

Department of Legislative Services
2017 Session

FISCAL AND POLICY NOTE
First Reader

Senate Bill 67 (Senator Waugh)
Budget and Taxation

Income Tax - Subtraction Modification - Military Compensation

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, 2017, and applies to tax year 2017 and beyond.

Fiscal Summary

State Effect: General fund revenues decrease by \$36.0 million in FY 2018, 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 2018	FY 2019	FY 2020	FY 2021	FY 2022
GF Revenue	(\$36.0)	(\$24.5)	(\$25.0)	(\$25.5)	(\$26.0)
Expenditure	0	0	0	0	0
Net Effect	(\$36.0)	(\$24.5)	(\$25.0)	(\$25.5)	(\$26.0)

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

Local Effect: Local revenues decrease by \$22.7 million in FY 2018 and by \$16.4 million in FY 2022. 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. Certain pay may be excluded from federal and State taxation if the individual serves in a combat zone as described below.

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. U.S. government employees, however, are generally not subject to foreign income taxes. Under Section 112 of the Internal Revenue Code, certain pay received by a member of the U.S. Armed Forces serving in a designated combat zone can be excluded from federal adjusted gross income. The combat exclusion may apply if 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. 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 and protections as they enter and serve 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.

In addition, the Military Spouses Residency Relief Act provides that 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 wage income of a spouse of the military member is generally not subject to the Maryland income tax.

State Revenues: Additional active duty military pay can be exempted beginning in tax year 2017. 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 \$36.0 million in fiscal 2018, reflecting the impact of all of tax year 2017 and about one-half of tax year 2018. **Exhibit 1** shows the estimated impact of the bill on State and local revenues.

Exhibit 1
State and Local Revenue Impacts
Fiscal 2018-2022
(\$ in Millions)

	<u>FY 2018</u>	<u>FY 2019</u>	<u>FY 2020</u>	<u>FY 2021</u>	<u>FY 2022</u>
State	(\$36.0)	(\$24.5)	(\$25.0)	(\$25.5)	(\$26.0)
Local	(22.7)	(15.5)	(15.8)	(16.1)	(16.4)
Total Revenues	(\$58.7)	(\$40.0)	(\$40.8)	(\$41.6)	(\$42.5)

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 \$22.7 million in fiscal 2018 and by \$16.4 million in fiscal 2022, as shown in Exhibit 1.

Additional Information

Prior Introductions: SB 192 of 2016 received a hearing in the Senate Budget and Taxation Committee, but no further action was taken. Its cross file, HB 691, 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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