

# How Different States Exempt Social Security Income from Income Tax

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# Who receives Social Security benefits?

- ~145,000 people in Vermont received benefits as of Dec. 2016
- Old-Age benefits (73% of OASDI beneficiaries in VT)
  - Age 62+ if 40 quarters of work
- Survivors Insurance benefits (8% of beneficiaries in VT)
  - Widows or widowers age 60 or older (age 50 if disabled) if married > 9 months, or of any age if care for child under age 16 or disabled
  - Unmarried children up to age 19 if full-time in elementary or secondary school
  - Children at any age if disabled before age 22
  - Dependent parents > 62 if provide at least 50% of their support
  - Surviving divorced spouses if > 60 and married at least 10 years
- Disability Insurance benefits (16% of beneficiaries in VT)
  - Ages 16-64 with severe disability

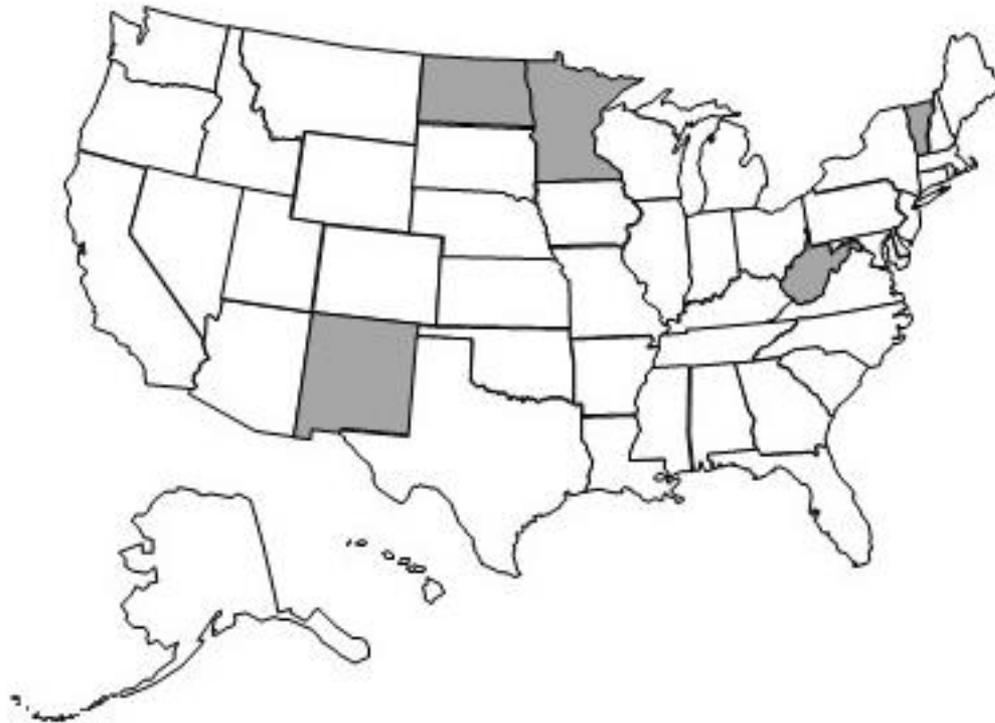
# Two simple approaches

1. No broad-based state income tax
  - 9 states, including New Hampshire
  
2. Exempt Social Security benefits completely from taxation at the state level
  - 27 states and D.C., including Maine and Massachusetts

### 3. Apply the state income tax to Social Security benefits that are taxable at the federal level

- Occurs in 5 states, including VT
- Why are some Social Security benefits exempt at the federal level?
  - FICA taxes paid by the employee when working (6.2% of earnings up to \$128,400) are included in taxable wages
  - Back in 1993, single males had the lowest ratio of lifetime benefits to payroll taxes paid; they had already paid federal income tax on about 15% of their benefit value, so that portion was declared to be exempt from further federal income tax

