Department of Legislative Services
Maryland General Assembly
2003 Session

FISCAL AND POLICY NOTE

Senate Bill 196 (Senator Green) (By Request)
Budget and Taxation

Income Tax - Subtraction Modification for Retirement Income

This bill alters the computation of the State's pension exclusion subtraction modification. The bill increases the maximum State pension exclusion to a specified percentage of the maximum annual benefit under the Social Security Act less any Social Security or Railroad Retirement benefits received. The percentage is 105% for tax year 2004, 110% for 2005; 115% for 2006; and 120% for 2007 and beyond.

The bill also decouples the State and local income tax by creating a separate pension exclusion calculation to be used when computing the local income tax. For purposes of calculating the local income tax, the maximum pension exclusion is equal to the maximum annual benefit allowed under Social Security less any Social Security or Railroad Retirement benefits received.

The 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 $5.0 million in FY 2004, which represents the impact of one-half tax year. Future year revenue decreases reflect increasing pension exclusion amounts and growth. General fund expenditures would increase by approximately $155,300 in FY 2005, which includes one-time costs. Future years reflect ongoing expenses and a 1% annual increase.

(in dollars)	FY 2004	FY 2005	FY 2006	FY 2007	FY 2008
GF Revenue	($5,039,400)	($19,469,200)	($36,984,800)	($53,893,500)	($63,616,400)
GF Expenditure	0	155,300	109,800	110,400	112,000
Net Effect	($5,039,400)	($19,624,500)	($37,094,600)	($54,003,900)	($63,728,400)

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

Local Effect: None. Local government revenues would not be affected due to the separate calculation of the local income tax under the bill.

Small Business Effect: None.

Analysis

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

In addition to the total exemption for Social Security benefits, 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 ($18,500 for 2002) 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. The pension exclusion has been a part of the Maryland income tax since 1965.

One important feature of the current pension exclusion is that it is limited to income received from an "employee retirement system." Chapter 524 of 2000 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 special treatment of Social Security and other retirement income, other 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 exemptions allowed for all individuals ($2,400 per exemption for 2002).

State Fiscal Effect: Based on the *1997 Maryland Statistics of Income* data, it is estimated that general fund revenues would decrease by about $10 million in tax year 2004. Because the pension exclusion calculation is altered beginning with tax year 2004, 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 $5.0 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 65,629 joint returns and an additional 56,751 other returns were filed that claimed the pension exclusion;

- the maximum annual benefit under the Social Security Act for tax year 2003 is $39,800 for joint returns and $19,000 for all others, and is estimated to increase by $700 annually; and

- the maximum pension exclusion under the bill (for joint returns) would be $43,260 for tax year 2004, $46,860 for tax year 2005, $50,600 for tax year 2006, $54,480 for tax year 2007, and $56,160 for tax year 2007.

In future years it is assumed that the one-half of a tax year impact will be realized in the first fiscal year with the remaining impact in the second fiscal year. After tax year 2006, revenues are expected to decrease by approximately 5% annually.

The Comptroller's Office advises that general fund expenditures would increase by approximately $153,060 in fiscal 2005. This is the result of creating two pension exclusion calculations – one for the State income tax and one for the local income tax, which requires adding additional pages to the income tax booklet for instructions and worksheets for the new calculations. The costs include a one-time computer programming charge of $44,795 to make changes to the SMART processing system; one-time cost for artwork of $1,278; and recurring costs for printing and postage and temporary staff of approximately $109,240. Recurring costs are expected to increase by 1% annually.

Additional Information

Prior Introductions: A similar bill was introduced as SB 372 in the 2002 session. It received an unfavorable report from the Senate Budget and Taxation Committee.

Cross File: HB 292 (Delegate Conroy, *et al.*) – Ways and Means.

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

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