

**Department of Legislative Services**  
Maryland General Assembly  
2016 Session

**FISCAL AND POLICY NOTE**  
**First Reader**

Senate Bill 5 (Senator Young)  
Budget and Taxation

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

This bill expands the existing pension exclusion subtraction modification under the State income tax for taxpayers who are at least 70 years of age or those who qualify under current law due to a disability. The maximum pension exclusion increases to \$75,000, phased in over seven tax years.

The bill takes effect July 1, 2016.

**Fiscal Summary**

**State Effect:** General fund revenues decrease significantly beginning in FY 2017 due to additional pension income being exempted. Based on limited data, general fund revenues may decrease by \$25.1 million in FY 2017 due to additional income being exempted. Future year revenue decreases reflect the estimated number of eligible taxpayers and retirement income. General fund expenditures increase by \$35,400 in FY 2017 due to one-time implementation costs at the Comptroller's Office.

| (\$ in millions) | FY 2017  | FY 2018  | FY 2019  | FY 2020  | FY 2021  |
|------------------|----------|----------|----------|----------|----------|
| GF Revenue       | (\$25.1) | (\$47.3) | (\$66.1) | (\$82.3) | (\$95.8) |
| GF Expenditure   | \$0.0    | \$0      | \$0      | \$0      | \$0      |
| Net Effect       | (\$25.2) | (\$47.3) | (\$66.1) | (\$82.3) | (\$95.8) |

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

**Local Effect:** Local revenues may decrease by \$16.9 million in FY 2017 and by \$64.4 million in FY 2021. Local expenditures are not affected.

**Small Business Effect:** None.

## Analysis

**Bill Summary:** The bill increases the maximum pension exclusion for qualifying individuals to (1) \$33,000 in tax year 2016; (2) \$40,000 in tax year 2017; (3) \$47,000 in tax year 2018; (4) \$54,000 in tax year 2019; (5) \$61,000 in tax year 2020; (6) \$68,000 in tax year 2021; and (7) \$75,000 beginning in tax year 2022. The maximum exclusion amount in each year is reduced by the amount of Social Security payments received as provided under current law.

**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 (\$29,200 for 2015) 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 “Social Security offset” is the reduction in the maximum pension exclusion allowed under current law for 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 even though benefits are partially taxable for federal purposes, 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 significant feature of the current pension exclusion is that it is limited to income received from an “employee retirement system.” Chapter 524 of 2000 clarified the definition of an “employee retirement system” by providing for the types of retirement income that may be included for purposes of calculating the pension exclusion. As defined by Chapter 524, eligible employee retirement systems are retirement plans established and maintained by an employer for the benefit of its employees and qualified under § 401(a), § 403, or § 457(b) of the Internal Revenue Code (IRC). These include defined benefit and defined contribution pension plans, 401(k) plans, 403(b) plans, and 457(b) plans. However, Chapter 524 also included language clarifying what is not included in an “employee retirement system”: (1) an individual retirement account (IRA) or annuity under § 408 of the IRC; (2) a Roth IRA under § 408A of the IRC; (3) a rollover IRA; (4) a simplified employee pension under § 408(k) of the IRC; or (5) an ineligible deferred compensation plan under § 457(f) of the IRC. Since 2000, there have been no substantive changes to the pension exclusion. **Exhibit 1** shows the eligible and ineligible retirement income under the pension exclusion.

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**Exhibit 1**  
**Eligible and Ineligible Retirement Plans under the Pension Exclusion**

| <u>Eligible</u>  | <u>Ineligible</u>  |
|--|--|
| <ul style="list-style-type: none"><li>• 401(k) Cash or Deferred Arrangement Plans</li><li>• 403(b) Plans</li><li>• 457(b) Plans</li><li>• Thrift Savings Plans</li><li>• Savings Incentive Match Plan for Employees Retirement Plans under § 401(k) of the IRC</li></ul> | <ul style="list-style-type: none"><li>• Traditional IRAs</li><li>• Rollover IRAs</li><li>• Roth IRAs</li><li>• Keogh Plans</li><li>• Simplified Employee Pensions</li><li>• Savings Incentive Match Plan for Employees Retirement Plans under § 408 of the IRC</li></ul> |

