

State Income Taxes and Senior Citizens

State governments provide a wide array of tax breaks for their elderly residents. Almost every state levying an income tax now allows some form of income tax exemption or credit for its over-65 citizens that is unavailable to non-elderly taxpayers. But many states have enacted poorly-targeted, unnecessarily expensive elderly tax breaks that make state tax systems less sustainable and less fair. This policy brief surveys approaches to elderly income tax relief and suggests options for reforming elderly tax breaks.

The Starting Point: Federal Income Tax Breaks for the Elderly

Most states base their income tax on federal rules: the starting point in calculating a given taxpayer's taxable income for state purposes is usually the amount of taxable income reported on federal tax forms. This makes the process of filing and administering state income taxes much simpler for taxpayers and state tax administrators, but also means that states automatically allow some of these federal tax breaks to reduce state tax collections.

Federal tax law provides two substantial tax breaks to elderly taxpayers:

- A larger **standard deduction**. An under-65 married couple gets a \$10,000 standard deduction in 2005; an elderly couple receives an extra \$1,000 for each over-65 spouse.
- A partial exemption for **Social Security benefits**. Seniors with incomes below \$25,000 (\$32,000 for married couples) pay no tax on Social Security benefits.

How States Give Income Tax Breaks for Seniors

Virtually every state conforms to at least one of the federal government's elderly tax breaks. All 42 states that levy broad-based income taxes follow the federal exemption for Social Security benefits, and 10 states allow their seniors to claim the same higher federal standard deduction. But most income tax states go beyond these tax preferences inherited from federal income tax rules to allow special elderly-only tax breaks of their own, including:

- **Higher personal exemptions** for elderly taxpayers. 21 states allow senior citizens an extra exemption or exemption credit—allowing these taxpayers to shelter twice as much of their income from tax as similar non-elderly taxpayers can claim.
- Special elderly exemptions that only apply to **certain types of income**. 37 states allow exemptions for private or public pension benefits. 33 states provide an extra exemption for Social Security benefits in addition to the federal tax break, and 29 of these exempt *all* Social Security benefits from tax. A few states exempt interest, dividends, or capital gains income received by seniors.

Design Issues for Elderly Income Tax Breaks

The goal of providing income tax relief to elderly taxpayers is a simple one—and lawmakers in virtually every state have taken steps to achieve it. But lawmakers seeking to provide such tax breaks must confront several important design issues that can make the difference between an effective tax-relief device and a poorly-targeted tax giveaway.

✎ **Income limits.** Some states allow elderly exemptions only for low-income seniors. For example, New Mexico offers an extra elderly exemption of up to \$8,000 for over-65 single taxpayers earning less than \$18,000. The exemption is gradually reduced to zero for taxpayers with incomes over \$28,500 (for married couples, the range is \$30,000 to \$50,000). However, most states extend elderly tax breaks to all income levels. Of the 37 states that provided extra

Most Americans agree that elderly taxpayers should never be “taxed out of their homes,” and lawmakers have enacted an array of income tax breaks ostensibly designed to achieve this goal. But most states’ elderly income tax breaks are poorly targeted, delivering the lion’s share of their benefits to wealthier retirees.

What elderly tax breaks does your state provide?
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exemptions for their elderly residents in 2005, only 9 imposed income limits for eligibility. But cash-strapped states have re-evaluated these poorly targeted tax breaks in recent years: most recently, Virginia added a \$75,000 income limit to its elderly exemption in 2004. Imposing income limits helps target the benefits of pension tax breaks to truly needy seniors.

☞ What types of income should be eligible for tax breaks? State income tax exemptions for non-elderly taxpayers typically do not discriminate between wages and other income sources: these exemptions can be used to reduce any source of taxable income. But many state income tax exemptions for elderly taxpayers apply only to particular income sources, such as pension benefits and Social Security benefits, while providing no relief for earned income such as salaries and wages. Special tax breaks for pension benefits shift the cost of funding public services away from retirees and onto working taxpayers—including working seniors.

☞ How large a deduction? States that provide elderly exemptions usually limit the amount that can be deducted. For example, Arizona allows seniors to exempt the first \$2,500 of pension benefits. But other states impose much higher caps on the deduction: a married Maryland couple could deduct as much as \$43,000 in benefits in 2005. And three states (Illinois, Mississippi and Pennsylvania) completely exempt all pension benefits from income tax while fully taxing seniors’ wages. Imposing a low cap on these exemptions helps target the benefits of elderly tax breaks to low-income seniors, and makes these exemptions more affordable.

☞ Deduction or credit? States can provide income tax breaks through deductions and exemptions, which reduce taxable income, or through credits, which provide a dollar-for-dollar reduction in tax liability. Deductions are usually worth much more to upper-income taxpayers, while credits are more valuable for lower-income taxpayers.

☞ Refundable or non-refundable credit? A *refundable* income tax credit is one that is available even to those who owe little or no income tax. Refundability is important for fixed-income seniors, for whom sales and property taxes are often more burdensome than income taxes. Kansas and Idaho each allow special “grocery tax” credits for seniors that are administered through the income tax, but are designed to offset sales taxes on low-income seniors who may owe no income tax. Refundable credits are the best-targeted, and least expensive, approach to achieve income tax relief for fixed-income seniors.

Demographic Trends Mean Growing Costs for Elderly Tax Breaks

Poorly targeted tax breaks for the elderly are a costly commitment for many states—and long-term demographic changes threaten to make these tax breaks unaffordable in the long run. In 1994, as many states contemplated expanding elderly income tax breaks, 12.5 percent of Americans were over 65. By 2030, almost 20 percent of the population will be over 65. Over time, this demographic shift will mean that a shrinking pool of workers will be forced to fund tax breaks for an increasing pool of retirees—heightening the need to target these tax breaks appropriately to minimize their cost.

Elderly Tax Breaks: Matching Rhetoric with Reality

Few demographic groups receive more attention from state lawmakers than do fixed-income seniors. There is a virtual consensus among elected officials that retirees should not be “taxed out of their homes.” Yet state income tax breaks for seniors typically reserve the lion’s share of their benefits for better-off elderly taxpayers. These poorly targeted tax breaks shift the cost of funding public services towards non-elderly taxpayers, many of whom are less well-off than the seniors benefiting from the tax breaks. Retooling elderly exemptions to better target the neediest seniors will help states, in the long run, to achieve a fairer and more sustainable tax system.