



RICK SNYDER  
GOVERNOR

STATE OF MICHIGAN  
DEPARTMENT OF TREASURY  
LANSING

NICK A. KHOURI  
STATE TREASURER

## REVENUE ADMINISTRATIVE BULLETIN 2017-25

Approved: December 15, 2017

### INDIVIDUAL INCOME TAX – TAX TREATMENT OF RETIREMENT INCOME FROM IRC 403(b) PLANS

(Replaces Revenue Administrative Bulletin 1988-30)

Pursuant to MCL 205.6a, a taxpayer may rely on a Revenue Administrative Bulletin issued by the Department of Treasury after September 30, 2006, and shall not be penalized for that reliance until the bulletin is revoked in writing. However, reliance by the taxpayer is limited to issues addressed in the bulletin for tax periods up to the effective date of an amendment to the law upon which the bulletin is based or for tax periods up to the date of a final order of a court of competent jurisdiction for which all rights of appeal have been exhausted or have expired that overrules or modifies the law upon which the bulletin is based.

**RAB 2017-25.** This Revenue Administrative Bulletin (RAB) updates RAB 1988-30 and discusses the tax treatment of contributions to and distributions from an annuity plan created under Internal Revenue Code (IRC) 403(b).<sup>1</sup>

#### ISSUES

- I. What is a 403(b) plan?
- II. What is the Michigan tax treatment of a 403(b) plan?
- III. Under what circumstances is a subtraction of a 403(b) distribution, or part of a distribution, disallowed?
- IV. What is the Michigan tax treatment of a 403(b) plan that is rolled over into another plan?
- V. How do contributions, distributions, and rollovers affect Total Household Resources?

#### CONCLUSIONS

- I. A 403(b) plan, commonly referred to as a tax-sheltered annuity, is a retirement plan for employees of public schools, employees of certain IRC 501(c)(3) tax-exempt organizations, and certain employees of churches or church associations.

---

<sup>1</sup> IRC 403(b).

- II. To the extent that 403(b) distributions are included in federal adjusted gross income (AGI), they are included in Michigan taxable income unless an adjustment applies. Distributions from a 403(b) plan that are defined as retirement benefits under the Michigan Income Tax Act (Part 1) may be subtracted from Michigan income subject to certain age and dollar limitations. The retiree must have retired under the terms of the plan, and the distribution must be attributable to employer contributions or employee contributions mandated by the plan.
- III. Whenever a distribution, in whole or in part, is considered to be deferred compensation, no subtraction is allowed for that portion of the distribution. A distribution or portion thereof is considered to be deferred compensation when it derives from a 403(b) plan that allows an employee to set the amount of compensation to be deferred and does not prescribe retirement age or years of service, or when it derives from that portion of the plan attributable to employee contributions not mandated by the plan, or when a distribution is made prior to eligibility under the terms of the plan.
- IV. The amount rolled over from a 403(b) plan into another plan is treated as deriving from the original 403(b) plan when it is distributed. Any post-rollover contributions or accumulated earnings are treated as deriving from the plan from which the distribution is made and taxpayers must allocate accordingly.
- V. Contributions to a 403(b) plan that are deducted in the calculation of AGI need not be added back to Total Household Resources (THR) and therefore indirectly reduce THR. Distributions and rollovers that are included in AGI are included in THR.

## INTRODUCTION

An employee retirement benefit plan is any plan, fund, or program that is established or maintained by an employer or employee organization that provides retirement income to employees.<sup>2</sup> The IRC separates retirement benefit plans into two categories for tax purposes: qualified and nonqualified plans. A qualified plan is one that “qualifies” for special tax treatment because it complies with provisions of the IRC.<sup>3</sup> Nonqualified plans defer compensation or otherwise provide benefits payable at retirement or termination of employment that do not qualify under the IRC and are not entitled to favorable tax treatment. To qualify for favorable tax treatment under the IRC, a retirement plan must meet certain standards such as minimum vesting requirements, minimum distribution requirements and certain nondiscrimination criteria. This RAB discusses only retirement benefit plans created under IRC 403(b). Most plans created under IRC 403(b) are qualified plans, meaning the plans satisfy the provisions of the IRC and the Employee Retirement Income Security Act (ERISA) and are eligible for favorable tax treatment. Michigan, therefore, defines distributions from plans

---

<sup>2</sup> IRC 403(b).

