New Michigan Law Changes Taxes and Withholding on Retirement Income

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The way in which Michigan taxes pensions and other retirement income will change significantly beginning next year. A new withholding requirement also affects payors of that income.

Retirement Income Exemption is Limited

The new rules phase out the Michigan income tax exemption for pension and retirement income, depending on birth date and total income level. The rules are tied to the birth date of the older spouse when a joint return is filed, regardless of which spouse receives the pension and retirement income. Here are the highlights:

Taxpayers born before 1946:
The tax treatment of retirement or pension income generally do not change. Government, military, and railroad pensions, as well as Social Security benefits, are completely exempt from taxation. A portion of pension and retirement income from non-governmental plans continues to be exempt from tax (up to $45,120 for single filers or $90,240 for joint filers in tax year 2010, and adjusted for inflation). This latter exemption is reduced by the amount of any governmental, military, or railroad pension benefits.

Taxpayers born in the years 1946-1952:
The current exemptions for Social Security income and military and railroad pensions remain in place.

Until the taxpayer reaches age 67, the exemption for all other pension and retirement income, including governmental retirement income, is reduced to $20,000 for a single return or $40,000 for a joint return. After the taxpayer reaches age 67, the exemption amount applies to all other income, including non-retirement income.

Regardless of the taxpayer's age, the $20,000/$40,000 exemption is unavailable if total household resources exceed $75,000 for a single return, or $150,000 for a joint return, or if a taxpayer claims the deduction for a military pension or railroad pension. The taxpayer may still use the standard personal exemption, regardless of age.

Taxpayers born after 1952:
All exemptions for any type of pension or retirement income other than Social Security income and military and railroad pensions are not available until the taxpayer reaches the age of 67. Then, the taxpayer may choose between an exemption ($20,000 for a single return or $40,000 for a joint return) against all types of income, including Social Security, retirement and non-retirement income or a deduction of 100% of Social Security income plus the standard personal exemption.

The $20,000/$40,000 exemption is unavailable if total household resources exceed $75,000 for a single return or $150,000 for a joint return, or if a taxpayer claims the deduction for a military or railroad pension.

New Withholding Tax Requirements

The new law requires any person who disburses pension or other retirement payments to withhold income tax. The withholding is at the Michigan individual income tax rate, which will be 4.35% next year. Withholding is not required on any part of the payment that "is not expected to be includable" in the recipient's gross income.

Because the exempt amount of pension or other retirement payments depends on household resources, the birth date of the older spouse and other factors, determining what part "is not expected to be includable" would be very difficult. It is not yet clear what steps will need to be taken by those who disburse pension or other retirement payments to ascertain this amount. We are hoping for prompt guidance from the Michigan Department of Treasury on this issue.
In the meantime, if you have questions about the changes in the tax law, please contact Jay Kennedy (jkennedy@wnj.com or 248.784.5180), Mary Jo Larson (mlarson@wnj.com or 248.784.5183) or any other member of the Tax or Employee Benefits groups at Warner Norcross & Judd.