NORTH CAROLINA GENERAL ASSEMBLY

2023 Session

Legislative Fiscal Note

Short Title: Eliminate Tax on Gov't Retirees.
Bill Number: House Bill 46 (First Edition)
Sponsor(s): Rep. Cleveland, Rep. Iler, Rep. Hardister, and Rep. White

SUMMARY TABLE

FISCAL IMPACT OF H.B. 46, V.1 ($ in millions)

	FY 2023-24	FY 2024-25	FY 2025-26	FY 2026-27	FY 2027-28
State Impact					
Personal Income Tax	(97.8)	(204.6)	(220.8)	(235.9)	(255.1)
Less Expenditures	-	-	-	-	-
General Fund Impact	**(97.8)**	**(204.6)**	**(220.8)**	**(235.9)**	**(255.1)**
NET STATE IMPACT	**($97.8)**	**($204.6)**	**($220.8)**	**($235.9)**	**($255.1)**

FISCAL IMPACT SUMMARY

House Bill 46 reduces revenue collections by providing a State income tax exemption for payments made from a federal, North Carolina State, or North Carolina local government retirement plan that are not already exempt under current law.

The Fiscal Research Division (FRD) estimates this bill would reduce General Fund revenue from individual income tax by $97.8 million in FY 2023-24 and $204.6 million in FY 2024-25. Because the deduction would be effective for taxable years beginning on or after January 1, 2024, the impact in FY 2023-24 is estimated to be approximately half of the tax year 2024 cost. In FY 2027-28, the estimated cost increases to $255.1 million.

FISCAL ANALYSIS

BACKGROUND

Certain retirement income is exempt from taxation under current law. In *Bailey v. State of North Carolina*, the Court held that government retirement benefits paid to former employees of the State of North Carolina, its local governments, and the federal government who vested in their governmental benefit plan prior to August 12, 1989, as well as to their survivor beneficiaries, are exempt from State income tax. In addition, current law provides a State income tax exemption for retirement benefits paid to former members of the uniformed services who served at least 20 years or who were medically retired, as well as payments to their beneficiaries from the Survivor Benefit Plan.

This bill exempts all distributions from a federal, North Carolina State, or North Carolina local governmental retirement plan, regardless of the vesting date, years of service, the reason for the distribution, or whether the plan was included in the Bailey Settlement. In general, distributions due to termination of employment or death prior to retirement would be exempt from taxation; however, Survivor Benefit Plan payments made to beneficiaries of retired members of the uniformed services of the United States who were not medically retired and served fewer than 20 years would continue to be taxable. Payments from an out-of-state governmental retirement plan would also continue to be taxable.

ASSUMPTIONS AND METHODOLOGY

Fiscal Research determined the fiscal impact of this bill by:

1. Estimating the total amount that State, local, and federal governmental retirement systems expect to pay to North Carolina taxpayers for tax years 2024-2028.
2. Estimating the share of future retirement plan distributions that would be taxable under current State law.
3. Estimating the reduction in tax liability resulting from exempting these distributions from taxation.

The fiscal impact is calculated by multiplying the estimated amount of exempted income by the estimated average effective tax rate applicable to filers with qualifying retirement income. This rate is calculated based on the estimated average payment from each category of qualifying retirement system, estimated total average taxable income for taxpayers who would qualify for the deduction, the standard deduction, and the individual income tax rate in effect each tax year (which declines from 4.6% in 2024 to 3.99% in 2027). To translate the impacts from tax year to fiscal year, FRD assumes that the majority of tax revenue derived from retirement income is withheld from monthly pension benefit payments and remitted to the Department of Revenue at roughly the same time as the payments are made. As such, the revenue impact from each tax year would be evenly distributed between the first half of the calendar year and the second, and thus equally distributed between each fiscal year that it overlaps.

This analysis estimates of the total amount of taxable distributions exempted by this bill for three categories of qualifying retirement systems:

1) State-Administered Retirement Systems in North Carolina
2) Locally Administered Retirement Plans in North Carolina
3) Federal Retirement Systems

The methodologies for each category are described below.

<u>State-Administered Retirement Systems in North Carolina</u>

The North Carolina Department of State Treasurer (DST) administers the defined benefit pension plans and supplemental retirement savings plans that cover most State and local governmental employees in North Carolina. The revenue impact resulting from exempting retirement income from qualifying plans covering State employees amounts to approximately $32.3 million in FY

2023-24 and $67.8 million in FY 2024-25. This constitutes about 33% of the impact of this bill over the biennium. The impact of exempting retirement income from plans covering local governmental employees, including locally administered plans described in the next section, is approximately $21.2 million is FY 2023-24, and $44.7 million in FY 2024-25. This represents around 22% of the bill's impact over the biennium.

