

**REPORT ON EXEMPTING
PRIVATE EMPLOYER RETIREMENT
INCOME FROM STATE TAXATION**

RESEARCH MEMORANDUM NO. 462

LEGISLATIVE RESEARCH COMMISSION

December, 1991

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PRIVATE EMPLOYER RETIREMENT
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Prepared by:

C. Gilmore Dutton
Terry Jones
Pamela J. Lester

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TO: Senator Michael R. Moloney
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Interim Joint Committee on
Appropriations and Revenue

FROM: C. Gilmore Dutton
Staff Administrator
Appropriations and Revenue Committee

DATE: December 18, 1991

SUBJECT: Results of a Study on the Cost of Exempting
Private Employer Retirement Income From
State Taxation

The Legislative Research Commission was directed by 1990 Senate Resolution 196 to study the fiscal and economic development impacts of providing an exemption from state taxation for private employer retirement income, with the results to be reported to the Interim Joint Committee on Appropriations and Revenue. Due to an absence of data, the study was limited to the fiscal (revenue) effects of the exemption, but was expanded to include all retirement pay, both private and public. The results are hereby transmitted.

Terry Jones and Pam Lester, staff to the Interim Joint Committee on Appropriations and Revenue, were responsible, respectively, for the fiscal analysis and legal research and text of the report.

AN ANALYSIS OF THE FISCAL IMPACT OF PROVIDING AN INCOME TAX EXEMPTION FOR RETIREMENT PLAN INCOME

Introduction

Senate Resolution 196, adopted by the Senate during the 1990 Regular Session of the General Assembly, directed the Legislative Research Commission to study the impact of providing a \$20,000 income tax exemption to all retired persons living in Kentucky. The study request was prompted by the enactment of Senate Bill 4 during the 1990 Session, which fully exempted federal retirement plan income, as well as income from a few remaining local public employee retirement plans, from state income taxation.

Senate Bill 4 was enacted in response to the 1989 decision of the United States Supreme Court in *Davis v. Michigan*, in which the Court held that the constitutional doctrine of intergovernmental tax immunity and the Public Salary Tax Act of 1939 prevent a state from taxing retirement benefits received by federal civil service retirees differently than it taxes retirement benefits received by state and local retirees. At the time *Davis* was decided, Kentucky was one of 24 states that offered a more attractive income tax exemption to retired state employees than that offered to retired federal employees. Retirement benefits received by state and local retirees were, in most cases, fully exempt from the imposition of Kentucky income tax, while retirement benefits received by federal and military employees were only partially exempt.

Faced with a taxing scheme very similar to one declared unconstitutional by the United States Supreme Court, the 1990 General Assembly took action, in anticipation of a Kentucky court mandate to provide equal treatment to federal, state and local government retirees under Kentucky law. In order to bring Kentucky's taxing scheme in compliance with the holding in *Davis*, the General Assembly had to pass legislation which would tax equally retirement plan income received by state, local and federal retirees. Of the several options that would have satisfied the mandate of *Davis*, the Kentucky General Assembly elected to fully exempt federal retirement benefits from the Kentucky income tax. Thus, Kentucky law currently exempts retirement plan income received by all state, local and federal retirees from state income taxation, while fully taxing retirement income received by retirees under private retirement plans.¹

In Senate Resolution 196, the Senate expresses concern over the fact that retirees living in Kentucky are not all afforded the same exemption from Kentucky's income tax. The Resolution states that "it is the intention of the General Assembly and of the Commonwealth to provide fair and equitable treatment through taxation to all retired persons residing in our state." The Resolution further states that "this segment of our population has made and continues to make a valuable contribution to the social and economic fabric of our Commonwealth."

The following study examines the following areas and issues:

- The history of the exemption and taxation of retirement benefits in Kentucky.
- The issues considered in the enactment of 1990 SB 4, and the genesis of 1990 SR 196.
- The treatment of income received from private retirement plans by other states for income tax purposes.
- The effects of the United States Supreme Court decision in Davis v. Michigan on the various states.
- The “cost” of exempting income received from private retirement plans from Kentucky’s individual income tax, using the following parameters:
 - Absolute exemption for income received from a retirement plan. The cost of exempting private, state, federal and total income received from a retirement plan based upon an absolute amount of retirement income, beginning at \$5,000, and increasing in \$5,000 increments through \$30,000.
 - Exemption based upon total amount of income. The cost of exempting private, state, federal, and total income received from a retirement plan based upon the total amount of income from whatever source, with retirement plan income being exempt from income taxation to the extent that gross income from other sources is less than a statutory gross income threshold, with the exemption being equal to the lesser of retirement plan income or the difference between gross income from other sources and the statutory threshold. The statutory threshold begins at \$15,000 and increases in \$5,000 increments through \$40,000.

