NORTH CAROLINA GENERAL ASSEMBLY

Session 2019

Legislative Fiscal Note

Short Title: Equal Tax Treatment of Gov't Retirees.
Bill Number: House Bill 213 (First Edition)
Sponsor(s): Representatives Cleveland, Blackwell, Hurley, Speciale

SUMMARY TABLE

FISCAL IMPACT OF H.B. 213, V.1 ($ in millions)

	FY 2019-20	FY 2020-21	FY 2021-22	FY 2022-23	FY 2023-24
State Impact					
General Fund Revenue	(24.8)	(52.9)	(81.2)	(108.5)	(135.0)
Less Expenditures	-	-	-	-	-
General Fund Impact	**(24.8)**	**(52.9)**	**(81.2)**	**(108.5)**	**(135.0)**
NET STATE IMPACT	**($24.8)**	**($52.9)**	**($81.2)**	**($108.5)**	**($135.0)**

TECHNICAL CONSIDERATIONS: **See Technical Considerations Section**

FISCAL IMPACT SUMMARY

Benefits paid to State, local, or federal government retirees who were vested as of August 1989 are exempt from income tax under current law. This bill would phase-in a deduction for benefits from government retirement plans for those who vested after August 1989. The estimated reduction in tax revenue for the first year is $24.8 million. The cost of the bill will increase every year until the deduction is fully phased-in for the 2028 tax year.

FISCAL ANALYSIS

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 retirement benefits paid to former employees of the State of North Carolina, its local governments, and the federal government who were vested as of August 12, 1989 may not be taxed by the State. This exclusion also extends to persons receiving these benefits as survivor beneficiaries. For most government retirement systems, a person is considered vested for the purposes of the Bailey settlement if the person had five or more years of creditable service in a qualifying State, local or federal retirement system as of August 12, 1989. For certain qualifying plans, such as the State's 401(k) and 457 plans and the Federal Thrift Savings Plan, the vesting period is less.

Retirees who were not vested by August 12, 1989 and retirees receiving benefits from government retirement plans of other states continued to receive a $4,000 deduction until the deduction was repealed, effective for the 2014 tax year.

BILL SUMMARY:

House Bill 213 would gradually implement a full deduction of retirement benefit income received from a State, local, or federal government retirement plan by extending the date by which employees must be vested to receive the exclusion by three years each tax year until all State, local, or federal government retirement income is deductible. For example, for tax year 2019, the date by which an employee must be vested to receive the deduction would be August 1992. For tax year 2020, the date would be extended to August 12, 1995 and so on. Taxpayers vested on or before August 2019 would first become eligible for the deduction in tax year 2027, and all taxpayers would be eligible for the deduction in 2028.

Beginning in tax year 2028, benefits received from a state or local government retirement plan of a state other than North Carolina would become deductible. The allowable deduction for benefits from a state other than North Carolina would be limited to the extent that the other state would not subject the equivalent amount received under a North Carolina state or local government retirement plan to individual income tax.

ASSUMPTIONS AND METHODOLOGY:

Fiscal Research determined the fiscal impact by:

1. Estimating the total amount of retirement benefits that qualifying State, local, and federal retirement systems expect to pay to North Carolina taxpayers for FY 2019-20 through FY 2023-24.
2. Estimating the share of future retirement benefits that will be taxable in North Carolina under current law.
3. Estimating the share of future taxable retirement benefits that would become tax deductible under House Bill 213 and the associated reduction in tax liability.

Income North Carolina Taxpayers Receive from Government Retirement Plans

North Carolina taxpayers receive the majority of retirement benefits from qualifying State, local, and federal retirement plans administered by The North Carolina Department of State Treasurer (DST), the United States Department of Defense (DOD) and United States Office of Personnel Management (OPM). These three agencies provided estimates of the total amount of benefits paid to North Carolina residents in 2018 from the retirement systems under their agency's purview. Fiscal research used recent financial statements to estimate the amount of benefits paid from qualifying retirement plans administered by other agencies.

