History of Passage of Michigan's New Pension Tax With Links to Important Documents

By Mary Pollock, Michigan SERA Legislative Representative

In early February 2011, Governor Rick Snyder announced an overhaul of the Michigan income and business tax in Michigan. The tax reform featured abolishment of the Michigan Business tax, establishment of a flat 6% Corporate Income Tax, and imposition of an income tax on pensions as well as other changes to the individual income tax.

HB 4361 of 2011 amending the Income Tax Act was introduced March 1, 2011. It proposed elimination of all tax exemptions for private and public pensions as well as repealing exemptions for investment income for seniors. The bill also proposed elimination of the senior special exemption of $2,300 and modified the Homestead Property Tax Credit for seniors. Additionally numerous other personal tax credits, exemptions, and deductions were eliminated for all taxpayers. A few weeks later HB 4480 of 2011 was introduced modifying the State Employees' Retirement Act to be consistent with the changes proposed in HB 4361.

HB 4362 of 2011 proposed replacing the Michigan Business Tax with a flat 6 % Corporate Income Tax. The effect of both bills was to increase individual income taxes by 23% and reduce business taxes by 86%.

According to the Legislature's fiscal analysis of PA 38, these changes were projected to increase taxes of individuals by $1.4 billion in FY 2012-2013 and decrease business taxes by $1.65 billion in FY 2012-2013.

Michigan SERA Coordinating Council Chair Bob Kopasz, Michigan SERA attorney Dan McLellan, Michigan State Employees' Retirement System Board Chair Doug Drake, and Michigan SERA Legislative Representative Mary Pollock testified against the tax changes at a hearing of the House Tax Policy Committee on March 16, 2011. Fifteen SERA members visited the House Tax Policy Committee hearing of March 30 and several testified and/or put in cards opposing the pension tax.

Because of the massive negative reaction to the proposed pension tax from seniors and others, an April 12 compromise among the Republican leadership of the House and Senate with the Governor was announced:

- Taxpayers born before 1946, about 2/3 of all pensioners, will retain their current exemptions for their pensions and investment income. Public pension distributions for people in this age group will remain completely tax-exempt. Private pension retirees will have capped pension exemptions of $45,120 per single filer and $90,240 for joint filers.
- Taxpayers born in 1946 through 1952 will have their pension exemption – whether public or private – capped at $20,000 per single filer and $40,000 per joint filer. At age 67, the tax exemption is based on total household resources. The tax bill provided that taxpayers in this group receive no pension or income exemptions if their total household resources (all income received less any net business, rental, or royalty losses) exceed $75,000 per single filer and $150,000 per joint filers.
- Taxpayers born in 1953 or earlier will have their pensions taxed, whether public or private from the first dollar. Once they turn 67, these taxpayers will receive an income exemption of $20,000 per single filer and $40,000 per joint filers. The tax bills provided that taxpayers in this group are not eligible for the income exemption if their total household resources exceed $75,000 per single filer and $150,000 for joint filers.

Despite the compromise, younger retirees were still negatively affected by the pension tax and SERA continued its opposition. Our analysis indicated that seniors and pensioners would be contributing $528 million of the projected $1.4 billion in increased individual income taxes. Not only would retirees face a pension tax, but removal of the senior $2,300 special exemption, the exemptions for investment income, and changes in the Homestead Property Tax Credit.

SERA representatives again testified against the bill before the Senate Reforms, Restructuring, and Reinventing Committee on May 10, 2011. Thirty SERA members attended the Senate Reforms Committee hearing, submitting cards opposed to the pension tax.

HB 4361 passed both the House and Senate with the bare minimum number of votes and bi-partisan opposition. It was signed into law on May 25, 2011 as PA 38 of 2011. One week later the Governor asked for an advisory opinion concerning the constitutionality of the pension tax from the Michigan Supreme Court pursuant to Article 3, § 8 of the Michigan Constitution. The Governor asked the high court to give its opinion on four questions:

1. Does reducing or eliminating the statutory tax exemption for public-pension incomes impair accrued financial benefits of a "pension plan [or] retirement system of the state [or] its political subdivisions" under article 9, § 24 of the Michigan Constitution?
2. Does reducing or eliminating the statutory tax exemption for pension incomes impair a contract obligation in violation of article 1, § 10 of the Michigan Constitution, or of article 1, § 10 of the United States Constitution?
3. Does determining eligibility for income-tax exemptions based on total household resources, or age and total household resources, create a graduated income tax in violation of article 9, § 7 of the Michigan Constitution?
4. Does determining eligibility for income-tax exemptions based on date of birth violate equal protection of the law under article 1, § 2 of the Michigan Constitution, or under the 14th Amendment to the United States Constitution?

