State Notes

TOPICS OF LEGISLATIVE INTEREST

Summer 2011

Michigan Income Taxes on Seniors and Retirees Under the 2011 Tax Restructuring Legislation

By David Zin, Chief Economist

Introduction

On May 25, 2011, Governor Snyder signed House Bill (HB) 4361 into law as Public Act (PA) 38 of 2011 and initiated arguably the most substantial changes in the Michigan individual income tax since its establishment in 1967. House Bill 4361 was part of a package of bills to substantially alter business taxes in Michigan. In addition to changes in the individual income tax, the package repealed the Michigan Business Tax for most businesses and imposed a corporate income tax. The business tax changes were estimated to reduce tax revenue by $1,094.3 million in FY 2011-12, and $1,647.6 million in FY 2012-13. In addition to making changes in the tax rate and base, PA 38 also repeals a substantial number of credits against the tax and substantially modifies the Homestead Property Tax Credit (HPTC). The total of these individual income tax changes is expected to generate an additional $559.1 million in FY 2011-12 and $1,423.7 million during FY 2012-13, the first full fiscal year the changes will be effective. Except for changes to the income tax rate, which take effect October 1, 2011, PA 38 will not take effect until January 1, 2012, and therefore will not affect the taxation of income in 2011.

Among the most controversial changes, and those that generate the largest share of the increased revenue, are changes in the way retirement and pension benefits are taxed. This article will summarize those changes, as well as discuss select other changes that affect seniors -- the demographic group that represents the largest share of taxpayers who receive retirement and pension benefits.

Background

Retirement and pension benefits include distributions from a wide variety of plans and savings instruments, including: qualified trusts and annuity plans operated under Section 401(a) of the Internal Revenue Code (including plans for self-employed individuals, such as KEOGH plans); individual retirement accounts (IRAs) under Section 408, if distributions are not made until the participant is at least age 59-1/2; employee annuities or tax-sheltered annuities purchased under section 403(b) by 501(c)(3) organizations or public school systems; 401(k) distributions related to employer contributions or mandatory employee contributions; plans maintained by churches or associations of churches; and other unqualified plans that prescribe eligibility for retirement and predetermine contributions or benefits, if the distributions are made from a pension trust. Effectively, if an employer sets rules on the retirement plan and contributes money to the plan, Michigan tax law treats it as a retirement or pension benefit.

Many of the changes in PA 38 affect different types of retirement and pension income differently. For example, for some taxpayers income from public pensions will no longer be fully exempt, while income from private pensions will face a different set of exemptions. Both public and private pensions include defined benefit plans, in which an employee earns a specified retirement payment based on years of service and average compensation, and defined contribution plans, in which an employee receives a specified payment from his or her employer into a retirement account during the term of their employment. Public pensions are those that are created by the Federal government, the State of Michigan, or a political subdivision of Michigan. Public pensions also include those from a retirement system of another state or local government, if the tax treatment for Michigan retirement income is taxed in a reciprocal fashion. As a result, affected pensions include a wide variety of retirement plans, including 401k and 457 plans and both defined contribution and defined benefit plans, from a wide variety of employers.

Under the law prior to PA 38, retirement and pension benefits from public entities were exempt from taxation, as were social security benefits. Similarly, compensation and retirement benefits received for service in the U.S. armed forces were exempt from the income tax. Income from private pensions was exempt from taxation up to a certain level that was adjusted for inflation. In tax year 2010, $45,120 of income from private pensions was exempt for single filers, while married filing jointly taxpayers received an exemption of $90,240. Certain withdrawals from retirement plans that were directed to charitable institutions or used to pay higher education expenses also were exempt from taxation. Seniors also received an exemption for interest, dividends, and capital gains, up to a specified level that was adjusted for inflation. In tax year 2010, $10,058 of interest, dividends, and capital gains earned by single seniors was exempt, while married filing jointly taxpayers received an exemption of $20,115. Several of these exemptions were reduced by any amount claimed under other provisions. For example, the exemption for private pension income was reduced by any exemptions claimed for military service or a public pension. Each senior claimed as a dependent also received an additional deduction, which totaled $2,300 in tax year 2010.

