PENSION OR ANNUITY DEDUCTION

EVALUATION SUMMARY | JULY 2021 | 2021-TE20

TAX TYPE	Income
YEAR ENACTED	1975
REPEAL/EXPIRATION DATE	None
REVENUE IMPACT	$506.3 million (TAX YEAR 2018)
NUMBER OF RETURNS	504,000

KEY CONCLUSION: The deduction provides a substantial tax benefit for older taxpayers with pension and annuity income, which may help them cover essential expenses, such as food, housing, transportation, clothing, and medical care and prescriptions.

WHAT DOES THE TAX EXPENDITURE DO?

The Pension or Annuity Deduction allows individuals who are at least 55 years of age at the end of the taxable year to deduct "amounts received as pensions or annuities from any source…to the extent included in federal adjusted gross income." For individuals who are at least 55 years of age, but less than 65 years of age, the deduction is capped at $20,000 per year. For individuals who are at least 65 years of age, the deduction is capped at $24,000 per year.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute and the enacting legislation for the Pension or Annuity Deduction do not explicitly state its purpose; therefore, we could not definitively determine the General Assembly's original intent. Based on its operation and information published by the National Conference of State Legislatures on state income tax treatment of pension benefits, we considered a potential purpose: to reduce income tax on retirement income for taxpayers who are less likely to be in the workforce.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider:

- Establishing a statutory purpose and performance measures for the deduction.
- Whether the deduction's cap should be adjusted to account for inflation.

PENSION OR ANNUITY DEDUCTION

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

The Pension or Annuity Deduction [Section 39-22-104(4)(f), C.R.S.] allows individuals who are at least 55 years of age at the end of the taxable year to deduct "amounts received as pensions or annuities from any source…to the extent included in federal adjusted gross income." For individuals who are at least 55 years of age, but less than 65 years of age, the deduction is capped at $20,000 per year. For individuals who are at least 65 years of age, the deduction is capped at $24,000 per year. The deduction effectively exempts the first $20,000 or $24,000, depending on the age of the taxpayer, of pension or annuity income from Colorado income tax. If a taxpayer files a joint return with a spouse and both taxpayers receive eligible pension or annuity benefits, then each spouse can claim up to the cap. Individuals who are less than 55 years of age are eligible to claim the deduction only for pension or annuity income that they receive due to the death of the person who earned the income; their deduction is capped at $20,000 per year.

Pensions and annuities are defined in statute [Section 39-22-104(4)(f)(III), C.R.S.] as "retirement benefits that are periodic payments attributable to personal services performed by an individual prior to his or her retirement from employment and that arise from an employer-employee relationship, from service in the uniformed services of the United States, or from contributions to a retirement plan which are deductible for federal income tax purposes." Statute provides that the following qualify as pensions or annuities:

- Distributions from individual retirement arrangements and self-employed retirement accounts (e.g., Colorado Public Employees' Retirement Association, 401(k) distributions, traditional individual retirement accounts (IRAs)).

- Amounts received from fully matured privately purchased annuities.
- Social security benefits (to the extent included in federal taxable income).

Department of Revenue (Department) Rule [1 CCR 201-2, Rule 39-22-104(4)(f)(4)] provides a non-exhaustive list of pension or annuity benefits that do not qualify for the deduction, including contributions to and distributions from Roth IRAs, sick leave or vacation leave payout, unemployment benefits, life insurance proceeds, and disability payments that are not for a permanent disability.

The General Assembly created the deduction in 1975 with Senate Bill 75-003. The deduction has undergone several substantial changes since its enactment, as shown in EXHIBIT 1.

EXHIBIT 1. LEGISLATIVE HISTORY OF THE PENSION OR ANNUITY DEDUCTION	
Bill	Description of Modification
Senate Bill 75-003	Created the Pension or Annuity Deduction. At the time of its enactment, the maximum deduction allowed was $3,000 per year, per individual, but was increased by $3,000 each year until the maximum allowable deduction reached $15,000 in 1979.
House Bill 82-1075	Amended the deduction so that it was capped at $20,000 for all individuals regardless of the source of their pension or annuity income or their age.
House Bill 89-1354	Amended the deduction so that it is only available to individuals who are at least 55 years of age at the end of the taxable year, except individuals who are under 55 years of age are allowed to claim the deduction for pension or annuity income they received due to the death of the person who earned the income.
House Bill 99-1151	Increased the deduction cap to $24,000 for individuals who are at least 65 years of age at the end of the taxable year.
House Bill 21-1311	Eliminated the deduction cap only for social security income for tax years beginning on or after January 1, 2022, for taxpayers who are at least 65 years of age. This will allow taxpayers to deduct all social security income that is included in federal taxable income.
SOURCE: Office of the State Auditor analysis of the legislative history of the Pension or Annuity Deduction.	