History Of The Taxation And Exemption Of Retirement Plan Benefits In Kentucky

A. State and Local Employee Retirement Plan Income.

Kentucky law provides for a total exemption from income taxation for retirement pay received by all state and local retirees. State and local retirees covered by the exemption include participants in the Kentucky Employees, Teachers', Legislative, Judicial, State Police, County Employees, Municipal, and University sponsored retirement systems.

All state and local retirees are participants in one of the retirement systems listed above. The various state and local retirement systems were created as separate systems at different times, and the governing provisions of the separate systems are codified in different sections of the Kentucky Revised Statutes.² With the exception of university sponsored retirement plans, which were granted exemption in 1986, and a few miscellaneous local retirement plans, which were exempted in 1990, all of the state and local employee retirement systems have enjoyed full exemption from state, local and municipal taxation since their inception. The theory behind exempting state and local employees' retirement plan benefits from state income taxation is that by offering the "perk" of exemption from state and local income taxation for retirement plan income, Kentucky and its local governments are able to attract and retain qualified employees who would otherwise take jobs in the private sector for higher wages.

B. Federal and Military Retirement Income.

A partial exemption from state income taxation for persons receiving federal civil service retirement income and military retirement income was first enacted in 1972.³ As initially enacted, the statute provided that all persons over 65 receiving federal civil service retirement income and military retirement income would be entitled to a partial exemption from the Kentucky income tax, up to a maximum amount of \$4,000, phasing out in graduated steps as the taxpayer's earned income approached \$6,000. In 1976, the statute was amended to apply to civil service and military retirees over 50 years of age. In 1978, the statute was amended to include all persons over 50 receiving retirement income from a federal retirement system. The statute was amended again in 1990, in response to the United States Supreme Court decision in *Davis v. Michigan* to fully exempt all federal retirement income.

C. Private Retirement Income.

Private retirement income has always been fully subject to Kentucky's individual income tax.

Issues Considered In The Enactment Of Senate Bill 4 And The Genesis Of 1990 Senate Resolution 196

In March of 1989, the United States Supreme Court decided the case of *Davis v. Michigan*.⁴ In *Davis v. Michigan*, the Court held that the taxing scheme imposed by the State of Michigan, under which state and local retirees were granted full exemption from the imposition of the state income tax, while federal retirees were granted a partial exemption, was unconstitutionally discriminatory, because it violated both the doctrine of intergovernmental tax immunity and the Public Salary Tax Act of 1939.⁵

The case of *Davis v. Michigan* began in 1984 when Paul Davis, a retired United States government employee, filed a claim for a refund of state income taxes paid on his federal retirement income. At that time, Michigan fully exempted retirement benefits received by state and local employees, while only partially exempting retirement benefits received by federal government retirees. Davis claimed that Michigan could not legally tax his federal retirement benefits under the Public Salary Tax Act of 1939. Davis' refund claim was denied by the state courts in Michigan. Davis appealed his case to the United States Supreme Court. In an 8 to 1 majority opinion, written by Justice Kennedy, the Supreme Court concluded that Davis was correct, and that the state of Michigan could not legally tax Davis' federal retirement income, because it fully exempted retirement income received by state and local employees. The Court also rejected an argument presented by the state of Michigan that it could discriminate in its taxation of federal employees, as long as there was a rational basis for such discrimination. Although the Supreme Court struck down Michigan's scheme of taxation as discriminatory, it did not specifically direct what action Michigan should take to eliminate the discrimination. Rather, the Supreme Court remanded the case to the state courts, for the state to determine how the discrimination should be eliminated. Further, the Supreme Court did not specifically address the issue of whether Davis was entitled to a refund, because the state of Michigan had conceded in its brief that if its system of taxation was declared to be discriminatory, Davis would be entitled to a refund.

