

**THE POLICY IMPLICATIONS
OF
DELAWARE'S TAX TREATMENT OF RETIREMENT INCOME**

A report submitted to the Joint Finance Committee

in response to

Section 130 of the FY 2013 Budget Act.

Department of Finance

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EXECUTIVE SUMMARY

The FY 2013 Budget Act (SB 260 in the 146th General Assembly) contained the following:

Section 130. The Department of Finance will prepare a report for the members of the JFC by January 15, 2013 which will examine the options available to equalize the tax treatment of retirees who are not covered or are only partially covered by the Social Security System with those retirees receiving Social Security income which is presently tax exempt. This report should indicate what groups are affected and should provide recommendations about how to address any inequity, including but not limited to examining other states' tax laws. The report should also include the fiscal impact associated with any recommendations.

This report is submitted in fulfillment of Section 130's directive.

Findings

- Certain pensioners, such as those federal retirees receiving Civil Service Retirement System pensions who do not receive Social Security as a result of their federal employment, receive less generous tax treatment than most pensioners who do receive Social Security.
- HB 97 from the 146th General Assembly addressed this uneven treatment insofar as it extended to federal and military retirees. HB 97 was estimated to reduce State tax revenues by \$3.0 to \$3.5 million annually.
- It is estimated that extending HB 97 to other similarly situated state and local government pensioners would cost another \$0.7 million.
- In aggregate, Delaware's current income tax breaks for those age-60 and over reduce annual revenues by roughly \$100 million. As currently constructed, these tax breaks have serious deficiencies:
 - ✓ **They are unfair:** Younger taxpayers and wage-earners pay significantly higher effective tax rates than older taxpayers and pensioners having the same level of income. It is not uncommon, too, for lower- and middle-income wage earners to pay much steeper effective tax rates than high-income retirees.
 - ✓ **They are unaffordable:** The current \$100 million price tag will balloon with an aging population. The rate of growth in Delaware's age-60 and over population will outpace the rate of growth in the population at large in every year for the next 20 years.
- Because a narrowly drawn solution, like extending HB 97 to include all public employees, does nothing to address the current system's larger equity shortcomings and, more importantly, would actually exacerbate the monumental fiscal challenge posed by an aging population, it should not be considered as a policy option.
- Comprehensive reform is recommended. It must address the issue identified by Section 130 of the Budget Act. More importantly, such a reform must control the size of retiree tax breaks, which, if left unchecked, will exact a progressively higher cost over the next 20 years.

INTRODUCTION

The 146th General Assembly tasked the Department of Finance to prepare for the members of the Joint Finance Committee a report examining the options available to equalize the tax treatment of two retiree populations in Delaware: 1) Retirees who are not covered or are only partially covered by the Social Security System and 2) Retirees who receive full Social Security benefits. Presently, Social Security income is tax exempt in Delaware.¹

Specifically, the Department of Finance was directed to identify the groups affected and to make recommendations for addressing any inequity.

This report is submitted in fulfillment of that request.

Overview of the Issue: For a number of years, many federal retirees have contended that Delaware's tax treatment of certain federal retiree income is unfair. More specifically, federal retirees covered by the Civil Service Retirement System (CSRS) have asserted that Delaware's combination of a limited pension exclusion coupled with a complete exemption of Social Security income results in a State tax system that shortchanges CSRS retirees.

Federal employees up until 1986 were covered by the Civil Service Retirement System (CSRS). Under the CSRS, employees shared in the expense of the annuities to which they eventually became entitled. CSRS-covered employees contributed 7.0, 7.5 or 8.0 percent of their pay to CSRS, while they generally paid no Social Security Old-Age, Survivor and Disability Insurance (OASDI) tax. Federal employees covered by the CSRS are not eligible to receive Social Security benefits because they were not required to pay into the Social Security system. CSRS retirees often contend that, because of their relatively high employee pension contributions and their exclusion from the Social Security system, the U.S. Congress in effect considered Social Security and federal employee retirement systems, including the CSRS, to be "equivalent programs."

The CSRS was replaced by the Federal Employees Retirement System (FERS) for Federal employees who first entered covered service on and after January 1, 1987. The FERS retirement plan requires federal workers to pay into the Social Security system and, as a result, they are eligible to receive Social Security benefits at the appropriate time.

If one accepts the view that CSRS pensions and Social Security are equivalent programs, then it is easy to see how one might conclude that Delaware's tax system produces an unfair result. While a typical retiree is entitled to exclude up to \$12,500 of pension income and all Social Security income, because the CSRS retiree does not receive Social Security income as a result of his or her federal government employment, he or she is entitled to only a \$12,500 pension exclusion.² The following table provides a simple hypothetical example:

¹ Senate Bill 260, section 130

² The CSRS retiree could, of course, have some Social Security income as a result working for an employer other than the federal government.

<u>Income</u>	Retiree	
	<u>CSRS</u>	<u>Non-CSRS</u>
Pension Income	\$40,000	\$24,000
Social Security	0	16,000
Total Income	\$40,000	\$40,000
<u>Exemptions</u>		
Pension & Retirement Income Exclusion	\$12,500	\$12,500
Social Security	0	16,000
Total Exclusions	\$12,500	\$28,500
Income after Exclusions	\$27,500	\$11,500

House Bill No. 97: This issue has been addressed with legislation in each of the past four General Assemblies. In each case, House Bill No. 97 was introduced and tackled the issue by:

1. Establishing a second pension exclusion that is available only to federal retirees, and
2. Limiting the size of the new federal retiree pension exclusion based on the amount of Social Security received by the taxpayer.

The latest iteration of the bill, introduced during the 146th General Assembly, allowed those 60 years of age or over to exclude from their taxable income any pensions received from the United States, including military retirement income, up to a maximum of \$37,500, less any Social Security benefits paid by the United States in the taxable year. (See Attachment 1.)

Because the first \$12,500 of pension income was already excluded from taxable income, this version of HB 97 granted federal retirees another \$25,000 in pension exclusion for a total of \$37,500. If a federal retiree (presumably a CSRS retiree) had participated in the Social Security program while employed by another employer over the course of their career, any Social Security income received in retirement as a result of that other job would be subtracted from the amount of the taxpayer's federal pension to determine the size of the new exclusion.

The latest version of HB 97 had an estimated cost in terms of forgone revenue of \$3.0 to \$3.5 million. No version of HB 97 has been enacted.

CURRENT PROVISIONS AFFECTING RETIREES

Delaware, like most states that employ a personal income tax, provides a number of favorable tax preferences for persons who have reached “retirement age” (either 60 or 65, depending upon the provision in question) or who derive income from pensions, retirement income, or Social Security. More specifically, Delaware has four personal income tax provisions that affect retirees.³

1. Exclusion of Pension and Eligible Retirement Income

- **Statutory Provision:** Title 30, Delaware Code, Chapter 11, §1106(b)(3)
- **Description:** Certain amounts of income received as pensions from employers or meeting the definition of "eligible retirement income" are excludable from Delaware taxable income. This exclusion is limited to \$12,500 a year for taxpayers age-60 and older. As defined in §1106(b)(3)b.2(B) of Title 30, eligible retirement income includes:
 - ✓ Distributions from qualified retirement plans defined under §4974 of the Internal Revenue Code (IRC);
 - ✓ Distributions from cash or deferred arrangements described in §401(k) of the IRC;
 - ✓ Distributions from government deferred compensation plans described in §457 of the IRC;
 - ✓ Dividends;
 - ✓ Capital Gains;
 - ✓ Interest; and,
 - ✓ Net Rental Income

Taxpayers under 60 years of age may exclude up to \$2,000 of pension income per year. These taxpayers may not exclude eligible retirement income.

- **Estimated Tax Year 2014 Revenue Loss:** \$55.4 million
- **Comments:** Any taxpayer with pension income or, if age-60 or over, eligible retirement income is entitled to claim this tax preference, regardless of his or her ability-to-pay. In fact, the term “retirement income” is a bit of a misnomer. An individual does not need to be retired to benefit from this provision. For example, a 60 -year-old taxpayer who is employed full-time is entitled to fully exclude \$12,500 in capital gains or rental income.