Source: Department of Legislative Services

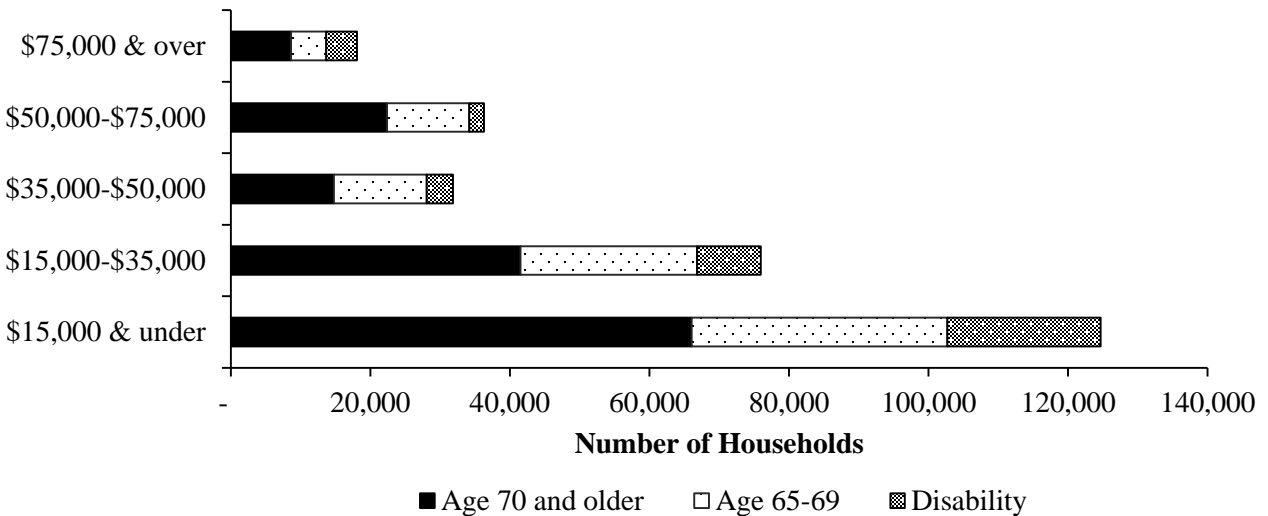
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In addition to the special treatment of Social Security and other retirement income, additional income tax relief is provided to senior citizens regardless of the source of their income. Each individual age 65 and older is allowed a \$1,000 personal exemption in addition to the regular personal exemption allowed for all individuals. According to the Department of Budget and Management, in fiscal 2016 the State subtraction modification for Social Security benefits reduced State revenues by \$210.5 million (this is in addition to the revenue loss resulting from the partial federal exemption of Social Security benefits), the State pension exclusion reduced State revenues by \$166.0 million, and the additional personal exemption reduced State revenues by \$30.3 million.

In calendar 2011, an estimated 286,800 Maryland households received a pension that could qualify for the pension exclusion. A little more than one-half of these pensions were received in a household where at least one member was 70 years of age or older, one-third were 65 to 69 years of age, and the remaining 15% were disability pensions, including certain nontaxable pensions, paid to households where the family members were younger than age 65. An average pension income of \$26,700 was received for each household reporting pension income. Households in the 65 to 69 years of age range had the highest average pension; disability pension households had an average pension that was 20% lower (the households in the highest age range had an average pension income that was about 10% lower than those in the 65 to 69 years of age range). **Exhibit 2** shows the number of Maryland households by the amount of pension income received by the household in calendar 2011.

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**Exhibit 2**  
**Number of Maryland Households by Amount of Pension Income**  
**Calendar 2011**



Note: Disability pensions include only those households under the age of 65 years old.

Source: U.S. Census Bureau; Department of Legislative Services

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**State Revenues:** The bill expands the existing State pension exclusion subtraction modification beginning in tax year 2016 for taxpayers who are at least 70 years of age or who qualify for the exclusion under current law because of a disability. Accordingly, general fund revenues may decrease significantly beginning in fiscal 2017.

Due to taxpayer confidentiality requirements, the Department of Legislative Services (DLS) does not have access to income tax data and is dependent on data from the Comptroller’s Office. The Comptroller’s Office has advised DLS that it does not have sufficient data to produce an accurate fiscal estimate of various proposals to alter the State pension exclusion. According to the Comptroller’s Office, it is in the process of redesigning the personal income tax forms in an effort to overcome the data limitations described above.

Based on limited data from the Comptroller’s Office, and the U.S. Census Bureau, DLS estimates that the bill will decrease general fund revenues by \$25.1 million in fiscal 2017, \$47.3 million in fiscal 2018, \$66.1 million in fiscal 2019, \$82.3 million in fiscal 2020, and \$95.8 million in fiscal 2021. Revenue losses could, however, be significantly different than estimated.

**Local Revenues:** Local revenues decrease by approximately 3% of the total net State subtraction modifications claimed. Accordingly, local income tax revenues may decrease by \$16.9 million in fiscal 2017, \$31.8 million in fiscal 2018, \$44.4 million in fiscal 2019, \$55.4 million in fiscal 2020, and \$64.4 million in fiscal 2021.

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### **Additional Information**

**Prior Introductions:** SB 209 of 2015 received a hearing in the Senate Budget and Taxation Committee, but no further action was taken. Its cross file, HB 392, received a hearing in the House Ways and Means Committee, but no further action was taken. SB 451 of 2014, a similar bill, received an unfavorable report from the Senate Budget and Taxation Committee. Its cross file, HB 868, was withdrawn. Similar legislation was introduced in the 2013 and 2012 sessions.

**Cross File:** HB 311 (Delegate K. Young, *et al.*) - Ways and Means.

**Information Source(s):** U.S. Census Bureau, Comptroller's Office, Department of Legislative Services

**Fiscal Note History:** First Reader - February 8, 2016  
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