Legislative Analysis

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

Analysis available at
http://www.legislature.mi.gov

INCOME TAX ACT CHANGES

House Bill 4001 as enacted
Public Act 4 of 2023
Sponsor: Rep. Angela Witwer
House Committee: Tax Policy [Discharged]
Senate Committee: Committee of the Whole
Complete to 10-26-23

SUMMARY:

House Bill 4001 amends the Income Tax Act to provide for the phase-out of the three-tier system of taxing retirement and pension benefits, change the tax treatment of police and firefighter retirement income, increase the value of the state earned income tax credit (EITC), increase the percentage of gross income tax collections earmarked to the School Aid Fund, provide for the deposit of certain revenue collected under the act into various state funds, and create the Revitalization and Placemaking Fund.

Retirement Tax Phase-Out

The three-tier system for taxing retirement income 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 provides 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 will be able to elect to deduct retirement or pensions benefits up to 25% of the maximum deduction available to taxpayers in Tier 1 for private retirement income.
- For the 2024 tax year, taxpayers born after 1945 and before 1963 will be able to elect to deduct retirement and pension benefits up to 50% the maximum deduction described above.
- For the 2025 tax year, taxpayers born after 1945 and before 1967 will be able to elect to deduct retirement and pension benefits up to 75% the maximum deduction described above.
- For the 2026 tax year, all taxpayers will be able to elect to claim the maximum deduction of retirement and pension benefits described above.

The bill also will allow taxpayers with retirement or pension benefits received for service as a public police or fire department employee, a county corrections officer, or a state police trooper or state police sergeant to claim the tax treatment of retirement income available to taxpayers currently in Tier 1, beginning with the 2023 tax year.

As currently, the deduction available for joint returns will be based on the older spouse's date of birth. If the older spouse dies, the surviving spouse can continue qualifying with the older spouse's birth year as long as they do not remarry.

School Aid Fund Earmark

The bill also will 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 will increase this earmark to the SAF to 1.015% divided by the tax rate. For FY 2024-25, the earmark will be 1.023% divided by the income tax rate. For FY 2025-26, the earmark will be 1.033% divided by the tax rate. Beginning in FY 2026-27, the earmark will be 1.040% 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	23.882%
FY 2024-25	24.071%
FY 2025-26	24.306%
FY 2026-27 and beyond	24.471%

Earned Income Tax Credit Increase

House Bill 4001 also will increase value of the state EITC. The state EITC is a refundable individual income tax credit which is now capped at 6% of the federal EITC. (The state credit was previously capped at 20% of the federal credit until it was reduced to 6% by 2011 PA 38.) The bill will increase the state EITC cap to 30% of the federal credit, beginning in the 2023 tax year.

In addition, the bill will allow taxpayers that claim the credit for the 2022 tax year to claim an additional one-time credit equal to 24% of the taxpayer's federal EITC. The credit to which each taxpayer is entitled will be calculated by the Department of Treasury and have to be refunded as soon as practical.

Distribution of Corporate Income Tax Revenue

The bill also will amend the distribution of revenue collected under Part 2 of the Income Tax Act, which includes the corporate income tax and various other business taxes. Currently, the act provides that revenue collected under Part 2 be deposited into the general fund.

The bill will provide for the distribution of this revenue to various funds in future fiscal years. For FY 2022-23 through FY 2024-25, up to $1.2 billion will initially be deposited into the general fund. After this amount, deposits will be made in the following order:

- Up to $50.0 million to the Michigan Housing and Community Development Fund.
- Up to $50.0 million to the Revitalization and Placemaking Fund (see below).
- Up to $500.0 million to the Strategic Outreach and Attraction Reserve (SOAR) Fund.
- Any remaining balance to the general fund.

For each fiscal year beginning with FY 2025-26, $50.0 million of the revenue collected under Part 2 will be deposited in the Michigan Housing and Community Development Fund. The remaining revenue will be deposited in the general fund.

Revitalization and Placemaking Fund

The bill will create the Revitalization and Placemaking Fund in the state treasury. The fund can receive money and other assets from any source. The state treasurer will direct the investment of the fund and credit to the fund any interest and earnings from fund investments. Money in the fund at the end of each fiscal year will remain in the fund.

Beginning with FY 2022-23, the Michigan Strategic Fund (MSF) will expend money from the fund, upon appropriation, to create and operate the Revitalization and Placemaking Grants Program. The program will invest in projects that enable population and tax revenue growth by doing the following:

- Rehabilitating vacant and blighted buildings and historic structures.
- Rehabilitating and developing vacant properties.
- Developing permanent place-based infrastructure associated with social zones and traditional downtowns, outdoor dining, and place-based public spaces.

Residential projects for which grant funds are used will have to comply with other program guidelines and eligibility requirements as determined by MSF.

MSF will have to prepare and submit a report to the House and Senate appropriations committees by December 31 annually detailing the amount of revenue received by the fund and expenditures from it during the prior state fiscal year and the fund balance at the end of the prior fiscal year.