2. Exclusion of Taxable Social Security Benefits

- **Statutory Provision:** Title 30, Delaware Code, Chapter 11, §1106(b)(4).
- **Description:** For purposes of federal income taxation, recipients of Social Security benefits or Railroad Retirement Board payments who have modified adjusted gross income from all

³ See Delaware’s *Tax Preference Report 2011*, Items 1.02, 1.03, 1.05 and 1.07.

sources above a "base amount" of \$25,000 (\$32,000 for taxpayers who file jointly) are taxed on a portion of these benefits. This taxable portion is the lesser of 50% of the Social Security benefits received, or 50% of a taxpayer's "combined" income over the "base amount." Combined income is 50% of these benefits plus adjusted gross income plus any tax-exempt income or income earned from a foreign country or U.S. possession which is excluded from federal gross income. If a taxpayer's income exceeds \$34,000 (\$44,000 if married, filing jointly), the lesser of 85% of Social Security benefits or 50% of the combined income above the base amount is included in federal adjusted gross income.

- **Estimated Tax Year 2014 Revenue Loss:** \$36.7 million
- **Comments:** Like the exclusion for pension and retirement income, this provision is not a means-tested tax preference and, as a consequence, is available to taxpayers regardless of their ability-to-pay. Moreover, only taxpayers over certain income thresholds are required to include these benefits in their federal gross income. As a result, only taxpayers who have income above the relatively high federal threshold go on to benefit from Delaware's exclusion of Social Security and Railroad Retirement Board payments, effectively removing the federal means-test originally designed to limit the preferential tax treatment of such income to those most in need.

3. Additional Standard Deduction for the Blind or Persons Age 65 or Over

- **Statutory Provision:** Title 30, Delaware Code, Chapter 11, §1108(b).
- **Description:** Taxpayers who are at least 65 years of age (or blind), and who do not itemize their deductions, are entitled to an additional standard deduction of \$2,500. Non-itemizers who are at least age 65 *and also* blind may claim an additional standard deduction of \$5,000.
- **Estimated Tax Year 2014 Revenue Loss:** \$3.7 million
- **Comments:** This provision is not a means-tested tax preference and, as a consequence, is available to taxpayers regardless of their ability-to-pay. Unlike the pension and Social Security exclusions discussed above, the extra standard deduction is not tied to specific forms of income. Any taxpayer may take advantage of this provision so long as he or she has reached the age of 65.

By definition, an additional standard deduction is not available to taxpayers who itemize their deductions. Because taxpayers taking the standard deduction typically have lower incomes, it may be argued that this additional standard deduction primarily benefits lower-income taxpayers. But many taxpayers in this age group no longer have mortgage interest deductions, making them less likely to itemize even if they are middle- or high-income taxpayers.

4. Additional Personal Credit for Persons Age-60 and Over

- **Statutory Provision:** Title 30, Delaware Code, Chapter 11, §1110(b)(2).
- **Description:** Taxpayers who are age-60 and over are entitled to claim an additional non-refundable personal credit. Married taxpayers who file jointly receive an additional \$110 credit if only one of the couple is age-60 or older, and an additional \$220 if both persons meet this age test.
- **Estimated Tax Year 2014 Revenue Loss:** \$9.6 million
- **Comments:** Attaining the age of 60 is the only requirement needed to take advantage of this provision. Thus, it is available to any taxpayer 60 years of age or older regardless of ability-to-pay or composition of income.

TAX FAIRNESS

As recent events in Washington D.C. demonstrate, the notion of tax fairness or equity can accurately be described as a “hot-button” issue. While any discussion of a concept like tax equity will undoubtedly include a certain level of subjectivity and personal bias, public finance economists have established a useful framework that adds a measure of objectivity to the evaluation of tax policy.

In the context of personal income taxes, the most fundamental concept with respect to fairness is that the size of an individual’s tax bill should be based on his or her “ability-to-pay.” With respect to an income tax, ability-to-pay is generally considered to equate to the notion of “net income,” which equals gross income less certain costs associated with earning income. From this starting point, one can advance the two basic principles of tax equity:

1. Vertical Equity -- Individuals with higher net incomes (ability-to-pay) should pay more in taxes than those with lower levels of net income, and
2. Horizontal Equity -- Individuals with equal net incomes (ability-to-pay) should pay the same level of tax.

More specifically, *vertical equity* is the principle that tax burdens should be distributed “fairly” among taxpayers with different abilities-to-pay. Vertical equity is a subjective concept that, at its core, is essentially a value judgment. Among policy makers and academics, however, there is general agreement that the tax system should not be regressive; i.e., that those with lower incomes should not pay a larger proportion of their income in taxes than those with higher incomes.

Horizontal equity means that, all other things being equal, taxpayers with similar ability-to-pay should have similar net tax burdens. Generally speaking for tax purposes, equal ability-to-pay is defined in terms of equal income. But income does not always equate with ability-to-pay. For example, if “Taxpayer A” and

"Taxpayer B" have the same level of income, but "Taxpayer A" spends two-thirds of her income on unavoidable medical expenses, "Taxpayer A" has less ability-to-pay than "Taxpayer B." Horizontal equity, therefore, does not necessarily imply one set of rules for all. Tax rules can be adjusted to take account of special circumstances and thereby maintain horizontal equity. The problem is determining *which* special circumstances justify special treatment for tax purposes. These special circumstances are typically unavoidable, catastrophic expenses that a taxpayer faces involuntarily.

Based on the example provided on page 3 above, there is certainly a concern that the difference in tax treatment between the retiree receiving Social Security income and the CSRS retiree not receiving Social Security income violates the principle of horizontal equity. All else being equal, two retirees with similar amounts of income should pay a similar amount in taxes. This observation, however, represents a narrow and, perhaps, selective application of the concepts of horizontal and vertical equity. It neglects more basic questions, such as:

- To what extent, if at all, does a taxpayer's age determine his or her ability-to-pay?
- To what extent, if at all, should "retirement" income receive preferential treatment over other forms of income?

WHO IS AFFECTED

Legislative efforts to address and equalize the tax treatment of retirees who are not covered or only partially covered by the Social Security System with those retirees receiving Social Security income have thus far focused exclusively on federal retirees (HB 97). This report's scope extends beyond federal retirees.⁴

The following table contains estimates for the number of retirees in Delaware that participate in CSRS, the Federal Employee Retirement System (FERS), and military retirement, as well as those with pensions from state and local pension systems that, like CSRS, did not require Social Security contributions.⁵

NUMBER OF PENSIONERS POTENTIALLY AFFECTED

FEDERAL RETIREES		
Civilian Annuitants and Survivors		
CSRS	6,100	
FERS	1,700	
Subtotal		7,800
Military		8,500
TOTAL FEDERAL RETIREES		16,300
OTHER SYSTEMS		
Closed State Police Plan	700	
NCC Police	250	
City of Wilmington	750	
Other	0	
TOTAL OTHER SYSTEMS		1,700
TOTAL ALL SYSTEMS		18,000

Even if HB 97's tax treatment were extended to all public pensioners, clearly not all 18,000 of the pensioners listed above would actually receive a tax cut as a result of such a provision. Because they are

⁴ Section 130 of the FY 2013 Budget Act did not restrict the scope of this report to federal retirees; it mandated that the report "report should indicate what groups are affected."

⁵ CSRS and FERS figures were derived using CBO Civil Service Retirement and Disability Fund data, March 2012, http://www.cbo.gov/sites/default/files/cbofiles/attachments/43067_CivilServiceRetirementDisabilityFund.pdf.

Delaware's share of national totals was assumed to be 0.3%. Data for the other state and local systems was provided by the State Pension Office, New Castle County and City of Wilmington. Inquiries were also made with Kent and Sussex Counties as well as the Cities of Newark and Dover.

Social Security eligible, most 1,700 FERS retirees would not benefit. Many military pensioners are under age-60 so they, too, would not be eligible. There are, however, exceptions to these general rules.

Both FERS and military retirees could benefit if they have reached age-60, but have not yet begun to draw Social Security. For example, a 60-year-old FERS pensioner who now works full-time for a private employer in Delaware (no Social Security) would still see his or her pension exclusion jump from \$12,500 to as much as \$37,500 as a result of HB 97.

Ultimately, the groups most certain to benefit would be the 6,100 CSRS retirees and the 1,700 local government retirees (listed under "Other Systems" in the table above), totaling 7,800 individuals.

