taxanalysts special report

State Income Tax Revenues In 2002 and 2030: The Impact Of the Retirement of the Baby Boom

by Nina Manzi, Joel Michael, and Paul Wilson

Nina Manzi and Joel Michael are legislative analysts with the Minnesota House of Representatives' Research Department. Paul Wilson is director of tax research with the Minnesota Department of Revenue.

This report was prepared for the National Tax Association's Annual Conference, held November 17-19 in Miami. It will be published by the NTA and is published here with permission.

Introduction

The implications for public finance of the baby-boom generation (roughly individuals born between 1946 and 1960) have long been recognized by public finance researchers and the media. With the older baby boomers nearing retirement, much of the focus has been on the implications for various federal and state spending programs for the elderly — for example, the potential effect on spending for Social Security, Medicare, and Medicaid. Because state and federal spending per capita are significantly higher for the elderly, the impending budget pressures on public expenditures seem obvious. However, there are also implications for the revenue side of the budget equation. As a result of special federal and state tax benefits and lower incomes, elderly taxpayers face lower average effective federal and state tax rates than the nonelderly. Thus, just as the demand to finance public services for the elderly is increasing, federal and state revenues may decline relative to personal income or other broad measures of economic activity.

Some research has begun to focus on the implications of special state income tax provisions for the elderly. Penner (2000) analyzes the various federal and state tax preferences for the elderly and points out the significant tax benefits enjoyed by many middle- and upper-income elderly taxpayers relative to younger taxpayers with equivalent incomes. In addition to federal benefits, the elderly also receive extensive state benefits. Most states exempt all Social Security benefits and some pension income from taxation. A few states go further, exempting all pension income. As a result, the revenue implications of the aging of the baby boom are likely to be felt more by state budgets than federal budgets.

As a result of special federal and state tax benefits and lower incomes, elderly taxpayers face lower average effective federal and state tax rates than the nonelderly.

Using data from the Statistics of Income public-use sample, Edwards and Wallace (2004) estimate the effective state income tax rates affecting the elderly on a state-by-state basis. They show that the lower effective rates for the elderly are statistically significant in more than three-quarters of the states with income taxes. In two-thirds of those states, nonelderly taxpayers have effective rates at least one and a half times as high as the elderly. Using these effective rates, Edwards and Wallace forecast the growth in state income tax revenues attributable to the growth in relative elderly and nonelderly populations through 2015. Their approach holds constant the average effective tax rates of the elderly and nonelderly.

Using richer data from federal and Minnesota tax returns, we build on Edwards and Wallace's research by simulating the combined effect of an aging population and state and federal elderly tax preferences on Minnesota income tax revenues in the year 2030. Because Minnesota tax return data include the age of the taxpayer and spouse, we can simulate effects for different age cohorts within the elderly and nonelderly populations. Second, using the macroeconomic forecast by the state's economic consultant (Global Insight Inc.), we adjust the relative shares of capital, labor, and retirement income between the base year, 2002, and 2030 to match the

(C) Tax Analysts 2006. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

forecast. Finally, because some tax preferences for the elderly are not indexed, we adjust for the effect of inflation.

The report is divided into five sections. Section I describes the federal and state income tax preferences for the elderly. Section II briefly describes the characteristics of the data used in the analysis and the characteristics of the Minnesota individual income tax. Section III describes how income and tax liability are distributed by age in the base year, 2002. Section IV describes how we model changes in the age distribution of the population, the mix of incomes (labor, capital, and retirement income), and inflation for the 2030 projection. It reports the changes in Minnesota income tax filers, liability, and effective tax rates for the elderly and nonelderly populations between 2002 and 2030. Section V reports how our results would change if Minnesota allowed additional elderly preferences, like those available in many other states (full Social Security exemption, pension exclusions, and additional personal exemptions for the elderly). Section VI summarizes our findings, notes limitations, and discusses possible future research.

The revenue implications of the aging of the baby boom are likely to be felt more by state budgets than federal budgets.

In general, our analysis finds that for state tax structures similar to Minnesota's (that is, those allowing essentially only the federal preferences for the elderly), the decline in tax revenues resulting from the aging of the population will be relatively modest (1.8 percent). While the growth in the elderly population (with its lower effective tax rates) reduces revenues, increases in their effective tax rates partially offset that effect, as inflation erodes the value of the dollar thresholds in the Social Security exclusion. States with more typical elderly tax benefits (for example, exemption of all Social Security benefits and partial pension exclusions) will experience much larger drops in revenue (4.4 percent). Exemption of all Social Security benefits and all pension income would result in an even larger decrease (10 percent). Because the results are based on Minnesota data, tax structure, and projected demographic changes, there are obvious limitations in extrapolating to other states, particularly those whose population characteristics or projected changes in populations differ significantly from Minnesota's. However, because projections of aging for Minnesota are relatively close to national projections, we believe that the results provide useful insights for other states.[1]

I. Description of Federal and State Tax Benefits for the Elderly

A. Federal Tax Benefits

The federal income tax provides three tax benefits targeted to the elderly: the partial exclusion of Social Security benefits from taxation; an additional standard deduction amount; and the elderly or disabled tax credit.

Many states offer exemptions, deductions, or credits based on age that are not restricted to a particular income source or type.

Of the three provisions, the partial exclusion of Social Security benefits is clearly the most important, at least in terms of its dollar impact.[2] Most Social Security benefits are not taxed. For higher-income recipients, up to 85 percent of benefits can be taxed under a complicated three-tier formula, based on provisional income over dollar thresholds that vary by filing status.[3] These dollar thresholds are

[1]Population projections for 2000 to 2030 show the share for age 65 and over rising from 12.1 percent to 18.9 percent in Minnesota, compared with 12.4 percent and 19.7 percent nationally. The share under age 18 falls from 26.2 percent to 23.9 percent in Minnesota (25.7 percent to 23.6 percent nationally). U.S. Census, *State Interim Population Projections by Age and Sex* (April 2005).

[2]The Treasury Department's tax expenditure estimates for fiscal 2006 are $19.77 billion for the exclusion of Social Security benefits for retired workers, $1.96 billion for the additional standard deduction for the elderly, and $20 million for the tax credit for the elderly or disabled. *Analytical Perspective: Budget of the United States Government Fiscal Year 2006,* p. 319 (February 2005). The estimates for the exclusion of Social Security assume that 85 percent of benefits would be taxed. *Id.* p. 346.

[3]Provisional income is total income recognized for tax purposes, plus tax-exempt interest, various exclusions from federal income taxation (interest on U.S. savings bonds used for education, employer-provided adoption benefits, foreign earned income or housing, and income earned in Puerto Rico or American Samoa by residents), and one-half of Social Security benefits. Christine Scott, "Social Security: Calculation and History of Taxing Benefits," CRS Report for Congress, p. 1 (Jan. 14, 2005). For taxpayers with provisional incomes less than $25,000 ($32,000 for married joint taxpayers), all Social Security benefits are excluded from taxable income. For provisional incomes between $25,000 and $34,000 ($32,000 and $44,000 for married joint taxpayers), up to 50 percent of Social Security benefits may be subject to tax.

(Footnote continued on next page.)

(C) Tax Analysts 2006. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

not indexed for inflation and have diminished in real terms since their enactments in 1983 (first threshold) and 1993 (second threshold). So long as the thresholds are not increased or indexed, increasing proportions of Social Security benefits will be subject to federal tax.

Federal law provides a higher standard deduction for taxpayers who are 65 years or older. For tax year 2005, the amount is $1,200 for a single taxpayer and $950 for each married taxpayer. Those amounts are indexed for inflation and are scheduled to rise by $50 each for tax year 2006 (that is, to $1,250 and $1,000).

Federal law also provides a limited, nonrefundable elderly or disabled credit to low-income individuals. The credit is 15 percent of a base amount (varying by filing status) less the sum of nontaxable Social Security and other retirement benefits and adjusted gross income over dollar thresholds. The income limits are so low that very few taxpayers qualify for the credit. Moreover, they are not indexed for inflation.[4]

B. State Tax Benefits

Nearly all states grant at least the equivalent of the federal tax preferences for the elderly. Most states provide additional tax preferences that exclusively or predominantly benefit elderly taxpayers. Some of those benefits are significantly more generous than those under the federal tax. The state provisions can be divided into three categories: more generous exemptions of Social Security benefits than allowed under federal law; partial or full exclusion of various forms of pension and similar retirement income; and age-based general exemptions, deductions, or credits.

1. Social Security Benefits

For tax year 2004, 28 states and the District of Columbia provided full exemptions for Social Security benefits. (Seven states do not have personal income taxes.) Nine states, including Minnesota, followed the federal rules. The rest (six states) taxed some Social Security benefits, but fewer than under the federal tax. Wisconsin will join the states fully exempting Social Security benefits beginning in tax year 2008 as a result of legislation enacted in 2005. Table 1 in Appendix A (p. 230) provides the state-by-state details.

2. Pension Income

Many states partially or fully exempt pension income. The rules vary a great deal from state to state. States define qualifying pension or retirement income differently. Most exclusions apply to pensions, individual retirement accounts, and deferred compensation (401(k), 403(b), and 457 plans, but often not nonqualified deferred compensation). A few states extend the exemptions to investment income (for example, interest and dividends), while others limit the exemptions to classic defined benefit-style pensions. The parameters for the exemptions often differ for governmental retirement plans (federal civil service, military, and state and local governments) versus private plans.[5] Some states impose age and income limits, while others do not. For tax year 2004, 25 states had some form of exclusion or credit for private pension income.[6] Of those, five states fully exempted private and public pension income.[7] Another eight states had dollar-limited exemptions of at least $20,000 for married couples. Only five states, including Minnesota, provide no exemption for any private or public pensions. Table 2 in Appendix A (p. 232) provides the state-by-state details.

3. Age-Based General Exemptions

Many states also offer exemptions, deductions, or credits based on age that are not restricted to a particular income source or type. Fifteen states provide higher standard deduction amounts for individuals age 65 or older. Of those, nine, including

---

For those with provisional incomes over $34,000 ($44,000 for married joint taxpayers), up to 85 percent of Social Security benefits may be included in taxable income.

[4]The base amounts used to calculate the credit are set at $5,000 for single individuals (any filing status) and married joint filers when only one spouse is age 65 or older; $7,500 for married joint filers when both are age 65 or older; and $3,750 for married separate filers. The base amount is reduced by nontaxable Social Security and other retirement benefits, plus one-half of federal adjusted gross income over $7,500 for single, head-of-household, or qualifying widow(er) filers; $10,000 for married joint filers; and $5,000 for married separate filers. Section 22(c) (2004).

[5]Exemptions for public pensions are more common than for private pensions. Federal law requires exemptions for state and local pensions to be provided equally to federal retirees. 4 U.S.C. Section 111; *Davis v. Mich. Dep't. of Treasury*, 489 U.S. 803 (1989). Those exemptions for state and local workers could easily be considered an employee compensation feature rather than as a tax benefit for the elderly. As both employer and taxing authority, the state can choose a compensation package with higher direct pension benefits or a lower pension coupled with favorable state tax treatment. The latter approach may have a slight federal tax advantage for the public pension recipient if the recipient uses the standard deduction or is subject to the federal alternative minimum tax; in those cases, the state income tax benefit escapes federal income taxation, while an increase in pension benefits of an equal dollar amount would not. The penalty (from a state budget perspective) is that federal law requires the state to afford similar state tax benefits to retired federal employees.

[6]New Hampshire and Tennessee have limited income taxes that do not extend to pension income; they are not counted as part of the 25 states with pension preferences.

[7]These states are Alabama (defined benefit plans only), Hawaii (elective employee deferrals excluded), Illinois, Mississippi, and Pennsylvania.

(C) Tax Analysts 2006. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Table 1. Proportion of FAGI Components and Net Liability Reported on Returns Not Reporting Age[a]

Percent of:	Returns Reporting Age	Returns Not Reporting Age
All returns	93.7%	6.3%
Earned income	94.9%	5.1%
Capital income	90.6%	9.4%
Retirement income	95.2%	4.8%
Other components of FAGI		
Schedule E income	86.7%	13.3%
Other income	95.5%	4.5%
Adjustments to income	93.3%	6.7%
FAGI	94.2%	5.8%
Net MN liability before credits	93.7%	6.3%

[a]Earned income consists of wages, Schedule C (sole proprietor and partnership) income, and Schedule F (farm) income. Capital income consists of dividends, capital gains, interest (tax-exempt and taxable), and other gains or losses. Other income consists of state tax refunds, alimony received, unemployment compensation, and other income or losses. Retirement income consists of taxable and nontaxable Social Security benefits, pension income, and IRA distributions. Adjustments to income are the above-the-line subtractions on lines 23 to 33 of the 2002 federal Form 1040.

