Legislative Analysis

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

INCOME TAX DEDUCTION FOR EARLY DISTRIBUTION FROM IRA FOR MEDICAL EXPENSES

House Bill 5838 (Substitute H-1)
Sponsor: Rep. John Garfield
Committee: Tax Policy

First Analysis (5-23-06)

BRIEF SUMMARY: The bill would allow taxpayers to deduct from Michigan taxable income early distributions made from an IRA used for medical expenses.

FISCAL IMPACT: The fiscal impact cannot be determined because the number of taxpayers that would qualify is not known. The resulting reduction in income tax revenue is likely to be relatively small.

THE APPARENT PROBLEM:

Reportedly, it is not uncommon for taxpayers to take an early distribution from an IRA to pay for catastrophic medical expenses. When this occurs, the amount distributed is subject to taxation as ordinary income under federal tax laws. This income is then carried over and subject to state income tax as well. Also, depending on the amount distributed, the taxpayer may be required to make estimated tax payments to the state or face a penalty for filing a late payment or not filing at all. It has been suggested that an early distribution from an IRA used to pay medical expenses be excluded from state income taxation.

THE CONTENT OF THE BILL:

House Bill 5838 would amend the Income Tax Act to permit taxpayers, in determining Michigan taxable income, to subtract from AGI early distributions made from an IRA for medical expenses—as described in IRC Section 72 (t)(2)(B)—to the extent that the distribution was included in determining AGI.

MCL 206.30

BACKGROUND INFORMATION:

IRA Distributions

The federal Internal Revenue Code imposes a 10 percent penalty on early distributions from qualified retirement plans, such as a 401(k) or IRA. (Generally, early distributions are those received before age 59 ½.) However, under Section 72(t)(2)(b) of the IRC, a taxpayer may receive an early distribution to pay unreimbursed medical expenses less than or equal to the amount that may be deducted on a itemized federal return, without being subject to the 10 percent penalty. Section 213 of the IRC allows taxpayers to claim a deduction for unreimbursed medical expenses that exceed 7.5 percent of adjusted gross income. The taxpayer does not have to itemize to be exempted from the penalty provision. Early distributions are subject to taxation and combined with other types of income and various deductions to determine federal adjusted gross income, which becomes the starting point on the Michigan Income Tax return.

Estimated Payments

Under the Income Tax Act, taxpayers are required to make quarterly estimated payments if they reasonably expect to owe more than $500 when filing a yearly tax return. For the 2006 tax year, estimated payments are not necessary if the withholding for 2006 is expected to be at least: (1) 90 percent of the 2006 tax; (2) 100 percent of the 2005 taxes; or (3) 110 percent of 2005 taxes if the 2005 AGI was $150,000 ($75,000 for married, filing separately). Late payments are subject to a penalty equal to five percent of the total amount due. After two months, the penalty increases by an additional five percent per month, up to 25 percent of the amount due. In lieu of quarterly payments, taxpayers may make an advance payment for the succeeding year, on the current year's return. [For 2005 return, taxpayers may credit a portion of their refund, if any, to their 2006 estimated payment.]

ARGUMENTS:

For:

The bill provides some tax relief to taxpayers who must take an early distribution from an IRA to pay for unreimbursed medical expenses that exceed 7.5 percent of adjusted gross income. Generally, this income is subject to both federal and state income taxes. The decision to take an early distribution from an IRA isn't taken lightly, and often is done in cases of financial hardship. Subjecting this income to taxation further burdens taxpayers.

Currently, this income is included in federal Adjusted Gross Income, the starting point of a Michigan tax return. Medical expenses, however, are a "below the line" deduction, meaning that they are deducted from AGI to determine federal taxable income, and are not carried over onto a Michigan return. On a federal return, then, the taxpayer comes out even: they add as an IRA distribution, the amount deducted for unreimbursed medical expenses. Given that the state taxes this income but does not provide a similar deduction, the state, in some respects, penalizes the taxpayer.

Moreover, exempting this income from taxation avoids the possibility that some taxpayers may be required to make estimated payments or be subject to fines and penalties for failing to do so.

Against:

In essence, the bill allows a deduction for unreimbursed medical expenses if the money used to pay those expenses comes from an IRA. Deductions of this nature, however, are not provided for within the Income Tax Act. The bill sets a bad precedent, opening the door to other deductions in the future and further eroding the tax base. Moreover, the bill does not treat taxpayers equitably. For example, a taxpayer who pays unreimbursed medical expenses out of a savings account cannot claim a deduction on a state return.

POSITIONS:

The Department of Treasury opposes the bill. (5-3-06)

Legislative Analyst: Mark Wolf
Fiscal Analyst: Jim Stansell