The Davis decision caught many states, including Kentucky, by surprise, since the common understanding prior to Davis was that if federal employees were generally treated the same as other residents of the state, then such employees were not being discriminated against. Because Kentucky's scheme of taxation was similar to that found to be discriminatory in Michigan, the 1990 General Assembly anticipated that the Kentucky courts would mandate that the retirement income received by federal, state and local retirees be taxed equally, and decided to address the issue by enacting new legislation. The options available to the 1990 General Assembly included extending the full exemption given to state retirees to federal retirees, repealing the exemption for state retirees, or providing a limited exemption to both state and federal retirees.

After considering the projected revenue impact of the options available, as well as the other concerns raised by various groups, the Kentucky General Assembly elected to retain the full exemption for state and local employees, and to fully exempt federal retirement income from Kentucky's income tax.⁶ The projected annual cost of providing

such an exemption was \$19 million, based upon the assumption of an average effective tax rate of 4.5%. Floor amendments were added to SB 4 in both the Senate and the House to fully exempt private retirement plan income, as well as all federal retirement plan income; however, both amendments were defeated before the bill was passed.

The language of 1990 SR 196 expresses the concern of the Senate that with the passage of 1990 SB 4, the General Assembly took action that benefits only a portion of the retired persons residing in Kentucky. Prompted by this concern, the Senate requested the present study, to determine the feasibility of providing a more equitable exemption from income taxation that would impact all retirees, equally, regardless of the source of retirement plan income.

Treatment Of Private Retirement Plan Income By Other States, And By Kentucky

A. Statutory Treatment of Pension Income.

Forty states have what is considered to be a broad-based personal income tax. Of these forty states, seven fully tax all pension income. Five states provide for a fixed exclusion from income, ranging in amount from \$7,500 to \$8,000 for all persons over the age of 65, regardless of the income source. Ten states, including Kentucky, provide a partial or full exemption for state and federal pension income, while fully taxing private retirement pension income. Eighteen states specifically provide for some type of exemption for private pension income. Of those eighteen states, twelve provide equal exemptions for all pension income, regardless of whether the retiree was a public or private employee. Of those twelve, only two states, Pennsylvania and Hawaii, fully exempt all pension income. Illinois comes close to exempting all pension income, with only retirement income received from IRAs excluded from the exemption. The amount of pension income exempted, when such exemptions are less than the full amount, ranges from \$3,000 in Delaware to \$20,000 in Colorado.⁷

B. Case Law.

Under the current interpretation of the United States Supreme Court decision in *Davis*, states were not required to provide an equal exemption from income taxation for private retirees or retirees receiving retirement income from other states. This is because The *Davis* decision was based upon the constitutional doctrine of intergovernmental tax immunity, as well as the Public Salary Tax Act of 1939, which the Supreme Court interpreted as restricting the states' ability to treat state and federal employees and retirees differently for tax purposes. Neither the provisions of the Public Salary Tax Act of 1939 nor the doctrine of intergovernmental immunity applies to the state taxation of retirement benefits received by private retirees. However, in responding to the *Davis* decision, many states elected to tax all retirees equally. In some cases, this meant that the states imposed a partial tax on retirement benefits received by state and local retirees that were previously

exempt from the state income tax. In other cases, this meant that partial exemptions were granted to federal and private retirees where no exemption existed previously.

Several states, including Kentucky, responded to the *Davis* decision by increasing the exemption for federal retirees so that it matched the exemption provided for state and local retirees, while continuing to fully tax private retirees. As a result of legislative action of this nature, there have been lawsuits filed by private retirees in several states, including Kentucky, alleging that it is inequitable and unconstitutional to treat different classes of retirees differently for income tax purposes. Of the five lawsuits filed, two have been decided, and in both cases the highest courts in those states ruled against the taxpayer.⁸ In general, the courts have found that nongovernmental retirees whose retirement benefits were taxed differently than those of former government workers were not denied equal protection under the law. By contrast with the standard established in the *Davis* case, the state merely had to show a rational basis for taxing private retirees differently from former government employees.

The lawsuit filed in Kentucky, styled *Cope et al. v. Revenue Cabinet*,⁹ was filed in the Franklin Circuit Court by two retired plumbers. The suit is based upon the premise that for purposes of taxation, all retirees should be treated as one class, with no distinction between public and private retirees. The plaintiffs claim that the distinction between public and private retirees has no rational basis, and therefore violates the equal protection clause of the Fourteenth Amendment of the United States Constitution and Sections 1, 2, 3, 26 and 59 of the Kentucky Constitution. An opinion has not yet been rendered in this case.

