



**SOUTH CAROLINA REVENUE AND FISCAL AFFAIRS OFFICE**  
**STATEMENT OF ESTIMATED FISCAL IMPACT**  
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**Bill Number:** H. 3147 As amended by the Senate on April 21, 2016  
**Author:** G.M. Smith  
**Subject:** Taxable Income Deductions  
**Requestor:** Senate Finance  
**RFA Analyst(s):** Shuford  
**Impact Date:** April 27, 2016

**Estimate of Fiscal Impact**

	<b>FY 2016-17</b>	<b>FY 2017-18</b>
<b>State Expenditure</b>		
General Fund	\$0	\$0
Other and Federal	\$0	\$0
Full-Time Equivalent Position(s)	0.00	0.00
<b>State Revenue</b>		
General Fund	(\$16,958,909)	\$0
Other and Federal	\$0	\$0
<b>Local Expenditure</b>	\$0	\$0
<b>Local Revenue</b>	\$0	\$0

**Fiscal Impact Summary**

This bill as amended will have no expenditure impact on the General Fund, Federal Funds, or Other Funds. The bill as amended will decrease General Fund individual income tax revenue by \$16,958,909 in FY 2016-17.

**Explanation of Fiscal Impact**

**Explanation of Amendment by the Senate on April 21, 2016**

**State Expenditure**

This amendment provides a deduction from South Carolina taxable income of individuals for retirement benefits attributable to service on active duty in the Armed Forces of the United States for taxpayers age 65 or older, or a deduction of earned income equal to the amount of military retirement pay, not to exceed \$15,000, for taxpayers under age 65. The Department of Revenue estimates that this legislation will increase General Fund expenditures by a minimal amount that can be absorbed within current funding.

**State Revenue**

This amendment adds Section 12-6-1171 to provide an individual income tax deduction of up to \$15,000 of earned income for taxpayers under age 65 that receive military retirement income. The deduction is equal to the amount of military retirement income, not to exceed \$15,000. When a taxpayer reaches age 65, the taxpayer may deduct up to \$30,000 of military retirement income. These additional deductions begin in tax year 2016. Any amount claimed as a deduction in Section 12-6-1171 will reduce the deduction claimed in Section 12-6-1170. This RFA analysis utilizes updated South Carolina specific military retiree data for 2012 through

2015 provided by staff of the Department of Defense, Office of the Actuary and a 2013 tax year sample of federal and state income tax returns from 2013 that is adjusted to tax year 2016.

Since Section 12-6-1171 allows different amounts of retirement income deductions by taxpayers depending on their age, we use Department of Defense data to segregate these taxpayers with military retirement income into two categories: under age 65 and age 65 and older. Taxpayers under age 65 may deduct earned income equal to their military retirement income up to a maximum of \$15,000 per year. Taxpayers age 65 and older may deduct military retirement income of up to \$30,000 per year.

In FY 2016-17, we anticipate 19,338 taxpayers under age 65 with military retirement income. We can estimate earned income eligible for the proposed deduction for these taxpayers from a survey of 2013 tax year data adjusted to tax year 2016. We segregated all income tax returns where retirees currently claim the \$3,000 deduction. We then recalculated these returns by subtracting the proposed maximum \$15,000 deduction. This recalculation accounts for returns with no earned income or amount of earned income less than the proposed maximum \$15,000 deduction. We found that taxpayer returns claiming the current \$3,000 deduction can also deduct an average of \$14,135 in earned income under the proposed deduction. We estimate that returns of the anticipated 19,338 military retirees under age 65 in tax year 2016 will deduct an additional \$14,135 in earned income. At an average tax rate of 3.0%, we expect this proposed deduction would reduce General Fund individual income tax revenue by \$8,200,279 in FY 2016-17.

The average tax rate and the amount of earned income available for the proposed deduction are based on a recalculation of the income tax for each return after the proposed deduction is applied. This method takes into account the taxpayers with no earned income to claim the deduction, the large number of returns that have zero taxable income, returns that are reduced to zero taxable income by the deduction, and returns that do not benefit from the full amount of the proposed deduction.