Minnesota, do so by adopting the federal standard deduction amount. Many states provide relatively small dollar exemptions (or comparable credits) for individuals age 65 or older, loosely following the pre-1986 federal practice of allowing an additional personal exemption to the elderly.[8] A few states, including Minnesota, offer larger exemptions, exclusions, or deductions that are more analogous to pension exclusions, but are not restricted by income source.[9] Some of those exemptions are limited by income or are coordinated with the exemptions for Social Security benefits or pension income. They appear to be intended to provide tax benefits comparable to those afforded to recipients of Social Security or pensions. Finally, four states offer tax benefits (either credits or deductions) tied to the federal credit for the elderly or disabled. Table 3 in Appendix A (p. 236) provides the state-by-state details.

4. *Inflation Indexing of State Tax Benefits*

Many state tax benefits for the elderly use fixed dollar amounts in their calculations. Only rarely are those amounts indexed for changes in either prices or real income. Seven of the elderly provisions in six states are indexed for inflation (aside from those states that use the additional federal standard deduction for the elderly, which is indexed for inflation).[10]

II. Data Sources and Minnesota Income Tax

A. Description of the Data

We use a stratified, random sample of 2002 Minnesota income tax returns prepared by the Minnesota Department of Revenue. The sample includes most items from the Minnesota tax return, including most of the relevant items on sources of income and deductions from the federal return that must be filed as part of the Minnesota return. Identifiers were removed, and various other items (for example, alimony and property tax paid) were "blurred" under the procedure used by the SOI division of the IRS for public data samples. Additional masking procedures were used for high-income returns to ensure confidential information was not disclosed to non-DOR personnel.

The original sample consisted of 18,287 returns, each of which contains 413 variables. Minnesota

[8]Depending on how one characterizes those exemptions, roughly 20 states provide additional personal exemptions (or credits) for individuals age 65 or older. That does not include states that provide significantly larger exclusions that may be coordinated with or offset by the exemptions for Social Security benefits or pension exemptions. *See* note 9.

[9]Six states offer those types of provisions with deductions ranging from $8,000 to $30,000 for a married couple, both of whom meet the age requirements.

[10]Idaho and Maryland tie their exclusions to the maximum Social Security benefit, which grows with increases in the Social Security wage base. Kentucky and Michigan index their exclusions to the consumer price index. However, the 2005 Kentucky legislature repealed the indexing adjustments after tax year 2005. California, Michigan, and Montana index their additional exemptions or credits for the elderly to the consumer price index. This is based on our research of state tax law; none of the other state-by-state comparisons of state tax features explicitly document indexing features. Because of the difficulty of tracking features of more than 40 state income tax laws, we do not have a high degree of confidence that we have identified every indexing provision.

(C) Tax Analysts 2006. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

income tax returns include the taxpayer's and spouse's dates of birth, and those variables are included in the data. (DOR uses the date of birth, name, and Social Security number in combination as a unique identifier for tax administration.) The House Income Tax Simulation (HITS) model is a parameterized microsimulation model that recomputes the tax of each sample return. HITS inflates the various data items from each return from the base year to the year being simulated, using 45 growth factors selected by the user. HITS then recalculates state and federal liability for each return and multiplies the result by the weight of each return to yield an estimate for the entire population of tax filers. See Appendix B (p. 239) for a more detailed description of the sample.

For our analysis, we dropped nonresident and part-year resident returns and returns for which age variables were not available.[11] That reduced the number of records in the sample to 16,913. In the sample, ages were available for 93.7 percent of returns. When joint returns are counted as two taxpayers, 94.5 percent of taxpayers reported date of birth. Table 1 (previous page) shows the percent of returns that did and did not report age, and the percent of the various components of federal adjusted gross income (FAGI) and net Minnesota liability that was reported on each of the two types of returns. Returns not reporting age account for a disproportionately high share of Schedule E income, but a roughly proportional share of net Minnesota liability (6.5 percent of liability came from the 6.3 percent of returns that did not report age).[12]

B. The Minnesota Individual Income Tax

The Minnesota individual income tax uses federal taxable income (FTI) as the starting point in computing its tax base.[13] It requires a small number of additions to and subtractions from FTI in computing the tax base, and then applies a progressive rate structure with three rates: 5.35, 7.05, and 7.85 percent. Realized capital gains are taxed in full as ordinary income. The personal exemption amounts, standard deduction, and rate brackets are indexed for inflation.

Unlike most state income taxes, the Minnesota tax does not provide significant tax benefits for the elderly. Minnesota taxes both Social Security benefits and pensions on the same basis as the federal tax and does not provide broad additional exclusions for taxpayers over a certain age. Minnesota allows a largely inconsequential exclusion for low-income elderly or disabled taxpayers.[14]

III. 2002 Base Simulation

Because we seek to isolate the effect of the changed age distribution in 2030 on state income tax revenues, we need to control for tax law changes since 2002 and for those scheduled to take effect in future years. We assume that the same federal and state tax parameters will be in effect in both 2002 and 2030. We assume that features of the federal tax that are scheduled to expire in 2011 will be made permanent and extended through 2030. In other words, we make the 2002 estimates consistent with those for 2030 by assuming that 2010 federal and state law was in effect in 2002 (2002 base) and will be in effect in 2030 (2030 projected).

Because of data limitations or modeling difficulties, we do not simulate the effects of two minor features of the Minnesota income tax, the alternative minimum tax[15] and the Minnesota subtraction for certain dependent education expenses.[16] Each of those features involves relatively small and offsetting amounts of revenue (less than 0.6 percent). The

---

[11]We dropped nonresidents because those returns often reflect unusual circumstances that are of little relevance to elderly tax benefits. For example, they often are high-income investors who own real estate or interests in businesses (partnerships or S corporations) in Minnesota. We dropped part-year residents because we did not have sufficient information to distinguish them from nonresidents.

[12]Four records for which age was unavailable accounted for nearly one-quarter of this Schedule E income.

[13]Minnesota has conformed to federal changes through April 15, 2005, with the exception of the accelerated phase-in of the increased standard deduction for married filers provided in the Working Families Tax Relief Act of 2004 (P.L. 108-311).

[14]The exclusion follows the basic structure of the federal credit for elderly or disabled. The maximum exclusion for a married couple is $12,000. The exclusion is reduced by any nontaxable Social Security and railroad retirement benefits. In addition, one-half of adjusted gross income over dollar thresholds further reduces the exclusion. The exclusion benefits about 11,000 taxpayers per year, at an annual cost to the state of about $1 million in forgone revenues. *Tax Expenditure Budget, FY 2004-2007*, Minnesota Department of Revenue (February 2004). This is relative to total annual revenues from the individual income tax of about $6.5 billion.

[15]As a result of a variety of technical factors, the simulation model and microdata samples consistently have overestimated alternative minimum tax liability. Moreover, the Minnesota AMT exemption is not indexed for inflation. If we were to assume that this continued, the AMT over a 25-year period would become a major factor (rather than the 0.6 percent of revenues it now composes). That seems unlikely to happen and would cloud our efforts to isolate the effects of an aging population and elderly preferences on regular tax liability. Further, taxpayers age 65 and older constitute a relatively small share of those with state AMT liability: About 15 percent of all taxpayers are 65 and older, but only about 7 percent of taxpayers with AMT liability are age 65 and older. Senior filers are unlikely to claim large mortgage interest deductions or a large number of dependent exemptions, two preferences that result in Minnesota taxpayers shifting to the state's AMT.

[16]We do not have information (school grade for dependents or projected birth rates for individuals who privately school their children) that would allow easily modeling long-run

(Footnote continued on next page.)

(C) Tax Analysts 2006. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

simulations set the AMT rate to zero and eliminate the subtraction for dependent education expenses in both the 2002 base and the 2030 projection.

Finally, we don't model the effects on Minnesota's three refundable credits for low-income taxpayers: The working family tax credit supplements the federal earned income tax credit, the dependent care credit supplements the federal dependent care credit but is income-limited and refundable, and the education credit offsets 75 percent of qualifying expenses. All three of these credits could be viewed as social transfer programs that could be operated independently of the income tax system.

A. 2002 Results

Figure 1 shows how the composition of total income varies by age for the 2002 base. Throughout the report, total income is defined as federal adjusted gross income plus nontaxable pensions, nontaxable Social Security benefits, nontaxable IRA distributions, and federally exempt interest.[17] Younger taxpayers derive a large share of their total income from earnings, while the income of older taxpayers is mostly retirement income and capital income. As expected, earned income makes up over 50 percent of total income for all groups through age 64, while retirement income makes up over half of income for returns reporting ages of 65 or older.[18]

Figure 2 shows total income broken into FAGI and nontaxable income. The portion of total income that is nontaxable increases as age increases, exceeding 10 percent after age 60 and 30 percent after age 80. If each age cohort's share of FAGI and nontaxable income remained constant, all other things equal, a growing share of total income would become nontaxable as the baby-boom generation ages.

Figure 1. Composition of Total Income by Age Group, Tax Year 2002

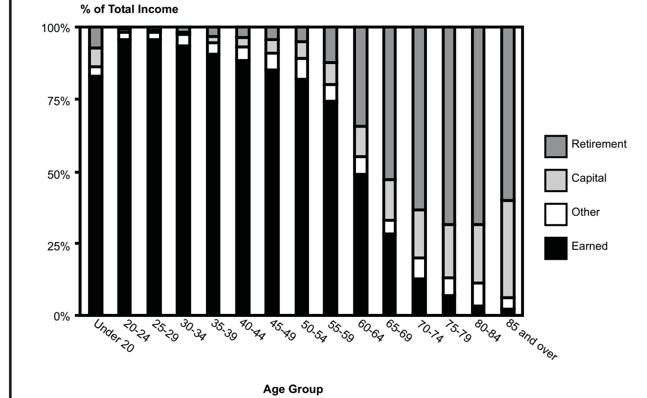
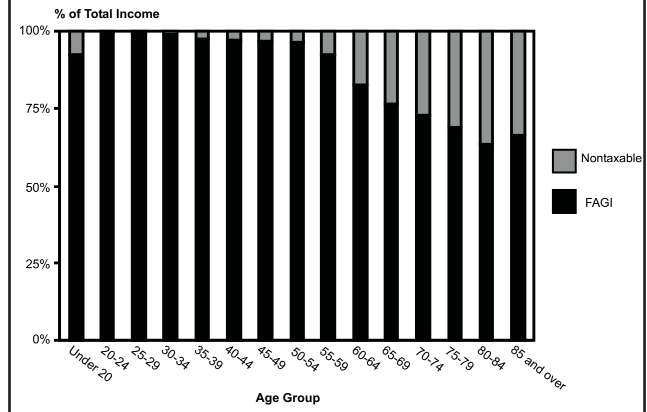


Figure 2. FAGI and Nontaxable Income as Shares of Total Income, Tax Year 2002



Average FAGI per taxpayer[19] climbs sharply as age increases, topping $40,000 for taxpayers age 40 to 44, and remaining over $40,000 until age reaches 60. The average drops to less than $30,000 for taxpayers age 65 and older.

