

# Vermont Legislative Joint Fiscal Office

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## *ISSUE BRIEF*

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### **Tax Treatment of Government Pension Payments Other than Social Security**

#### **Overview**

Questions have arisen regarding Vermont's tax treatment of payments from government pensions other than Social Security. In Vermont, legislation under consideration would exempt Social Security benefits from income taxes for single filers with income less than or equal to \$45,000 and for married filing jointly filers with income less than or equal to \$60,000.<sup>1</sup>

Preliminary information from tax year 2014 suggests that fewer than 1,000 Vermonters over age 65 with income below those thresholds receive no Social Security benefits but have pension or annuity income from other sources, often the federal government; they are not included in the proposed tax change. The federal pensions not integrated with Social Security come from pre-1987 federal retirement systems. This Issue Brief discusses tax treatment of the two common forms of federal pensions and the situations in which retirees would not see tax relief under the proposed legislation.

#### **The Federal Retirement System Pensions**

The most common form of government pension income other than Social Security is federal retirement benefits. Federal employees with sufficient years of service receive retirement benefits, usually in the form of annuity payments as long as they live. Two different systems have existed in recent decades: the Civil Service Retirement System (CSRS) and the Federal Employees Retirement System (FERS). Lifetime CSRS employees may not have any Social Security benefits, but FERS employees are part of the Social Security system. The two types of annuity payments are treated the same for tax purposes, however, at the federal level and in most states.

Vermont follows federal law regarding taxation of CSRS and FERS annuity payments, meaning that a large portion of the payment is taxable. An overview of the two retirement systems and how the annuities are taxed appears below.

#### **Background on CSRS and FERS**

The Civil Service Retirement Act became effective on August 1, 1920 and established a retirement system for certain federal employees. It was replaced by the Federal Employees Retirement System (FERS) for federal employees who first entered covered service on and after January 1, 1987.

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<sup>1</sup> H.911 includes a phase-out range up to \$55,000 if single and \$70,000 if married filing jointly.

The Civil Service Retirement System (CSRS) is a defined benefit, contributory retirement system. Employees share in the expense of the annuities to which they become entitled. CSRS covered employees contribute a portion of pay to CSRS. They generally pay no Social Security retirement, survivor and disability (OASDI) tax, but they do pay the Medicare tax. The employing agency matches the employee's CSRS contributions. The average monthly annuity payment to workers who retired under CSRS in FY2016 was \$4,755.<sup>2</sup>

FERS is a retirement plan that provides benefits from three different sources: a Basic Benefit Plan, Social Security and the Thrift Savings Plan (TSP). FERS participants pay the Social Security payroll tax as well as the Medicare tax. Two of the three parts of FERS (Social Security and the TSP) can go with the employee to his or her next job after leaving the Federal Government before retirement.

The Basic Benefit and Social Security parts of FERS require the employee to pay a share of the cost each pay period. The employee's contributions are subject to income tax. The employing agency also contributes. After retirement, annuity payments are paid out each month as long as the employee lives. Workers who retired under FERS received an average monthly annuity of \$1,714 in FY 2016. FERS annuities are supplemented by Social Security benefits and the TSP.

In FY 2016, 4,649 people in Vermont received civil service annuities as retired federal employees, surviving spouses, or surviving dependents. Information on the breakdown between CSRS and FERS was not immediately available.

### **Federal Tax Treatment of CSRS and FERS Annuity Payments**

CSRS covered employees contributed 7, 7 ½ or 8 percent of wages to CSRS but did not pay any Social Security (OASDI) tax. Employees paid income tax on their contributions, but those contributions usually amount to about 5 percent to 10 percent of annual pension income from CSRS. As a result, 90 percent to 95 percent of the CSRS retirement benefit is taxable at the federal level. FERS employees contributed between 0.08 percent and 4.4 percent when working, and those contributions were taxed as well. FERS benefits not funded by the employee's contributions are taxed when payments are made. The taxable amount of annuity payments for both CSRS and FERS is reported to the annuitant on Form CSA 1099-R each year.<sup>3</sup>

Social Security benefits for higher-income taxpayers receive similar treatment; up to 85 percent of Social Security benefits are taxable under federal law.<sup>4</sup> Lower-income taxpayers pay no federal income tax on their Social Security benefits.

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<sup>2</sup> Congressional Research Service, *Federal Employees' Retirement System: Summary of Recent Trends*, February 2, 2018; available at <https://www.everycrsreport.com/reports/98-972.html>.

<sup>3</sup> Annuitants whose retirement start date was prior to November 19, 1996 may use a different method for calculating the taxable portion of their annuity payment. See IRS Publication 721 (2017) available at [https://www.irs.gov/publications/p721#en\\_US\\_2017\\_publink1000228167](https://www.irs.gov/publications/p721#en_US_2017_publink1000228167).

<sup>4</sup> The Social Security payroll tax is 6.2 percent of wages for the employee up to a maximum amount and an additional 6.2 percent of wages for the employer up to a maximum amount (\$127,200 in 2018). The employee's contribution was taxed at the time it was paid, but those contributions make up no more than 15 percent of the benefit on average. Hence up to 85 percent of Social Security retirement benefits are taxable under federal law

**Tax Treatment of CSRS and FERS Annuities by States**

The National Association of Retired Federal Employees compiled information on the state tax treatment of CSRS and FERS benefits in the 50 states for tax year 2016.<sup>5</sup> At that time, 9 states exempted their own nonparticipating retirement systems and all civil service annuities from state income tax. Five other states exempted certain federal civil service annuities, often based on year of birth or dates of service. And 9 states had no personal income taxes. The other 27 states appear to follow the federal treatment (see Table below).

Table. Tax Treatment of Civil Service Pensions by States in 2016			
Exempt	Partially exempt	No Income Tax	Follow Federal Treatment
Alabama Hawaii Illinois Kansas Louisiana Massachusetts Mississippi New York Pennsylvania	Kentucky Michigan North Carolina Oklahoma Oregon	Alaska Florida Nevada New Hampshire South Dakota Tennessee Texas Washington Wyoming	All others, including Vermont
Source: NARFE			

Vermont follows the federal treatment of CSRS and FERS annuity payments, meaning that a large portion of CSRS and FERS benefits are taxable. The taxable portion of FERS and CSRS annuities as well as the taxable portion of Social Security benefits appear above the line for taxable income, meaning that only the taxable portion of benefits flows through to adjusted gross income (AGI). As mentioned above, fewer than 1,000 Vermont tax filers had no income from Social Security but did have income from pensions that are not integrated with Social Security such as CSRS or some state pension systems such as the one in Massachusetts.

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and under current law in Vermont. The average monthly Social Security benefit for retired workers was \$1,360 in 2017.

<sup>5</sup> See NARFE, State Tax Treatment, available at <https://www.narfe.org/pdf/StateTaxRoundupTaxYear2016.pdf>.