This analysis is based on tax return data, which may have more than one retiree reporting retirement and earned income. We use this approach for two reasons. First because we have no other data to estimate this revenue impact. Secondly, the bill states that a taxpayer's earned income deduction is from South Carolina taxable income. Taxable income is not specified by taxpayer on jointly filed South Carolina income tax returns. Therefore, we anticipate that the amendment would allow a taxpayer to deduct all earned income on a jointly filed return, regardless of which specific taxpayer may have earned the income, as many court decisions have stated that the taxpayer should receive the benefit of doubt when ambiguity exists. In addition, since taxpayer data is not individually specified on South Carolina income tax returns, we would not be able to determine the revenue impact if this ambiguity were further clarified. Requiring identification of military retirement income and earned income to a specific taxpayer on a joint return would add to taxpayer burden and the complexity of the tax return. Finally, since we have no way to identify military retirees on the federal or state income tax returns, this analysis relies on the premise that the amount of earned income by military retirees under age 65 is similar to the amount claimed by all retirees claiming the current \$3,000 retirement deduction.

The revenue impact of the April 21, 2016, amendment for military retirees age 65 and older is unchanged from the bill as amended by the Senate Finance Sales and Income Tax Subcommittee on March 15, 2015. We expect 17,874 active duty military retirees age 65 or older in FY 2016-17 with military retirement income totaling \$556,478,000. This results in a \$31,133 average annual military retirement benefit. After accounting for the proposed \$30,000 deduction, we estimate that the remaining \$20,255,000 in taxable retirement benefits at an average tax rate of 2.47 percent would generate \$500,299 in individual income tax revenue in FY 2016-17. This amount is \$8,035,350 less than the \$8,535,648 in estimated tax for this age group under the current maximum \$15,000 deduction.

In addition, we anticipate that 11,154 South Carolina taxpayers age 65 and older will receive \$187,963,000 in military retirement from the National Guard and Reserves, for an annual average retirement benefit of \$16,852 in FY 2016-17. While National Guard or Reserve retirement income is not generally taxed in South Carolina, National Guard and Reserve retirement attributable to active duty service is taxable. This adjustment is made by taxpayers on line 3v of the SC 1040 income tax form. Based on an analysis of taxpayers claiming a retirement deduction and having an adjustment on line 3v of the income tax returns, we estimate that approximately 13 percent of this retirement income is from active duty service. Multiplying the \$187,963,000 by 13 percent and applying an average tax rate of 2.96 percent results in an estimated \$723,280 tax liability for taxpayers aged 65 and older. This amount of income tax revenue would be eliminated under the proposed \$30,000 maximum military retirement income deduction.

Combining the revenue impacts of the earned income tax deduction for military retirees under age 65 and the military retirement income deduction for taxpayers age 65 and older results in an estimated reduction in General Fund individual income tax revenue of \$16,958,909 in FY 2016-17.

#### **Local Expenditure**

N/A

#### **Local Revenue**

N/A

### **Explanation of Amendment by Senate Finance Sales and Income Tax Subcommittee on March 15, 2015**

#### **State Expenditure**

This amendment provides a deduction from South Carolina taxable income of individuals for retirement benefits attributable to service on active duty in the Armed Forces of the United States. The Department of Revenue estimates that this legislation will increase General Fund expenditures by a minimal amount that can be absorbed within current funding.

#### **State Revenue**

This amendment strikes all after the enacting words of the bill and adds an individual income tax deduction of up to \$15,000 of military retirement income for taxpayers under age 65 and up to \$30,000 of military retirement income for taxpayers age 65 or older for tax year 2016. Any

amount claimed as a deduction in Section 12-6-1171 will reduce the deduction claimed in Section 12-6-1170. This RFA analysis utilizes updated South Carolina specific military retiree data for 2012 through 2015 provided by staff of the Department of Defense, Office of the Actuary.

Generally, retirement income from active duty military service is taxable in South Carolina, while National Guard or Reserve retirement income is not taxed. However, Guard and Reserve retirement attributable to active duty service is taxable and is one of the adjustments made on line 3v of the SC 1040 income tax form. Also, any retirement income based on disability is excluded from federal and South Carolina income tax. The taxability of the remaining active duty, Reserve, and Guard military retirement income is discussed below.

Since Section 12-6-1171 allows different amounts of retirement income deductions by taxpayers depending on their age, we use Department of Defense data to segregate these taxpayers into two categories: age 65 and older and under age 65. Taxpayers age 65 and older may deduct income of up to \$30,000 per year, while taxpayers under age 65 may deduct retirement income up to \$15,000 per year.

