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Revisiting Exclusion of Retirement Income from the Illinois Income Tax Base

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llinois is virtually unique in how it taxes what is characterized as "retirement income:" social security, public and private pensions, IRAs, 401 (k) plans, 457s, Thrift Savings Plans, deferred compensation, payments to retired partners, etc. Such plans are funded with "pre-tax contributions," meaning the income is set aside and not taxed when earned. The federal government and most states delay taxation and tax payments to individuals from the plans (except for a portion of social security); Illinois never taxes the income. Only Illinois, Pennsylvania and Mississippi exempt all "retirement income" from taxation.

This article updates a research article published by TFI in 2007.[1] In addition, it presents a brief discussion of recent research findings on how taxation of retirement income influences state out-migration, and develops revenue estimates for taxing some or all retirement income in Illinois. The report is laid out as follows:

1. How much tax are we foregoing by not taxing retirement income? What can we learn about who benefits from this exemption?

2. How did we get here?
   - History of exclusion;
   - Changes in poverty and labor force participation rates for those 65 years of age and older;
   - Expansion of retirement saving options.
3. What do other states do in terms of taxing retirement income?
4. Presentation of several retirement income taxation options.
5. Discussion of the taxation or non-taxation of retirement income within the framework of sound tax policy principles.

Summary of Findings

- Illinois treats retirement income for tax purposes significantly different from the federal government and most other states.
- If Illinois treated retirement income like the IRS and most other states, it would have generated $2.3 billion in 2012.
- Retirement income is growing at a significantly higher annual rate than either Adjusted Gross Income (AGI) or Net Income (NI).
- The growth in the newly authorized "pre-tax" defined contribution plans means that Illinois' retirement subtraction allows an ever larger portion of Illinois income to go untaxed.
- One in four Illinois personal income tax returns contains a retirement income subtraction.
- Taxpayers with higher incomes have higher retirement income subtractions.
- Poor seniors who have to work pay income tax on their wages. Retirees who do not have to work because they have sufficient retirement income do not pay income tax.
- The population of seniors living at or below the poverty line has declined significantly since Illinois excluded retirement income from taxation; the poverty rate for those under 65 has increased during this same period.
- Much of the tax benefit is received by those below 65 years of age.

The time has come to reexamine the policy reasons behind why Illinois has a complete retirement income subtraction and raise questions such as should the subtraction be modified to target those who are of retirement age and/or have low to moderate income?

Illinois Retirement Income Subtraction

The federal government excludes a portion (between 15 to 100 percent) of social security income from taxation and taxes other components of retirement income. Many states follow this lead. However, in Illinois – in contrast with the general tendency to be coupled to the federal tax code – no retirement income is taxed. Only two other states provide for such a comprehensive exclusion.

As a consequence, any discussion of taxing some portion of retirement income should be viewed in the context of taxing income in Illinois in a way that is more comparable to how the federal government, and most other states, treat this income stream.

Most recent data provided by the Illinois Department of Revenue indicates that in 2012 one in four returns claimed a retirement income subtraction and that, at a 5 percent tax rate, the Illinois retirement income subtraction has an associated tax expenditure value of around $2.3 billion.[2] **Table 1 below** illustrates how Adjusted Gross Income (AGI), Net Income (NI) and the retirement income subtraction in Illinois have changed during the period 2007-2012.[3] Net income is income to which the Illinois individual income tax rate is applied.

First, note that the number of resident returns as a whole actually decreased slightly during this period, while those returns with retirement income subtraction increased by 9 percent. This is significant as it illustrates an increasing number of Illinois residents are becoming eligible for the retirement income subtraction, while a decreasing number of residents are filing an Illinois return.

However, more alarming than the trend in number of returns is the income trend when comparing AGI, NI and Retirement Income Subtraction. While AGI and NI of Illinois' residents grew by 7.5 percent and 6.5 percent respectively during the period 2007-2012, the retirement income subtraction grew by 36.0 percent. In sum, retirement income is taking up a larger and larger part of the total income pie in Illinois.