REVIEW OF OTHER STATES' TAX TREATMENT OF RETIREMENT INCOME

Many states exclude Social Security retirement benefits from state income taxes. RetirementLiving.com, operated by the Retirement Living Information Center, provides a comprehensive overview of how each state taxes retirement income⁶. In addition, the National Conference of State Legislatures produced a report in 2010 which included a table summarizing how each state treats various pensions⁷. (See Attachment 2.)

The District of Columbia and 26 states with income taxes provide a full exclusion for Social Security benefits — Alabama, Arizona, Arkansas, California, Delaware, Georgia, Hawaii, Idaho, Illinois, Indiana, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Mississippi, New Jersey, New York, North Carolina, Ohio, Oklahoma, Oregon, Pennsylvania, South Carolina, Virginia and Wisconsin.

The remaining 15 states with broad-based income taxes tax Social Security to some extent:

- Minnesota, Nebraska, North Dakota, Rhode Island, Utah, Vermont and West Virginia tax Social Security income to the extent it is taxed by the federal government.
- Connecticut, Iowa, Kansas, Missouri and Montana tax Social Security income above an income floor. Iowa will gradually phase out its Social Security tax levy from 2008 through 2014. Kansas residents can exclude Social Security income if their adjusted gross income is less than \$75,000.
- Colorado and West Virginia provide a general retirement income exclusion or credit that may result in the exclusion from taxation of part or all of Social Security benefits, or a credit against taxes otherwise due on Social Security benefits.

Michigan recently created a new approach. Starting in 2012, three tiers of taxpayers were established. For those in the first tier, age-67 or older in 2012, government pension income remains entirely exempt; private pensions are taxed only if they are more than \$47,309 for single filers and \$94,618 for couples.

Those in the second tier, ages 60-66 in 2012, will be allowed to exempt pension income from any source up to \$20,000 for single filers and \$40,000 for couples (the tier is based on the age of the older spouse). At

⁶ <http://www.retirementliving.com/taxes-by-state>

⁷ National Conference of State Legislatures, State Personal Income Taxes on Retirement Income: Tax Year 2010.

67, the \$20,000 and \$40,000 exemptions can be applied to income from any source (e.g., pensions, 401(k), wages etc.), and shall not be available to those reporting household income above \$75,000 for single filers and \$150,000 for couples.

In the third tier, those 59 and younger in 2012, the pension exemptions are eliminated. When members of the third tier reach age-67, the exemptions for \$20,000 and \$40,000 on all forms of income – including Social Security, military pensions and private pensions – would kick in. Taxpayers in this group would also have the option of exempting all Social Security income and taking a \$3,900 personal income exemption (adjusted for inflation).

States are prohibited from taxing benefits of U.S. military retirees if they exempt the pensions of state and local government retirees. Most states that impose an income tax exempt at least part of pension income from taxable income. Different types of pension income (private, military, federal civil service, and state or local government) are often treated differently for tax purposes.

States are generally free from federal control in deciding how to tax pensions, but some limits apply. State tax policy cannot discriminate against federal civil service pensions.

Nine states exclude all federal, state and local pension income from taxation. These include Alabama, Hawaii, Illinois, Kansas, Louisiana, Massachusetts, Mississippi, New York and Pennsylvania.

Among these 9 states, only Kansas taxes any Social Security income, but only to the extent it is subject to federal taxation. These 9 states differ on the taxation of retirement income from private-sector sources. Kansas and Massachusetts do not exclude any private-sector retirement income, but most of the others allow a fairly broad exclusion. Kansas residents with an adjusted gross income of less than \$75,000 may exclude Social Security income from state taxes. Pennsylvania allows a full exclusion. Alabama excludes income from defined benefit plans. Hawaii excludes income from contributory plans. Illinois and Mississippi exclude income from qualified retirement plans. Louisiana, Michigan and New York cap the private-sector exclusion at \$6,000, \$47,309 and \$20,000, respectively.

Five states (California, Connecticut, Nebraska, Rhode Island, and Vermont) allow no exemptions or tax credits for pension and other retirement income that is counted in federal adjusted gross income. Most in-state government pensions are taxed the same as out-of-state government pensions. However, Arizona, Idaho, Kansas, Louisiana, New York, and Oklahoma provide greater tax relief for in-state plans than they do for out-of-state government pension plans. The District of Columbia also provides greater tax relief for DC-government pensions than for state-government pensions.

Three states (New Jersey, Massachusetts, and Pennsylvania) do not allow IRA contributions to be deducted from taxable income. Of the three, only Pennsylvania does not tax IRA earnings of taxpayers who are age 59½ years or older because these earnings are treated like pension income, which is tax exempt.

IDENTIFYING EQUALIZATION OPTIONS

As is made obvious by the preceding section, the states levying personal income taxes offer a myriad of combinations of tax breaks regarding their tax treatment of traditional pensions (private and federal, state and local governments), other retirement income (e.g., IRA distributions) and Social Security income. In terms of addressing the issue at hand, however, four broad approaches emerge.

- 1. Full Exclusion of both Pensions and Social Security** – Essentially the policy in place in Alabama and Pennsylvania, this approach is broadly consistent with the premise advanced by CSRS retirees, namely that CSRS pensions and Social Security are “equivalent programs” and, as a consequence, should be entitled to identical tax treatment. This approach differs from HB 97, however, because it extends this logic and tax treatment to all pensioners and not just federal retirees, and it also imposes no upper limit on the size of the exclusion.
- 2. Follow the Internal Revenue Code** – This approach rejects the notion that pension income should receive favorable treatment. Generally speaking, pension income is taxable at the federal level. This approach also accepts the federal approach to Social Security taxation that only excludes from state taxation the amount excluded on the federal return. Connecticut, Minnesota, Nebraska, North Dakota, Rhode Island, Vermont and West Virginia follow this approach. While this approach does not address the specific inequity identified by HB 97’s proponents, it does shed light on two important issues.

First, it calls into question the idea that Congress considers CSRS and Social Security to be equivalent programs. At least as far as the Internal Revenue Code is concerned, Congress determined that for tax purposes CSRS pensions (no federal exemption) should be treated differently than Social Security, which receives a means-tested exemption.

Second, by not providing preferential treatment for pension income, this approach allows one to inquire as to what is different about pension income to require special treatment. All other things being equal, equal amounts of pension and wage income, for example, imply equal ability-to-pay indicating that, when its implications on horizontal equity are considered, the very basis for preferential treatment of pension income appears suspect.

- 3. The HB 97 Approach** – As discussed above, this method involves developing an exclusion from income that takes into account both Social Security and pension income and, to the extent that a taxpayer lacks Social Security income, the amount of pension income available for the exclusion increases. HB 97 established the exclusion’s upper limit at \$37,500 and limited the proposed provision’s availability to federal and military retirees. Maryland offers a similar mechanism; however, its approach is not limited to any particular group of pensioners.
- 4. Comprehensive Reform** – As stated above, if one accepts the view that CSRS pensions and Social Security are equivalent programs, then it is easy to see how one might conclude that Delaware’s

tax system produces an unfair result. This view, while not unreasonable, examines only one aspect of Delaware’s current tax structure relating to retirees. In fact, it is fairly clear that this specific issue represents only the tip of the proverbial iceberg and that there are other issues that are far more fundamental in terms of equity, and far more profound in terms of the State’s fiscal future.

In addition, unlike the second approach above, “Follow the Internal Revenue Code,” which eliminates all preferential State tax treatment for pensions, eligible retirement income, and Social Security, this fourth approach continues to offer a tax preference to retirees. Like HB 97, a combination of pensions, eligible retirement income, and Social Security together determine the size of the “retirement income” exclusion. Unlike HB 97, this approach would apply to all taxpayers and not just federal and military retirees. More importantly, however, this approach subjects the resulting retirement income exclusion to a means-test.

Before each option is evaluated, though, it is important to consider the policy implications presented by Delaware’s current array of retiree tax breaks. As is the case with other demographically-driven fiscal and equity issues (e.g., the solvency of Social Security and Medicare), the long-term fiscal implications of simply maintaining the status quo are stark.

