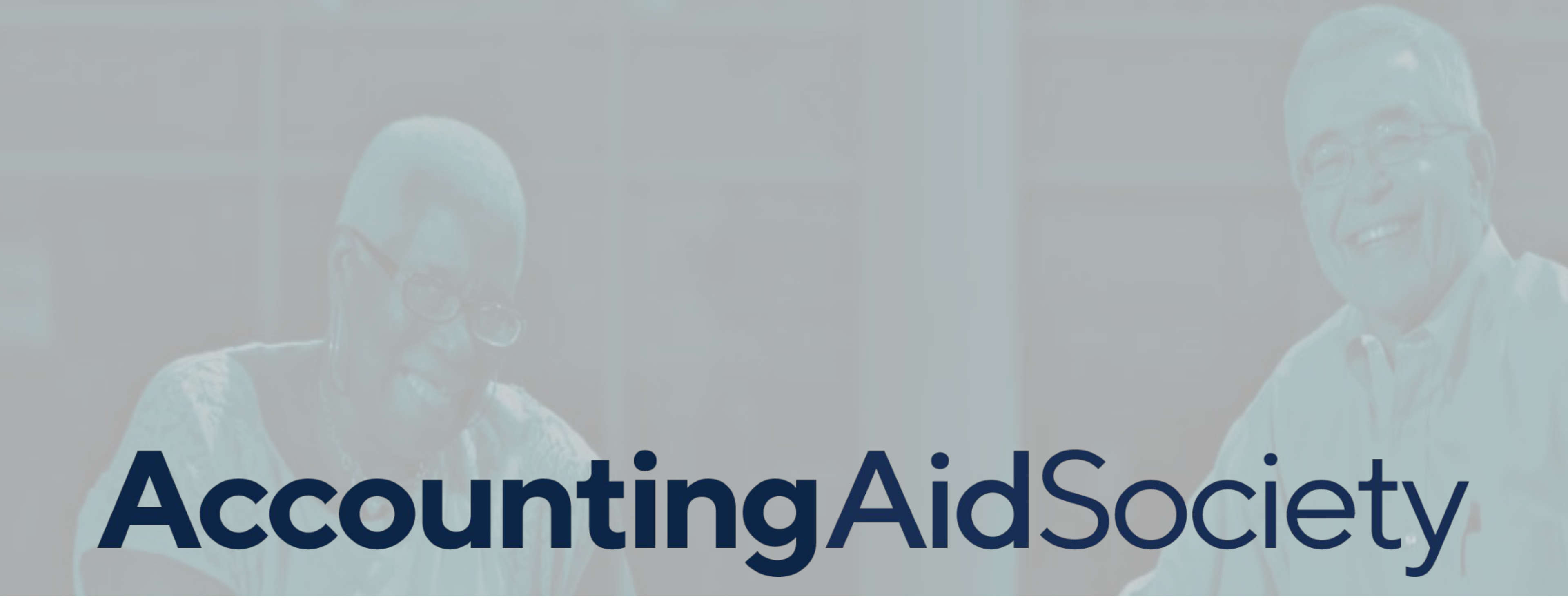

Pension Subtraction

Pension Subtraction guide included in folder

Pension Benefits Subtraction

The following retirement and pension benefits are **always** subtracted:

- U.S. Military Pensions
- Michigan National Guard Pensions
- Railroad Retirement Benefits
- Rollovers not included in the Federal Adjusted Gross Income (AGI)

Some retirement account distributions are eligible for a subtraction from AGI, making them not subject to Michigan tax.

- Subtraction eligibility is based on:
  - type of distribution (codes)
  - taxpayer’s age
  - taxpayer’s situation
  - type of pension.

Pension Benefits Subtraction

A subtraction is allowed on the Michigan return for qualifying distributions from retirement plans.

- Retirement plans include private and public employer plans, and individual plans such as IRA's.
  - Private pension plans include
    - employer plans
    - individual plans such as IRAs and senior citizen annuities (such as from Ford or GM)
  - Public pension plans include benefits received from
    - federal, state, or municipal governments,
    - military
    - railroad pensions (such as police, firefighters, teachers, or postal workers)

Tax Treatment

Step 1: Verify Qualified Distribution Requirements

Step 2: Choose What Works Best

- **Option 1:** Tier Structure Subtraction
- **Option 2:** Qualified Fire, Police, and Corrections Retiree Subtraction
- **Option 3:** Phase-In Subtraction

Tax Treatment – Step 1

Step 1: Verify Qualified Distribution Requirements

Primary requirement for a Michigan retirement subtraction:

- The taxpayer must retire under the provisions of a retirement plan.
  - Employer plans and individual plans each have specific rules for receiving pension distributions which also must be adhered to for a retirement distribution to qualify for the subtraction.
- These include most payments that are reported on Form 1099-R
  - Use the distribution code in Box 7 to determine whether a retirement and/or pension benefits qualifies as a subtraction.

