

Department of Legislative Services  
 Maryland General Assembly  
 2002 Session

**FISCAL NOTE**

House Bill 479 (Delegate Howard)  
 Ways and Means

**Income Tax - Subtraction Modification for Retirement Income**

This bill alters the State’s pension exclusion calculation for retirement income. Specifically, the bill: (1) expands the types of income eligible for the pension exclusion by including income from Individual Retirement Arrangements (IRAs), rollover IRAs, and simplified employee pensions (SEPS); (2) increases the maximum amount of pension exclusion annually so that by 2011 all retirement income is nontaxable; and (3) phases out the Social Security offset through 2010.

The bill takes effect July 1, 2002 and applies to all taxable years beginning after December 31, 2001.

**Fiscal Summary**

**State Effect:** General fund revenue decrease of approximately \$128.5 million in FY 2003 (one and one-half tax years). Future year decreases reflect a single fiscal year’s loss, a new maximum pension exclusion, a reduced Social Security offset, and 4% annual growth in the amount of the pension exclusion. No effect on expenditures.

(\$ in millions)	FY 2003	FY 2004	FY 2005	FY 2006	FY 2007
GF Revenue	(\$128.5)	(\$125.7)	(\$152.6)	(\$173.1)	(\$188.2)
Expenditure	\$0	\$0	\$0	\$0	\$0
Net Effect	(\$128.5)	(\$125.7)	(\$152.6)	(\$173.1)	(\$188.2)

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

**Local Effect:** Based on the above estimate, total local revenues would decrease by approximately \$73.2 million in FY 2003, which represents the impact of one and one-half tax years.

**Small Business Effect:** None.

## Analysis

**Bill Summary:** Exhibit 1 illustrates the maximum pension exclusion and the phase-out of the Social Security offset proposed by the bill.

### Exhibit 1

<u>Tax Year</u>	<u>Maximum Exclusion</u>	<u>Social Security Offset Required</u>
2002	\$18,000	90%
2003	\$20,000	80%
2004	\$22,000	70%
2005	\$24,000	60%
2006	\$26,000	50%
2007	\$28,000	40%
2008	\$30,000	30%
2009	\$32,000	20%
2010	\$34,000	10%
2011 and later	All income	None

**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 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 (\$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. 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.

**State Fiscal Effect:** Based on the *1996 Maryland Statistics of Income* data (the last year for which data with the necessary level of detail is available), it is estimated that general fund revenues would decrease by approximately \$73.3 million in tax year 2002. Although the changes in the maximum pension exclusion and the Social Security offset take effect in tax year 2002, it is assumed that most taxpayers will not adjust their estimated payments to reflect the increased subtraction until after July 1, 2002. Consequently, general fund revenues are estimated to decrease by \$128.5 million in fiscal 2003, 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 83,356 joint returns were filed claiming an average pension exclusion of \$7,245; an additional 73,479 returns were filed claiming an average pension exclusion of \$5,885. The average pension exclusion for 2002 is estimated to be \$8,877.
- The maximum annual benefit under the Social Security Act for tax year 1996 was \$14,400 (\$17,300 for tax year 2001).

- The average pension exclusion increases by approximately 4% each year.
- Income from rollover IRAs is assumed to be included with IRA data; income from SEPs is assumed to be included with taxable pensions and annuities data.

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 withholdings and estimated payments to reflect the changes made by the bill. Future years also reflect a new maximum pension exclusion, a reduced Social Security offset and 4% annual growth in the amount of the pension exclusion.

**Local Revenues:** Local revenues would decrease by approximately 2.8% of the State pension exclusion subtraction in tax year 2002. This results in a loss of approximately \$73.2 million in fiscal 2003 (one and one-half tax years) and \$74.1 million in fiscal 2004.

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### **Additional Information**

**Prior Introductions:** This bill was introduced as HB 286 in the 2001 session. It received an unfavorable report from the House Ways and Means Committee.

**Cross File:** None.

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

**Fiscal Note History:** First Reader - February 18, 2002  
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