Taxpayers Born Before 1946

Public Act 38 makes no changes in the treatment of retirement or pension income for taxpayers born before 1946. (For married couples, the age of the older spouse determines if they fall into this category.) For these taxpayers, public pensions, as well as social security benefits and several other categories of income (including social security income), remain completely exempt from taxation. A portion of pension and retirement income from private plans will continue to be exempt from tax ($45,120 for single filers or $90,240 for joint filers in tax year 2010, and adjusted for inflation), and the private pension exemption will continue to be reduced by the amount of any compensation and retirement benefits received for service in the armed forces as well as any public pension. However, not only does PA 38 retain the provisions regarding the interaction of these exemptions, but it also reduces the private exemption by the amount of any retirement or pension benefits received under the Federal Railroad Retirement Act of 1974.

As shown in Table 1, while PA 38 does not change the tax treatment of retirement or pension income for individuals born before 1946, numerous other changes in the bill do affect these individuals. Among the changes that will affect individuals born before 1946 are the elimination of the additional deduction for seniors, changes in the tax rate, changes in the HPTC, and the phase-out of the standard exemption for higher-income taxpayers.

Taxpayers Born During the 1946-1952 Period

For taxpayers born during the 1946 to 1952 period (determined by the age of the older spouse, for married couples), PA 38 limits many of the exemptions for retirement and pension income, although the exemptions for social security income and several other types of income (such as income related to service in the armed forces) are retained while taxpayers are less than 67 years of age. For taxpayers in this age group who have not yet reached age 67, PA 38 limits the value of exemption of pension and retirement income to $20,000 for a single return or $40,000 for a joint return, regardless of whether the income is from a public or private pension. After the taxpayer reaches age 67, PA 38 keeps the exemption amount the same, but applies the exemption to all income, including retirement and nonretirement income. However, a taxpayer in this age group with household income of more than $75,000 if single, or $150,000 if married filing jointly, may not claim the exemption. Similarly, a taxpayer who claims the unlimited deduction for income related to service in the armed forces, or for income under the Railroad Retirement Act of 1974, may not claim the $20,000/$40,000 exemption. Under PA 38, a taxpayer in this age group may continue to claim the standard personal exemption, regardless of age or whether any other deduction or exemption is claimed.

As will be discussed later, the more general provisions of PA 38 also will affect taxpayers in this age group, including the elimination of the additional deduction for seniors, changes in the tax rate, changes in the HPTC, and the phase-out of the standard exemption for higher-income taxpayers. Table 2 shows the changes in tax treatment for this group.

Taxpayers Born After 1952

For taxpayers born after 1952 (determined by the age of the older spouse, for married couples), PA 38 eliminates any exemption of public or private pension or retirement income until the taxpayer reaches 67 years of age, although the exemption for other social security income and certain other types of income (such as income related to service in the armed forces) is retained. After a taxpayer reaches age 67, PA 38 eliminates the standard personal exemption and creates a deduction ($20,000 for a single return or $40,000 for a joint return) against all types of income, including social security income and other types of income (including retirement and nonretirement income).

Public Act 38 allows a taxpayer to forgo the $20,000/$40,000 exemption and instead deduct 100% of social security income and continue to claim the standard personal exemption. As with taxpayers born during the 1946-1952 period, PA 38 also eliminates the $20,000/$40,000 exemption if total household resources exceed $75,000 for a single return, or $150,000 for a joint return, or if a taxpayer claims the deduction for a military pension or railroad pension. Table 3 shows the changes in the tax treatment for individuals born after 1952.

Other Significant Provisions Affecting Seniors and Retirees

Regardless of age, PA 38 eliminates the standard personal exemption if total household resources exceed $75,000 for a single return, or $150,000 for a joint return. All taxpayers will also be affected by the changes in the tax rate, which had been scheduled to drop 0.1 percentage point, to 4.25%, on October 1, 2011, and then drop another 0.1 percentage point every October 1 after that until the rate reached 3.9%. Under PA 38, the rate is scheduled to remain at 4.35% through January 1, 2013, when it will decline to 4.25%. No additional rate reductions are scheduled under PA 38.

All taxpayers, regardless of age, also will be affected by the provisions in PA 38 that eliminate nonrefundable credits, including the Public Contribution Credit, the Homeless Shelter/Food Bank Credit, and the Community Foundation Credit. Similarly, all taxpayers living in a city with an income tax will be affected by the elimination of the City Income Tax credit.

