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Limiting Expensive Income Tax Break for Higher-Income Retirees Is Important Part of Tax Reform

By Jason Bailey

A limit on the state's large retirement income tax break for higher-income people is an important component of tax reform, and Governor Beshear's plan includes such a limit. Reforming the existing tax break will improve the fairness of Kentucky's tax system, generate needed revenue for public services and reduce the revenue losses that would come with an aging population in future years.

The legislature created this tax break in 1995. Six years earlier, the U. S. Supreme Court ruled that states cannot give preferential tax treatment for state employee pension income while not extending the same treatment to federal employee pensions. Kentucky responded by giving an income tax break to all retirees, even those with retirement income from the private sector who were not impacted by the court ruling.[1] The amount of retirement income individuals could exclude from the income tax started at $6,250, went up to $35,000 in 1997 and was indexed to inflation thereafter.

Recognizing the impact such a large and growing exclusion had on state revenue, the 2005 General Assembly froze the exclusion at $41,110 as part of a tax reform package. It has remained at that level since. The exclusion applies to individuals, meaning that married couples can each exclude up to $41,110 in retirement income from the income tax. It applies to income from pensions, annuities, IRA accounts, 401k plans, death benefits and other similar accounts or plans. Social Security income is untaxed in Kentucky.

In his tax reform plan, Governor Beshear proposes to phase out the exclusion for those that have at least $80,000 in total income.[2] The amount of excludable income would decline proportionately as total income increases between $80,000 and $100,000 such that no exclusion can be claimed for those with total income over $100,000. For example, the maximum exclusion a married couple filing jointly with income of $90,000 could claim would be $20,555 per person, half of the previous $41,110 maximum. However, Social Security income would remain untaxed.

Why should Kentucky take action to limit this tax break as part of tax reform?

It has a substantial impact on the state budget.

The exclusion results in at least several hundred million dollars in lost revenue each year.[3] The proposal in Governor Beshear's plan would only affect 90,200 of Kentucky's 1.8 million income tax filers and generate significant new revenue, raising $176 million for the budget. That's important given Kentucky's many needs in education, health and other areas.

Phasing out the tax break for high-income people will also reduce its impact in future years as the baby boomers retire. The share of the Kentucky population over age 65 is expected to grow from 13 percent now to 20 percent by 2030.[4] If we don't limit the exclusion, a growing share of the population will have their income shielded from taxation, contributing to continued erosion of state revenue in the coming years.

It is much larger tax break than in most other states.

Kentucky's exclusion of up to $41,110 in retirement income from the income tax is very high compared to most other states. Of nearby states: [5]

- Indiana has no exclusion for retirement income.
- North Carolina's exclusion ranges from $2,000 to $8,000 depending on income and family size.
- West Virginia's exclusion is $2,000 for public sector retirees and $0 for private sector retirees.
- Ohio has no exclusion but allows a small retirement tax credit of up to $200 based on income.
- Virginia's exclusion is $12,000 ($24,000 for married couples filing jointly) but is phased out for higher-income people.
- Missouri allows an exclusion of $6,000 for private pensions and up to $33,703 for public pensions with income limits.

Of nearby states, only Illinois provides a full exclusion. Also, fourteen states including West Virginia tax some portion of Social Security income.[6] A 2006 survey indicated that Kentucky provides among the biggest state tax breaks for seniors.[7]

Limiting it introduces greater fairness into the Kentucky tax system based on ability to pay.

Kentucky has a regressive tax system now, in that low- and middle-income people pay a greater share of their income in state and local taxes than the wealthy.[8] At the same time, income inequality is growing both in Kentucky and the nation.[9] Asking higher-income retirees to pay a little more in income taxes will help improve the overall fairness of the tax system.

By phasing out the exclusion for those with at least $80,000 in total income, the governor's plan only impacts relatively higher-income retirees. The state reports that the average adjusted gross income of households affected by the phase-out is $215,000. 74 percent of Kentucky tax returns with federally-taxable pension and annuity income had an adjusted gross income of less than $75,000 in 2011, and 86 percent had less than $100,000.[10] The median household income (which differs somewhat from adjusted gross income) in Kentucky is only $30,023 for householders at least 65 years old.[11]

Seniors do receive other significant tax advantages. Investment gains in retirement plans (whether in a 401k account or a pension plan) are not taxed as they are earned. In many types of plans, contributions are also shielded from income taxes. As mentioned earlier, Social Security income is not taxed in Kentucky. And those over 65 regardless of income level can claim a homestead exemption of $36,000 that lowers property taxes.

