SB 336

Department of Legislative Services
Maryland General Assembly
2005 Session

FISCAL AND POLICY NOTE

Senate Bill 336 (Senator DeGrange, *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, 2005 and applies to tax year 2005 and beyond.

Fiscal Summary

State Effect: General fund revenues would decrease by approximately $5.4 million in FY 2006. Future year revenues reflect 1% increase in the number of eligible individuals overseas. No effect on expenditures.

($ in millions)	FY 2006	FY 2007	FY 2008	FY 2009	FY 2010
GF Revenue	($5.4)	($5.5)	($5.5)	($5.6)	($5.6)
Expenditure	$0	$0	$0	$0	$0
Net Effect	($5.4)	($5.5)	($5.5)	($5.6)	($5.6)

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

Local Effect: Local government revenues would decrease by approximately $3.5 million in FY 2006; revenue losses increase by 1% annually in FY 2007 and beyond.

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 $80,000 of foreign earned income may be excluded for federal income tax purposes. An individual working overseas may also be eligible for an additional exclusion for foreign housing costs incurred within certain limitations. Federal law provides that the foreign earned income exclusion is limited to the excess of a taxpayer's foreign income over the foreign housing exclusion claimed.

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. These federal employees, however, are not subject to foreign income or Social Security taxation unlike private sector individuals working overseas.

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: General fund revenues would decrease by approximately $5.4 million in tax year 2005. As a result, general fund revenues are estimated to decrease by approximately $5.4 million in fiscal 2006. It is assumed that the decrease in tax liability does not affect withholdings remitted by these individuals in fiscal 2006. To the extent that these individuals are having Maryland taxes withheld and lower the amount withheld in response to the tax decrease, fiscal 2006 revenue losses will be greater. Future fiscal year revenue decreases increase by 1% annually. The estimate is based on the following facts and assumptions:

- As of September 30, 2004, there were approximately 1.4 million total active duty military personnel.
- It is estimated that Maryland's share of total active duty personnel who are subject to State taxation is 0.75%.
- Approximately 35% of active military are serving overseas.
- The total amount of subtraction modifications claimed by individuals is based on the estimated income for all military personnel as estimated by the U.S. Department of Defense and Congressional Budget Office.
- The number of Maryland residents in the military will increase by approximately 1% each year.
- Eighteen percent of returns are assumed to be nontaxable. Providing a subtraction modification to these individuals will not result in State tax revenue losses.

To the extent active military personnel are serving in a designated combat zone and not subject to State taxation, revenue losses will be less.

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

- According to the U.S. Office of Personal Management, in 2002 there were 133,000 Maryland federal employees. The number of Maryland federal employees is increased by approximately 1.1% annually from 2002 through 2010.
- From 2000 to 2002 on average 3.3% of all federal employees were serving overseas.
- The total amount of subtraction modifications claimed by these individuals is based on the income distribution of all tax returns in tax year 2003, including approximately 18% nontaxable returns.

Additional Information

Prior Introductions: SB 409/HB 363, identical bills, were introduced at the 2002 session. SB 409 received an unfavorable report from the Budget and Taxation Committee. HB 363 was not reported from the Ways and Means Committee.

Cross File: HB 1242 is listed as a cross file, but the bills are not identical.

Information Source(s): Congressional Budget Office, Comptroller's Office, U.S. Department of Defense, U.S. Office of Personnel Management, Department of Legislative Services

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mp/hlb

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