POLICY IMPLICATIONS OF CURRENT PROVISIONS

Background: Delaware’s tax breaks for its older citizens have been adopted and expanded incrementally over the past 25 years. These incremental changes’ cumulative effect on Delaware’s fiscal condition is presented below:

RETIREE TAX BREAKS

CY 2014 Delaware Population Estimate 60+	208,395	
Current Retiree Tax Breaks -- Available to all regardless of income	Estimated	Est. Cost
	Number on DE	All Returns
	<u>Resident Returns</u>	<u>(millions)</u>
CY 2014		
Extra Personal Credit for those Age 60+	145,000	\$9.6
Exclusion of Pension / Other Retirement Income (\$12.5k)	93,000	\$55.4
Exclusion of Federally Taxable SS (Overrides federal means-test)	76,000	\$36.7
Extra Standard Deduction 65+ (\$2,500)	68,000	\$3.7

Altogether, the combined cost of these provisions expected in 2014 is roughly \$100 million.⁸ A significant portion of Delaware’s retirees do not file income tax returns. For many, the combination of tax breaks

⁸ Each provision’s impact was calculated separately so, to the extent one provision alone could eliminate a taxpayer’s liability, adding all of the provisions together overstate their aggregate impact. On the other hand, due to the combined impact of all of these provisions, a significant portion of older Delawareans owe no income tax and, as a result, are not required to even file a tax return. While the elimination of a single tax break may not cause many of

outlined above reduces their income to a point below the filing threshold, which means they are legally not required to file a return. For example, in 2014 the estimate for Delaware’s population age-60 and over is 208,395.⁹ It is estimated however, that only 145,000 of these individuals will be accounted for on a tax year 2014 return meaning that approximately 63,395 Delawareans will not file a return. Moreover, for a significant portion of those Delawareans age-60 and over who do file tax returns, the combination of tax breaks offered under the current system eliminates their tax liabilities altogether.

In 2010, for example, the Delaware Population Consortium estimated that there were 183,616 Delawareans age-60 and over. Roughly 128,500 of these individuals either filed or were counted as dependents on 104,750 Delaware tax returns. Among those 104,750 tax returns, there were roughly 47,500 (60,600 individuals) that owed no tax and about 57,250 (67,900 individuals) that had a net tax liability greater than \$0. Thus, of the total age 60+ population of 183,616, only 67,900 or 37% filed or were a dependent on a tax return that actually owed Delaware tax. This means, of course, that the majority (63%) of Delawareans age-60 and over paid no State income tax in 2010.

Horizontal Equity and Age under Delaware’s Tax Code (Old vs. Young): Because elderly taxpayers can utilize more than one of these preferences at a time, the combined effect of these preferences can result in dramatically different tax treatment of individuals with the same ability-to-pay.

Cumulative Effect of Non-means Tested Preferences

An illustration of the equity problems caused by the cumulative effect of these tax preferences can be seen in the following example. Consider the following two households:

	<u>Household A</u>	<u>Household B</u>
Family size:	4	2
Both Spouses Age:	35	65
Number of Children:	2	0
Both Spouses Work:	Yes	No
Total Household Income:	\$74,400	\$74,400

“Household A” receives its income exclusively from wages and interest, while “Household B” receives its income primarily from Social Security and pension income. The differences in sources of income between these two households will have a dramatic impact on their tax liability.

those older taxpayers to file returns and pay taxes, it is fairly certain that the elimination of all of these tax breaks would cause many older taxpayers to begin paying taxes and filing returns. To the extent that this would occur, the figures presented understate the aggregate impact.

⁹ Center for Applied Demography and Survey Research, University of Delaware, *Annual Population Projections by Delaware Population Consortium 2010 (DPC)*

Household A

	<u>First Spouse</u>	<u>Second Spouse</u>
Pension:	\$0	\$0
Interest:	\$500	\$500
Dividends:	\$0	\$0
Wages:	\$36,700	\$36,700
Social Security:	\$0	\$0
Total Income:	\$37,200	\$37,200

Household B

	<u>First Spouse</u>	<u>Second Spouse</u>
Pension:	\$20,000	\$20,000
Interest:	\$7,200	\$7,200
Dividends:	\$0	\$0
Wages:	\$0	\$0
Social Security:	\$10,000	\$10,000
Total Income:	\$37,200	\$37,200

In computing taxable income, each spouse in Household A can reduce his/her taxable income by \$3,250 (a total of \$6,500 - the amount of the standard deduction). In contrast, the couple in Household B, because of the sources of their income and their age, can eliminate taxable income almost completely. This reduction represents the exclusion of Social Security benefits, the pension and eligible retirement income exclusion, the standard deduction, and the additional standard deduction for persons 65 and over. (See table below.)

Tax Liability Comparison				
Two-earner Family of Four vs. Two Taxpayers Over 65				
	<u>Household A</u>		<u>Household B</u>	
<u>Type of Income</u>	<u>First Spouse</u>	<u>Second Spouse</u>	<u>First Spouse</u>	<u>Second Spouse</u>
Total Income	\$37,200	\$37,200	\$37,200	\$37,200
Wages	\$36,700	\$36,700	\$0	\$0
Social Security Exclusion	\$0	\$0	-\$10,000	-\$10,000
Pension Income	\$0	\$0	\$20,000	\$20,000
Dividend Income	\$0	\$0	\$0	\$0
Interest Income	\$500	\$500	\$7,200	\$7,200
Total Pension/Retirement Income	\$0	\$0	\$27,200	\$27,200
Pension Exclusion	\$0	\$0	-\$12,500	-\$12,500
Delaware AGI	\$37,200	\$37,200	\$14,700	\$14,700
Standard Deduction	-\$3,250	-\$3,250	-\$3,250	-\$3,250
Additional Standard Deduction	\$0	\$0	-\$2,500	-\$2,500
Taxable Income	\$33,950	\$33,950	\$8,950	\$8,950
Gross Tax Liability	\$1,497	\$1,497	\$220	\$220
Personal Credit	-\$330	-\$110	-\$110	-\$110
Additional Personal Credit	\$0	\$0	-\$110	-\$110
Child Care Credit	\$0	-\$250	\$0	\$0
Net Liability	\$1,167	\$1,137	\$0	\$0
Total Household Liability	\$2,304		\$0	

In the end, Household A has a gross liability of \$2,994 which is reduced to \$2,304 through the use of four \$110 personal credits, and the child care credit.¹⁰ Household B, on the other hand, has \$440 in gross liability. This liability, however, is completely eliminated because the couple in Household B qualifies for four \$110 personal credits – two regular credits plus two additional credits for persons age-60 or over. The retirees in Household B, despite having the same income and no dependents, pay no income tax, while the working family of four owes the state over \$2,300.

¹⁰ This couple can use four personal credits -- one personal credit for each spouse and one for each dependent.

This example, while dramatic, is not unrepresentative of the radically different tax treatment of similarly situated taxpayers possible through the cumulative effect of age-based, non-means-tested tax preferences.

Horizontal Equity among the Elderly under Delaware’s Tax Code: The current system’s horizontal equity shortcomings are not confined to comparisons of retirees and younger taxpayers. The disparities among the elderly, depending upon a taxpayer’s composition of income, can be nearly as wide as those between young and old. Consider the case of the elderly person who has no pension or other resources and must, by necessity, continue working. A 65-year-old worker whose income consists of wages does benefit from an enhanced standard deduction and an additional personal credit. But assuming \$37,200 in income (like the spouses in our example above), a 65-year-old wage earner would still owe nearly \$1,140 in State taxes.¹¹ As we saw in the example above, a 65-year-old with an equal total income that just happened to consist primarily of pensions and Social Security would pay no tax.

Vertical Equity and Age under Delaware’s Tax Code (Old vs. Young): Here too the State’s current system is at odds with basic notions of fairness. Consider the example comparing the retired couple and the working family explored above using the same facts except, in this case, assume that the retired couple has \$50,000 in additional income split evenly between the spouses. The retirees’ individual incomes would increase from \$37,200 to \$62,200; their household income would rise from \$74,400 to \$124,400. The additional income would increase the couple’s State tax bill from \$0 to \$2,555 (\$1,277.50 per spouse).

With the additional income, the retired couple would pay \$251 ($\$2,555 - 2,304$) or 11% more than the working parents. The retirees’ extra \$50,000, however, represents 67% more in income and ability-to-pay than the working parents’ income. Despite having substantially less income, the working parents’ effective tax rate of 3.10% ($\$2,304 / 74,400$) is roughly 50% higher than the retired couples’ 2.05% effective rate ($\$2,555 / 124,400$), a textbook example of regressivity.

