SB 409

Department of Legislative Services
Maryland General Assembly
2002 Session

FISCAL NOTE

Senate Bill 409 (Senator Neall, *et al.*)
Budget and Taxation

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

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This bill provides for a subtraction modification under the Maryland income tax for the "foreign earned income" of an individual earned as an employee of the United States or an agency of the United States. The amount of the subtraction may not exceed $20,000 in any taxable year.

The bill takes effect July 1, 2002 and applies to all taxable years beginning after December 31, 2001.

Fiscal Summary

State Effect: General fund revenue decrease of approximately $15.0 million in FY 2000, which reflects the impact of one and one-half tax years. Future years reflect one fiscal year's loss, 4% increases in pay, and a declining number of individuals stationed overseas beginning after TY 2002. No effect on expenditures.

($ in millions)	FY 2003	FY 2004	FY 2005	FY 2006	FY 2007
GF Revenue	($15.0)	($9.7)	($9.4)	($9.4)	($9.4)
Expenditure	$0	$0	$0	$0	$0
Net Effect	($15.0)	($9.7)	($9.4)	($9.4)	($9.4)

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

Local Effect: Based on the above estimate, local government revenues would decrease by approximately $8.9 million in FY 2003 and $5.7 million in FY 2004.

Small Business Effect: None.

Analysis

Current Law: Under federal law a U.S. citizen or resident alien living and working abroad may qualify to exclude all or part of his or her foreign earned income from federal income taxes. Foreign earned income is defined as pay, such as wages, salaries, and professional fees, for personal services performed in a foreign country during the time an individual's tax home is in another country. Foreign earned income usually does not include items such as interest, dividends, pensions, annuities, or amounts attributable to employee trusts. To qualify, an individual must meet one of two tests: a bona fide residence test or a physical presence test.

The bona fide residence test may be used by U.S. citizens and certain resident aliens. It provides that the individual must be a resident of a foreign country (or countries) for an uninterrupted period that includes an entire taxable year. This often entails the individual establishing a home and settling in the country with an intention of settling permanently. The physical presence test may be used by any U.S. citizen or resident alien and requires that the individual be physically present in a foreign country or countries for at least 330 full days during any 12-month period.

If an individual qualifies under either test, then up to $76,000 of foreign earned income may be excluded for federal income tax purposes for tax year 2000. This amount increases by $2,000 per year until it reaches a maximum of $80,000 in tax year 2002 and beyond. An individual working overseas may also be eligible for an additional exclusion for foreign housing costs incurred within certain limitations.

However, these exclusions for foreign earned income and foreign housing costs are not applicable to income or housing costs that are paid or provided by the U.S. government to its employees.

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 Fiscal Effect: Based on tax year 1999 data (*Fall 2001 Statistics of Income Bulletin*) and the estimated number of federal government employees, it is estimated that general fund revenues would decrease by about $10.0 million in tax year 2003. Because the subtraction is effective beginning with tax year 2002, it is assumed that most taxpayers will adjust their estimated payments to reflect the increased subtraction after July 1, 2002. Consequently, general fund revenues are estimated to decrease by $15.0 million in fiscal 2003 reflecting the impact of one and one-half tax years. The estimate is based on the following facts and assumptions:

- In tax year 1999, there was a foreign earned income exclusion on 314,486 federal income tax returns totaling approximately $14.1 billion. The average exclusion was $44,951 per return.

- Approximately 18.6% of U.S. military personnel were stationed overseas in calendar 2000.

- Approximately 5% (6,146) of all Maryland civilian/non-postal federal government employees (122,920) will be stationed overseas and therefore be eligible for the subtraction in tax year 2002; the average subtraction is approximately $50,564; therefore all would qualify for the maximum $20,000 exclusion proposed by the bill.

- Approximately 18.6% (3,720) of all U.S. military personnel who are Maryland residents (20,000) were stationed overseas in tax year 2001; the average subtraction was approximately $16,754; for the purpose of this estimate, it assumed that approximately 25% (5,000) of these individuals will be stationed overseas for fiscal 2002 due to the events of September 11, 2001 and that the average subtraction will be approximately $17,424; the percentage stationed overseas is assumed to decline in future years.

- Average income of overseas government employees will increase by 4% annually.

In future years it is assumed that the one-half of a tax year impact will be realized in the first fiscal year and with the remaining impact in the second fiscal year.

Local Fiscal Effect: Local government revenues would decrease by approximately 2.8% of the total State subtraction taken. Based on the estimate above, this would result in a local revenue decrease of approximately $8.9 million in fiscal 2003 and $5.7 million in fiscal 2004.

Additional Information

Prior Introductions: A similar bill was introduced as HB 931 in the 2001 session. It received an unfavorable report from the House Ways and Means Committee.

Cross File: HB 363 (Delegate Love, *et al.*) – Ways and Means.

Information Source(s): Comptroller of the Treasury (Bureau of Revenue Estimates), Department of Legislative Services

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