Fiscal Note 2015 Biennium

GOVERNOR'S OFFICE OF BUDGET AND PROGRAM PLANNING

Bill #	HB0049	**Title:**	Exempt military pensions from state income tax
Primary Sponsor:	Ingraham, Pat	**Status:**	As Amended in House Committee

- ☐ Significant Local Gov Impact
- ☐ Needs to be included in HB 2
- ☑ Technical Concerns
- ☐ Included in the Executive Budget
- ☐ Significant Long-Term Impacts
- ☐ Dedicated Revenue Form Attached

FISCAL SUMMARY

	FY 2014 Difference	FY 2015 Difference	FY 2016 Difference	FY 2017 Difference
Expenditures:				
General Fund	$0	$0	$0	$0
Revenue:				
General Fund	($12,502,145)	($13,081,043)	($13,688,665)	($14,324,319)
Net Impact-General Fund Balance:	($12,502,145)	($13,081,043)	($13,688,665)	($14,324,319)

Description of fiscal impact: This bill as amended would exempt military retirement pay that is based on length of service and survivors benefits from the individual income tax.

FISCAL ANALYSIS

Assumptions:

Department of Revenue

1. Under current law, military disability payments are exempt from federal and state taxation, but retirement pay based on length of service and survivor benefits generally are taxable. This bill would exempt military retirement pay and military survivor benefits from the state income tax beginning in CY 2013.
2. The Department of Defense periodically produces a compilation of reports called "Military Compensation Background Papers." The latest edition, published in 2011, includes information through federal fiscal year 2009. The following table shows the number of persons drawing pensions based on active service and service in the reserves and the number receiving survivor's benefits in 2009. For each group, it shows the average pension amount in 2009.

	Regular Retirees		Reserve Retirees		Survivors	
	number	average pension	number	average pension	number	average benefit
2009	1,467,445	$26,943	344,393	$13,489	341,114	$14,526

3. The Department of Veterans Affairs Annual Benefits Report for federal fiscal year 2011 provides an estimate of 100,904 veterans living in Montana out of a national total of 22,234,242. Based on these estimates, Montana has 0.454% of the national veteran population. This fiscal note assumes that Montana has the same percent of the military retiree and survivor populations.
4. The number of individuals receiving retirement and survivor's benefits will grow over time. Average benefits will grow over time as individual benefits are increased by one percentage point less than the inflation rate each year, as new retirees enter the system, and as older retirees die. This fiscal note assumes that the numbers of recipients and average benefits will continue to grow at the average growth rates for the period 2001 to 2009, which are shown in the following table.

	Regular Retirees		Reserve Retirees		Survivors	
	number	**average pension**	**number**	**average pension**	**number**	**average benefit**
average annual growth rate 2001 - 2009	0.85%	3.43%	4.49%	2.90%	1.13%	3.09%

5. The following table shows the number of recipients, average benefits, and total benefits in 2013 through 2016 assuming growth at the rates in assumption #4, starting from the base shown in assumptions #2 and #3.

	Regular Retirees		Reserve Retirees		Survivors		Total Benefits
	number	**average pension**	**number**	**average pension**	**number**	**average benefit**	
2013	6,888	$30,832	1,863	$15,121	1,619	$16,404	$267,102,102
2014	6,947	$31,889	1,946	$15,560	1,637	$16,910	$279,488,663
2015	7,005	$32,982	2,034	$16,011	1,656	$17,432	$292,475,684
2016	7,065	$34,113	2,125	$16,475	1,674	$17,970	$306,094,088

6. A portion of military pension benefits are exempt from income tax under current law. All taxpayers with federal adjusted gross income of $31,920 or less can exempt the first $3,830 of pension income in 2012. For taxpayers with higher incomes, the exemption is reduced by $2 for every $1 that the taxpayer's federal adjusted gross income exceeds $31,920, and the exemption is completely phased-out for federal adjusted gross income over $33,835. Both the exemption amount and the phase-out threshold are adjusted annually for inflation. The average pension for regular service retirees is expected to be above the exemption phase-out threshold most years, but some regular service retirees will have incomes below the threshold. The average reservist pension and the average survivor's benefit are expected to be less than the threshold, but some of these taxpayers will have other income that puts them above the threshold. This fiscal note assumes that the total amount of military pensions and survivor's benefits that would be exempt under current law is approximately equal to the number or reserve retirees and survivors multiplied by the exemption amount. This is shown in the following table.