Beginning January 1, 2012, senior citizens born after 1945 will no longer be able to deduct a portion of interest, dividends, and capital gains received. Prior to PA 38, seniors age 65 or older could deduct a portion of this income, up to $10,058 for singles and $20,115 for joint filers in tax year 2010, although the deduction was reduced by the amount of any exemptions claimed for public and private pension benefits or income related to service in the armed forces. Other deductions related to retirement income that are eliminated by PA 38 include distributions from certain individual retirement accounts used to pay qualified higher education expenses and charitable contributions made from a qualified retirement plan or account.

The additional $1,800 exemption allowed for each individual age 65 and older claimed by taxpayer, is terminated by PA 38. The elimination of this provision affects all taxpayers and dependents age 65 and older, regardless of the year they were born.

Regardless of age, taxpayers will no longer be eligible for the Homestead Property Tax Credit if the taxable value of their homestead exceeds $135,000. (For a new home, this limit equates to a sale value of $270,000.) Public Act 38 also lowers the household income limits for taxpayers to be eligible for the HPTC, with the credit phased out starting at total household resources of $41,000 and eliminated once total household resources reach $50,000. Prior to PA 38, the phase-out did not begin until household income exceeded $73,650.

For most taxpayers, the HPTC is calculated based on some percentage of the property taxes that exceed 3.5% of household income. Prior to PA 38, the applicable percentage varied, with most taxpayers receiving 60.0%, while seniors and disabled individuals were able to receive 100%. Changes were enacted in PA 38 that affect the HPTC, but some of the changes conflict with others, and likely will require additional cleanup legislation to correct the problem.

Originally, the Governor's proposal for the HPTC increased the percentage for most taxpayers to 80.0%, lowered the percentage for seniors from 100% to 80.0%, and kept the percentage for disabled individuals at 100%. According to information released during legislative debate on the bill, the legislation's intent was to eliminate the difference in rates between seniors and most taxpayers, setting the applicable percentage at 60.0%, except for senior citizens with income of $21,000 or less, where the applicable percentage would be 100%, and phased down in four percentage point increments every $1,000 of household resources until the applicable percentage declined to 60.0% at household resources of $30,000. Public Act 38 does contain these provisions, but it also contains language (that had been inserted at one point in a separate section, but not subsequently removed) to make the applicable percentage 100% for all seniors, regardless of income (rather than only for seniors with household resources of $21,000 or less). As a result, PA 38 offers seniors two different, and somewhat contradictory, formulas for computing the HPTC. Consequently, it is anticipated that legislation to correct this issue will be introduced at some point, particularly given that the revenue estimates for the bill assumed that the language providing seniors with 100% HPTC would be limited to those with household resources of $21,000 or less.

Prior to PA 38, several types of withdrawals or contributions from retirement income were either deductible or exempt from taxation. For example, charitable contributions made from a retirement plan were deductible, and withdrawals used to pay higher education expenses were exempt from taxation. Public Act 38 eliminates most of these provisions, although contributions and payments to the Michigan Education Trust or a Michigan Education Savings Plan remain exempt.

Conclusion

Changes in the taxation of retirement and pension income are expected to account for $224.9 million (40.2%) of the $559.1 million of increased individual income tax revenue in FY 2011-12, and $343.8 million (24.1%) of $1,423.7 million of increased individual income tax revenue in FY 2012-13, under PA 38. While individuals born before 1946 are largely held harmless from the changes in the taxation of pension income, all seniors (whether or not they receive retirement or pension income) will be affected by other changes in the bill. The elimination of the additional senior exemption, combined with the elimination of the senior exemption for interest, dividends and capital gains, accounts for another $12.9 million of the revenue increase in FY 2011-12, and $47.2 million of the revenue increase in FY 2012-13. Seniors also will be affected by the higher tax rates on other types of incomes, the changes in the HPTC, and the elimination of the nonrefundable credits.

Public Act 38 makes significant changes in Michigan's individual income tax, changes that will affect every taxpayer in the State. Seniors, and individuals receiving some sort of retirement or pension income, are perhaps the demographic most affected by the changes. While the legislation phases in a system that will tax income more uniformly, eliminating many provisions that treated income from different sources differently, the transition period will not only retain some of this differential treatment but also treat the same income differently based on the age of the taxpayer. During the phase-in period, for the same income, taxpayers born in earlier years will receive more exemptions and deductions from income than taxpayers born in later years will receive. As a result, as taxpayers born in earlier years die and individuals born after 1952 represent an increasingly larger portion of seniors, the individual income tax revenue generated from seniors under the provisions of PA 38 will increase.