The Aftermath Of Davis—Litigation Abounds

A. Refund Litigation in General.

In addition to requiring twenty-four states to amend their laws, the *Davis* decision has spawned litigation in almost every jurisdiction affected by the decision.

The most prevalent type of litigation involves the question of whether federal retirees in those states that treated federal and state retirees differently prior to the *Davis* decision are entitled to refunds for taxes paid in years that remain open under the applicable state statute of limitations. Results of state court actions have varied. Some state courts have determined that federal retirees are entitled to refunds, while others have determined that the holding in *Davis* should only be applied prospectively. Broadly stated, taxpayers have maintained that state tax refund statutes generally permit or require the refund of taxes that have been erroneously or illegally collected or paid when a timely refund claim has been filed. The general argument has been that states should not be entitled to keep what does not legally belong to them. States, on the other hand, have argued that it is not necessary to determine whether state statutes permit a refund, because under federal law, the holding in *Davis* cannot be applied retroactively.

It is generally understood that the determination of whether a particular United States Supreme Court decision should be applied retroactively is a question of federal law. However, what the federal law is regarding retroactive application is unclear at best.

Because the various state courts have come to differing conclusions regarding the retroactive application of the *Davis* decision, it is likely that one of the cases currently in the state courts will end up in the United States Supreme Court.

B. Litigation in Kentucky.

In Kentucky, shortly after the *Davis* decision was rendered, federal retirees began filing amended income tax returns, seeking refunds of state income taxes paid on their federal retirement income. The Revenue Cabinet denied the refund claims, which resulted in the filing of a lawsuit in the Marshall Circuit Court by the federal retirees. That case, *Gossum v. Revenue Cabinet*,¹⁰ was certified as a class action.

In its briefs, the Revenue Cabinet conceded that Kentucky's former scheme of taxation was unconstitutional, in light of the *Davis* decision. This fact, coupled with the fact that the General Assembly remedied the constitutional problem by fully exempting pension income received by federal retirees from state income taxation prospectively, left as the only issue before the court whether the *Davis* decision should be applied retroactively, and if so applied, whether federal retirees should be entitled to go back two years or four years in seeking their refunds.

In January of 1991, the Marshall Circuit Court held that the federal retirees were entitled to refunds going back two years from the time the taxing scheme was declared unconstitutional. The decision of the Marshall Circuit Court was appealed to the Court of Appeals; however, the case was remanded back to the Circuit Court because the Circuit Court had failed to address an issue that had been placed before it. At the present time, the case is awaiting further action by the Marshall Circuit Court. The Kentucky Revenue Cabinet has estimated that it will cost the state \$36 million to refund payments made by federal retirees if the state loses in the courts and the two year statute of limitations is applied. If the plaintiffs prevail in their contention that the four-year statute of limitations applies, the Revenue Cabinet estimates the state's potential exposure to be \$60 million.

C. Other Types of Litigation.

The *Davis* case has also given rise to other types of lawsuits in this area, including suits by state employees and retirees whose income tax exemption was taken away or reduced by post-*Davis* legislative action. In these types of suits, the taxpayers have alleged that the reduction or repeal of their tax exemptions violates a contractual arrangement between the state and its employees. Other lawsuits filed have alleged that it is unconstitutional for a state to exempt retirement benefits received by former state and federal retirees, while continuing to tax retirement benefits received from another state by a former employee of that state.

This discussion has been included here because the battles being waged in the courts in response to the *Davis* decision and the various states' legislative responses to the *Davis* decision could have a direct effect on any changes made in Kentucky's scheme of income taxation during the 1992 Session. One of the many factors that must be considered

by the General Assembly in determining whether the current pension exemptions should be maintained, increased, or reduced, is the potential litigation that may ensue as a result of any legislative changes that are made.

Analysis Of The "Cost" of Exempting Retirement Plan Income, With Methodology

A. Cost.

This study examines the cost of providing an income tax exemption for pensions under two different scenarios. The first scenario, hereinafter referred to as the "absolute amount" scenario, considers the cost of providing an absolute exemption for pension income beginning with an exemption of \$5,000 and increasing in \$5,000 increments to an exemption of \$30,000. The cost of providing a total exemption of pension income is also included. This scenario is illustrated in Table 1.

