HB 994

Department of Legislative Services
Maryland General Assembly
2006 Session

FISCAL AND POLICY NOTE

House Bill 994 (Delegate Love, *et al.*)
Ways and Means Budget and Taxation

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

This bill creates 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.

The bill takes effect July 1, 2006 and applies to tax years 2007, 2008, and 2009.

Fiscal Summary

State Effect: General fund revenues would decrease by approximately $855,400 in FY 2008 due to additional subtraction modifications as provided by the bill. Future years reflect estimated number of taxpayers eligible for the subtraction modification. No effect on expenditures.

(in dollars)	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011
GF Revenue	$0	($855,400)	($861,800)	($868,200)	$0
Expenditure	$0	$0	$0	$0	$0
Net Effect	$0	($855,400)	($861,800)	($868,200)	$0

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

Local Effect: Local government revenues would decrease by approximately $540,300 in FY 2008, $544,300 in FY 2009, and $548,300 in FY 2010. No effect on expenditures.

Small Business Effect: None.

Analysis

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

Background: 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 adjusted gross income (FAGI). The FAGI of a taxpayer is the starting point for determining Maryland State income tax liability. Unless required by any provision of State law, any amount excluded from FAGI will not be taxable for State income tax purposes. 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.

Military Pay Treatment

Under Section 112 of the Internal Revenue Code, active service pay received by a member of the armed forces serving in a designated combat zone can be excluded from

FAGI. Active service compensation for enlisted personnel is not included in FAGI for a month during which any part the individual either served in a combat zone or was hospitalized due to service in a combat zone. The amount of pay that can be excluded due to hospitalization is limited to within two years after the date of termination of combat in such zone, and the hospitalization need not occur in the combat zone. 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.

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 $855,400 in tax year 2007. Given that the maximum decrease in tax liability per individual provided by the bill is approximately $166, it is assumed that the decrease in tax liability does not affect withholdings remitted by eligible individuals in fiscal 2007. As a result, general fund revenues are estimated to decrease by approximately $855,400 in fiscal 2008. The estimate is based on the following facts and assumptions:

- As of December 31, 2005, 430,295 active duty military personnel were stationed outside the United States.
- It is estimated that Maryland's share of total active duty personnel who are subject to State taxation is 0.75%.
- The number of Maryland residents in the military will increase by approximately 1% each year.
- Fifty-four percent 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 would decrease from civilian federal employees serving overseas:

- According to the U.S. Office of Personnel Management, in 2004 there were 104,087 Maryland federal employees.
- Of all federal employees, 31% were serving overseas. It is assumed that Maryland federal employees worked outside of the United States at the same rate.
- The number of Maryland federal employees increases by 0.6% annually.

Additional Information

Prior Introductions: Similar bills were introduced at the 2005 session as SB 336/HB 1242. SB 336 was not reported from the Senate Budget and Taxation Committee. As amended by the House Ways and Means Committee, HB 1242, an identical bill, passed the House but was not reported from the Senate Budget and Taxation Committee.

Cross File: SB 557 (Senator DeGrange) – Budget and Taxation.

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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