Table 1

Taxation of Individuals Born Before 1946

Type of Income	Previous Law	New Law
Wage Income	Taxed	Taxed
Compensation/Retirement benefits received for service in U.S. armed forces	Exempt	Exempt
Retirement/Pension benefits under Railroad Retirement Act of 1974	Taxed	Exempt
Retirement/Pension benefits from a Federal public retirement system	Exempt	Exempt
Retirement/Pension benefits from a Michigan public retirement system	Exempt	Exempt
Retirement/Pension benefits from a public retirement system of local government in Michigan	Exempt	Exempt
Retirement/Pension benefits from other state/local retirement system with reciprocal treatment of Michigan income	Exempt	Exempt
Retirement/Pension benefits from any other retirement system/pension system/retirement annuity[1)]	Limited Exemption	Limited Exemption
Other types of retirement income[2)]	Taxed	Taxed
Social Security benefits	Exempt	Exempt
Eligible under Section 22 of Internal Revenue Code (elderly/disabled credit)	Exempt	Exempt
Charitable contributions/payments to the Michigan Education Trust	Exempt	Exempt
Contributions to Michigan Education Savings Account	Exempt	Exempt
Interest/dividends/capital gains received by senior citizens	Limited Exemption	Limited Exemption
IRA withdrawals used to pay higher education expenses	Exempt	Taxed
Charitable contributions made from a retirement or pension plan	Exempt	Taxed
Additional deduction for seniors	$2,300	None
Personal exemption	Not Limited	Limited
Nonrefundable Credits (homeless shelter/food bank, city income tax, public contributions, etc.)	Available	Eliminated
Homestead Property Tax Credit		
Percent of tax eligible for credit for regular/seniors[3)]	60%/100%	Varies based on income
Income eligibility phase-out range	$73,650-$82,650	$41,000-$50,000
Business income included in household income	Yes	No
Taxable value cap	None	$135,000
Maximum credit	$1,200	$1,200

1) Includes retirement and pension benefits from private systems, whether defined benefit (traditional pension) or defined contribution (such as a 401k plan).
2) Includes all retirement income not listed elsewhere, such as nonqualified IRAs and self-purchased annuities.
3) See text for additional explanation.

Table 2

Taxation of Individuals Born During 1946-1952 Period

Type of Income	Previous Law	New Law: Prior to Age 67	New Law: Age 67 or Older
Wage income	Taxed	Taxed	Taxed
Compensation/Retirement benefits received for service in U.S. armed forces	Exempt	Exempt[4]	Exempt[4]
Retirement/Pension benefits under Railroad Retirement Act of 1974	Taxed	Exempt[4]	Exempt[4]
Retirement/Pension benefits from a Federal public retirement system	Exempt	Limited Exemption[4]	Limited Exemption[4]
Retirement/Pension benefits from a Michigan public retirement system	Exempt	Limited Exemption[4]	Limited Exemption[4]
Retirement/Pension benefits from a public retirement system of local government in Michigan	Exempt	Limited Exemption[4]	Limited Exemption[4]
Retirement/Pension benefits from other state/local retirement system with reciprocal treatment of Michigan income	Exempt	Limited Exemption[4]	Limited Exemption[4]
Retirement/Pension benefits from any other retirement system/pension system/retirement annuity[1]	Limited Exemption	Limited Exemption[4]	Limited Exemption[4]
Other types of retirement income[2]	Taxed	Taxed	Limited Exemption[4]
Social Security benefits	Exempt	Exempt	Exempt
Eligible under Section 22 of Internal Revenue Code (elderly/disabled credit)	Exempt	Exempt	Exempt
Charitable contributions/payments to the Michigan Education Trust	Exempt	Exempt	Exempt
Contributions to Michigan Education Savings Account	Exempt	Exempt	Exempt
Interest/dividends/capital gains received by senior citizens	Limited Exemption	Taxed	Limited Exemption[4]
IRA withdrawals used to pay higher education expenses	Exempt	Taxed	Taxed
Charitable contributions made from a retirement or pension plan	Exempt	Taxed	Taxed
Additional deduction for seniors	$2,300	None	None
Personal exemption	Not Limited	Limited	Limited
Nonrefundable Credits (homeless shelter/food bank, city income tax, public contributions, etc.)	Available	Eliminated	Eliminated
Homestead Property Tax Credit			
Percent of tax eligible for credit for regular/seniors[3]	60%/100%	Varies based on income	Varies based on income
Income eligibility phase-out range	$73,650-$82,650	$41,000-$50,000	$41,000-$50,000
Business income included in household income	Yes	No	No
Taxable value cap	None	$135,000	$135,000
Maximum credit	$1,200	$1,200	$1,200

