HB 775

Department of Legislative Services
2011 Session

FISCAL AND POLICY NOTE

House Bill 775 (Delegate Love, *et al.*)
Ways and Means

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

This bill reestablishes the $3,500 subtraction modification under the State income tax for the foreign earned income paid by the U.S. government to an employee working abroad. The previous subtraction modification was available only for tax years 2007, 2008, and 2009.

The bill takes effect July 1, 2011, and applies to tax year 2011 and beyond.

Fiscal Summary

State Effect: General fund revenues decrease by $1.0 million annually beginning in FY 2012 due to additional subtraction modifications as provided by the bill. Expenditures are not affected.

(in dollars)	FY 2012	FY 2013	FY 2014	FY 2015	FY 2016
GF Revenue	($1,000,000)	($1,000,000)	($1,000,000)	($1,000,000)	($1,000,000)
Expenditure	0	0	0	0	0
Net Effect	($1,000,000)	($1,000,000)	($1,000,000)	($1,000,000)	($1,000,000)

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

Local Effect: Local government revenues decrease by about $625,000 annually beginning in FY 2012. Expenditures are not affected.

Small Business Effect: None.

Analysis

Current Law: Chapter 368 of 2006 established 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 and applied to tax years 2007, 2008, and 2009.

Several other laws determine the federal and State taxation of federal employees serving overseas, as discussed below.

Background: A U.S. citizen or resident alien living and working abroad will typically pay income taxes to the country in which he/she is currently residing. Under Section 911 of the Internal Revenue Code (IRC), the individual may qualify to exclude all or part of the foreign earned income, including housing allowances, from federal adjusted gross income (FAGI).

Unlike other citizens living and working abroad, U.S. government employees are generally not subject to foreign income taxes. Most payments received by U.S. government civilian employees for working abroad, including pay differentials, are taxable for federal income tax purposes. Certain foreign area allowances, cost-of-living allowances, and travel allowances are tax free. Maryland conforms to federal tax treatment, so any amount received by a U.S. government employee serving abroad that is not taxable for federal income tax purposes is not taxable for State income tax purposes.

Military Pay Treatment

Under Section 112 of the IRC, certain pay received by a member of the armed forces serving in a designated combat zone can be excluded from FAGI. The combat exclusion applies for any month in which the individual either served in a combat zone or was hospitalized due to service in a combat zone.

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. In tax year 2010, designated combat zones include the Afghanistan, Kosovo, and Arabian Peninsula areas. Military service outside a combat zone is considered to be performed in a combat zone if the Department of Defense designates that the service is in direct support of the operations within the combat zone and the military service qualifies for hostile fire pay. The Department of Defense has certified 12 locations for combat zone tax benefits for specified periods due to their direct support of military operations. In addition, designated areas of former Yugoslavia qualifies as a combat zone for income tax purposes.

Maryland conforms to federal tax treatment of military pay in combat zones so any amount received is not taxable for State income tax purposes.

The Servicemembers Civil Relief Act (50 U.S.C. App. §§ 501-596) is a federal law that provides military members certain protections as they enter active duty and other protections while they are on active duty. Section 511 provides that a nonresident service member's military income and personal property are not subject to state taxation if the service member is present in the state only due to military orders. States are also prohibited from using the military pay of these nonresident service members to increase the state income tax of the spouse. For example, a Maryland member of the military that is stationed in California is exempt from the California income tax but pays Maryland income taxes if the individual maintains a permanent residence or is domiciled in Maryland. Conversely, Maryland does not tax the military pay of a California military member merely because the individual is stationed at a Maryland military base.

Under current State law, certain Maryland residents serving a military assignment overseas are allowed a State income tax subtraction modification. 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.

In addition, Chapters 571 and 572 of 2010 allow homeowners employed by the federal government who are stationed out of state for not more than six consecutive years to maintain the homestead property tax credit on their principal residence even if they do not live in the residence for more than six months of the year, provided they are otherwise eligible for the tax credit.

State Revenues: The bill reestablishes the $3,500 income tax subtraction modification for the foreign earned income of U.S. government employees beginning in tax year 2011. As a result, general fund revenues decrease by $1.0 million in fiscal 2012.

The Comptroller's Office advises that the previous subtraction modification was listed on the income tax form as one of the miscellaneous subtraction modifications. Therefore, the Comptroller's Office cannot provide the amount of subtraction modifications that have been claimed to date. The estimated revenue loss from extending the subtraction modification is based on the following facts and assumptions:

- as of September 2010, about 100,000 active duty military personnel were stationed in a foreign country but not in a combat zone; and

- the Heritage Foundation estimates that Maryland residents comprised 1.6% of total U.S. military enlistments in 2007.

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

- according to the 2007 edition of the *Office of Personnel Management's Federal Civilian Workforce Statistics Fact Book*, approximately 88,700 civilian employees of the federal government work overseas, with most of these employees from the Department of Defense (54.3%) and the State Department (23.4%); and
- based on the percentage of total employment within these agencies and data from the U.S. Bureau of Economic Analysis, Maryland's share of total federal civilian employees serving overseas is 5%.

The estimate also takes into account the current overseas military income tax subtraction modification. It is also assumed that about 10% of all tax returns are not taxable (in addition to combat zones).

Local Revenues: Local government revenues decrease by 3% of the State subtraction modification claimed. Accordingly, local government revenues decrease by $625,000 annually beginning in fiscal 2012.

Additional Information

Prior Introductions: SB 262 of 2010 and SB 213 of 2009 received a hearing in the Senate Budget and Taxation Committee, but no further action was taken. HB 819 of 2010 and HB 752 of 2009 received a hearing in the House Ways and Means Committee, but no further action was taken.

Cross File: None.

Information Source(s): Comptroller's Office, Internal Revenue Service, Globalsecurity.org, Heritage Foundation, U.S. Bureau of Economic Analysis, U.S. Office of Personnel and Management, Department of Legislative Services

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Analysis by: Robert J. Rehrmann

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