GENERAL ASSEMBLY OF NORTH CAROLINA

Session 2005

Legislative Fiscal Note

BILL NUMBER: House Bill 1267 (First Edition)

SHORT TITLE: Exclude Pensions from Income Tax.

SPONSOR(S): Representative Underhill

FISCAL IMPACT ($Mill.)

	Yes (x)	No ( )	No Estimate Available ( )		
	FY 2005-06	**FY 2006-07**	**FY 2007-08**	**FY 2008-09**	**FY 2009-10**
REVENUES:					
State General Fund	-24.4	-24.5	-34.1	-47.4	-66.3
EXPENDITURES:					
POSITIONS (cumulative):					

PRINCIPAL DEPARTMENT(S) & PROGRAM(S) AFFECTED: The income tax is administered by the Department of Revenue. The enactment of the bill is not expected to affect the budget requirements of the Department.

EFFECTIVE DATE: Tax years beginning on or after January 1, 2005.

BILL SUMMARY: Under the **Bailey** decision, public sector retirees who have five years of creditable service as of August 12, 1989, are entitled to an income tax exclusion for 100% of their retirement pay. The remaining "nonvested" public sector retirees as of that date and taxpayers receiving a pension from a state or local unit in another state are eligible for a $4,000 exclusion. The bill provides that all federal, state, and local retirees would receive the full exclusion regardless of their vesting status or their state of employment. For state and local government retirees from other states, the exemption would be limited to the amount the other state allows to retirees of the North Carolina or its political subdivisions, but not lower than $4,000.

ASSUMPTIONS AND METHODOLOGY: **"Nonvested" Public Sector Retirees:** The Department of State Treasurer provided Fiscal Research with a tabulation of retiree benefits for "nonvested" state and local retirees. This table showed the number of retirees by size of retirement check for April 2005 for the state, local, judicial, and legislative retirement systems. The numbers for each system were then added to get an overall total.

The next step was to calculate the tax savings for the average retiree in each statistical reporting class. This determination was made by subtracting the current $4,000 exclusion allowed under current law from the average annual pension for each class and then multiplying the result by an assumed marginal tax rate (6%, 7%, or 7 ¾%). The "per retiree" tax saving was then multiplied by the number of retirees for that income class to determine the annual revenue loss for the income grouping. The total loss for each income class was then added to the amount for each of the other classes to determine the total statewide impact.

There was no comparable distribution data for federal civil service and military retirees. To make an estimate for these classes, we took the total number of federal pensioners, relative to the number of state and local retirees, used in the 2001 analysis of a similar bill (federal number was 5.6% higher) and the average check size (federal is 35% more than state and local) and arrayed this total into various check size amounts. The tax savings were then tabulated using the same methodology as that used for state and local retirees.

To estimate the future year cost of the permanent impact portion of the estimate, an annual growth rate of 40% was used. This rate is based on the actual experience between February 1999, and April 2005. The rate is high due to a combination of: (1) the exponential growth in the number of August 12, 1989 nonvested retirees, (2) the recent tendency for employees to work for the state just long enough to obtain health insurance coverage, and (3) the annual increase in pension benefits.

The analysis indicates that there are about 11,420 state and local retirees who would receive relief under the bill. The estimated number of impacted federal retirees is 12,066. These numbers represent only 51% of the August 12, 1989 nonvested retirees because many receive a pension that is lower than the $4,000 exclusion and thus do not currently pay tax on their benefits.

The impact for the 2005-06 fiscal year is more than 100% of the annual tax year impact because the January 1, 2005 effective date of the bill means that during the 2005-06 fiscal year taxpayers affected by the bill will receive 100% relief for the 2005 tax year plus partial relief for the 2006 tax year (reduced withholding or estimated payments)

Retirees of Other States: There is no data in North Carolina on the number of retirees from state and local units of other states or the amount of exclusion allowed in the other states for retirees of the North Carolina system. For the purpose of this analysis, it is assumed that the impact for this category for the 2005 tax year is 10% of the amount for state and local retirees in North Carolina. For future years, this first year amount was assumed to grow 5% per year.

SOURCES OF DATA:

TECHNICAL CONSIDERATIONS: None

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