Again, while a dramatic example, this result does reflect the basic arithmetic of Delaware’s current system. When large portions of income are excluded from taxation for certain groups but not others, such results are bound to occur.

Vertical Equity among the Elderly under Delaware’s Tax Code: As discussed above, the current system of retiree preferences results in higher effective tax rates on both younger and older wage earners. As a consequence, just like the working parents, a relatively low-income 65-year-old wage earner can expect to pay a higher effective tax rate than a 65-year-old pensioner with substantially higher income.

Revenue Adequacy and Demographics: Producing steady revenues, even in economic downturns, is the most important role of any tax system. Tax preferences, such as those currently in effect for Delaware’s retirees, affect the adequacy of tax systems because they narrow the tax base and reduce the liability of

¹¹ Assumes the taxpayer does not itemize and makes use of the \$2,500 additional standard deduction and the extra \$110 personal credit.

certain groups of taxpayers, thereby reducing the ability of a tax system to raise revenue in a stable and reliable manner through alternating economic cycles. Generally, tax preferences linked to certain income sources or investment activities increase revenue instability because taxpayers can change their economic behavior in unpredictable ways. With respect to the Delaware's elderly tax breaks, however, the growth in their use is not driven by taxpayers' decisions regarding income and investment. In the aggregate, the growth is driven largely by demographics.

It is often said that "demographics are destiny." It is also clear that, compared to forecasts of other social and economic phenomena, demographic forecasts tend to produce the most accurate and reliable estimates. Given that the use and cost of Delaware's current elderly tax breaks will largely be determined by demographics, it is imperative that policymakers are aware of what the next two decades portend.

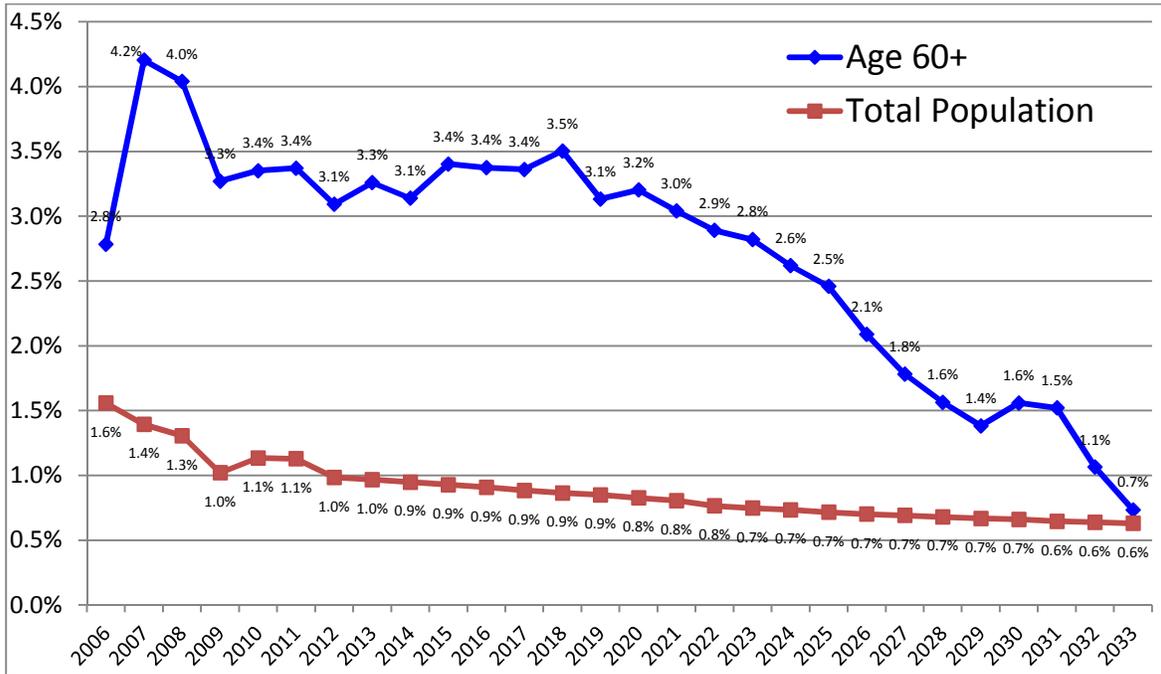
The oldest baby-boomers reached age-60 in 2006. Since 2006, Delaware's age-60 and over population has grown 27.3%, compared to an overall population growth rate of 8.2%.¹² This means, of course, that in the last seven years, 27.3% more taxpayers were able to avail themselves to Delaware's pension and retirement income exclusion, as well as the extra person credit – regardless of their income level and regardless of whether they were actually retired.

The last seven years are just the beginning. Delaware's expected rate of growth in the age-60 and over cohort will surpass the overall rate of growth in population for the next 20 years. From 2013 to 2023, the age-60 and over cohort is expected to grow 36.8%, a rate that is 4.2 times as high as the general population's 8.9%. From 2023 to 2033, the age-60 and over cohort is expected to grow 18.1%, a rate that is 2.6 times as high as the general population's 7.0%.

The policy implications of these dramatic growth rates are clear. The current array of non-means-tested tax breaks available to Delaware's older taxpayers, which already costs the State roughly \$100 million annually, will likely grow proportionally faster than the overall personal income tax base for the next two decades. The following chart illustrates this expected trend:

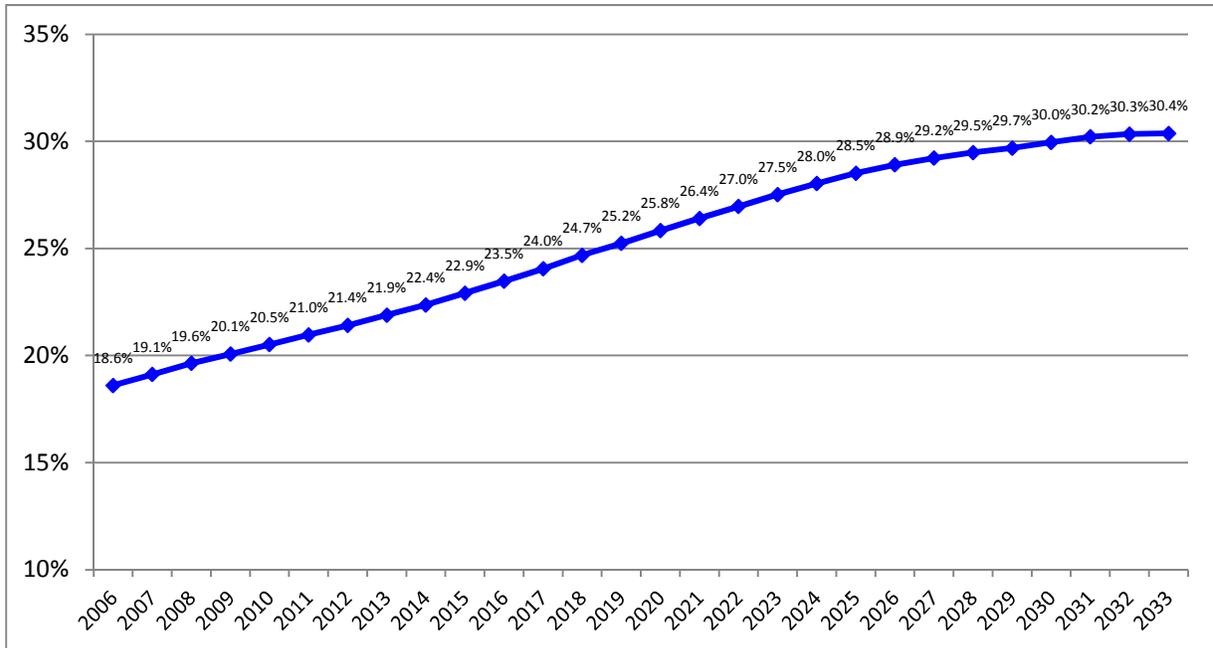
¹² Delaware Population Consortium, 2010.

ANNUAL GROWTH IN DELAWARE POPULATION 2006 - 2033



The cumulative effect of 27 years of proportionally higher growth in Delaware’s age-60 and over population is demonstrated in the following chart.