Taxpayers claim the Pension or Annuity Deduction on Line 3 (for the primary taxpayer) and/or Line 4 (for the spouse filing jointly, if applicable) of the Subtractions from Income Schedule (Form DR 0104AD), which taxpayers must attach to the Colorado Individual Income Tax Return (Form DR 0104).

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute provides that the intended beneficiaries of the Pension or Annuity Deduction are individual taxpayers who are at least 55 years of age and receive pension or annuity income. Individuals who are under 55 years of age are also intended beneficiaries when they receive pension or annuity income due to the death of the person who earned the income.

In Tax Year 2018, taxpayers claimed the Pension or Annuity Deduction on just over 504,000 Colorado income tax returns. This may represent more than 504,000 individual taxpayers because some returns (i.e., married filing jointly taxpayers) may include two individuals, both of whom may have been eligible for and claimed the Pension or Annuity Deduction.

According to the Department of Local Affairs' State Demography Office data, about 27 percent of the State's population was potentially eligible for the deduction in 2018 due to their age. Specifically, about 712,000 individuals in Colorado (13 percent of Colorado's population) were between 55 and 64 years of age, and just over 810,000 individuals (14 percent) were at least 65 years of age, though it is possible not all of these individuals receive qualifying pension or annuity income.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute and the enacting legislation for the Pension or Annuity Deduction do not explicitly state its purpose; therefore, we could not definitively determine the General Assembly's original intent. Based on the operation of the deduction and information published by the National Conference of State Legislatures on state income tax treatment of pension benefits, we considered a potential purpose: to reduce income tax on retirement income for taxpayers who are less likely to be in the workforce. Most states have similar provisions, which are generally intended to reduce the tax burden on older taxpayers who may no longer be in the workforce and may live on fixed incomes.

IS THE TAX EXPENDITURE MEETING ITS PURPOSE AND WHAT PERFORMANCE MEASURES WERE USED TO MAKE THIS DETERMINATION?

We could not definitively determine whether the Pension or Annuity Deduction is meeting its purpose because no purpose is provided for it in statute or its enacting legislation. However, we found that it is likely meeting the potential purpose we considered in order to conduct this evaluation because it provides a substantial tax benefit for many eligible taxpayers, which may help them cover essential expenses, such as food, housing, transportation, clothing, and medical care and prescriptions.

Statute does not provide quantifiable performance measures for this deduction. Therefore, we created and applied the following performance measure to determine the extent to which the deduction is meeting its potential purpose.

PERFORMANCE MEASURE: *To what extent does the deduction provide a tax benefit on retirement income of Colorado taxpayers who are at least 55 years of age?*

RESULT: We determined that the deduction provides a tax benefit on pension or annuity retirement income of Colorado taxpayers who are at least 55 years of age, but how substantial the benefit is, varies significantly among taxpayers. To determine the average deduction claimed and average taxpayer benefit, we analyzed Department data on the number of full-year Colorado resident returns on which the Pension or Annuity Deduction was claimed by different federal adjusted gross income (AGI) groups for Tax Year 2017, which was the most recent year for which detailed taxpayer data was available. We calculated the average benefit (i.e., the estimated reduction in tax liability) per return by multiplying the average deduction claimed in each AGI group by the state income tax rate of 4.63 percent, which was the rate that was in effect for Tax Year 2017. We found that the average benefit varies by AGI groups, ranging from no benefit for taxpayers with negative AGI to almost $1,300 for taxpayers in the $100,000-$199,999 AGI group. EXHIBIT 2 summarizes this data.

