

GENERAL ASSEMBLY OF NORTH CAROLINA

Session 2005

Legislative Fiscal Note

BILL NUMBER: House Bill 61 (First Edition)

SHORT TITLE: Income Tax - Exempt Certain Military Income.

SPONSOR(S): Representative Culpepper

FISCAL IMPACT					
	Yes ()	No ()	No Estimate Available ()		
	<u>FY 2005-06</u>	<u>FY 2006-07</u>	<u>FY 2007-08</u>	<u>FY 2008-09</u>	<u>FY 2009-10</u>
REVENUES:					
Traditional Military	(154.4)	(83.4)	(87.2)	(91.1)	(94.9)
Guard & Reserve	(1.6)	(0.8)	(0.8)	(0.8)	(0.8)
Retirees	(17.1)	(9.6)	(24.5)	(25.1)	(27.1)
Survivors	(9.2)	(4.6)	(4.6)	(4.6)	(4.6)
TOTAL	(182.3)	(98.4)	(117.1)	(121.6)	(127.4)
PRINCIPAL DEPARTMENT(S) & PROGRAM(S) AFFECTED: North Carolina Department of Revenue.					
EFFECTIVE DATE: January 1, 2004					

BILL SUMMARY:

Enacts new GS 105-134.6(b)(5c) to exempt the amount received during the taxable year from the U.S. government as retirement pay for a retired member of the armed forces or as survivorship benefits for survivors of active duty or retired members of the armed forces. Further enacts new GS 105-134.6(b)(18) to exempt compensation paid by the armed forces to an individual on active duty as a full-time officer or enlisted member. Effective Jan. 1, 2004.

ASSUMPTIONS AND METHODOLOGY: The legislation exempts four classes of military or military service related pay. They are traditional military pay, active duty pay to Army Reserve and National Guard, military retirement pay not covered by the Bailey decision, and survivorship benefits.

Active Duty, Army Reserve, and National Guard: Presently, all military pay earned by enlisted personnel, warrant officers, and commissioned warrant officers are exempt from state income tax if the individual is either serving in a combat zone or is hospitalized as a result of serving in a combat zone. A similar exemption is applied to commissioned officers serving in a combat zone

or hospitalized as a result of serving in a combat zone. However, the exemption is limited to the highest rate of enlisted pay plus imminent danger/hostile fire pay. As a result, the legislation only impact military personnel who list North Carolina as their state of residence and are not in a combat zone, or those officers whose current exemption is capped. Through a variety of executive orders the President has deemed the following areas combat zones, the equivalent of combat zones, or combat support zones eligible for tax exemption: Persian Gulf, Red Sea, Gulf of Oman, portions of the Arabian Sea, the Gulf of Aden, Bahrain, Iraq, Kuwait, Oman, Qatar, Saudi Arabia, United Arab Emirates, Yugoslavia, Albania, the Adriatic Sea, portions of the Ionian Sea, Afghanistan, Bosnia, Herzegovina, Croatia, Macedonia, Pakistan, Tajikistan, Jordan, Turkey, Kyrgyzstan, Uzbekistan, portions of the Philippines, Yemen, Djibouti, Israel, portions of the Mediterranean Sea, Jordan, and Egypt.

According to the Department of Defense 2003 Atlas/Data Abstract Workforce publication, there were 96,560 active duty military personnel in North Carolina in 2003. Their average pay at that time \$35,455. Approximately 47.4% of those individuals are in the Army, 41.7% are Navy and Marine Corp personnel, and the balance are in the Air Force.

According to the Department of Defense Statistical Report of Personnel and Readiness, there are approximately 25,500 military personnel who declare North Carolina as their legal residence in 2001. This number is increased by 10% to 28,050 and is used as a proxy for current levels. The average military pay at North Carolina military installations was \$35,455 in 2003. Under federal law, military pay increases are linked to the Bureau of Labor Statistics generated Employment Cost Index (ECI) for civilian employment. Between 2000 and 2006 military pay increases must meet or exceed 1/2% above the private sector increase for employment costs. After 2006, the increase must match ECI. Historic data from Labor Statistics and forecasts provided by Economy.com suggest the following average salaries for calendar years 2004 – 2010.

Calendar year	Average Pay
2003	35,455
2004	36,529
2005	37,852
2006	39,335
2007	40,685
2008	42,056
2009	43,448
2010	44,882

Previously provided military data suggests that 53% of North Carolina residents that are active duty military are married with an average of two dependents. The remaining 47% are single. For purposes of this analysis, spouses are assumed to earn 80% of the average military pay. No other exemptions or exclusions to state income are considered. Using this data, applying the appropriate federal and state deductions, exemptions, and credits, produces the following calendar year losses.

	2005	2006	2007	2008	2009	2010
Married	51,083,012	53,892,875	56,390,531	58,992,256	61,593,981	64,255,174
Single	28,198,437	29,529,920	30,782,305	32,074,239	33,313,441	34,658,107
TOTAL Loss	79,281,449	83,422,795	87,172,836	91,066,495	94,907,422	98,913,281

The legislation also exempts pay received by Reserve and National Guard members while on active duty. According to the North Carolina Army Reserve and National Guard comptroller, in the most recent fiscal year North Carolina Guard and Reserve soldiers earned \$10.67 million in taxable active duty pay. Applying an average personal income tax rate of 7.0% suggests a loss of approximately \$750,000 annually.

Military Retirees and Survivors: As a result of the North Carolina Supreme Court's decision in *Bailey v. State of North Carolina*, North Carolina may not tax certain retirement benefits received by retirees of the State of North Carolina and its local government or by the United States government retirees for each retirement plan if the retiree has five or more years of creditable service as of August 12, 1989. This exclusion includes military retirees who had five years of military service by August 12, 1989.

In 2003 North Carolina military retirees received \$1,275,163,000 in retirement pay from the service. This equates to approximately \$17,250 per retiree. Because all current retirees are covered by the Bailey decision, all that income is excluded from tax. Under the federal military retirement program, service members are eligible for retirement after twenty years of service. Beginning in 2004, some active duty military that are too young to be covered by the Bailey decision are eligible for retirement. Their retirement will be taxable. Using the 2003 pay stream, with Consumer Price Index based cost of living (COLA) adjustments, and applying the 7.0% income tax rate suggests the following potential tax revenue stream.

	Total pay	Growth	Potential tax
2003	1,275,163,000	0.0227	89,261,410
2004	1,304,109,200	0.0269	91,287,644
2005	1,339,189,738	0.0231	93,743,282
2006	1,370,125,021	0.0211	95,908,751
2007	1,399,034,658	0.0247	97,932,426
2008	1,433,590,815	0.0219	100,351,357
2009	1,464,986,453	0.0213	102,549,052
2010	1,496,190,665	0.021	104,733,347

While this is the maximum potential cost for each fiscal year, the actual number of retirees that are not covered by Bailey is expected to be relatively small for the first few fiscal years. However, because the legislation is retroactive to January 1, 2004, the first year's estimate is increased to reflect likely refunds because of amended returns.

In terms of survivors, data from the North Carolina Office of Veterans Affairs indicates that in 2003 there were 8,683 individuals in the state receiving military survivor benefits. These benefits total \$66.0 million annually and are taxable. Applying a 7.0% tax rate suggests annual losses of \$4.6 million. The first year fiscal impact is increased to account for the retroactive effective date.

NOTE: Given the age of the active military estimates, and the current deployment situation, actual impacts could vary significantly.

SOURCES OF DATA: Department of Defense, North Carolina National Guard, Army Reserve, and the North Carolina Division of Veterans Affairs.

TECHNICAL CONSIDERATIONS: None

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