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INCOME TAX ACT CHANGES

House Bill 4001 CR-1
Sponsor: Rep. Angela Witwer
House Committee: Tax Policy [Discharged]
Senate Committee: Committee of the Whole
Revised 2-8-23

SUMMARY:

House Bill 4001 would amend the Income Tax Act to provide for the phase-out of the three-tier system of taxing retirement and pension benefits, change the tax treatment of police and firefighter retirement income, provide for the issuance of income tax rebates to Michigan taxpayers, increase the value of the state earned income tax credit (EITC), increase the percentage of gross income tax collections earmarked to the School Aid Fund, provide for the deposit of certain revenue collected under the act into various state funds, and create the Michigan Taxpayer Rebate Fund and the Revitalization and Placemaking Fund.

Retirement Tax Phase-Out

The three-tier system for taxing retirement income was created in the Income Tax Act by 2011 PA 38. Prior to that act, federally taxable Social Security, military, federal, and state and local government retirement income were fully exempt from state taxation. Private retirement income (e.g., from private pensions, 401(k)s, etc.) was exempt up to a specific threshold that was adjusted annually for inflation. In addition, defined benefit plans (i.e., pensions) from public employment were fully exempt. Seniors also were able to claim a deduction for interest, dividends, and capital gains received from investments, up to a cap that was adjusted annually for inflation.

Currently, retirement income in Michigan is subject to taxation based on the birth year of the taxpayer (or their spouse) as follows:

- **Tier 1**: Taxpayers born before 1946 continue to be taxed under the same system that existed prior to the changes made by 2011 PA 38. For the 2022 tax year, the deduction of private retirement income was capped at $56,961 for single filers and $113,922 for joint returns. The deduction for investment income was capped at $12,697 for single filers and $25,394 for joint returns. These taxpayers remain able to claim other personal exemptions for which they are eligible.
- **Tier 2**: Taxpayers born from 1946 to 1952 are able to take a limited deduction ($20,000 for single filers/$40,000 for joint returns) against all types of income.[1] These taxpayers remain able to claim other personal exemptions for which they are eligible.
- **Tier 3**: Taxpayers born after 1952 are not able to exempt any retirement income, except for Social Security income, until reaching age 67. After turning 67, these taxpayers who choose to take the $20,000/$40,000 deduction against all income will have that deduction reduced by the taxable portion of Social Security and any personal exemptions claimed.

[1] These provisions apply at age 67, which all taxpayers in Tier 2 have already reached.

House Bill 4001 would provide for the phase-out of the three-tier system by the 2026 tax year, as follows:

- For the 2023 tax year, a taxpayer born after 1945 and before 1959 would be able to elect to deduct retirement or pensions benefits up to 25% of the maximum deduction available to taxpayers in Tier 1 for private retirement income.
- For the 2024 tax year, taxpayers born after 1945 and before 1963 would be able to elect to deduct retirement and pension benefits up to 50% the maximum deduction described above.
- For the 2025 tax year, taxpayers born after 1945 and before 1967 would be able to elect to deduct retirement and pension benefits up to 75% the maximum deduction described above.
- For the 2026 tax year, all taxpayers would be able to elect to claim the maximum deduction of retirement and pension benefits described above.

The bill also would allow taxpayers with retirement or pension benefits received for service as a public police or fire department employee, a county corrections officer, or a state police trooper or state police sergeant to claim the tax treatment of retirement income available to taxpayers currently in Tier 1, beginning with the 2023 tax year.

As currently, the deduction available for joint returns would be based on the older spouse's date of birth. If the older spouse died, the surviving spouse could continue qualifying with the older spouse's birth year as long as they did not remarry.

School Aid Fund Earmark

The bill also would change the percentage of income tax collection that is deposited in the State School Aid Fund (SAF). Currently, the act requires a percentage of gross individual income tax revenue (i.e., income tax revenue before refunds) to be deposited in the SAF. That percentage is 1.012% divided by the tax rate (currently 4.25%), or about 23.8%.

For fiscal year (FY) 2023-24, the bill would increase this earmark to the SAF to 1.015% divided by the tax rate. For FY 2024-25, the earmark would be 1.023% divided by the income tax rate. For FY 2025-26, the earmark would be 1.033% divided by the tax rate. Beginning in FY 2026-27, the earmark would be 1.040% divided by the tax rate. The percentage of gross collections earmarked to the SAF is shown in the chart below (for a 4.25% tax rate).

