

Vermont Legislative Joint Fiscal Office

One Baldwin Street • Montpelier, VT 05633-5701 • (802) 828-2295 • Fax: (802) 828-2483

ISSUE BRIEF

Date: February 3, 2020

Prepared by: Graham Campbell and Joyce Manchester

Taxation of Federal Retiree Benefits: An Update

This Issue Brief explores the taxation of Federal retiree benefits in Vermont and a possible income tax exemption of these benefits.¹ This brief is intended to be a follow-up to an Issue Brief published in March 2018.²

Federal retirees are in one of two retirement systems: Civil Service Retirement System (CSRS), which was created in the 1920s, or Federal Employees Retirement System (FERS), which was created in the 1980s. All Federal employees hired after 1983 are in FERS. For the purposes of income and taxation, a key difference between the two systems is that CSRS retirees did not pay into nor do they receive Social Security benefits.

JFO estimates that exempting the pensions of CSRS and FERS retirees for those with incomes below the Vermont Social Security exemption thresholds (\$45,000 for a single filer and \$60,000 for a married couple) will reduce personal income tax revenues between \$2.3 and \$2.8 million in FY2021.³

- JFO estimates that about 2,600 retirees (out of the total 4,787 Federal retirees in Vermont) will benefit, for an average tax benefit of between \$900 and \$1,000.
- For CSRS retirees, JFO estimates that just over 1,600 retirees would benefit. The average tax cut would be between \$1,100 and \$1,500 per year.
- For FERS retirees, JFO estimates that just under 1,000 retirees would benefit. The average tax cut would be roughly \$450 per year.

For reference, Vermont's Social Security exemption passed in 2018 benefitted about 40,000 Vermonters with an average benefit of roughly \$140. At the time, that exemption was expected to cost about \$5 million per year.

An exemption for Federal retirees is costlier on a per-person basis than Vermont's Social Security exemption because at least 15% (and up to 100% for low-income taxpayers) of Social Security benefits have long been considered tax-free by the Federal government. When Vermont exempted Social Security benefits for taxpayers with middle incomes, this Federal exemption covered a large portion of the overall benefit, making Vermont's exemption relatively small (in most cases, less than 50% of total Social Security benefits). With Federal retirees, the existing Federal exemption is very small at 5% to 10%. Therefore, Vermont would be exempting 90% to 95% of these retirees' pension income, as opposed to at most 85%, but in most cases, less than 50% for the Social Security exemption.

¹ H.695 of the 2019 session would exempt Civil Service Retirement Service (CSRS) and Federal Employee Retirement System (FERS) income from Vermont income taxes for taxpayers with incomes below the thresholds established by Vermont's exemption for Social Security.

² "Tax Treatment of Government Pension Payments Other than Social Security."

https://ljfo.vermont.gov/assets/docs/issue_briefs_and_memos/fca0df7eea/Tax_Treatment_of_Government_Pension_Payments.pdf

³ This estimate assumes that distributions from the Thrift Savings Plan (TSP) are not included in the definition of a Federal government pension payment as defined in H.695. If they are deemed part of the FERS pension payment, this revenue loss would be higher.

Brief Background on Federal Retiree Systems

Federal government retirees are in one of two retirement systems: Civil Service Retirement System (CSRS) or Federal Employees Retirement System (FERS). CSRS is an older system which was created in the 1920s. In the mid-1980s, the Federal Government reformed their retirement system and created FERS. Employees hired after 1983 are required to be in the FERS system. Both systems are defined benefit pension plans. CSRS is entirely defined benefit while FERS is a mix of a smaller defined benefit plus a 401k-style savings plan (the Thrift Savings Plan) plus Social Security.

For the purpose of taxation, the major difference between the two is that **CSRS recipients do not receive Social Security**. FERS retirees are eligible for Social Security (and therefore already eligible for Vermont's Social Security exemption).

For more background on these two systems and their differences, please see JFO's Issue Brief "Tax Treatment of Government Pension Payments Other than Social Security" published March 2018.⁴

Estimating the Cost of an Income Tax Exemption for Federal Retirees

JFO relied upon data from the Congressional Research Service⁵, the Federal Government Office of Personnel Management (OPM), and Vermont personal income tax data to estimate the costs of a personal income tax exemption for retiree benefits for both CSRS and FERS, such as the one outlined in H.695.

JFO estimates that exempting the pension payments of CSRS and FERS retirees for households with income below the current Vermont Social Security exemption thresholds would reduce personal income tax revenue by between \$2.3 and \$2.8 million in FY2021.

- JFO estimates that about 2,600 retirees (out of the total 4,787 Federal retirees in Vermont) will benefit, for an average tax benefit of between \$900 and \$1000.
- For CSRS retirees, JFO estimates that just over 1,600 retirees would benefit. The average cut would be between \$1,100 and \$1,500 per year.
- For FERS retirees, JFO estimates that just under 1,000 retirees would benefit. The average tax cut would be roughly \$450 per year.

For reference, Vermont's Social Security exemption passed in 2018 benefitted about 40,000 Vermonters with an average benefit of roughly \$140. At the time, that exemption was expected to cost about \$5 million per year.

This estimate assumes that distributions from the Thrift Savings Plan (TSP) are not included in the definition of a Federal government pension payment as defined in H.695. If they are deemed part of FERS pension payments, this revenue loss would be higher.

