Military Retirement Benefits Deduction

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OFFICE OF THE STATE AUDITOR

C O L O R A D O

This income tax deduction allows military retirees under age 55 to deduct $15,000 of their military retirement pension income from state taxable income. Under statute, the deduction's purpose is to "honor the sacrifice and service of veterans and to create an incentive for more veterans to make their post-military homes in the state."

The deduction provides a gesture of honor to veterans for their service. However, it may not be a significant incentive for military retirees under age 55 to locate in Colorado.

- According to stakeholders, providing a tax benefit to military retirees, regardless of income level or financial need, serves as a way to honor and thank military retirees for their service.
- The deduction provides a relatively small financial incentive (about $660) compared to other states, many of which do not tax any military retirement pension income.
- Location decisions are complex, and tax incentives are just one of many decision factors for military retirees. Colorado's quality of life and strong job market are more likely to attract military retirees than the tax deduction. Additionally, the tax benefit the deduction provides is likely too small to overcome other financial considerations for veterans when selecting a place of residence, such as the overall cost of living in the state and employment opportunities.

Policy Considerations

If the deduction is renewed, the General Assembly may want to consider periodically increasing the amount of the deduction to account for pension cost of living increases and/or inflation.

Tax Type:	**Income tax**	Year Enacted:	**2018**
Expenditure Type:	**Deduction**	Repeal/Expiration date:	**1/1/2024**
Statutory Citation:	**Section 39-22-104(4)(y), C.R.S.**	Revenue Impact (2020):	**$2.5 million**

Purpose given in statute or enacting legislation? **Yes**

Military Retirement Benefits Income Tax Deduction

Background

The Military Retirement Benefits Deduction allows military retirees under age 55 to deduct $15,000 of their military pension income from their Colorado taxable income.

House Bill 18-1060 established the deduction, phasing in the deduction amount between Tax Years 2019 and 2022 and setting it to expire January 1, 2024. For Tax Year 2023, the $15,000 annual deduction amount provides a maximum reduction in tax liability of about $660. However, because the deduction can only be applied to military pension payments during the same tax year, taxpayers with less military pension income than the deduction maximum cannot claim the full benefit. Exhibit 1 shows the maximum tax savings for beneficiaries each year assuming that taxpayers had sufficient tax liability and military retirement income to be able to deduct the maximum amount.

Exhibit 1
Maximum Deduction Benefit to Taxpayers for Tax Years 2019 through 2023

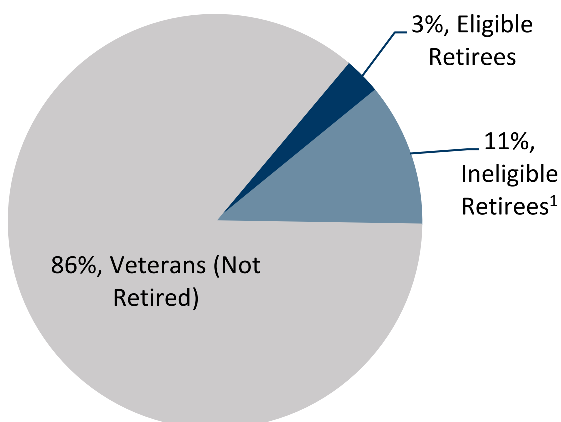
Tax Year	Deduction Limit	Tax Rate	Maximum Tax Savings
2019	$4,500	4.5%	$203
2020	$7,500	4.55%	$341
2021	$10,000	4.55%	$455
2022	$15,000	4.4%	$660
2023	$15,000	4.4%	$660

Source: Section 39-22-104(4)(y), C.R.S., and Office of the State Auditor analysis of the monetary benefit of the deduction based on state tax rates for Tax Years 2019 through 2023.

Beneficiaries of the deduction are individuals younger than 55 who are paid a *regular* military retirement pension that is subject to federal tax (i.e., non-disabled active duty service members).

