

DEPARTMENT OF TAXATION

2018 Fiscal Impact Statement

1. **Patron** Bryce E. Reeves

3. **Committee** Senate Finance

4. **Title** Individual Income Tax; Phased-in Subtraction of
Military Retirement Income

2. **Bill Number** SB 480

House of Origin:

X **Introduced**

 Substitute

 Engrossed

Second House:

 In Committee

 Substitute

 Enrolled

5. **Summary/Purpose:**

This bill would provide an individual income tax subtraction for military retirement income. This subtraction would be phased in over a five-year period beginning with a 20 percent subtraction for Taxable Year 2018 and reaching a 100 percent subtraction for Taxable Year 2022 and thereafter.

This bill would be effective for taxable years beginning on or after January 1, 2018.

6. **Budget amendment necessary:** Yes.

7. **Fiscal Impact Estimates are:** Preliminary. (See Line 8.)

8. **Fiscal implications:**

Administrative Costs

The Department of Taxation ("the Department") has not assigned any administrative costs to this bill because the changes required by a single bill such as this can be implemented as part of the annual changes to our systems and forms. As stand-alone legislation, the Department considers implementation of this bill as "routine," and does not require additional funding.

The Department will provide specific administrative costs on any legislation that is not "routine." Additionally, the Department will review all state tax legislation likely to be enacted prior to the passage by each house. If the aggregate number of routine bills likely to pass either house is unusually large, it is possible that additional resources will be required. If so, the Department will identify the costs at that time.

Revenue Impact

Based on data from the Department of Defense, this bill is estimated to decrease General Fund revenues by approximately \$115.97 million in Fiscal Year 2019, \$142.58 million in Fiscal Year 2020, \$195.84 million in Fiscal Year 2021, \$231.47 million in Fiscal Year 2022, \$245.52 million in Fiscal Year 2023, and \$251.67 million in Fiscal Year 2024. According to the "Fiscal Year 2016 Department of Defense Statistical Report on the Military Retirement System," there were 160,485 Virginia retirees receiving retirement compensation paid by the Department of Defense or the Department of Homeland Security in 2016.

9. Specific agency or political subdivisions affected:

Department of Taxation

10. Technical amendment necessary: No.

11. Other comments:

Federal Law

A military retiree (generally, a service member who serves 20 years or more in the military) typically qualifies for military retirement pay and certain other veterans benefits. The amount of military retirement pay a military retiree receives is based on a formula or scale that factors in the person's military rank at retirement and the person's length of military service. Military retirement pay is determined and paid by the U.S. Defense Finance and Accounting Service ("DFAS"). DFAS is an agency of the United States Department of Defense.

As a general rule, pension income is taxable. Therefore, military retirement pay received from DFAS that is based on age, length of service, or rank is taxable under federal law, regardless of whether a military retiree is disabled. Concurrent Retirement and Disability Payments ("CRDP") received from DFAS are also taxable pursuant to federal law, because such payments are intended to recover the retirement pay that military retirees waive to receive VA disability compensation.

In contrast, federal law exempts from taxation certain benefits or compensation received under any law administered by the VA. VA disability compensation received from the VA by any veteran—including a military retiree—is exempt from taxation under federal law.

Federal law also exempts from taxation any pension income, annuities, or similar allowances for personal injuries or sickness resulting from active service in the armed forces of any country. Except for taxpayers who were entitled to receive pension income, annuities, or similar allowances for personal injuries or sickness on or before September 24, 1975, or who were members of the armed forces of any country (or a reserve component thereof) or under a binding written commitment to become such a member on September 24, 1975, such exemption is only allowed to the extent that:

- The taxpayer received such income by reason of a combat-related injury;
- The taxpayer would be entitled to receive disability compensation from the Department of Veterans Affairs if they applied; or
- The taxpayer received such income on account of personal physical injuries or physical sickness.

Combat-Related Special Compensation ("CRSC") payments received from DFAS are exempt under federal law, because military retirees receive such payments by reason of their combat-related injuries. Military retirement pay received from DFAS that is based on a disability is not taxable to the extent that such pay meets one of the tests above.

Military retirement pay received from DFAS based on disability is generally taxable unless the taxpayer received such income by reason of a combat-related injury; the taxpayer would be entitled to receive disability compensation from the Department of Veterans Affairs if he applied; or the taxpayer received such income on account of personal physical injuries or physical sickness.

