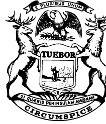

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DEPARTMENT OF TREASURY
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REVENUE ADMINISTRATIVE BULLETIN 2017-21

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INDIVIDUAL INCOME TAX – INDIVIDUAL RETIREMENT ARRANGEMENTS

(Replaces RAB 1988-22)

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 2017-21. This Revenue Administrative Bulletin (RAB) replaces RAB 1988-22 and discusses the treatment of Individual Retirement Arrangements (IRAs) under the Michigan Income Tax Act.

I. MICHIGAN INCOME TAX TREATMENT OF IRAs

Section 30(1)(f) of the Michigan Income Tax Act authorizes a subtraction from Michigan taxable income for certain "retirement or pension benefits" received by a taxpayer during the year.[1] "Retirement or pension benefits" is broadly defined to include common public and private retirement options, including IRAs. This RAB focuses on the common transactions and issues related to IRAs[2] as a subtractable "retirement or pension benefit" in Michigan.

i. Contributions to IRAs

The Michigan Income Tax Act does not authorize a subtraction for contributions to IRAs. However, because Michigan taxable income is based upon federal adjusted gross income (AGI), the provisions of the Internal Revenue Code (IRC) indirectly allow for certain plan contributions to reduce the Michigan income tax base. While contributions made to a Roth IRA are not deductible,[3] certain pre-tax contributions to Traditional IRAs may be deducted in computing AGI.[4] The overall extent of that deduction is subject to annual limitations based upon the age, plan type, and compensation level of the taxpayer. Michigan taxpayers making contributions to a Traditional

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[1] MCL 206.30(1)(f).
[2] There are many types of IRA plans established by both individuals and employers. However, the tax attributes of most plans generally follow the rules of either a Traditional IRA or a Roth IRA. For this reason, this RAB generally refers only to Traditional or Roth IRAs.
[3] IRC 408A(c)(1).
[4] See IRC 219.

IRA should consult the applicable federal statutes and rules to determine the availability of any deductions in computing AGI.

ii. Distributions from IRAs

Section 30(1)(f)(*iv*) of the Michigan Income Tax Act authorizes a deduction for certain "retirement or pension benefits" to the extent that those benefits are included in federal AGI. Retirement or pension benefits are defined, in relevant part, to include:

> Individual retirement accounts that qualify under section 408 of the internal revenue code if the distributions are not made until the participant has reached 59-1/2 years of age, except in the case of death, disability, or distributions described by section 72(t)(2)(A)(*iv*) of the internal revenue code.[5]

The amount of the deduction is also subject to certain annual limitations based upon the birth date of the recipient or, for a joint return, the birth date of the oldest spouse.[6] Subtracting a distribution from an IRA is a two-step process that begins with a threshold determination of whether the distribution is a qualifying distribution and ends with the application of the annual deduction limits.

a. Qualifying Distributions

The limitation that retirement benefits may only be subtracted "to the extent included in adjusted gross income" has two important implications for IRAs in Michigan. The language precludes distributions from Roth IRAs from being claimed as a subtraction on the Michigan return because any such distribution is already excluded from AGI under the federal rules.[7] Likewise, the language limits subtractable Traditional IRA distributions to the portion of the distribution that relates to pre-tax contributions only. Taxpayers may contribute both pre-tax and after-tax dollars to a Traditional IRA. Unlike pre-tax contributions, an after-tax contribution is not subject to tax upon distribution and therefore is not deductible on the Michigan return. When an IRA includes both pre-tax and after-tax amounts, distributions must be prorated between the taxable and non-taxable portion. Thus, only the portion of a distribution from a Traditional IRA that relates to the *pre-tax* contributions may be claimed as a subtraction from Michigan taxable income.

A distribution that is included in AGI may be subtracted when it is made pursuant to any of the following statutory conditions:[8]

1. **After 59-1/2 years of age.** Unless the distribution meets any of the other distribution requirements, a recipient must have reached 59-1/2 years of age at the time of the distribution to qualify.

[5] MCL 206.30(8)(a)(*ii*).
[6] MCL 206.30(9)(f).
[7] IRC 408A(d)(1).
[8] MCL 206.30(8)(a)(*ii*). Generally, the Department will refer to the distribution code as reported on a 1099-R for evidence of the basis of a distribution.

2. **Disability.** A person is considered to be disabled if that person is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration.[9]

3. **Death.** Distributions after the death of the participant may only be subtracted by a spouse, and only if the distributions qualified as a subtraction for the participant at the time of death.

4. **Qualifies under IRC 72(t)(2)(A)(*iv*).** A distribution qualifies under IRC 72 if it is received from a retirement annuity policy for which payment is made for life to a senior citizen. Senior citizen is defined as an individual who is 65 years of age or older at the close of the tax year, including an unremarried surviving spouse of a person who was 65 years of age or older at the time of death.[10]

Though not explicitly set forth by statute, an IRA distribution may also be deductible where the IRA is funded from the rollover of an otherwise exempt retirement plan.[11] In *Magen v Dep't of Treasury,* at issue was whether distributions from a Traditional IRA funded by the rollover of an exempt IRC 403(b) retirement account were a subtractable retirement or pension benefit. Looking through to the original funding source of the plan, the Michigan Court of Appeals held that the income did not lose its exempt character merely because it was converted into a different form of retirement account. This was based, in part, on the determination that the legislature defined retirement or pension benefits to include the original IRC 403(b) account as generally exempt from tax. Thus, the court concluded that the tax-exempt character survived the rollover and the subsequent IRA distribution was subtractable on the return.