The second scenario looks at the cost of providing an exemption for pension income based upon the total amount of income from all sources, including pension income. Under this scenario, hereinafter referred to as the "gross income benchmark" scenario, pension income is exempt from income taxation to the extent that gross income is less than or greater than a statutory gross income threshold. The amount of the exemption is the lesser of pension income or pension income minus the amount by which the gross income exceeds the statutory threshold. This scenario is illustrated in Table 2.

TABLE 1 ABSOLUTE EXEMPTION

PRIVATE PENSIONS

| GROSS INCOME | EXEMPT | EXEMPT | EXEMPT | EXEMPT | EXEMPT | EXEMPT | EXEMPT | EXEMPT | EXEMPT | TOTAL |
|---------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|
| | \$5,000 | \$10,000 | \$15,000 | \$20,000 | \$25,000 | \$30,000 | \$30,000 | \$30,000 | \$30,000 | EXEMPTION |
| UNDER 5000 | \$0 | \$0 | \$0 | \$0 | \$0 | \$0 | \$0 | \$0 | \$0 | \$0 |
| 5000 - 10000 | (\$1,398,000) | (\$1,420,000) | (\$1,420,000) | (\$1,420,000) | (\$1,420,000) | (\$1,420,000) | (\$1,420,000) | (\$1,420,000) | (\$1,420,000) | (\$1,420,000) |
| 10000 - 15000 | (\$3,712,000) | (\$4,283,000) | (\$4,295,000) | (\$4,295,000) | (\$4,295,000) | (\$4,295,000) | (\$4,295,000) | (\$4,295,000) | (\$4,295,000) | (\$4,295,000) |
| 15000 - 20000 | (\$3,805,000) | (\$5,053,000) | (\$5,251,000) | (\$5,256,000) | (\$5,256,000) | (\$5,256,000) | (\$5,256,000) | (\$5,256,000) | (\$5,256,000) | (\$5,256,000) |
| 20000 - 25000 | (\$3,408,000) | (\$4,787,000) | (\$5,251,000) | (\$5,313,000) | (\$5,314,000) | (\$5,314,000) | (\$5,314,000) | (\$5,314,000) | (\$5,314,000) | (\$5,314,000) |
| 25000 - 30000 | (\$2,956,000) | (\$4,203,000) | (\$4,763,000) | (\$4,954,000) | (\$4,991,000) | (\$4,992,000) | (\$4,992,000) | (\$4,992,000) | (\$4,992,000) | (\$4,992,000) |
| OVER 30000 | (\$13,603,000) | (\$19,900,000) | (\$23,525,000) | (\$25,719,000) | (\$27,099,000) | (\$27,995,000) | (\$27,995,000) | (\$27,995,000) | (\$27,995,000) | (\$31,050,000) |
| TOTAL | (\$28,882,000) | (\$39,646,000) | (\$44,505,000) | (\$46,957,000) | (\$48,375,000) | (\$49,272,000) | (\$49,272,000) | (\$49,272,000) | (\$49,272,000) | (\$52,327,000) |

STATE PENSIONS

| GROSS INCOME | EXEMPT | EXEMPT | EXEMPT | EXEMPT | EXEMPT | EXEMPT | EXEMPT | EXEMPT | EXEMPT | TOTAL |
|---------------|-------------|-------------|-----------|-----------|-----------|----------|----------|----------|----------|-----------|
| | \$5,000 | \$10,000 | \$15,000 | \$20,000 | \$25,000 | \$30,000 | \$30,000 | \$30,000 | \$30,000 | EXEMPTION |
| UNDER 5000 | \$1,028,000 | \$309,000 | \$98,000 | \$37,000 | \$16,000 | \$7,000 | \$7,000 | \$7,000 | \$7,000 | \$0 |
| 5000 - 10000 | \$1,368,000 | \$447,000 | \$143,000 | \$49,000 | \$15,000 | \$4,000 | \$4,000 | \$4,000 | \$4,000 | \$0 |
| 10000 - 15000 | \$1,098,000 | \$373,000 | \$119,000 | \$41,000 | \$16,000 | \$6,000 | \$6,000 | \$6,000 | \$6,000 | \$0 |
| 15000 - 20000 | \$864,000 | \$324,000 | \$116,000 | \$41,000 | \$12,000 | \$4,000 | \$4,000 | \$4,000 | \$4,000 | \$0 |
| 20000 - 25000 | \$680,000 | \$267,000 | \$96,000 | \$32,000 | \$9,000 | \$2,000 | \$2,000 | \$2,000 | \$2,000 | \$0 |
| 25000 - 30000 | \$446,000 | \$175,000 | \$68,000 | \$27,000 | \$9,000 | \$3,000 | \$3,000 | \$3,000 | \$3,000 | \$0 |
| OVER 30000 | \$1,157,000 | \$483,000 | \$190,000 | \$79,000 | \$34,000 | \$15,000 | \$15,000 | \$15,000 | \$15,000 | \$0 |
| TOTAL | \$6,641,000 | \$2,378,000 | \$830,000 | \$306,000 | \$111,000 | \$41,000 | \$41,000 | \$41,000 | \$41,000 | \$0 |

