SB 466

Department of Legislative Services
Maryland General Assembly
2006 Session

FISCAL AND POLICY NOTE

Senate Bill 466 (Senators Stone and Astle)
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 (IRA) or annuity 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, 2006 and applies to tax year 2006 and beyond.

Fiscal Summary

State Effect: The extent of any general fund revenue loss depends on several 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 decrease by approximately $4.8 million annually beginning in FY 2007.

Local Effect: Based on the assumptions above, local government revenues could decrease by approximately $3.0 million annually beginning in FY 2007.

Small Business Effect: None.

Analysis

Background: 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 ($21,500 for 2005) 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 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 are not considered employee retirement systems.

The "Social Security offset" is the reduction in the maximum pension exclusion allowed under current law by individual. The Social Security offset was established at the same time as the pension exclusion. Given that Social Security benefits are exempt from Maryland income tax, 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 Income Tax Treatment for Elderly Individuals

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. 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: (1) is allowed a $1,000 personal exemption in addition to the regular personal exemption of $2,400 allowed for all individuals; and (2) can earn more income without being required to file taxes.

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 tax year 1997 and 2004 income tax return data, it is estimated that general fund revenues would decrease by about $4.8 million in fiscal 2007. Although the pension exclusion is expanded for tax year 2006, it is assumed that most taxpayers will not adjust their estimated payments to reflect the increased subtraction until after July 1, 2007. The estimate is based on the following facts and assumptions:

- for tax year 2004, approximately 16,677 returns were filed with IRA distributions totaling approximately $308.7 million, but no pension income; the average distribution was $18,512;
- the average pension exclusion in tax year 1997 was $7,207;
- the annual growth in the pension exclusion amount is 5%;
- 50% 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 $11,180 in tax year 2006;
- 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 ($21,500 for tax year 2005).

Local Revenues: Local government revenues would decrease by approximately 3% of the total State subtraction taken in tax year 2006. Based on the estimate above, this would result in a loss of approximately $3.0 million in fiscal 2007.

Additional Information

Prior Introductions: This bill was introduced in the 2000, 2001, 2002, 2003, 2004, and 2005 sessions. SB 89 of 2003, SB 135 of 2004, and SB 273 of 2005 received unfavorable reports from the Budget and Taxation Committee. SB 399 of 2002 passed the General Assembly but was vetoed by the Governor for tax policy reasons. SB 152 of

2001 passed the Senate but was not reported from the Ways and Means Committee. SB 319 of 2000 was referred to interim study by the Budget and Taxation Committee.

Cross File: None.

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

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