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# Iowa Legislative Fiscal Bureau

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State Capitol  
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June 9, 1993

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## Taxing Nonresident Retirement Pensions

### ISSUE

Under current law, individuals who earned pension benefits while working in the State of Iowa must pay Iowa Individual Income Taxes on the taxable portion of benefits when received. This rule applies to both resident and nonresident retirees.

### AFFECTED AGENCIES

The Department of Revenue and Finance (DRF)

### CODE AUTHORITY

Chapter 422, Code of Iowa

### BACKGROUND

The taxation of pension income came to the forefront in 1989 when the United States Supreme Court ruled that Michigan's tax treatment of federal pensions was unconstitutional. Approximately 20 states, including Iowa, were forced to alter tax policies to adjust for discriminatory taxation of federal pensions. As a result, many other issues surrounding pensions began to surface. One such issue was the attempt to collect State income taxes owed on pension income earned by nonresidents.

The problems with taxing pensions on nonresidents have been addressed on several levels. Initially, the individuals in question are often difficult to identify. Secondly, apportioning liability can be a cumbersome process, due to the fact that retirees often earned portions of their pensions in different states. As a result, compliance is difficult to measure and maintain. Nonuniform rules from state to state add to the complexity. Nevada, for example, passed legislation preventing out-of-state tax collectors from placing liens against property in Nevada. Even states with reciprocal collection agreements have administrative problems due to diverse withholding policies.

### CURRENT SITUATION

Iowa is one of 5 states that actively taxes pension income earned by nonresidents. A nonresident who receives pension income earned from employment or self-employment in this State is required to file a State tax return. State and local government pensions are the

easiest to track. As a result, an individual who initially earned the pension working for the State of Iowa is much more likely to be forced into compliance than one who worked for a private firm.

The same individual may also be required to pay income taxes in another state on the same pension income. Iowa issues a credit to a resident who is paying income taxes as a nonresident of another state, but there is concern that some states occasionally refuse such credits. Consequently, there could be a number of retirees, a disproportionate share of which were at one time employees of the State of Iowa, who are taxed twice on the same income.

The DRF estimates that approximately \$8.0 to \$10.0 million would be deposited into the General Fund each year if compliance were 100.0%. Although compliance rates are difficult to determine, the DRF estimates that the rate is 8.0% to 10.0%. These estimates indicate that Iowa, like most states, has a *de facto* policy of tax forgiveness. The Department has not implemented an audit program to identify pension income by nonresidents unless

the taxpayer is the subject of an audit for other reasons.

### **ALTERNATIVES**

The following alternatives would address the dilemmas created by the State's nonresident tax policies:

Expand collection efforts. Work towards uniform federal standards. Consider the effect of reciprocity agreements with other states.

Tax pension income when it is earned, rather than when the benefits are received. This would entail denying employers deductions for contributions to their employees pensions.

Exempt nonresident pension income from State Individual Income Taxes if the nonresident is assessed a tax in another state on the same income but denied a tax credit by the host state.

Exempt all nonresident pension income from State Individual Income Taxes.

The first alternative would be the likely result of inaction on the part of the General Assembly. The DRF is currently reviewing administrative rules to more effectively collect the taxes that are due from nonresident retirees. Uniform federal standards friendly to nonresident taxation would eliminate any problems of double-taxation as well as disputes between Iowa and other states. Federal rules, however, will not necessarily take this approach. Nevada's Congressional delegation has introduced federal legislation that would prohibit nonresident pension taxation altogether.

The second alternative would not solve the problem of current nonresidents, but would eliminate the problem of collection from future retirees. Taxing pension income when it is earned appeals to those who hold that taxation should occur at the time services are received. However, this plan would increase the probability of double-taxation for those retirees who leave the State, as credits on past tax burden would be more difficult to determine. If the Nevada plan succeeds on the federal level, this is the only alternative that would ensure tax collection on pension income earned in the State by nonresidents.

The third alternative addresses the problem of double-taxation. According to the DRF and the American Association of Retired Persons, the problem of double-taxation is a relatively rare occurrence. This alternative would merely institutionalize a policy so the State of Iowa would bear the burden if a nonresident retiree's resident state refused to allow tax credits for income tax paid to Iowa on pension income.

The fourth alternative, exempting all nonresident pension income, would solve the problem by default. Assuming that wealthier retirees migrate at a higher rate than poorer retirees, the policy would enhance regressivity. This policy would also create an incentive for retirees on pensions, especially large pensions, to leave the State when they would have stayed otherwise. The budgetary impact of this effect, however, is impossible to determine.

### **BUDGET IMPACT**

The fiscal effect of the alternatives presented is difficult to quantify. The DRF estimated that approximately \$800,000 in taxes on pensions from nonresidents was collected in FY 1989. Virtually all of the revenue received from nonresident pensions can be considered voluntary. As the proportion of elders in Iowa increases, the amount collected is expected to increase. The \$10.0 million in total liability will probably increase due to the same demographic trends.

The budget impact of the first alternative depends on the nature of reciprocity agreements and changes in federal law. If the federal government prohibits collection of taxes on nonresident pension income, the impact would be a loss to the General Fund of approximately \$800,000. Likewise, reciprocity agreements tend to have a negative effect on revenues for the State. Since only 4 states have tax policies similar to Iowa's, collections will increase as a result of agreements with those states. Reciprocity agreements with states who do not tax nonresident pensions would make the process simpler for the taxpayer and the states, but would hamper the ability of the DRF to step up collection efforts. Iowa exports more retirees than it imports. Alternatively, the State could avoid reciprocity agreements and increase collection efforts. The extensive litigation and inability to locate nonresidents would probably negate any achievable revenue increases.

The second alternative would require decoupling Iowa's tax policies from the federal government's. No quantified estimate is available at this time, but the policy would certainly increase revenues to the General Fund by a significant amount. The policy would also create an environment relatively more hostile to savings rates and new investment, because real return on pension savings as well as disposable income would decline for those who are the primary source of savings. Michigan has instituted a similar policy. The State taxes income from pensions in the final year of residence, or upon receipt of the benefits, whichever comes first. The DRF has stated that, from a policy perspective, the Michigan option would be very awkward to impose. If successful, however, the DRF could significantly increase collection of taxes from nonresidents before they actually leave the State. Each 10.0% jump in compliance would increase the General Fund by approximately \$1.0 million, but it is not currently possible to predict how quickly the effect would be realized.

As indicated in the previous section, the third alternative would have almost no fiscal impact. Exempting nonresident pension income from those filers who reside in a state that will not issue a credit would eliminate any double-taxation problem that might exist. The problem appears to be so small in scope, however, that it would be unlikely to have any measurable fiscal effect. This assumes, of course, that other states would not alter their tax credit rules in response to a policy change in Iowa.

The final alternative would simply exempt all nonresident pension income. This would put Iowa in line with most other states. The policy shift would result in a decrease to the General Fund of between \$800,000 and \$1.0 million in FY 1995. This option would simplify the process of taxing pension income. From an administrative perspective, this is the most desirable option.

According to the DRF, the revenue generated from these taxes does not justify either the cost of litigation and tax collection efforts or the confusion and frustration that many retirees continue to face.

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