According to the U.S. Department of Defense, Office of the Actuary, as of September 2020, there were about 10,000 military retirees in Colorado who were under age 55 and receiving a federally taxable pension. The total population eligible for the deduction represents a relatively small segment of military veterans in the state. According to the Department of Military and Veterans Affairs, as of 2020, roughly 394,000 veterans resided in Colorado; of those, about 54,000 were military retirees. Exhibit 2 shows that only 3 percent of the veteran population in Colorado is eligible for the deduction.

Exhibit 2
Proportion of the State's Veteran Population Who Are Military Retirees Eligible for the Deduction, Federal Fiscal Year 2020



Source: Office of the State Auditor analysis of Department of Military and Veterans Affairs data and U.S. Department of Defense, Office of the Actuary data for reports published December 2020.
[1]Ineligible Retirees include individuals whose benefits are not taxed at the federal level (i.e., those with a combat-related disability or those receiving benefits through the Veterans Administration) or those who are 55 years or older and not eligible for this deduction.

Technical Note:
IRS Publication 525 defines types of income and states that both military pension benefits for retirees with a combat-related disability, as well as Veterans Administration (VA) benefits are not considered taxable income. Because these benefits are not federally taxed, they are also automatically excluded from Colorado taxable income.

In general, to qualify for military retirement pay, service members must serve a minimum of 20 years. Active duty service members are those who work for the military full-time, whereas reserve members (Reservists) are part-time military service members that generally hold a civilian job at the same time. Because Reservists serve part-time, they must also be at least 60 years old to receive retirement benefits, making them ineligible for the deduction. These taxpayers would instead be eligible for the State's broader Pension and Annuity Deduction.

The General Assembly established the deduction to "honor the sacrifice and service of veterans and to create an incentive for more veterans to make their post-military homes in the state."

According to testimony during the committee hearings for House Bill 18-1060, this deduction was intended to both honor veterans and economically benefit Colorado by incentivizing veterans who are still of working age to locate in the state. Statute does not provide performance measures to evaluate whether this deduction is meeting its purpose; therefore, we developed the following performance measures to evaluate the deduction:

- To what extent is the deduction being used?
- Does the deduction provide veterans a gesture of honor for their service?
- To what extent does the deduction act as an incentive for military retirees to locate in Colorado?

To assess these performance measures we:

- Reviewed data from the Department of Revenue; the U.S. Department of Defense, Office of the Actuary; and the Department of Military and Veterans Affairs on the veteran population, the military retiree population, and the taxpayers claiming the deduction.
- Interviewed stakeholders about their awareness of the deduction and its value to veterans.
- Reviewed similar tax benefits provided in other states, and researched the relative importance of an income tax incentive for military retirees.
- Analyzed changes in Colorado's military retiree population compared to national, and other state trends.

Evaluation Results

The deduction is partially meeting its purpose because it provides a benefit specific to veterans that honors them for their service. However, it likely does not have a significant impact on the number of military retirees under age 55 who locate in Colorado.

