

**Department of Legislative Services**  
**Maryland General Assembly**  
**2006 Session**

**FISCAL AND POLICY NOTE**  
**Revised**

Senate Bill 22

(Senator Astle, *et al.*)

Budget and Taxation

Ways and Means

**Income Tax - Subtraction Modification - Military Retirement Income**

This bill provides that an individual may exempt the first \$5,000 of military retirement income from State taxation if the retirement income resulted from: (1) service in an active or reserve component of the armed forces of the United States; (2) service in the Maryland National Guard; or (3) separation after July 1, 1991 from active duty with the Commissioned Corps of the Public Health Service, the National Oceanic and Atmospheric Administration (NOAA), or the Coast and Geodetic Survey.

The bill also repeals the existing military retirement income subtraction modification and provides that military retirement income exempted under the bill cannot be counted towards the State pension exclusion.

The bill takes effect July 1, 2006 and applies to tax years 2006 and beyond.

**Fiscal Summary**

**State Effect:** General fund revenues could decrease by approximately \$14.3 million in FY 2007 due to additional military retirement income being exempted from the State income tax. The FY 2007 budget assumes a general fund revenue decrease of approximately \$3.5 million in FY 2006 and \$10.3 million in FY 2007 for exempting military retirement income. Expenditures would not be affected.

(\$ in millions)	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011
GF Revenue	(\$14.3)	(\$10.2)	(\$10.9)	(\$11.5)	(\$12.1)
Expenditure	\$0	\$0	\$0	\$0	\$0
Net Effect	(\$14.3)	(\$10.2)	(\$10.9)	(\$11.5)	(\$12.1)

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

**Local Effect:** Local revenues would decrease by approximately \$9.0 million in FY 2007 and by \$7.6 million in FY 2011. Expenditures would not be affected.

**Small Business Effect:** None.

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## **Analysis**

**Bill Summary:** Military retirement income is eligible for the subtraction modification if the retirement income resulted from service in: (1) an active or reserve component of the armed forces of the United States; (2) the Maryland National Guard; or (3) active duty with the Commissioned Corps of the Public Health Service, the National Oceanic and Atmospheric Administration (NOAA), or the Coast and Geodetic Survey. The bill expands the existing subtraction modification for military retirees by repealing: (1) the requirements that an individual be at least 55 years old on the last day of the taxable year; and (2) the current phase-out of the subtraction modification that begins once federal gross income exceeds \$17,500. If an individual exempts military retirement income under the provisions of this bill, that income cannot be counted towards the State pension exclusion exemption.

**Current Law:** A subtraction modification is provided for military retirement income. Under State law, the first \$2,500 of military retirement income received by an individual can be subtracted from federal adjusted gross income for the taxable year provided that the individual is at least 55 years of age on the last day of the taxable year and was an enlisted member of the military at the time of retirement. This subtraction is reduced by 50% of the amount by which the federal adjusted gross income exceeds \$17,500. No subtraction is allowed for individuals having federal adjusted gross income over \$22,500.

Maryland law also provides a pension exclusion subtraction 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 (\$21,500 maximum for 2005) 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.

### *Additional Income Tax Treatment for Elderly Individuals*

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 of \$2,400.

**Background:** 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), 44,014 Military retirees received a total of approximately \$80 million in retirement income from the Department of Defense (DoD) in the month of September 2004. This includes individuals who served in the Army (including Maryland National Guard), Navy, Marines, and Air Force. On an annualized basis, the retirement income totaled approximately \$958.4 million. This amount included 2,129 retirees who received approximately \$30 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 as they are exempted from federal taxation. In addition, DMDC reports that 1,083 Coast Guard retirees received retirement income (including disability pay) in the amount of approximately \$22.4 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 1** lists the average annual DoD-paid nondisability military retirement income received by Maryland residents in 2004 by age and whether or not the individual served as an officer or enlisted member. **Exhibit 2** lists the total retirement pay (including disability pay) received by Maryland military retirees by branch of service.