Tax Treatment – Step 1

What Distributions Do Not Qualify for a Subtraction?

- Under Michigan law, deferred compensation is taxable. These distributions include:
  - All distributions from 457 plans
  - Distributions from 401(k) or 403(b) plans sourced to employee contributions and the earnings from those contributions if they were not matched by the employer
  - Early distributions under the terms of the retirement plan are always taxable

Tax Treatment – Step 1

Intake/Interview:

- Part of the interview with a client that has received a 1099-R should involve the following:
  - Ask if their distribution is from a deferred compensation plan.
    - If yes, it doesn't qualify for a subtraction.
  - Ask if they made contributions to the pension or retirement plan that were not matched by the employer.
    - If yes, more information is needed to determine the portion of the distribution that can be subtracted.
- Once it's been established that the pension or retirement benefit is eligible for a retirement subtraction, then use the 1099-R distribution code to determine if it's a qualified distribution.

Distribution Codes	
Form 1099-R, Box 7 Distribution Code	**Is the retirement and/or pension benefits eligible for subtraction?**
Code 1 – Early distribution, no known exception	No
Code 2 – Early distribution, exception applies	No, unless: Part of a series of mainly equal periodic payments made for the life of the employee or the joint lives of the employee and their beneficiary; Early retirement under the terms of the plan
Code 3 – Disability	Yes
Code 4 – Death	Yes, for surviving spouse only and only if the decedent would have also qualified for a normal distribution under Distribution Code 7 at the time of death
Code 7 – Normal Distribution	Yes
Codes 5, 6, 8 and 9 – Out of Scope	

Practice Scenario

John comes in to file his tax return, receives social security and a 1099-R with distribution code 7. During the interview he says it is not from a deferred compensation plan.

Would this be a qualified distribution eligible for pension subtraction?

A. Yes
B. No

Practice Scenario

John comes in to file his tax return, receives social security and a 1099-R with distribution code 7. During the interview he says it is not from a deferred compensation plan.

Would this be a qualified distribution eligible for pension subtraction?

A. Yes

B. No

Explanation: This is a distribution that was not part of a deferred compensation plan and has a code for a normal distribution. This would be considered a qualified distribution and eligible for subtraction.

Practice Scenario

Joe comes in to file his tax return, he receives a W-2 and a 1099-R with distribution code 1. During the interview he says it is not from a deferred compensation plan.

Would this be a qualified distribution eligible for pension subtraction?

A. Yes
B. No

Practice Scenario

Joe comes in to file his tax return, he receives a W-2 and a 1099-R with distribution code 1. During the interview he says it is not from a deferred compensation plan.

Would this be a qualified distribution eligible for pension subtraction?

A. Yes

B. No

Explanation: Joe received a 1099-R with a code 1 distribution. Early distributions are not generally considered eligible for subtraction.

Practice Scenario

Jane comes in to file her tax return, she receives a 1099-R with distribution code 3. During the interview she says it is not from a deferred compensation plan.

Would this be a qualified distribution eligible for pension subtraction?

A. Yes
B. No

Practice Scenario

Jane comes in to file her tax return, she receives a 1099-R with distribution code 3. During the interview she says it is not from a deferred compensation plan.

Would this be a qualified distribution eligible for pension subtraction?

A. Yes
B. No

Explanation: A 1099-R with distribution code 3 would be a qualified distribution eligible for subtraction. Whether she will be able to take the subtraction relies on other factors such as age.

Tax Treatment – Step 2

Step 2. Choose What Works Best

- **Option 1:** Tier Structure Subtraction
- **Option 2:** Qualified Fire, Police, and Corrections Retiree Subtraction
- **Option 3:** Phase-In Subtraction

Option 1: Tier Structure Subtraction

- If a retiree receives a qualified pension distribution, the allowable pension subtraction is calculated based on:
  - date of birth of the taxpayer (for single/married filing separate returns)

    or
  - the oldest spouse (for married filing a joint return)
- Retirees are divided into three tiers:
    - Tier 1 – Taxpayers Born Before 1946
    - Tier 2 – Taxpayers Born between 1946 and 1952
    - Tier 3 – Taxpayer Born after 1952

Option 1: Tier Structure Subtraction – Tier 1

<u>TIER 1 – Taxpayers Born Before 1946:</u>

Retirees may subtract:

- All qualifying pension benefits received from federal or Michigan public sources.
  - Public pensions income from other states is limited to the private retirement maximums. (Some pensions from other states may not have to be limited; see the instructions.)
- Qualifying private and retirement benefits subject to the private pension limit (adjusted by inflation each year)
  - The private pension limit is reduced by any deduction on the return for
    - Military pay and retirement benefits from the U.S. Armed Forces
    - Michigan National Guard
    - Railroad Retirement Board.

