CHAPTER 15

TAXING RETIREMENT INCOME

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"Is it true that retirees pay no state income tax on their retirement income?"

A quick, simple answer is "yes." Before I explain, however, let me ask a multiple-choice question.

> When the president of a large Hawaii corporation retires on a great big pension, will he or she be able to:
>
> A. Play golf at Waialae Country Club every day instead of just twice a week.
> B. Use his or her yacht more often.
> C. Pay zero income taxes to the State of Hawaii.
> D. Receive an annual welfare check from the State of Hawaii.
> E. All of the above.

Remarkably, the answer could be "E. All of the above." This is so because Hawaii is a great place for golfing and boating *and* because it is one of only two states that exempts all pension and Social Security income from state income taxes. Our retired executive can receive unlimited income from such sources, pay no state income tax, and qualify to receive a "welfare" check in the form of refundable tax credits. With the help of an aggressive tax advisor, a clever person of any age may be able to receive tax-free "pension" benefits from his or her controlled corporation. The law is remarkably ambiguous, and it is common knowledge among tax experts that aggressive planning in this area generally works by default.

The rationale. Since most working people pay a significant portion of their income to the state tax collector, it is reasonable for them to ask why this special treatment is provided to *all* who receive pension income. After all, sooner or later every tax break gets paid for by other taxpayers.

Just before statehood, the territorial government studied the potential for attracting well-off retired people to live in Hawaii as a way of fostering economic development. There is no documentary evidence that the income-tax preferences for retirement income are related to that effort. However, some argue that they are necessary to keep Hawaii attractive as a retirement location, especially for federal civilian and military retirees.

For the most part, however, the tax preferences are rationalized on the basis of the economic needs of the elderly. As a group, the elderly have made many positive contributions to our society and deserve respect. Many are burdened by ever-increasing medical costs and some lack the funds to meet basic needs.

It is a popular stereotype that all the elderly are poor and live on a fixed income. As is the case for most stereotypes, this is far from the truth.

Elderly aren't so poor. As a whole, the elderly are no poorer than the rest of the adult population. According to the U.S. Census Bureau, the 1989 income per U.S. household member was essentially the same for households with elderly ($13,345) and without ($13,978). Another study found that the proportion of elderly living in poverty fell significantly from 1970 to 1982, to the point where the elderly, as a group, had lower poverty rates than any other age group. Nevertheless, myths about the elderly always being poor persist, and Hawaii's special treatment of pension income is built largely upon this myth.

For better or worse, let's consider the federal income tax as a benchmark. Pension income generally is fully taxable, and 50 percent of social security benefits are taxable for single taxpayers with income above $25,000 or joint filers with income above $32,000. While most states have special rules affecting the elderly, of all states that have income taxes Hawaii is the most generous in its treatment of retirement income. All income from pensions (whether public or private) and all social security benefits are excluded for tax purposes. The pension income of someone living in California, for example, is fully taxable, the same as any other type of income.

In Hawaii, a taxpayer doesn't have to report retirement income. The tax forms don't even have a space for it. Naturally, this encourages aggressive taxpayers to take extreme positions with respect to the definition of "pensions" and "retirement." Many tax advisors argue that a person does not have to be elderly or stop working to "retire." Even the State Department of Taxation agrees that "pension" benefits can be received in one lump sum and still qualify for special treatment.

Tax exemptions. In addition to the exclusion of pension income, Hawaii provides a double exemption—an extra $1,040 per exemption in 1991—for elderly taxpayers, thereby further reducing taxable income. Since Hawaii has some of the highest state income-tax rates in the nation (up to 10 percent), the value of these exclusions and exemptions can be considerable.

The exclusion of pension and social security income means that the State is not collecting as much revenue as it otherwise would. Unlike the federal government which can borrow to make up for revenue shortfalls, the State must raise taxes elsewhere when it provides tax breaks to select groups. Based on research done in 1989 for the Hawaii State Tax Review Commission, retirement income exclusions reduce state income tax collections by about 5 percent. That amounted to about $35 million in 1990. Stated another way, the exclusions cost every tax filer about $100 in additional income taxes.