# Which 5 states?



# The federal approach, cont.

- First, find combined or provisional income
  - = federal AGI excluding Social Security benefits
  - + tax-exempt interest (e.g., from municipal bonds)
  - + ½ of Social Security benefits

**Federal Taxation of Social Security Benefits**

|   | <b>Married couple</b>                            | <b>Single filer</b>                              |
|---|--|--|
| <b>Social Security exempt</b>   | Provisional income less than \$32,000            | Provisional income less than \$25,000            |
| <b>Social Security included in taxable income at up to 50% rate (first tier)</b>  | Provisional income between \$32,000 and \$44,000 | Provisional income between \$25,000 and \$34,000 |
| <b>Social Security included in taxable income at up to 85% rate (second tier)</b> | Provisional income over \$44,000                 | Provisional income over \$34,000                 |

# The federal approach, cont.

- Those thresholds have not been updated since 1983
  - This was deliberate, to align with tax treatment of pension income eventually
- Share of beneficiary families who pay income tax on benefits nationwide
  - 1984: 8 percent
  - 1993: 20 percent
- Share of beneficiaries who pay income tax on benefits
  - 2003: 39 percent
  - 2014: 49 percent
  - Average tax payment in 2014 is 6.7% of benefit income

## 4. Tax some Social Security benefits but less than under the federal rules

- Partial exemption
  - Based on combined or provisional income
  - Based on AGI
  - Based on age and AGI
- Exemption for pension income, including Social Security income
- Retirement tax credit

# Partial exemption, cont.

9 states do this in different ways

1) CO exempts some *pension* income by age

- 55-64: up to \$20,000 pension income is exempt
- 65+: up to \$25,000 pension income is exempt

2) CT exempts most Social Security benefits

- Deduct 100% of benefits if federal AGI < \$60K for MFJ or < \$50K for singles
- If AGI > threshold, exempt 75% of federally taxable benefits

3) KS exempts all Social Security benefits if federal AGI < \$75,000

# Partial exemption, cont.

## 4) Minnesota changed its approach in 2017

- MN followed federal rules through 2016, but then expanded the amount of benefits exempt
- The state subtraction is reduced by 20% of provisional income over a threshold, adjusted by inflation beginning in 2018

|                                     | Maximum subtraction | Start of phaseout | End of phaseout |
|-------------------------------------|---------------------|-------------------|-----------------|
| <b>Married joint</b>                | \$4,500             | \$77,000          | \$99,500        |
| <b>Single and head of household</b> | \$3,500             | \$60,200          | \$77,700        |
| <b>Married separate</b>             | \$2,250             | \$38,500          | \$49,750        |

# Partial exemption, cont.

## 5) Missouri has the heftiest exemption in this group

- AGI < \$85,000 if single, < \$100,000 if married and age 62+ or disabled
- Partial exemption if income exceeds the limit by less than taxable OASDI benefits and if age 62+ or disabled
- The exemption is decreased by the amount AGI exceeds the limit

## 6) MT

- Expand federal exemption for singles to include HOH

## 7) NE

- Exempt if AGI <\$43,000 single or HOH; \$58,000 married filing jointly
- Bill to index thresholds to inflation was under consideration in January 2018

# Partial exemption, cont.

## 8) RI has the 2<sup>nd</sup> highest exemption in this group

- Exempt if AGI <\$80,000; \$100,000 if married

## 9) UT

- Follow federal rules, but filer and spouse may each be eligible for a retirement tax credit of up to \$450 if age 65 or over.
- The credit is phased out at the rate of 2.5% when MAGI (including nontaxable interest income) exceeds \$25,000 if single or \$32,000 if married filing jointly or HOH.
- Examples for married filing jointly:

| MAGI           | \$32,000 | \$40,000 | \$50,000 | \$60,000 | \$65,000 | \$68,000 |
|----------------|----------|----------|----------|----------|----------|----------|
| Ret tax credit | \$900    | \$700    | \$450    | \$200    | \$75     | \$0      |