Legislative Analysis

HOUSE FI$CAL AGENCY

PHASE OUT THREE-TIER TAX TREATMENT
OF RETIREMENT INCOME

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House Bill 4001 as introduced
Sponsor: Rep. Angela Witwer
Committee: Tax Policy
Complete to 1-25-23

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 pensions benefits and to increase the percentage of gross income tax collections earmarked to the State School Aid Fund.

The three-tier system 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 deduct retirement or pensions benefits up to 25% of the maximum deduction they would be able to take if the tiered system were not in place. (This maximum deduction is the deduction allowed for taxpayers in Tier 1.)
- For the 2024 tax year, taxpayers born after 1945 and before 1963 would be able to deduct retirement and pension benefits up to 50% the maximum deduction available if the tiered system were not in place.
- For the 2025 tax year, taxpayers born after 1945 and before 1967 would be able to deduct retirement and pension benefits up to 75% the maximum deduction available if the tiered system were not in place.
- For the 2026 tax year, the tier system would be eliminated and all taxpayers would be able to claim the maximum deduction of retirement and pension benefits.

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.

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 1.019% divided by the tax rate. For FY 2024-25, the earmark would be 1.031% divided by the income tax rate. Beginning in FY 2025-26, the earmark would be 1.045% 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	23.976%
FY 2024-25	24.259%
FY 2025-26 and beyond	24.588%

MCL 206.30 and 206.51

FISCAL IMPACT:

As written, House Bill 4001 can be expected to reduce general fund revenue by just over $450 million when fully phased in as of FY 2025-26. Using information supplied by the Department of Treasury, the phase-in would reduce general fund revenue by about $40 million in FY 2022-23, $175 million in FY 2023-24, $340 million in FY 2024-25, and, as noted, about $450 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.

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■ 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.