Because Minnesota does not provide significant age-related tax preferences, the distribution of tax liability by age group roughly follows the distribution of FAGI by age group. As shown in Figure 4, tax liability per taxpayer climbs with age, passing $2,000 per taxpayer at age 45 and remaining there

---

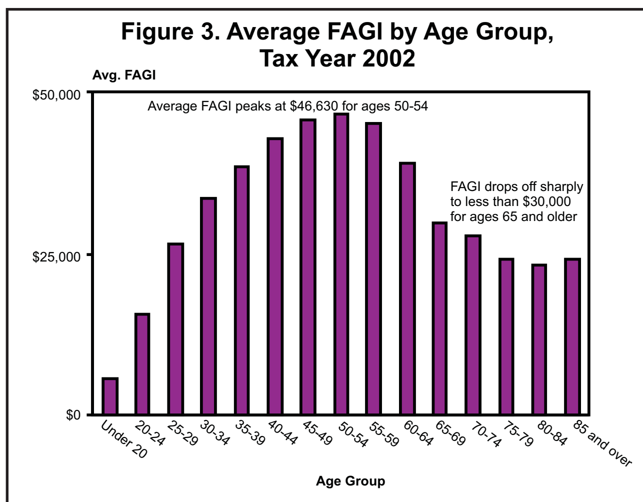
growth of the deduction for K-12 dependent education expenses. As a result, we ignored this minor feature of the tax, which reduces annual revenues by about 0.2 percent.

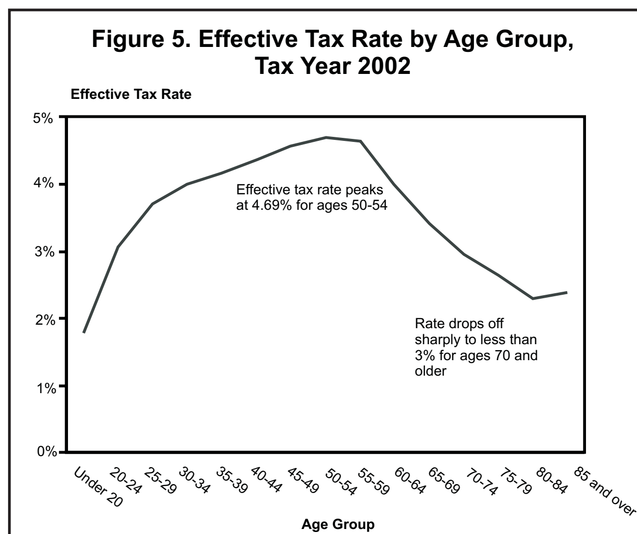
[17]This definition is narrower than the definition of comprehensive income used by Edwards and Wallace (2004). It excludes unrealized capital gains (which are not included in the Minnesota sample), retirement contributions, and self-employed health insurance deductions. It is also much less comprehensive than the definition used by the Treasury Department.

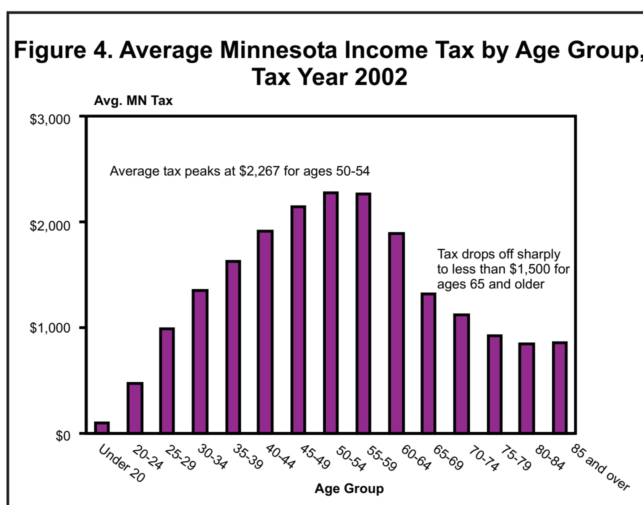
[18]Earned income consists of wages, self-employment income reported on Schedule C, and farm income reported on Schedule F. Capital income is interest (both taxable and tax-exempt), dividends, capital gains, and other gains and losses as reported on Form 1040. Retirement income consists of taxable and nontaxable pensions, Social Security benefits, and IRA distributions as reported on Form 1040. "Other" includes business income reported on Schedule E, state income tax refunds, alimony received, unemployment compensation, and other income and losses, reduced by above-the-line subtractions on lines 23 to 33 of the 2002 federal Form 1040.

[19]Married joint returns were counted as two taxpayers and assigned to an age group based on the taxpayer's reported age, with no adjustment made for the spouse's age. Failing to double-count married joint returns would result in obscuring the data with the effect of marriage patterns. Over half of returns from taxpayers age 35 to 79 are from married joint filers, while most returns from younger and older taxpayers are from single or head-of-household filers.

(C) Tax Analysts 2006. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.







through age 59. After age 59, liability per taxpayer begins a steady drop until it plateaus at about $850 for age 80 and above.

Figure 5 shows effective tax rates (ETRs) by age group. The ETRs are computed relative to total income. As shown in Figure 2, because nontaxable income is heavily concentrated among older age groups (over $12,000 per return for taxpayers age 80 and over, compared with less than $2,000 per return for taxpayers under age 55), the reduced burden imposed on older age groups becomes apparent, even with Minnesota's minimal elderly preferences. The average ETR for taxpayers under age 65 (4.26 percent) is 1.47 times higher than the average for those age 65 and older (2.9 percent).

IV. 2030 Projection

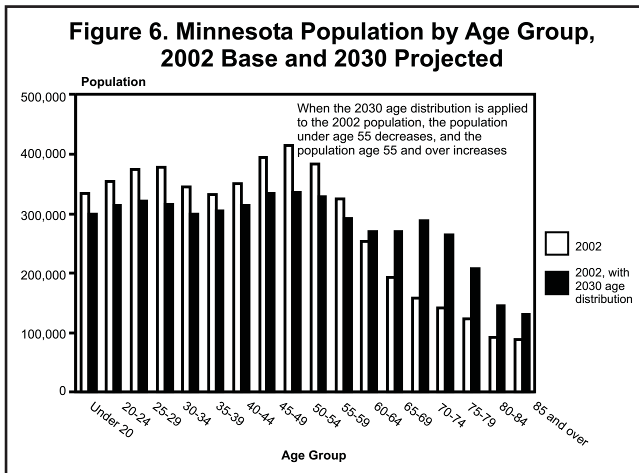
Minnesota's income tax revenue will change between 2002 and 2030 for many reasons. To isolate the impact of aging, we want to control for the general impact of economic growth. To do that, we allow both the age distribution and the mix of incomes (earned income, capital income, and retirement income) to vary, but hold both total population and total real income constant at 2002 levels. As explained in the previous section, we assume that tax law is the same in 2002 and 2030. We compare the tax paid in the 2002 base with the tax that would have been paid if both the population mix and the income mix matched what is projected for 2030. That requires estimates of population shares (by age) in 2030, income shares (by type of income) in 2030, and inflation between 2002 and 2030.

A. Population Share Adjustment

Population shares by age group were estimated for both 2002 and 2030, using projections prepared by the Minnesota State Demographic Center.[20] Because we hold population constant, the number of young and middle-aged tax filers falls while the number of older filers rises. For example, the weight for each sample taxpayer age 40 to 44 is reduced by 19 percent (because that share of the population is projected to fall by 19 percent). In contrast, the weight for each sample taxpayer age 70 to 74 is increased by 87 percent (because that share of the population is projected to grow by 87 percent). The share of taxpayers age 65 and over rises from 14.9 percent to 24.8 percent. Figure 6 compares the age distribution in 2002 with that in 2030, holding population constant at the 2002 level. The population decreases for all age groups under age 55 and increases for all groups age 55 and older.

[20]Minnesota Planning, State Demographic Center, *Minnesota Population Projections 2000-2030* (October 2002).

(C) Tax Analysts 2006. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.



B. Income Share and Inflation Adjustment

The HITS model projects income growth from 2002 to 2007 based on the latest state forecast (February 2005). The growth projected for the various components of total income from 2007 to 2030 is generally based on Global Insight Inc.'s long-term trend projection.[21] Because that projection does not include capital gains or pension income, we projected growth for those components using other sources.

Capital gains reported on federal tax returns are assumed to grow from 2.28 percent of GDP in 2002 to 3.25 percent of GDP in 2030 — the ratio assumed for 2015 by the Congressional Budget Office.[22] As a result, capital gains are assumed to grow 43 percent faster than Global Insight Inc.'s projection of GDP between 2002 and 2030.

Pension and IRA income reported on federal tax returns is assumed to grow from 4 percent of GDP in 2002 to 7.4 percent of GDP in 2030, based on projections by the CBO.[23] As a result, pension income (taxable and nontaxable) is assumed to grow 85 percent faster than Global Insight Inc.'s projection of GDP between 2002 and 2030.

After growing each of the components of nominal Minnesota taxable income to 2030 projected levels, we convert them to real values using the CPI. Real total income is projected to roughly double between 2002 and 2030. To hold real income constant at its 2002 level, all components are scaled back proportionally. Because real income is held constant at its 2002 level, some taxpayers have lower incomes (particularly those with mostly wage income) and others have higher incomes (particularly those whose income is mostly capital or retirement income).

Global Insight Inc. projects that the CPI will roughly double between 2002 and 2030 (an annual increase averaging 2.25 percent). That estimate deflates the nonindexed portions of tax law by roughly one-half in the 2030 projection.

C. Projected Changes in Income, Tax Revenue, and Effective Tax Rates

Table 2 (next page) summarizes the projected change in the number of taxpayers, income, and tax revenue from 2002 to 2030.

Although the population is held constant, the change in the age mix increases the number of taxpayers (joint returns counted as two taxpayers) by 4.1 percent. Much of the decline in the younger population is among those under age 20, few of whom file a tax return. Their absence does little to reduce the number of taxpayers. The aggregate population of the remaining age groups rises. Not only does the number of tax returns increase (by 2.5 percent), but a higher proportion are joint returns.[24]

---

[21]Global Insight Inc., *The U.S. Economy: 25-Year Focus* (First Quarter 2005). Those projections are consistent with the Minnesota Department of Finance's February 2005 forecast. Growth rates for U.S. bond interest and state and local bond interest were taken from the second quarter 2005 projections, because the first-quarter estimates appear inconsistent with the rest of the first-quarter projections.

[22]Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2006 to 2015* (January 2005), pages 26 and 84.

[23]Congressional Budget Office, *Tax Deferred Retirement Savings in Long-Term Revenue Projections* (May 2004), pages 17 and 19. Our analysis assumes that each of the following grow at the same rate between 2002 and 2030: taxable pension income, nontaxable pension income, taxable IRA distributions, and nontaxable IRA distributions. It would certainly be preferable to model each of those pieces separately to take account of likely future changes in retirement savings. CBO notes its estimates are most sensitive to the assumptions about "the degree to which taxpayers switch to **(Footnote continued in next column.)** Roth IRAs and 'back-loaded' 401(k) accounts," which provide nontaxable distributions. *Id.* p. 1. The fairly recent availability of those types of plans (that is, since tax year 1998 for Roth IRAs and starting in 2006 for back-loaded 401(k)s) may suggest that their growth rates (that is, for nontaxable distributions) should not be assumed to be the same as taxable pensions.

[24]The number of filers rises by 2.5 percent. The number of joint returns rises by 7.7 percent, while other filer returns fall by 1.7 percent. Because we hold income constant, the 4.1 percent increase in the number of taxpayers reduces average income per taxpayer by about 4 percent. With a progressive tax, spreading the same income over a larger population reduces tax revenue. If we had held the number of taxpayers constant (rather than population), tax revenue would have fallen only 0.2 percent between 2002 and 2030, rather than the 1.8 percent shown in Table 2. The 1.6 percent difference is explained by noting that the average marginal tax rate (roughly 5.6 percent) is roughly 1.4 times the average tax rate (about 4 percent). By shifting 4 percent of total income from a rate of 4 percent to 5.6 percent, holding the number of taxpayers constant would raise total revenue by (5.6 percent/4 percent) × 4 percent, or 1.6 percent.

(C) Tax Analysts 2006. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Table 2. Changes From 2002 Base To 2030 Projected	
	2002 Base to 2030 Projected
Tax returns	2.5%
Taxpayers (joint=2)	4.1%
Earned income	-12.7%
Capital income	34.1%
Retirement income	51.6%
FAGI	-0.7%
Exempt income	9.6%
Total income	0.0%
Tax	-1.8%

Real income is held constant, but earned income falls by 12.7 percent. Capital income rises by 34.1 percent, and retirement income rises by 51.6 percent. Exempt income rises by almost 10 percent while FAGI falls slightly (by 0.7 percent). The relative increase in capital and retirement income is partly due to the presence of more taxpayers in age ranges in which those income types dominate, and partly to the higher growth rates for that income. Total tax liability falls by 1.8 percent.

