SB 192

Department of Legislative Services

2016 Session

FISCAL AND POLICY NOTE
First Reader

Senate Bill 192 (Senators Waugh and Peters)

Budget and Taxation

Income Tax - Subtraction Modification - Military Compensation

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This bill expands the existing overseas military pay income tax subtraction modification by (1) exempting 100% of the active duty military pay received by an individual; (2) extending eligibility to active duty members who serve in the United States; and (3) eliminating the current phase out that reduces or eliminates the benefit for an individual whose military pay exceeds specified amounts.

The bill takes effect July 1, 2016, and applies to tax year 2016 and beyond.

Fiscal Summary

State Effect: General fund revenues decrease by $33.6 million in FY 2017, reflecting the impact of one and one-half tax years. Future year estimates reflect annualization and a 2% annual increase in eligible military pay. Expenditures are not affected.

($ in millions)	FY 2017	FY 2018	FY 2019	FY 2020	FY 2021
GF Revenue	($33.6)	($22.9)	($23.4)	($23.9)	($24.1)
Expenditure	0	0	0	0	0
Net Effect	($33.6)	($22.9)	($23.4)	($23.9)	($24.1)

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

Local Effect: Local revenues decrease by $21.2 million in FY 2017 and by $15.2 million in FY 2021. Local expenditures are not affected.

Small Business Effect: None.

Analysis

Current Law: Members of the U.S. Armed Forces who are on active duty overseas qualify for a State income tax subtraction modification. The subtraction modification includes the first $15,000 of military pay attributable to the military service of an individual outside the United States who is in active service of any branch of the U.S. Armed Forces. The amount of the subtraction is reduced dollar for dollar in the amount by which the individual's military pay exceeds $15,000 and is reduced to zero if pay exceeds $30,000.

Background:

Taxation of Military Pay – Serving Overseas

A U.S. citizen or resident alien living and working abroad will typically pay income taxes to the country in which he/she is currently residing. Under Section 911 of the Internal Revenue Code (IRC), the individual may qualify to exclude all or part of the foreign earned income, including housing allowances, from federal adjusted gross income (FAGI).

Unlike other citizens living and working abroad, U.S. government employees are generally not subject to foreign income taxes. Most payments received by U.S. government civilian employees for working abroad, including pay differentials, are taxable for federal income tax purposes. Certain foreign area allowances, cost-of-living allowances, and travel allowances are tax free. Maryland conforms to federal tax treatment, so any amount received by a U.S. government employee serving abroad that is not taxable for federal income tax purposes is not taxable for State income tax purposes.

Under Section 112 of the IRC, certain pay received by a member of the U.S. Armed Forces serving in a designated combat zone can be excluded from FAGI. The combat exclusion applies for any month in which the individual either served in a combat zone or was hospitalized due to service in a combat zone.

A combat zone is any area the President of the United States designates by executive order as an area in which U.S. armed forces are engaging or have engaged in combat. Designated combat zones include the Afghanistan, Kosovo, and Arabian Peninsula areas. Military service outside a combat zone is considered to be performed in a combat zone if the Department of Defense designates that the service is in direct support of the operations within the combat zone and the military service qualifies for hostile fire or imminent danger pay. In calendar 2015, the Department of Defense certified 12 locations for combat zone tax benefits for specified periods due to their direct support of military operations.

Maryland conforms to federal tax treatment of military pay in combat zones so any amounts received are not taxable for State income tax purposes.

Taxation of Military Pay – Serving within the United States

The Servicemembers Civil Relief Act (50 U.S.C. App. §§ 501-596) is a federal law that provides military members certain benefits as they enter active duty and other protections while they are on active duty. Section 511 provides that a nonresident service member's military income and personal property are not subject to state taxation if the service member is present in the state only due to military orders. States are also prohibited from using the military pay of these nonresident service members to increase the state income tax of a spouse. For example, a Maryland member of the military who is stationed in California is exempt from the California income tax but pays Maryland income taxes if the individual maintains a permanent residence or is domiciled in Maryland. Conversely, Maryland does not tax the military pay of a California military member merely because the individual is stationed at a Maryland military base. Furthermore, the spouse of a military member does not acquire a new domicile for income tax purposes if the spouse's presence in the state is solely due to the member's military orders. Accordingly, the spouse's wage income is generally not subject to the Maryland income tax.

State Revenues: Additional active duty military pay can be exempted beginning in tax year 2016. The Comptroller estimates that active duty military members paid a total of about $22.0 million in State income taxes in tax year 2014. This estimate is increased by 2% annually and it is assumed individuals adjust withholdings and estimated payments. As a result, general fund revenues decrease by $33.6 million in fiscal 2017, reflecting the impact of all of tax year 2016 and about one-half of tax year 2017. **Exhibit 1** shows the estimated impact of the bill on State and local revenues.

Exhibit 1
State and Local Revenue Impacts
Fiscal 2017-2021
($ in Millions)

	FY 2017	FY 2018	FY 2019	FY 2020	FY 2021
State	($33.6)	($22.9)	($23.4)	($23.9)	($24.1)
Local	(21.2)	(14.5)	(14.8)	(15.1)	(15.2)
Total Revenues	**($54.9)**	**($37.4)**	**($38.2)**	**($38.9)**	**($39.3)**

Local Revenues: Local income tax revenues will decrease as a result of subtraction modifications claimed against the personal income tax. Local revenues will decrease by $21.2 million in fiscal 2017 and by $15.2 million in fiscal 2021, as shown in Exhibit 1.

Additional Information

Prior Introductions: Legislation to eliminate the phase out of the overseas military subtraction modification but retain eligibility for those serving overseas was introduced in the 2009, 2011, and 2012 sessions. HB 1376 of 2009, HB 1257 of 2011, and HB 548 of 2012 received a hearing in the House Ways and Means Committee, but no further action was taken.

Cross File: None.

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

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min/jrb

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