

**LEGISLATIVE SERVICES AGENCY
OFFICE OF FISCAL AND MANAGEMENT ANALYSIS**

301 State House
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FISCAL IMPACT STATEMENT

LS 8000
BILL NUMBER: SB 560

DATE PREPARED: Jan 21, 2001
BILL AMENDED:

SUBJECT: Taxation of Federal Retiree Benefits.

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FUNDS AFFECTED: **GENERAL**
DEDICATED
FEDERAL

IMPACT: State & Local

Summary of Legislation: This bill provides an Adjusted Gross Income (AGI) Tax deduction for the part of a federal government pension (including a military pension) equal to the difference between:

- (1) the maximum benefits payable under Social Security that could have been excluded from federal gross income for the year; minus
- (2) the Social Security benefits actually received by the taxpayer during the year.

The bill also provides that a taxpayer may not claim both this deduction and the existing military service deduction or federal civil service deduction.

Effective Date: January 1, 2002.

Explanation of State Expenditures: The Department of State Revenue (DOR) will incur some administrative expenses related to the revision of tax forms, instructions, and computer programs to incorporate this deduction. These expenses could be absorbed given the DOR's existing budget and resources.

Explanation of State Revenues: This bill provides an Individual AGI Tax deduction for recipients of federal civil service pensions and military pensions. A taxpayer would be permitted to deduct the amount of civil service and military pension benefits included in the taxpayer's federal AGI. However, the deduction may not exceed (1) the civil service or military benefits that would have been tax-exempt if they had been treated as Social Security benefits; minus (2) the amount of Social Security benefits actually received. A taxpayer may only take the deduction established by this proposal *or* the existing military service deduction or federal civil service deduction.

No data is available regarding the average Social Security benefits received by individuals receiving income from military or civil service pensions or the amount of benefits payable under Social Security that could

have been excluded from federal gross income for the year. The estimations below reflect the impact associated with this proposal assuming *all* income from these sources would be deducted. *Based on these projections, state revenue could be reduced by as much as \$30.2 M in FY 2003.* The actual fiscal impact would be reduced to the extent to which these taxpayers (or their spouses) receive Social Security benefits. The impact could also be reduced if the pension income exceeds the maximum amount of benefits payable under Social Security that could have been excluded from federal gross income for the year.

Civil service annuities: If all civil service annuity income was deducted from state taxable income, the corresponding loss of revenue in FY 2003 would be \$20.8 M. According to the Federal Office of Personnel Management, there were approximately 25,000 federal retirees and 8,900 surviving spouses who resided in Indiana in 1999. These individuals received approximately \$600 M in civil service annuity income. Based on 1998 DOR income tax data, 4,335 taxpayers were able to claim the current \$2,000 maximum deduction for a total of \$7.7 M deducted from state taxable income. This resulted in a revenue loss of \$262,800 in FY 1999 (\$7.7 M multiplied by the Individual AGI tax rate of 3.4%). The impact projected above assumes a 3% growth rate for civil service annuity income and nets out the effect of the existing \$2,000 deduction.

Military retirement benefits: If all military retirement benefits were deducted from state taxable income, the corresponding loss of revenue would be \$9.3 M in FY 2003. The Department of Defense reports that as of September 1999 there were 21,651 retired military personnel residing in Indiana. 18,796 of these retirees received approximately \$284 M in taxable retirement income in 1999. (Some military retirement income is not taxable at the federal level and would not affect Indiana's individual income taxation.) As noted above, there is a military service income tax deduction of up to \$2,000 for all types of military income, including retirement benefits and active duty pay. It is estimated that the impact of military retirees claiming the existing deduction will be \$1.3 M in FY 2003 (this amount has been subtracted from the net impact above). Military retirement income is estimated to grow at a 3% rate annually. Retirement income for Indiana taxpayers is projected to be \$311.6 M in CY 2002.

Individual AGI Tax revenue is deposited in the General Fund. As this bill is effective January 1, 2002, the fiscal impact to the state will begin in FY 2003.

Explanation of Local Expenditures:

Explanation of Local Revenues: Counties imposing local option income taxes (CAGIT, COIT, and/or CEDIT) may experience an indeterminable decrease in revenue from these taxes as a result of this proposal.

State Agencies Affected: Department of State Revenue.

Local Agencies Affected: Counties imposing local option income taxes.

Information Sources: DOR 1998 individual income tax data; Ed Callicott, Federal Office of Personnel Management (202)606-1782; Mike Dove, Department of Defense, Manpower Data Center, (408) 583-2400.