EXHIBIT 2. NUMBER OF RETURNS ON WHICH THE DEDUCTION WAS CLAIMED, AVERAGE DEDUCTION PER RETURN, AND AVERAGE BENEFIT PER RETURN BY FEDERAL ADJUSTED GROSS INCOME
TAX YEAR 2017

Federal Adjusted Gross Income[1]	Number of Returns	Average Deduction Claimed Per Return[2]	Estimated Average Taxpayer Benefit Per Return
Negative Income	4,465	$10,332	$0
$0-$9,999	20,727	$5,336	$247[3]
$10,000-$19,999	37,174	$11,057	$512
$20,000-$49,999	106,519	$17,815	$825
$50,000-$99,999	146,091	$24,184	$1,120
$100,000-$199,999	105,129	$27,519	$1,274
$200,000-$499,999	32,697	$25,803	$1,195
$500,000-$999,999	4,556	$23,589	$1,092
$1,000,000 or more	2,274	$23,558	$1,091

SOURCE: Office of the State Auditor analysis of Department of Revenue Statistics of Income data for full-year Colorado resident returns.
[1] Federal adjusted gross income is federal gross income minus certain deductions (e.g., trade or business deductions, interest on education loans), but not minus the federal standard deduction or itemized deductions.
[2] Some of the average deduction amounts claimed per return may appear to exceed the cap. This occurs because some of the returns are joint returns filed by married taxpayers so each individual on the return is eligible to claim up to the maximum amount ($20,000 or $24,000, depending on the age of the taxpayer).
[3] It is likely that taxpayers in the $0-$9,999 AGI group receive a lower benefit than $247. This is because taxpayers with AGI below $10,000 are likely to have all of their income eliminated by the federal standard deduction and personal exemptions.

We lacked data on the average Colorado tax liabilities of taxpayers that claimed the Pension or Annuity Deduction. However, the tax savings for some taxpayers as a result of the deduction can be substantial. EXHIBIT 3 provides an example of the Colorado income tax liability with and without the Pension or Annuity Deduction for a hypothetical couple that is married and files a joint income tax return, both spouses are over 65 years of age, and their total AGI is $75,000. To keep the example simple, this scenario assumes the taxpayers claim no federal or state deductions except for the federal standard deduction and personal exemptions.

EXHIBIT 3. CALCULATION OF COLORADO INCOME TAX LIABILITY WITH AND WITHOUT THE DEDUCTION ON A HYPOTHETICAL RETURN		
	Without Deduction	With Deduction
Federal Adjusted Gross Income, 2017	$75,000	$75,000
Federal Standard Deduction, 2017	$15,200	$15,200
Federal Personal Exemptions, 2017	$8,100	$8,100
Federal Taxable Income	$51,700	$51,700
Pension or Annuity Deduction	N/A	($24,184)[1]
Colorado Taxable Income	$51,700	$27,516
Colorado Tax Liability (Colorado Taxable Income x 4.63 percent)	$2,394	$1,274
Difference in Tax Liability	$1,120	

SOURCE: Office of the State Auditor analysis of hypothetical taxpayer scenario.
[1] In this hypothetical scenario, we used the average deduction amount claimed on a return in the $50,000-$99,999 AGI group in Tax Year 2017, which was $24,184.

As shown in the example in EXHIBIT 3, the Pension or Annuity Deduction reduced the couple's Colorado tax liability by $1,120, which was a reduction of about 47 percent.

To put the tax savings into context, we compared the estimated annual tax savings provided by the deduction to Consumer Expenditure Survey data, which is a survey conducted regularly by the U.S. Bureau of Labor Statistics on spending habits by households in different age and income groups. We found that households with under $50,000 in pretax income in which one member is at least 65 years of age generally incur expenses on essentials in excess of their pretax income, and therefore the Pension or Annuity Deduction may help bridge the gap between income and essential expenses for some taxpayers. To conduct this analysis, we calculated the average amount spent per household in various income groups on essentials, which we considered to be food, housing-related expenses, transportation, clothing, healthcare, and personal care products and services. We also calculated total spending per household in the same income groups, which includes additional categories of spending, such as entertainment, tobacco products, and alcoholic beverages. We then compared spending to the average pretax income in each group to determine, on average, how much income households had remaining after their spending on essentials and all of their spending. EXHIBIT 4 summarizes our analysis of the 2016-2017 Consumer Expenditure Survey data for all income groups in which at least one member of the household was at least 65 years of age.

