SB 236

Department of Legislative Services

Maryland General Assembly
2009 Session

FISCAL AND POLICY NOTE

Senate Bill 236 (Senator Exum)
Budget and Taxation

Income Tax - Subtraction Modification - Federal Pensions

This bill exempts from the State income tax 100% of the federal government retirement income received by an individual. Income exempted under the existing military retirement income subtraction modification cannot be exempted under the bill.

The bill takes effect July 1, 2009 and applies to tax years 2009 and beyond.

Fiscal Summary

State Effect: General fund revenues decrease by $239.9 million in FY 2010 due to additional federal retirement income being exempted. Future year revenues reflect annualization and estimated number of eligible taxpayers. General fund expenditures increase by $20,700 in FY 2010 for one-time tax form changes and computer programming modifications at the Comptroller's Office.

($ in millions)	FY 2010	FY 2011	FY 2012	FY 2013	FY 2014
GF Revenue	($239.9)	($169.1)	($177.4)	($184.8)	($191.0)
GF Expenditure	$.0	$0	$0	$0	$0
Net Effect	($239.9)	($169.1)	($177.4)	($184.8)	($191.0)

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

Local Effect: Local government revenues decrease by $152.1 million in FY 2010 and by $120.9 million in FY 2014. Expenditures are not affected.

Small Business Effect: None.

Analysis

Current Law: The following is a brief discussion on income tax benefits for State residents and military retirees.

State Income Tax Benefits for All Eligible Individuals

Maryland law provides a pension exclusion subtraction for individuals who are at least age 65 or who are totally disabled. Up to a specified maximum amount of taxable pension income ($24,000 maximum for 2008) 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. The pension exclusion has been a part of the Maryland income tax since 1965.

The "Social Security offset" is the reduction in the maximum pension exclusion allowed under the current law by the 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, the offset works to equalize the tax treatment of individuals who receive their retirement benefits from different sources by reducing the amount of allowable exclusion by the amount of Social Security benefits received.

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. Each individual age 65 or older can also earn more income without being required to file taxes. The additional exemption amount allowed for elderly or blind individuals is $1,000. This amount is in addition to the regular personal exemption available to all taxpayers.

Military Retirement Tax Benefits

Chapter 226 of 2006 expanded a $2,500 military retirement income subtraction that was limited to enlisted military members with a federal adjusted gross income of $22,500 or less. Under Chapter 226, an individual may exempt the first $5,000 of military retirement income from State taxation if the retirement income resulted from service in an active or reserve component of the armed forces of the United States or in the Maryland National Guard.

Under Chapter 226, retirees from active duty with the Commissioned Corps of the Public Health Service, National Oceanic and Atmospheric Administration (NOAA), or the Coast and Geodetic Survey qualified for the subtraction modification, but only if separated from service after July 1, 1991. Chapter 553 of 2007 eliminated this restriction and allowed all the individuals described previously to qualify for the subtraction modification, beginning tax year 2007, without regard to the date of separation from employment.

Military retirement income exempted under this provision cannot be counted toward the State pension exclusion.

Certain military and government disability pensions are not taxable for federal income tax purposes. Individuals can generally exempt from federal income taxes amounts received as a pension, annuity, or similar allowance for personal injury or sickness resulting from active service in one of the following government services: (1) armed forces of any country; (2) the National Oceanic and Atmospheric Administration; (3) the Public Health Service; and (4) the Foreign Service. Maryland conforms to federal tax treatment of federal service-related disability pensions; any amount received is not taxable for State income tax purposes.

Background: The following provides information on federal retirement payments to Maryland residents and provisions relating to federal civilian and military retirement.

Federal Retirement Payments to Maryland Residents

Maryland has a higher than average number of federal retirees given proximity to the District of Columbia combined with numerous federal agencies and military installations located within the State. For example, 6.8% of all federal civilian retirement payments during federal fiscal 2007 were made to Maryland residents. **Exhibit 1** lists the total amount of federal retirement and disability payments to Maryland residents during federal fiscal 2007.

Exhibit 1
Federal Retirement and Disability Payments to Maryland Residents
Federal Fiscal 2007

	Total Payments
Military	$1,045,951,000
Military – Pensions to Surviving Spouses and Children	8,843,370
Coast Guard and Uniformed Employees	36,089,351
NOAA Commissioned Officer Corps	3,251,778
Public Health Service	49,126,306
Foreign Service Officers	66,207,285
Tennessee Valley Authority	246,971
All Other Civilian	4,095,166,563
Total Payments to Maryland Residents	**$5,304,882,624**

Source: 2007 Consolidated Federal Funds Report

Federal Civilian Retirement

The Civil Service Retirement Act, which became effective on August 1, 1920, established a retirement system for certain federal employees. It was replaced by the Federal Employees Retirement System (FERS) for federal employees who first entered covered service on and after January 1, 1987.

The Civil Service Retirement System (CSRS) is a defined benefit, contributory retirement system. Employees share in the expense of the annuities to which they become entitled. CSRS covered employees contribute 7, 7½, or 8% of pay to CSRS and, while they generally pay no Social Security retirement, survivor, and disability tax, they must pay the Medicare tax (currently 1.45% of pay). The employing agency matches the employee's CSRS contributions. CSRS employees may increase their earned annuity by contributing up to 10% of the basic pay for their creditable service to a voluntary contribution account. Employees may also contribute a portion of pay to the Thrift Savings Plan (TSP). There is no government contribution, but the employee contributions are tax-deferred.