FEDERAL PENSIONS

| GROSS INCOME | EXEMPT | EXEMPT | EXEMPT | EXEMPT | EXEMPT | EXEMPT | EXEMPT | EXEMPT | EXEMPT | TOTAL |
|---------------|--------------|-------------|-------------|-------------|-----------|-----------|-----------|-----------|-----------|-----------|
| | \$5,000 | \$10,000 | \$15,000 | \$20,000 | \$25,000 | \$30,000 | \$30,000 | \$30,000 | \$30,000 | EXEMPTION |
| UNDER 5000 | \$5,404,000 | \$2,395,000 | \$1,077,000 | \$499,000 | \$222,000 | \$92,000 | \$92,000 | \$92,000 | \$92,000 | \$0 |
| 5000 - 10000 | \$2,165,000 | \$975,000 | \$435,000 | \$200,000 | \$96,000 | \$45,000 | \$45,000 | \$45,000 | \$45,000 | \$0 |
| 10000 - 15000 | \$2,005,000 | \$905,000 | \$390,000 | \$173,000 | \$79,000 | \$35,000 | \$35,000 | \$35,000 | \$35,000 | \$0 |
| 15000 - 20000 | \$1,994,000 | \$891,000 | \$377,000 | \$168,000 | \$78,000 | \$37,000 | \$37,000 | \$37,000 | \$37,000 | \$0 |
| 20000 - 25000 | \$1,647,000 | \$740,000 | \$315,000 | \$145,000 | \$70,000 | \$37,000 | \$37,000 | \$37,000 | \$37,000 | \$0 |
| 25000 - 30000 | \$1,125,000 | \$478,000 | \$201,000 | \$86,000 | \$37,000 | \$17,000 | \$17,000 | \$17,000 | \$17,000 | \$0 |
| OVER 30000 | \$2,962,000 | \$1,432,000 | \$685,000 | \$353,000 | \$186,000 | \$99,000 | \$99,000 | \$99,000 | \$99,000 | \$0 |
| TOTAL | \$17,302,000 | \$7,816,000 | \$3,480,000 | \$1,624,000 | \$768,000 | \$362,000 | \$362,000 | \$362,000 | \$362,000 | \$0 |

NET CHANGE

| | | | | | | | | | | |
|--|---------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|
| | (\$4,939,000) | (\$29,452,000) | (\$40,195,000) | (\$45,027,000) | (\$47,496,000) | (\$48,869,000) | (\$48,869,000) | (\$48,869,000) | (\$48,869,000) | (\$52,327,000) |
|--|---------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|

TABLE 2 GROSS INCOME BENCHMARK

PRIVATE PENSIONS

| GROSS INCOME | EXEMPT IF GROSS & PENSION GROSS & PENSION GROSS & PENSION | | | |
|---------------|---|----------------|----------------|----------------|
| | < \$15,000 | < \$20,000 | < \$25,000 | < \$30,000 |
| UNDER 5000 | \$0 | \$0 | \$0 | \$0 |
| 5000 - 10000 | (\$1,420,000) | (\$1,420,000) | (\$1,420,000) | (\$1,420,000) |
| 10000 - 15000 | (\$4,295,000) | (\$4,295,000) | (\$4,295,000) | (\$4,295,000) |
| 15000 - 20000 | (\$4,689,000) | (\$5,256,000) | (\$5,256,000) | (\$5,256,000) |
| 20000 - 25000 | (\$3,517,000) | (\$4,944,000) | (\$5,314,000) | (\$5,314,000) |
| 25000 - 30000 | (\$2,433,000) | (\$3,502,000) | (\$4,675,000) | (\$4,991,000) |
| 30000 - 35000 | (\$1,556,000) | (\$2,388,000) | (\$3,207,000) | (\$4,100,000) |
| OVER 35000 | (\$2,998,000) | (\$4,829,000) | (\$7,077,000) | (\$9,561,000) |
| TOTAL | (\$20,908,000) | (\$26,634,000) | (\$31,244,000) | (\$38,242,000) |