TABLE 1: ILLINOIS' RETIREMENT INCOME SUBTRACTION, 2007-2012

Tax Year	Number of Resident Returns	AGI	Net Income	Resident Returns with Retirement Income	Retirement Income Subtraction
2007	5,627,395	$364,026,772,210	$308,705,658,167	1,319,540	33,427,666,675
2008	5,642,389	$362,832,131,816	$308,310,656,362	1,338,556	35,162,685,250
2009	5,506,933	$329,026,247,598	$276,972,670,973	1,352,431	34,362,303,304
2010	5,531,602	$348,177,983,589	$289,212,830,524	1,386,723	39,391,762,599
2011	5,551,381	$358,556,780,229	$300,806,610,768	1,400,096	41,687,827,405
2012	5,596,956	$391,225,950,142	$328,712,973,827	1,437,933	45,461,776,149
Percent Change 2007-2012	-0.5%	7.5%	6.5%	9.0%	36.0%

Source: Illinois Department of Revenue, Report ID TDWR-IITEOY-017
Note: This table contains information for residents only.

TABLE 2 (a): GENERAL RETIREMENT INCOME SUBTRACTION STATISTICS, 2012				
Adjusted Gross Income Bracket	Number of Resident Returns with Retirement Income Subtraction	Value of Resident Retirement Income Subtraction	Share of All Returns with Retirement Income	Share of Total Retirement Income Subtraction
$0-$25,000	342,647	$3,386,792,594	23.8%	7.4%
$25,001-$50,000	309,414	$6,101,104,236	21.5%	13.4%
$50,001-$75,000	252,888	$7,924,595,695	17.6%	17.4%
$75,001-$100,000	189,661	$7,639,933,639	13.2%	16.8%
$100,001-$250,000	289,592	$15,249,623,226	20.1%	33.5%
$250,001-$500,000	36,462	$2,581,145,185	2.5%	5.7%
$500,001-$1,000,000	10,641	$975,012,025	0.7%	2.1%
More than $1,000,000	6,628	$1,603,569,549	0.5%	3.5%
Total	1,437,933	$45,461,776,149	100.0%	100.0%

Source: Illinois Department of Revenue, Report ID TDWR-IITEOY-017
Note: This table contains information for residents only.

TABLE 2 (b): ILLINOIS RETURNS WITH RETIREMENT INCOME SUBTRACTION: ADDITIONAL STATISTICS, 2012			
Adjusted Gross Income Bracket	Percent of Filers 65 and Older (1)	Average AGI Per Return	Average Retirement Income Subtraction Per Return
$0-$25,000	65.8%	$9,514	$9,884
$25,001-$50,000	43.7%	$36,878	$19,718
$50,001-$75,000	36.7%	$62,075	$31,336
$75,001-$100,000	33.9%	$86,690	$40,282
$100,001-$250,000	28.0%	$143,701	$52,659
$250,001-$500,000	27.4%	$332,743	$70,790
$500,001-$1,000,000	28.4%	$681,716	$91,628
More than $1,000,000	30.3%	$3,603,975	$241,939
Total	40.3%	$91,588	$31,616

Source: Illinois Department of Revenue, Report ID TDWR-IITEOY-017
Note: This table contains information for residents only.
(1): Information in this column takes the total number of 65+ Exemptions and divides by Total Exemptions for each AGI bracket.

It is important to note that the retirement income subtraction illustrated in Table 1 does not necessarily translate directly into a revenue estimate for repeal of the subtraction. Any change in behavior arising from taxation of retirement income has to be factored into making a revenue estimate. Would taxation cause retirees to relocate from Illinois to states with more favorable tax treatment? Research on this topic suggests that there is not strong evidence to indicate that seniors' mobility is significantly influenced by state tax policies.[4] This finding suggests any adjustment to the tax expenditure figure due to relocation would be minimal.

Tables 2(a) and 2 (b) provide some general characteristics about retirement income by AGI in 2012. In Table 2(a) we see that the percent of returns with retirement income varies significantly by AGI. The largest number of returns with a retirement income subtraction fall within the $0 to $25,000 AGI category. The largest amount of the retirement income subtraction falls in the $100,001 to $250,000 category.

