HB 58

Department of Legislative Services

Maryland General Assembly
2018 Session

FISCAL AND POLICY NOTE
Third Reader - Revised

House Bill 58 (Delegate Brooks, *et al.*)

Ways and Means Budget and Taxation

Income Tax - Subtraction Modification - Retirement Income

This bill expands the pension exclusion by allowing income from individual retirement accounts and annuities under Section 408 of the Internal Revenue Code (IRC) to be included within the State subtraction modification allowed for retirement income (pension exclusion) if the contributions to the IRA or annuity consist entirely of the tax-free rollover of distributions from an employee retirement system. **The bill takes effect July 1, 2018, and applies to tax year 2018 and beyond.**

Fiscal Summary

State Effect: General fund revenues decrease significantly beginning in FY 2019 due to additional pension income being exempted. Based on data provided by the Comptroller's Office, general fund revenues may decrease by $10.0 million annually beginning in FY 2019. Expenditures are not affected.

($ in millions)	FY 2019	FY 2020	FY 2021	FY 2022	FY 2023
GF Revenue	($10.0)	($10.0)	($10.0)	($10.0)	($10.0)
Expenditure	0	0	0	0	0
Net Effect	($10.0)	($10.0)	($10.0)	($10.0)	($10.0)

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

Local Effect: Local revenues may decrease by $6.5 million annually beginning in FY 2019 due to additional pension income being exempted. Local expenditures are not affected.

Small Business Effect: None.

Analysis

Current Law/Background:

State Pension Exclusion

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." 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 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.

Exhibit 1
Eligible and Ineligible Retirement Plans under the Pension Exclusion

Eligible	**Ineligible**
• 401(k) Cash or Deferred Arrangement Plans	• Traditional IRAs
• 403(b) Plans	• Rollover IRAs
• 457(b) Plans	• Roth IRAs
• Thrift Savings Plans	• Keogh Plans
• Savings Incentive Match Plan for Employees Retirement Plans under § 401(k) of the IRC	• Simplified Employee Pensions
	• Savings Incentive Match Plan for Employees Retirement Plans under § 408 of the IRC

Source: Department of Legislative Services

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 2018 the State subtraction modification for Social Security benefits reduced State revenues by $212.5 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 $167.5 million, and the additional personal exemption reduced State revenues by $30.6 million.

Rollover IRAs and Retirement Income

IRAs are a significant source of retirement savings, holding more than one-quarter of all U.S. retirement assets. There are several types of IRA accounts – traditional, originating from contributions; traditional, originating from rollovers; Roth IRAs; Simplified Employee Pensions; and SIMPLE Plans. Both types of traditional IRAs can receive rollovers or contributions subsequent to their establishment; for example, individuals might make contributions to an IRA originating from a rollover.

Rollovers have become more common over time and are now a significant source of IRA assets as companies shift from defined benefit plans to defined contribution systems and as a growing number of Americans enter retirement. Most rollovers occur when people change jobs and wish to move 401(k) or 403(b) assets into an IRA. According to the U.S. Government Accountability Office, millions of employees change jobs each year and some leave their savings in their former employers' 401(k) plans. If their accounts are small enough and they do not instruct the plan to do otherwise, plans can transfer their savings – a forced transfer – into an IRA without their consent.

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. As required by Chapter 648 of 2016, the Comptroller's Office altered the personal income tax form to capture additional data on the pension exclusion by adding Form 502R. In tax year 2016, 705,360 taxpayers filed Form 502R and reported $21.7 billion in retirement income (of all sources). A total of 227,900 of these taxpayers reported $3.8 billion in IRA retirement income. Of the taxpayers reporting IRA retirement income, about 2% reported that the IRA consisted entirely of the tax-free rollover of distributions from an employee retirement system. DLS notes that approximately 108,000 taxpayers who reported $3.3 billion in retirement income (of all sources) did not file Form 502R.

State/Local Revenues: The bill expands the State pension exclusion beginning with tax year 2018 by allowing a rollover IRA or annuity to qualify for the pension exclusion if the contributions to the IRA or annuity consist entirely of the tax-free rollover of distributions from an employee retirement system. Based on a preliminary analysis of data provided by the Comptroller's Office and adjusting for individuals who did not file Form 502R, State revenue losses resulting from the bill may total about $10.0 million annually. Local income tax revenues will decrease by approximately $6.5 million annually. Revenue losses could also be greater due to tax compliance issues as there may be difficulty in determining whether all, part, or none of an IRA consists of a rollover contribution.

Additional Information

Prior Introductions: None.

Cross File: None.

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

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