SB 162

SUBJECT: INCOME, Tax on pensions

BILL NUMBER: SB 162, Proposed SD-1

INTRODUCED BY: Senate Committee on Ways and Means

BRIEF SUMMARY: Adds a new section to HRS chapter 235 to provide that beginning after December 31, 2010, pension income under HRS sections 88-91, 235-7(a)(2), and 235-7(a)(3) shall be subject to state income taxation if a taxpayer's federal adjusted gross income (FAGI) is: (1) $75,000 and over for a taxpayer filing a single return or a married person filing separately; (2) $100,000 and over for a taxpayer filing as a head of household or surviving spouse; or (3) $125,000 and over for a taxpayer filing a joint return.

EFFECTIVE DATE: Tax years beginning after December 31, 2010

STAFF COMMENTS: This measure proposes that certain pension income shall be taxable under the state income tax. While Hawaii does not currently tax pension income, this measure recognizes those who depend on that pension income for their basic needs by setting a floor before pension income is to be included in gross income for state income tax purposes. This "floor," or threshold, is set at $75,000 of federal adjusted gross income for individuals, $100,000 for heads of households, and $125,000 for those filing a join return. The problem with using "federal adjusted gross income" is that not only does it already include pension income, but it may also include one-half of the taxpayer's Social Security benefits. Thus, this proposal not only changes the policy regarding the taxation of pension income, but it also changes the policy with regard to the taxation of Social Security benefits (See HRS Section 235-2.3, paragraph 3). It is not that the state tax will be levied on Social Security benefits per se, but because federal adjusted gross income includes Social Security benefits which then define whether or not one's pension becomes taxable for state income tax purposes, it has an indirect effect of taxing those benefits.

This approach also ignores the actual size of the retiree's pension income as exceeding the threshold or floor and throws all of the retiree's income on the table to be taxed. So, the retiree may have been employed at a business where the pension plan met the bare minimum requirements of the law and the contributions to the plan may have been relatively small in favor of paying more generous wages. That retiree, being prudent, set aside some of those generous wages either in savings or purchased equities to provide for his or her retirement. As a result, the earnings of those savings and investments provide for the bulk of the retiree's income. Because these sources of income are included along with what might be considered a pittance of pension income, the retiree exceeds the threshold subjecting all of the pension income to the state income tax. On the other hand, another retiree's only source of income is his pension, but that pension falls just below the proposed threshold of federal adjusted gross income and thus escapes any state income tax.

It would seem fairer that if pension income is now to be taxable for state income tax purposes, the threshold be measured only against the form of income called pensions. Treatment of this form of income would be identical regardless of other sources of income and regardless of the federal definition of income.

This measure sets the FAGI threshold at much higher levels than the administration's proposal. One has to wonder whether or not an evaluation of taxable pension income was done by the tax department and thresholds, as proposed, by the administration produced substantially more income that those proposed in this measure. If that is the case, lawmakers may want to be generous in this bill only to find that at these thresholds, the revenues to be generated will be insufficient to address the budget shortfall. Thus, lawmakers may come back next session and have to reduce the thresholds. For once established as taxable income, pensions are subject to the "slippery slope" as the need for additional revenues becomes more apparent. Given the unpopular reaction this proposal has received, consideration might be given to setting a sunset date that would give both pensioners and lawmakers a chance to evaluate the impact of taxing pensions has on Hawaii's seniors.

That said, one has to ask why has it come to this point that the state has to tax a source of income that traditionally has been exempt? All taxpayers, both workers and retirees, must share the blame as few paid attention to how lawmakers frittered our tax dollars away on this or that program. Now that many of those programs and services lawmakers initiated in the last few years have constituencies, it has been difficult for lawmakers to rein in that spending. The swift and vehement rejection of the proposal to tax pensions lies not so much in the fact that it will now tax income that was formerly exempt as much as it is the fact that taxpayers already reel under the heavy burden of taxes in Hawaii. As one senior noted, "What have lawmakers been doing with all the taxes we pay?"

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