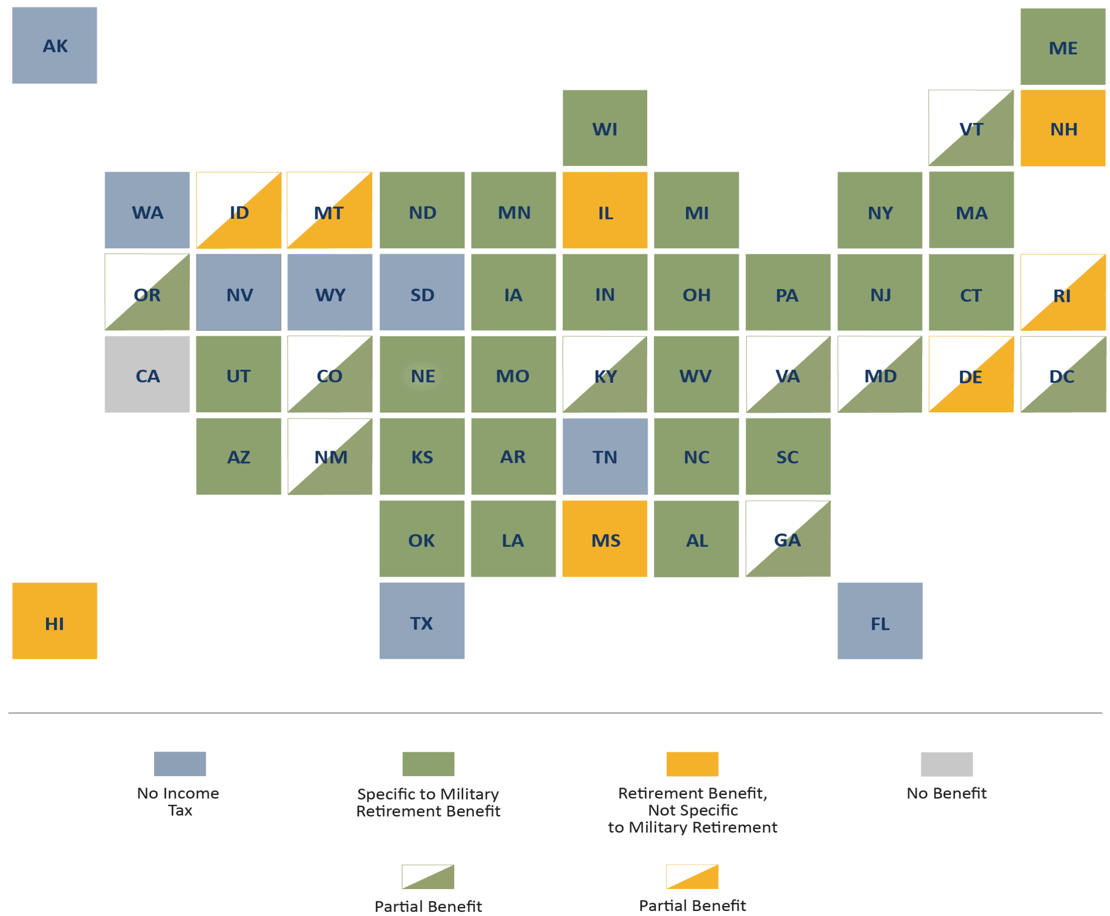
According to Department of Revenue data **for Tax Year 2020, about 7,700 taxpayers claimed the deduction, and it had a revenue impact to the State of about $2.5 million.** More than 90 percent of the taxpayers claimed the full $7,500 deduction available that year, which provided a tax benefit of about $340 to each taxpayer. Based on our review of U.S. Department of Defense, Office of the Actuary data, the 7,700 taxpayers claiming the deduction represent about 77 percent of the

10,000 potentially eligible military retirees. It is possible that some eligible military retirees did not claim the deduction, either due to a lack of awareness or because they did not have taxable income.

Stakeholders reported that a tax benefit for military retirees serves as a way to honor and thank veterans for their service. We spoke with representatives from two veterans' advocacy organizations and both reported that a tax benefit specific to veterans honors their service. One organization reported that other similar income tax deductions, such as the Pension and Annuity Deduction, do not honor veterans in the same way because they are also available to non-military retirees. Stakeholders also reported that the deduction was particularly effective at honoring veterans' service because it was available to all retired veterans under age 55 regardless of income level. In contrast, they reported that many veterans' benefits through the Veterans Administration are based on financial need, income level, and disability rating. While these benefits are important in financially and socially assisting veterans, the Military Retirement Benefits Deduction serves as a way to value all retired military service members separate from programs that may provide specific groups with government assistance.

The deduction probably does not provide a significant incentive for military retirees to locate in Colorado because most states have larger exemptions, the financial benefit is relatively small, and tax incentives are just one of many factors military retirees take into account when deciding where to live. Almost every state offers a tax incentive for military retirees either by allowing a deduction or credit specific to military pensions, or through a more general pension deduction available to all taxpayers. Colorado is one of 33 states and the District of Columbia (DC) that has an income tax deduction specifically for military retirees. Most of these states allow military retirees to deduct their full pension from income taxes, but eight states (including Colorado) and DC only offer a partial benefit. Another 16 states provide either a broader pension deduction to other types of retirees, or have no income tax and, therefore, military retirement income is also not taxed. Only one state, California, fully taxes military retirement income. Exhibit 3 shows the different states and their treatment of military retirement income.

