Legislative Analysis

INCOME TAX CUT; CHILD TAX CREDIT;
ELIMINATE THREE-TIERED
TREATMENT OF RETIREMENT INCOME

Phone: (517) 373-8080
http://www.house.mi.gov/hfa

Analysis available at
http://www.legislature.mi.gov

Senate Bill 768 (proposed substitute H-3)
Sponsor: Sen. Aric Nesbitt
House Committee: Tax Policy [Discharged]
Senate Committee: Finance
Complete to 3-1-22

SUMMARY:

Senate Bill 768 would amend Part 1 of the Income Tax Act to lower the income tax rate to 3.9% from its current rate of 4.25%, effective January 1, 2022. Additionally, the bill would allow an increased exemption level for taxpayers 62 and older on retirement income (if they qualify after exercising the standard deduction), also effective January 1, 2022.

Currently under the act, retirement income is taxed in a three-tier system, depending on the taxpayer's date of birth:

In the first tier, for taxpayers born before 1946, public pension and social security income is tax-exempt. Eligible taxpayers in this tier may subtract private retirement income, but the exemption for private retirement income or for a combination of private retirement income and tax-exempt public retirement income cannot exceed a specific limit, which for tax year 2021 is $54,404 for single filers and $108,808 for joint filers.[1]

In the second tier, taxpayers born between 1946 and 1952 who have reached age 67 (currently everyone in this cohort) are eligible for an exemption against retirement income of $20,000 for single filers or $40,000 for joint filers. However, they are eligible for an exemption against all income of $20,000/$40,000 only if they do *not* choose to claim a military or railroad pension exemption.

In the third tier, for taxpayers born after 1952, taxation once again varies based on whether the taxpayer has reached the age of 67. For those younger than 67 (currently the majority of those in this cohort), social security, railroad pension, and military pension income is tax-exempt. These taxpayers also are ineligible for retirement income exemptions. Like taxpayers in Tier 2, once they turn 67, they are eligible for an exemption against all income of $20,000 for single filers and $40,000 for joint filers if they claim no military or railroad pension exemption. However, unlike Tier 2 taxpayers, they would also be unable to claim a social security or personal exemption. Or, they may choose to receive the social security, military or railroad pension, and personal exemptions, but not the overall exemption of $20,000/$40,000. As such, Tier 3 taxpayers are subject to less favorable tax treatment than Tier 2 taxpayers.

[1] https://www.michigan.gov/taxes/0,4676,7-238--572810--,00.html

For joint returns under this system, the date of birth of the older spouse determines the tax treatment of income reported jointly, regardless of the date of birth of the younger spouse.

Generally, the bill would absorb Tier 3 into Tier 2 and lower the eligibility age for the retirement tax deduction from 67 to 62, effective January 1, 2022. In effect, as Tier 1 taxpayers (those currently aged 76 and older) cease to file returns, the tiered system will be eliminated in favor of a single system for retirement income deductions for those aged 62 and older.

Once a taxpayer reaches age 62, the taxpayer would be eligible for a $20,000 deduction against *all* income for a single return and a $40,000 deduction for a joint return. (This deduction is currently allowed for those aged 67 or older.)

As in Tier 2 currently, a taxpayer *could not* take the $20,000/$40,000 exemption along with a military or railroad pension exemption, but *could* claim social security and a personal exemption in addition to the $20,000/$40,000 exemption. (Currently, those in Tier 3 currently may not take the $20,000/$40,000 exemptions in conjunction with any of those four exemptions.)

Additionally, if a taxpayer who has taken the $20,000/$40,000 deduction described above still has *retirement or pension benefits* that the person would otherwise be able to deduct as retirement or pension benefits from a state or federal public retirement system or a retirement annuity policy, the taxpayer could take an additional deduction of those benefits of up to $20,000 for a single return or $40,000 for a joint return.

The bill also would lower the income tax for all taxpayers to 3.9% from its current rate of 4.25%, effective January 1, 2022.

Finally, for tax years that begin on and after January 1, 2022, a taxpayer could claim a credit of $500 for each ***qualified dependent*** claimed by the taxpayer for that tax year. If the credit exceeded the taxpayer's tax liability for that tax year, the excess would not be refunded.

> ***Qualified dependent*** would mean a dependent who was less than 19 years of age on the last day of the tax year for which the credit was claimed.