EXHIBIT 4. AVERAGE PRETAX INCOME AND SPENDING BY INCOME GROUPS 2016-2017

Income Group	Less than $15,000	$15,000 to $49,999	$50,000 to $99,999	$100,000 and More
Average Amount Spent on Essentials	$20,557	$32,101	$47,115	$73,506
Average Income Remaining After Purchasing Essentials	$(10,761)	$(2,908)	$22,788	$107,166
Average Total Spending	$23,853	$39,345	$60,625	$106,260
Average Income Remaining After All Spending	$(14,057)	$(10,153)	$9,279	$74,411

SOURCE: Office of the State Auditor analysis of U.S. Bureau of Labor Statistics Consumer Expenditure Survey data.

As shown, for households with under $50,000 in pretax income, both their spending on essentials and all spending exceeded their pretax income. In these cases, households would need to find other ways to cover their expenses, such as using their savings or incurring debt. However, lower income households may be less likely to have substantial savings from which they can draw from to cover expenses. For households with $50,000 or more in pretax income, their income generally covered their expenses. Our analysis of the Consumer Expenditure Survey data does not take into consideration taxes paid.

As shown in EXHIBIT 2 taxpayers with AGI under $50,000 received an average tax reduction from the Pension or Annuity Deduction ranging from $0 for taxpayers with negative AGI to $825 for taxpayers with between $20,000 and $49,999 in AGI in Tax Year 2017. If a household in the $15,000 to $49,999 income group, which on average had essential expenses that exceeded their pretax income by $2,908, received an $825 tax reduction from the Pension or Annuity Deduction, the amount saved would cover about 28 percent of the expenses that exceeded income.

WHAT ARE THE ECONOMIC COSTS AND BENEFITS OF THE TAX EXPENDITURE?

According to Department data, in Tax Year 2018, which is the most recent year for which the Department has data, about $10.9 billion in pension or annuity deductions were claimed on approximately 504,000 individual income tax returns, resulting in a revenue impact of about $506.3 million to the State. The 504,000 represents the number of returns rather than the number of individual taxpayers because many income tax returns are filed by married couples who file joint income tax returns.

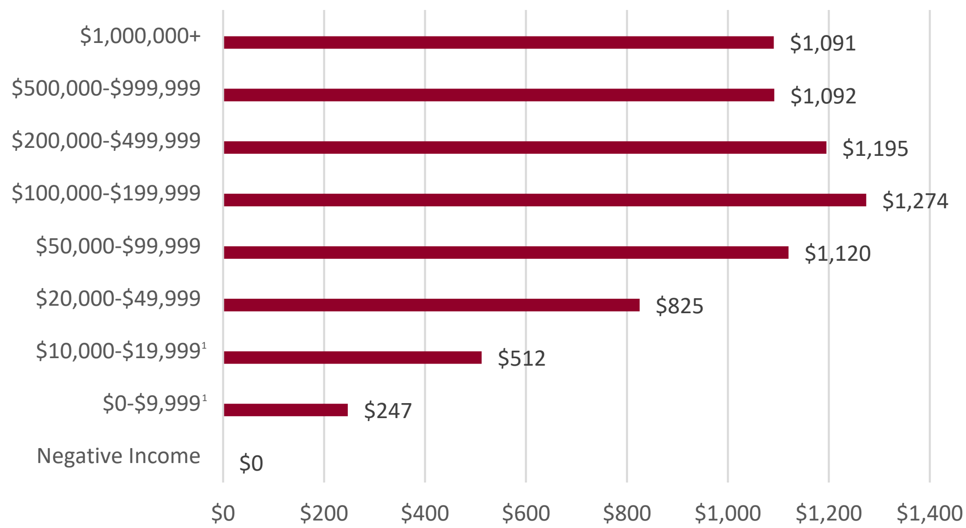
However, it is possible that the actual revenue impact of the deduction is less than $506.3 million because the Department's data includes some taxpayers who report the deduction on their returns, but who may not have sufficient taxable income to benefit from all or part of the Pension or Annuity Deduction that they reported. For example, in Tax Year 2017, which is the most recent year for which the Department has detailed data on claims of the Pension or Annuity Deduction, more than 62,000 taxpayers with federal AGI under $20,000 reported about $567.8 million in deductions. Assuming these taxpayers were not required to make any significant income tax addbacks when calculating their Colorado taxable income, it is likely that most received little or no benefit from the Pension or Annuity Deduction despite reporting it on their returns. This is because their federal income would likely have been entirely or substantially eliminated by the federal standard deduction and personal exemptions. Because the revenue impact estimate is based on the total deductions reported by taxpayers and not the actual reduction in tax liability it provided, this could result in an overstatement of the revenue impact of the Pension or Annuity Deduction for these taxpayers, up to $26.3 million for Tax Year 2017. To estimate the possible overstatement, we multiplied the total deductions reported by taxpayers with AGI under $20,000 ($567.8 million) by the state income tax rate in effect in Tax Year 2017 (4.63 percent).