[1] Includes retirement and pension benefits from private systems, whether defined benefit (traditional pension) or defined contribution (such as a 401k plan). [2] Includes all retirement income not listed elsewhere, such as nonqualified IRAs and self-purchased annuities. [3] See text for additional explanation. [4] Before the taxpayer reaches age 67, the total exemption for retirement and pension income in these categories is limited to $20,000 (single)/$40,000(joint). Once the taxpayer is age 67, the same exemption can be claimed against all income, not just retirement and pension income. The exemption is not available to taxpayers with incomes above $75,000 (single)/$150,000 (joint) or to those who elect to fully exempt compensation/retirement benefits received for service in the armed forces or under the Railroad Retirement Act.

Table 3

Taxation of Individuals Born After 1952

Type of Income	Previous Law	New Law: Prior to Age 67	New Law: Age 67 or Older
Wage income	Taxed	Taxed	Limited Exemption[4)]
Compensation/Retirement benefits received for service in U.S. armed forces	Exempt	Exempt	Exempt[4)]
Retirement/Pension benefits under Railroad Retirement Act of 1974	Taxed	Exempt	Exempt[4)]
Retirement/Pension benefits from a Federal public retirement system	Exempt	Taxed	Limited Exemption[4)]
Retirement/Pension benefits from a Michigan public retirement system	Exempt	Taxed	Limited Exemption[4)]
Retirement/Pension benefits from a public retirement system of local government in Michigan	Exempt	Taxed	Limited Exemption[4)]
Retirement/Pension benefits from other state/local retirement system with reciprocal treatment of Michigan income	Exempt	Taxed	Limited Exemption[4)]
Retirement/Pension benefits from any other retirement system/pension system/retirement annuity[1)]	Limited Exemption	Taxed	Limited Exemption[4)]
Other types of retirement income[2)]	Taxed	Taxed	Limited Exemption[4)]
Social Security benefits	Exempt	Exempt	Limited Exemption[4)]
Eligible under Section 22 of Internal Revenue Code (elderly/disabled credit)	Exempt	Exempt	Exempt
Charitable contributions/payments to the Michigan Education Trust	Exempt	Exempt	Exempt
Contributions to Michigan Education Savings Account	Exempt	Exempt	Exempt
Interest/dividends/capital gains received by senior citizens	Limited Exemption	Taxed	Limited Exemption[4)]
IRA withdrawals used to pay higher education expenses	Exempt	Taxed	Taxed
Charitable contributions made from a retirement or pension plan	Exempt	Taxed	Taxed
Additional deduction for seniors	$2,300	None	None
Personal exemption	Not Limited	Limited	Eliminated[4)]
Nonrefundable Credits (homeless shelter/food bank, city income tax, public contributions, etc.)	Available	Eliminated	Eliminated
Homestead Property Tax Credit			
Percent of tax eligible for credit for regular/seniors[3)]	60%/100%	Varies based on income	Varies based on income
Income eligibility phase-out range	$73,650-$82,650	$41,000-$50,000	$41,000-$50,000
Business income included in household income	Yes	No	No
Taxable Value Cap	None	$135,000	$135,000
Maximum credit	$1,200	$1,200	$1,200

[1)] Includes retirement and pension benefits from private systems, whether defined benefit (traditional pension) or defined contribution (such as a 401k plan). [2)] Includes all retirement income not listed elsewhere, such as nonqualified IRAs and self-purchased annuities. [3)] See text for additional explanation. [4)] Once the taxpayer is age 67, the total exemption for all income (including all income in these categories) is limited to $20,000 (single)/$40,000(joint). Taxpayers may elect to forgo this exemption, and instead fully exempt social security benefits and claim the personal exemption. The $20,000/$40,000 exemption is not available to taxpayers with incomes above $75,000 (single)/$150,000 (joint) or to those who elect to fully exempt compensation/retirement benefits received for service in the armed forces or under the Railroad Retirement Act.