For example, we expect 17,874 active duty military retirees age 65 or older in FY 2016-17 with military retirement income totaling \$556,478,000. This results in a \$31,133 average annual military retirement benefit. After accounting for the proposed \$30,000 deduction, we estimate that the remaining \$20,255,000 in taxable retirement benefits at an average tax rate of 2.47 percent would generate \$500,299 in individual income tax revenue in FY 2016-17. This amount is \$8,035,350 less than the \$8,535,648 in estimated tax for this age group under the current maximum \$15,000 deduction.

In FY 2016-17, we anticipate 19,338 taxpayers under age 65 with military retirement income of \$531,856,000 resulting in an average \$27,503 annual military retirement benefit. After accounting for the proposed \$15,000 deduction, we estimate that the remaining \$241,781,000 in taxable retirement benefits multiplied by an average tax rate of 2.96 percent will generate \$7,156,718 in individual income tax revenue in FY 2016-17. This amount is \$9,427,720 less than the \$16,584,435 in estimated tax for this age group under the current maximum \$3,000 deduction.

As stated earlier, the active duty portion of National Guard and Reserve retirement income is taxable in South Carolina. We anticipate that 11,154 South Carolina taxpayers age 65 and older will receive \$187,963,000 in military retirement, an annual average retirement benefit of \$16,852 in FY 2016-17. Based on an analysis of taxpayers claiming a retirement deduction and having an adjustment on line 3v of the income tax returns, we estimate that approximately 13 percent of this retirement income is from active duty service. Multiplying the \$187,963,000 by 13 percent and applying an average tax rate of 2.96 percent results in an estimated \$723,280 tax liability for taxpayers aged 65 and older. This amount of income tax revenue would be eliminated under the proposed \$30,000 maximum military retirement income deduction.

We estimate further that the 5,212 taxpayers under age 65 with National Guard and Reserve retirement income totaling \$116,093,000 results in a \$22,274 average annual benefit. These

taxpayers will remit an estimated \$528,220 in tax under current statutes after applying an average tax rate of 3.5 percent to the \$116,093,000 of retirement income. After accounting for the proposed \$15,000 deduction, we estimate that these taxpayers would remit \$145,880 in tax, or \$382,340 less in tax compared to current statutes.

The average tax rates used in this analysis are based on a re-calculation of the income tax for each return after the proposed deduction is applied. This method takes into account the large number of returns that have zero taxable income, returns that are reduced to zero taxable income by the deduction, and returns that do not benefit from the full amount of the proposed deduction. The tax rates for the two age groups are different because the larger deduction for age 65 and older further reduces remaining South Carolina income subject to tax.

Combining the revenue impacts of the military retirement deduction for both age groups and different types of military retirement income results in an estimated reduction in General Fund individual income tax revenue of \$18,568,690 in FY 2016-17.

### **Local Expenditure**

N/A

### **Local Revenue**

N/A

## **Explanation of Bill Filed on January 13, 2015**

### **State Expenditure**

This bill provides a deduction from South Carolina taxable income of individuals for retirement benefits attributable to service on active duty in the Armed Forces of the United States.

The Department of Revenue estimates that this legislation will have a minimal expenditure impact on the department from revising forms and instructions. The department will have some additional General Fund expenditures that can be absorbed within their current funding.

### **State Revenue**

#### **Updated on May 14, 2015 to Include Revised Analysis and Additional Revenue Impact**

Sections 2 and 4 of this bill allow a deduction of military retirement benefits attributable to service on active duty in the Armed Forces of the United States for taxable years beginning after 2014 from South Carolina taxable income. This deduction is phased-in over three years, with the deduction being 33.33 percent in tax year 2015. The deduction increases to 66.66 percent in tax year 2016 and reaches 100 percent in tax year 2017.

Based on the latest data from the U.S. Department of Defense, Office of the Actuary, there were 57,755 military retirees in South Carolina as of September 2013 receiving \$1,361,388,000 in annual military retirement benefits. This equates to an average annual retirement benefit of \$23,572 for each retiree in South Carolina.

Since Section 12-6-1170 allows different amounts of retirement income deductions by taxpayers depending on their age, we use Department of Defense data to segregate these taxpayers into two categories: age 65 and older and under age 65. Taxpayers age 65 and older may deduct

retirement income of up to \$15,000 per year, while taxpayers under age 65 may deduct retirement income up to \$3,000 per year.