In addition, the deduction's revenue impact has been increasing since 2011. According to Department data, in Tax Year 2011, the revenue impact was about $359.7 million compared to $506.3 million in Tax Year 2018; an increase of about $146.6 million (41 percent) from 2011 to 2018. This increase could be due, in part, to a larger percentage of the population aging into the eligible age range for the deduction (at least 55 years of age) or becoming eligible for the larger maximum deduction (at least 65 years of age). According to the Department of Local Affairs' State Demography Office data, in 2011, there were approximately 1.2 million Coloradans who were at least 55 years of age, with just under 600,000 of them at least 65 years of age. By 2018, there were more than 1.5 million Coloradans at least 55 years of age, with more than 800,000 of them at least 65 years of age. However, we lacked data on how many of these individuals had eligible pension or annuity income. Inflation and gains in the stock market, which could both potentially increase taxpayers' pension and annuity income, could also be factors for why the revenue impact has been increasing steadily.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

If the deduction were eliminated, it would increase the income tax liability for taxpayers with eligible pension or annuity income. The amount of the increase would depend on the amount claimed by taxpayers. EXHIBIT 5 shows the average reduction in tax liability as a result of the Pension or Annuity Deduction by federal adjusted gross income (AGI) groups for full-year Colorado residents in Tax Year 2017, which would generally correspond to the expected increase in tax liability if the deduction were eliminated. However, EXHIBIT 5 does not take into consideration the federal standard deduction or personal exemptions, which reduce federal AGI when calculating federal taxable income; federal taxable income is the starting point for computing Colorado taxable income.

EXHIBIT 5. AVERAGE BENEFIT PER RETURN BY FEDERAL ADJUSTED GROSS INCOME GROUPS FOR FULL-YEAR COLORADO RESIDENTS TAX YEAR 2017



SOURCE: Office of the State Auditor analysis of Department of Revenue Statistics of Income data for full-year Colorado resident returns.
[1] Taxpayers in these AGI groups may receive a benefit that is less than the amount indicated because the federal standard deduction and personal exemptions may reduce their federal taxable income to $0 or close to $0, which means that any Pension or Annuity Deduction they claim does not provide an actual benefit or provides less of a benefit than indicated in this exhibit.

Assuming taxpayers have no significant state addbacks, taxpayers with less than $20,000 federal AGI are less likely to be impacted by the elimination of this deduction because the federal standard deduction and personal exemptions (in years in which they are available) are likely to eliminate all or most taxable income, though both the federal standard deduction and total personal exemption amounts depend on whether the taxpayers file a single or joint return. Additionally, if the federal standard deduction were decreased, taxpayers with less than $20,000 AGI could be impacted by the elimination of this deduction because they may have more federal taxable income.

We spoke with organizations that represent the interests of senior and retired Coloradans, and they reported that the deduction is very important for retirees in Colorado who have seen the cost of their prescription drugs, medical care, utilities, rent, and/or property taxes increase in recent years, and that it helps retirees on a fixed income maintain a comfortable quality of life. One stakeholder reported that the deduction is helpful for taxpayers who retire prior to being eligible for Medicare because private insurance is very expensive for people in their early 60s who have not reached Medicare eligibility age. Additionally, one stakeholder mentioned that the deduction could help keep retirees in the state since income taxes play a role in retirees deciding where they would like to live in retirement. However, there are many factors not related to tax that play a role in where people choose to retire, such as being close to their kids and grandkids, a pleasant climate, and access to recreational activities, though stakeholders did mention that the overall tax burden (i.e., state and local taxes combined) does factor into retirees' decisions regarding where to live.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We examined the 40 other states (excluding Colorado) and the District of Columbia with a broad-based income tax and found that most offer an income tax benefit for some retirement benefits, though the types of benefits that qualify, the maximum amounts allowed to be claimed, and taxpayer eligibility vary among states:

PRIVATE PENSIONS—We identified 25 states that offer an income tax benefit for private pension retirement benefits. Most of these states have a minimum age requirement for when taxpayers become eligible for the tax benefit, which generally ranges from 55 to 65, though some states allow it for any age. States structure their tax benefits for private pensions in a variety of ways. Most states allow up to a certain amount of pension income to be deducted or excluded from state taxable income; this ranges from $2,000 in Delaware to $65,000 in Georgia. Additionally, some states structure their deduction in a similar way as Colorado's deduction and allow a smaller benefit for younger retirees and larger benefit for taxpayers over a specified age. One state (Connecticut) allows a percentage of pension income to be deducted; for the tax year beginning on January 1, 2021, 42 percent could be deducted, and this will gradually increase to 100 percent of pension income for tax years beginning January 1, 2025. Two states (Ohio and Oregon) offer a tax credit rather than a deduction or exclusion. Additionally, eight states only allow a taxpayer to claim the tax benefit if their state or federal adjusted gross income (AGI) is below a certain threshold, which varies among the eight states.

PUBLIC PENSIONS—We identified 31 states that offer an income tax benefit for public pension retirement benefits. Some states offer the tax benefit for local, state, and federal pensions and others only offer it for federal pensions. For example, Indiana does not provide a tax benefit for state or local pensions, but allows up to $16,000 to be deducted for federal (civilian) pensions. Additionally, some states only allow certain public pension benefits to be deducted, such as public pension benefits received by law enforcement officers and firefighters. In *Davis v. Michigan Department of the Treasury*, 489 U.S. 803, (1989) the U.S. Supreme Court held that it is a violation of federal law for a state to tax local and state government retirees' benefits more favorably than federal retirees, which limits the states' ability to offer a tax benefit only for pensions for local and state governments, while not providing an equivalent benefit for federal government retirees. Some states allow all public pension income to be deducted or excluded, but many limit it to a cap, ranging from $2,000 in West Virginia and Delaware to $60,000 in New Jersey. Additionally, as was the case with private pensions, some states structure their deduction for public pensions in a similar way as Colorado's deduction and allow a smaller benefit for younger retirees and larger benefit for taxpayers over a specified age.

MILITARY RETIREMENT BENEFITS—We identified 36 states that allow some or all military retirement benefits to be deducted or excluded from state income tax. However, some states provide only a narrow tax benefit for military retirement income. For example, Virginia allows only recipients of the Congressional Medal of Honor to exclude retirement benefits from income. Additionally, three states only allow a taxpayer to claim the tax benefit if their state or federal AGI is below a certain threshold, which varies among the three states.

SOCIAL SECURITY RETIREMENT BENEFITS—We identified 37 states and the District of Columbia that allow a tax benefit for social security retirement benefits. Thirty-five of those states and the District of Columbia fully exempt social security benefits from state income tax, while the remaining two states allow a partial exemption. Additionally, eight states only allow a taxpayer to claim the tax benefit for social security benefits if their state or federal AGI is below a certain threshold, which varies among the eight states. New Mexico, Utah, and West Virginia treat social security benefits the same as they are treated for federal income tax purposes; therefore, to the extent benefits are excluded from federal income, they may also be excluded from state taxable income in those states (see the discussion of federal tax treatment of social security retirement benefits in the *Are There Other Tax Expenditures or Programs with a Similar Purpose Available in the State?* section below).

ARE THERE OTHER TAX EXPENDITURES OR PROGRAMS WITH A SIMILAR PURPOSE AVAILABLE IN THE STATE?

We identified several tax expenditures that apply to retirement benefits and/or are available to senior Coloradans:

COLORADO MILITARY RETIREMENT BENEFITS DEDUCTION—Statute [Section 39-22-104(4)(y)(I), C.R.S.] allows taxpayers who are under 55 years of age who have military retirement benefits included in their federal adjusted gross income to deduct some of that income from their federal taxable income when calculating Colorado taxable income. For tax years beginning on or after January 1, 2021, but before January 1, 2022, the maximum amount that can be deducted is $10,000. For tax years beginning on or after January 1, 2022, but before January 1, 2024, the maximum amount that can be deducted is $15,000. This deduction is scheduled to expire on January 1, 2024. When taxpayers who are eligible for the Military Retirement Benefits Deduction reach 55 years of age, they are eligible for the Pension or Annuity Deduction.