MCL 206.30 and 206.51; proposed MCL 206.277

BACKGROUND:

The bill is understood to be a partial repeal of 2011 PA 38, which first introduced the three-tiered tax system for taxpayers collecting retirement income.[2]

A chart depicting the treatment under the tiers can be viewed here:
2021RetirementPensionBenefitsChart_741840_7.pdf (michigan.gov)

[2] House Fiscal Agency analysis of 2011 PA 38 (HB 4361): http://www.legislature.mi.gov/documents/2011-2012/billanalysis/House/pdf/2011-HLA-4361-6.pdf

House Bill 5838,[3] which did not include the $500 child tax credit but is otherwise identical, was considered and reported by the House Tax Policy committee on February 24, 2022.

Senate Bill 378,[4] which was passed by the Senate in May 2021 and is under consideration in the House Tax Policy committee, also proposed a $500 child tax credit but included a sunset (expiration date) of December 31, 2025.

FISCAL IMPACT:

As written, the bill would reduce the income tax rate from 4.25% to 3.9%, effective January 1, 2022. In addition, taxpayers born after 1952 who are 62 or older as of January 1, 2022, will be eligible to claim a standard deduction against all income up to $20,000 for a single return or $40,000 in the case of a joint return. Further, these taxpayers are also eligible to claim an additional exemption of up to $20,000 for a single return or $40,000 in the case of a joint return for eligible retirement income not already excluded from the taxable income by the standard deduction. Finally, it would provide a nonrefundable child tax credit of up to $500 per dependent child.

The estimated impacts on a fiscal year basis are shown below:

Estimated Impact by Fiscal Year (in millions)

	FY 2021-22	FY 2022-23	FY 2023-24	Total
Tax Rate Reduction to 3.9%	($240.8)	($1,551.4)	($1,108.2)	($2,900.4)
Retirement Income Changes	($140.3)	($841.8)	($561.2)	($1,543.3)
Child Tax Credit	($569.9)	($751.8)	($746.3)	($2,068.0)
Fiscal Year Total	($951.0)	($3,144.9)	($2,415.8)	($6,511.7)

The estimates assume that the changes, if enacted, would only be in effect for a portion of FY 2021-22. Thus, due to timing, most of the FY 2021-22 impact would not be realized until FY 2022-23.

Under current law, the School Aid Fund receives approximately 23.81% of gross income tax revenue (withholding, flow through entity tax, quarterly payments, and annual payments). However, because the earmark percentage is a function of the income tax rate, the percentage adjusts automatically to hold the School Aid Fund harmless against rate changes. Decreasing the rate to 3.9% would increase the earmark to approximately 25.95% of gross income tax revenue. A portion of the revenue reduction attributable to the expanded treatment of retirement income would be borne by the School Aid Fund, but the amount depends on the degree to which taxpayers adjust their payments. Finally, although the child tax credit might either lower annual payments or result in higher refunds, it would likely have an impact on

[3] House Fiscal Agency summary of HB 5838 http://www.legislature.mi.gov/documents/2021-2022/billanalysis/House/pdf/2021-HLA-5838-BCDF9B46.pdf
[4] House Fiscal Agency summary of SB 378 (S-1) http://www.legislature.mi.gov/documents/2021-2022/billanalysis/House/pdf/2021-HLA-0378-03D2D6F1.pdf

both the School Aid Fund and the general fund. However, it is expected that the bulk of the credit (perhaps 80% or more) would reduce general fund revenue. Suffice it to say, since the bulk of the revenue impact stems from the rate reduction and child tax credit, the vast majority of the overall revenue reduction would be absorbed by the general fund.

The bill would also have implications for the federal State Fiscal Recovery Fund (SFRF) distributions received by the state. Pursuant to the American Rescue Plan Act and its associated rules, when evaluating tax reductions, actual tax revenue in any given year must exceed baseline tax revenue, which is defined in ARP and ARP rules as 2019 tax revenue adjusted annually for inflation, through December 31, 2024. Any amount below baseline tax revenue must be "paid for" or an equivalent amount of SFRF is subject to recoupment under the act. To "pay for" the reduction in tax revenues, the state can use alternative revenue increases or spending reductions as an alternative to having SFRF funds recouped.

Based on estimated tax revenue reductions noted above and HFA estimates of actual versus baseline tax revenues in FYs 2021-22, 2022-23, and 2023-24, it is estimated that the bill might result in actual tax revenues falling below baseline revenues in FY 2021-22 and would result in actual tax revenues falling below baseline revenues in FY 2022-23 by an estimated $2.5 billion and in FY 2023-24 by approximately $1.8 billion. If these amounts were not paid for by alternative revenue increases or spending reductions, then an equivalent amount of SFRF would be subject to recoupment in FY 2022-23 and FY 2023-24.

Legislative Analyst: Jenny McInerney
Fiscal Analyst: Jim Stansell

■ This analysis was prepared by nonpartisan House Fiscal Agency staff for use by House members in their deliberations and does not constitute an official statement of legislative intent.