Under *Magen,* the underlying source of any retirement or pension benefits must be considered in determining whether those benefits are subtractable on the Michigan return. Any subtractable retirement or pension benefit under *Magen* remains subject to any rules regarding a qualifying distribution and the annual deduction limits to the extent those rules and limits would be applicable to the original source funds.[12] Taxpayers that claim a subtraction based upon the result in *Magen* may be required to submit all relevant account documentation regarding the original account and subsequent rollover to substantiate the claim for subtraction.[13]

b. Non-Qualifying Distributions

A non-qualifying distribution refers to any distribution that is not a "retirement or pension benefit" as defined by statute.[14] For example, a premature distribution from either a Roth or Traditional IRA that was not made on the basis of death or disability of the account-holder constitutes a non-

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[9] IRC 72(m)(7); 26 CFR 1.72-17(A)(f) (providing examples of impairments resulting in disability).
[10] MCL 206.514(1).
[11] *Magen v Dep't of Treasury*, 299 Mich App 566 (2013).
[12] See *id.* at 571.
[13] Cf. *Southfield Western, Inc v City of Southfield*, 146 Mich App 585, 590 (1985).
[14] MCL 206.30(8)(a)(*ii*).

qualifying distribution. In addition, certain distributions are statutorily treated as non-qualifying distributions. These include:

1. Distributions from a plan that allows the employee to set the amount of compensation to be deferred and does not prescribe retirement age or years of service, including IRC 457 deferred compensation plans, certain distributions from 401(k) plans,[15] and most plans qualified under IRC 403(b);[16]
2. Premature distributions paid on separation, withdrawal, or discontinuance of a plan prior to the earliest date the recipient could have retired under the provisions of the plan; or
3. Payments received as an incentive to retire early unless the distributions are from a pension trust.[17]

As discussed above, the holding in *Magen* may require that subtractions for otherwise qualifying distributions be denied. The Department is required to look through to the original source of funds where the taxpayer has rolled over a retirement account into a Traditional or Roth IRA. Distributions that may be sourced to any retirement plans not eligible for the Michigan pension subtraction, such as a distribution sourced to any of the above-defined plans, must be treated as a non-qualifying distribution. This is true regardless of the type of IRA into which those funds were converted.

> **Example 1.** Taxpayer funds a Traditional IRA by rolling over a non-qualifying IRC 457 deferred compensation plan. In the following year, the taxpayer receives a distribution from that IRA and is 64 years of age at the time of that distribution. While Traditional IRA distributions may be eligible for the subtraction where the taxpayer reaches the age of 59-1/2, the distribution in this case is subject to tax. Under *Magen,* the subtraction is not available where the source of the distribution is an otherwise-taxable IRC 457 plan.

c. Annual Deduction Limits Applicable to IRAs

The total amount of the subtraction for all qualifying distributions is subject to annual limits. These limits are based upon the date of birth of the recipient or, for joint returns, the date of birth of the oldest spouse regardless which spouse received the distribution. The total amount of any qualified distribution subtractable on the Michigan return is limited as follows:

> **Tier 1:** A Tier 1 retiree is any taxpayer born before 1946. A Tier 1 retiree may generally claim a subtraction for all private retirement or pension benefits, including IRAs, up to an inflation-adjusted statutory maximum.[18]

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[15] Distributions from a 401(k) plan that are attributable to employee contributions mandated by the plan or attributable to employer contributions are treated as retirement or pension benefits. MCL 206.30(8)(a)(iv).
[16] Distributions from certain annuities purchased under IRC 403(b) by organizations exempt under section 501(c)(3) of the IRC, or by public school systems, are treated as retirement or pension benefits. MCL 206.30(8)(a)(iii).
[17] MCL 206.30(8)(d).
[18] MCL 206.30(9)(a). The inflation-adjusted maximum for the 2016 tax year was $49,861 for a single return and $99,723 for a joint return.

Tier 2: A Tier 2 retiree is any taxpayer born in 1946 through 1952. The subtraction for public and private retirement benefits received by Tier 2 retirees is limited to $20,000 for a single return or $40,000 for a joint return.[19] At age 67, the taxpayer may no longer claim a subtraction for retirement or pension benefits but is eligible for a subtraction applied to all income (referred to as a "standard deduction").[20]

Tier 3: For most taxpayers born after 1952, a subtraction for retirement and pension benefits is not available. At age 67, the taxpayer may elect to claim a standard deduction equal to $20,000 for a single return and $40,000 for a joint return.[21]

Example 2. Taxpayer is a Tier 2 retiree who is a single filer. At the age of 64, taxpayer receives a $10,000 distribution from a Traditional IRA that is included in AGI. Taxpayer may claim a subtraction up to the $10,000 distribution for retirement or pension benefit income that was included in AGI. If taxpayer had reached the age of 67, taxpayer could claim the standard deduction and subtract up to $20,000 against all income on the Michigan return.

iii. How are Rollovers Treated?