Limiting it won't harm Kentucky's economy.

Even after limiting Kentucky's income tax exclusion for retirees, it will be more generous than many other states. And it is wrong to assume that limiting this tax break would cause measurable harm to Kentucky's economy. A 2012 paper in the *National Tax Journal* examined the migration patterns of the elderly and found they were not affected by changes in state tax laws over a thirty year period that were designed to benefit them. The authors write that "our results are overwhelming in their failure to reveal any consistent effects of state income tax breaks on elderly migration."[12] Limiting the tax break as part of a tax reform plan that raises significant new revenue can help Kentucky's economy by allowing greater investment in education, health and other fundamentals of economic growth.

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[1] Merl Hackbart, "Tax Reform: Review and Perspective," *Financing State and Local Government*, Kentucky Long-Term Policy Research Center, 2001, http://kltprc.info/books/taxation.pdf.
[2] Income is measured as federal adjusted gross income. Social Security income is only partially included in adjusted gross income (AGI) depending on an individual or couple's total income and filing status. Social Security income is generally not included for people who rely on Social Security as their only income source. Those with some income from other sources can have up to 50 percent of Social Security included in AGI, and those with higher total incomes can have up to 85 percent included. See more here: http://www.ssa.gov/planners/taxes.htm.
[3] A presentation to the Blue Ribbon Commission on Tax Reform put the fiscal impact at roughly $350 million. Greg Harkenrider, "Options—Tax Reform Initiatives," May 8, 2012, http://ltgovernor.ky.gov/taxreform/Documents/20120508_Options.pdf. The latest tax expenditure report put the lost revenue from the exclusion for private pensions and IRAs at $967 million. "Tax Expenditure Report 2012-2014," http://www.osbd.ky.gov/NR/rdonlyres/043EF3FC-B7DC-4B30-9204-53D590ECDE1E/0/2012_2014_TaxExpenditure_Doc.pdf.
[4] Kentucky State Data Center, Population Projections, http://ksdc.louisville.edu/index.php/kentucky-demographic-data/projections.
[5] Ronald Snell, "State Personal Income Taxes on Pensions and Retirement Income: Tax Year 2010," National Conference of State Legislatures, February 2011, http://www.ncsl.org/documents/fiscal/TaxonPensions2011.pdf.
[6] Institute on Taxation and Economic Policy, "State Income Taxes and Older Adults," September 2011, http://www.itep.org/pdf/pb30eld.pdf.
[7] Elizabeth McNichol, "Revisiting State Tax Preferences for Seniors," Center on Budget and Policy Priorities, March 6, 2006, http://www.cbpp.org/cms/?fa=view&id=149.
[8] Institute on Taxation and Economic Policy, "Kentucky State and Local Taxes," *Who Pays: A Distributional Analysis of the Tax Systems in All 50 States, 4th Edition*, January 2013, http://www.itep.org/pdf/ky.pdf.
[9] Elizabeth McNichol, et al., "Pulling Apart: A State-by-State Analysis of Income Trends," Center on Budget and Policy Priorities and Economic Policy Institute, November 15, 2012, http://www.cbpp.org/files/11-15-12sfp.pdf.
[10] IRS Statistics of Income, Individual Income and Tax Data, by State and Size of Adjusted Gross Income, Tax Year 2011, http://www.irs.gov/uac/SOI-Tax-Stats---Historic-Table-2.
[11] U. S. Census Bureau, 2012 American Community Survey 1-Year Estimates. Among other differences with adjusted gross income, household income includes all Social Security income while AGI includes only a portion, as noted above.
[12] Jason Bailey, "Senior Tax Breaks Don't Attract Migrants," Kentucky Center for Economic Policy, June 1, 2012, http://www.kypolicy.us/senior-tax-breaks-dont-attract-migrants. Karen Smith Conway and Jonathan C. Rork, "No Country for Old Men (or Women)—Do State Tax Policies Drive Away the Elderly?" *National Tax Journal* (June 2012), Volume 64, No. 2, http://ntj.tax.org/wwtax/ntjrec.nsf/009a9a91c225e83d852567ed006212d8/de93ed23981659d685257a1e004d2ded/$FILE/A03_Conway.pdf.