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## Expanding the Social Security Benefit Exemption Under the Iowa Income Tax

by Peter S. Fisher<sup>1</sup>

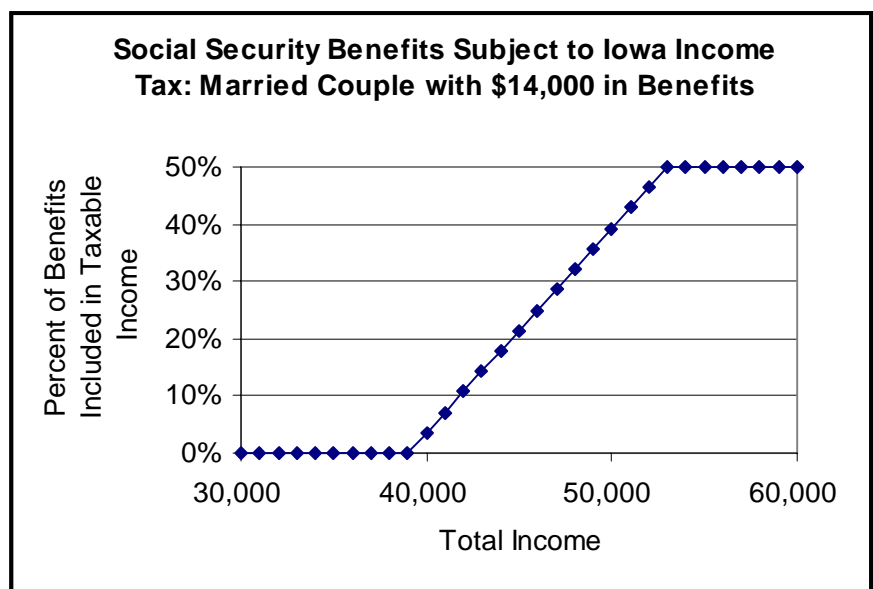
Iowa currently exempts the majority of retirees from paying state income taxes on their Social Security benefits. Some have suggested extending the exemption to higher income retirees. This policy brief describes how the current exemption works and considers the proposal to completely exempt Social Security benefits from Iowa tax. The expansion proposal is evaluated in terms of fairness, fiscal soundness, and economic effects.

### How Iowa Exempts Social Security Benefits

#### *Couples*

To determine if one's Social Security benefits are subject to tax, the taxpayer completes a worksheet included in the Iowa 1040 instructions. The first step calculates "provisional income," which is the total of most sources of money income (including tax exempt interest) but excluding half of Social Security benefits. If provisional income for a married couple is \$32,000 or less (whether they file jointly or separately), then 100% of their Social Security benefits are tax exempt. For provisional income in excess of this amount, the tax is phased in until the maximum of 50% of benefits are taxed.

The exemption and its phase-out are illustrated in the figure to the right for an elderly married couple who receive an



<sup>1</sup> Dr. Peter S. Fisher is Professor of Urban and Regional Planning at the University of Iowa. An economist who specializes in state and local government finance, he has published numerous articles, reports and books on tax policy issues.

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average amount of Social Security benefits — \$14,000 per year. As long as their income from other sources (interest, dividends, pensions, IRA distributions etc.) is less than \$25,000, this couple does not pay tax on any of their Social Security benefits, because \$25,000 plus half of their Social Security income produces a provisional income of just \$32,000. If the couple's other income is between \$25,000 and \$39,000 (that is, their total income is between \$39,000 and \$53,000), they must include an increasing percentage of Social Security benefits in their taxable income. At a total income level of \$53,000 or more, the maximum of 50% of benefits is taxable.

### *Single Individuals*

For single taxpayers, the provisional income threshold is \$25,000. An individual with \$10,000 in Social Security benefits, for example, could earn \$20,000 in other income (for a total income of \$30,000) and still have just \$25,000 in provisional income (\$20,000 plus half the Social Security benefit). This would allow him or her to pay no taxes on the \$10,000 in Social Security income.

