Department of Legislative Services

Maryland General Assembly
2022 Session

FISCAL AND POLICY NOTE
First Reader

House Bill 189 (Delegate Brooks)
Ways and Means

Income Tax - Subtraction Modification - Retirement Income

This bill expands the pension exclusion by allowing income from individual retirement accounts (IRAs) 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, 2022, and applies to tax year 2022 and beyond.**

Fiscal Summary

State Effect: General fund revenues decrease significantly beginning in FY 2023 due to additional pension income being exempted. General fund expenditures increase by $69,700 in FY 2023 due to implementation costs at the Comptroller's Office. Future years reflect annualization and ongoing costs.

(in dollars)	FY 2023	FY 2024	FY 2025	FY 2026	FY 2027
GF Revenue	(-)	(-)	(-)	(-)	(-)
GF Expenditure	$69,700	$112,400	$115,700	$118,800	$122,100
Net Effect	($69,700)	($112,400)	($115,700)	($118,800)	($122,100)

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

Local Effect: Local revenues decrease significantly beginning in FY 2023 due to additional retirement income being exempted. Local expenditures are not affected.

Small Business Effect: None.

Analysis

Current Law:

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 ($34,300 for 2021) 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

- 401(k) Cash or Deferred Arrangement Plans
- 403(b) Plans
- 457(b) Plans
- Thrift Savings Plans
- Savings Incentive Match Plan for Employees Retirement Plans under § 401(k) of the IRC

Ineligible

- Traditional IRAs
- Rollover IRAs
- Roth IRAs
- Keogh Plans
- 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.

Rollover Individual Retirement Accounts and Retirement Income

IRAs are a significant source of retirement savings. There are several types of IRA accounts – traditional, originating from contributions; traditional, originating from rollovers; Roth IRAs; Simplified Employee Pensions; and SIMPLE Plans. 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.

State Revenues: The bill expands the State pension exclusion beginning with tax year 2022 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 significantly beginning in fiscal 2023. However, the amount of the revenue loss cannot be reliably estimated and depends on the amount of additional pension income excluded in the tax year.

Due to taxpayer confidentiality requirements, the Department of Legislative Services 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. The Comptroller's Office has used this data and other income tax data to develop a model to estimate the fiscal impact of various proposals to alter the State pension exclusion.

Based on the amount of pension income taxpayers report distributing from eligible rollover IRAs in Form 502R, the bill may reduce general fund revenues by about $2.5 million annually beginning in fiscal 2023. The amount of this pension income reported by taxpayers is significantly less than national estimates of the percentage of IRA assets that consist of rollover contributions. Therefore, using this data may underestimate the impact of the bill.

State Expenditures: General fund expenditures for the Comptroller's Office increase by $69,714 in fiscal 2023, which assumes a six-month start-up delay from the bill's July 1, 2022 effective date. This estimate reflects the cost of hiring two revenue examiners to process and approve additional subtraction modifications. The estimate includes salaries, fringe benefits, one-time start-up costs, and ongoing operating expenses.

Positions	2
Salaries and Fringe Benefits	$55,558
Other Operating Expenses	14,156
Total FY 2023 State Expenditures	**$69,714**

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. Under the assumptions above, local income tax revenues may decrease by about $1.6 million annually beginning in fiscal 2023.

Additional Information

Prior Introductions: HB 682 of 2020 and 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: SB 123 (Senator Klausmeier) - Budget and Taxation.

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

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