Most North Carolina State and local governmental employees are covered by one of four major defined benefit pension plans administered by DST. The Department provided data on the amount of benefits paid from these four plans in 2022 to retirees and beneficiaries who were and were not eligible for tax-free retirement benefits under the Bailey Settlement. Fiscal Research used these data to determine the total amount of benefits paid from these plans, as well as the share of these benefits that are taxable under current law.

Fiscal Research used recent plan financial statements to estimate the amount of North Carolina governmental retirement income that was paid out of other qualifying plans, including the State-managed defined contribution plans. Given that the four major pension plans provide nearly 92 percent of all distributions from plans administered by DST, this analysis assumes that the growth rates and the taxable share of this retirement income is consistent with that of the four major plans. Growth rates and taxable share projections based on data provided by DST offered much greater detail than was available for the smaller plans.

To project the amount of future retirement income expected to be paid from the four major North Carolina retirement systems in tax years 2023 to 2028, Fiscal Research used the actual amount of benefits paid in 2022 and the projected future benefit payments using the annual growth rate projections given in each plan's actuarial valuation and assumed an additional 1% benefit increase each year to account for any future Cost-of-Living Adjustments or other benefit increases.

The share of retirement income that is subject to State income tax increases each year because new retirees are less and less likely to have vested in their retirement plan by 1989 and therefore meet the criteria for a tax exemption under current State law (the "Bailey Settlement"). According to data from the Department of State Treasurer, the percentage of retirement benefits that are taxable has increased from 9% in 2006 to 51% in 2022. To estimate the future increase in the share of projected retirement income expected to be taxable in tax years 2023 through 2028, Fiscal Research analyzed a database of public records maintained by DST that includes information about each North Carolina Retirement Systems member's retirement benefits and first year of employment. By assuming no breaks in service during the first five years of employment, FRD can project the share of total retirement income that would be taxable each year from 2023 to 2028. Importantly, analysis of the data revealed substantial differences in the current share of taxable retirement benefits between State and local pension plans: Taxable retirement income made up 47 percent of State pension benefits in tax year 2022 compared to 63 percent of local pension benefits. Projections of the taxable share of retirement income for State retirement systems (TSERS, CJRS, and LRS) were therefore calculated separately from projections of the major local pension plan (LGERS). These projections were then calibrated to actual payroll data provided by DST for both State and local pension plans to minimize error.

Locally Administered Retirement Plans in North Carolina

This bill also exempts income from retirement plans administered by local governmental employers in North Carolina from State income tax. Such plans primarily include locally administered supplemental retirement savings plans like 457 plans, as well as 403(b) plans offered to local school district employees.

There are a very large number of distinct retirement savings plans offered by North Carolina's local governmental employers, and FRD was not provided data on total plan assets or annual distributions from any of these plans in a timely fashion. Instead, Fiscal Research attempted to provide a rough estimate using a patchwork of methods and figures from ancillary sources. To estimate the amount of taxable retirement income paid to retirees in NC from locally administered supplemental retirement plans, Fiscal Research first reviewed economic research and analysis on North Carolina public sector workers' retirement savings behavior and plan offerings in a sample of State agencies as well as a sample of local school districts to provide approximate measures of typical employee contributions to retirement savings plans. Next, we used survey data from the 2021 NC County Salary Survey conducted by the University of North Carolina School of Government to estimate the amount that local governmental employers contribute to employees' retirement savings plans. We then incorporated data from the 2021 Annual Survey of Public Employment & Payroll to estimate the total annual contributions made to local governmental employees' retirement savings plans. This analysis assumes that the ratio of annual contributions to annual distributions for the State-administered retirement savings plans – the NC 401(k) Supplemental Retirement Income Plan and the NC 457 Deferred Compensation Plan – is consistent with that of these locally administered retirement savings plans.

Federal Retirement Systems

This bill exempts retirement income from qualifying federal retirement plans covering both civilian governmental employees as well as military retirement income paid to a small class of retirees whose retirement income is not already exempt under State law. FRD estimates that exempting federal governmental retirement income will reduce revenue by approximately $44.3 million in FY 2023-24 and $92.1 million in FY 2024-25. This represents 45% of the total revenue impact of this bill over the biennium.

Civilian Plans

The US Office of Personnel and Management (OPM) administers most of the retirement plans covering federal employees. The two plans most relevant to this analysis are the Federal Employees' Retirement System (FERS), which provides defined benefit pension benefits to eligible retirees, and the Thrift Savings Plan, which provides a defined contribution retirement savings plan funded through both employer and employee contributions.