COLORADO SENIOR HOMESTEAD PROPERTY TAX EXEMPTION—The Colorado Constitution [Article X, Section 3.5] provides a property tax exemption for seniors who are at least 65 years of age on the assessment date and have lived on the property for at least the previous 10 years. The provision exempts 50 percent of the first $200,000 of actual value from local property taxes. However, the Colorado Constitution gives the General Assembly the authority to raise or lower the maximum amount of the actual value that is exempt from taxation, which means that the exemption is not available in years in which the General Assembly lowers the exempted amount to $0. In years in which the exemption is available, the State reimburses local governments for foregone revenue from this exemption. In 2020, the State reimbursed local governments about $148 million for property tax exemptions for almost 256,000 eligible seniors for Tax Year 2019.

PROPERTY TAX/RENT/HEAT CREDIT REBATE—Statutes [Sections 39-31-101 and 104, C.R.S.] provide that full-year Colorado residents who are at least 65 years of age (or at least 58 years of age if a surviving spouse) with income under a certain amount may apply to receive a rebate for some of the property taxes, rent, or heating bills they paid during the year. The income eligibility threshold changes every year to adjust for inflation; in 2020, the threshold was $15,591 for single individuals and $21,057 for married couples. The maximum rebate a resident may claim is $735 for property tax or rent and $202 for heat; these amounts are adjusted annually for inflation.

RAILROAD RETIREMENT ANNUITY BENEFITS EXEMPTION—Federal law [45 USC 231m] exempts railroad retirement annuity benefits from state taxation. If an eligible taxpayer has both annuity income from railroad retirement and other eligible pension or annuity income, their railroad retirement annuity benefit does not count toward the $20,000 or $24,000 Pension or Annuity Deduction cap. In Tax Year 2017, the Railroad Retirement Annuity Benefits Exemption was claimed on approximately 3,700 full-year resident returns with positive federal adjusted gross income. These taxpayers claimed about $88.1 million in railroad retirement benefits deductions, resulting in an estimated revenue impact to the State of about $4.1 million when not taking into consideration the federal standard deduction or personal exemptions.

ADDITIONAL FEDERAL STANDARD DEDUCTION—Federal law [26 USC 63(c)(3) and (f)] provides an additional $600, adjusted annually for inflation, to be added to the federal standard deduction for taxpayers who are at least 65 years of age; the additional amount for a couple that files with married filing jointly status is doubled if both taxpayers are at least 65 years old.

FEDERAL INCOME TAX EXCLUSION FOR ALL OR SOME SOCIAL SECURITY RETIREMENT BENEFITS—Whether a taxpayer's social security retirement benefits are subject to federal income tax, and how much of a taxpayer's social security benefits are subject to tax, depends on a taxpayer's calculation of their income. A taxpayer calculates their income for purposes of determining taxability of social security retirement benefits by adding half of their annual social security retirement benefits to their other income, including wages, pensions, (taxable and non-taxable) interest, dividends, and capital gains. Based on the amount of their income, none or some of the taxpayer's social security retirement benefits may be subject to federal income tax, as shown in EXHIBIT 6.

EXHIBIT 6. FEDERAL INCOME TAXATION OF SOCIAL SECURITY BENEFITS

Income	Amount of Social Security Benefits Subject to Federal Income Tax
$25,000 or less ($32,000 or less for married filing jointly)	None
More than $25,000 to $34,000 (more than $32,000 to $44,000 for married filing jointly)	Up to 50 percent[1]
More than $34,000 (more than $44,000 for married filing jointly)	Up to 85 percent[1]

SOURCE: Office of the State Auditor analysis of Internal Revenue Service guidance.
[1] Taxpayers may pay federal income tax on a percentage of their social security retirement benefits that is less than 50 or 85 percent. For example, according to the Internal Revenue Service's Interactive Tax Assistant, a taxpayer with $16,000 in social security retirement benefits and $35,000 of other income would pay federal income tax on $12,150 of their social security retirement benefits, which is about 76 percent of their total social security retirement benefits.