AGE 60+ SHARE OF DELAWARE POPULATION 2006 - 2033



In 2006, those age-60 and over comprised 18.6% of Delaware's population. Currently, that share stands at 21.9%. Over the next ten years, though, that share is forecast to increase to 27.5%. By 2033, it will peak at 30.4%. Thus, from 2006, when the first baby-boomers reached age-60, to 2033, when the trend is expected to end, the share of the population accounted for by those age-60 and over will have grown 63% (30.4% vs. 18.6%).

Policy Summary of Current Provisions: Generally, the current provisions available to Delaware's taxpayers age-60 and over achieved their ostensible goal, namely cutting taxes for older Delawareans. The policy rationale for these provisions is often questioned, though. There is little evidence to suggest that the elderly as a class are worse off than other segments of the population. Historically, their rates of poverty have been less than the general population and substantially below the levels for children.¹³

Additionally, the current provisions produce serious equity concerns. The lack of means-testing and the disparate treatment of various income sources result in inequitable tax burdens in which younger taxpayers and wage earners systematically pay higher effective tax rates than older taxpayers and pensioners regardless of their ability-to-pay.

Finally, the current provisions are expensive and there is no doubt that the cost will escalate as Delaware's population ages. This trend is well under way and will increasingly constrain tax collections over the next 20 years.

EVALUATION OF OPTIONS

To be useful, policy options can be neither fiscally unaffordable nor politically unrealistic. Clearly, the issues of affordability and palatability often overlap. That which is too expensive, for example, is often nothing more than a pipedream no matter how popular it might seem politically. Using affordability and political practicality to determine the initial cut, it is easy to dismiss two of the four approaches outlined above:

- 1. Full Exclusion of both Pensions and Social Security** – This approach is plainly unaffordable as it would massively expand a combination of tax breaks that already cost the State approximately \$100 million annually. From a pure policy perspective, it is also the least appealing in that it exacerbates the current system's equity shortcomings.
- 2. Follow the Internal Revenue Code** – At the present time, this approach appears to be a political non-starter. While budgets are certainly tight and additional resources would certainly be

¹³ See discussion of poverty rates. *Delaware's Tax Preference Report 2011*, Item 1.02.

welcome, there appears to be no appetite for what could amount to a \$100 million tax increase on taxpayers age-60 and older.

By process of elimination, this leaves two options to be considered more fully:

1. The HB 97 Approach – To review, this method generally involves developing an exclusion from income that:

- a) takes into account both Social Security and pension income and,
- b) to the extent that a taxpayer lacks Social Security income, the amount of pension income available for the exclusion increases.

HB 97, specifically, was available to taxpayers age-60 and over. HB 97 established the exclusion's upper limit at \$37,500 and limited the proposed provision's availability to federal and military retirees.

HB 97's estimated cost was \$3.0 to \$3.5 million per year. While there are an estimated 16,300 federal and military retirees in Delaware, as discussed above, the number who would actually benefit from HB 97 is substantially smaller. After taking into account the number likely to have Social Security income (most FERS retirees, for example) and the number under age-60 and therefore not eligible (many military retirees), the number estimated to benefit was reduced substantially.

Furthermore, the estimated number of CSRS retirees that would benefit was reduced after considering the impact of Delaware's existing pension exclusion, and additional standard deduction and personal credits on lower-income retirees. In other words, some CSRS pensioners already escape tax due to the State's already generous tax treatment of retirees. In these cases, expanding the size of the pension tax break adds no cost.

After working through these assumptions, the number of federal retirees projected to benefit from HB 97 was estimated at roughly 6,050 individuals, most of whom were CSRS retirees.

If added to HB 97's scope of eligible retirees (i.e., federal and military retirees), the 1,700 state and local government retirees identified above would be expected to add roughly \$700,000 to the overall cost. Thus, the total cost of extending HB 97's approach to all public retirees would be roughly \$4.0 million.

In the short-run, the affordability of a \$4.0 million price tag is really a question of how one priority stacks up against another. It is essentially a question of "opportunity cost" and begs the questions:

- What among current spending and financial priorities should be eliminated in order to afford a relatively narrowly targeted tax cut, or

- If \$4.0 million in additional spending authority were added to the 98% limit, among all other priorities, would this be first?

In the long-run, this option's affordability needs to also take into account what this proposal fails to address. As discussed above, there is ample evidence that, given the demographic realities Delaware faces over the next two decades, the current system of non-means tested senior tax breaks is likely unsustainable. This proposal, while adding only \$4.0 million to the current system's roughly \$100 million, does nothing to address the more fundamental fiscal problem. Additionally, this proposal does not address the larger equity issues discussed above. While well-intended, this approach represents a continuation of the incrementalism that produced the current system.

2. **Comprehensive Reform** – As stated above, if one accepts the view that CSRS pensions and Social Security are equivalent programs, then it is easy to see how one might conclude that Delaware's tax system produces an unfair result. A broader understanding of this issue's fiscal and equity challenges, however, demands a more far-reaching policy update. As witnessed in the national debate over the future of entitlements, it is no exaggeration to conclude that the central fiscal challenge of the next decade will be addressing Delaware's "demographic vice."

As the population ages, the demand for health care services also increases. Higher demand is expected to translate into higher costs for all health care consumers. Health care is a major component of the State's budget, and dealing with higher costs will further constrain already tight budgets. The expenditure side of the issue alone is an enormous challenge. As outlined above, the cost of Delaware's combination of tax breaks, already pegged at roughly \$100 million annually, will escalate creating the revenue side of the vice. Left unchecked, the demographic trend will pressure budgets and taxpayers from both the expenditure and the revenue side.

From the revenue perspective, simultaneously addressing the broad fiscal challenge presented by an aging population and, as required by Section 130 of the Budget, the uneven treatment of retirees who are not eligible to receive Social Security requires two basic steps:

1. Like HB 97, the distinction between Social Security and pension income must be erased; and
2. To control costs and improve equity, means-testing must be employed.

Naturally, there are many methods by which a means-test could be employed. To accurately reflect a taxpayer's ability-to-pay, the means-test should encompass the broadest measure of income. Additionally, in order to avoid arbitrary results, the means-test should be phased-in over a reasonable income range.

Two hypothetical reform proposals are examined below. In Example 1, the scope of "retirement income" includes federally taxable social security plus all pension and eligible retirement income

that qualifies for Delaware’s existing exclusion. Like the current exclusion, a taxpayer must be at least 60 years old to qualify. The maximum exclusion would be \$37,500 for joint returns and \$25,000 for all other filers.

The means-test incorporates all federal income, including tax-exempt interest, and is referred to as “total income” in the table below. (Federally exempt interest itself would not be taxed in Delaware under this proposal, but it would be used to determine the size of the retirement exclusion.) Any taxpayer with total income below \$50,000 (\$75,000 for joint filers) would be entitled to a full exclusion of retirement income up to the maximum of \$25,000 (\$37,500 for joint filers). Partial exclusions would be available for taxpayers with total income between \$50,000 and \$100,000 (\$75,000 and \$125,000 for joint filers). Taxpayers with total income above \$100,000 (\$125,000 joint) would not be eligible for the retirement exclusion. The projected results of this policy option are presented in the table (Example 1), below:

Hypothetical Reform Proposals

- A. Eliminate all existing retiree tax breaks
- B. Replace them with a single, means-tested tax break:
 1. Income threshold, below which taxpayer gets 100% of exclusion amount
 2. Phase-out range in which taxpayer gets partial exclusion
 3. Incomes above phase-out range, taxpayer gets no exclusion

EXAMPLE 1.	Retirement Income Maximum <u>Exclusion</u>	Total Income Phase-out <u>Start</u>	Total Income Phase-out <u>End</u>
Type of Return			
Single / MFS	\$25,000	\$50,000	\$100,000
Joint	\$37,500	\$75,000	\$125,000
CY 2014 Revenue Increase (millions)	\$47.0		
Age 60+ w/ Tax Cut	9,700		
Age 60+ w/Tax Increase	84,700		
Age 60+ No Change	50,400		
Under Age 60 w/ Tax Increase	7,700		

It is immediately obvious that this hypothetical proposal is truly an example of comprehensive reform. Because it employs a mean-test and more accurately bases tax levels on ability-to-pay, this example increases Delaware tax revenues by an estimated \$47.0 million. Because it eliminates the distinction between Social Security and pension income, the proposal would improve horizontal equity among retirees. At a given level of total income, all retirement income would be treated the same.