On June 15, 2011, the Michigan Supreme Court granted the Governor's request for an advisory opinion.

Solicitor General John Bursh from the Office of the Attorney General defended the pension tax and Deputy Solicitor General Eric Restuccia from the Office of the Attorney General argued against its constitutionality. Briefs and reply briefs from all the parties are here.

SERA, AARP, and National Active and Retired Federal Employees represented by Attorney Dan McLellan (former General Counsel for the Michigan Civil Service Commission) filed a joint amicus brief concerning question 1 and 2, arguing that the tax on public pensions was unconstitutional. A summary of our brief was provided at our press conference on August 10. The retiree organizations also filed a reply brief on August 26, 2011.

Others filing briefs opposed to the pension tax were the UAW, AFL-CIO/SEIU-Local 517M, and the MEA. Those filing briefs in support of the pension tax were the Michigan Bankers Association/Michigan Chamber of Commerce/Michigan Retailers Association and Business Leaders for Michigan/Small Business Association of Michigan.

Opponents of PA 38 argued that:

- The bill violates Article 9, §24 of the state Constitution because it reduces the pension income that public sector employees have already earned. Under this constitutional provision, the bill's opponents contend, public employees can rely on a certain level of retirement income. By reducing this income, the Legislature diminishes or impairs "a contractual obligation" of the state and its political subdivisions.

- Similarly, the bill violates public employees' constitutional right against impairment of contract (Article 1, § 10 of the state Constitution and Article 1, §10(1) of the U.S. Constitution). In effect, the state has gone back on its agreement with public employees by reducing their income after they have performed the work.
- PA 38 also violates Article 9, § 7 of the Michigan Constitution because it effectively creates a graduated tax – and eliminates exemptions in some cases – based on income levels, opponents assert. They point out that there are no other tax exemptions or deductions in Michigan for which eligibility is based on income.
- The bill's opponents also argued that basing tax exemptions on age and marital status violates equal protection of the laws. (Marital status is a factor because a pensioner who is otherwise ineligible for a full exemption becomes eligible if his or her spouse is born before 1946.)

Supporters of PA 38 argued that:

- Article 9, §24 of the state Constitution does not create a permanent, irrevocable tax exemption for public pension distributions, or even imply that public pensioners should not pay taxes, the bill's supporters contend. When the ratifiers of Michigan's 1963 Constitution wanted to create a permanent tax exemption, they did so expressly – for example, for non-profit religious and educational organizations (Article 9, §4).
- Because there is no right to a permanent exemption for pension distributions, PA 38 does not violate public pensioners' right to contract. Even if public employees had a contract right to a tax exemption on public pension distributions, PA 38 does not alter the right to receive the pension or basic benefits, supporters maintain.
- PA 38 does not create a graduated income tax; income is either taxed at a flat rate of 4.35 percent, or is exempted from taxation. The use of exemptions does not convert a flat tax into a graduated income tax. "Total household resources" includes items that Michigan and the federal government ordinarily exclude from gross income, so PA 38's exemptions are not based on the taxpayer's income level, the bill's supporters argue.
- Because age is not a "suspect classification" for equal protection analysis, the "rational basis" test applies. Supporters argue that the lines drawn by the Legislature are rationally related to a legitimate governmental interest (protecting older retirees who are less able to adjust to tax changes that affect their income) and the bill is narrowly drafted to achieve that goal.

Oral argument was held September 7, 2011 to a packed Michigan Supreme Court. The video of the Michigan Supreme Court hearing can be accessed through the State Bar of Michigan Virtual Court.

On November 18, 2011, in a 4-3 decision along party lines, the Michigan Supreme Court upheld the pension tax on public employee retirees born after 1945 and the age and marital status distinctions but overturned the phase out of the pension tax exemption for higher income taxpayers. The Michigan Supreme Court has provided a summary of the decision in its Syllabus.

The Michigan Department of Treasury has supplied a brief overview of the Income Tax Changes for Retirement Benefits Effective for Tax Year 2012 (for returns filed in 2013) and a general overview of the 2012 Michigan Income Tax Changes.

On December 2, 2011, SERA, AARP, NARFE, and the Michigan Association of Retired School Personnel called for repeal of the pension tax by passage of HB 4118 of 2011 and/or SB 519 of 2011.