<sup>3</sup> MCL 206.30(8)(a)(iii) provides that plans qualified under IRC 401(a) include IRC 403(b) plans. However, IRC 403(b), not IRC 401(a), is the source for qualifying these plans. Since section 30(8) of the Michigan Income Tax Act specifically includes IRC 403(b) plans as “qualified,” but misidentifies the appropriate IRC section, the Department accepts 403(b) plans as “qualified” for purposes of the pension or retirement benefits distribution deduction.

created under IRC 403(b), including those from church plans, as retirement benefits generally, subject to the limitations discussed later in this RAB.<sup>4</sup>

### **WHAT IS A 403(b) PLAN?**

A 403(b) plan, commonly referred to as a tax-sheltered annuity (TSA), is a retirement benefit plan for employees of public schools, employees of certain tax-exempt (IRC 501(c)(3)) organizations, and certain employees of churches or church associations. Despite its popularization as a TSA, a plan established under IRC 403(b) is not limited to annuity contracts purchased from insurance companies as it once was.<sup>5</sup> An employer establishing a 403(b) plan may purchase annuity contracts from insurance companies, but may also establish custodial accounts for eligible employees, so long as the contributions are invested only in mutual funds. Church and church association employers may establish “retirement income accounts” for eligible employees, which can be invested in either annuities or mutual funds.<sup>6</sup>

### **FUNDING OF THE PLAN AND FEDERAL TAX TREATMENT**

A 403(b) plan may be funded by either an employer or an employee contribution or both. Employee contributions are considered elective salary deferrals made under a salary reduction agreement and can include the following types of contributions: pre-tax; Roth; after-tax (non-Roth type)<sup>7</sup>; and any combination of these types.<sup>8</sup> With the exception of Roth and non-Roth after-tax contributions, federal income taxation of these contributions as well as any earnings or gains on these contributions is deferred until withdrawal from the account. Roth contributions are taxed as ordinary income upon contribution, but qualified Roth distributions are tax-free. To the extent that an employee’s elective salary deferral exceeds contributions mandated by the 403(b) plan, it is considered a supplemental contribution.

Employer contributions are non-elective contributions to an eligible employee’s 403(b) account and can be either matching contributions, which match the employee’s elective deferral contribution up to a certain dollar amount or percentage of compensation, or nonmatching contributions, which are not tied to a salary reduction agreement or contribution by the employee.

The IRC permits distributions from a 403(b) plan to be made when a plan beneficiary reaches age 59½, severs from employment, becomes disabled or dies.<sup>9</sup> Permissible distributions, other than Roth distributions and distributions made from non-Roth type plans where the

---

<sup>4</sup> MCL 206.30(8)(a)(iii). See MCL 206.30(8)(d)(i)(C) for exclusion of 403(b) distributions from plans other than those described in 30(8)(a)(iii) from the definition of retirement benefits.

<sup>5</sup> See Employee Retirement Income Security Act of 1974 (ERISA), Pub L No. 93-406, 88 Stat 829 (1974) (codified as amended in scattered sections in 29 USC and 26 USC), which broadened the types of investments available to creators of 403(b) plans.

<sup>6</sup> See 1983 WL 145864 (O.C.C.), Office of the Comptroller Interpretive Letter and IRC 403(b) and IRS Publication 571.

<sup>7</sup> After-tax contributions are employee contributions made with after-tax income that are not Roth contributions.

<sup>8</sup> See IRS Publication 571.

<sup>9</sup> A distribution is also permitted for reasons of financial hardship if the eligible employee made elective deferrals of compensation.

contributions were made with after-tax dollars, are fully taxable at the federal level as ordinary income.<sup>10</sup>

## **MICHIGAN INCOME TAX TREATMENT**

Michigan's income tax treatment of 403(b) plan distributions depends on whether the distributions come within the definition of "taxable income" in the Michigan Income Tax Act (MITA).<sup>11</sup> Taxable income is defined in Section 30 of the MITA as AGI subject to adjustments. To the extent 403(b) plan distributions are included in AGI,<sup>12</sup> they are included in Michigan taxable income unless an adjustment applies. Adjustments related to retirement benefit distributions are found in three subsections of Section 30 of the MITA: subsections 30(1)(f), 30(8), and 30(9).