Table 2(b) illustrates that the percent of retirement income received by those over 65 varies dramatically with levels of AGI. At higher levels of AGI, a smaller percentage of those claiming a retirement income subtraction are 65 or older. For example, in the $25,000 or less bracket some 65.8 percent of individuals were 65 or older, while at the AGI bracket of $1,000,000 or greater only 30.3 percent of individuals were 65 or older.

TABLE 3: ILLINOIS RETIREMENT INCOME RETURNS PROFILE, 65 OR OLDER COMPARED TO THOSE UNDER 65, 2012

Adjusted Gross Income Bracket	Retirement Income Subtraction on Returns That Claim a 65 or Over Exemption			Retirement Income Subtraction on Returns That Do Not Claim a 65 or Over Exemption		
Range	**Returns**	**Amount**	**Average**	**Returns**	**Amount**	**Average**
$0-$25,000	254,824	$2,792,291,723	$10,958	98,150	$725,014,878	$7,387
$25,001-$50,000	175,112	$4,494,693,206	$25,668	147,540	$1,779,999,824	$12,065
$50,001-$75,000	132,382	$5,648,067,352	$42,665	134,068	$2,574,849,373	$19,206
$75,001-$100,000	95,889	$5,432,015,387	$56,649	106,465	$2,576,931,844	$24,204
$100,001-$250,000	135,131	$10,321,887,815	$76,384	183,473	$6,210,258,661	$33,848
$250,001-$500,000	19,980	$1,956,482,290	$97,922	24,737	$1,175,927,424	$47,537
$500,001-$1,000,000	7,160	$866,696,758	$121,047	7,689	$466,445,002	$60,664
More than $1,000,000	7,125	$2,143,050,316	$300,779	6,012	$1,267,418,489	$210,815
Total	827,603	$33,655,184,847	$40,666	708,134	$16,776,845,495	$23,692

Source: Illinois Department of Revenue, Report ID TDWR-IITEOY-014
Note: This table contains information for both residents and non-residents.

On average, retirement income makes up 34.5 percent of total AGI. Looking at the extremes, the retirement income subtraction, on average, is larger than AGI for the lowest income group, but represents only 7 percent of average AGI for the highest group. However, in absolute terms, the average retirement income subtraction for the highest group is 25 times larger than for the lowest.

Table 3 on page 5 shows 2012 Illinois returns with retirement income split between those that claim a 65 or older exemption and those that do not. Almost half of returns (claiming one-third of the total Illinois retirement income subtraction) are from households that do not claim a 65 or older exemption. This is because any retirement income stream is completely tax exempt in Illinois, irrespective of the age or income of the individual earning the income stream.

Having presented information that sheds light on the magnitude of the retirement income subtraction in Illinois and some general characteristics of returns that claim this exemption, the next step in our research is to analyze how this retirement income subtraction lowers effective tax rates for returns that claim the subtraction.

Even though the legal tax rate in Illinois was 5 percent in 2012, no one likely paid that percent of all their income in Illinois income tax. For most people, the tax rate they pay is less than 5 percent because the state permits many adjustments to AGI. The retirement income subtraction is by far the largest subtraction permitted on the IL-1040.

TABLE 4: EFFECTIVE TAX RATES FOR RETURNS WITH A RETIREMENT SUBTRACTION

Adjusted Gross Income Bracket	Effective Tax Rate (Net Tax Divided by Adjusted Gross Income)	Effective Tax Rate if Retirement Income Were Taxed
$0-$25,000	1.3%	N/A
$25,001-$50,000	1.7%	4.4%
$50,001-$75,000	2.0%	4.5%
$75,001-$100,000	2.2%	4.5%
$100,001-$250,000	2.7%	4.6%
$250,001-$500,000	3.6%	4.7%
$500,001-$1,000,000	4.1%	4.7%
More than $1,000,000	4.2%	4.6%
Total	2.9%	4.6%

Source: Illinois Department of Revenue, Report ID TDWR-IITEOY-017
Note: This table contains information for residents only.

Table 4 calculates effective tax rates for Illinois residents under current tax law and compares that with what the effective tax rate would be if retirement income were taxable. We can see that the current average effective tax rate is 2.9 percent. Should retirement income become taxable, the average effective tax rate increases to 4.6 percent. This data suggests that policy proposals to tax retirement income should contemplate a mechanism to protect those at the lower end of the income scale.

