

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

**FISCAL AND POLICY NOTE**

Senate Bill 165

(Senator Middleton, *et al.*)

Budget and Taxation

**Income Tax - Subtraction Modification for Active Duty Income - Military  
Reserves and Maryland National Guard**

This bill creates a subtraction modification under the State income tax for the income received by a member of a reserve component of the armed forces or Maryland National Guard and attributable to active duty service under orders from the President of the U.S. or the Governor. If an individual exempts income as provided by this bill, that income cannot be counted towards the existing overseas military pay exemption.

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

**Fiscal Summary**

**State Effect:** General fund revenues would decrease by approximately \$660,800 in FY 2007 due to additional military pay exemptions. Future years reflect a stable number of activated reservists. Expenditures would not be affected.

(in dollars)	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011
GF Revenue	(\$660,800)	(\$660,800)	(\$660,800)	(\$660,800)	(\$660,800)
Expenditure	\$0	\$0	\$0	\$0	\$0
Net Effect	(\$660,800)	(\$660,800)	(\$660,800)	(\$660,800)	(\$660,800)

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

**Local Effect:** Local government revenues would decrease by approximately \$417,300 annually beginning in FY 2007. Expenditures would not be affected.

**Small Business Effect:** None.

## Analysis

**Current Law:** Military personnel serving overseas are allowed a subtraction modification under the State income tax. The subtraction modification includes the first \$15,000 of the overseas military pay attributable to active service of any branch of the armed forces. The amount of the subtraction modification is (1) reduced dollar for dollar in the amount by which military pay received by the individual exceeds \$15,000; and (2) reduced to zero if military pay received by the individual exceeds \$30,000.

**Background:** Members of the armed forces receive many different types of pay and allowances. Some are included in the calculation of an individual's federal adjusted gross income (FAGI) while others are excluded. Generally, most forms of pay such as basic, specialty and incentive pay, and bonuses are included in FAGI while certain allowances for housing, travel, family, and in-kind military benefits are not. 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.

Under Section 112 of the Internal Revenue Code (IRC), 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.

**Exhibit 1** list the number of reservists who have been called to duty nationwide as of February 1, 2006. According to the Department of Defense, 2,323 reservists from Maryland are currently on active duty.

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**Exhibit 1**  
**Total Number of Activated Reservists**  
**February 1, 2006**

<u><b>Military Service</b></u>	<u><b>Individuals Called to Active Duty</b></u>
Air Force	7,559
Army – National Guard and Reserves	107,802
Coast Guard	419
Marine Corps	7,085
Navy	<u>4,959</u>
<b>Total</b>	<b>127,824</b>

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Chapter 389 of 2003 allows State employees who serve in the military to receive paid leave while on active duty. The leave is limited to the difference between a member's federal active duty base salary and State base salary or wages, and may not exceed an employee's State salary. Eligible employees must elect to use the military administration leave authorized by the Act or the fully paid military leave (up to 15 days) allowed under a separate provision of law. Subsequent legislation extended the termination date of these provisions to June 30, 2005.

According to a 2000 survey by the U.S. Department of Defense, based on self-reported earning loss data, 41% of reservists reported income loss during their most recent deployment, 29% reported an income gain, and 30% reported no change in income. A 2005 report by the RAND Corporation, however, reached different conclusions. This study concluded that 72% of reservists experienced a significant increase in earnings. The average increase in earnings was \$850 a month, which represented an increase of approximately 25%. However, a sizable fraction of reservists, 28%, experienced some loss in earnings and for some reservists (20%) the losses were greater than 10% when compared to not activated.

Concern over the financial impact on reservists who have been activated has led to legislation by the federal government and states. The Uniformed Services Employment and Reemployment Rights Act of 1994 (USERRA) was signed into law on October 13, 1994 and is intended to minimize the disadvantages to an individual that occur when that person needs to be absent from his or her civilian employment to serve in the armed forces. USERRA establishes the cumulative length of time that an individual may be absent from work for military duty and retain reemployment rights to five years (the

previous law provided four years of active duty, plus an additional year if it was for the convenience of the Government). There are important exceptions to the five-year limit USERRA provides that returning service members are reemployed in the job that they would have attained had they not been absent for military service (the long-standing “escalator” principle), with the same seniority, status, and pay, as well as other rights and benefits determined by seniority.

Reservists and members of the National Guard, when activated, are also afforded legal and financial protections under the Servicemembers Civil Relief Act. These protections include capping at 6% the annual interest rate applied to the outstanding loans of a reservist whose ability to pay financial obligations has been affected by activation.

**State and Local Revenues:** The bill provides that additional overseas military pay of reservists could be exempted beginning in tax year 2006. As a result, general fund revenues could decrease by approximately \$660,800 in fiscal 2007 and local government revenue could decrease by approximately \$417,300.

The Defense Manpower Data Center (DMDC) provided data on the State reservists and Maryland National Guard members who were called into active duty in 2005. A total of 1,820 of these individuals were activated in 2005. Legislative Services received data on the amount of annual military pay received by each reservist (without any identifying characteristics), and whether or not these wages were subject to State taxation. Approximately \$14.5 million in State taxable wages were paid to these reservists. This amount of wages was increased to reflect the additional numbers of State reservists and National Guard members who have been activated in 2006; and reduced, by one-quarter, to reflect the estimated effect of the existing overseas military subtraction.

It is assumed that reservists do not adjust State withholdings. To the extent that reservists adjust withholding in fiscal 2006, revenue losses would be greater than estimated in that year. Further, it is also assumed that the number of State reservists and Maryland National Guard members remains constant.

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### **Additional Information**

**Prior Introductions:** None.

**Cross File:** HB 6 (Delegate Levy) – Ways and Means.

**Information Source(s):** Comptroller's Office, Defense Manpower Data Center, Department of Defense, Internal Revenue Service, Rand Corporation, Department of Legislative Services

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ncs/hlb

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