This proposal also improves vertical equity by concentrating the tax relief to lower- and middle-income retirees. Under this proposal, a retiree with total income above the top of the phase-out range would no longer pay an effective tax rate that is a fraction of what a middle-income wage earner pays.

From a pure policy perspective, however, this proposal is far from perfect. For taxpayers with total incomes below the top of the phase-out range, those age-60 and over with eligible retirement income would still pay lower effective tax rates than wage earners of all ages having the same ability-to-pay.

What is also apparent is that, like any true reform, this proposal would produce winners and losers when compared to the current system. It is critical to reiterate here that the current system is hardly ideal. As discussed at length above, it is wrought with horizontal and vertical equity problems and its costs are rapidly becoming untenable. “Fixing” the current system requires change. Whether this particular proposal is the appropriate mechanism is certainly debatable. While its scope and timing (i.e., should it be implemented in one step or phased-in over a number of years) are issues worthy of additional consideration, arguing against this or any other policy proposal that effectively addresses the issue exclusively on the grounds that such a proposal results in “winners and losers” is effectively tantamount to avoiding the issue altogether.

As seen above, the hypothetical proposal would increase taxes on some 84,700 taxpayers age-60 and over. Taxpayers experiencing a tax increase under this hypothetical example, however, would likely have a total income in excess of \$50,000 (\$75,000 for joint filers). Those receiving a tax cut or having no change are likely to have total income under the thresholds.

As a point of comparison, a less dramatic proposal using the same mechanism is presented in Example 2, below:

EXAMPLE 2.	Retirement	Total Income	Total Income
	Income	Phase-out	Phase-out
Type of Return	<u>Maximum</u>	<u>Start</u>	<u>End</u>
Single / MFS	\$37,500	\$60,000	\$120,000
Joint	\$60,000	\$80,000	\$150,000
CY 2014 Revenue Increase (millions)	\$21.0		
Age 60+ w/ Tax Cut	30,300		
Age 60+ w/Tax Increase	59,200		
Age 60+ No Change	55,200		
Under Age 60 w/ Tax Increase	7,700		

In Example 2, the larger retirement exclusion and the more generous phase-out range produce a less dramatic shift in tax burden than the policy outlined in Example 1. Example 2's hypothetical proposal would increase taxes on some 59,200 taxpayers age-60 and over. It would increase Delaware tax revenues by an estimated \$21.0 million.

RECOMMENDATIONS

The impetus behind this report was a desire to better understand the methods by which Delaware could eliminate its seemingly disparate tax treatment of two groups of pensioners: 1) Those with Social Security and 2) Those without Social Security. As is pointed out throughout the report, this particular disparity is one of the more minor flaws in Delaware's current approach to taxing retirees. The current system has significant shortcomings both in terms of equity and affordability.

A narrow policy solution, like the HB 97 approach, would do nothing to address these larger and more serious issues. While the HB 97 approach would improve one equity issue (i.e., pensioners with Social Security vs. those without Social Security), it would aggravate other equity concerns (e.g., the disparity between pensioners and wage earners). Moreover, instead of providing a policy mechanism that would allow Delaware to address the real and growing costs of an aging population, the HB 97 approach would actually aggravate, albeit only somewhat, the magnitude of the fiscal headwind that is expected to endure for the next two decades.

In light of these facts, Delaware should adopt policy measures that address both the disparity among pensioners identified in Section 130 of the FY 2013 Budget Act and, more importantly, the larger issues brought about by its aging population. The two hypothetical examples of comprehensive reform provided in this report represent a good starting point, but are by no means the only ways to address such a critical issue. Still, using those examples as a starting point provides the basis for further analysis and policy development. At a minimum, such analysis should consider the following issues:

- **Age:** To the extent that it is a trigger for eligibility, what age should a taxpayer reach before becoming eligible? In the debate over Social Security, for example, increasing the retirement age is one of the methods by which costs have been controlled. Given Delaware's relatively low threshold (age-60) for its most costly tax break (the exclusion of pension and eligible retirement income), it seems eminently reasonable to consider this as a policy option.
- **Means-testing:** As discussed above, any effort to improve vertical equity and control costs should include means-testing. To avoid abrupt and arbitrary increases in effective tax rates as incomes increase, the mechanism by which this is achieved should include a phase-out range. (The exclusion is gradually phased-out for taxpayers with aggregate incomes above a predetermined threshold.) How the phase-out range works will depend on the designer's notion of what constitutes vertical equity and also on fiscal constraints.

- **Scope of “Retirement” Income:** Obviously, the scope of income eligible for the exclusion must include both pensions and Social Security (the basic reason for the report). If the idea is for the exclusion to capture “retirement” income, then distributions from IRAs and other qualified plans should also be included. Delaware’s current provision also includes dividends, interest, net rental income and capital gains. It seems reasonable to question whether any of these sources legitimately meet the concept of “retirement income.” For example, consider a 62-year old landlord whose primary source of income comes from the rent on the dozens of apartments he or she owns. The apartment owner works full-time and receives no Social Security. Yet by including net rental income within the scope of the exclusion, he or she is entitled to a \$12,500 exclusion from income.
- **Implementation:** Given the number of people affected and the potential for significant changes to individuals’ tax burdens, a comprehensive reform should be gradually phased-in over a number of years so that current retirees and those considering retirement have time to plan accordingly.

Attachment 1.



SPONSOR: Rep. Hocker & Sen. Simpson ;
Reps. Lavelle, Blakey, Briggs King, Hudson, Kenton,
Lee, Manolakos, Miro, Outten, Peterman, Ramone, D.
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Sens. Booth, Bunting, Bushweller, Cloutier, Connor,
Venables

HOUSE OF REPRESENTATIVES
146th GENERAL ASSEMBLY

HOUSE BILL NO. 97

AN ACT TO AMEND TITLE 30 OF THE DELAWARE CODE RELATING TO THE PERSONAL INCOME TAX.

BE IT ENACTED BY THE GENERAL ASSEMBLY OF THE STATE OF DELAWARE:

- 1 Section 1. Amend § 1106(b), Title 30 of the Delaware Code by adding a new paragraph "(10)" to read as follows:
2 "(10) For taxable years beginning on or after January 1, 2011, amounts received by persons 60 years of age or
3 older as pensions from the United States, including military retirement income, in excess of \$12,500.00 but not in excess of
4 \$37,500.00 reduced by the amount of Social Security benefits paid by the United States in the taxable year to the extent
5 included in Federal adjusted gross income."

SYNOPSIS

This Bill excludes from income taxes pensions received from the United States, including military retirement income, up to a maximum of \$37,500.00 less any Social Security benefits paid by the United States in the taxable year. It is intended to equalize the treatment of Federal retirees who are not covered or are partially covered by the Social Security System with those retirees receiving Social Security benefits which are presently exempt from tax.

Attachment 2.

STATE PERSONAL INCOME TAXES ON RETIREMENT INCOME:

State	State/Local Pension Exclusion	Federal Civil Service Pension Exclusion	Military Pension Exclusion	Social Security	Private Pension Exclusion
AL	Full	Full	Full	Full	Full
AK	No personal income tax.				
AZ	AZ plans: \$2,500	\$2,500	\$2,500	Full	None
AR	\$6,000	\$6,000	\$6,000	Full	\$6,000
CA	None	None	None	Full	None
CO	65 +, \$24,000 55-65, \$20,000	65 +, \$24,000 55-65, \$20,000	65 +, \$24,000 55-65, \$20,000	65 +, \$24,000 55-65, \$20,000	65 +, \$24,000 55-65, \$20,000
CT	None	None	50% exclusion	Same as federal	None
DE	60+, \$12,500 under 60, \$2,000	60+, \$12,500 under 60, \$2,000	60+, \$12,500 under 60, \$2,000	Full	60+, \$12,500 under 60, \$2,000
DC	62+, \$3,000.	62+, \$3,000.	62+, \$3,000.	Full	None
FL	No personal income tax.				
GA	See below	See below	See below	Full	See below
Taxpayers aged 62 and over are entitled to a retirement income exclusion of \$35,000 per taxpayer (\$70,000 joint), of which a maximum of \$4,000 per taxpayer may be earned income. Beginning in 2012 the exclusion for taxpayers 65 and older increases to \$65,000; in 2013 \$100,000; 2014 150,000; 2015 \$200,000; 2016 fully excluded.					
HI	Full	Full	Full	Full	Full except for partial taxation of plans to which employees contributed.
ID	65+, 62+ if disabled: \$27,876 filing singly/\$41,814 filing jointly, (minus SS/RR benefits) limited to certain public safety officers' benefits. Applies to ID pensions only.	65+, 62+ if disabled: \$21,900 filing singly/\$32,850 filing jointly, (minus SS/RR benefits). Applies only to CSRS not to FERS benefits	Capped at the same exclusion as CSRS benefits.	Full	None
IL	Full	Full	Full	Full	Full for qualified plans
IN	None	62+ \$2,000 - SS income	62+ \$5,000 - SS income	Full	None

Attachment 2.