STATE PENSIONS

| GROSS INCOME | EXEMPT IF GROSS & PENSION GROSS & PENSION GROSS & PENSION | | | |
|---------------|---|-------------|-------------|-------------|
| | < \$15,000 | < \$20,000 | < \$25,000 | < \$30,000 |
| UNDER 5000 | \$171,000 | \$56,000 | \$22,000 | \$8,000 |
| 5000 - 10000 | \$679,000 | \$225,000 | \$77,000 | \$27,000 |
| 10000 - 15000 | \$1,200,000 | \$470,000 | \$164,000 | \$61,000 |
| 15000 - 20000 | \$1,266,000 | \$798,000 | \$345,000 | \$135,000 |
| 20000 - 25000 | \$985,000 | \$798,000 | \$493,000 | \$212,000 |
| 25000 - 30000 | \$668,000 | \$527,000 | \$431,000 | \$279,000 |
| 30000 - 35000 | \$503,000 | \$407,000 | \$329,000 | \$275,000 |
| OVER 35000 | \$1,431,000 | \$1,265,000 | \$1,093,000 | \$933,000 |
| TOTAL | \$6,903,000 | \$4,546,000 | \$2,954,000 | \$1,930,000 |

FEDERAL PENSIONS

| GROSS INCOME | EXEMPT IF GROSS & PENSION GROSS & PENSION GROSS & PENSION | | | |
|---------------|---|--------------|-------------|-------------|
| | < \$15,000 | < \$20,000 | < \$25,000 | < \$30,000 |
| UNDER 5000 | \$1,190,000 | \$547,000 | \$242,000 | \$102,000 |
| 5000 - 10000 | \$1,039,000 | \$456,000 | \$201,000 | \$90,000 |
| 10000 - 15000 | \$1,888,000 | \$947,000 | \$409,000 | \$177,000 |
| 15000 - 20000 | \$2,464,000 | \$1,770,000 | \$905,000 | \$374,000 |
| 20000 - 25000 | \$2,140,000 | \$1,865,000 | \$1,321,000 | \$677,000 |
| 25000 - 30000 | \$1,606,000 | \$1,420,000 | \$1,211,000 | \$843,000 |
| 30000 - 35000 | \$1,262,000 | \$1,145,000 | \$991,000 | \$821,000 |
| OVER 35000 | \$3,129,000 | \$2,950,000 | \$2,687,000 | \$2,362,000 |
| TOTAL | \$14,718,000 | \$11,100,000 | \$7,967,000 | \$5,446,000 |

NET CHANGE

| | | | | | | |
|--|-----------|----------------|----------------|----------------|----------------|------------|
| | \$713,000 | (\$10,988,000) | (\$20,323,000) | (\$27,524,000) | (\$33,365,000) | (\$37,000) |
|--|-----------|----------------|----------------|----------------|----------------|------------|

Both tables provide separate cost figures under each exemption amount for private pensions, state pensions and federal pensions, with the net change reflected at the bottom of each table. In both tables, the private pension numbers are all negative, since any exemption of private pensions would result in an additional cost to the state. State and federal pension numbers are all positive, since these pensions are currently fully exempt, and any taxation of such pensions would result in a decrease in the current cost of the exemption.

The operation of both scenarios as applied to an individual taxpayer can be illustrated as follows:

Taxpayer Income:

| | |
|-----------------|----------|
| Pension Income: | \$15,000 |
| Other income: | 15,000 |
| Total Income: | \$30,000 |

The absolute exemption amount is \$25,000

The gross income benchmark is \$25,000

Under the absolute amount scenario, the taxpayer would receive an exemption of \$15,000. This result is reached because the taxpayer's pension income is less than the absolute exemption amount of \$25,000.