Other States

At least 34 states offer some form of tax benefit to taxpayers receiving military retirement compensation, and these states generally do not limit such tax benefits to taxpayers with a military 100 percent service-connected disability. Of these jurisdictions, 14 states (Alabama, Hawaii, Illinois, Kansas, Louisiana, Massachusetts, Michigan, Mississippi, Missouri, New Jersey, New York, Ohio, Pennsylvania, and Wisconsin) exempt military retirement compensation from personal income tax, although this number includes states that provide benefits for a broad range of retirement income. The remaining 21 states allow taxpayers to exclude a specified amount of military retirement compensation from their income.

Of the jurisdictions surrounding Virginia, Maryland offer exemptions ranging from \$5,000 for those under age 65 to \$10,000 for those ages 65 or older. North Carolina offers a full exemption for retirees with five years of service as of August 12, 1989. In addition, Kentucky and West Virginia offer exemptions of \$41,110 and \$20,000, respectively.

Virginia's Military Tax Preferences

Since the starting point for determining an individual's Virginia income tax is federal adjusted gross income, any income exempt for federal income tax purposes is generally exempt for Virginia income tax purposes.

In addition, taxpayers may subtract the following military-related items for the purposes of computing Virginia taxable income:

- Wages or salaries received for service in the Virginia National Guard, not exceeding income for thirty-nine days of service or \$3,000, whichever is less. This subtraction only applies to persons in the ranks of O3 and below.
- All military pay and allowances earned while serving in a combat zone or qualified hazardous duty area, to the extent they were included in federal adjusted gross income.
- \$15,000 of military basic pay for military personnel on extended active duty for periods in excess of ninety days. The subtraction amount is reduced dollar-for-dollar by the amount which the taxpayer's military basic pay exceeds \$15,000 and will be reduced to zero if such pay is equal to or exceeds \$30,000.
- Any amount received as military retirement income by an individual awarded the Congressional Medal of Honor.
- The amount of military death gratuity payments received after September 11, 2001, by survivors of military personnel who are killed in the line of duty. This subtraction amount must be reduced dollar-for-dollar by the amount that is allowed as an exclusion from federal adjusted gross income to the survivor on his or her federal income tax return.

For taxable years beginning on or after January 1, 2011, Virginia exempts from taxation the real property, including the joint real property of a husband and wife, and the land, not exceeding one acre, upon which the real property is situated of any military veteran who has been rated by the VA to have a 100 percent service-connected, permanent, and total disability, and who occupies the real property as his or her principal place of residence. The surviving spouse of a veteran may also qualify for this exemption, so long as the following conditions are met: the veteran's death

occurred on or after January 1, 2011; the surviving spouse does not remarry; and the surviving spouse continues to occupy such real property as his or her principal place of residence.

Virginia's Age and Disability Tax Preferences

Taxpayers age 65 and older may claim an additional \$800 personal exemption. Certain taxpayers may also qualify for an age deduction of up to \$12,000. For taxpayers born on or before January 1, 1939, the amount of the age deduction is \$12,000. For taxpayers born after January 1, 1939, who have attained the age of 65, the amount of the age deduction is means-tested. Accordingly, the \$12,000 age deduction is reduced dollar-for-dollar for single taxpayers whose income exceeds \$50,000 and for married taxpayers whose combined income exceeds \$75,000.

Taxpayers who are totally and permanently disabled may exclude up to \$20,000 of disability income, as defined under federal law, in calculating Virginia taxable income. Taxpayers may claim either an age deduction or a disability deduction, but not both.

Proposed Legislation

This bill would provide an individual income tax subtraction for military retirement income. This subtraction would be phased in over a five-year period beginning with a 20 percent subtraction for Taxable Year 2018 and reaching a 100 percent subtraction for Taxable Year 2022 and thereafter. The subtraction would increase by twenty percent each year as provided in the chart below:

Taxable Year	Subtraction Amount
2018	20 percent
2019	40 percent
2020	60 percent
2021	80 percent
2022 and after	100 percent

This bill would prohibit individuals from claiming both the Congressional Medal of Honor subtraction and this subtraction for the same taxable year.

This bill would be effective for taxable years beginning on or after January 1, 2018.

Similar Bills

House Bill 792 would allow a subtraction for military retirement income received by certain disabled veterans whose income is not in excess of 150 percent of the federal poverty level for a four-person household.

Senate Bill 473 would allow a subtraction for military retirement income received by certain disabled veterans whose income is not in excess of 250 percent of the federal poverty level for a four-person household.

cc: Secretary of Finance

Date: 1/28/2018 RWC