STATE PERSONAL INCOME TAXES ON RETIREMENT INCOME:

State	State/Local Pension Exclusion	Federal Civil Service Pension Exclusion	Military Pension Exclusion	Social Security	Private Pension Exclusion
IA	55+ \$6,000 individual; \$12,000 joint	55+ \$6,000 individual; \$12,000 joint	55+ \$6,000 individual; \$12,000 joint	Exclusion of 55% of Taxable SS benefits. Taxation of SS benefits will be phased out by 2014.	55+ \$6,000 individual; \$12,000 joint
KS	Full; Applies to KS pensions only.	Full	Full	Full for AGI of \$75,000 or less	None
KY	\$41,110 per taxpayer	\$41,110 per taxpayer	\$41,110 per taxpayer	Full	\$41,110 per taxpayer
LA	Full	Full	Full	Full	65+: \$6,000 single, \$12,000 joint
ME	See below	See below	See below	Full	See below
----- \$6,000 per taxpayer; \$6,000 per spouse or survivor minus SS/RR benefits.					
MD	See below	See below	See below	Full	See below
----- Taxpayers aged 65 and over are entitled to an exemption of \$26,300 per person minus SS/RR benefits.					
MA	Full for MA pensions out of state pensions exempt if there is a reciprocal agreement	Full	Full	Full	None
MI	Full for MI pensions For age 67+	Full For age 67+	Full	Full	\$47,309 single, \$94,618 joint. For age 67+
----- Taxpayers born after 1946 will see a graduated reduction in their exemptions.					
MN	None	None	None	Same as federal	None
----- Taxpayers aged 65 and over are entitled to an exemption of \$9,000 for single taxpayer (\$18,000 joint)					
MS	Full	Full	Full	Full	Full for qualified plans
MO	Age 62+: 100%, \$34,141 cap per spouse; income limits apply. Amount of Social Security exclusion must be deducted from pension exclusion.	Age 62+: 100%, \$34,141 cap per spouse; income limits apply. Amount of Social Security exclusion must be deducted from pension exclusion.	60%; increasing to 100% in 2016	100%; income limits	\$6,000; income limits

Attachment 2.

STATE PERSONAL INCOME TAXES ON RETIREMENT INCOME:

State	State/Local Pension Exclusion	Federal Civil Service Pension Exclusion	Military Pension Exclusion	Social Security	Private Pension Exclusion
MT	Up to \$3,760 for single filers whose AGI is less than \$31,370. For joint filers who both have retirement income, up to \$7,520.	Up to \$3,760 for single filers whose AGI is less than \$31,370. For joint filers who both have retirement income, up to \$7,520.	Up to \$3,760 for single filers whose AGI is less than \$31,370. For joint filers who both have retirement income, up to \$7,520.	SS is taxable for taxpayers whose income including SS exceeds \$25,000 single, \$32,000 joint.	Up to \$3,760 for single filers whose AGI is less than \$31,370. For joint filers who both have retirement income, up to \$7,520.
NE	None	None	None	Same as federal	None
NV	No personal income tax.				
NH	No personal income tax.				
NJ	62+, \$20,000 joint; \$15,000 single, subject to an income ceiling	62+, \$20,000 joint; \$15,000 single, subject to an income ceiling	Full	Full	62+, \$20,000 joint; \$15,000 single, subject to an income ceiling
Taxpayers over the age of 62 are entitled to an additional income exclusion to allow them to reach the amount of the pension exclusion. The sum of the pension exclusion and the additional exclusion may exceed the pension exclusion if the recipient is ineligible to receive Social Security retirement payments.					
NM	None	None	None	None	None
Taxpayers aged 65 and older are eligible for an income exemption capped at \$8,000 single, \$16,000 filing jointly, phased out as AGI grows, and ended at AGI of \$51,001 for joint filers, \$28,501 for single. People aged 100 or older are fully exempt from income tax unless claimed as a dependent					
NY	Full for NY and DC pensions; out-of-state treated like private pensions.	Full	Full	Full	\$20,000 for taxpayers aged 59 years, six months and older.
NC	\$4,000 single; \$8,000 filing jointly	\$4,000 single; \$8,000 filing jointly	\$4,000 single; \$8,000 filing jointly	Full	\$2,000 single; \$4,000 filing jointly
ND	None	None	None	Same as federal	None
OH	None	None	Full	Full	See note
A retirement income tax credit of as much as \$200 is allowed, depending on income. A senior citizen tax credit of \$50 per tax return is allowed to filers of 65 or older; each taxpayer may claim it only once. A one-time tax credit is available for lump-sum distributions to people over 65: \$50 multiplied by remaining life expectancy.					

Attachment 2.

STATE PERSONAL INCOME TAXES ON RETIREMENT INCOME:

State	State/Local Pension Exclusion	Federal Civil Service Pension Exclusion	Military Pension Exclusion	Social Security	Private Pension Exclusion
OK	\$10,000 per individual. Spouses must qualify individually.	100% of CSRS benefits, plus up to \$10,000 in FERS and remaining CSRS benefits.	Greater of 75% of benefits or \$10,000 not to exceed amount included in federal AGI.	Full	\$10,000 per individual.
OR	62+: 9% credit for retirement income. Income limits apply	Income attributable to service before October 1991 is exempt. In addition: 62+: 9% credit for retirement income. Income limits apply	62+: 9% credit for retirement income. Income limits apply	Full	Payments from certain plans can be subtracted if previously taxed. 62+: 9% credit for retirement income. Income limits apply
PA	Full	Full	Full	Full	Full
RI	None	None	None	Same as federal	None
SC	Under 65 \$3,000; over 65 \$10,000	Under 65 \$3,000; over 65 \$10,000	Under 65 \$3,000; over 65 \$10,000	Full	Under 65 \$3,000; over 65 \$10,000
SD	No personal income tax.				
TN	The individual income tax is imposed only on individuals and other entities receiving interest from bonds and notes and dividends from stock. Persons over 65 with total income less than \$16,200 for a single filer or \$27,000 for a joint filer are exempt.				
TX	No personal income tax.				
UT	Utah provides individual taxpayers aged 65 and older a non-refundable retirement income tax credit of \$450. The credit is reduced and phased out at higher income levels, beginning at \$25,000 single and \$32,000 married filing jointly.				
VT	None	None	None	Same as federal	None
VA	Virginia provides individual taxpayers aged 65 and older a deduction of up to \$12,000 (\$24,000 married filing jointly.) The deduction is reduced and phased out at higher income levels, beginning at \$50,000 for single taxpayers and at \$75,000 for married couples regardless of their filing status. The base is state-adjusted federal AGI.				
WA	No personal income tax.				

Attachment 2.

STATE PERSONAL INCOME TAXES ON RETIREMENT INCOME:

State	State/Local Pension Exclusion	Federal Civil Service Pension Exclusion	Military Pension Exclusion	Social Security	Private Pension Exclusion
WV	WV state or local police, deputy sheriffs' or firefighters' retirement benefits are fully exempt. Other WV pensions: \$2,000.	\$2,000; see below	\$22,000; see below	Same as federal; see below	None; see below
Each West Virginia taxpayer aged 65 or older is entitled to a deduction of \$8,000 minus retirement income deductions.					
WI	65+: \$5,000 for filers with an AGI of less than \$15,000 (single) or \$30,000 (joint)	65+: \$5,000 for filers with an AGI of less than \$15,000 (single) or \$30,000 (joint)	Full	Full	65+: \$5,000 for filers with an AGI of less than \$15,000 (single) or \$30,000 (joint)
WY	No personal income tax.				

Source: National Conference of State Legislatures Report on State Personal Income Taxes on Pensions and Retirement Income: Tax Year 2010

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