### **Retirement Benefits Defined**

To be entitled to adjustment, a distribution must fit within the MITA's definition of "retirement or pension benefits."<sup>13</sup> The MITA specifically defines distributions from a 403(b) plan created and maintained by an IRC 501(c)(3) tax-exempt organization, public school system, or church as a retirement benefit.<sup>14</sup> The MITA excludes from the definition of retirement or pension benefits 403(b) plan distributions 1) from plans that allow the employee to set the amount of compensation to be deferred and that do not prescribe retirement age or years of service,<sup>15</sup> 2) that are made prematurely such as distributions paid on separation, withdrawal, or discontinuance of a plan prior to the earliest date the eligible employee could have retired under the plan provisions,<sup>16</sup> or 3) that are paid as an incentive to retire early, unless made from a pension trust.<sup>17</sup>

Distributions falling into any of these three categories are treated as deferred compensation under the MITA, and statutory adjustments applicable to distributions characterized as retirement or pension benefits do not apply. In other words, distributions that do not meet the MITA's definition of retirement or pension benefits are not deductible from taxable income.

A distribution from a 403(b) plan may be characterized as part retirement benefit and part deferred compensation. Michigan tax treatment of the distribution depends on what portion of the distribution is attributable to deferred compensation and what portion constitutes a qualified retirement benefit. A distribution from a 403(b) plan is a qualified distribution to the extent that it is attributable to an employer's contributions or an employee's contributions that were mandated by the plan. An employee contribution required by the plan to elicit an employer match is considered mandated.

---

<sup>10</sup> Distributions from a Roth account within a 403(b) plan are not included in income because the contributions were made with after-tax dollars.

<sup>11</sup> MCL 206.30(1).

<sup>12</sup> The exceptions to inclusion in federal AGI are a distribution from a Roth account within a participant's 403(b) plan or a distribution from a non-Roth type plan where the contributions were made with after-tax dollars

<sup>13</sup> MCL 206.30(8)(a).

<sup>14</sup> MCL 206.30(8)(a)(iii) and 30(8)(b)(ii).

<sup>15</sup> MCL 206.30(8)(d)(i)(C).

<sup>16</sup> MCL 206.30(8)(d)(ii).

<sup>17</sup> MCL 206.30(8)(d)(iii).

A distribution from a 403(b) plan is deferred compensation to the extent it 1) is attributable to a supplemental contribution – an employee contribution in excess of that mandated by the plan, 2) is a premature distribution – paid prior to the earliest retirement date provided for in the plan, or 3) is distributed from a plan that allows an employee to set the amount to be deferred and does not prescribe retirement age or years of service for benefit eligibility.

A taxpayer receiving a distribution of 403(b) benefits must allocate between deductible retirement benefits and non-deductible tax deferred compensation. The deductible amount is determined by multiplying the annual benefits by a fraction, the denominator of which is total contributions, and the numerator of which is contributions by the employer and employee as required by the plan.

Example. Taxpayer receives a \$10,000 403(b) distribution. The following contributions were made to the plan:

Employer contribution required by plan	\$40,000
Employee contribution required by plan	20,000
Employee additional payments	<u>30,000</u>
Total contributions	\$90,000

Percent of benefits deductible is \$60,000 divided by \$90,000 or 66.67%. Deductible retirement benefits equal \$10,000 distribution multiplied by 66.67% or \$6,667. Tax deferred compensation is \$3,333.

All distributions considered to be deferred compensation are taxable income under the MITA.<sup>18</sup> Distributions from a 403(b) plan that are within the MITA’s definition of retirement or pension benefits may be subtracted from Michigan income subject to a dollar limitation and certain age limitations based on the date of birth of the retiree on a single return or the date of birth of the oldest spouse on a joint return or in some instances the date of birth of a deceased spouse.<sup>19</sup> These dollar and age limitations separate taxpayers into three tiers and apply beginning in tax year 2012.