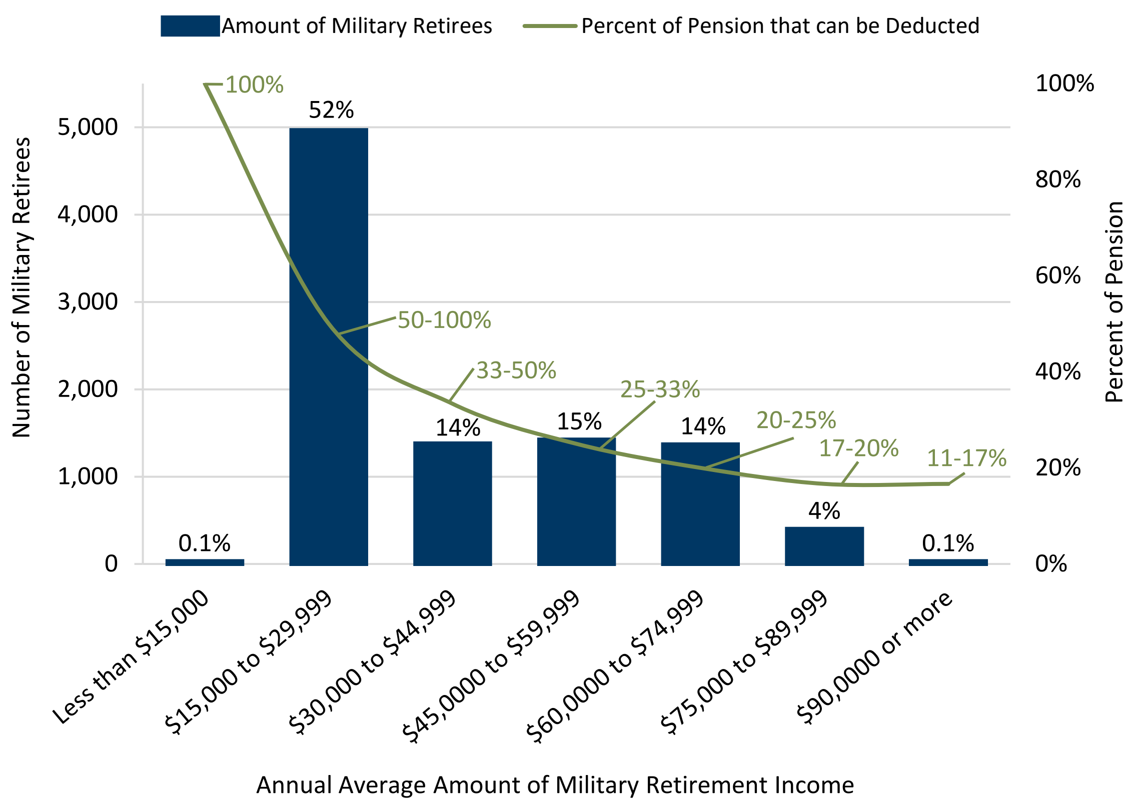
Exhibit 3
State Tax Treatment of Military Retirement Benefits



Source: Office of the State Auditor analysis of the U.S. Army military benefits website and state statutes and regulations, as of 2022.

In addition to offering a smaller benefit than most states, the deduction's $660 maximum tax benefit may provide a relatively small reduction in overall tax liability for many military retirees. According to data from the U.S. Department of Defense, Office of the Actuary, in 2022, less than 1 percent of military retirees under age 55 in Colorado had pensions below the $15,000 statutory limit. Therefore, almost every retiree would still have to pay income tax on a portion of their retirement income. As shown in Exhibit 4, about half the military retirees in Colorado had between $15,000 and $29,999 in military retirement income and would be able to deduct between 50 and 100 percent of their retirement income. A little less than half of the retirees had at least $30,000 in military retirement income and would be able to deduct between 11 and 50 percent of their retirement income.