Projections of benefit payments are based on the growth predicted in the major systems' actuarial reports, plus an assumed 1% Cost-of-Living Adjustment (COLA) for systems that did not include COLAs in their projections.

Taxable Retirement Benefit Income Under Current Law

This analysis assumes that the same vesting periods used for the purposes of the Bailey Settlement would be used to determine eligibility for the tax deduction under House Bill 213.

DST provided data on the amount of benefits paid from the four major pension plans for State and local governmental employees that are not eligible for the tax exemption under the Bailey settlement. Fiscal Research used the share of taxable benefits in these four major pension plans to estimate the amount of taxable benefits paid from the other North Carolina retirement plans.

DOD provided data on the total amount of Military Retirement benefits paid to North Carolina residents who first earned service after 1984. This analysis assumes that all military retirement benefits that are based on service earned after 1984 are subject to taxation under current law.

Fiscal Research estimated the percent benefits paid to former Federal employees that are taxable based on information in OPM's *Civil Service Retirement and Disability Fund Annual Report for Fiscal Year Ended September 30, 2018* and the *Thrift Savings Fund Financial Statements for December 31, 2016 and 2015.* The reports used for this analysis provided information about the entire population of benefit recipients, not just North Carolina residents. This analysis estimates the share of benefits paid to former Federal employees who were vested as of August 1989 and applies this share to the benefit total for North Carolina residents provided by OPM. This assumption is supported by data from FedScope about the length of service for Federal retirees living in North Carolina who retired between FY 2004-05 and FY 2016-17.

To estimate the amount of benefits paid to North Carolina residents from other state and local governments, Fiscal Research first estimated the number of residents receiving these benefits using state-to-state migration flow data from the 2017 American Community Survey. This is used to calculate the recent net migration patterns of people aged 65 and older to and from North Carolina. This analysis assumes that migration patterns for state and local government retirees mirror those of all individuals over age 65. Multiplying the estimate of the number of residents receiving income from other state and local retirement systems by the average benefit paid by all state and local government pension plans, as reported in the U.S. Census Bureau's 2017 Annual Survey of Public Pensions gives the total estimated benefit amount. All benefits from government retirement plans of other states are taxable under current law.

Estimated North Carolina Resident Income from State, Local, and Federal Retirement Systems by State Tax Exemption Status for Tax Year 2018
($ Millions)

Retirement System	Total Benefit Payments	Taxable Benefit Payments	Percent of Benefit Payments that are Taxable
North Carolina Retirement Systems	$5,496.7	$2,032.9	37%
Federal Civilian Retirement Systems	$2,941.0	$867.2	29%
Military Retirement System	$2,754.6	$551.6	20%
Other Government Retirement Systems	$79.0	$79.0	100%
Total Benefit Payments	**$11,271.3**	**$3,530.7**	**31%**

According to information from the North Carolina Department of Revenue, approximately 233,000 returns included a deduction for retirement benefits received pursuant to the Bailey settlement in 2016. The total amount reported was $7.6 billion. This analysis expects the amount of exempt retirement benefits to increase to $7.9 billion for tax year 2019, leaving $3.8 billion in taxable benefits from government retirement plans.

Each year, the percentage of new retirees who were vested by August 1989 decreases. According to data from the Department of State Treasurer, the percentage of benefits that are taxable has increased from 9% in 2006 to 37% in 2018. Fiscal Research used data provided by DST on retirees' first year of employment to determine the share of benefit payments that would be taxable each year by assuming no breaks in service during the first five years of employment. National data provided by OPM and DOD about retirees' average years of service and year of retirement to was used to approximate first year of employment for the Federal Civilian Retirement Systems and Military Retirement System.

