SB 135

Department of Legislative Services

Maryland General Assembly
2004 Session

FISCAL AND POLICY NOTE

Senate Bill 135 (Senator Stone)
Budget and Taxation

Income Tax - Subtraction Modification for Retirement Income - Rollovers to Individual Retirement Accounts

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This bill allows income from a rollover individual retirement account or annuity (IRA) under Section 408 of the Internal Revenue Code (IRC) to be included within the subtraction modification allowed for retirement income from an employee retirement system if: (1) the contributions to the IRA consist entirely of the tax-free rollover of distributions from an employee retirement system; and (2) the tax-free rollover resulted from the mandatory withdrawal of amounts in the employee retirement system.

The bill takes effect July 1, 2004 and applies to all taxable years beginning after December 31, 2003.

Fiscal Summary

State Effect: The extent of any general fund revenue loss depends on a number of unknown factors, including the number and amount distributed each year from such nontaxable rollovers and the amount of Social Security received by the individuals utilizing these rollovers. Under one set of assumptions, general fund revenues could decline by approximately $2.4 million annually.

Local Effect: Based on the assumptions above, local government revenues could decrease by approximately $1.4 million.

Small Business Effect: None.

Analysis

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

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 ($19,900 for 2003) 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 exemption of $2,400 allowed for all individuals.

For illustrative purposes, the table below presents the savings to a hypothetical retiree under current law and under the bill. The retiree is assumed to receive $14,000 in annual pension income through an employer retirement plan, $4,000 in distributions from an IRA, and $0 in Social Security (SS) payments. As the table indicates, the additional State tax savings to the retiree as a result of the bill is $190.

State Tax Savings to Retirees from the Pension Exclusion in 2003						
	Current Law			**SB 89**		
Types of Income	**Retirement Income**	**IRA**	**SS Payment Received**	**Retirement Income**	**IRA**	**SS Payment Received**
Amount of Income	$14,000	$4,000	$0	$14,000	$4,000	$0
Pension Exclusion Calculation (max. SS benefit allowed in 2003 is $19,900)						
	Take lesser of:			Take lesser of:		
	$14,000 or ($19,900 - $0)			$18,000 or ($19,900-$0)		
Pension Exclusion	$14,000			$18,000		
State Tax Savings	$613			$803		

State Revenue Effect: 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 resulting from the mandatory withdrawal of amounts in the employee retirement system and the amount of Social Security benefits received by these individuals.

However, *for illustrative purposes only*, based on the tax year 1997 and 2001 income tax return data, it is estimated that general fund revenues would decrease by about $2.4 million in tax year 2004. Although the pension exclusion is expanded for tax year 2004, it is assumed that most taxpayers will not adjust their estimated payments to reflect the increased subtraction until after July 1, 2004. The estimate is based on the following facts and assumptions:

- for tax year 2001, approximately 19,107 returns were filed with IRA distribution totaling $320,399,056, but no pension income; the average distribution was $16,769;

- the average pension exclusion in tax year 1997 was $7,207;

- the annual growth in the pension exclusion amount is 4%;

- 25% of IRA distributions resulted from the nontaxable rollover of a distribution from an employee retirement system that resulted from the mandatory withdrawal of amounts in the employee retirement system, and each taxpayer qualifies for an estimated average pension exclusion of $9,484 in tax year 2004;

- permanently disabled individuals and spouses who take the pension exclusion increase costs by approximately 7%; and

- the maximum annual benefit under the Social Security Act for tax year 1996 was $14,400 ($20,400 for tax year 2004).

Local Revenues: Local revenues would decrease by approximately 2.8% of the total State subtraction taken in tax year 2004. Based on the estimate above, this would result in a loss of approximately $1.4 million in tax year 2004.

Additional Information

Prior Introductions: SB 89 of 2003, an identical bill, received an unfavorable report from the Senate Budget and Taxation Committee. This bill was also introduced in the 2002 and 2001 sessions. SB 399 of 2002 passed the General Assembly but was vetoed by the Governor for tax policy reasons. SB 152 of 2001 was passed by the Senate but no action was taken by the House Ways and Means Committee.

Cross File: None.

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

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