FY 2022-23 (current)	23.812%
FY 2023-24	23.882%
FY 2024-25	24.071%
FY 2025-26	24.306%
FY 2026-27 and beyond	24.471%

Michigan Taxpayer Rebate Fund

The bill also would create the Michigan Taxpayer Rebate Fund in the state treasury. The fund could receive money and other assets from any source. The state treasurer would direct the investment of the fund and credit to the fund any interest and earnings from fund investments.

If the bill takes effect before April 18, 2023, the fund would be used to issue a rebate of $180 to each ***eligible taxpayer*** for the 2022 tax year. If the eligible taxpayer was married and did not file a joint return for the 2022 tax year, the rebate would be $90. If the eligible taxpayer was married and filed a joint return, the rebate would be $90 for each spouse.

> ***Eligible taxpayer*** would mean an individual taxpayer who was a resident of this state as of December 31, 2022, and who filed an income tax return for the 2022 tax year on or before October 18, 2023. The term would include a spouse who filed a joint state income tax return for the 2022 tax year, even if only one spouse on the joint return was a Michigan resident as of December 31, 2022. It would also include a ***claimant*** who did not file a state income tax return for the 2022 tax year but filed a claim for the homestead property tax credit or the home heating credit for the 2022 tax year on or before October 18, 2022. It would not include a nonresident individual or an individual for whom a dependency exemption is allowable to another taxpayer for the 2022 tax year.
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> ***Claimant*** means an individual who filed a claim for the homestead property tax credit or the home heating credit and, if the claim was for the homestead credit, was domiciled in Michigan at least six months of the previous calendar year.

The rebate would be an advance refund payment of a refundable credit against tax liability for the 2023 tax year. The credit amount available to an eligible taxpayer would equal the amount of the rebate, and the credit amount when claimed for the 2023 tax year would be reduced by the amount of the advance refund issued.

The Department of Treasury would have to issue the advance refund payment automatically as soon as practical under procedures established by the department. The payment would be disbursed electronically to the direct deposit account authorized by the taxpayer for the 2022 tax year. If the taxpayer did not authorize direct deposit, the refund would be issued as a negotiable check sent by first-class mail. No advance refunds would be issued after December 31, 2023.

The advance refund payment would be exempt from interception, execution, levy, attachment, garnishment or any other legal process to collect a debt. It could not be applied as an offset to a liability of the taxpayer under 1941 PA 122 or any arrearage or other debt.

Money in the fund at the end of each fiscal year would remain in the fund, except that money in the fund after all rebates have been issued would lapse to the general fund at the end of that fiscal year.

Earned Income Tax Credit Increase

House Bill 4001 would also increase value of the state EITC. The state EITC is a refundable individual income tax credit which is now capped at 6% of the federal EITC. (The state credit was previously capped at 20% of the federal credit until it was reduced to 6% by 2011 PA 38.)

The bill would increase the state EITC cap to 30% of the federal credit, beginning in the 2023 tax year.

In addition, the bill would allow taxpayers that claim the credit for the 2022 tax year to claim an additional one-time credit equal to 24% of the taxpayer's federal EITC. The credit to which each taxpayer is entitled would be calculated by the Department of Treasury and would have to be refunded as soon as practical.

Distribution of Corporate Income Tax Revenue

The bill also would amend the distribution of revenue collected under Part 2 of the Income Tax Act, which includes the corporate income tax and various other business taxes. Currently, the act provides that revenue collected under Part 2 be deposited into the general fund.

If the bill takes effect before April 18, 2023, $800.0 million of the revenue would be deposited into the Michigan Taxpayer Rebate Fund (see above) for FY 2021-22 only. The remaining revenue collected for that fiscal year would be deposited in the general fund.

The bill also would provide for the distribution of this revenue to various funds in future fiscal years. For FY 2022-23 through FY 2024-25, up to $1.2 billion would initially be deposited into the general fund. After this amount, deposits would be made in the following order:

- Up to $50.0 million to the Michigan Housing and Community Development Fund.
- Up to $50.0 million to the Revitalization and Placemaking Fund (see below).
- Up to $500.0 million to the Strategic Outreach and Attraction Reserve (SOAR) Fund.
- Any remaining balance to the general fund.

For each fiscal year beginning with FY 2025-26, $50.0 million of the revenue collected under Part 2 would be deposited in the Michigan Housing and Community Development Fund. The remaining revenue would be deposited in the general fund.

Revitalization and Placemaking Fund

The bill would create the Revitalization and Placemaking Fund in the state treasury. The fund could receive money and other assets from any source. The state treasurer would direct the investment of the fund and credit to the fund any interest and earnings from fund investments. Money in the fund at the end of each fiscal year would remain in the fund.