How Did We Get Here?

After litigation and a Supreme Court case, in 1972 the Illinois General Assembly passed legislation that excluded all income from state, local and federal pensions, social security and all qualified private pensions from taxation.[5] One interpretation of making this broad based exclusion is offered by Nowlan.[6] He suggests that the legislation was enacted as a way of making the flat-rate income tax somewhat more progressive, out of a belief that the elderly had higher levels of poverty than the general population. Transcripts of the 1972 debate estimated the projected revenue loss to the state in 2002 at $200 million.

At the time the retirement income subtraction was passed by the legislature, the poverty rate for seniors was close to 24.6 percent. As initially documented by Nowlan (2007), the poverty rate for seniors has continued to decline, whereas the poverty rate for the under 18 and 18-64 cohorts has increased.[7] The senior poverty rate has continued to decline since 2007, and in 2010 stood at 8.3 percent.[8] During approximately the same period the percent of working seniors has risen from 11.5 percent in 1992 to 18.5 percent in 2012.

As **Table 5** indicates, the US Bureau of Labor Statistics is forecasting the labor force participation rate for seniors will increase from 18.5 percent in 2012 to 23.0 percent in 2022. It is important to note that working seniors have to pay income tax on their earnings, while seniors who can live on their retirement income do not pay Illinois income tax on that income.

Retirement Saving Options

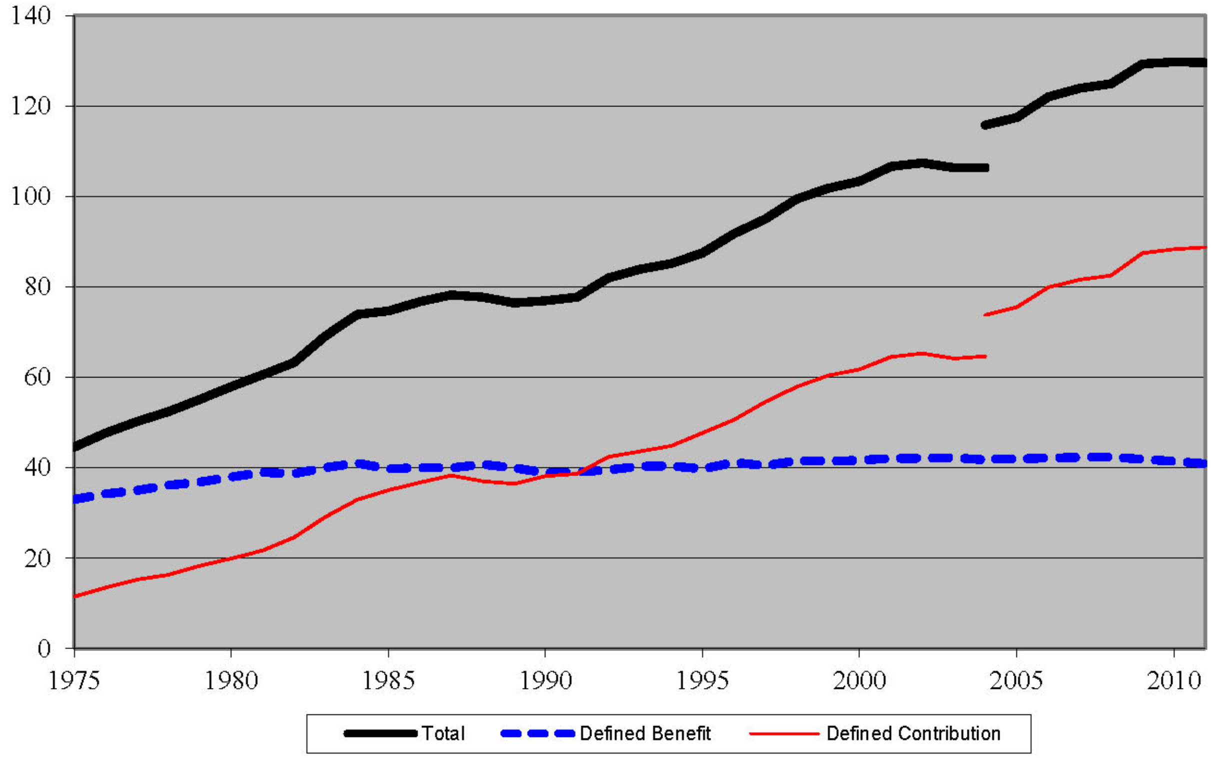
Since enactment of the Illinois retirement income subtraction, many new retirement options have become available and are now widespread. Individual Retirement Accounts (IRAs) were authorized in 1974 for employees without employer sponsored plans. This was followed, in 1978, by the authorization of 401(k) plans.[9] These type of plans have evolved to such a degree that defined contribution plans are now the most common retirement savings vehicle.[10] It is important to note that these new options more often than not are funded through "pretax contributions," wages set aside and not taxed at the federal or state