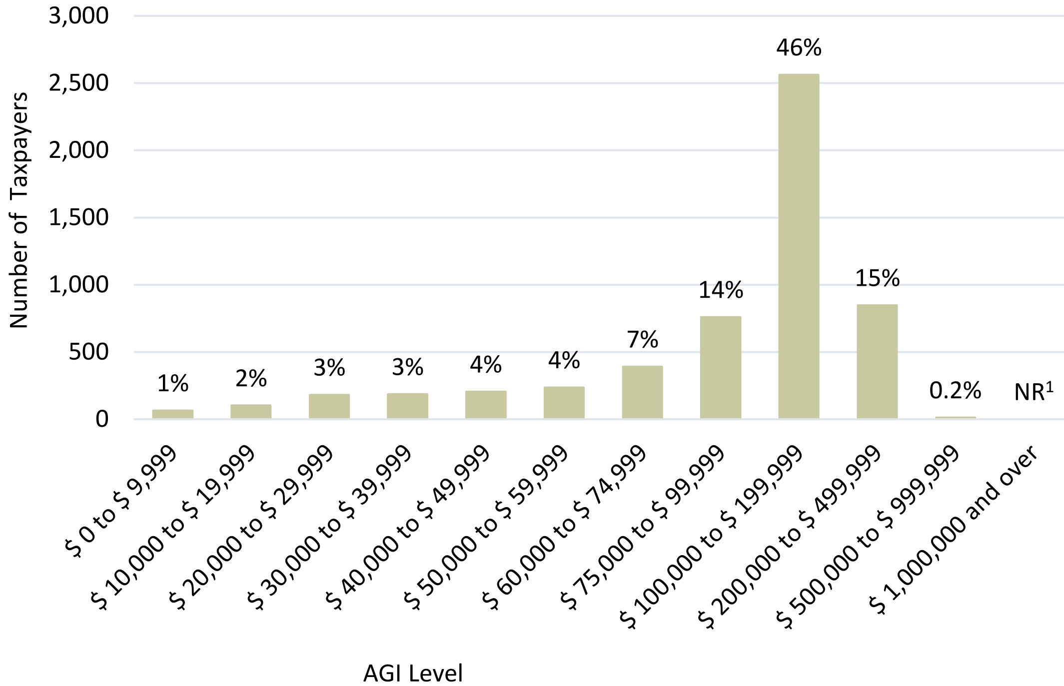
Exhibit 4
Amount of Military Retirees by Amount of Annual Pension Income and the Percentage of Retiree Pension Income That Can Be Deducted, Federal Fiscal Year 2022



Source: Office of the State Auditor analysis of U.S. Department of Defense, Office of the Actuary data on average annual pension payments for Non-Disabled Military Retirees between the ages of 38 and 54 for Federal Fiscal Year 2022.

In addition to military retirement benefits, many military retirees under age 55 have additional income as they (and/or their spouse) obtain post-military employment. For example, according to Department of Revenue data for Tax Year 2019, nearly half of the retirees who claimed the deduction had between $100,000 and $200,000 in Adjusted Gross Income (AGI); therefore, the tax savings provided by the deduction is a relatively small portion of their overall tax burden. For example, a taxpayer with $100,000 in taxable income would owe approximately $4,400 in state income taxes (at a 4.4 percent income tax rate). The deduction (valued at $660 in this scenario) would only save them about 15 percent on their total state income taxes, which might not be enough to significantly influence their retirement location decision. Exhibit 5 shows the AGI levels of Colorado taxpayers who claimed the deduction in Tax Year 2019.

Exhibit 5
Amount of Taxpayers Claiming the Deduction by AGI Level, Tax Year 2019



Source: Office of the State Auditor analysis of the Department of Revenue Statistics of Income, number of Full Year Resident tax returns claiming the Military Retirement deduction, by AGI, for Tax Year 2019.
[1] Figure is not reportable per Department of Revenue taxpayer confidentiality requirements.

