

**TESTIMONY OF
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DEPARTMENT OF ADMINISTRATIVE AND FINANCIAL SERVICES**

Before the Joint Standing Committee on Taxation
Hearing Date: *May 6, 2025*

LD 1622 – “*An Act to Exempt Certain Income from State Income Tax*”

Senator Grohoski, Representative Cloutier, and members of the Taxation Committee – good afternoon, my name is Michael Allen, Associate Commissioner for Tax Policy in the Department of Administrative and Financial Services. I am testifying at the request of the Administration Against LD 1622, “*An Act to Exempt Certain Income from State Income Tax.*”

For tax years beginning on or after January 1, 2026, the bill proposes to exempt all pension income, tip income, and overtime income from Maine individual income tax by providing income subtraction modifications to reduce taxable income by the amounts received, to the extent the income is included in the taxpayer’s federal adjusted gross income.

Generally, overtime and tip income are subject to both federal and Maine individual income tax. However, similar federal exemptions have been proposed by President Trump and are being considered alongside the Tax Cuts and Jobs Act extensions. This has caused an increased discussion of the topic federally and may lead to conformity discussions at the state level.

The Tax Foundation has recently addressed the issue of exempting overtime and tip income, raising important policy concerns including the introduction of “severe horizontal inequity” – two workers earning the same annual income could face vastly different tax burdens based on classification of their wage – and noting

how these exemptions would “complicate tax administration and invite avoidance.”

Currently, the pension income deduction for non-military pension income is limited to the maximum annual benefit that an individual eligible to retire at the retirement age as of January 1 of the tax year may receive under the federal Social Security Act as amended through June 28, 2023, reduced by the amount of social security benefits received by the taxpayer. For tax years beginning in 2025, the maximum pension deduction amount is \$48,216. Military retirement pay is fully exempt from Maine individual income tax.

The Administration notes the following technical concerns:

- The definition of “pension deduction amount” in the bill (36 M.R.S. § 5122(2)(M-3)(2)(d)) will result in a decreased pension deduction for some taxpayers who receive social security benefits and retirement plan benefits.
- The bill does not exempt from Maine income tax overtime pay not required by 26 M.R.S. § 664(3) but required by other labor laws, a situation that may occur when a Maine resident performs overtime work in another state. This may raise constitutional concerns.
- The bill should clarify whether the overtime income exemption is for all compensation received for hours worked over 40 hours a week or if only the amount above the employee’s normal wage is exempt.
- The bill should clarify whether overtime pay received by an employee after working eight hours/day, whether the employee works 40 hours/week or not, is exempt from income tax.

- The bill does not directly address compensatory time agreements used to satisfy the State's overtime pay requirement applicable to executive or judicial employees under 26 M.R.S. § 664(4).
- The bill should establish reporting requirements for affected employers to notify employees of the amount of eligible overtime income and tip income paid during the year. For example, these amounts could be reported on the employee's annual Form W-2, Wage and Tax Statement.
- Based on the IRS News Release FS-2015-8, February 2015, the definition of "tip" included in Section 3 of the bill may allow a deduction for certain service charges automatically included in a customer's bill and reported to an employee as non-tip wages by the employer for federal tax purposes.
- Taxpayers would need to provide supporting documentation, such as pay stubs, to verify the income exempt from Maine income tax. This would place a burden on taxpayers and the State.
- Exempting tip income and overtime pay from Maine income tax could lead workers and employers to reclassify wage income that may lead to a shift toward lower base pay and higher tip/overtime income.
- The lack of a cap or phase-out on the exempt overtime and tip income is cause for concern. The bill may result in increased fraudulent activities as many taxpayers may attempt to deduct unqualified income.

The preliminary estimated fiscal impact of this bill is a potential revenue loss of \$185 million or more.

The preliminary estimated administrative costs are under review. One-time computer programming and related system testing costs are required to add two additional lines to the individual income tax return to accommodate the two new

income subtraction modifications. The bill is expected to affect a significant portion of the 795,000 individual income tax returns filed annually.

The Administration looks forward to working with the Committee on the bill; representatives from MRS will be here for the Work Session to provide additional information and respond in detail to the Committee's questions.