TABLE 5: LABOR FORCE PARTICIPATION RATE, BY AGE

Group	Labor Participation Rate			
	1992	2002	2012	2022
Total, 16 years and older	66.4%	66.6%	63.7%	61.6%
16 to 24	66.1%	63.3%	54.9%	49.6%
25 to 54	83.6%	83.3%	81.4%	81.0%
55 to 64	56.2%	61.9%	64.5%	67.5%
55 to 59	67.4%	70.7%	72.5%	75.5%
60 to 64	45.0%	50.5%	55.2%	59.8%
65 and older	11.5%	13.2%	18.5%	23.0%
65 to 69	20.6%	26.1%	32.1%	38.3%
70 to 74	11.1%	14.0%	19.5%	24.0%
75 and older	4.5%	5.1%	7.6%	10.5%
75 to 79	6.3%	7.4%	11.4%	14.9%

Source: http://www.bls.gov/emp/ep_table_303.htm

CHART 1: NUMBER OF PARTICIPANTS IN PENSION PLANS, BY TYPE OF PLAN, 1975-2011 (thousands)



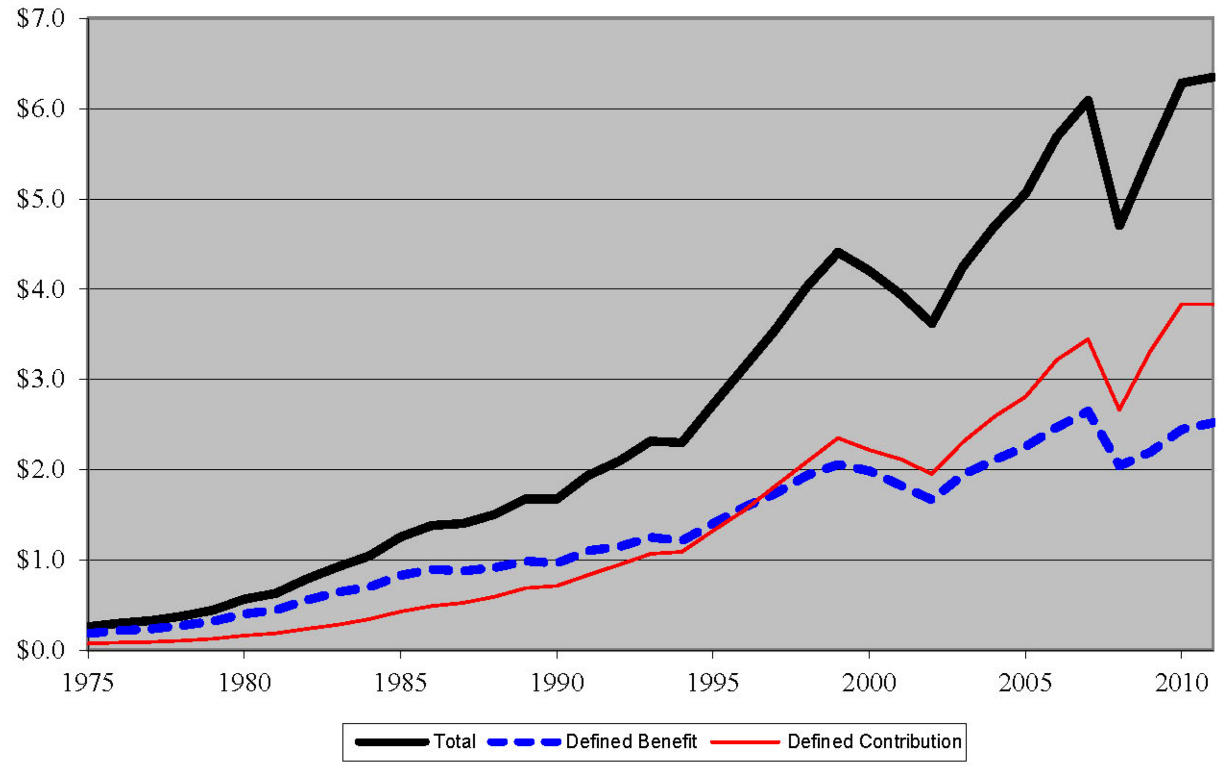
Source: http://www.dol.gov/ebsa/publications/form5500dataresearch.html. Note: total participant and active participant definitions were changed beginning with the 2005 Private Pension Plan Bulletin.

