GENERAL ASSEMBLY OF NORTH CAROLINA

Session 2013

Legislative Fiscal Note

BILL NUMBER: House Bill 96 (First Edition)

SHORT TITLE: Equal Tax Treatment of Gov't Retiree Benefits.

SPONSOR(S): Representatives Cleveland and Boles

FISCAL IMPACT

($ in millions)

☑ **Yes** ☐ **No** ☐ **No Estimate Available**

State Impact	**FY 2013-14**	**FY 2014-15**	**FY 2015-16**	**FY 2016-17**	**FY 2017-18**
General Fund Revenues:	(17.1)	(36.1)	(69.2)	(114.3)	(184.4)
General Fund Expenditures:					
State Positions:					
NET STATE IMPACT	**($17.1)**	**($36.1)**	**($69.2)**	**($114.3)**	**($184.4)**

PRINCIPAL DEPARTMENT(S) & PROGRAM(S) AFFECTED: NC Dept. of Revenue

EFFECTIVE DATE: January 1, 2013

TECHNICAL CONSIDERATIONS:
None

BACKGROUND:
Prior to 1989, certain retirement benefits paid to North Carolina State and local governmental retirees were exempt from North Carolina State income taxes. Federal retirement benefits, however, were subject to North Carolina State income tax with a partial deduction. In 1989, the US Supreme Court ruled in *Michigan v. Davis* that states must treat federal retirees the same as their State and local retirees for State income tax purposes. As a result, North Carolina granted a $4,000 income tax deduction for all governmental retirees and taxed any retirement income in excess of $4,000. In 1998, the NC Supreme Court ruled in *Bailey v. State of North Carolina* that the relationship between the State and its employees is contractual in nature and the right to benefits exempt from state taxation was a term of that contract. As a result, the Court held that North Carolina State and local governmental retirees, federal and military retirees who were vested (generally requires five years of creditable service) as of August 12, 1989, are entitled to a full income tax deduction from North Carolina income tax for their retirement pay. This deduction also applies to retirement benefits received from the State's 401 (k) and 457 plans if the retiree had

contributed or contracted to contribute to the plan prior to August 12, 1989. The remaining "nonvested" retirees as of that date and retirees receiving a pension from another state or a local government in another state receive a $4,000 deduction. A deduction of up to $2,000 applies to private pensions.

BILL SUMMARY:
House Bill 96 would gradually implement a full deduction of paid retirement benefits for all federal, State, and local retirees by extending the date by which employees must be vested to receive the exclusion by three years each tax year until all retirees are covered by the deduction. For example, for tax year 2013, the date by which an employee must be vested to receive the deduction would be August 12, 1992. For tax year 2014, the date would be extended to August 12, 1995 and so on. The deduction for retirees from other states would be limited to the amount the other state allows to North Carolina state and local government retirees, but not lower than $4,000.

ASSUMPTIONS AND METHODOLOGY:
Calculating the Impact of a Full Exclusion
The Department of State Treasurer provided the Fiscal Research Division with a tabulation of the total number of "non-vested" (as of 8/12/89) North Carolina State and local governmental retirees by size of annual paid benefit. The analysis indicates that there are about 72,000 state and local retirees who would receive relief under the bill. The estimated number of impacted federal retirees is 53,000. To account for the 401 (k) and 457 plan benefits, the paid benefit amounts were increased based on the ratio of total balances in 401 (k) and 457 plans compared to the total balances in defined benefit plans. This calculation results in an increase of 8 percent in annual paid benefits.

The first step in determining the fiscal impact is to account for the existing $4,000 income tax deduction. After subtracting this amount from the average annual paid benefit for the various retiree categories and benefit ranges, the "after-exclusion" pension amount is calculated by multiplying the number of retirees in each category by the average amount of pension in excess of the current exclusion. This amount is multiplied by 7% to obtain the overall tax loss resulting from the total exemption.

There was no comparable distribution data for federal civil service and military retirees. To make an estimate for these classes, data from federal and military agencies were used to determine the total number of federal pensioners relative to state and local retirees (federal is 26% lower) and the average check size (federal is 34% higher) to develop an estimate for total federal pension dollars in North Carolina. The tax costs were then tabulated using the same methodology as that used for State and local retirees.

Retirees of Other States: There is no data on the number of retirees receiving retirement pay from other states and local governments of other states who are residing in North Carolina. Although the impact from retirees of other states is not expected to be significant compared to the cost of the exclusion for North Carolina State and federal retirees, there would be some increased cost for retirees from states with deductions greater than the current $4,000 deduction. An estimate of cost for each 1,000 retirees can be determined by dividing the estimated tax loss for North Carolina State retirees by the number of retirees to determine the average tax loss per retiree

($639). Multiplying this number by 1,000 yields an estimate of $640,000 for every 1,000 qualifying out-of-state retirees. This estimate represents the cost of the exclusion when fully implemented; the actual cost under the bill would be less during the phase-in.

Projecting Growth of Impact for Future Years
The next issue was how to project the fiscal impact for future years. The method used was to analyze the actual growth in the fiscal impact of the proposal between the 2007 session estimates and the 2012 estimates. The average annual growth rate turns out to be 25.6%. This growth rate is used to project the impact for each subsequent year.

Prorating the Impact to Reflect Gradual Implementation
Because H96 would phase in the implementation of the exclusion by extending the date for eligibility by three years every year until fully implemented, the fiscal estimate for each year must be prorated to reflect the gradual implementation. The methodology for prorating the impact assumes that the number of qualifying non-Bailey retirees will be evenly distributed throughout the implementation period. Thus, the number of new tax-exempt, non-Bailey retirees for each extension period is assumed to be proportional to the number of years by which the date for vesting is extended. Since the vesting date is extended each year by three years, the number of qualifying retirees is the total number of non-Bailey retirees multiplied by a fraction, the numerator of which is 3 years and the denominator of which is the total number of years since 1989. This fraction is used to project the fiscal impact for each phase of implementation.

Because the bill is effective January 1, 2013, the FY 12-13 impact includes the full impact of calendar year 2013, plus the impact of estimated payments in the first half of 2014, which represents approximately 45% of the annual impact.

SOURCES OF DATA:
NC Department of State Treasurer
Statistical Report on the Military Retirement System; US Dept of Defense:
http://actuary.defense.gov/statbook11.pdf,
Annual Survey of Public Pensions; US Census Bureau: http://www.census.gov/govs/retire/
US Office of Personnel Management: http://www.opm.gov/data/

TECHNICAL CONSIDERATIONS: None
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