Beginning with FY 2022-23, the Michigan Strategic Fund (MSF) would expend money from the fund, upon appropriation, to create and operate the Revitalization and Placemaking Grants Program. The program would invest in projects that enable population and tax revenue growth by doing the following:

- Rehabilitating vacant and blighted buildings and historic structures.
- Rehabilitating and developing vacant properties.
- Developing permanent place-based infrastructure associated with social zones and traditional downtowns, outdoor dining, and place-based public spaces.

Residential projects for which grant funds are used would have to comply with other program guidelines and eligibility requirements as determined by MSF.

MSF would have to prepare and submit a report to the House and Senate appropriations committees by December 31 annually detailing the amount of revenue received by the fund and expenditures from it during the prior state fiscal year and the fund balance at the end of the prior fiscal year.

MCL 206.30 et seq.

FISCAL IMPACT:

Using information provided by the Department of Treasury, the phase-in of the exemption against retirement income and changes to the treatment of police and fire retirement pension benefits would reduce general fund revenue by about $58 million in FY 2022-23, $233 million in FY 2023-24, $408 million in FY 2024-25, and about $515 million in FY 2025-26. The revenue reduction would be expected to grow over time as new retirees become eligible and distributions from retirement accounts increase. It should be noted that, because of the changes to the School Aid Fund earmarks, the School Aid Fund will be held harmless against the revenue loss, with the full reduction coming from general fund revenue.

In addition, an increase in the earned income tax credit from the current 6% of the federal EITC to 30% of the federal EITC beginning with TY 2022 would be expected to reduce individual income tax revenue by about $385 million per year beginning in FY 2022-23. Because the expanded EITC affects net income tax refunds, the full impact would likely be borne be the general fund.

Earmarks of corporate income tax (CIT) revenue are expected to reduce general fund revenue by $800 million in FY 2021-22, *up to* $600 million in FY 2022-23 through FY 2024-25, and *up to* $50 million per year thereafter beginning with FY 2025-26. The CIT earmark estimates in Table 1 below are based on January 2023 Consensus Revenue Estimating Conference (CREC) projections for CIT revenue. CIT revenue is not estimated to reach $1.8 billion in FY 2022-23 and FY 2023-24, which would be necessary for the entire SOAR Fund deposit to be realized.

Based on January 2023 CREC revenue estimates and preliminary final revenue, the FY 2021-22 earmark of CIT revenue would reduce FY 2021-22 GF/GP revenue to an amount below capped GF/GP revenue, which would result in no income tax rate reduction.

From the $800.0 million of CIT revenue earmarked in FY 2021-22 to the Michigan Taxpayer Rebate Fund, the bill would authorize the Department of Treasury to distribute a tax rebate of $180 to each eligible taxpayer. Under the provisions of the bill, both a joint return and single return would receive $180. Any amount remaining in the fund not distributed as a rebate would lapse to the general fund.

According to the Department of Treasury, the EITC provisions requiring the department to distribute refunds to taxpayers for the 2022 tax year via check will cost approximately $925,000. Costs include mailing, printing, and issuing checks to taxpayers, as well as processing returns, handling correspondence with taxpayers, and any other activities necessary to administer the changes. The provisions could require up to two additional full-time equated positions.

The department indicated that the retirement tax phase-in component would increase annual administrative costs by approximately $225,000 to accommodate 2.0 FTEs over four years beginning in FY 2023-24. Additionally, the tax rebates are expected to increase administrative costs by $2.2 million on a one-time basis for temporary staff, information technology system changes, and tax rebate check processing. Of that total, approximately $2.0 million would support check processing.

Table 1: Estimated Impact on GF/GP Revenue (in millions)

	FY 2022	FY 2023	FY 2024	FY 2025	FY 2026
Retirement Income Tax Exemption Phase-in	--	($58.0)	($233.0)	($408.0)	($515.0)
Earned Income Tax Credit Increase	--	(385.0)	(385.0)	(385.0)	(385.0)
CIT Earmarks:*					
Strategic Outreach and Attraction Reserve Fund	--	(460.0)	(465.0)	(500.0)	--
Michigan Taxpayer Rebate Fund	(800.0)	--	--	--	--
Revitalization and Placemaking Fund	--	(50.0)	(50.0)	(50.0)	--
MI Housing and Community Development Fund	--	(50.0)	(50.0)	(50.0)	(50.0)
TOTAL	**($800.0)**	**($1,003.0)**	**($1,183.0)**	**($1,393.0)**	**($950.0)**

**CIT Earmark estimates are based on January 2023 Consensus Revenue Estimating Conference revenue estimates.*

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