of the unrestricted charitable contributions made by an individual to a community foundation's endowment during the taxable year. The credit may not exceed the difference between the State income tax and the State income tax reduced by the amount of the individual's qualified capital gain. The credit is only allowed if the individual's qualified capital gain for the taxable year for which the credit is received is at least $10,000,000.

Current Law: 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 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 ($17,300 for 2001) 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.

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 Internal Revenue Code (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

In addition to the regular personal exemptions allowed for individuals ($2,400 per exemption for 2002), each individual age 65 and older is allowed to deduct an additional $1,000 personal exemption.

Charitable Contributions

Federal and State income tax laws allow deductions from income for donations made to qualified charitable organizations.

Examples of qualified organizations include: churches and other religious organizations; charitable organizations like the Red Cross and the United Way; nonprofit educational organizations such as the Boy Scouts, museums, and colleges; nonprofit hospitals and research facilities; and public parks and recreational facilities. Under federal law, an individual who itemizes deductions may deduct charitable contributions up to a set limit -- 50%, 30%, or 20% -- of the individual's contribution base depending on the type of organization to which the donation is made and/or the type of property that is donated.

Under State law, only individuals who itemize deductions on their federal income tax return may itemize deductions on their State income tax return. Unless an individual itemizes deductions, no tax incentive is currently provided for making charitable contributions. Prior to 1987, taxpayers who did not itemize deductions could claim their charitable contributions as an adjustment to gross income on their federal return, which would flow through to the calculation of the Maryland income tax.

State Fiscal Effect: Based on the 1997 income tax data, it is estimated that general fund revenues would decrease by about $90.9 million in tax year 2004. Because the pension exclusion calculation is altered beginning with tax year 2003, it is assumed that most taxpayers will adjust their estimated payments to reflect the increased subtraction prior to July 1, 2003. Consequently, general fund revenues are estimated to decrease by $45.5 million in fiscal 2004, reflecting the impact of one-half tax year. The estimate is based on the following facts and assumptions:

- for tax year 1997, approximately 62,014 joint returns and an additional 52,511 other returns were filed by residents over age 65 that claimed the pension exclusion;

- the maximum annual benefit under the Social Security Act for tax year 1996 was $14,400 ($17,300 for tax year 2001);

- the maximum estimated pension exclusion (for joint returns) would be $38,200 less 75% of Social Security benefits for tax year 2004, $39,400 less 50% of Social Security benefits for tax year 2005, $40,800 less 25% of Social Security benefits for tax year 2006, and $41,800 for tax year 2007; and

- the amount of the pension exclusion is expected to increase by 4% annually.

For future years, 50% of the revenue loss for a given tax year will be incurred in the first fiscal year, with the remaining 50% in the second fiscal year as taxpayers adjust their withholding and estimated payments to reflect the changes made by the bill. Future year losses are expected to increase by about 4% annually.

The cost of the provision dealing with charitable contributions cannot be reliably estimated. The extent of the revenue loss depends on the number of individuals who report a qualified capital gain, the amount of their unrestricted charitable contributions, and their income tax liability in the taxable year in which the contribution was made.

However, as a point of reference, in tax year 1996, 16 returns were filed which reported a capital gain (or loss) of at least $10 million. The combined tax liability of these returns was approximately $77,000, and most were filed by nonresidents. In tax year 1999, 60 returns were filed which reported a capital gain (or loss) of at least $10 million, totaling approximately $1.3 billion. The combined tax liability of these returns was approximately $33.2 million. Some of this was likely subtracted as nonresident income, meaning that not all of the $33.2 million could be claimed.

If the bill had been in effect in either of these years, general fund revenues would have decreased by a maximum of $77,000 in 1996, and a maximum of $33.2 million in 1999.

The Office of the Comptroller would incur a one-time expenditure of $45,100 in fiscal 2005 to make changes to the SMART processing systems to add the credit to form 502CR of the income tax return. The Department of Legislative Services advises that since forms and instructions are updated annually, the cost of these changes could be absorbed within existing resources.

Local Fiscal Effect: Local revenues would decrease by approximately 2.8% of the total State subtraction in fiscal 2004. Based on the new pension exclusion calculation, this results in a loss of approximately $26.8 million in fiscal 2004 (one-half tax years) and $62.3 million in fiscal 2005. Future year revenue losses increase by about 4% annually.

To the extent the bill encourages charitable contributions, local government revenues would decrease as well.

Additional Information

Prior Introductions: The provision of this bill dealing with charitable contributions was introduced as HB 1429 in the 2001 session. It failed third reading in the House.

Cross File: HB 1082 (Delegate Hixson, *et al.*) – Ways and Means, is a similar bill.

Information Source(s): Comptroller's Office (Bureau of Revenue Estimates), Department of Legislative Services

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