Department of Legislative Services

Maryland General Assembly
2018 Session

FISCAL AND POLICY NOTE
First Reader

House Bill 354 (The Speaker, *et al.*) (By Request - Administration)
Ways and Means

Income Tax Subtraction Modification - Correctional Officers (Hometown Heroes Act of 2018)

This Administration bill expands the State subtraction modification for retired law enforcement, fire, rescue, and emergency services personnel by (1) extending eligibility to retirees who are at least age 50; (2) increasing the amount of eligible retirement income that may be exempted to 100% by tax year 2020; and (3) extending eligibility to retired correctional officers. It also makes specified employees of the Department of Juvenile Services (DJS) members of the Correctional Officers' Retirement System (CORS) as a condition of their employment. **The bill takes effect July 1, 2018, and applies to tax year 2018 and beyond.**

Fiscal Summary

State Effect: General fund revenues decrease by $1.2 million in FY 2019 and by $11.4 million in FY 2023 due to additional retirement income being exempted. Annual revenue decreases reflect the estimated number of eligible taxpayers, the amount of retirement income, and the phase in of the subtraction modification as specified by the bill. As discussed below, revenue losses may be greater. State pension contributions increase by approximately $2.33 million beginning in FY 2020; out-year expenditures increase according to actuarial assumptions, and costs are assumed to be allocated 60% general funds, 20% special funds, and 20% federal/other funds. Special fund expenditures increase by $100,000 in FY 2019 for programming costs.

(in dollars)	FY 2019	FY 2020	FY 2021	FY 2022	FY 2023
GF Revenue	($1,211,700)	($5,553,300)	($10,787,900)	($11,066,100)	($11,351,400)
GF Expenditure	$0	$1,398,000	$1,452,000	$1,512,000	$1,560,000
SF Expenditure	$100,000	$466,000	$484,000	$504,000	$520,000
FF Expenditure	$0	$466,000	$484,000	$504,000	$520,000
Net Effect	($1,311,700)	($7,883,300)	($13,207,900)	($13,586,100)	($13,951,400)

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

Local Effect: Local revenues decrease by $0.8 million in FY 2019 and by $7.4 million in FY 2023, as discussed below. Expenditures are not directly affected.

Small Business Effect: The Administration has determined that this bill has minimal or no impact on small business (attached). The Department of Legislative Services (DLS) concurs with this assessment.

Analysis

Bill Summary:

Law Enforcement Officers and Fire, Rescue, and Emergency Services Personnel

Beginning in tax year 2018, retired federal, State, and local correctional officers are eligible to take the subtraction modification. In addition to a retiree of CORS (as expanded by the bill), an eligible retiree includes (1) a security chief, facility administrator, assistant warden, or warden who is a retiree of the Employees' Pension System (EPS) or Employees' Retirement System (ERS) and (2) a retiree who was employed as a local detention center officer.

Beginning in tax year 2019, all eligible law enforcement, correctional officers, and fire, rescue, and emergency services personnel retirees who are at least age 50 may take the subtraction modification (under current law retirees must be at least 55 years old). The bill also increases the maximum subtraction modification from $15,000 to a percentage of retirement income equal to (1) 50% in tax year 2019 and (2) 100% beginning in tax year 2020.

Correctional Officers' Retirement System

The bill makes DJS employees in the following positions members of CORS as a condition of their employment:

- advisor lead, advisor supervisor, or advisor trainee;
- cook or food service worker;
- maintenance assistant, maintenance chief, maintenance mechanic, or maintenance supervisor; and
- resident advisor or resident advisor team lead.

An individual who is in one of the specified positions on or before June 30, 2018, is eligible to retire from CORS if vested in CORS, with a combined total of at least 20 years of *eligibility* credit in CORS and either EPS or ERS. Any such individual who retires under this provision is entitled to a normal service retirement benefit based on *creditable* service in CORS. By October 1, 2018, the State Retirement Agency (SRA) must notify individuals affected by the bill of their *right* to transfer *creditable* service from EPS or ERS to CORS (there is *no requirement* in the bill to transfer creditable service).

Current Law/Background:

State Pension Exclusion – All Eligible Individuals

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 ($29,900 for 2017) 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. 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(b) 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, Keogh plans, and simplified employee pension plans are not considered employee retirement systems.

Law Enforcement Officers and Fire, Rescue, and Emergency Services Personnel

Retired law enforcement officers and fire, rescue, or emergency services personnel who are age 65 or older or are totally disabled qualify and claim the State pension exclusion in the same manner as other eligible retirees as described above.

