

Department of Legislative Services
Maryland General Assembly
2021 Session

FISCAL AND POLICY NOTE
Third Reader - Revised

House Bill 864
Ways and Means

(Delegate Charles)

Budget and Taxation

Income Tax - Subtraction Modification - Military Retirement Income

This bill expands the existing military retirement income tax subtraction modification by increasing to \$20,000 the maximum amount of retirement income that can be excluded. In order to qualify for the increased subtraction modification, the individual must have a permanent 100% service-connected disability as determined by the U.S. Department of Veterans Affairs (VA). **The bill takes effect July 1, 2021, and applies to tax year 2021 and beyond.**

Fiscal Summary

State Effect: General fund revenues may decrease beginning in FY 2022 due to additional retirement income being exempted. Expenditures are not affected.

Local Effect: Local revenues may decrease beginning in FY 2022 due to additional subtraction modifications claimed against the State income tax. Local expenditures are not affected.

Small Business Effect: None.

Analysis

Current Law:

Disability and Military Retirement Income

Military retirement pay based on age or length of service is considered taxable income for federal and State income tax purposes.

Certain military disability pensions and veterans benefits are not taxable for federal income tax purposes. The State conforms to the federal tax treatment of this income; this income is also not taxable for State income tax purposes.

Publication 525 of the Internal Revenue Service lists the conditions that generally must be met in order for an individual to exclude the income from federal taxation. In general, the disability must be service-connected and the individual (1) received the disability payments for a combat-related injury or (2) is entitled to receive disability compensation from VA if an application is filed for it. In the latter case, the exclusion is generally equal to the amount entitled to receive from VA. Disability income may also be excluded if the individual was entitled to receive the payment before September 25, 1975, or was a member of a listed government service or its reserve component, or had a written commitment to become a member as of September 24, 1975.

If an individual receives a disability pension based on the years of service, in most cases it must be included as income. However, if the pension qualifies as a service-connected disability, the part of the pension that would have been received if the pension had been based on a percentage of disability is excluded from income. The rest of the pension must be included as taxable income.

If an individual retires from the U.S. Armed Forces based on years of service and is later given a retroactive service-connected disability rating by VA, the retirement pay for the retroactive period is not taxable up to the amount of disability benefits entitled to receive.

Military Retirement Income Subtraction Modification

Chapter 226 of 2006 expanded a \$2,500 military retirement income subtraction that was previously limited to enlisted military members with federal adjusted gross income of \$22,500 or less. An individual can exempt certain military retirement income from State and local taxation if the retirement income resulted from service (1) in an active or reserve component of the U.S. Armed Forces; (2) as a member of the Maryland National Guard; or (3) as an active duty member with the Commissioned Corps of the Public Health Service, the National Oceanic and Atmospheric Administration, or the Coast and Geodetic Survey. The subtraction modification can also be claimed by a surviving spouse or ex-spouse.

Legislation enacted in the 2015 and 2018 sessions expanded the maximum value of the subtraction modification to:

- \$15,000 for individuals who are at least age 55; and
- \$5,000 for all other individuals.

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 (\$33,100 for 2020) 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). Military retirees who are at least age 65 or are totally disabled can qualify and claim the State pension exclusion for retirement income that is not excluded under the military retirement income subtraction.

Social Security benefits and benefits received under the federal Railroad Retirement Act are totally exempt from the Maryland income tax, even though they may be partly taxable for federal income tax purposes. In addition to the special treatment of Social Security and other retirement income, other income tax relief is provided to senior citizens regardless of the source of their income. In addition to the regular personal exemption available to all taxpayers, an additional exemption amount of \$1,000 may be claimed by an elderly or blind individual.

State Revenues: Additional retirement income may be exempted beginning in tax year 2021 if the individual has a permanent 100% service-connected disability as determined by VA. Accordingly, general fund revenues may decrease beginning in fiscal 2022 due to additional retirement income being exempted.

In general, most service-connected disability pensions are not expected to be taxable under current law. The bill may increase the amount of nondisability pension income that may be excluded under the military retirement income subtraction. Data on the taxable and nontaxable income received by these Maryland individuals is not available.

Additional Information

Prior Introductions: HB 1110 of 2020 received a hearing in the House Ways and Means Committee, but no further action was taken.

Designated Cross File: None.

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

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