## Expansion of the Exemption to Higher Income Retirees: An Evaluation

### *Iowa is not out of line with its neighbors*

Among the surrounding states, Kansas, Nebraska, Minnesota, and Missouri all tax up to 85% of Social Security benefits (in conformity with the Federal government) and Wisconsin taxes up to 50%. Illinois is the only neighboring state with an income tax that does not tax benefits at all. (South Dakota has no income tax.) Furthermore, 69% of the elderly still pay lower taxes in Iowa than in Illinois because Illinois does not allow itemized or standard deductions, nor any deduction for Federal income taxes.<sup>2</sup>

### *The migration issue doesn't hold water*

There is no hard evidence that elderly Iowans are leaving the state in substantial numbers for tax reasons. Admittedly, the absence of an income tax in South Dakota may tip the balance for a few retirees in Northwest Iowa who decide to move across the state line. But eliminating the tax on Social Security benefits is unlikely to change that. Even among households earning \$100,000 to \$200,000 the average tax paid on Social Security benefits in 2001 will be \$843, and the average among all households paying tax on benefits is just \$418.<sup>3</sup> It is difficult to believe that such tax amounts would be the decisive factor in the retirement location decision of a high-income retired household, given all the other factors that weigh in such a decision—housing costs, climate, proximity to family, access to health care etc.

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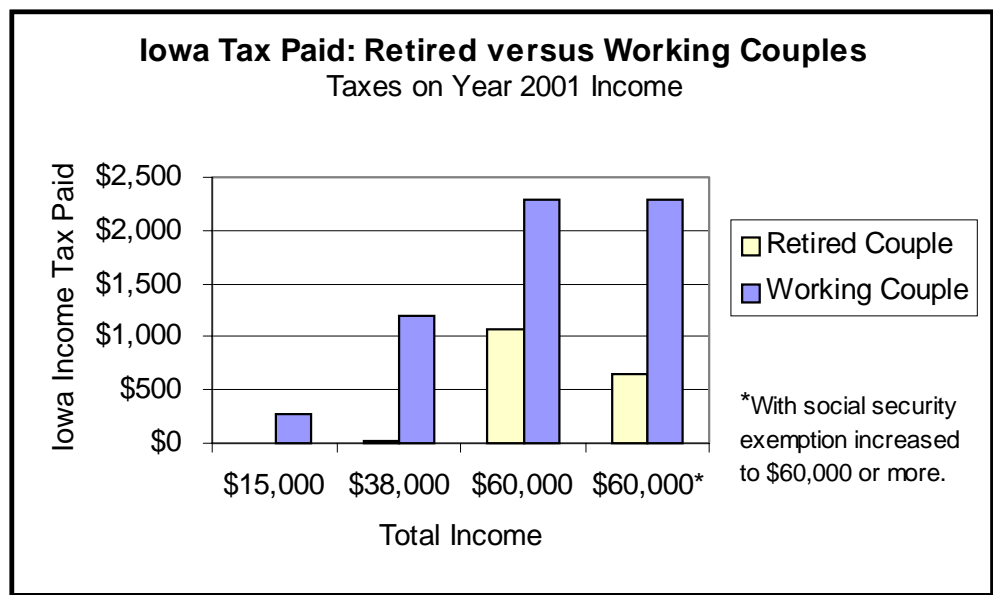
<sup>2</sup> *Choices for Iowa: Building a Better Tax System*. Institute for Taxation and Economic Policy, September 1998, p. 31.

<sup>3</sup> *Addendum to Social Security Paper*. Iowa Department of Revenue and Finance, Table 2-B.

### *Exemption violates the principle of equal treatment of equals*

Taxing certain sources of income and exempting others brings inequity into the tax system. To tax a dollar of wages and not tax a dollar of Social Security benefits is to tax two individuals with identical incomes and similar ability to pay, differently.

The present Social Security exemption and pension exclusion provisions already make for very different taxes on the same amount of income. As the example in the table at the end of this report illustrates, a middle-income working couple earning \$38,000, mostly from wages and salaries, would pay \$1,205 in Iowa income taxes under current law. A couple with the same total income but with \$12,000 of that income from Social Security benefits would pay only \$18. A couple with \$60,000 total income would pay \$2,294 if working, and \$1,078 if most of the income were Social Security and pensions. These tax differences are due mainly to the Social Security exemption and the exclusion from Iowa taxable income of \$6,000 (\$12,000 married filing jointly) of pensions, annuities, or IRA distributions that are federally taxable.<sup>4</sup>



Expanding the present Social Security benefit exemption to high income retired persons would make the equity problem worse. While the taxes on the low and middle income couples would be no different, the upper income retired couple with \$60,000 income that now pays taxes on half their Social Security benefits would save about \$428. This couple under current law already pays only 47% of the taxes paid by the working couple with the same income. Completely exempting Social Security income from income tax would reduce that fraction to 28%, as the upper income couple's Iowa tax bill would fall to \$650.