Rollover transactions will be subject to tax in Michigan to the extent the rollover results in the recognition of income under the federal rules.[22] In applying the Michigan retirement or pension benefits subtraction to any such income, the rollover transaction is treated as a distribution from the original retirement account. That is, any income included in AGI from a rollover may be subtracted if the rollover distribution is a qualifying distribution at the time of the rollover.

Example 3. Taxpayer rolls over the entire balance of a Traditional IRA to a Roth IRA at the age of 60. Assume the entire amount of the rollover must be included in AGI in the year of the rollover under federal rules. Because the rollover distribution from the Traditional IRA constitutes a qualifying distribution at the time of the rollover, the income included in AGI may be subtracted up to the applicable annual deduction limit.

Where a plan has been rolled over, the deductibility of any subsequent distributions will be subject to *Magen's* general rule that the rollover does not alter the original tax-exempt or taxable character of the funds. Taxpayers may be required to retain and submit detailed information regarding the rollover in order to substantiate eligibility for any claimed subtraction. Any subsequent distributions that are eligible for the subtraction will be subject to the annual deduction limits.

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[19] MCL 206.30(9)(b). Though not covered within this RAB, additional limits may apply to retirees who receive retirement or pension benefits from employment with a governmental agency not covered by the Social Security Act. MCL 206.30(9)(c).
[20] MCL 206.30(9)(b). The standard deduction may be reduced to the extent the taxpayer subtracts railroad, military, or National Guard pension benefits on the Michigan return.
[21] MCL 206.30(9)(e).
[22] See e.g., IRS Publication 590-A, *Contributions to Individual Retirement Arrangements (IRAs) (2016)* and IRS Publication 590-B, *Distributions from Individual Retirement Arrangements (IRAs) (2016).*

Example 4. Taxpayer funds a 401(k) plan by rolling over a Traditional IRA wholly funded by pre-tax dollars. At the age of 60, the taxpayer receives a $50,000 distribution from the 401(k). No part of the distribution is attributable to either employee contributions mandated by the plan or employer contributions. The entire 401(k) distribution would therefore not ordinarily qualify as a retirement or pension benefit. However, the distribution in this case does qualify as a retirement or pension benefit under *Magen* because the distribution is sourced to a Traditional IRA and such distribution would qualify as a retirement or pension benefit at the time of the distribution. In applying the relevant deduction limit, assume that the taxpayer files jointly with an older spouse who qualifies as a Tier 2 retiree and has not yet reached the age of 67. Because the annual deduction is based upon the age of the oldest spouse on a joint return, and assuming there are no other retirement or pension benefits, the subtraction is limited to $40,000, meaning $10,000 of the distribution would be included in Michigan taxable income.

iv. How do distributions, contributions, and rollovers affect Total Household Resources?

"Total household resources" (THR) is used for Michigan income tax purposes to compute the homestead property tax credit and the home heating credit.[23] The calculation of total household resources 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."[24] Items that are specifically excluded from AGI are listed in IRC 101 through 140.[25]

Contributions. Contributions deducted in the calculation of AGI are not required to be added back to THR.[26] Deductible pre-tax contributions to a Traditional IRA will therefore indirectly reduce THR in that tax year. For other contributions that are not deducted in computing AGI, such as contributions to a Roth IRA or after-tax contributions to a Traditional IRA, no adjustment to THR is permitted.

Distributions. The Income Tax Act only authorizes a subtraction of retirement or pension benefits in the calculation of Michigan taxable income. Likewise, the holding in *Magen* applies only to the calculation of taxable income and does not apply to the calculation of THR. Thus, there is no subtraction for any IRA distributions that are included in AGI. A qualified distribution of a Roth IRA, which is generally exempt from AGI, must be added to THR only to the extent that distribution exceeds taxpayer contributions into the plan.

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

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[23] See RAB 2015-18, *Income Tax – Total Household Resources Defined*.
[24] MCL 206.510(1).
[25] IRC 101-140.
[26] See IRC 219.

II. WITHHOLDING ON NON-QUALIFYING DISTRIBUTIONS

Non-qualifying distributions may not be subtracted on the Michigan return and are subject to the Michigan income tax. The Michigan Income Tax Act requires any person who disburses pension or annuity payments to withhold the amount of Michigan income tax due on the taxable portion of those payments.[27] Withholding is not required to be remitted to the extent the distribution is not expected to be included in adjusted gross income or is otherwise entirely deductible as a retirement or pension benefit under the provisions of the Act. Taxpayers must file Form MI W-4P to notify pension plan administrators of the correct amount to withhold from any non-qualifying distributions. Plan administrators that do not have nexus with Michigan are not required under the Act to withhold on non-qualifying distributions. In that circumstance, estimated tax payments by the taxpayer may be necessary.

[27] MCL 206.703(1).