While tax incentives are often included in evaluations of "best places to live" provided by veterans organizations and the U.S. Department of Defense, other factors likely influence retirement location decisions more than tax benefits. Research suggests that military retirees evaluate retirement destination largely based on family proximity, lifestyle amenities, previous experiences in the state, economic opportunity, the cost of living, the quality of government services, and access to military communities and resources. For example, a 2017 study from the University of Utah, Kem C. Gardner Policy Institute, *Analysis of Military Retirees in Utah: Impacts, Demographics and Tax Policy* found that tax policy is one of the less important factors known to influence place of residence decisions and that state income tax benefits were unlikely to result in an increase in military retirees locating in Utah. Additionally, according to a 2018 study on military retiree location decisions for retirees of all ages, conducted by the Fermanian Business and Economic Institute, the most important indicators of the number of military retirees residing in each state were:

- The size of Active Duty installations
- Home prices

- Share of military retiree pay taxed
- Average temperature
- Job opportunities
- Unemployment rate

In general, states with no income tax, such as Florida and Texas, tend to have the highest number of military retiree populations.

We also spoke with stakeholders about the importance of a tax incentive for military retirees when they are deciding where to retire. Overall, stakeholders reported that having some type of favorable tax policy can be important because it is something veterans will look at when making a decision, but may be very important for retirees age 55 and over who are at the end of their working career and are living on a fixed income. Retirees under age 55 are generally looking for post-military employment and are more likely to factor in the economic conditions of a state, including job opportunities, cost of living, and the overall quality of life (e.g., schools, support services for veterans, weather). For example, stakeholders reported that a military retiree under age 55 is more likely to locate in an area where they or their spouse receive a job opportunity, and to consider lifestyle amenities such as access to the outdoors and weather, rather than prioritizing state income tax policies. Additionally, stakeholders reported that high housing costs may deter retirees from locating in Colorado despite the state tax benefit.

While we could not quantify the impact of the deduction on Colorado's military retirement population, there do not appear to have been significant changes in this population since the deduction's enactment compared to overall national trends. According to data from the U.S. Department of Defense, Office of the Actuary, since the deduction was enacted in 2018, Colorado has remained as the state with the ninth-largest military retiree population under age 55. In the last 5 years, Colorado has seen a slight decrease (6.5 percent decline) in its military retiree population under age 55. However, this is similar to the overall nationwide decrease and may also be the result of military retirees aging out of the eligible population and fewer service members retiring rather than leaving the state.

Although there are economic benefits associated with military retirees choosing to live in a location, including additional spending and property and income taxes, studies on military retiree tax deductions as an incentive generally do not show that deductions incentivize military retirees to move to a state. Therefore, revenue losses from the deduction may not be offset through increased additional economic activity. However, we did not have sufficient data for employment, spending, and location decisions from beneficiaries to develop an estimate of these economic benefits.

Policy Considerations

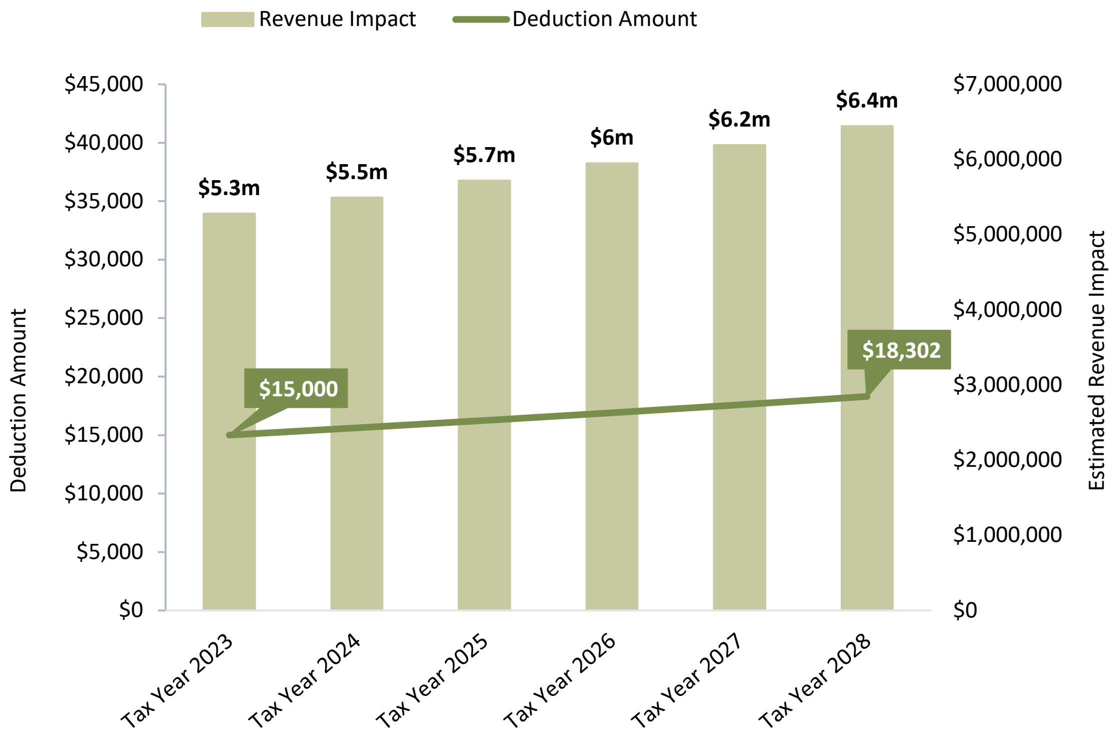
If the General Assembly chooses to renew the deduction, it may want to consider adjusting the deduction limit to account for cost of living increases and inflation.