	Reserve Retirees and Survivors	Pension Exemption Amount	Current Law Pension Exemption
2013	3,482	$3,880	$13,508,890
2014	3,583	$3,950	$14,153,111
2015	3,689	$4,016	$14,815,147
2016	3,799	$4,090	$15,539,942

7. The total tax reduction from this bill depends on the other income of affected taxpayers, which is unknown. For any individual affected by this bill, the reduction in tax liability depends on the amount of the pension that this bill would exempt and the amount and type of the person's other income. A single person over age 65 with no income other than an average survivor's benefit would have a tax reduction of about 1.6% of the amount of the pension. This person would be in the 3% rate bracket under current law, and would be moved to owing no tax by having less than half the pension exempted. A person with an average pension for a regular retiree and the same amount of income from another pension would have a tax reduction of about 7.8% of the amount of the military pension. This person would be in the 6.9% rate bracket, and exempting the military pension would reduce this person's adjusted gross income below the phase-out threshold for partial exemption of the other pension.
8. The ratio of total tax reductions to total increases in exempt income was calculated for a range of scenarios, where affected taxpayers were assumed to have other income between 0% and 100% of their military pensions and where that other income was and was not assumed to be from another pension. The average ratio of total tax reductions to total increases in exempt income was 4.93%. This fiscal note assumes that this ratio would hold if this bill were enacted.
9. The following table shows the net increase in exempt pension income from this bill, which is total military retirement benefits from assumption #5 less the portion exempt under current law from assumption #6, and the resulting reduction in income tax liability.

	Net Increase in Exempt Pension Income	Total Reduction in Income Tax Liability
2013	$253,593,212	$12,502,145
2014	$265,335,552	$13,081,043
2015	$277,660,538	$13,688,665
2016	$290,554,145	$14,324,319

10. For affected taxpayers, the change in tax liability is significant enough that most would eventually reduce their estimated payments or withholding in line with their reduced tax liabilities. However, affected taxpayers are likely to make this change over several years as they find they are receiving larger-than-expected refunds. Each calendar year tax liability reduction in assumption #9 is therefore assumed to translate into reduced revenue in the next fiscal year.
11. Changes to tax forms and instructions would be made as part of the normal annual update process with no additional costs.

Fiscal Impact: **Department of Revenue**	**FY 2014 Difference**	**FY 2015 Difference**	**FY 2016 Difference**	**FY 2017 Difference**
Expenditures:				
TOTAL Expenditures	$0	$0	$0	$0
Funding of Expenditures:				
TOTAL Funding of Exp.	$0	$0	$0	$0
Revenues:				
General Fund (01)	($12,502,145)	($13,081,043)	($13,688,665)	($14,324,319)
TOTAL Revenues	($12,502,145)	($13,081,043)	($13,688,665)	($14,324,319)
Net Impact to Fund Balance (Revenue minus Funding of Expenditures):				
General Fund (01)	($12,502,145)	($13,081,043)	($13,688,665)	($14,324,319)

Technical Notes:

1. In the U.S. Supreme Court case *Davis v. Michigan Dep't of Treasury*, 489 U.S. 803, 109 S.Ct. 1500, 103 L.Ed.2d 891 (1989), the Court held that the Michigan tax that favored retired state employees based on the source of their retirement benefits, the tax violated principals of intergovernmental tax immunity. Following this case, federal employees sued the State of Montana on existing law that exempted from income taxation all retirement benefits paid to teachers and state government retirees, while taxing benefits paid to federal retirees. *Sheehy v. State, Dep't of Revenue*, 250 Mont. 437, 820 P.2d 1257 (1991). Based on *Davis*, the parties stipulated that the tax was invalid and the state issued refunds to federal retirees in the amount of $15.7 million.

Sponsor's Initials	*Date*	*Budget Director's Initials*	*Date*