Deductible Retirement Benefit Income Under House Bill 213

Because HB 213 would phase in the implementation of the exclusion by extending the date for eligibility by three years every year until fully implemented in 2028, the fiscal impact for each year prior to 2028 is less than the impact of a full tax deduction.

For the North Carolina Retirement System, Fiscal Research used data on retirees' first year of employment to determine the share of benefit payments that would become eligible each year, assuming no breaks in service during the first five years of employment. This analysis involved first measuring the length of time between each future tax year and its corresponding window of vesting dates conferring eligibility for tax exclusions, pursuant to HB 213. Then, the parallel window of vesting dates occurring an equivalent amount of time prior to 2017 that would have conferred eligibility for tax exclusions if HB 213 had been effective for tax year 2017 was determined. Using this equivalent vesting window, Fiscal Research determined the proportion of benefits paid in 2017 to members who would have been eligible for tax exclusions in 2017 (i.e. who became vested during the equivalent vesting window) and calculated the same proportion of benefits to be paid in the corresponding future tax year. After repeating this analysis with data from 2014 and 2015 and finding that the distribution of benefits by time since first employed is relatively constant across years, Fiscal Research applied the assumption that this distribution remains constant throughout the implementation period.

A similar methodology was used for the Federal Civilian Retirement Systems and Military Retirement System, using national data on retirees' average years of service and year of retirement to approximate first year of employment.

Under House Bill 213, benefits paid to North Carolina residents from other state and local governments do not become tax deductible until 2028, therefore these benefits are not included in the calculation of the fiscal impact.

To determine the fiscal impact, Fiscal Research multiplied the total amount of benefits eligible for the tax deduction under House Bill 213 by an estimated effective tax rate of 3.25 percent. The impact for each fiscal year is assumed to equal the impact of the tax year ending in December.

TECHNICAL CONSIDERATIONS

After the Bailey Settlement was passed, the Court was called upon to resolve several issues related to defining when "vesting" occurs in different plans. The period of time required to "vest" for the purposes of the Bailey Settlement, does not always match the vesting period specified by the retirement plan. For example, participants in the Military Retirement System vest in the retirement plan after 20 years of service; but they "vest" for the purposes of the Bailey settlement after 5 years. It is unclear what vesting period would be used for the Military Retirement System under HB 213. Similarly, it is unclear how House Bill 213 would treat government retirement plans with graded vesting schedules where the employee vests in different components of the benefit at different times.

DATA SOURCES

<u>North Carolina Department of State Treasurer</u>
- Data provided by the Retirement Systems Division
- 2015 Valuation Reports

<u>North Carolina Office the State Controller</u>
- 2016 Comprehensive Annual Financial Report

<u>North Carolina Department of Revenue</u>
- Data provided by Revenue Research Division

<u>United States Department of Defense</u>
- Data provided by the Office of the Actuary
- FY 2017 Valuation of the Military Retirement System
- FY 2001 – FY 2017 Military Retirement System Statistical Reports

<u>United States Office of Personnel Management</u>
- Data provided by the Data Analysis Group

- FY 2018 Civil Service Retirement and Disability Fund Annual Report
- FedScope Separations FY 2005-FY 2017

Federal Retirement Thrift Investment Board

- Thrift Savings Fund Financial Statements for December 31, 2015 and 2016

United States Census Bureau

- 2017 Annual Survey of Public Pensions
- 2017 American Community Survey

LEGISLATIVE FISCAL NOTE – PURPOSE AND LIMITATIONS

This document is an official fiscal analysis prepared pursuant to Chapter 120 of the General Statutes and rules adopted by the Senate and House of Representatives. The estimates in this analysis are based on the data, assumptions, and methodology described in the Fiscal Analysis section of this document. This document only addresses sections of the bill that have projected direct fiscal impacts on State or local governments and does not address sections that have no projected fiscal impacts.

CONTACT INFORMATION

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April 15, 2019

Official
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Publication

Signed copy located in the NCGA Principal Clerk's Offices