Legislative Analysis

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ELIMINATE THREE-TIERED TREATMENT OF RETIREMENT INCOME

House Bill 4002 as introduced
Sponsor: Rep. Joseph N. Bellino, Jr.
Committee: Tax Policy
Complete to 4-13-21

SUMMARY:

House Bill 4002 would amend Part 1 of the Income Tax Act by allowing an exemption for the distribution of retirement income after December 31, 2021. This exemption would apply to retirement income for all taxpayers, regardless of the taxpayer's date of birth. The bill would also allow for all senior citizens a deduction of certain investment income that is currently only available to those born before 1946.

Currently under the act, retirement income is taxed in a three-tier system, depending on the taxpayer's date of birth:

In the first tier, for taxpayers born before 1946, public pension and social security income is tax-exempt. Eligible taxpayers in this tier may subtract private retirement income, but the exemption for private retirement income or for a combination of private retirement income and tax-exempt public retirement income cannot exceed a specific limit, which for tax year 2018 is $51,570 for single filers and $103,140 for joint filers.

In the second tier, for taxpayers born between 1946 and 1952, taxation of retirement income varies depending on whether the taxpayer has reached the age of 67. For those who have not, their social security, railroad pension, and military pension income is tax-exempt. They are eligible for an exemption against retirement income of $20,000 for single filers or $40,000 for joint filers. Once they reach age 67, they are eligible for an exemption against all income of $20,000/$40,000, but only if they do not choose to claim a military or railroad pension exemption.

In the third tier, for taxpayers born after 1952, taxation once again varies based on whether the taxpayer has reached the age of 67. For those younger than 67 (currently everyone in this cohort), social security, railroad pension, and military pension income is once again tax-exempt. These taxpayers also are ineligible for retirement income exemptions. Like taxpayers in tier two, once they turn 67, they are eligible for an exemption against all income of $20,000 for single filers and $40,000 for joint filers if they claim no military or railroad pension exemption. However, unlike tier two taxpayers, they would also be unable to claim a social security or personal exemption. Or, they may choose to receive the social security, military or railroad pension, and personal exemptions, but not the overall exemption of $20,000/$40,000. As such, tier three taxpayers are subject to less favorable tax treatment than tier two taxpayers.

For joint returns under this system, the date of birth of the older spouse determines the tax treatment of income reported jointly, regardless of the date of birth of the younger spouse.

The bill would remove this tiered system, and all taxpayers would receive the exemptions for retirement income currently allowed to taxpayers under the first tier.

Senior investment income deduction

Under current law, taxpayers who were born before 1946 (those in the first tier, above) may deduct income such as dividends, interest, and capital gains, up to a deduction limit that is indexed to inflation, with the maximum allowable deduction reduced by any subtraction from income made for retirement income exemptions. (For tax year 2020, the deduction limit is $11,983 for single filers and $23,966 for joint filers.) The bill would allow this deduction for all taxpayers 65 years of age or older.

The bill would apply beginning with the 2022 tax year.

MCL 206.30

BACKGROUND:

This bill is understood to be a partial repeal of 2011 PA 38,[1] which first introduced the three-tiered tax system for taxpayers collecting retirement income.

FISCAL IMPACT:

As written, the bill would reduce individual income tax revenue on a full fiscal year basis by about $370 million, and that amount would be expected to grow by about $10 million per year as new retirees become eligible and retirement accounts continue to grow. The School Aid Fund would be reduced by approximately $80 million, and the remaining $290 million reduction would be borne by the general fund.

Because the bill would restore the treatment of retirement income to pre-TY 2012 law, the $20,000/$40,000 exemption against all income available to tier two and tier three taxpayers would no longer exist and any taxpayers who continue to work beyond age 66 without drawing retirement income would likely realize a tax increase.

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[1] House Fiscal Agency analysis of 2011 PA 38 (HB 4361): http://www.legislature.mi.gov/documents/2011-2012/billanalysis/House/pdf/2011-HLA-4361-6.pdf