

401(K) DISTRIBUTIONS, ETC.

House Bill 5106 (Substitute H-2) First Analysis (4-26-00)

**Sponsor: Rep. Jim Howell
Committee: Tax Policy**

THE APPARENT PROBLEM:

Under the Income Tax Act, taxpayers may deduct certain retirement and pension benefits when calculating taxable income for purposes of the state income tax. A taxpayer can deduct up to \$34,170 for a single filer or \$68,340 for joint filers in private retirement and pension benefits. (The deduction amounts cited are for the 1999 tax year; they are adjusted for inflation annually.) However, those amounts must be reduced by the amount of public retirement benefits received. The current level of deductions stems from 1994 legislation that aimed to put private pensions on an equal footing with public pensions. Public pensions had been completely exempt from taxation but not private pension and retirement income. The term "retirement and pension benefits" is defined in the Income Tax Act to include some 401(k) distributions (payouts) and exclude others.

The act says a taxpayer can deduct distributions from a 401(k) plan attributable to employee contributions mandated by the plan or attributable to employer contributions. (The instructions that accompany the state income tax form say a taxpayer can deduct distributions "attributable to employer contributions or attributable to employee contributions to the extent they result in matching contributions by the employer.") Other distributions from 401(k) plans apparently are not deductible. In particular, the act says a taxpayer cannot deduct amounts received from a deferred compensation plan that lets the employee determine the amount to be put aside and does not set a retirement age or requirements for years of service. Some people consider these provisions confusing and unfair. They say that it can be difficult for a taxpayer to determine what portion of a distribution is attributable to employer contributions to a plan and what portion to employee contributions, and it can be difficult for a taxpayer to know if a plan qualifies for the deduction at all. They argue that all 401(k) distributions, and distributions from similar plans, should be treated alike and be included in the amounts that can be deducted from income.

THE CONTENT OF THE BILL:

The bill would amend the Income Tax Act to allow all distributions from a 401(k) plan to be included in the definition of "retirement or pension benefits" for the purpose of the deduction of such benefits when calculating taxable income. Similarly, distributions from 403(b) plans would be included in the definition. The existing provisions that prevent some 401(k) and 403(b) plans from being deducted would be eliminated from the act.

MCL 206.30

FISCAL IMPLICATIONS:

The House Fiscal Agency has estimated that the bill could reduce income tax revenues by as much as \$15 million to \$20 million. Of this, about \$4.5 million would be lost to the State School Aid Fund with the bulk of the remainder lost to the General Fund. (HFA fiscal note dated 11-15-99) The Department of Treasury testified before the House Tax Policy Committee that its revenue loss estimate was about \$10 million. (4-25-00)

ARGUMENTS:

For:

The bill would simply allow the deduction of all distributions (payouts) from 401(k) plans in the calculation of taxable income. This would remove the current confusing and unfair provisions that allow some 401(k) distributions to be counted as retirement and pension income but not others. The bill treats 403(b) distributions similarly. The bill is consistent with legislative efforts over the past few years to put retirement income from private sources on an even footing with retirement income from public pensions. For years public pensions were fully exempt from the state income tax but only a smaller portion of private retirement income. In 1994, the legislature substantially increased the amount of private retirement and pension income that is exempt. The 401(k) and 403(b) distributions would be subject to the retirement and pension income deduction cap. It should be noted that some people say that the bill should have no significant

fiscal impact on the state because knowledgeable retirees, or those with good advisors, would in any case “roll over” their 401(k) into an individual retirement account (IRA) because distributions from IRAs are fully deductible.

Against:

State tax officials are concerned about the fiscal impact of the bill and have recommended that the issue be put off for now and re-examined after the next revenue forecasting conference later this spring.

POSITIONS:

The Department of Treasury is opposed to the bill at this time. (4-25-00)

Analyst: C. Couch

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