Chapters 153 and 154 of 2017 established a pension exclusion for retired law enforcement officers or fire, rescue, or emergency services personnel. Retirement income qualifies for the State pension exclusion if the individual is at least age 55 and the retirement income is attributable to employment as a law enforcement officer or as a fire, rescue, or emergency services personnel of the United States, the State, or a local jurisdiction. Emergency services personnel includes emergency medical technicians and paramedics. The maximum exclusion in the tax year is $15,000.

Correctional Officers' Retirement System Membership

Eligibility for CORS membership is limited to (1) correctional officers in the first six job classifications; (2) security attendants at the Clifton T. Perkins Hospital Center; (3) correctional dietary, maintenance, supply, and laundry officers; (4) designated employees of Maryland Correctional Enterprises; (5) certain local detention center officers; (6) specified correctional officers serving as security chiefs, facility administrators, assistant wardens, or wardens; (7) correctional case management specialists, supervisors, or managers; (8) parole and probation agents, supervisors, or regional administrators; and (9) specified counselors, social workers, psychologists, and recreation officers within the Department of Public Safety and Correctional Services (DPSCS).

Although the bill applies to members of both ERS and EPS, this analysis assumes that all current individuals affected by the bill participate only in EPS (ERS was closed to new members in 1980); **Exhibit 1** shows the key provisions for CORS and EPS. As the exhibit shows, Chapter 110 of 2006 phased in a higher EPS employee contribution rate, from 2.0% in fiscal 2006 to 5.0% in fiscal 2009. Chapter 397 of 2011 made additional changes, raising the member contribution rate to 7.0% and reducing the benefit multiplier to 1.5% for members hired after June 30, 2011. Prior to July 1, 1998, EPS was noncontributory for most members.

Chapter 397 also raised the vesting requirement from 5 to 10 years for all members of the State Retirement and Pension System (SRPS) hired on or after July 1, 2011. However, Chapters 608 and 609 of 2012 allow a member of any SRPS system who was a member on June 30, 2011, and who transfers into another SRPS system on or after July 1, 2011, without a break in employment (of more than 30 days) to be subject to the same requirements for the new system that were in effect on June 30, 2011. For the purposes of this bill, individuals who were members of EPS before July 1, 2011, and who transfer to CORS under the bill, require only 5 years (instead of 10) to vest in CORS. Individuals who joined EPS on or after July 1, 2011, and transfer under the bill still need 10 years to vest in CORS.

"Eligibility service" means service credit that is recognized for determining eligibility for a retirement benefit. In general, a member of EPS receives one year of eligibility service credit for completing at least 500 hours of employment in a fiscal year. "Creditable service" is service credit that is recognized for computing a retirement benefit. In general, it equals eligibility service credit plus credit for unused sick leave.

Exhibit 1
Pension Plan Provisions

	Employees' Pension System		
	Hired Before July 1, 2011	**Hired After June 30, 2011**	**CORS**
Normal Retirement Age	62[1]	65[2]	55[3]
Years of Service for Normal Retirement	30	Age and service add to 90	20
Employee Contribution	None prior to 1998 2.0% (1998-2006) 3.0% in 2007 4.0% in 2008 5.0% (2009-2011) 7.0% after June 30, 2011	7.0%	5.0%
Benefit Multiplier	1.8% (after 1998) 1.2% (before 1998)	1.5%	1.82% of AFC

AFC: average final compensation
CORS: Correctional Officers' Retirement System

[1]Retiree must have at least 5 years of service.
[2]Retiree must have at least 10 years of service.
[3]Retiree must have 5 years of service if hired before July 1, 2011; otherwise, retiree must have 10 years of service if hired on or after July 1, 2011.

Source: Maryland Annotated Code; State Personnel and Pensions Article

Title 37 of the State Personnel and Pensions Article governs transfers from EPS to another contributory pension system (like CORS). Under Title 37, a "new system" means the system into which the member is transferring service credit, and "previous system" means the system from which the individual is transferring. Members transferring creditable service from EPS to another contributory system must pay the member contribution rates in effect for the period of service covered by the transferred service credit, plus interest. They are also refunded any accumulated contributions in the previous system that are in excess of the member contributions required by the new system. Under Title 37, an individual who retires from a new system within five years of transferring to that system receives benefits for the transferred credit that would have been payable under the previous system. Only after five years can benefits be paid for the transferred credit in accordance with the benefit formula in the new system.

