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Should states cut taxes on retirement income?

On the surface, income tax breaks might sound like a very nice perk for retirees. Supporters say they would reduce the tax burden on low-income seniors, and perhaps make a state more attractive to wealthier retirees. But neither argument holds up.

By Renu Zaretsky

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When we moved to Michigan from Florida in 2014, we braced ourselves for a dramatic change in weather (hello, snow!) and our state tax bill (good-bye, income-tax-free Florida!). We also learned from a newly-retired Michigander that when the time comes, we'd have to pay the state's 4.25 percent income tax on pension income.

Michigan expanded what our unhappy friend calls the "pension tax" in 2011. He was not thrilled: He had worked hard for many years and expected his pension to be largely free of state income tax, as it was under Michigan law for decades. At the time, I hadn't thought much about his predicament, other than to offer sympathy. But now, I might offer some context as well as commiserate.

Depending on the tax filer's age, Michigan still exempts some pension income from tax, but much less than it used to. Anybody born after 1952, like me, will pay state income tax on their retirement income, whether from a public or private pension or other retirement plan, once they reach age 67.

Michigan isn't the only state to have offered a tax break on retirement income. Don Boyd, Director of Fiscal Studies at SUNY's Rockefeller Institute of Government, notes that of the 41 states with broad-based income tax, 36 allow residents to exclude some retirement income beyond Social Security, or offer an elderly tax credit.

Of course, the federal government provides favorable tax treatment for retirement plans. Employers can deduct contributions to employee pensions, and investment earnings on those plans' assets are tax-exempt. Once the employee receives a distribution from the plan, she pays personal income tax. At the same time, IRA and defined contribution plans such as 401(k)s are also tax-advantaged.

And there is nothing new about states cutting taxes on retirement income. Karen Smith Conway of the University of New Hampshire and Jonathan C. Rork of Reed College explain that states' private pension exemptions became common in the 1970s, and "have evolved into weapons of state policy competition" for retirees.

Are they powerful, cost-effective weapons? On the surface, income tax breaks might sound like a very nice perk for retirees. Supporters say it would reduce the tax burden on low-income seniors, and perhaps make a state more attractive to wealthier retirees. But neither argument holds up.

Consider Illinois, which excludes all retirement income from its 3.8 percent income tax. Dennis Byrne of the *Chicago Tribune* took a closer look at the policy with research by Natalie Davila, formerly the director of research for the Illinois Department of Revenue.

Her November/December 2014 study shows that the biggest beneficiaries are those with high incomes, including many who are younger than 65. While the number of residents filing Illinois tax returns declined slightly between 2007 and 2012—the number claiming a retirement income exemption climbed by 9 percent.

In 2012, one in four Illinois tax returns claimed a retirement income exemption. Strikingly, 60 percent of those claiming the tax break were below retirement age. Why? As Byrne explains, you can start receiving money from your 401(k) at age 59 ½, draw a government pension early, or be a designated IRA beneficiary of any age.

The kicker: Of those with adjusted gross incomes over $1 million, nearly three out of four were younger than 65. And they claimed an average exemption of $241,939.

In fiscal year 2015 the exemption cost Illinois $2.3 billion. And the state really could have used the money. Current estimates show that the Illinois budget deficit will grow to $14.75 billion by the end of fiscal year 2017.

Then, there is the tax Mecca argument. We've all seen those magazine articles that rank states as the best places to retire, and make low taxes a big piece of their calculation. We may read them, but few seniors take their advice.

My TPC colleague Howard Gleckman noted that in 2011 "fewer than one percent of seniors moved from state to state after age 65 for any reason. And very few appear to do so to reduce their taxes." Moreover, he noted in 2016 that "Millionaires hardly ever move from one state to another for any reason, and when they do there is little evidence that their choice is driven by taxes."

States may be slow to catch on to the folly of retirement tax breaks. Illinois Governor Bruce Rauner—leading a state that has not passed a budget since 2015—says he'd support the Illinois Senate's bipartisan budget plan, but only under certain conditions. Among them: No state tax on retirement income.

Other governors are learning more quickly. In Michigan, Republican Rick Snyder said in 2013 that reducing the private pension exemption was an "issue of fairness." It cost the state $930 million a year while the state's funds for roads, schools, and other essential public services suffered. Just last week, Michigan's House failed in their attempt to repeal the "pension tax" by phasing out the state income tax. That's because, as one state Democrat put it, "We have less money, we get less of those [public services]. It's that simple," he said.

To my Michigan friend, who as I type may be preparing his return and paying state income tax on his private pension income: I offer my sincere thanks, but regrettably, not much sympathy.

This story originally appeared on TaxVox.

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