JFO's estimate for CSRS exemption delineated between postal and non-postal employees, as there is reason to believe a large number of retirees in Vermont are postal retirees who may have lower average pensions than the overall average.

⁴ Note that many of the numbers in that Issue Brief have been updated.

⁵ "Federal Employees' Retirement System: Summary of Recent Trends" Congressional Research Service. January 2020. <https://fas.org/sgp/crs/misc/98-972.pdf>

Finally, it is important to note that excluding this income from tax leads to lower overall taxable income for a married couple. This results in the income of the spouse being taxed at lower effective rates. This also drives the cost estimate higher.

Exemption Costs: Social Security versus Federal Retiree Benefits

To understand why this exemption has a higher per-person cost than the Social Security exemption, it is important to understand how the taxation of both Social Security and CSRS/FERS currently works at the Federal level. In general, for all retirement income (pensions, 401ks, IRAs, Social Security), tax is paid either when the beneficiary contributes to the account or when the benefits are withdrawn. The IRS and Vermont generally tax the portion of the benefit that is contributed by employers plus the earnings on both employee and employer contributions. The portion of the benefit that is contributed by the beneficiary is usually tax free.

Under Social Security, the Federal government has determined that, depending on the income level of the beneficiary, about 15% of the benefit was contributed by the beneficiary and therefore tax-free. Over the history of Social Security, Congress has decided that for low-income individuals, the benefit should be 100% tax-free. The benefit slowly phases out as income rises:

Federal Taxation of Social Security Benefits

Combined Income		% of Social Security Benefits exempt
Single	Married Filing Joint	
< \$25,000	< \$32,000	All 100% Exempt
\$25,001 - \$34,000	\$32,001 - \$44,000	Up to 50% Exempt
\$34,001 and over	\$44,001 and over	At least 15% exempt and up to 50% exempt

Source: Social Security Administration (<https://www.ssa.gov/planners/taxes.html>)

This tax-free exemption at the Federal level has existed since the 1980s and is incorporated into Federal Adjusted Gross Income (AGI). Because Vermont’s tax base for personal income taxes begins with AGI, this “exemption” is picked up on Vermont taxes. This means that even prior to Vermont exempting Social Security benefits for some taxpayers, Vermonters were already benefiting from an exemption from the Federal government on their Vermont taxes. For instance, even before the Vermont exemption was passed, taxpayers with AGI below \$25,000 (single filer) and \$32,000 (married) paid no Federal or state income tax on their Social Security payments. People with incomes higher than those thresholds receive at least a 15% exemption on their benefits.

In sum, when Vermont exempted Social Security benefits for those with incomes below \$45,000 (single) and \$60,000 (married), the cost to the State was smaller because the Federal exemption already covered a very large portion of their Social Security benefits. Vermont was largely giving a small benefit beyond the Federal exemption.

For Federal government retirees, the Federal government generally considers about 5-10% of the total benefit to be contributed by the employee (and therefore, tax-free). In other words, 90-95% of the retirement benefit is currently taxable at both the Federal and Vermont level. Exempting this income would

mean exempting 90-95% of their pension benefit from Vermont taxation. This is in contrast with Social Security, where at maximum, the State is exempting 85% of the benefit, and in most cases, exempting less than 50% of the total benefit.

In short, the average tax benefit for this exemption (and therefore average cost to the State) is much higher for CSRS and FERS retirees than for Social Security retirees because the Federal exemption on Social Security (which Vermont picks up as part of AGI), already covered/exempted a large portion of the Social Security benefits. For the CSRS and FERS retirees, the State would be exempting 90-95% of their retirement income, whereas with Social Security, that number was at most 85%, but often much lower.

Another factor driving up the cost of this exemption is the higher average retiree benefit these retirees receive relative to Social Security. The median monthly CSRS payment was \$4,469 per month in 2018. The median for FERS was \$1,834. By contrast, the average Social Security check in Vermont before the Federal exemption was \$1,547 per month.

Other Considerations

As of tax year 2016, 14 states provided some form of specific tax relief to Federal retiree benefits. Nine states exempted their own nonparticipating retirement systems and all civil service annuities from state income tax. Five other states exempted certain federal civil service annuities, often based on year of birth or dates of service. Nine states have no income tax.

27 states, including Vermont, follow the Federal treatment of these benefits.

<u>Table 1: Tax Treatment of Civil Service Pensions by States, Tax Year 2016</u>			
<u>Exempt</u>	<u>Partially Exempt</u>	<u>No Income Tax</u>	<u>Follow Federal Treatment</u>
Alabama	Kentucky	Alaska	All others, including Vermont
Hawaii	Michigan	Florida	
Illinois	North Carolina	Nevada	
Kansas	Oklahoma	New Hampshire	
Louisiana	Oregon	South Dakota	
Massachusetts		Tennessee	
Mississippi		Texas	
New York		Washington	
Pennsylvania		Wyoming	
Source: NARFE			

Additionally, CSRS is not the only pension system where the retirees did not contribute to the Social Security program and therefore are not eligible for Social Security benefits. 15 states have teacher retiree systems where some beneficiaries are not covered by Social Security. Some state government retirees, such as those from Massachusetts and California, may also not be eligible for Social Security benefits.