OPM provided the total amount of retirement benefits from all federal retirement plans paid to NC residents in fiscal year ending September 30, 2021. To estimate the share of federal retirement benefits paid to all federal retirees in the United States who were vested as of August 1989, and therefore who qualify for tax-free retirement benefits, Fiscal Research first assumes that all retirees covered under the Civil Service Retirement System (CSRS) were vested as of August 1989, and that no retirees covered by the Federal Employees' Retirement System were vested by August 1989. Thus, under current State law, no CSRS retirement benefits would be taxable, but all FERS retirement benefits would be taxable. We then drew figures from OPM's Civil Service Retirement and Disability Fund (CSRDF) Annual Report for Fiscal Year Ended September 30, 2021, and the Thrift Savings Fund Financial Statements for December 31, 2021, and 2020 to determine the proportion of FERS retirement benefits to CSRS retirement benefits as an approximation of the taxable and non-taxable shares of retirement income paid to all federal retirees in the US. This analysis also assumes that the proportion of estimated taxable retirement benefits paid to federal retirees across the US is the same as the proportion paid to federal retirees in NC, and applies this share to the total amount of federal retirement benefits paid to NC retirees provided by OPM to arrive at NC's portion of the estimated taxable share of federal retirement income.

FRD also adjusted the share of taxable federal retirement income upward to account for benefits paid from smaller federal plans not included in the total benefits provided by OPM. This adjustment is based on a report from the U.S. Government Accountability Office examining the population of federal retirees that indicated fewer than four percent of retired federal employees were covered by plans other than the Federal Employees' Retirement System (FERS) and the Civil Service Retirement System (CSRS).

To project the amount of defined benefit federal retirement benefits NC retirees will receive from tax year 2022 to 2028, this analysis starts with the expected growth rate in expected future benefit payments each year from the CSRDF Annual Report. Next, we increase this growth rate by 1% to account for the faster-than-average growth in the federal retiree population in North Carolina compared to the rest of the nation. Additionally, because of the recent and ongoing period of unusually high rates of inflation, this analysis further increases the growth rates to reflect the Cost-of-Living Adjustments (COLAs) provided to members of the Federal Employees Retirement System (FERS). Federal law provides FERS retirees an automatic COLA each year that is indexed to the CPI; given recent inflation, FERS retirees have received COLAs well in excess of the two percent COLA assumed in the plan's 2021 actuarial valuation in recent years. For defined contribution benefits from the Thrift Savings Plan, estimated benefits are projected using the annual average growth rate since 2014.

Uniformed Services Plans

Current law provides a tax exemption for retirement benefits paid to former members of the uniformed services who served at least 20 years or who were medically retired. Because virtually all non-medically retired servicemembers are required to attain 20 years of service to be eligible for retirement, current law already provides an exemption for the vast majority of payments from the uniformed services retirement systems. However, some exceptions to the 20-year requirement do exist. For this analysis, the most important exceptions are 1) early retirement benefits paid through the Temporary Early Retirement Authority (TERA) program, and 2) distributions from the defined contribution component of the new "Uniformed Services Blended Retirement System."

Expanding the exemption to include pay to servicemembers with fewer than 20 years of service who are not medically retired to is expected to reduce revenue by less than $2.5 million annually during the first five years it is effective. The estimated cost was determined using the data and assumptions underlying FRD's 2021 fiscal note accompanying S.L. 2021-180 (Senate Bill 105, v.4) about the share of military retirement income that is exempt under the "Bailey Settlement" and the estimated average effective rate applicable to filers who received income from the Military Retirement System. These assumptions were combined with the following information to develop annual estimates.

The Temporary Early Retirement Authority program has periodically permitted certain servicemembers to apply for early retirement benefits after only 15 years of service. This program is only available on a limited basis and must be approved by the Secretary of each branch of service. It was authorized from 1993-2002, and again in 2012. It is expected to end by 2025. Approximately two percent of the total benefits paid from the Military Retirement System in FY 2020-21 were to TERA retirees. Since 2013, the average annual growth rate in TERA benefit dollars has been approximately four percent.

Starting in 2018, new recruits were enrolled in the Uniformed Services Blended Retirement System (BRS), which allows some benefits to be paid to those who leave prior to attaining 20 years of service. Members who had served for fewer than 12 years as of December 31, 2017, had the option to "opt-in" to BRS via an irrevocable election in 2018. During the analysis period, most of the benefits that would be taxable under current law are expected to come from the defined contribution component of the new plan, which is offered through the same Federal Thrift Savings Plan that covers civilian employees. As of September 2022, BRS Participants held less than one percent of the total assets in the Thrift Savings Plan. However, as the Thrift Savings Plan is now a core component of new recruits' retirement benefit package, it is expected that servicemembers' share of TSP assets will grow considerably in future years.

TECHNICAL CONSIDERATIONS

N/A

DATA SOURCES

North Carolina Retirement Systems, Department of State Treasurer
North Carolina Department of Revenue
North Carolina Office of the State Controller
FRD Individual Income Tax Microsimulation Model
Moody's Analytics
United States Office of Personnel Management
University of North Carolina, Chapel Hill - School of Government
Federal Retirement Thrift Investment Board
United States Census Bureau
North Carolina Supplemental Retirement Plans
United States Department of Defense, Office of the Actuary

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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