level. The assumption is that the income will be taxable when individuals retire and withdraw the funds. However, in Illinois, because of the retirement income subtraction this income stream is never taxed.

Chart 1 illustrates the dramatic growth in participation in defined contribution retirement investment vehicles. This is in contrast to the stagnating number of participants in defined benefit pensions. **Chart 2 on page 9** illustrates the growth in assets in both defined benefit and defined contribution plans. The growth in defined contribution plan assets has increased at a higher rate than defined benefit plan assets.

Unlike traditional defined benefit pensions where participants cannot collect benefits until they reach a certain age, people with defined contribution plans may withdraw funds from these plans at any time if they meet certain conditions or are willing to pay penalties. These withdrawals are tax-free in Illinois because they fall under the definition of retirement income. In addition, unlike traditional pensions, beneficiaries of IRAs are not limited to spouses. A beneficiary can be anyone selected by the owner. Anyone may inherit defined contribution retirement investment vehicles, and in Illinois this income stream is not taxed, regardless of age or income level.

CHART 2: PENSION PLAN ASSETS, BY TYPE OF PLAN, 1975-2011 ($ trillions)



Source: http://www.dol.gov/ebsa/publications/form5500dataresearch.html

How Other States Tax Retirement Income

Of the 43 states with an individual income tax, all offer a partial or full exemption for Social Security benefits. Thirty-one exempt all Social Security benefits, while the remaining states tax Social Security either to the extent that it is taxed at the federal level or based on income levels.[11] Ten states tax government pensions, while the remaining 33 states provide either a full or partial exclusion. Nine states differ in the way they tax private and public sector retirement income sources.

Illinois, Mississippi and Pennsylvania are the only states that do not impose income tax on any retirement income, while at the other end of the spectrum California, Minnesota, Nebraska, North Dakota, Rhode Island, Utah and Vermont tax all non-social security retirement income sources. Seventeen states provide an age-based retirement income deduction.

Some Examples of Revenue Generating Potential of Taxing Some Portion of Retirement Income

The revenue estimates, presented in Tables 6 and 7 may be useful in any future debate about whether and how Illinois should tax retirement income. This analysis uses 2012 data (with its 5

TABLE 6: REVENUE ESTIMATES, LIMITING RETIREMENT INCOME SUBTRACTION PER RETURN	
Options	**Revenue Estimate ($ Millions)**
No exclusion	$2,273
$20k exclusion per return	$1,033
$25k exclusion per return	$816
$30k exclusion per return	$620
$35k exclusion per return	$470
$40k exclusion per return	$336
Source: Illinois Department of Revenue, Report ID TDWR-IITEOY-017 Note: Estimates based on resident retirement income subtraction only.	

TABLE 7: REVENUE ESTIMATES, LIMITING RETIREMENT INCOME SUBTRACTION TO THOSE 65 AND OLDER	
Options	**Revenue Estimate ($ Millions)**
$20k per 65 exclusion	$1,341
$25k per 65 exclusion	$1,170
$30k per 65 exclusion	$1,011
$35k per 65 exclusion	$863
$40k per 65 exclusion	$729
$50k per 65 exclusion	$500
Source: Illinois Department of Revenue, Report ID TDWR-IITEOY-017 Note: Estimates based on resident retirement income subtraction only.	

percent tax rate) and assumes that, similar to almost all states, Illinois would continue to exempt social security income from taxation in a manner that mirrors the federal tax code.