The deduction is not scheduled to increase in order to account for inflation or adjustments to military pension payments, which could reduce the relative benefit it provides in future years. Military retirement pay is adjusted annually, as a Cost of Living Adjustment (COLA). While the actual adjustment for individual retirees varies based on several factors, including their enlistment and retirement dates and the type of pension plan they are enrolled in, the U.S. Department of Defense, Defense Finance and Accounting Service reports an annual average COLA each year, ranging from 1.3 percent for 2021 up to 8.7 percent for 2023. Because of these adjustments, the General Assembly may want to consider increasing the amount of the deduction annually to maintain the value of the deduction commensurate with the value of the military retirement income. Additionally, because the COLAs will vary among individual retirees, the General Assembly may want to consider using an inflation index, such as the U.S. Bureau of Labor Statistics' Consumer Price Index or the U.S. Department of Defense, Defense Finance and Accounting Service's annual average COLA adjustment, for simplicity.

Adjusting the deduction for inflation would increase the cost of the deduction to the State and may make the deduction more difficult to administer for the Department of Revenue since the amount would change each year and certain changes require updates to tax forms and programming in its tax processing and information system, GenTax. Exhibit 6 shows a hypothetical example of the estimated revenue impact of increasing the current deduction amount of $15,000 by 4.06 percent annually (the U.S. Department of Defense, Defense Finance and Accounting Service's reported average COLAs between 2019 and 2023). Overall, assuming about 8,000 taxpayers per year are able to claim the full deduction, this increase would result in the revenue impact increasing from about $5.3 million in Tax Year 2024 to about $6.4 million in Tax Year 2028.

Exhibit 6

Hypothetical Revenue Impact of Renewing the Deduction at $15,000 and Annually Adjusting the Deduction by 4.06 Percent[1], Assuming 8,000[2] Military Retirees Can Claim the Maximum Deduction



Source: Office of the State Auditor analysis of the U.S. Department of Defense, Office of the Actuary data using the 5-year average Cost of Living Adjustment and Department of Revenue-reported amounts of beneficiaries claiming the deduction in Tax Year 2020.

[1] Annual average Cost of Living Adjustment of 4.06 percent is based on the U.S. Department of Defense, Defense Finance and Accounting Service's most recent average Cost of Living Adjustment increases in pensions and does not project future adjustments which could differ from the 5-year average.

[2] 8,000 military retirees is an assumed amount based the U.S. Department of Defense, Office of the Actuary data for Federal Fiscal Year 2022 of 9,400 military retirees under age 55 in Colorado and Department of Revenue data for Tax Year 2020 showing that about 7,700 taxpayers used the deduction in Tax Year 2020. Not all eligible military retirees claim the deduction or the full amount of the deduction; therefore, we adjusted the eligible beneficiaries amount downward.