Those changes are the combined effect of changes in population shares, income shares, and the CPI. If we had only changed the population shares, earned income would not have declined as much (by 6.4 percent rather than 12.7 percent). Capital income would have only risen by 29.7 percent (rather than 34.1 percent) and retirement income would have risen by 50 percent (rather than 51.6 percent). Exempt income would have risen by 43 percent (rather than 9.6 percent) and FAGI would have risen by 1.9 percent (rather than falling by 0.7 percent). Total income would have risen by more than 5 percent. With higher FAGI, tax revenue would have risen by 1.7 percent, rather than falling by 1.8 percent. Clearly, adjusting only the sample weights (while assuming that each sample taxpayer's income and tax liability remain at 2002 levels) presents an incomplete picture of the future.

The relatively small reduction in tax revenue — 1.8 percent — is largely due to the lack of complete indexing of tax parameters.[25] In 2002 only 32 percent of Social Security benefits that Minnesotans reported on tax returns were included in FAGI and subject to Minnesota tax. Under current law, that percentage is projected to rise to 63 percent in 2030. However, if income tax thresholds were fully indexed for inflation, the share of Social Security subject to tax would have risen only to 36 percent.

Minnesota's elderly exclusion is one of the features not indexed for inflation. Without indexing, the tax reduction attributable to the elderly exclusion falls from about $1 million in 2002 to a negligible amount.

Figure 7 (next page) shows the effective tax rates in the 2002 base and the 2030 projection. The effective tax rate rises by almost 20 percent for taxpayers age 65 and over (from 2.9 percent to 3.43 percent of income). For those age 75 and over, the effective tax rate increases by 24 percent (from 2.47 percent to 3.05 percent of income). Roughly half of the change in each case is due to the failure to index the thresholds for taxing Social Security income and the cap on net capital losses (which both affect seniors more than others). The other half is due to the change in income shares (less earned income and more capital and retirement income).[26]

With both the number of older taxpayers and their effective tax rates increasing, the share of total tax paid by those over age 65 more than doubles (from 10.6 percent to 21.6 percent of total tax). The change in total tax by age group is shown in Figure 8 (next page).

Those results suggest that a state (like Minnesota) that follows federal law in taxing Social Security benefits and pension income may not face large declines in tax revenue because of the aging of the population. The relative growth in retirement income and capital income (much of it received by older taxpayers), combined with the lack of indexing of the Social Security thresholds, will raise the effective tax rate of older taxpayers.

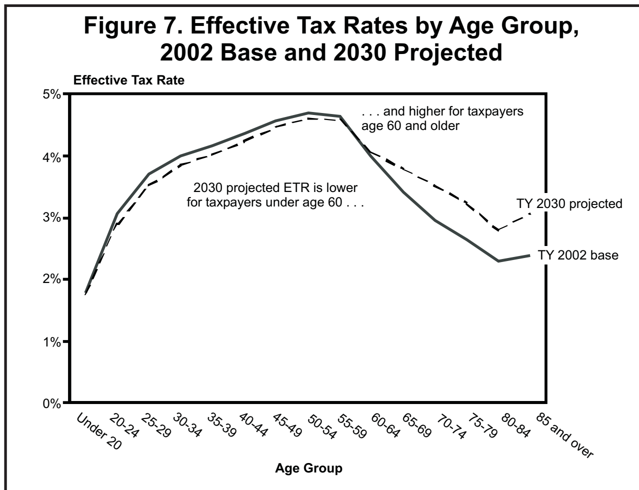
D. Sensitivity Analysis and Effect on Projected Changes in Tax Revenue

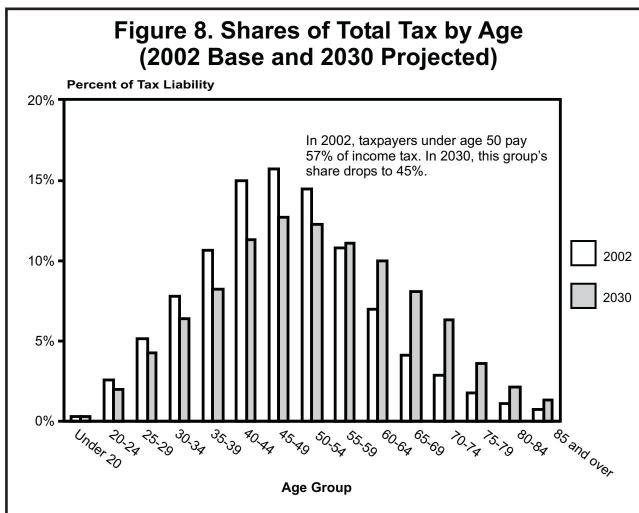
Our results depend on how the shares of income shift between 2002 and 2030. Slower growth of retirement income would reduce its assumed share in 2030. Because we hold total income constant (and retirement income is taxed at a lower average rate than other income), that would have a favorable

[25]The principal unindexed features of the tax law are the thresholds used to determine the portion of Social Security benefits included in taxable income, and the $3,000 cap on capital losses. The estimated inflation between 2002 and 2030 would reduce the $3,000 cap to $1,489 in real terms. In a typical year, that would increase reported capital gains realizations by about 2.6 percent. Because 2002 was an unusual year, with a large number of filers reporting the maximum net loss, we used an off-model adjustment to limit the impact to 2.6 percent.

[26]As shown in Figure 7, tax rates fall for younger taxpayers. The average drops by 2 percent for taxpayers under age 65 (from an average of 4.16 percent to 4.06 percent). With income held constant, average incomes fall for younger taxpayers, reducing effective tax rates under a progressive tax. Half of that drop in income for younger taxpayers is due to the declining share of earned income. The other half is due to the projected increase in the number of taxpayers, as described in footnote 24, which spreads total income over more filers.

(C) Tax Analysts 2006. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.





revenue impact. If the level of total pension and IRA distributions in 2030 were 20 percent less than assumed above, our analysis would show a smaller drop in tax revenue (0.8 percent rather than 1.8 percent). Similarly, if Social Security benefits were 20 percent less than assumed above (perhaps because of enacted benefit cuts), tax revenue would fall by 1.4 percent rather than 1.8 percent.

Slower growth in capital gains income would have the opposite effect. Minnesota taxes capital gains income at regular rates, and most capital gains are realized by higher-income taxpayers, so the average tax rate on capital gains exceeds that on most other forms of income. The base year for this analysis (2002) had an unusually low level of capital gains income. That accounts, in part, for the relatively high growth between 2002 and 2030. To illustrate the potential sensitivity of our results to the use of the atypical 2002 base year, we recalculated 2002 tax assuming that capital gains income was 30

Table 3. Sensitivity of Tax Revenue To Alternative Assumptions

	2002 Base to 2030 Projected
Baseline result	-1.8%
Assume pension income is 20% less in 2030	-0.8%
Assume Social Security benefits are 20% less in 2030	-1.4%
Assume capital gains were 30% higher in 2002	-2.3%
Revenue-neutral single tax rate on Minnesota taxable income (rather than progressive rates)	-1.5%

percent higher. All other incomes were reduced proportionately to hold total income constant. With the 30 percent increase, the capital gains share of total income in the base year equals what we projected for 2030. The 2002 tax would have increased by 0.4 percent, so the estimated reduction from 2002 to 2030 would have been larger, falling by 2.3 percent rather than 1.8 percent. Use of a more typical base year might therefore have made our results slightly more pessimistic.[27]

Our results also depend on how we define total income, because we hold 2030 total income at the 2002 level. For example, suppose we had included fringe benefits in our measure of income. If fringe benefits are an increasing share of total income, that would increase the share of exempt income in 2030, and the analysis would show a larger reduction in tax revenue. However, if we had defined total income to exclude nontaxable pension and IRA distributions, our analysis would have shown tax revenue rising between 2002 and 2030, rather than falling.

To see whether Minnesota's progressive rate structure affected our results, we repeated the analysis assuming a revenue-neutral flat tax on Minnesota's tax base. Tax revenue fell by slightly less (1.5 percent rather than 1.8 percent).

Finally, if Minnesota's refundable tax credits had been included in the analysis, the estimated drop in tax revenue would have been smaller (or revenues might have risen instead). Those credits reduced tax liability by 3.2 percent in 2002, and 93 percent of those benefits went to taxpayers under age 50. Though largely indexed for inflation, the changing age distribution would likely shrink their relative size under current law.

---

[27]Retirement income was a relatively high share of income in 2002, though, which may somewhat offset that effect because retirement income is taxed at relatively low rates.

(C) Tax Analysts 2006. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Table 4. Revenue Effects of Tax Benefits for the Elderly				
	Revenue Effect as % of		Total Change, 2002 to 2030, With Preference in Both Years	Portion of Total Because of Preference
	2002 Base Revenues	2030 Projected Revenues		
Full exemption of Social Security	-2.3%	-5.0%	-4.5%	-2.7%
Indexing of Social Security benefits, 2002 to 2030	NA	-1.9%	-3.7%	-1.9%
$10,000 pension exclusion, indexed	-2.7%	-4.6%	-3.8%	-1.9%
$10,000 pension exclusion, not indexed	-2.7%	-2.7%	-1.8%	0%
Full pension exclusion	-6.4%	-12.6%	-8.3%	-6.5%
$1,000 additional personal exemption, indexed	-0.4%	-0.8%	-2.2%	-0.4%
$1,000 additional personal exemption, not indexed	-0.4%	-0.4%	-1.8%	0%
Full exemption for Social Security and $10,000 pension exclusion, indexed	-4.9%	-9.2%	-6.3%	-4.5%
Full exemption for Social Security and $10,000 pension exclusion, not indexed	-4.9%	-7.4%	-4.4%	-2.7%
Full exemption for Social Security and pension exclusion	-8.1%	-15.8%	-10.0%	-8.2%

V. Simulation of Common Tax Benefits For the Elderly Provided by Other States

To assess the impact on states that offer broader (and more typical) income tax benefits for the elderly, we simulated the effect of fully exempting Social Security benefits; $10,000 and unlimited pension exclusions; and additional $1,000 personal exemptions for individuals over age 65 for both the 2002 base and 2030 projection. We also simulated the effect of indexing the parameters for including Social Security benefits in taxable income from 2002 to 2030.[28] The percentage effects on Minnesota revenues are displayed in Table 4. The first two columns show the revenue impact of allowing each type of preference on 2002 revenues and on 2030 revenues. For example, a full Social Security exemption would reduce income tax revenues in 2002 by 2.3 percent, and in 2030 by 5 percent. The next two columns show the change in revenues from 2002 to 2030 if the preference were in effect in both years. A full Social Security exemption would result in 4.5 percent lower revenues in 2030 than in 2002. Because tax revenues absent any additional preferences decrease by 1.8 percent from 2002 to 2030, revenues with the preference would fall by the additional 2.7 percent shown in the far right column. As can be seen, allowing those quite typical elderly tax benefits can significantly increase the negative revenue impact of an aging population.

The rest of this section provides additional details on the individual elderly tax benefits.

A. Full Exemption of Social Security Benefits

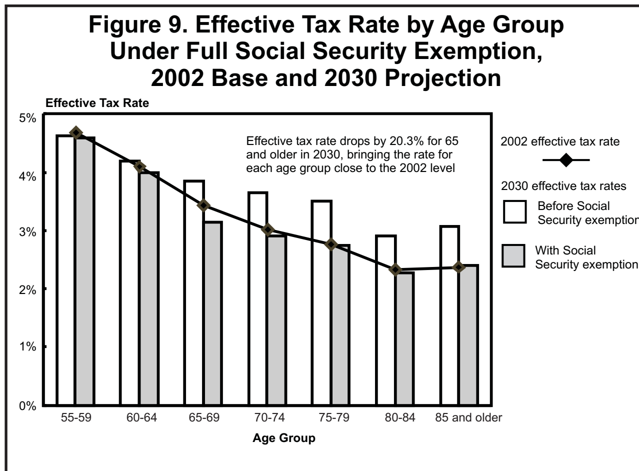
As noted in Section I, the District of Columbia and 28 states with income taxes fully exempt Social Security benefits. If Minnesota fully exempted Social Security benefits from state taxation, state income tax revenues in the 2002 base would decrease by $107 million, reducing revenues from the tax by 2.3 percent. Applying the same exemption to the 2030 projection would decrease income tax revenues by 5 percent, or $225 million. In other words, the aging of the population would more than double the relative cost of a full exemption for Social Security benefits. As described in Section IV, two factors are at work here. The aging of the population and the growth in real Social Security benefits increase the aggregate amount of exempt Social Security benefits. Second, the failure to index the parameters for taxing Social Security under the federal rules reduces the share of Social Security benefits that are exempt under the baseline and, thereby, increases the cost of a full exemption.