Taxpayers born before 1946 (tier 1 taxpayers) may subtract eligible distributions from a 403(b) plan up to \$50,509 on a single return, or \$101,019 on a joint return (2017 limits).<sup>20</sup> If the eligible distribution is from a public source (such as a school district), the tier 1 taxpayer may subtract the entire eligible distribution.<sup>21</sup> Taxpayers born in the period 1946 through 1952 (tier 2 taxpayers) may subtract a maximum retirement benefit, including eligible 403(b) distributions, of \$20,000 for a single return or \$40,000 for a joint return. At age 67, the deduction is no longer restricted to retirement income, but can be applied to all income.

If a taxpayer in tier 2 receives a retirement benefit from a governmental agency that was not covered by the federal Social Security Act (SSA), the “uncovered” taxpayer who has not yet

---

<sup>18</sup> For treatment of retirement income based on resident or non-resident status, see RAB 1988-25, *Income Tax - Deduction of Retirement and Pension Benefits Received from a Public Retirement System of another State*, or any successor or replacement RABs.

<sup>19</sup> MCL 206.30(9).

<sup>20</sup> MCL 206.30(1)(f)(iv). Limits are adjusted annually for inflation.

<sup>21</sup> MCL 206.30(9)(a).

reached age 67 may deduct up to \$35,000 of retirement benefits on a single return and up to \$55,000 of retirement benefits on a joint return (up to \$70,000 on a joint return if both spouses were “uncovered”). Taxpayers in tier 2 who have reached age 67 may apply these amounts against all income. For taxpayers born after 1952 (tier 3 taxpayers), with one limited exception, there is no retirement benefit deduction for tax years beginning 2012 and later. The exception is for taxpayers in tier 3 who receive retirement benefits from a governmental agency not covered by the SSA. The “uncovered” taxpayer, who is at least 62, may deduct up to \$15,000 of retirement benefits, or up to \$30,000 if both spouses filing a joint return were “uncovered.”

### **Rollovers**

Where a taxpayer receives a distribution from a retirement plan that has been rolled over from another retirement plan, Michigan case law, as set forth in *Magen v Dep’t of Treasury*, now holds that the original plan is considered to be the source of the distribution for purposes of determining whether a distribution is a retirement benefit as defined under MITA and what subtractions, if any, are available.<sup>22</sup> According to *Magen*, only the amount transferred from the original plan is treated as derived from the original plan. Any post-rollover contributions or accumulated earnings are treated as deriving from the post-rollover plan. When reporting a retirement distribution originally sourced to a 403(b) plan, a taxpayer must identify that plan and allocate the distribution. The Department may require documentation of a rollover establishing the source, timing and amount of the rollover as well as a statement of any post-rollover contributions and accrued earnings.

### **Effect on Total Household Resources**

“Total household resources” is used for Michigan income tax purposes to compute the homestead property tax credit and the home heating credit.<sup>23</sup> The calculation of THR is based, in relevant part, on a definition of income that means “the sum of federal adjusted gross income as defined in the internal revenue code plus all income specifically excluded or exempt from the computations of the federal adjusted gross income.”<sup>24</sup> Items that are specifically excluded from AGI are listed in sections 101 through 140 of the IRC.<sup>25</sup>

**Contributions.** Contributions deducted in the calculation of AGI are not required to be added back to THR.<sup>26</sup> Deductible pre-tax contributions to a 403(b) plan will, therefore, indirectly reduce THR in that tax year.

**Distributions.** The MITA only authorizes subtracting qualifying distributions of retirement or pension benefits in the calculation of Michigan taxable income. Thus, there is no subtraction from THR for any 403(b) distributions that are included in AGI.

**Rollovers.** There is no adjustment to THR for income that must be reported due to a rollover. Any rollover that results in income on the federal return must be included in THR.

---

<sup>22</sup> See *Magen v Dep’t of Treasury*, 299 Mich App 566 (2013).

<sup>23</sup> See RAB 2015-18, *Income Tax – Total Household Resources Defined*.

<sup>24</sup> MCL 206.510(1).

<sup>25</sup> IRC 101-140.

<sup>26</sup> MCL 206.508(4).