HB 682

Department of Legislative Services

Maryland General Assembly
2020 Session

FISCAL AND POLICY NOTE
First Reader

House Bill 682 (Delegate Brooks, *et al.*)
Ways and Means

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 individual retirement account (IRA) or annuity consist entirely of the tax-free rollover of distributions from an employee retirement system. **The bill takes effect July 1, 2020, and applies to tax year 2020 and beyond.**

Fiscal Summary

State Effect: General fund revenues may decrease by $10.3 million in FY 2021 due to additional pension income being exempted. Future years reflect projected growth in eligible retirement income. General fund expenditures increase by $61,200 in FY 2021 due to implementation costs at the Comptroller's Office. Future years reflect annualization and ongoing costs.

($ in millions)	FY 2021	FY 2022	FY 2023	FY 2024	FY 2025
GF Revenue	($10.3)	($10.8)	($11.4)	($11.9)	($12.5)
GF Expenditure	$0.1	$0.1	$0.1	$0.1	$0.1
Net Effect	($10.4)	($10.9)	($11.5)	($12.0)	($12.6)

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

Local Effect: Local revenues decrease by $6.7 million in FY 2021 and by $8.1 million in FY 2025. 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 ($31,100 for 2019) 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 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

IRA: individual retirement account
IRC: Internal Revenue Code

Source: Department of Legislative Services

Additional retirement income may be exempted if the individual has qualified U.S. military, law enforcement, correctional officer, fire, rescue, or emergency services personnel retirement income.

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 2020 these benefits will reduce State revenues by $620.6 million and local income tax revenues by $373.1 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 Revenues: The bill expands the State pension exclusion beginning with tax year 2020 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. As a result, State income tax revenues will decrease by $10.3 million in fiscal 2021. **Exhibit 2** shows the estimated impact of the bill on State and local revenues.

Exhibit 2
State and Local Revenue Impacts
Fiscal 2021-2025
($ in Millions)

	FY 2021	FY 2022	FY 2023	FY 2024	FY 2025
State	($10.3)	($10.8)	($11.4)	($11.9)	($12.5)
Local	(6.7)	(7.0)	(7.4)	(7.8)	(8.1)
Total	**($17.0)**	**($17.8)**	**($18.7)**	**($19.7)**	**($20.7)**

This estimate is based on the amount of eligible retirement income reported on Form 502R and adjusted for those taxpayers who reported pension income on a tax return but did not report pension income on Form 502R. 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.

State Expenditures: General fund expenditures for the Comptroller's Office increase by $61,200 in fiscal 2021, which assumes a six-month start-up delay from the bill's July 1, 2020 effective date. This estimate reflects the cost of hiring two revenue examiners to process and approve subtraction modifications. The estimate includes salaries, fringe benefits, one-time start-up costs, and ongoing operating expenses.

Positions	2
Salaries and Fringe Benefits	$50,748
Other Operating Expenses	10,415
Total FY 2021 State Expenditures	**$61,163**

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

Local Revenues: Local income tax revenues decrease as a result of additional retirement income exempted against the personal income tax. Local revenues decrease by $6.7 million in fiscal 2021 and by $8.1 million in fiscal 2025, as shown in Exhibit 2.

Additional Information

Prior Introductions: HB 14 of 2019 received a hearing in the House Ways and Means Committee, but no further action was taken. HB 58 of 2018 received a favorable with amendments report from the House Ways and Means Committee, passed the House, and received a hearing in the Senate Budget and Taxation Committee, but no further action was taken.

Designated Cross File: None.

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

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