# Department of Legislative Services
2011 Session

## FISCAL AND POLICY NOTE

House Bill 586 (Delegate Gilchrist, *et al.*)
Ways and Means

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

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 State income tax subtraction modification (pension exclusion) allowed for retirement income if the contributions to the IRA or annuity consist entirely of the tax-free rollover of distributions from an employee retirement system. The bill also eliminates indexing of the State pension annual exclusion and freezes the maximum value of the annual pension exclusion at $26,100.

The bill takes effect July 1, 2011, and applies to tax year 2011 and beyond.

## Fiscal Summary

**State Effect:** The extent of any general fund revenue decrease from rollover distributions depends on several unknown factors, including the amount distributed each year from nontaxable rollovers and the amount of Social Security income received by the individuals utilizing these rollovers. Based on tax year 2006 data, general fund revenues may decrease by $0.6 million in FY 2012. General fund revenues increase beginning in FY 2013 as the revenue gains from limiting the pension exclusion are greater than the revenue losses from eligible rollovers. Expenditures are not affected.

| ($ in millions) | FY 2012 | FY 2013 | FY 2014 | FY 2015 | FY 2016 |
|---|---|---|---|---|---|
| GF Revenue | ($0.6) | $0.6 | $2.2 | $3.5 | $5.2 |
| Expenditure | 0 | 0 | 0 | 0 | 0 |
| Net Effect | ($0.6) | $0.6 | $2.2 | $3.5 | $5.2 |

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

**Local Effect:** Local government revenues may decrease by $407,000 in FY 2012, and increase by $404,000 in FY 2013. Expenditures are not affected.

**Small Business Effect:** None.

## Analysis

**Current Law\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 ($26,100 for 2010) 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 (Social Security offset). The pension exclusion has been a part of the Maryland income tax since 1965.

The "Social Security offset" is the reduction in the maximum pension exclusion allowed under current law by an 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.

One important feature of the current pension exclusion is that it is limited to income received from an "employee retirement system." 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.

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 allowed for all individuals; and can also earn more income without being required to file taxes.

**State Revenues:** The actual cost of the bill, which cannot be reliably estimated at this time, depends on the number of eligible rollovers and the amount of income distributed each year from these eligible rollovers, the amount of Social Security benefits received by these individuals, and the impact of freezing the pension exclusion amount.

However, *for illustrative purposes only*, based on tax year 2006 income tax return data, it is estimated that net general fund revenues may decrease by about $0.6 million in fiscal 2012; which constitutes a revenue increase of $2.6 million resulting from freezing the value of the pension exclusion minus a revenue loss of $3.2 million from eligible rollovers. Although the bill is effective in tax year 2011, it is assumed that most taxpayers will not adjust estimated payments. This estimate is based on the following facts and assumptions:

- for tax year 2006, about 15,500 returns were filed with IRA distributions totaling approximately $268.7 million but no pension income; the average distribution was $17,299;
- the maximum pension exclusion was $24,000 in tax year 2008;
- 50% of IRA distributions are from an account consisting entirely of tax-free rollovers from employee retirement systems; and
- the number of eligible individuals increases by 2% annually from tax year 2006 to 2009.

**Exhibit 1** shows the potential fiscal impact of the bill in fiscal 2012 through 2016 on both State and local revenues.

**Exhibit 1**
**Fiscal Impact of HB 586**
**Fiscal 2012-2016**

| | FY 2012 | FY 2013 | FY 2014 | FY 2015 | FY 2016 |
|---|---|---|---|---|---|
| Pension Exclusion | $2,555,000 | $3,999,000 | $5,703,000 | $7,196,000 | $9,110,000 |
| Rollover IRAs | (3,200,000) | (3,360,000) | (3,528,000) | (3,704,000) | (3,889,000) |
| Net Effect | | | | | |
| State Revenues | (645,000) | 639,000 | 2,175,000 | 3,492,000 | 5,221,000 |
| Local Revenues | (407,000) | 404,000 | 1,374,000 | 2,205,000 | 3,297,000 |

Legislative Services advises that there is considerable uncertainty over the fiscal impact of allowing rollover IRAs to qualify for the pension exclusion. As such, the revenue impact may be significantly different than the amounts shown in Exhibit 1.

**Local Revenues:** Local government revenues decrease by approximately 3% of the total net State subtraction modification claimed. Based on the estimate above, the revenue decrease may total approximately $407,000 in fiscal 2012, with the revenue increase of $404,000 in fiscal 2013.

## Additional Information

**Prior Introductions:** None.

**Cross File:** None.

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

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mc/jrb

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