Figure 9 displays the drop in effective tax rates (ETRs) for older taxpayers under the 2030 projection, resulting from fully exempting Social Security benefits from taxation. The columns show the ETRs

[28]Indexing the Social Security parameters are among the changes proposed recently by the President's Advisory Panel on Federal Tax Reform; our simulation indexes the two sets of thresholds from 2002 to 2030, for comparability with our modeling of other senior preferences.

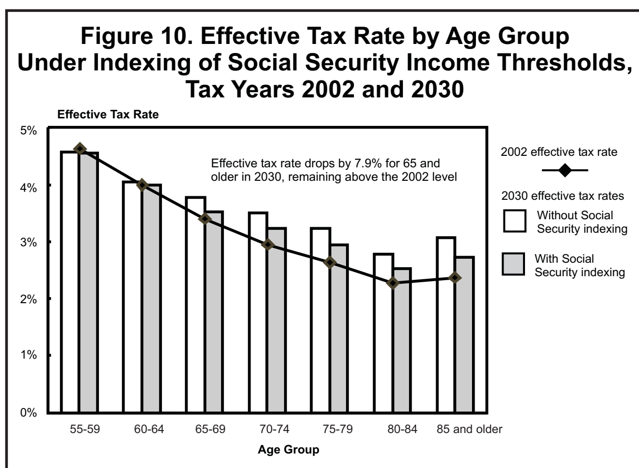
(C) Tax Analysts 2006. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

before and after the exemption for the 2030 projection, and the line shows ETRs for the 2002 base without the exemption for comparison. The largest absolute drop in effective tax rate is 0.73 percentage points for taxpayers age 70 to 74. ETRs decrease by more than 20 percent for all taxpayers over age 70, and the ETRs for these age groups are close to those calculated for the 2002 base.



B. Indexing Social Security Parameters

The President's Advisory Panel on Federal Tax Reform included among its proposals the indexing of the two provisional income thresholds (described in Section I) used to determine the portion of Social Security benefits included in federal taxable income. The change would result in the exemption of a larger share of Social Security benefits from taxation and in lower income tax revenue over time for states, like Minnesota, that conform to federal rules for taxing Social Security benefits. Minnesota income tax revenues would decrease by $87 million, or 1.9 percent, in 2030 if the thresholds had been indexed beginning in 2002. Figure 10 shows the effect on ETRs of indexing Social Security thresholds for inflation.



C. Pension Exclusions

As noted in Section I, most states with income taxes provide some type of exclusion or deduction for pension income. We simulate the effect of a $10,000 pension exclusion, both indexed and not indexed for inflation, as well as an unlimited exemption for pension income. The $10,000 limit in the simulation applies equally to joint and single filers and is roughly at or slightly below the typical dollar limited pension exclusions allowed.

> ***If Minnesota fully exempted Social Security benefits from state taxation, state income tax revenues in the 2002 base would decrease by $107 million, reducing revenues from the tax by 2.3 percent.***

Allowing a $10,000 pension exclusion in Minnesota would reduce state income tax revenues in the 2002 base by $124 million, or 2.7 percent. The same exemption in 2030 would reduce state income tax revenues by $123 million, or 2.7 percent. The increases in the number of taxpayers qualifying for the exclusion and the total amount of pension income are offset by the effect of inflation eroding the real dollar value of the $10,000 limitation. If the $10,000 exemption were indexed for inflation, the cost in 2030 would increase to $210 million, a 71 percent increase over the cost of the 2002 simulation. The cost of the pension exclusion grows more slowly than a full Social Security exemption because the failure to index the tier structure of the Social Security tax rules makes a larger portion of Social Security benefits taxable. Although pension income increases in the 2030 projection faster than total Social Security benefits (65 percent compared with 19 percent), taxable Social Security increases much faster (135 percent).

Figure 11 (next page) displays the effects on 2030 ETRs of exempting $10,000 of otherwise taxable pension income, not adjusted for inflation. The largest drops in effective tax rates in the 2030 projection, calculated using total income as the base, are about 0.3 percentage points for taxpayers age 70 to 84. The average ETR falls by 8.3 percent for taxpayers age 65 and older.

If Minnesota were to fully exempt pension income, the cost of forgone income tax revenues in tax year 2002 would be $298 million, or 6.4 percent of 2002 revenues. Fully exempting pension income in the 2030 projection would cost $574 million, or 12.6 percent of state income tax revenues. The aging of the population and forecast changes in the income mix essentially double the cost of a full pension income exclusion from 2002 to 2030. Figure 12

(C) Tax Analysts 2006. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

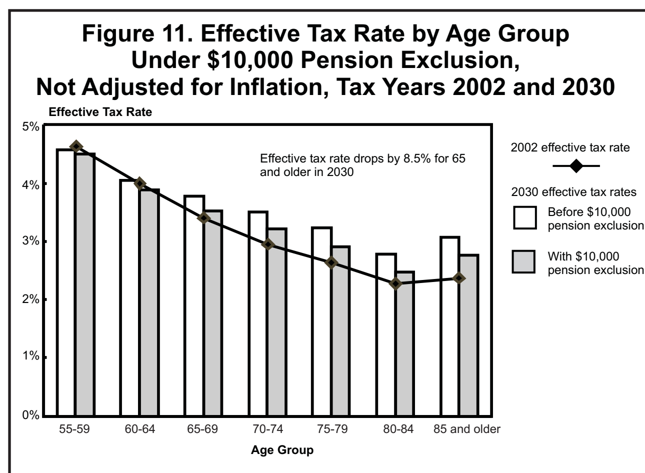


Figure 11. Effective Tax Rate by Age Group Under $10,000 Pension Exclusion, Not Adjusted for Inflation, Tax Years 2002 and 2030

displays the effect on 2030 ETRs by age. ETRs under the 2030 projection would decrease dramatically, falling over 1 percentage point for filers age 65 and older — over a 30 percent decrease. The resulting ETRs for all filers age 55 and older would be below the rates for the 2002 base.

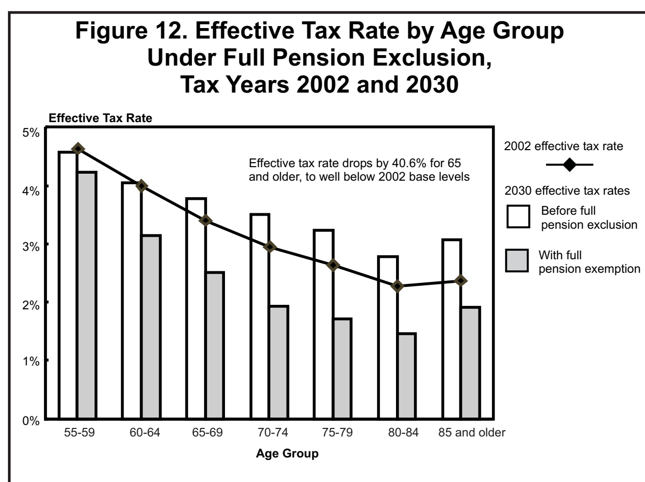


Figure 12. Effective Tax Rate by Age Group Under Full Pension Exclusion, Tax Years 2002 and 2030

D. Age-Based Exemption Amount

Many states allow taxpayers age 65 or older to exempt a fixed amount of income. $1,000 is a common amount, although many states allow larger amounts. These amounts are typically not indexed for inflation, although at least three states have indexed them. A $1,000 general income exclusion for each taxpayer age 65 or older would reduce state income tax revenues in the 2002 base by $17.5 million, or 0.4 percent of revenues. Allowing the same exemption in the 2030 projection would cost about the same amount of forgone revenues and again equal 0.4 percent of total state income tax revenues. The aging of the population roughly doubles the cost of the exemption. However, failure to index the exemption amount roughly halves the growth that otherwise would occur. Figure 13 shows the ETR effect in 2030 of a $1,000 general exclusion for each taxpayer age 65 or older.

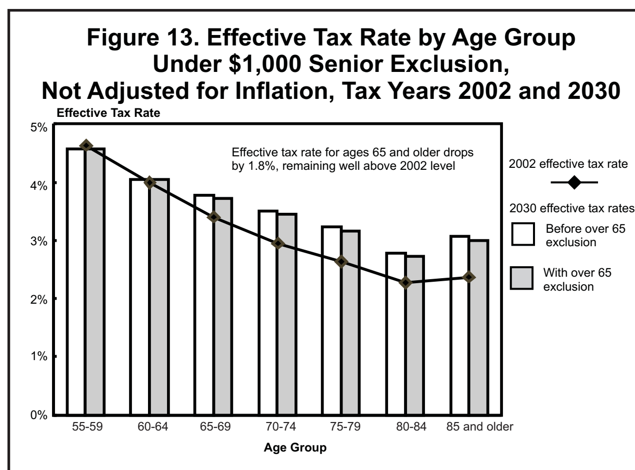


Figure 13. Effective Tax Rate by Age Group Under $1,000 Senior Exclusion, Not Adjusted for Inflation, Tax Years 2002 and 2030

E. Combination of Social Security and Pension Exclusion

Many states allow both a full Social Security exemption and a partial pension exclusion. If Minnesota exempted Social Security income from taxation and allowed a $10,000 pension exclusion, state income tax revenues would decline by $226 million, 4.9 percent of state income tax revenues in the 2002 base. Allowing the same exemption in the 2030 projection, with the pension exclusion not indexed, would result in forgone revenues of $337 million, or 7.4 percent of state income tax revenues. Figure 14 (next page) shows the effect on ETRs.

The most generous senior preferences include full Social Security and pension exclusions, available in Alabama, Hawaii, Illinois, Mississippi, and Pennsylvania. If Minnesota were to allow full Social Security and pension exclusions, income tax revenues would drop by $375 million in the 2002 base, or 8.1 percent of liability. Fully exempting Social Security and pension benefits in the 2030 projection would cost $717 million, reducing income tax revenues by 15.8 percent. The effect of combined full exemptions for pensions and Social Security benefits on ETRs is shown in Figure 15 (next page).

Another way of looking at the effect of the various senior preferences modeled is to compare the change in the average effective tax rate for seniors with the average effective tax rate for nonseniors. Table 5 (next page) shows ETRs under the various proposals in 2002 and 2030, and the ratio of the average ETR for taxpayers 65 and over to that of taxpayers under 65.