WHAT DATA CONSTRAINTS IMPACTED OUR ABILITY TO EVALUATE THE TAX EXPENDITURE?

The Department was unable to provide detailed data on taxpayers who had federal AGI under $20,000 (including taxpayers with negative AGI) and who claimed the Pension or Annuity Deduction. This information may have allowed us to provide a more accurate revenue impact estimate and determine which taxpayers are benefitting from the deduction. Specifically, taxpayers report the Pension or Annuity Deduction on Line 3 (for the primary taxpayer) and/or Line 4 (for the spouse filing jointly, if applicable) of the Subtractions from Income Schedule (Form DR 0104AD), which taxpayers must attach to the Colorado Individual Income Tax Return (Form DR 0104). To report the revenue impact of the deduction, the Department extracts the total amount of deductions claimed on those lines. However, as discussed, some taxpayers may report their eligible pension or annuity benefits on those lines but not have sufficient income to offset with the deduction and would not receive the full benefit of the deduction. However, the Department was not able to provide us with detailed data on the modified federal taxable income (i.e., federal taxable income plus

Colorado required addition modifications to federal taxable income) for taxpayers who claimed the Pension or Annuity Deduction. Without this data, we were only able to provide an explanation and rough estimate of the data limitations regarding taxpayers with AGI under $20,000 who claimed the Pension or Annuity Deduction.

To collect this data, the Department would need to program GenTax, its tax processing system, to capture the modified federal taxable income of each taxpayer who claimed the Pension or Annuity Deduction (Line 4 of the Colorado Individual Income Tax Return) and their corresponding Pension or Annuity Deduction. Programming GenTax to capture and house this information would require additional resources (see the Tax Expenditures Overview section of the *Office of the State Auditor's Tax Expenditures Compilations Report* for additional details on the limitations of Department data and the potential costs of addressing the limitations).

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES FOR THE PENSION OR ANNUITY DEDUCTION. As discussed, statute and the enacting legislation for the exemption do not state the deduction's purpose or provide performance measures for evaluating its effectiveness. Therefore, for the purposes of our evaluation, we considered a potential purpose for the deduction: to reduce income tax on retirement income for taxpayers who are less likely to be in the workforce. We identified this purpose based the operation of the deduction and information published by the National Conference of State Legislatures. We also developed a performance measure to assess the extent to which the deduction is meeting this potential purpose. However, the General Assembly may want to clarify its intent for the deduction by providing a purpose statement and corresponding performance measure(s) in statute. This would eliminate potential uncertainty regarding the deduction's purpose and allow our office to more definitively assess the extent to which the deduction is accomplishing its intended goal(s).

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER WHETHER THE PENSION OR ANNUITY DEDUCTION CAP SHOULD BE ADJUSTED TO ACCOUNT FOR INFLATION. Because the deduction's cap was last increased in 2000, its potential tax benefit has decreased substantially since that time due to inflation. Specifically, in 2000, $24,000 would have the same buying power as about $38,000 in 2021, a 59 percent difference. Therefore, the General Assembly could consider increasing the deduction or tying it to an inflation index to maintain its benefit over time. However, our review of the legislative history for the deduction did not indicate why the General Assembly chose $20,000 ($24,000 for taxpayers who are at least 65 years of age) as the maximum deduction amount, so it is unclear the extent to which the General Assembly intended to exempt pension and annuity income. Although the deduction continues to exempt a significant amount of income, if the deduction is intended to protect the amount of retirement income necessary to cover retirees' typical expenses from taxation, it may be reasonable to periodically adjust the deduction cap to account for inflation. According to the U.S. Bureau of Labor Statistics' Consumer Expenditure Survey results, in 2000, the average annual total expenditures for households in which at least one member was 65 years of age were about $27,000; in 2019, that rose to about $50,000. Additionally, stakeholder organizations that represent seniors and retirees in Colorado reported that tying the deduction cap to an inflation index would be helpful because retirees are often on a fixed income and costs of essentials such as prescription drugs, medical care, utilities, rent, and/or property taxes have increased substantially. Increasing the deduction's amount would also increase the revenue impact to the State, although we lacked information to quantify this potential impact.