

Department of Legislative Services
Maryland General Assembly
2008 Session

FISCAL AND POLICY NOTE

Senate Bill 315 (Senator Lenett, *et al.*)
Budget and Taxation

Income Tax - Subtraction Modification - Military Retirement Income

This bill expands the existing military retirement income subtraction modification for specified lower- to moderate-income individuals. The expanded subtraction modification would be equal to 100% or 50% of military retirement income depending on income thresholds specified by the bill. The increased benefit is phased in over a three-year period. Individuals with federal adjusted gross income (FAGI) greater than \$100,000 would not qualify for the expanded benefit (\$150,000 for joint filers).

The bill takes effect July 1, 2008 and applies to tax years 2008 and beyond.

Fiscal Summary

State Effect: General fund revenues would decrease by \$20.3 million in FY 2009 due to additional military retirement being exempted. Future years reflect annualization, phase-in as provided by the bill, and estimated number of eligible taxpayers. Expenditures would not be affected.

(\$ in millions)	FY 2009	FY 2010	FY 2011	FY 2012	FY 2013
GF Revenue	(\$20.3)	(\$22.8)	(\$26.2)	(\$26.6)	(\$27.0)
Expenditure	\$0	\$0	\$0	\$0	\$0
Net Effect	(\$20.3)	(\$22.8)	(\$26.2)	(\$26.6)	(\$27.0)

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

Local Effect: Local government revenues would decrease \$13.2 million in FY 2009 and \$17.6 million by FY 2013. Expenditures would not be affected.

Small Business Effect: None.

Analysis

Bill Summary: The bill would allow lower- to moderate-income individuals to exempt additional amounts of military retirement income. **Exhibit 1** lists the proposed exemptions based on the taxpayer's FAGI and filing status. For all individuals, the exemption equals the greater of \$5,000 or amount specified below.

Exhibit 1 SB 315 Proposed Military Exemptions by Tax Year

<u>FAGI</u>	<u>TY 2008</u>	<u>TY 2009</u>	<u>TY 2010 and Beyond</u>
Single Filers			
\$50,000 or Less	33%	67%	100%
\$50,001-\$100,000	17%	33%	50%
Over \$100,000	\$5,000	\$5,000	\$5,000
Joint Filers			
\$75,000 or Less	33%	67%	100%
\$75,001-\$150,000	17%	33%	50%
Over \$150,000	\$5,000	\$5,000	\$5,000

Current Law: Chapter 226 of 2006 expanded a \$2,500 military retirement income subtraction that was limited to enlisted military members with a federal adjusted gross income of \$22,500 or less. Under Chapter 226, an individual may exempt the first \$5,000 of military retirement income from State taxation if the retirement income resulted from service in an active or reserve component of the armed forces of the United States or in the Maryland National Guard.

Under Chapter 226, retirees from active duty with the Commissioned Corps of the Public Health Service, NOAA, or the Coast and Geodetic Survey qualified for the subtraction modification, but only if separated from service after July 1, 1991. Chapter 553 of 2007 eliminated this restriction and allowed all of the individuals described previously to qualify for the subtraction modification, beginning tax year 2007, without regard to the date of separation from employment.

Military retirement income exempted under this provision cannot be counted towards the State pension exclusion.

Maryland law also provides a pension exclusion subtraction for individuals who are at least 65 years old or who are totally disabled. Up to a specified maximum amount of taxable pension income (\$23,600 maximum for 2007) 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.

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 available to all taxpayers.

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 \$80 million in retirement income from the Department of Defense (DoD) in 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 reflects 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 because 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 2 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 3** lists the total retirement pay (including disability pay) received by Maryland military retirees by branch of service.

Exhibit 2
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

Exhibit 3
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	<u>13,793</u>	<u>12,751</u>	<u>268.8</u>	<u>21,080</u>
Subtotal	48,002	44,014	\$958.4	\$21,776
Coast Guard	<u>1,129</u>	<u>1,083</u>	<u>22.4</u>	<u>20,698</u>
Total	49,131	45,097	\$980.8	\$21,749

Source: Defense Manpower Data Center

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 65, compared with approximately 55% nationally. Nationally, the average age of a military retiree who retired in federal fiscal 2004 was 48.5. 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.

State Revenues: Additional retirement income could be exempted beginning in tax year 2008. As a result, general fund revenues would decrease by approximately \$10.5 million in tax year 2008 and \$19.6 million in tax year 2009. It is assumed that most taxpayers will adjust withholdings and estimated payments. As a result, fiscal 2009 revenues would decrease by both the change in tax year 2008 revenues and also by one-half of tax year 2009, resulting in a decrease of approximately \$20.3 million in fiscal 2009.

Exhibit 4 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.

Exhibit 4
Projected State and Local Revenue Loss – Military Exemption
(\$ in Millions)

<u>Fiscal</u>	<u>State</u>	<u>Local</u>	<u>Total</u>
2009	\$20.3	\$13.2	\$33.5
2010	22.8	14.9	37.7
2011	26.2	17.1	43.3
2012	26.6	17.3	43.9
2013	27.0	17.6	44.6

This estimate is based on the number of retirees and amount of retirement income received by State residents as reported by DMDC and the Office of Commissioned Corps Force Management Information System, estimated cost of the current military retirement subtraction modification, and interaction with the State pension exclusion. Based on an analysis of the 2006 American Community Survey Public Use Microdata Sample File (Maryland) from the U.S. Census Bureau, it is estimated that 40% of retirees would qualify for the full benefit proposed by the bill, 48% would qualify for the reduced benefit, and 12% would be unaffected by the bill.

Exhibit 5 lists the average reduction in State and local taxes provided by the bill based on whether the individual qualifies for the full benefit specified by the bill and the age of the individual.

Exhibit 5
Average State and Local Taxes Savings
Tax Year 2008-2010

	<u>TY 2008</u>	<u>TY 2009</u>	<u>TY 2010</u>
<u>Qualify for Full Benefit</u>			
Under 65 Years Old	\$648	\$1,303	\$1,584
65 Years and Older	354	670	804
<u>Qualify for Reduced Benefit</u>			
Under 65 Years Old	\$341	\$534	\$809
65 Years and Older	142	276	419

Average savings beyond tax year 2010 would be similar to the average amounts estimated in tax year 2010. Individuals under 65 years old would benefit by the bill on average by a greater amount since they do not qualify for the State pension exclusion, which can be used to exempt military retirement income above and beyond any amount subtracted under the military retirement subtraction modification. About 20,000 individuals would qualify for the full benefit in tax year 2008 and about 24,000 would qualify for the reduced benefit.

Local Fiscal Effect: Local government revenues would decrease by 3% of the net change in State tax liability in tax year 2008 resulting from the provisions of the bill. In fiscal 2009, the decrease would be approximately \$13.2 million. Exhibit 4 lists the local income tax revenue impact by fiscal year.

Additional Information

Prior Introductions: None.

Cross File: None.

Information Source(s): U.S. Census Bureau, Defense Manpower Data Center, National Oceanic and Atmospheric Administration, Office of Commissioned Corps Force Management Information System, Department of Legislative Services

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