The average ETR for taxpayers age 65 and older is projected to increase from 2.9 percent in the 2002 base to 3.43 percent in the 2030 projection. While that would only be 82 percent of the average ETR for

(C) Tax Analysts 2006. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

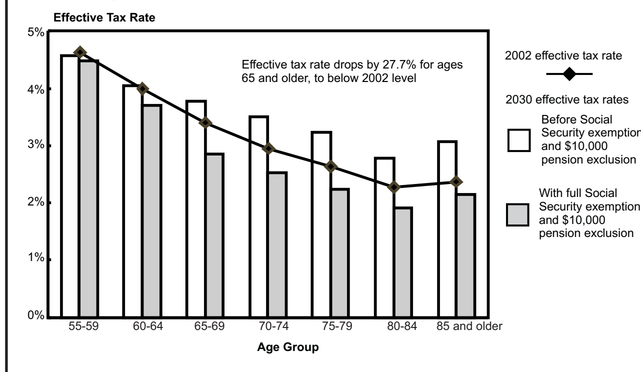


Figure 14. Effective Tax Rate by Age Group Under Full Social Security Exemption And $10,000 Pension Exclusion, Not Adjusted for Inflation, Tax Years 2002 and 2030

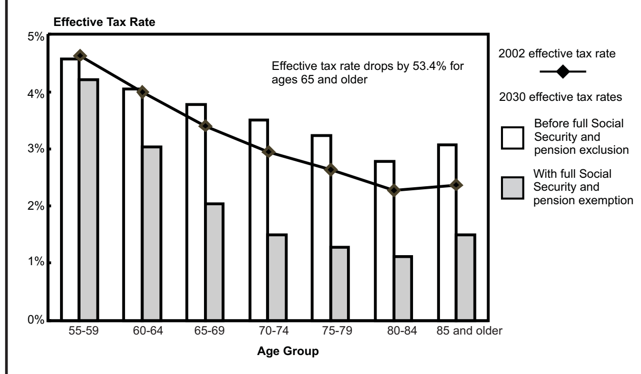


Figure 15. Effective Tax Rate by Age Group Under Full Social Security Exemption And Pension Exclusion, Tax Years 2002 and 2030

nonsenior taxpayers, our analysis shows that seniors as a group will face higher ETRs in 2030 than they do in 2002, when the average ETR for seniors is only 68 percent of the average for nonseniors. The gradual increase in seniors' ETRs in the coming years could increase pressure on policymakers to provide exclusions to seniors, particularly in states like Minnesota that offer few such benefits today. The most generous option modeled — a full Social Security exemption and full pension exclusion — would reduce the average ETR for seniors in 2030 to 1.6 percent, and the senior ETR to only 41 percent of the nonsenior ETR. Other more modest preferences, such as allowing a $10,000 pension exclusion, indexed for inflation, or fully exempting Social Security benefits, would return senior ETRs to close to the current relationship to those faced by nonseniors — 72 percent and 66 percent, respectively.

VI. Conclusion

These results suggest that a state (like Minnesota) that follows federal law in taxing Social Security benefits and pension income may not face large declines in tax revenue due to the aging of the population. The relative growth in retirement income and capital income (much of it received by older taxpayers), combined with the lack of indexing of the Social Security tax thresholds, will raise the effective tax rate of older taxpayers. As a result, tax revenues projected for 2030 are only 1.8 percent lower than in the 2002 base.

> ***A state that follows federal law in taxing Social Security benefits and pension income may not face large declines in tax revenue due to the aging of the population.***

States with more generous elderly preferences may face a different future. Our results suggest that revenue reductions could range from 4.4 percent to 10 percent depending on the preferences offered. Indexing the income thresholds used to determine the portion of Social Security benefits subject to tax, as proposed by the President's Advisory Panel on Federal Tax Reform, would increase the estimated revenue loss in Minnesota to a percentage more like that in states that fully exempt Social Security benefits.

Future work should include more careful modeling of future income changes, particularly for pension and IRA distributions. For example, better modeling of the effects of changes in the pattern of retirement savings and the availability of backloaded retirement plans (for example, Roth IRAs) would be useful, especially in light of policy proposals by the administration and the tax reform panel to provide more savings incentives on that basis. Exploration of increased labor supply among older taxpayers may also yield valuable insights. Updating the analysis using the 2003 income tax sample and updated version of the HITS model (available in early December) would help identify any bias from using 2002, which appears to be an atypical year for capital gains realizations, as the base year.

For Minnesota, the model could be used to examine the potential impact of alternative migration assumptions or the implications of moving to an alternative tax base (in response, perhaps, to federal tax reform). The analysis might also be extended to the quite different tax structures and demographic circumstances of other states that tax income.

(C) Tax Analysts 2006. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Table 5. Effective Tax Rates for Seniors With Elderly Tax Benefits, And Comparison With Effective Tax Rates for Nonseniors				
	Effective Tax Rate, Taxpayers Age 65 and Older		**ETR for Seniors as % of ETR for Nonseniors**	
	2002 Base	**2030 Projected**	**2002 Base**	**2030 Projected**
Current law	2.90%	3.43%	68%	82%
Full exemption of Social Security	2.38%	2.74%	56%	66%
Indexing of Social Security thresholds, 2002 to 2030	2.90%	3.16%	68%	76%
$10,000 pension exclusion, indexed	2.50%	2.93%	59%	72%
$10,000 pension exclusion, not indexed	2.50%	3.14%	59%	76%
Full pension exclusion	1.89%	2.04%	46%	51%
$1,000 additional personal exemption, indexed	2.80%	3.31%	66%	80%
$1,000 additional personal exemption, not indexed	2.80%	3.37%	66%	81%
Full exemption for Social Security and $10,000 pension exclusion, indexed	2.00%	2.29%	48%	56%
Full exemption for Social Security and $10,000 pension exclusion, not indexed	2.00%	2.48%	48%	61%
Full exemption for Social Security and pension exclusion	1.51%	1.60%	37%	41%

References

Congressional Budget Office. *Tax Deferred Retirement Savings in Long-Term Revenue Projections* (May 2005).

Congressional Budget Office. *The Budget and Economic Outlook: Fiscal Years 2006 to 2015* (January 2005).

Baer, David. *State Taxation of Social Security and Pensions in 2000*, Issue Brief No. 55 (AARP Public Policy Institute: November 2001).

Edwards, Barbara, and Sally Wallace. "State Income Tax Treatment of the Elderly," *Public Budgeting and Finance* Summer 2004; 1-20.

Global Insight Inc., *The U.S. Economy: 25-Year Focus* (First Quarter 2005).

Minnesota Planning, State Demographic Center, *Minnesota Population Projections 2000-2030* (October 2002).

National Conference of State Legislatures, "State Personal Income Taxes on Pensions and Retirement Income: Tax Year 2004" (Nov. 3, 2004).

Office of Management and Budget. *Analytical Perspectives,* Budget of the United States Government Fiscal Year 2006 (January 2005).

Penner, Rudolph. *Tax Benefits for the Elderly*, The Retirement Project Occasional Paper No. 5 (Urban Institute: April 2000).

The President's Advisory Panel on Federal Tax Reform. *Simple, Fair, & Pro-Growth: Proposals to Fix America's Tax System* (November 2005).

Rogers, Diane Lim; Eric Toder, and Landon Jones. *Economic Consequences of an Aging Population*, The Retirement Project Occasional Paper No. 6 (Urban Institute: September 2000).

Russell, Faith. *Individual Income Tax Provisions in the States,* Wisconsin Legislative Fiscal Bureau Informational Paper (January 2005).

Scott, Christine. *Social Security: Calculation and History of Taxing Benefits*, CRS Report for Congress (Jan. 14, 2005).

(C) Tax Analysts 2006. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Appendix A
Summary of State Income Tax Benefits for the Elderly

Table 1. State Taxation of Social Security Benefits

State	All Benefits Exempt	Follows Federal Taxation	Follows Pre-1993 Federal Taxation	Unique State Tax Rules
Alabama	X			
Alaska	No individual income tax			
Arizona	X			
Arkansas	X			
California	X			
Colorado				Follows federal rules, but allows taxable Social Security benefits to qualify for the pension exclusion[a]
Connecticut				Exempt if adjusted gross income is below $50,000 ($60,000 joint), up to one-fourth of benefits taxable at higher incomes
Delaware	X			
District of Columbia	X			
Florida	No individual income tax			
Georgia	X			
Hawaii	X			
Idaho	X			
Illinois	X			
Indiana	X			
Iowa			X	
Kansas		X		
Kentucky	X			
Louisiana	X			
Maine	X			
Maryland	X			
Massachusetts	X			
Michigan	X			
Minnesota		X		
Mississippi	X			
Missouri		X		
Montana				Separate state calculation of taxable amount[b]
Nebraska		X		
Nevada	No individual income tax			
New Hampshire	Tax applies only to interest and dividends			
New Jersey	X			
New Mexico		X		
New York	X			
North Carolina	X			
North Dakota		X		
Ohio	X			
Oklahoma	X			
Oregon	X			
Pennsylvania	X			

(C) Tax Analysts 2006. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Table 1. State Taxation of Social Security Benefits
(continued)

State	All Benefits Exempt	Follows Federal Taxation	Follows Pre-1993 Federal Taxation	Unique State Tax Rules
Rhode Island		X		
South Carolina	X			
South Dakota	No individual income tax			
Tennessee	Tax applies only to interest and dividends			
Texas	No individual income tax			
Utah				Follows federal rules, but allows taxable benefits to qualify under the retirement income exemption/ deduction for individuals under age 65[c]
Vermont		X		
Virginia	X			
Washington	No individual income tax			
West Virginia		X		
Wisconsin	X (starting tax year 2008)		X (through tax year 2007)	
Wyoming	No individual income tax			

Information is generally for tax year 2004, except as otherwise noted.
Several states provide general exemptions for the elderly without regard to the source of income. See Table 3 for details. Those provisions are not treated as preferences for the Social Security benefits in this table.
[a]For a description of the Colorado pension exclusion, see Table 2. The Colorado pension exclusion amount is sufficiently high ($20,000 per person for individuals age 55 to 64 and $24,000 for individuals age 65 or older) that nearly all Social Security benefits will be exempt from taxation. However, receipt of taxable Social Security benefits will reduce the exclusion available for other pension income.
[b]This calculation parallels federal law but can be calculated separately for each spouse of a married couple who chooses to file separately on the same return (even if they filed a joint federal return). In that instance, the federal base amount is divided between the two spouses. As a result, the amounts of taxable Social Security may differ from the federal calculations.
[c]Individuals under age 65 may deduct $4,800 of qualifying income, including taxable Social Security benefits. Individuals age 65 or older may deduct $7,500 ($15,000 for married joint filers) without regard to the source of the income. The deduction is subject to an income offset that varies by filing status and age of the taxpayer. For a more complete description of the Utah retirement income exemption/deduction, see tables 2 and 3.
Source: Wisconsin Legislative Fiscal Bureau, *Individual Income Tax Provisions in the States* (January 2005), National Conference of State Legislatures, *State Personal Income Taxes on Pensions and Retirement Income: Tax 2004* (November 3, 2004), available at http://www.ncsl.org/programs/fiscal/pitaxret04.htm; supplemented by information from individual state laws and state tax returns and instructions.

(C) Tax Analysts 2006. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Table 2. State Income Tax Exemptions for Pension Income				
State	**Private**	**Federal**	**Military**	**State and Local**
Alabama	Defined benefit plans exempt	Exempt	Exempt	Defined benefit plans exempt
Alaska	No individual income tax			
Arizona	Taxable	$2,500 exemption	$2,500 exemption	$2,500 exemption for Arizona pensions; pensions from other state and local governments are taxable
Arkansas	$6,000 exemption	$6,000 exemption	$6,000 exemption	$6,000 exemption
California	Taxable	Taxable	Taxable	Taxable
Colorado	$20,000 per person exemption (age 55-64) or $24,000 per person (age 65 or older)[a]			
Connecticut	Taxable	Taxable	Taxable	Taxable
Delaware	$2,000 per person (under age 60) or $12,500 per person (age 60 or older)			
District of Columbia	Taxable	$3,000 if over age 62		
Florida	No individual income tax			
Georgia	$15,000 retirement income exclusion applies to individual age 62 or older or disabled; no more than $4,000 of this income may be from earned income			
Hawaii	Employer-funded plans are exempt; investment earnings on employee-funded plans are exempt[b]	Exempt	Exempt	Exempt
Idaho	Taxable	$32,850 exemption for married joint filers ($21,900 for single filers), age 65 or older or age 62 or older and disabled; the amount of the exemption is reduced by Social Security and railroad retirement benefits. Dollar amounts are keyed to the maximum annual Social Security benefit and, thus, are annually adjusted for inflation		
Illinois	Exempt	Exempt	Exempt	Exempt
Indiana	Taxable	If age 62 or older, $2,000 ($4,000 for married couple) exclusion reduced by Social Security benefits	If age 60 or older, $2,000 ($4,000 for married couple) exclusion	Taxable
Iowa	$6,000 exclusion per taxpayer, if recipient is age 55 or older[c]			
Kansas	Taxable	Exempt	Exempt	Kansas pension distributions are exempt, but out-of-state pensions are taxable[d]
Kentucky	$40,200	Fully exempt if retired before January 1, 1998; portion of pension earned before January 1, 1998, exempt; remainder exempt up to $40,200. Dollar amounts are adjusted for inflation (based on CPI-U) through 2005		
Louisiana	$6,000 per person exemption for age 65 or older	Exempt	Exempt	Pensions from Louisiana State Employees' Retirement System or Teachers Retirement System are exempt; out-of-state public pensions are treated as private pensions
Maine	$6,000 exempt per person, less Social Security and railroad retirement benefits[e]			
Maryland	$20,700-per-person exemption for age 65 or older;[f] dollar amounts are tied to the maximum annual Social Security benefit and, thus, are annually adjusted for inflation			
Massachusetts	Taxable	Exempt, if contributory pensions[g]	Exempt	Massachusetts contributory pensions are exempt[h]