Under the gross income benchmark scenario, the taxpayer would be entitled to an exemption in the amount of \$10,000 (\$5,000 of the taxpayer's pension income would be taxable), because the taxpayer's total income exceeds the benchmark amount by \$5,000. (The exemption amount is determined by taking the total amount of pension income (\$15,000) and subtracting from that figure the amount by which the taxpayer's total gross income exceeds the benchmark (\$5,000).

B. Methodology.

The information presented in Tables 1 and 2 was developed in two stages. First, a data base was created and a microsimulation model was developed that would allow tax liabilities for returns in the data base to be recalculated and compared using different tax laws.

The data base was arranged to provide for three groups of taxpayers. Social security numbers and pension income data from a 1986 state and local retirement data file were matched against the Revenue Cabinet's 1986 individual income tax data file to provide tax return data for state and local retirees.

Social security numbers and pension income data from a 1986 federal military and civil service retirement data file were matched against The Revenue Cabinet's 1986 individual income tax data file to provide tax return data for federal retirees.

Private pension tax return data was created by a process of elimination. If a social security number from the state or federal retirement data file matched a social security number from the federal income tax data file, the return was eliminated from the private retiree data base. The remaining social security numbers and pension income data were then matched with the 1986 Revenue Cabinet's individual income tax data file to provide tax return data for private retirees.

The method used to create a private retirees data base resulted in the inclusion of taxpayers who do not fit a strict definition of private retiree. Included are individuals receiving and reporting pension income from 401(k) and Keough plans (but not from IRA's), and public retirees from other states now living in Kentucky. No analysis was made, or could be made, of the impact of including those sources of retirement income in the data base.

The tax liability of each taxpayer in each group was recalculated, taking the non-deductibility of federal income tax and the low income tax credit provisions into account, and allowing for the various pension income exemptions. The resulting liabilities were compared with the original liability to arrive at the cost of each exemption scenario as it would have applied in the 1986 tax year.

Tax year 1986 was used in this analysis since that was the latest year for which information was available to create all of the data bases needed for the microsimulation model.

The second stage of the cost analysis was an inflation of the results of the microsimulation model to reflect what could be expected to occur under the various exemption scenarios for the 1992 tax year. Using 1980 and 1990 Census data, it was estimated that the over-65 age group in Kentucky would increase by 12.7% from 1986 to 1992. The results of the analysis were adjusted accordingly. The results of the analysis were also adjusted for the estimated change in the Consumer Price Index (CPI) from 1986 to 1992. The CPI was estimated to have increased from 1986 to 1992 by 32.2%.

FOOTNOTES

- 1 As used in this study, unless otherwise specifically stated, the terms "private employer retirement plans," "private pensions," "private retirement plans," or "private retirement income" shall include annuities or plans established by or retirement income received from states other than Kentucky.
- 2 Governing provisions of Kentucky's various retirement systems can be found in the following chapters of KRS: Legislators, KRS Chapter 6; State Police, KRS Chapter 16; Judges, KRS Chapter 21; Kentucky Employees' Retirement System, KRS Chapter 61; Urban County Governments, KRS Chapter 67A; County Employees, KRS Chapter 78; City Police and Firefighters, KRS Chapter 95; Teachers, KRS Chapter 161; and State Universities and Colleges, KRS Chapter 164.
- 3 Enact. Acts 1972, ch. 119, §1.
- 4 109 S.Ct. 1500 (1989).
- 5 4 U.S.C. §11. The Public Salary Act of 1939 provides, in relevant part, that:

The United States consents to the taxation of pay or compensation for personal service as an officer or employee of the United States . . . by a duly constituted taxing authority having jurisdiction, if the taxation does not discriminate against the officer or employee because of the source of the pay or compensation.
- 6 Acts 1990, ch. 305 §1, effective July 13, 1990.
- 7 Data for this section of the study was obtained from the following sources: Commerce Clearing House *State Tax Guide* and *State Tax Review*; Survey by the National Conference of State Legislatures, entitled "Exclusion of Pension Income From State Personal Income Taxes," March 5, 1990.
- 8 One of the two cases, *Hackman v. Director of Revenue*, Mo. banc, 771 SW2d 77 (1989), was filed and decided after *Davis*, while the other, *Streight v. Ragland*, Ark., 666 SW2d 459 (1983), was decided prior to *Davis*.
- 9 Franklin Cir. Ct., Action No. 90-CI-01302.
- 10 Marshal Circuit Court, Action No. 89-CI 248, January 4, 1991.