It is sometimes argued that a tax on social security benefits amounts to taxing the same income twice. While it is true that individuals paid taxes on their own contributions to Social Security while

<sup>4</sup>The tax calculations in the table and reported here are based on Iowa and Federal tax law for income year 2001, as we know it now. That is, the state and federal standard deductions, the federal personal exemption, and the state and federal tax brackets are those that will apply for 2001, not those that appear on 2000 tax forms now being mailed to taxpayers. Also, the Iowa pension exclusion was raised for 2001.

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working, they did not pay any taxes on the employer contributions. Self employed persons receive comparable treatment because they can exclude half of their self-employment taxes from taxable income. Furthermore, no tax is paid on the increase in value of one's contributions. Thus there is no double-taxation argument for extending the exemption to the half of Social Security benefits now taxed.

### *Extending the exemption provides tax relief only for relatively well-off retirees*

Of the 537,341 lowans who received Social Security benefits in 1998, only 166,252 or 31% paid any income tax at all on these benefits.<sup>5</sup> Thus a 100% exemption would provide tax relief only for the wealthiest 31% of the elderly population. Furthermore, most of the benefits are targeted at the richest 17% of Social Security recipients: households earning over \$50,000 would receive 81% of the benefits, and 46% of the benefits would go to households with income over \$75,000.<sup>6</sup> Expanding the exemption does nothing for the 69% who are already exempt from paying taxes on any benefits.

### *Extending the exemption shifts the tax burden in counterproductive ways*

One of the problems facing Iowa is that the demographics make the financing of public services more difficult. The proportion of Iowa's population that is 65 or older is about 15%, compared to the national average of 12.7%. This proportion is expected to rise substantially, in Iowa and in the US, in the next 15 to 20 years. In fact, the Iowa 2010 report highlights the declining share of the population that is working age and the increasing share that is over 65 as one of the most significant problems facing Iowa in the coming decade. Those of working age must generate the income to pay for the social services (including the state's share of Medicaid) for the elderly population. To continue to lower the tax burden on a segment of the population that is going to represent an increasing share of the taxpayers in Iowa, and that has the ability to pay taxes, is a recipe for future fiscal problems.

There are immediate costs to this strategy as well. However appealing it may be to confer tax advantages on the well-to-do elderly, someone else will have to bear the cost of this tax expenditure. The complete exemption of Social Security benefits would have the effect of reducing taxes on the elderly with the greatest ability to pay, and shifting the burden to those less well off and to working lowans under age 65. At a time when many in the legislature and the administration are arguing that the state faces a shortage of workers, why propose a tax policy that increases workers' share of the total tax burden?

One might argue that the proposed tax cut will not in fact be accompanied by tax increases on anyone else. Even if this is true in the short run, it is unlikely to be true in the long run. And it is

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<sup>5</sup> *Analysis of Options for Eliminating or Reducing the Taxation of Social Security Income in Iowa*. Iowa Department of Revenue and Finance, January 4, 2001, page 3.

<sup>6</sup> These figures are calculated from Tables 1-B and 2-B in the Iowa Department of Revenue's *Addendum to Social Security Paper*.

beside the point; the relative tax burden will of necessity shift. Furthermore, if the state does indeed have sufficient funds to finance \$53 million per year in tax cuts<sup>7</sup>, the question is: whose taxes should be cut and why?

## **Conclusion: The Tax Cut is Unfair, Unjustified, and Counterproductive**

Iowa should not and cannot attempt to be the lowest tax state for every population group and every kind of business. Such a policy would require gutting public services such as education, health care, and transportation that are important to the quality of life for all Iowans and that are important determinants of location choices, for people and businesses, as well. We already have a tax system that is attractive for the elderly compared to our neighbors; that should be good enough. In an era when workforce shortages are seen as one of the state's most significant problems, it is very difficult to find any economic or fiscal justification for spending \$53 million a year on the untested hope that it may help retain a handful of well-to-do elderly in the state.

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<sup>7</sup> The Legislative Fiscal Bureau estimates that the bills currently before the House and Senate would result in an annual revenue loss of \$53 million when the complete exemption is fully phased in.