Under the terms of Title 37, therefore, EPS members transferring creditable service to CORS have to pay the difference between the contribution rate paid to EPS, if any, and the 5.0% CORS contribution rate, plus interest, for any service credit earned prior to fiscal 2009, when the EPS member contribution rate was less than the 5.0% CORS contribution. For service credit earned prior to 1998, they likely must pay the full CORS contribution of 5.0% (plus interest) since EPS was noncontributory for most members. However, they will also receive credit for the higher member contributions (7.0%) paid in EPS since June 30, 2011, because those contributions are also transferred to CORS and credited to their account. Any net deficiency in their member contributions results in an actuarial reduction to their benefit at the time of retirement. DLS notes that there is no actual transfer of assets between plans because CORS and EPS/ERS are considered a single plan for the purpose of valuing their assets and liabilities.

Normal retirement age for most CORS members is age 55 if they have vested; they can also retire with 20 years of service regardless of age.

Chapter 340 of 2006 included 647 correctional dietary, maintenance, and supply workers in CORS. Chapters 408 and 409 of 2008 added correctional laundry workers and designated employees of Maryland Correctional Enterprises. Chapters 218 and 219 of 2016 added correctional case management specialists, supervisors, and managers. Chapters 688 and 689 of 2017 added parole and probation agents, supervisors, and regional administrators. Chapter 690 of 2017 added specified counselors, social workers, psychologists, and recreation officers within DPSCS.

Based on data provided by DJS, the actuary has determined that the bill affects approximately 660 employees in the specified job categories.

State Revenues:

Subtraction Modification

Additional retirement income may be exempted from the State income tax beginning in tax year 2018. It is assumed that individuals do not adjust withholdings and estimated payments. As a result, general fund revenues decrease by $1.2 million in fiscal 2019, increasing to $10.8 million in fiscal 2021 when 100% of retirement income may be exempted beginning in tax year 2020. **Exhibit 2** shows the estimated impact of the bill on State and local revenues.

DLS notes that the bill may be interpreted to allow eligible retirees to continue to exempt 100% of qualified retirement income after reaching the age of 65 *in addition to* the pension exclusion available to all taxpayers under current law. Accordingly, revenue losses could be significantly greater than reflected in this fiscal estimate to the extent that additional retirement income is exempted.

Exhibit 2
State and Local Revenue Impacts
Fiscal 2019-2023

	FY 2019	FY 2020	FY 2021	FY 2022	FY 2023
State	($1.2)	($5.6)	($10.8)	($11.1)	($11.4)
Local	(0.8)	(3.6)	(7.0)	(7.2)	(7.4)
Total Revenues	**($2.0)**	**($9.2)**	**($17.8)**	**($18.3)**	**($18.8)**

State Expenditures:

Pension Liabilities

As noted above, EPS/ERS and CORS are considered a single plan for actuarial reasons, so the employer contribution rates for each plan are the same. Also, current EPS members transferring creditable service to CORS have to make up any difference in member contributions. Therefore, any difference in member contributions has no effect on plan assets.

On the liability side, several competing factors affect the fiscal effect of the bill. On the one hand, some service credit in EPS accrued at a lower benefit level than CORS, whether at the 1.2% level, prior to 1998, or the 1.5% level, for those hired on or after July 1, 2011. Under the bill, that service credit may be paid at the 1.818% CORS level if the affected individuals elect to transfer creditable service from EPS to CORS. This factor increases State pension liabilities because accrued credit is being paid at a higher level.

A countervailing factor is the requirement in current law that individuals remain in CORS for at least 5 years before retiring in order to earn the CORS benefits and the bill's requirement that they vest in CORS (either 5 or 10 years) before they retire with a CORS benefit. This may cause some individuals to remain employed longer than they otherwise would, or not to transfer creditable service to CORS. Delayed retirements reduce State pension liabilities because payments are made for fewer years.

The bill's fiscal effect varies depending on the number and demographic characteristics of the current EPS members who elect to transfer prior creditable service in EPS to CORS. If a substantial number of affected employees with lots of creditable service accrued prior to

1998 elect to transfer, the effect is greater because all of that credit is paid at the 1.818% multiplier instead of 1.2%. Similarly, if a substantial number of recent hires, currently earning a benefit of 1.5% in EPS, elect to transfer service credit, the cost also is higher.

