

GENERAL ASSEMBLY OF NORTH CAROLINA



Legislative Fiscal Note

REVISED

**BILL NUMBER:** House Bill 61 (First Edition)

**SHORT TITLE:** Income Tax - Exempt Certain Military Income.

**SPONSOR(S):** Representative Culpepper

<b>FISCAL IMPACT</b>					
	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>
<b>REVENUES:</b>					
Traditional Military	(77.1)	(35.8)	(39.1)	(42.7)	(46.7)
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)
<b>TOTAL</b>	<b>(105.0)</b>	<b>(50.8)</b>	<b>(69.0)</b>	<b>(73.2)</b>	<b>(79.2)</b>
<b>PRINCIPAL DEPARTMENT(S) &amp; PROGRAM(S) AFFECTED:</b> North Carolina Department of Revenue.					
<b>EFFECTIVE DATE:</b> 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.

Data provided in May 2005 by the Defense Finance and Accounting Service of the Department of Defense indicate that for calendar year 2004, a total of \$28.7 million was paid in North Carolina state income taxes by active duty military personnel claiming North Carolina as their place of residency. This number is grown forward for future years by 9.2%. This is the five-year annual increase in the Department of Defense budget authority for military personnel. (This is a revision from the previous estimate. The previous note was based on seven year old data. The revision reflects new information provided by the US Department of Defense).

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.

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

**FISCAL RESEARCH DIVISION: (919) 733-4910**

**PREPARED BY:** Linda Struyk Millsaps

**APPROVED BY:** James D. Johnson, Director  
Fiscal Research Division



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