Income Tax on Pension and Annuity Income

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Issue

Describe the (1) phase-out of the income tax on pension and annuity income and (2) withholding requirement applicable to this income during the phase-out period. This report has been updated by OLR Report 2019-R-0098.

Summary

Beginning January 1, 2019, laws enacted in 2017 (1) authorize a six-year phase-out of the income tax on pension and annuity income (i.e., distributions) for taxpayers with incomes below specified thresholds and (2) require certain taxpayers to have the taxable portion of each distribution deducted or withheld. These distributions are subject to the same underpayment interest penalty that applies to taxpayers that do not pay enough taxes through withholding or estimated payments. The penalty applies to underpayments that exceed $1,000 and equals 1% interest on the under- or unpaid amount for each month or part of a month of nonpayment. The withholding requirement and penalty applies to distributions to Connecticut taxpayers by payers that maintain an office or transact business in Connecticut.

Tax Deduction for Pension and Annuity Income

In 2017, the legislature authorized a six-year phase out, from 2019 to 2025, of the income tax on pension and annuity income for taxpayers with federal adjusted gross incomes (AGIs) below the following thresholds:

1. $75,000 for single filers, married people filing separately, and heads of households and

2. $100,000 for married people filing jointly (PA 17-2, June Special Session, § 641).

Taxpayers with AGIs below these thresholds may deduct a percentage of their pension and annuity income when calculating their Connecticut AGI according to the schedule shown in Table 1.

Table 1: Schedule for Deducting Percentage of Pension and Annuity Income from Connecticut Income Taxes

Tax Year	Percent of Pension and Annuity Income Exempt from Income Tax
2019	14%
2020	28
2021	42
2022	56
2023	70
2024	84
2025	100

The tax on pension and annuity income resumes in 2026. (In phasing out the income tax on pension and annuity income, the legislature also made a conforming change to the existing teacher pension exemption by allowing taxpayers to claim either that exemption or the pension and annuity exemption.)

Interest Penalty for Underpaying Pension and Annuity Income Withholding Tax

Before 2018, taxpayers receiving pension and annuity income were allowed to withhold an estimated portion of the tax from each distribution instead of paying the entire tax when they filed their Connecticut income tax return. They did this by instructing the party that distributed the pension and annuity income (i.e., payers) to withhold the estimated amount. All taxpayers, regardless of whether they withheld, were subject to an interest penalty if did not pay enough taxes.

In 2017, the legislature imposed a withholding requirement on all taxpayers who receive distributions from payers that (1) maintain offices or conduct business in Connecticut and (2) make taxable payments to Connecticut residents. For the portion of a distribution that is subject to Connecticut withholding (see above), taxpayers must instruct their payers to withhold or deduct, as far as practicable, an amount substantially equal to the tax reasonably estimated to be due from the taxpayer during the calendar year (PA 17-147, §§ 6 & 8).

If a taxpayer fails to comply with this requirement, his or her payer may withhold at the highest marginal tax rate of 6.99% (Connecticut Department of Revenue Services, AN 2017 (11): *Revised For CT-W4P for Connecticut Resident Recipients of Pension and Annuity Distributions*). If the taxpayer withholds but underestimates the amount, he or she is liable for the existing interest penalty for underpaying the tax. The penalty (1) applies if a taxpayer owes $1,000 or more in income tax and (2) equals 1% interest on the under- or unpaid amount for each month or part of a month of underpayment (CGS § 12-722).

JR:cmg