Michigan Taxpayer Rebate Fund

The bill also creates the Michigan Taxpayer Rebate Fund in the state treasury. The fund can receive money and other assets from any source. The state treasurer will direct the investment of the fund and credit to the fund any interest and earnings from fund investments.

If the bill had taken effect before April 18, 2023, $800.0 million of revenue collected under Part 2 of the act would have been deposited into the fund for FY 2021-22 only and would have been used to issue a rebate of $180 to each eligible taxpayer for the 2022 tax year. The remaining revenue collected for that fiscal year would have been deposited in the general fund. Since the bill did not take effect by the required date, these provisions did not take effect.

Effectiveness

In Michigan, an enacted bill cannot take effect as law until 90 days have passed after the end of the legislative session it was passed in. However, the legislature can give immediate effect to a bill by a two-thirds vote of members elected and serving in each house. House Bill 4001 was not given immediate effect by the legislature, so it will go into effect on the ninety-first day after the session is adjourned.

MCL 206.30 et seq.

FISCAL IMPACT:

Using information provided by the Department of Treasury, the phase-in of the exemption against retirement income and changes to the treatment of police and fire retirement pension benefits will reduce revenue by about $281 million in FY 2023-24, $350 million in FY 2024-25, $453 million in FY 2025-26, and approximately $500 million in FY 2026-27 when fully phased in. The revenue reduction will be expected to grow over time as new retirees become eligible and distributions from retirement accounts increase.

It should be noted that the intent of the changes to the School Aid Fund earmarks was to hold the School Aid Fund harmless against the revenue loss, with the full reduction coming from general fund revenue. However, due to the earmarks reflecting January 2023 Consensus Revenue Estimating Conference (CREC) estimates (most recent estimates available at the time of enactment), it is estimated that there will be a reduction to the SAF due to the retirement changes. In FY 2023-24 the SAF reduction would comprise $57 million of the $281 million total revenue impact and in FY 2024-25 it would comprise $74 million of the $350 million.

In addition, an increase in the earned income tax credit from the current 6% of the federal EITC to 30% of the federal EITC beginning with TY 2022 will be expected to reduce individual income tax revenue by about $385 million per year beginning in FY 2022-23. However, due to the lack of immediate effect individuals will not be able to claim the FY 2022-23 expanded EITC until FY 2023-24, which would double the impact in FY 2023-24 to approximately $770.0 million. Because the expanded EITC affects net income tax refunds, the full impact will likely be borne be the general fund.

Earmarks of corporate income tax (CIT) revenue are expected to reduce general fund revenue by *up to* $600 million in FY 2022-23 through FY 2024-25, and *up to* $50 million per year thereafter beginning with FY 2025-26. The CIT earmark estimates in Table 1 below are based on May 2023 CREC projections for CIT revenue. CIT revenue is estimated to reach $1.8 billion in FY 2022-23, FY 2023-24, and FY 2024-25, which would be necessary for the entire SOAR Fund deposit to be realized.

According to the Department of Treasury, the EITC provisions requiring the department to distribute refunds to taxpayers for the 2022 tax year via check will cost approximately $925,000. Costs include mailing, printing, and issuing checks to taxpayers, as well as processing returns, handling correspondence with taxpayers, and any other activities necessary to administer the changes. The provisions could require up to two additional full-time equated positions.

The department indicated that the retirement tax phase-in component will increase annual administrative costs by approximately $225,000 to accommodate 2.0 FTEs over four years beginning in FY 2023-24. Additionally, the tax rebates are expected to increase administrative costs by $2.2 million on a one-time basis for temporary staff, information technology system changes, and tax rebate check processing. Of that total, approximately $2.0 million would support check processing.

Table 1: Estimated Impact on Revenue (in millions)

	FY 2023	FY 2024	FY 2025	FY 2026
Retirement Income Tax Exemption Phase-in	--	($281.0)**	($350.0)**	($453.0)**
Earned Income Tax Credit Increase	--	(770.0)	(385.0)	(385.0)
CIT Earmarks:*				
Strategic Outreach and Attraction Reserve Fund	(500.0)	(500.0)	(500.0)	--
Revitalization and Placemaking Fund	(50.0)	(50.0)	(50.0)	--
MI Housing and Community Development Fund	(50.0)	(50.0)	(50.0)	(50.0)
TOTAL	**($600.0)**	**($1,651.0)**	**($1,335.0)**	**($950.0)**

**CIT Earmark estimates are based on May 2023 Consensus Revenue Estimating Conference revenue estimates.*
***In FY 2024, of the $281M impact $224M is GF and $57M is SAF; in FY 2025, of the $350M impact $276M is GF and $74M is SAF; and in FY 2026 of the $453M it is estimated that approximately $350M is GF and about $100M is SAF*

Legislative Analyst: Alex Stegbauer
Fiscal Analysts: Jim Stansell
Ben Gielczyk