Adjusting the number of South Carolina military retirees and their retirement income in tax year 2013 to tax year 2015, or FY 2015-16, we anticipate 30,450 taxpayers age 65 or older with military retirement income totaling \$798,214,000. This results in an average \$26,214 annual military retirement benefit. After accounting for the current \$15,000 deduction and any non-taxable retirement income such as disability payments, we estimate that the remaining \$323,210,000 in taxable retirement benefits at an average tax rate of 2.9 percent would generate \$9,373,090 in individual income tax revenue in FY 2015-16. Adjusting this amount for the 33.33 percent deduction allowed in tax year 2015 results in an estimated \$3,124,051 reduction in General Fund individual income tax revenue in FY 2015-16.

We also anticipate 28,717 taxpayers under age 65 with military retirement income totaling \$665,618,000, resulting in an average \$23,179 annual military retirement benefit. After accounting for the current \$3,000 deduction and any non-taxable retirement income such as disability payments, we estimate that the remaining \$557,536,000 in taxable retirement benefits multiplied by an average tax rate of 3.4 percent will generate \$18,956,224 in individual income tax revenue in FY 2015-16. Adjusting this amount for the 33.33 percent deduction allowed in tax year 2015 results in an estimated \$6,318,109 reduction in General Fund individual income tax revenue in FY 2015-16.

The average tax rates used in this analysis are based on a re-calculation of the income tax for each return after the proposed deduction is applied. This method takes into account the large number of returns that have zero taxable income, returns that are reduced to zero taxable income by the deduction, and returns that do not benefit from the full amount of the proposed deduction. The tax rates for the two age groups are different because the larger deduction for age 65 and older further reduces remaining South Carolina income subject to tax.

Combining the revenue impact for these two age groups results in an estimated \$9,442,160 reduction in General Fund individual income tax revenue in FY 2015-16, the first year of the three-year phase-in. The total reduction in General Fund individual income tax revenue in FY 2016-17 with the 66.66 percent deduction is an estimated \$19,698,280. In the final year with the 100 percent deduction, the total reduction in General Fund individual income tax revenue is an estimated \$30,832,254 for FY 2017-18.

The revised analysis and additional revenue impact in this updated fiscal impact statement is from our reexamination of Section 3 that amends Section 12-6-1170(A)(2) for taxable years after 2016 to exclude military retirement income for purposes of the deduction allowed by this section. Section 12-6-1170 allows different amounts of retirement income deductions by taxpayers depending on their age. Significant to this analysis is Section 12-6-1170(B), which states that a taxpayer aged 65 and older is allowed a \$15,000 deduction from South Carolina taxable income reduced by the \$10,000 retirement income deduction. This proposed amendment in Section 12-6-1170(A)(2) would allow taxpayers aged 65 and older to deduct up to the \$15,000 amount allowed without subtracting \$10,000 of military retirement income that will no longer be taxable. This results in an increase in the revenue impact of this bill from our original estimate.

Based on data compiled by the Revenue and Fiscal Affairs Office from a Department of Revenue sample of 2012 federal and state matched returns, we estimate that the 30,450 taxpayers age 65 or older with military retirement income in tax year 2016 would be allowed to deduct an additional \$186,088,000 of South Carolina taxable income compared to the current statute. At an average tax rate of 2.9 percent, this would reduce General Fund individual income tax revenue by \$5,397,000. Adjusting this amount for the 33.33 percent deduction allowed in tax year 2015 results in an estimated \$1,799,000 reduction in General Fund individual income tax revenue in FY 2015-16. By FY 2017-18, these additional deductions are expected to total \$202,064,413 and reduce General Fund individual income tax revenue by \$5,860,000 when the deduction reaches 100 percent.

Combining the revenue impacts of the military retirement deduction and the revision to the maximum \$15,000 deduction allowed in Section 3 of the bill results in an estimated \$11,241,160 reduction in General Fund individual income tax revenue in FY 2015-16, the first year of the three-year phase-in. The total reduction in General Fund individual income tax revenue in FY 2016-17 with the 66.66 percent deduction is an estimated \$23,447,280. In the final year with the 100 percent deduction, the total reduction in General Fund individual income tax revenue is an estimated \$36,692,254 for FY 2017-18.

**Local Expenditure**

N/A

**Local Revenue**

N/A



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Frank A. Rainwater, Executive Director