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**Exhibit 1**  
**Average Maryland Pension by Age and Status**  
**2004**

	<u>Under 65</u>	<u>65+</u>	<u>All</u>
Officers	\$34,265	\$32,857	\$33,635
Enlisted	\$16,044	\$15,941	\$16,015
All	\$21,358	\$23,744	\$22,166

Source: Defense Manpower Data Center

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**Exhibit 2**  
**Retirement Payments by Branch of Service**  
**2004**

<u>Branch</u>	<u>Retirees</u>	<u>Received Pension</u>	<u>Annual (\$ in millions)</u>	<u>Average</u>
Army	17,919	16,475	\$346.2	\$21,017
Navy	13,929	12,773	298.3	23,353
Marines	2,361	2,015	45.1	22,398
Air Force	13,793	12,751	268.8	21,080
<b>Subtotal</b>	<b>48,002</b>	<b>44,014</b>	<b>\$958.4</b>	<b>\$21,776</b>
Coast Guard	1,129	1,083	22.4	20,698
<b>Total</b>	<b>49,131</b>	<b>45,097</b>	<b>\$980.8</b>	<b>\$21,749</b>

Source: Defense Manpower Data Center

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Compared to the rest of the nation, Maryland military retirees are on average younger and receive higher pensions. Approximately two-thirds of Maryland military retirees who receive a pension are under the age of 65, compared with approximately 55% nationally. Nationally, the average age of a military retiree who retired in federal fiscal 2004 was 48.5 years old. The average pension received by a State military retiree was approximately 11% higher than the national average.

According to the Office of Commissioned Corps Force Management Information System, 762 Maryland residents who retired from the Commission Corps of the Public Health Service received a total of \$52.1 million, or an average of \$68,312, in retirement income during 2005.

The fiscal 2007 budget assumes a general fund revenue decrease of \$3.5 million in fiscal 2006 and \$10.3 million in fiscal 2007 for the purpose of exempting military retirement income from the State income tax.

**State Revenues:** General fund revenues would decrease by approximately \$9.3 million in tax year 2006 and \$9.9 million in tax year 2007. It is assumed that most taxpayers will adjust withholdings and estimated payments. As a result, fiscal 2007 revenues would decrease by both the change in tax year 2006 revenues and also by one-half of tax year 2007, resulting in a decrease of approximately \$14.3 million in fiscal 2007. **Exhibit 3** shows the projected State and local revenue loss from exempting military retirement income. Annualization losses reflect 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.

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**Exhibit 3**  
**Projected State and Local Revenue Loss – Military Exemption**  
**(\$ in Millions)**

<u>Fiscal</u>	<u>State</u>	<u>Local</u>	<u>Total</u>
2007	\$14.3	\$9.0	\$23.4
2008	10.2	6.5	16.7
2009	10.9	6.9	17.7
2010	11.5	7.3	18.8
2011	12.1	7.6	19.8

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This estimate is based on the number of retirees and amount of retirement income received by State residents as reported by DMDC and Office of Commissioned Corps Force Management Information System and the following facts and assumptions:

- The number and pay of military retirees is increased from 2005 to 2011 based on the DoD’s Office of Actuary projections for military retirees nationally.

- It is estimated that the current military subtraction modification will decrease State revenues by approximately \$555,600 in tax year 2007.
- For tax year 1997, 44% of returns with a pension income also had a pension exclusion that averaged \$7,207. It is estimated that 50% of individuals with a military pension have a pension exclusion. The amount of military pension exclusion is estimated to be \$11,700 in tax year 2007 and increase by 5% annually. The estimated State revenue loss from the pension exclusion is approximately \$4.2 million in tax year 2007.
- Coast Guard retirees are disabled at the same rate of military retirees.
- 100 retirees from NOAA and the Coast and Geodetic Survey would be eligible to exclude retirement income under the bill.
- 10% of returns for individuals aged 65 and over are nontaxable.

**Local Fiscal Effect:** Local revenues would decrease by approximately 3% of the net change in State tax liability in tax year 2006 resulting from the provisions of the bill. In fiscal 2007 the decrease would be approximately \$9.0 million. Future year revenues total approximately \$6.5 million in fiscal 2008, \$6.9 million in fiscal 2009, \$7.3 million in fiscal 2010, and \$7.6 million in fiscal 2011.

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### **Additional Information**

**Prior Introductions:** Similar bills were introduced in the 2004 and 2005 sessions as SB 877/HB 1182 of 2004 and SB 211/HB 245 of 2005. SB 877 and SB 211 were not reported from the Senate Budget and Taxation Committee. HB 1182 was not reported from the House Ways and Means Committee. HB 245 received a favorable with amendments report from the House Ways and Means Committee and was passed the House, but was not reported from the Senate Budget and Taxation Committee.

**Cross File:** HB 35 is listed as a cross file, but the two bills are not identical.

**Information Source(s):** Comptroller's Office, Defense Manpower Data Center, Department of Defense (Office of the Actuary), National Oceanic and Atmospheric Administration, Office of Commissioned Corps Force Management Information System, Department of Legislative Services

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Analysis by: Robert J. Rehrmann

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