Finally, the analysis assumes that any individual who is within 5 years of retirement under EPS elects *not* to transfer creditable service to CORS but rather elects to retire with an EPS benefit. This is due to the fact that the individual would have to remain in CORS for 5 or 10 years in order to vest and retire with a CORS benefit. Given that the individual is within 5 years of retirement, the actuary assumes that the individual does not elect to work longer but instead chooses to retire with an EPS benefit. Otherwise, the analysis assumes that all other affected individuals for whom data is available elect to transfer creditable service to CORS and retire with a CORS benefit after vesting with either 5 or 10 years of service. Those individuals also have to reconcile any contribution deficiency under Title 37 resulting from the transfer. Based on the data provided by DJS, the General Assembly's actuary has determined that 60 of the affected members are eligible for retirement within 5 years.

The General Assembly's actuary advises that, with these assumptions, State pension liabilities increase by $7.65 million and the normal cost increases by $1.63 million. State pension liabilities are amortized over the remaining years of a closed 25-year amortization period. Therefore, adding the increased normal cost to the annual amortization payment results in a first-year cost of $2.33 million in fiscal 2020. Out-year pension costs increase according to actuarial assumptions. State pension costs in the combined employees' system (which includes both CORS and EPS) are assumed to be split 60% general funds, 20% special funds, and 20% federal/other funds.

For the purposes of this estimate, the actuary calculated the effect of members earning the more generous CORS benefit rather than the EPS benefit and assumed the liabilities are incorporated in the June 30, 2018 valuation. Therefore, the fiscal effect begins in fiscal 2020. However, the full effect of the bill will not be known until affected members notify the system whether they intend to transfer service credit from EPS to CORS. In most cases, they will notify the system after the bill's effective date (they must be told of the opportunity to transfer credit by October 2018), so the transfers will not be recognized until the June 30, 2019 valuation, which determines contribution rates for fiscal 2021. Thus, the actual fiscal impact of the bill will depend on the number of individuals who elect to transfer service credit to CORS, and the timing of those transfers, and may be less than the actuary's estimate.

This analysis does not include the effect of future individuals hired into the affected positions, including currently vacant positions.

Individuals with at least 20 years of service credit are not eligible to retire immediately from CORS. The bill specifies that, prior to retiring from CORS, they must be vested in CORS; as they are new members, they must acquire either 5 or 10 years of service credit, depending on when they first joined EPS.

Administrative Costs

Legislation transferring EPS members to CORS was enacted in both 2016 and 2017, affecting approximately 1,100 members. Notification of those members, as also required by this bill, included calculating pension deficiencies that would result for each member if they elected to transfer service credit. In addition, benefit projections were prepared for many of the affected members to help them decide whether it was beneficial for them to transfer service credit or keep the credit in EPS. These tasks occupied a great deal of staff time and SRA resources, including responding to inquiries and complaints from affected members, which affected the agency's ability to carry out other important functions. Given the large number of members affected by this bill, SRA therefore anticipates automating these functions. As much of the agency's information technology (IT) operations and maintenance are outsourced, doing so incurs $100,000 in programming costs from the agency's IT contractor.

Local Revenues: Local income tax revenues decrease as a result of subtraction modifications claimed against the personal income tax. Local revenues decrease by $790,800 in fiscal 2019 and by $7.4 million in fiscal 2023, as shown in Exhibit 2.

Additional Information

Prior Introductions: None.

Cross File:SB 299 (The President, *et al.*) (By Request - Administration) - Budget and Taxation.

Information Source(s): Bolton Partners, Inc.; Department of Juvenile Services; Comptroller's Office; State Retirement Agency; U.S Bureau of Labor Statistics; Department of Legislative Services

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md/rhh

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ANALYSIS OF ECONOMIC IMPACT ON SMALL BUSINESSES

TITLE OF BILL: **Income Tax Subtraction Modification - Correctional Officers (Hometown Heroes Act of 2018)**

BILL NUMBER: SB0299/HB0354

PREPARED BY: Melissa Ross, Governor's Legislative Office

PART A. ECONOMIC IMPACT RATING

This agency estimates that the proposed bill:

_X_ WILL HAVE MINIMAL OR NO ECONOMIC IMPACT ON MARYLAND SMALL BUSINESS

OR

___ WILL HAVE MEANINGFUL ECONOMIC IMPACT ON MARYLAND SMALL BUSINESSES

PART B. ECONOMIC IMPACT ANALYSIS