Legislative Snapshot

Three Tiered Treatment of Retirement Income

Date: March 2023 **Analyst: Alex Stegbauer**

Summary

2011 PA 38 made significant changes to the Income Tax Act, including changes to the way retirement income is taxed in Michigan. The collection of income taxes on retirement income instituted by Public Act 38 has commonly been referred to as the "Pension Tax." This session, 2023 PA 4 provided for the phase-out of the current system of taxing retirement income by the 2026 tax year.

Pre-2011 System

Before the 2011 changes, Social Security, military, federal, and state and local government retirement income were fully exempt from 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. 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. In addition, defined benefit plans (i.e., pensions) from public employment were fully exempt.

Three-Tiered System

2011 PA 38 created a three-tier system under which the taxpayer's (or their spouse's) birth year determines how retirement income is taxed. For spouses filing a joint return, the treatment of retirement income is based on the birth year of the older spouse. Under changes made by 2020 PA 65, if the older spouse dies, the surviving spouse can continue claiming the same treatment of retirement income as long as they do not remarry.

The taxation of retirement income is currently as follows:

- **Tier 1**: Taxpayers born before 1946 continue to be taxed under the same system that existed before the 2011 changes. 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 (all of whom have now reached age 67) are able to take a limited deduction ($20,000 for single filers/$40,000 for joint returns) against all types of income. These taxpayers remain able to collect other personal exemptions for which they are eligible.
- **Tier 3**: Taxpayers born after 1952 are not able to exempt any retirement income until reaching age 67, except for Social Security income. After turning 67, these taxpayers can choose between taking the $20,000/$40,000 deduction described above or continuing to exempt Social Security income and claiming other personal exemptions for which they are eligible.

Taxpayers in Tiers 2 and 3 are not eligible to claim the $20,000/$40,000 deduction if they deduct retirement income from the Armed Forces or under the federal Railroad Retirement Act.

Public Act 4 of 2023

2023 PA 4 amended the Income Tax Act to provide 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.

Individuals will be able to elect to continue the treatment of retirement income under the current system.

The act will also 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.

The table below presents a simplified version of the above information.

Tax Treatment of Retirement Income

Current Law			2023 PA 4 Fully Phased In (TY 2026)
Tier 1	Tier 2	Tier 3	
Born before 1946	Born 1946-1952	Born after 1952	Any Age
Public Pension benefits 100% tax free	Before 67, retirement/pension benefits deductible $20,000 single/$40,000 joint	No deduction for retirement/pension	**Public** and **Private** retirement income deductible @ amount equal to $68,094* single / $136,187* joint, less public benefit
Private retirement benefits deductible $56,961 single / $113,922 joint, less public benefit	At 67, standard deduction on all income up to $20,000 single / $40,000 joint	At 67, standard deduction on all income up to $20,000 single / $40,000 joint	Public Police and Fire, County Corrections Officer, State Police Trooper/Sergeant retirement income fully exempt beginning in TY 2023
plus personal exemption	plus personal exemption	no personal exemption	plus personal exemption

*Amounts adjusted annually based on estimated inflation rates– figures represent TY 2026 amount

NOTE: Tier 2 and 3 individuals would have option to elect retirement exemption or standard deduction on all income