The Taxation of Retirement Income: Adequate, Simple, Efficient and/or Fair?

Next we evaluate the taxation of retirement income in the context of the principles of sound tax policy. Illinois' fiscal crisis is well documented. One could argue that any additional revenue used to pay down the deficit, albeit partially, meets the adequacy principle. As **Tables 6 and 7** illustrate, the incremental revenue from taxing retirement income falls away quickly as the exemption level is increased.

From an administration and compliance standpoint, taxing retirement income is straightforward, as witnessed by the fact that most other states tax at least some portion of retirement income.

The remaining two tax policy principles, economic neutrality (efficiency) and equity (fairness) are much more difficult to evaluate. From an efficiency standpoint, since retirement income streams are not taxed in Illinois while all other personal income streams are taxed, the current tax code should be considered inefficient (the code treats different income streams differently). Taxing all retirement income would eliminate this inefficiency. Research cited above suggests that retirees are not very mobile and as such the taxation of retirement income or the lack thereof will not incent behavior to change in any significant way.

Providing a partial exclusion for retirement income or a greater exclusion for those 65 or older is inefficient since similar exclusions do not exist for other income streams. However, having exclusions for retirement income would be considered by many to be fairer than taxing all retirement income. While fairness is a matter of subjectivity, excluding or reducing the effective tax rate on some amount of income for those at the lower end of the economic spectrum is widely accepted. In determining how to give relief to lower income persons, policymakers must weigh the Illinois Constitution's prohibition against imposing a tax at a "non-graduated" rate and the concern that exclusions that vary by income could run afoul of the Constitution.

One final thought: the Illinois retirement income subtraction creates a classic tax policy dilemma. At the lower income levels the retirement income subtraction makes Illinois' flat rate tax less regressive. However, it does so at a very high price, with the largest benefit going to those with the highest incomes.

ENDNOTES

[1] Jim Nowlan, State of Illinois Retirement Income Tax Policy – A Review, Tax Facts, 62.5/December 2009, Taxpayers' Federation of Illinois.

[2] Illinois Department of Revenue, Report ID: TDWR-IITEOY-017, Report date 7 August, 2014. We exclude the retirement income subtraction claimed by part time and nonresidents as it seems unlikely that they would be legally liable for tax on their retirement income in Illinois if they do not live in the state.

[3] Adjusted gross income comes from the federal income tax return and is the starting point for the Illinois individual income tax return (Il-1040). On the other hand, Net Income (NI) is the income to which the Illinois individual income tax rate is applied.

[4] For a review of the literature see Full Exclusion of Retirement Income from State Taxation: Evaluating the Impact in Wisconsin, Workshop in Public Affairs, University of Wisconsin- Madison, June 4, 2013.

[5] Shortly after the Illinois Income Tax was instituted, taxpayers brought lawsuits claiming that Illinois could not tax income such as pensions and capital gains whose benefits had actually accrued prior to the date of enactment (Thorpe v. Mahin, 43 Ill.2d 36 (1969)). As a result of the Supreme Court finding, and the inability to find a compromise that was satisfactory to all parties, the General Assembly enacted P.A.77-2062, expanding the exclusion to apply to all retirement income in 1972.

[6] For more detail see Jim Nowlan, State of Illinois Retirement Income Tax Policy – A Review, Tax Facts, 62.5/ December 2009, Taxpayers' Federation of Illinois.

[7] https://www.census.gov/hhes/www/poverty/data/incpovhlth/2012/figure5.pdf

[8] http://factfinder2.census.gov/faces/tableservices/jsf/pages/productview.xhtml?src=bkmk

[9] These are investment vehicles whereby employees can elect to have their employer contribute a portion of their wages on a pretax basis.

[10] Other examples include 403(b)s, 457s and Thrift Savings Plans

[11] http://www.ncsl.org/documents/fiscal/taxonpensions2011.pdf