The retirement income preferences have other insidious effects, especially with respect to our sense of fairness. It is widely held that taxes, as distasteful as they are, should at least be fair. For the income tax, fairness is usually defined in the following way: those with equal incomes should pay roughly equal taxes. The retirement income preference insures this will not be the case.

In Table 1, Hawaii income-tax liabilities are calculated for three hypothetical households, all with the same gross income. Household A has two wage earners whose combined income is $40,000 a year (before taxes) and two children. (Don't ask how they can survive.) Household B is a retired couple with $17,000 in Social Security benefits and $23,000 of interest and dividend income from investments made before retiring. Household C also is a retired couple who together have $17,000 in Social Security benefits plus pension income of $23,000 per year.

Working family pays. The working family, Household A, must pay the State $1,843 in income taxes. The retirees of Household B are unfortunate enough to receive the majority of their retirement income from interest and dividends. This income is taxable. But, because of the exclusion of the Social Security benefits, plus the availability of refundable credits, they pay only a small tax—$158. The retirees of Household C, in contrast, with the same $40,000 in gross income, *receive* a $1,050 check from the State because none of their income is taxable and they qualify for refundable tax credits.

This violates basic standards of equity. All three families in the hypothetical example have $40,000 income, but only the working couple pays a significant tax and Household C actually receives a substantial payment from the State. Effectively, we penalize workers and retirees whose income is from interest and dividends in favor of those with pensions. And this doesn't even consider the possibility that Household C's "pension" is the result of clever tax planning.

You might argue that the elderly deserve special treatment, and I agree that some of the elderly do deserve tax preferences. However, not all people receiving pension income are elderly and not all need tax relief. In 1989, 37 percent of all pension income received by Hawaii residents went to taxpayers with an adjusted gross income (AGI) of more than $50,000 and almost two-thirds went to those with an AGI over $30,000. By excluding all pension income from the tax base, the "well-off" retired actually benefit much more than the "elderly poor."

Making it fairer. Our state income tax would be fairer if the tax relief currently provided to "retired" taxpayers were instead targeted a the poor (whether working or retired). This could be accomplished b adopting the same approach as the federal income tax. However, thi means virtually all pension income would be taxable. A less sever approach would be to do what many other states do: exempt only a certain amount of pension income from the tax, say, the first $10,00 per elderly person. Another way of increasing fairness would be t count all forms of income, including retirement, to determine eligibil- ity for credits and credit amounts.

These suggestions are consistent with the notion that an incom tax is fair if it taxes income the same way, regardless of the source. The also are consistent with the notion that a tax base should allow fe exclusions so that rates can be kept low. For a number of good reasons tax relief can and should be provided to the poor. By carefully targetin income-tax relief, we can afford to provide more relief to those wh really need it and keep taxes on everyone else as low as possible. Plus we can avoid the ridiculous situation of a retired corporate executiv qualifying for low-income tax credits.

Table 1
HAWAII INCOME TAX LIABILITIES OF
THREE HYPOTHETICAL HOUSEHOLDS, 1990

	Household A (working family)	Household B (retired couple with interest income)	Household C (retired couple with pension income)
Gross Income	$40,000	$40,000	$40,000
Adj. Gross Income Less standard deductions and exemptions	$40,000 $ 6,060	$23,000* $ 6,060	$0 ** $6,060
Taxable income	$33,940	$16,940	($6,060)
Tax from tax table	$ 2,503	$ 1,028	$0
Total credits ***	$ 600	$ 870	$ 1,050
Net tax liability	$ 1,843	$ 158	($1,050)

* Only $23,000 interest and dividend income is taxable. $17,000 Social Security income is exempt.

** $23,000 pension income and $17,000 Social Security income are exempt.

*** Includes food tax, excise tax, low income renter, general income tax and medical services credits.

" . . . the imposition of an excise tax on interbusiness transactions . . . violates principles of equity and efficiency . . . [this tax] is hidden from the consumers who ultimately pay it in the form of higher prices on goods and services." ***Hawaii State Tax Review Commission***