Congress created FERS in 1986, and it became effective on January 1, 1987. Since that time, new federal civilian employees who have retirement coverage are covered by FERS. FERS is a retirement plan that provides benefits from three different sources: a Basic Benefit Plan, Social Security, and TSP.

According to the U.S. Office of Personnel Management (OPM), there were 1.8 million individuals on federal annuity rolls at the end of federal fiscal 2005 – approximately 63% of these were normal retirees, 13% were disabled, and about one-quarter were deferred, involuntary, voluntary early, or special provision retirements. The average monthly annuity to all retirees was $2,123; survivors received $1,106. During federal fiscal 2004, about three-quarters of current federal employees were under FERS with the remaining under CSRS. For all retirements during federal fiscal 1995 through 2004, the average retiree on date of separation was 58 year old and had a salary of $54,353. According to OPM, the average salary of all federal employees is about 20% higher in Maryland.

Military Retirement

Chapter 94 of 2003 established the Task Force to Study the Financial Impact of Retired Military Service Personnel on the Economy of the State. The task force issued its final report in December 2003. Among its findings was that in 2000 there were approximately 42,600 military retirees living in Maryland. The task force estimated that median household income of military retirees was $71,484 compared with a median household income of $42,151 for all Maryland households. The average income reported by military retirees was $83,435, of which $18,266 was attributable to retirement pay and

$65,169 was derived from second career employment and other sources. These military retiree households were estimated to pay approximately $163 million in State and local income taxes.

According to the Defense Manpower Data Center (DMDC), 46,401 military retirees received a total of $94.5 million in retirement income from the Department of Defense in September 2007. This includes individuals who served in the Army (including Maryland National Guard), Navy, Marines, and Air Force. This amount reflects 3,790 retirees who received approximately $30.1 million annually in disability payments. Disability payments resulting from active service in the armed forces, NOAA, Public Health Service, or foreign service are not taxable for State income purposes because they are exempted from federal taxation. In addition, DMDC reports that 1,165 Coast Guard retirees received retirement income (including disability pay) in the amount of approximately $27.3 million on an annual basis. Data on total nondisability pay for Coast Guard retirees were unavailable. Coast Guard retirees are paid by the Department of Homeland Security.

Exhibit 2 lists the total retirement pay (including disability pay) received by Maryland military retirees by branch of service.

Exhibit 2
Retirement Payments by Branch of Service
2007

Branch	Retirees	Received Pension	Annual ($ in Millions)	Average
Army	18,483	17,166	$405.3	$23,610
Navy	14,509	13,610	355.6	26,130
Marines	2,478	2,141	54.8	25,580
Air Force	14,408	13,484	317.8	23,570
Subtotal	**49,878**	**46,401**	**$1,133.5**	**$24,430**
Coast Guard	1,215	1,165	27.3	23,440
Total	**51,093**	**47,566**	**$1,160.8**	**$47,870**

Source: Defense Manpower Data Center

Retirement Income for State Employees

In general, retirement income for State employees is taxable under Maryland law.

State Revenues: Additional federal retirement income can be exempted beginning in tax year 2009. As a result, general fund revenues will decrease by approximately $157.3 million in tax year 2009 and by $165.1 million in tax year 2010. It is assumed that most taxpayers will adjust withholdings and estimated payments. As a result, general fund revenues in fiscal 2010 will decrease by both the change in tax year 2009 revenues and also by one-half of tax year 2010 revenues, resulting in a decrease of approximately $239.9 million in fiscal 2010.

Exhibit 3 shows the projected State and local revenue loss from exempting federal retirement income. The annualized revenue loss reflects the estimated number of eligible retirees, increases in retirement income, and the estimated cost of the current subtraction modification and pension exclusion provided for military retirement income.

This estimate is based on the number of retirees and amount of retirement income received by State residents as reported by the Consolidated Federal Funds Report, DMDC and the Office of Commissioned Corps Force Management Information System; estimated cost of the current military retirement subtraction modification; and interaction with the State pension exclusion.

Exhibit 3
Projected State and Local Revenue Loss – Federal Retirement Income – Exemption
($ in Millions)

Fiscal	State	Local	Total
2010	$239.9	$152.1	$392.0
2011	169.1	107.1	276.2
2012	177.4	112.4	289.8
2013	184.8	117.0	301.8
2014	191.0	120.9	311.9

State Expenditures: The Comptroller’s Office reports that it will incur a one-time expenditure increase of $20,700 in fiscal 2010 to add the subtraction modification to the personal income tax form. This amount includes data processing changes to the SMART income tax return processing and imaging systems and systems testing.

Local Revenues: Local government revenues decrease by 3% of the net change in State tax liability resulting from the provisions of the bill. In fiscal 2010, the decrease will total approximately $152.1 million. Exhibit 3 lists the impact on local income tax revenues by fiscal year.

Additional Information

Prior Introductions: None.

Cross File: None.

Information Source(s): U.S. Census Bureau, *Consolidated Federal Funds Report* (2007), Defense Manpower Data Center, Department of Defense (Office of Actuary), National Oceanic and Atmospheric Administration, Office of Commissioned Corps Force Management Information System, U.S. Office of Personnel Management, Comptroller's Office, Department of Legislative Services

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