**Iowa Income Tax Comparisons:  
Retired Couples versus Working Couples at Three Income Levels**

	<b>Retired Couple</b>			<b>Working Couple (No Children)</b>		
	Income level:	Low	Middle	Upper	Low	Middle
<b>Income</b>						
Social security benefits	10,000	12,000	14,000	0	0	0
Wages and salaries	0	0	0	15,000	37,000	56,000
Taxable pensions	4,500	20,500	35,000	0	0	0
Taxable interest and dividends	500	5,500	9,000	0	1,000	2,000
Tax exempt interest	0	0	2,000	0	0	2,000
<b>Total Income</b>	<b>15,000</b>	<b>38,000</b>	<b>60,000</b>	<b>15,000</b>	<b>38,000</b>	<b>60,000</b>
<b>Taxable Social Security Benefits</b>						
One-half of social security benefits	5,000	6,000	7,000			
Wages and salaries	0	0	0			
Taxable pensions, interest, dividends	5,000	26,000	44,000			
Tax exempt interest	0	0	2,000			
Provisional Income	10,000	32,000	53,000			
Less: Exempt amount	32,000	32,000	32,000			
Excess provisional income	0	0	21,000			
One-half of excess provisional income	0	0	10,500			
<b>Taxable social security benefits</b>	<b>0</b>	<b>0</b>	<b>7,000</b>			
<i>(Lesser of 1/2 of social security or 1/2 of excess provisional income)</i>						
<b>Iowa Income Tax Calculation</b>						
Filing Status*	Joint	Separate	Separate	Joint	Separate	Separate
<i>Note: For married separate filers, all sources of income are evenly split and the tax calculations shown are for each spouse separately. The tax paid by each is combined on the last line to show the total tax for the couple.</i>						
Wages and salaries	0	0	0	15,000	18,500	28,000
Taxable pensions	4,500	10,250	17,500	0	0	0
Taxable interest and dividends	500	2,750	4,500	0	500	1,000
Taxable social security benefits	0	0	3,500	0	0	0
Iowa Gross Income	5,000	13,000	25,500	15,000	19,000	29,000
Less: Pension Exclusion	4,500	6,000	6,000	0	0	0
Iowa Net Income	500	7,000	19,500	15,000	19,000	29,000
Less: Deduction for Federal taxes	0	810	3,053	240	1,845	3,345
Balance	500	6,190	16,448	14,760	17,155	25,655
Less: Standard deduction	3,700	1,500	1,500	3,700	1,500	1,500
Taxable Income	0	4,690	14,948	11,060	15,655	24,155
Tax on taxable income	0	69	599	361	642	1,187
Less: Personal credits	120	60	60	80	40	40
Net Tax	0	9	539	281	602	1,147
<b>Combined Total Tax</b>	<b>0</b>	<b>18</b>	<b>1,078</b>	<b>281</b>	<b>1,205</b>	<b>2,294</b>

\*Lower income retired couple files jointly because only one person has pension income; they would pay no tax regardless. Middle and upper income retired couples file separately to take advantage of income splitting and taxation at lower rates. Lower income working couple has only one worker and so benefits from higher standard deduction by filing jointly; middle and upper income working couples have two earners, so they pay less tax by filing separately.

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**Iowa Income Tax Comparisons: (continued)**

Income level:	Retired Couple			Working Couple (No Children)		
	Low	Middle	Upper	Low	Middle	Upper
<b>Federal Income Tax Calculation</b>						
<i>All couples file joint Federal tax returns.</i>						
Wages and salaries	0	0	0	15,000	37,000	56,000
Taxable pensions	4,500	20,500	35,000	0	0	0
Taxable interest and dividends	500	5,500	9,000	0	1,000	2,000
Taxable social security benefits*	0	0	11,900	0	0	0
Federal AGI	5,000	26,000	55,900	15,000	38,000	58,000
Less: Standard deduction	9,400	9,400	9,400	7,600	7,600	7,600
Less: Personal exemptions	5,800	5,800	5,800	5,800	5,800	5,800
Taxable income	0	10,800	40,700	1,600	24,600	44,600
Tax paid (from tax rate schedule)	0	1,620	6,105	240	3,690	6,690

\*For Federal purposes, social security benefits are exempt from tax for those with \$32,000 or less of provisional income (for a married couple), with provisional income defined the same way as shown above for Iowa. However, up to 85% of social security benefits are included in Federal taxable income and the taxable portion is phased in differently.

**The Iowa Policy Project**  
 318 2<sup>nd</sup> Avenue North  
 Mt. Vernon, IA 52314  
 319-895-8731