(C) Tax Analysts 2006. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Table 2. State Income Tax Exemptions for Pension Income
(continued)

State	Private	Federal	Military	State and Local
Michigan	$38,550 exclusion allowed for single filers ($77,100 for married joint);[i] the dollar limit on the exclusion is indexed annually for increases in the consumer price index[j]	Exempt	Exempt	Pensions paid by Michigan governmental programs are exempt;[k] Tier 2 railroad retirement benefits are exempt
Minnesota	Taxable	Taxable	Taxable	Taxable
Mississippi	Exempt[l]			
Missouri	$6,000 exclusion allowed, subject to income limits: exclusion is reduced dollar for dollar by federal adjusted gross income (excluding taxable Social Security) over $25,000 for single filers ($32,000 for married joint and $16,000 for married separate)[m]			
Montana	Exclusion of $3,600 per person, subject to income limitations: exclusion is reduced by twice the dollar amount of federal adjusted gross income that exceeds $30,000			
Nebraska	Taxable	Taxable	Taxable	Taxable
Nevada	No individual income tax			
New Hampshire	Tax applies only to interest and dividends; earnings on retirement plans are exempt			
New Jersey	Exclusion of $20,000 for married joint ($15,000 for single and $10,000 married separate) for individuals age 62 or older or disabled	Exclusion of $20,000 for married joint ($15,000 for single and $10,000 married separate) for individuals age 62 or older or disabled	Exempt	Exclusion of $20,000 for married joint ($15,000 for single and $10,000 married separate) for individuals age 62 or older or disabled
New Mexico	Taxable	Taxable	Taxable	Taxable
New York	$20,000 exemption for pensions, individual retirement account distributions, and annuities for recipients age 59-1/2 or older	Exempt	Exempt	N.Y. state and local pensions exempt; out-of-state pensions treated as private pensions
North Carolina	$2,000-per-person exclusion allowed.[n]	$4,000-per-person exclusion allowed[o]		
North Dakota[p]	Taxable	$5,000 exclusion, reduced by the amount of Social Security benefits	$5,000 exclusion, reduced by the amount of Social Security benefits for recipients who are age 50 or older	$5,000 exclusion for participants in three North Dakota funds, reduced by the amount of Social Security benefits[q]
Ohio	A credit ranging from $25 to $200, based on the amount of retirement income, is allowed[r]			
Oklahoma	Effective for tax year 2005, $7,500 exclusion per person, if modified adjusted gross income is less than $37,500 ($75,000 for married joint filers) and the individual is age 65 or older[s]	Effective for tax year 2005, $7,500-per-person exclusion		Effective for tax year 2005, $7,500 exclusion for income from various Oklahoma state and local pension plans[t]
Oregon	Credit allowed for up to 9 percent of retirement benefits for individuals whose household income (AGI, plus Social Security and some other income) is less than $22,500 ($45,000 married joint), who are age 62 or older, and whose Social Security benefits are less than $7,500 ($15,000 married joint)[u]			
Pennsylvania[v]	Exempt	Exempt	Exempt	Exempt
Rhode Island	Taxable	Taxable	Taxable	Taxable
South Carolina	Individuals under age 65 may exclude $3,000 of retirement income; individuals 65 or older may exclude $10,000[w]			
South Dakota	No individual income tax			
Tennessee	Tax applies only to interest and dividends; pensions and retirement plan earnings are exempt			

(C) Tax Analysts 2006. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Table 2. State Income Tax Exemptions for Pension Income (continued)

State	Private	Federal	Military	State and Local
Texas	No individual income tax			
Utah	Individuals under age 65 are allowed a $4,800 exclusion for pension income, annuities, and taxable Social Security benefits. The exclusion is reduced by one-half of AGI (plus tax-exempt interest and lump sum distribution) over thresholds that vary by filing status and age (of taxpayer and spouse)[x]			
Vermont	Taxable	Taxable	Taxable	Taxable
Virginia	Taxable[y]	Taxable	Taxable, except exempt for winner of the Congressional Medal of Honor	Taxable
Washington	No individual income tax			
West Virginia	Taxable[z]	$2,000 exclusion allowed	$22,000 exclusion allowed[aa]	$2,000 exclusion for West Virginia plans
Wisconsin	Taxable	Exempt if member of plan before 1964	Exempt	Exempt if member of plan before 1964
Wyoming	No individual income tax			

Information is generally for tax year 2004, except as otherwise noted.
Unless otherwise specified, married taxpayers qualify for twice the amount allowed to an individual, and each spouse must qualify based on his or her own income and age.

[a]Exclusion applies to individual retirement account distributions, pension, annuities, and taxable Social Security. Colorado follows the federal rules for taxing Social Security benefits, but allows taxable Social Security benefits to qualify for the pension exclusion.

[b]Exempt amount for investment return is calculated using a ratio, computed in the first year of receipt of the annuity, based on the shares of the cost of the annuity.

[c]For married joint filers, only the recipient of the pension income needs to be age 55 or older, or disabled. If recipient is a surviving spouse, qualification is based on the age or disabled status of the decedent. If both spouses have pensions regardless of other eligibility, the $12,000 exclusion is allocated between them in proportion to their shares of pension income. Spouse can claim the entire $12,000 exclusion if he or she is the only recipient of pension income.

[d]Employee contributions to Kansas public pension plans are typically subject to tax (that is, although they are excluded under federal tax rules, they are added back in federal adjusted gross income for Kansas income tax purposes).

[e]Qualified pension income excludes distributions from an individual retirement account or ineligible deferred compensation plan. To qualify, the taxpayer must have earned the pension or the entitlement or must qualify as a surviving spouse. Military pension benefits are not subject to the reduction for Social Security benefits, but are subject to the $6,000 maximum.

[f]Qualified pensions do not include distributions from individual retirement accounts (traditional, Roth, or SEP), Keogh plans, or ineligible deferred compensation plans. Each spouse qualifies based on his own income and age. An individual may qualify, however, based on the spouse's disability. Maryland also has three special pension exclusions for limited situations: pension and disability payments made to firefighters and police officers for job-related injuries or disabilities; payments to a surviving spouse or other beneficiary by a retirement system for a law enforcement officer or firefighter whose death arose out of or in the course of employment; and $2,500 of retired military pay for an individual who was an enlisted member upon retirement, whose adjusted gross income is less than $22,500, and who is at least 55 years of age.

[g]Standard federal civil service pensions require employees to contribute and appear to be exempt.

[h]Out-of-state contributory pensions are exempt if the other state provides reciprocal treatment to Massachusetts state and local pensions. Recipients of pensions from states that have unlimited pensions exclusions or that provide unlimited exclusions for pensions from other state and local governments would appear to qualify for that treatment.

[i]Qualifying pensions include employer-funded pension benefits, individual retirement distributions that are not subject to the 10 percent penalty tax for early withdrawals, and 401(k) and similar plan distributions that are attributable to employee contributions made to meet the employer's match. Qualified plans do not include 401(k), 403(b), and 457 plans that represent only employee deferrals (not to meet an employer match). Any exclusion claimed for a public pension (federal, Michigan, or railroad retirement) reduces the maximum exclusion for private pensions.

[j]Mich. Comp. Laws section 206.30(1)(f)(v).

[k]Pensions from other states qualify under the rules for private pensions unless reciprocal treatment is provided to Michigan governmental pensions.

[l]Exemption does not apply to early or excess distributions or deferred compensation distributions received before reaching retirement age. Private plans must be qualified plans (for example, distributions from nonqualified deferred compensation plans would not qualify).

[m]Pensions include standard pensions and individual retirement account distributions (for example, amounts reported in lines 15b and 16b of the federal Form 1040 for 2004).

[n]The exclusions for private and public pensions may not exceed $4,000 per person.

[o]This combined exclusion is coordinated with the exclusion for private pensions, so the maximum exclusion may not exceed $4,000 per person. Special rules apply to certain public retirees under the settlement of *Bailey v. State of North Carolina*. The settlement allows a full exclusion of all retirement benefits to North Carolina state and local and federal retirees, if the retirees had five or more years of creditable service as of August 12, 1989.

(C) Tax Analysts 2006. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Table 2. State Income Tax Exemptions for Pension Income
(continued)

[p]To claim the North Dakota pension exclusions for either private pensions or public retirement benefits, the taxpayer must elect to pay tax under a separate tax base and (higher) rate schedule. Rates under the regular schedule range from 2.1 percent to 5.54 percent and under the alternative from 2.67 percent to 12 percent. The regular tax base and rate schedule results in lower taxes for 95 percent of taxpayers, according to the Department of Revenue's income tax instruction booklet.
[q]This applies to the North Dakota city firefighters' relief association, the North Dakota city policemen's pension fund, and the North Dakota highway patrolmen's retirement system.
[r]Credit is calculated based on income from pensions, profit-sharing plans, and annuities that are received because the taxpayer is retired. Social Security benefits do not qualify. Joint filers calculate the credit based on their combined incomes under the same credit schedule that applies to single filers.
[s]Under a referendum passed in November 2004, the dollar limits of all the Oklahoma pension exclusions were increased from $5,500 to $7,500. The income limits for private pensions were increased from $25,000 (single) and $50,000 (married joint).
[t]Pensions from other state and local plans, including those from other states, must qualify under the rules for private pensions (that is, subject to age and income limit).
[u]In addition, exemptions for federal and Oregon state and local pensions are provided for amounts earned for service before October 1, 1991.
[v]The pension exclusion contains a 59-1/2 age restriction for plans (for example, individual retirement accounts, 401(k), and so forth) that are subject to additional tax under federal law for early distributions. This age restriction does not apply if the federal rules do not impose the additional tax on early distributions.
[w]Retirement income includes all public pensions and amounts from plans under sections 401, 403, 408, and 457 of the Internal Revenue Code, as well as individual retirement accounts and Keogh plans. Any amount claimed under retirement income exclusion reduces the deduction for age 65 or older.
[x]Individuals age 65 or older are allowed a $7,500 retirement exclusion ($15,000 for married joint) that is not limited as to income source. See Table 3.
[y]Virginia allows a foreign-source retirement credit for income taxes paid to a foreign country on pension or retirement income derived from employment in a foreign country.
[z]A special deduction is provided for individuals whose pension was reduced as a result of a takeover of the plan by the federal Pension Benefit Guaranty Corporation.
[aa]This reflects a $20,000 exemption for military pensions, plus the $2,000 basic public pension exclusion. An individual with a separate public pension cannot claim an additional $2,000 for that pension.
Source: Wisconsin Legislative Fiscal Bureau, *Individual Income Tax Provisions in the States* (January 2005), supplemented by information from individual state tax forms, laws, and *State Tax Notes.*

(C) Tax Analysts 2006. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Table 3. General Age-Based State Tax Preferences				
State	**Additional Standard Deduction**	**Amount of Age-Based Exclusion or Exemption**	**Coordinate With Pension or Social Security Exemptions**	**Income Limit**
Alabama	No	No	NA	NA
Alaska	No individual income tax			
Arizona	No	$2,100 single ($4,200 joint)	No	No
Arkansas	No	$20 tax credit ($40 for married couple)	Yes, additional $20 credit if no pension exclusion claimed	No
California	No	$85 credit per personal exemption ($170 for married couple)[a]	No	Yes, exemption credit limited based on AGI over thresholds
Colorado	Follows federal rules	No	NA	NA
Connecticut	No	No	NA	NA
Delaware	$2,500 ($5,000 for married if each spouse is 65 or older)	$110 credit for age 60 or older ($220 for married couple)	No	No[b]
District of Columbia	No	$1,370 for single taxpayer ($3,740 for married couple)	No	No
Florida	No individual income tax			
Georgia	$1,300 each for taxpayer and spouse 65 or older	$4,000 of any type of income may be deducted under the retirement income exclusion by individuals age 62 or older[c]	Yes	No
Hawaii	No	$1,040 for single taxpayer ($2,080 for married couple)	No	No
Idaho	Follows federal rules	No	NA	NA
Illinois	NA	$1,000 for taxpayer ($2,000 for married couple)	No	No
Indiana	NA	$1,000 for taxpayer ($2,000 for married couple)	No	No
Iowa	No	$20 credit for taxpayer ($40 for married couple)	No	No
Kansas	$850 for single or head of household; $700 for one spouse; $1,400 for both spouses	No	NA	NA
Kentucky	No	$20 credit for single taxpayer ($40 for married couple)	No	No
Louisiana	No	$1,000 for single taxpayer ($2,000 for married couple)	No	No
Maine	$1,200 for single or head of household; $950 for one spouse; $1,900 for both spouses	No	NA	NA
Maryland	No	$1,000 for single taxpayer ($2,000 for married couple)[d]	No	No

