SB 213

Department of Legislative Services
Maryland General Assembly
2009 Session

FISCAL AND POLICY NOTE

Senate Bill 213 (Senator DeGrange)
Budget and Taxation

Income Tax - U.S. Government Employees' Foreign Earned Income

This bill extends, to tax year 2010 and beyond, the existing subtraction modification under the State income tax for the foreign earned income paid by the U.S government to an employee working abroad. Under current law, the $3,500 subtraction modification is available only for tax years 2007, 2008, and 2009.

The bill takes effect July 1, 2009.

Fiscal Summary

State Effect: General fund revenues decrease by $977,000 in FY 2011 due to additional subtraction modifications as provided by the bill. Future year revenues reflect estimated number of taxpayers eligible for the subtraction modification. Expenditures are not affected.

(in dollars)	FY 2010	FY 2011	FY 2012	FY 2013	FY 2014
GF Revenue	$0	($977,000)	($980,100)	($983,200)	($986,400)
Expenditure	0	0	0	0	0
Net Effect	$0	($977,000)	($980,100)	($983,200)	($986,400)

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

Local Effect: Local government revenues decrease by $615,700 in FY 2011 and by $621,700 in FY 2014. Expenditures are not affected.

Small Business Effect: None.

Analysis

Current Law: Chapter 368 of 2006 established a subtraction modification under the Maryland income tax for the foreign earned income of an individual employed by the United States or an agency of the United States. The amount of the subtraction may not exceed $3,500 in any taxable year and applies to tax years 2007, 2008, and 2009.

Several other laws determine the federal and State taxation of federal employees serving overseas as discussed below.

Background: 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. The individual may qualify to exclude all or part of his or her foreign earned income including housing allowances from federal adjusted gross income (FAGI). However, the foreign earned income and housing exclusions and foreign housing deduction do not apply to the income received as an employee of the U.S. government. 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; 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.

Military Pay Treatment

Under Section 112 of the Internal Revenue Code, certain pay received by a member of the 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. Income from the following sources can be excluded:

- active duty pay;
- imminent danger/hostile fire pay;
- a reenlistment bonus if the reenlistment occurs in the month served in a combat zone;
- pay for accrued leave earned in any month served in a combat zone;
- pay received for duties as a member of the armed forces in clubs, messes, and other nonappropriated funds;

- awards for suggestions or inventions if the submission was made in a month served in a combat zone; and
- student loan repayments.

The amount of pay that can be excluded by commissioned officers is limited to the highest rate of enlisted pay that can be earned that month plus any imminent danger/hostile fire received.

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. The current combat zones are the Afghanistan area, Kosovo area, and Persian Gulf area. In addition, since 1995 the hazardous duty area in the former Yugoslavia comprised of Bosnia and Herzegovina, Croatia, and Macedonia qualifies as a combat zone for income tax purposes.

Maryland conforms to federal tax treatment of military pay in combat zones; any amount received is not taxable for State income tax purposes.

The Servicemembers Civil Relief Act (50 U.S.C. App. §§ 501-596), which replaced the Soldiers' and Sailors' Civil Relief Act, is a federal law that provides military members certain protections 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 the spouse. For example, a Maryland member of the military that 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.

Under current State law, certain Maryland residents serving a military assignment overseas are allowed a State income tax subtraction modification. The amount of the exemption varies depending on the individual's rate of pay. The subtraction includes the first $15,000 of military pay that is: (1) attributable to military service of the individual who is in active service of any branch of the armed forces; and (2) attributable to military service of the individual outside the United States. 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.

State Revenues: The bill extends the existing subtraction modification for the foreign earned income of U.S. government employees beginning in tax year 2010. As a result, general fund revenues decrease by $977,000 in fiscal 2011.

The Comptroller's Office advises that the existing subtraction modification is listed on the income tax form as one of the miscellaneous subtraction modifications. Therefore, the Comptroller's Office cannot advise on the amount of subtraction modifications that have been claimed to date. The estimated revenue loss from extending the subtraction modification is based on the following facts and assumptions:

- About, 445,000 active duty military personnel are stationed outside the United States.
- It is estimated that Maryland's share of total active duty personnel who are subject to State taxation is 1%.
- A little less than one-half of individuals serving overseas are serving in a combat zone. Providing a subtraction modification to these individuals will not result in State tax revenue losses.

In addition to revenue loss from active military personnel serving overseas, general fund revenues will decrease from civilian federal employees serving overseas:

- As of September 2008, there were 34,268 federal civilian employees serving in a foreign country. Most of these employees were from the Department of Defense (91%) followed by the Department of Homeland Security, and USAID (about 3% each).
- Based on the percentage of total employment within these agencies, Maryland's share of total federal civilians serving overseas is 5%.
- The U.S. Foreign Service employs about 6,500 diplomats overseas.

It is also assumed that about 10% of all tax returns are not taxable. This is in addition to returns that are not taxable due to active military members serving in a combat zone.

Additional Information

Prior Introductions: None.

Cross File: None.

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

Fiscal Note History: First Reader - February 9, 2009
mlm/hlb

Analysis by: Robert J. Rehrmann

Direct Inquiries to:
(410) 946-5510
(301) 970-5510