Department of Legislative Services
Maryland General Assembly
2017 Session

FISCAL AND POLICY NOTE
First Reader

House Bill 33 (Delegate Afzali)
Ways and Means

Income Tax - Subtraction Modification - Retirement Account Withdrawals for Higher Education Tuition

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This bill exempts from the State and local income tax 100% of the income withdrawn from specified retirement accounts if the income is used to pay for tuition at an institution of higher education located in the State.

The bill takes effect July 1, 2017, and applies to tax year 2017 and beyond.

Fiscal Summary

State Effect: General fund revenues will decrease significantly beginning in FY 2018 due to the exemption of specified retirement income distributions. Based on limited data, the Comptroller's Office estimates that revenue losses will likely exceed $30.0 million annually. General fund expenditures increase beginning in FY 2018 due to implementation costs at the Comptroller's Office.

Local Effect: Local revenues will decrease significantly beginning in FY 2018. Based on limited data, the Comptroller's Office estimates that the revenue loss will likely exceed $20.0 million annually. Local expenditures are not affected.

Small Business Effect: None.

Analysis

Bill Summary: Income distributed from the retirement plans shown in **Exhibit 1** is exempt from State and local income taxes if the income is used during the taxable year to pay for tuition at an institution of higher education located in the State. An institution of higher education includes public, private, and for-profit institutions and career schools. In order to qualify, the tuition must be paid for an individual who is the taxpayer's spouse; child or descendent of the child; sibling or stepsibling; parent or ancestor of a parent; nephew or niece; aunt or uncle; or son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law. The bill requires that individuals claiming the subtraction modification submit to the Comptroller documentation from the institution of higher education of the amount of tuition paid.

Exhibit 1
Proposed Eligible Retirement Accounts
Qualified Tuition Distributions

- 401(k) Cash or Deferred Arrangement (CODA) Plans
- 403(b) Plans
- 457(b) Plans
- Thrift Savings Plans
- Savings Incentive Match Plan for Employees (SIMPLE) Retirement Plans Under § 401(k) of the IRC
- Traditional IRAs
- Roth IRAs
- Keogh Plans
- Simplified Employee Pensions
- SIMPLE Retirement Plans Under § 408 of the IRC

IRA = individual retirement account
IRC = Internal Revenue Code

Source: Department of Legislative Services

Current Law/Background:

Federal and State Retirement Income Taxation

The Internal Revenue Code and regulations adopted by the Internal Revenue Service provide for the tax treatment of distributions from retirement accounts as well as the circumstances under which a taxpayer can withdraw income. For example, taxpayers can generally distribute income from most qualified plans when the account owner reaches age 59½ years. These distributions are generally subject to federal income tax. Early distributions, those made before age 59½ years, are also subject to an additional 10% penalty, unless the distribution is made under certain circumstances. Taxpayers who take an early distribution from individual retirement accounts, SIMPLE retirement plans, or simplified employee pensions and use the income to pay for qualified education expenses are exempt from the 10% penalty but pay federal income taxes on the income withdrawn. In addition, certain plans allow for an individual to borrow against the value of the retirement account.

Except as described below, Maryland generally conforms to the federal income taxation of distributions from retirement accounts. 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 ($29,400 for 2016) may be exempt from tax, without regard to how the distribution is used. 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. As defined by Chapter 524 of 2000, 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.

Federal and State Tax Benefits for Qualified Education Expenses

Publication 970 of the Internal Revenue Service outlines the available federal tax benefits for education expenses, including the favorable tax treatment of certain:

- scholarships, grants, and tuition reductions;
- canceled student loans;
- student loan repayment assistance;
- tuition and fees;
- education savings accounts;
- qualified tuition programs;
- use of savings bonds for education costs;
- employer-provided educational benefits; and
- deductions for work-related education.

Maryland generally conforms to the federal tax treatment of these benefits.

State Revenues: The bill exempts from State and local income taxes 100% of the income withdrawn from specified retirement accounts if the income is used to pay for tuition at a qualified institution of higher education beginning in tax year 2017. Revenue losses will occur due to qualified distributions from retirement accounts that (1) do not currently qualify for the State pension exclusion or (2) would otherwise qualify for the State pension exclusion, but the taxpayer is unable under current law to deduct 100% of the retirement income. As a result, annual State and local income tax revenues will decrease significantly beginning in fiscal 2018.

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 accurate fiscal estimates of various proposals to alter the State pension exclusion. According to the Comptroller's Office, the personal income tax forms have been redesigned in an effort to overcome these data limitations.

Based on limited data on the amount of retirement income and eligible education expenses paid as reported on Maryland federal income tax returns relative to the amount claimed under the current pension exclusion, the Comptroller estimates that revenue losses resulting from the bill will likely exceed $30.0 million annually beginning in fiscal 2018.

State Expenditures: The Comptroller's Office advises that it will incur additional costs beginning in fiscal 2018 as a result of hiring one revenue examiner and incurring programming expenses. As a result, general fund expenditures increase by $84,800 in fiscal 2018, which reflects a January 1, 2018 hiring date. It includes a salary, fringe benefits, one-time start-up costs, and ongoing operating expenses.

Position	1
Salary and Fringe Benefits	$26,800
Operating Expenses	4,953
Programming Expenditures	53,000
Total FY 2018 Expenditures	**$84,753**

Future year expenditures reflect full salaries with annual increases and employee turnover and ongoing operating expenses.

Local Revenues: Local income tax revenues will decrease as a result of subtraction modifications claimed against the personal income tax. Under the assumptions above, local income tax revenues would likely decrease by at least $20.0 million annually beginning in fiscal 2018.

Additional Information

Prior Introductions: None.

Cross File: None.

Information Source(s): Comptroller's Office; Internal Revenue Service; Department of Legislative Services

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