(C) Tax Analysts 2006. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Table 3. General Age-Based State Tax Preferences (continued)				
State	Additional Standard Deduction	Amount of Age-Based Exclusion or Exemption	Coordinate With Pension or Social Security Exemptions	Income Limit
Massachusetts	NA	$700 for single taxpayer ($1,400 for married couple)	No	No
Michigan	NA	$2,000 for single taxpayer ($4,000 for married couple) and subtraction allowed for amount used to calculate the federal credit for the elderly and disabled	No, except amount used to determine federal elderly and disabled credit is reduced by nontaxable Social Security benefits	No
Minnesota	Follow federal rules	$12,000 married couple if one spouse age 65; $9,600 for single or head of household; $6,000 for married separate return	Nontaxable Social Security and railroad retirement benefits reduce the exclusion	One-half of AGI over thresholds reduces the exclusion: $18,000 for married joint; $14,000 single or married couple with only one spouse 65 or older; $9,000 for married separate return
Mississippi	No	$1,500 for single taxpayer ($3,000 for married couple)	No	No
Missouri	Follow federal rules	No[e]	NA	NA
Montana	No	$1,900 for single taxpayer ($3,800 for married couple)[f]	No	No
Nebraska	Follows federal rules, but phases out deduction at higher income levels	Credit equal to the federal elderly and disabled credit allowed	Yes, Social Security is taken into account in computing the state credit	Yes, under the federal credit
Nevada	No individual income tax			
New Hampshire	NA	No	NA	NA
New Jersey	NA	Three age-based exclusions are allowed:		
		1. $1,000 for taxpayer ($2,000 for married couple)	No	No
		2. Individuals age 62 or older with less than $3,000 of earned income allowed to use the retirement income exclusion for other forms of income[g]	Yes, it is tied to retirement income exclusion	No
		3. $3,000 special exclusion ($6,000 married) allowed to individuals age 62 or older and not covered by Social Security	Yes, targeted to individuals not covered by Social Security	No
New Mexico	Follows federal rules	$8,000 exemption; complete exemption for individuals age 100 or older	No	Yes, $8,000 exemption is subject to income limits that vary based on filing status[h]
New York	No	No	NA	NA

(C) Tax Analysts 2006. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Table 3. General Age-Based State Tax Preferences
(continued)

State	Additional Standard Deduction	Amount of Age-Based Exclusion or Exemption	Coordinate With Pension or Social Security Exemptions	Income Limit
North Carolina	$750 for single, head of household; $600 for one spouse or $1,200 for both	No	NA	NA
North Dakota	Follows federal rules	No	NA	NA
Ohio	NA	$50 credit allowed (same for single or married couple)	No	No
Oklahoma	No	$1,000 for taxpayer ($2,000 for married couple)	No	No
Oregon	$1,200 single; $1,000 per spouse	Credit equal to 40% of the federal elderly and disabled credit allowed	Yes, Social Security is taken into account in computing the federal credit	Yes, under the federal credit
Pennsylvania	NA	No	NA	NA
Rhode Island	No	Credit equal to the federal elderly and disabled credit allowed	Yes, Social Security is taken into account in computing the federal credit	Yes, under the federal credit
South Carolina	No	$15,000 deduction for taxpayer ($30,000 married couple)	Yes, deduction is reduced by the retirement income exclusion	No
South Dakota	No individual income tax			
Tennessee	NA	Yes, individuals age 65 or older exclude $16,200 ($27,000 married joint) from tax	NA (tax limited to interest and some dividends)	No
Texas	No individual income tax			
Utah	Follow federal rules	$7,500 ($15,000 married joint both age 65 or older)	No	Yes; varies by filing status and age
Vermont	Follow federal rules	Amount equal to federal elderly and disabled credit allowed as a deduction	Yes, Social Security is taken into account in computing the federal credit	Yes, under the federal credit
Virginia	No	$900 exemption ($1,800 married);[i] $6,000 deduction for persons age 62-65;[j] $12,000 for age 65 or older	No	Yes, phasing in income limits on the $12,000 deduction[k]
Washington	No individual income tax			
West Virginia	NA	$8,000 deduction for taxpayer ($16,000 married couple)	Yes, deduction reduced by the amount claimed under the pension exclusion[l]	No
Wisconsin	No	$250 exemption	No	No
Wyoming	No individual income tax			

Information is for tax year 2004, except as otherwise noted.
Preferences are for individuals age 65 or older, unless otherwise noted. Amounts for married couples assume both spouses meet requisite age requirement, unless otherwise noted.
NA: Not applicable — for example, states without a standard deduction or if no general age-based exemption or exclusion, no coordinating provisions, or no income limits for the provisions.

(C) Tax Analysts 2006. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Table 3. General Age-Based State Tax Preferences
(continued)

[a]These amounts are annually adjusted for inflation. In addition, California allows a very limited credit for senior head of household. The credit applies to individuals over age 65 who were a head of household during 2002 or 2003; whose adjusted gross income is less than $54,730 in 2004; and whose qualifying dependent died during 2002 or 2003.
[b]Delaware allows a special gross income exclusion of $2,000 for individuals age 60 or older with low incomes. To qualify, the individual (amounts are doubled for married couples where both spouses are age 60 or older) must have earned income less than $2,500 and adjusted gross income of $10,000 or less.
[c]This exclusion is $15,000 per person and is allowed for a variety of types of income, such as interest, dividends, and alimony, that go beyond standard pension, individual retirement account distributions, and so forth. Thus, the $4,000 amount essentially applies to wages, salaries, Schedule C profits, and similar. *See* Table 2 for a description of the Georgia retirement income exclusion.
[d]Maryland also allows an additional deduction of $2,400 to a taxpayer with a dependent who is age 65 or older.
[e]Missouri allows an additional deduction of $2,200 to taxpayer with a dependent who is age 65 or older. In addition, Missouri provides a tax credit for shared care of the elderly.
[f]Tax year 2005 amount. Montana also allows a tax credit for elderly care.
[g]See Table 2 for a description of the New Jersey retirement income exclusion.
[h]The exemption phases out in $1,000 increments ($500 increments for single and married separate filers) of adjusted gross income over specified thresholds: $30,000 for married joint; $18,000 for single; and $15,000 for married separate. Thus, the exemption is unavailable to married joint filers with AGI over $51,001; $28,501 for single filers; and $25,501 for married separate filers.
[i]This is effective for tax year 2005 as a result of legislation enacted in 2004; the $800 exemption applied in tax year 2004.
[j]Under legislation enacted in 2004, the $6,000 deduction for those under age 65 is being phased out. Individuals not eligible to receive an exclusion before tax year 2004 will not qualify. When all pre-2004 recipients are 65 or older, the exclusion is eliminated.
[k]The deduction is reduced by each dollar of adjusted gross income (less taxable Social Security) over $50,000 for single taxpayers and $75,000 for married filers. These income limits do not apply to individuals eligible to receive the deduction before tax year 2004.
[l]The deduction is also reduced by nontaxable U.S. bond interest.
Source: Wisconsin Legislative Fiscal Bureau, *Individual Income Tax Provisions in the States* (January 2005), National Conference of State Legislatures, *State Personal Income Taxes on Pensions and Retirement Income: Tax 2004* (November 3, 2004), available at http://www.ncsl.org/programs/fiscal/pitaxret04.htm; supplemented by information from individual state laws and state tax returns and instructions.

Appendix B: 2002 HITS Sample

The HITS sample is a random, stratified sample with strata designated for resident returns, part-year and nonresident returns,[29] filing status (married joint/surviving spouse, married separate/head of household, and single), and income ranges. The sample is drawn based on federal taxable income. While it would be preferable to draw the sample based on a broader income measure, such as federal adjusted gross income, that is not possible under Minnesota's current income tax system. Federal taxable income (FTI) is reported on the state return and maintained electronically by the Department of Revenue, and is thus available for use in drawing the sample. Federal adjusted gross income (FAGI) is obtained from the federal return required as part of the state return once a return is selected for inclusion in the sample, but is not available electronically for all returns filed. In 1999 the DOR began requesting FAGI on state returns, but because that figure is not used in any state calculations, the accuracy of reporting is less reliable than is the case for FTI as reported on state returns.

As part of its preparations to reengineer the state's income tax system in the late 1990s and early 2000s, DOR staff determined that a taxpayer's name and Social Security number by themselves were inadequate as a unique taxpayer identifier. Beginning with tax year 1999 returns, the department added taxpayer and spouse date of birth as required items on Minnesota returns. Date of birth, name, and Social Security number combined provide a unique identifier for tax administration by the department.

The following tables (next page) show the population, number of returns in the sample, and conversion rate used for the resident returns in the 2002 sample.

[29]Minnesota's tax forms do not allow distinguishing between nonresidents (individuals who did not reside in Minnesota during the tax year but who have Minnesota-source income) and part-year residents (individuals who lived in Minnesota for part of the tax year and have Minnesota-source income).

(C) Tax Analysts 2006. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Strata 100 to 110: Resident Single Filers			
Federal Taxable Income	**Population**	**Sample**	**Conversion Rate**
"Special"*	121	38	3.18421
($500,000) to ($25,000)	4,298	57	75.40351
($24,999) to $0	157,373	209	752.98086
$1 to $10,000	392,125	1,689	232.16400
$10,001 to $30,000	343,803	1,706	201.52579
$30,001 to $50,000	126,814	773	164.05433
$50,001 to $100,000	41,037	551	74.47731
$100,001 to $250,000	7,072	280	25.25714
$250,001 to $500,000	1,187	125	9.49600
$500,001 to $1,000,000	402	82	4.90244
Over $1,000,000	236	78	3.02564
Total	**1,074,468**	**5,588**	
Strata 200 to 208: Resident Married Joint and Surviving Spouse Filers			
Federal Taxable Income	**Population**	**Sample**	**Conversion Rate**
"Special"*	358	115	3.11304
($500,000) to ($25,000)	7,103	56	126.83929
($24,999) to $30,000	358,001	3,128	114.45045
$30,001 to $50,000	245,866	1,707	144.03398
$50,001 to $100,000	275,807	2,358	116.96650
$100,001 to $250,000	74,025	1,420	52.13028
$250,001 to $500,000	12,796	612	20.90850
$500,001 to $1,000,000	3,779	398	9.49497
Over $1,000,000	1,840	608	3.02632
Total	**979,575**	**10,402**	
Strata 300 to 312: Resident Head of Household and Married Separate Filers			
Federal Taxable Income	**Population**	**Sample**	**Conversion Rate**
"Special"*	33	11	3.00000
($500,000) to ($25,000)	669	5	133.80000
($24,999) to $0	53,440	90	593.77778
$1 to $5,000	38,695	206	187.83981
$5,001 to $10,000	30,882	76	406.34211
$10,001 to $20,000	48,865	137	356.67883
$20,001 to $30,000	29,462	107	275.34579
$30,001 to $50,000	23,416	115	203.61739
$50,001 to $100,000	8,095	75	107.93333
$100,001 to $250,000	1,752	50	35.04000
$250,001 to $500,000	300	19	15.78947
$500,001 to $1,000,000	83	16	5.18750
Over $1,000,000	49	16	3.06250
Total	**235,741**	**923**	
Grand Total, Resident Returns	2,289,748	16,913	
*Special taxpayers are those with FTI less than ($500,000) or additions or subtractions greater than $250,000.			

☆

(C) Tax Analysts 2006. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.