Option 1: Tier Structure Subtraction – Tier 2

TIER 2 – Taxpayers Born Between 1946 and 1952:

- Generally, taxpayers in Tier 2 are not eligible for a pension subtraction (See exception for some surviving spouses on next slide.)
- After reaching age 67 (on or before December 31 of the tax year), individuals are eligible to subtract the Michigan Standard Deduction against all income. (For tax years 2018 and before, see instructions for taxpayers who have not reached age 67.)
    - Standard deduction is $20,000 (single/MFS) / $40,000 (MFJ)
    - Standard deduction is reduced by any deduction on the return for military pay and retirement benefits from the U.S. Armed Forces, Michigan National Guard, and Railroad Retirement Board.
- **For Tax Years 2019 and forward, all taxpayers in this range have reached age 67**

Option 1: Tier Structure Subtraction – Tier 2

TIER 2 – Taxpayers Born Between 1946 and 1952 (cont.):

- SSA Exempt Employment – Retirees with benefits from employment with a government agency that was not covered by the federal Social Security Administration (SSA) are entitled to a greater standard deduction. (See next slides on SSA Exempt Employment.)

- Surviving Spouse – A surviving spouse born after 1945 who has reached the age of 67, has not remarried, and claimed a subtraction for retirement and pension benefits on a return jointly filed with the decedent in the year the spouse died,
  - May elect to take the retirement and pension benefits subtraction based on the older deceased spouse's year of birth subject to the limits available for a single filer instead of the standard deduction.

SSA Exempt Employment

SSA exempt employment is not covered by the federal Social Security Administration, which means the worker did not pay Social Security taxes and is not eligible for Social Security benefits based on that employment.

- Almost all employment is covered by the federal SSA.
- The most common instances of retirement and pension benefits from employment that is not covered by Social Security are:
  - Police and firefighter retirees,
  - Some federal retirees covered under the Civil Service Retirement System and hired prior to 1984,
    - Post Office employees
  - A small number of other state and local government retirees.
- Federal retirees hired since 1984 and those covered by the Federal Employees' Retirement System are covered under the SSA.

SSA Exempt Employment (cont.)

- Form CSA 1099R and Form CSF 1099R from the Office of Personnel Management
    - Always ask taxpayers with these forms if they paid Social Security taxes (taxes were withheld) when they were employed by the government agency.
- Police and firefighter retirees should also be asked if they paid Social Security taxes while working.

Example: Taxpayer worked as a police officer and paid no social security taxes while working.

Example: Taxpayer worked as a postal worker hired before 1984 and paid no social security taxes while working

Option 1: Tier Structure Subtraction – Tier 3

TIER 3 – Taxpayers Born After 1952:

- Most taxpayers born after 1952 are not eligible for a pension subtraction. (See exception for certain surviving spouses on a subsequent slide.)
- After reaching age 67 (on or before December 31 of the tax year), individuals are entitled to subtract the Michigan Standard Deduction against all income.
  - Standard deduction is $20,000 (single/MFS) / $40,000 (MFJ)
  - Standard deduction is reduced by:
    - The personal exemption amount,
    - Social Security benefits included in AGI, and
    - Any deduction on the return for military pay and retirement benefits from the U.S. Armed Forces, Michigan National Guard, and Railroad Retirement Board.

Option 1: Tier Structure Subtraction – Tier 3

TIER 3 – Taxpayers Born After 1952 (cont.):

- SSA Exempt Employment – For retirees with benefits from employment with a government agency that was not covered by the federal Social Security Administration (SSA):
  - If recipient has reached age 62 but has not reached the age of 67 – entitled to a retirement subtraction.
  - If recipient has reached age 62 but has not reached the age of 67 and retired as of January 1, 2013 – entitled to a greater retirement subtraction.
  - If recipient has reached the age of 67 and retired as of January 1, 2013 – entitled to a greater Standard Deduction.

See previous slides for information on SSA Exempt Employment.

Option 1: Tier Structure Subtraction – Tier 3

- **<u>TIER 3 – Taxpayers Born After 1952 (cont.):</u>**
  - <u>Surviving Spouse</u> – A surviving spouse born after 1945 who has:
    - Reached the age of 67,
    - Has not remarried, and
    - Claimed a subtraction for retirement and pension benefits on a return jointly filed with the decedent in the year the spouse died,

  May elect to take the retirement and pension benefits subtraction based on the older deceased spouse's year of birth subject to the limits available for a single filer instead of the standard deduction.

Practice Scenario

John comes in to file his Tax Return, he:

- Was Born in 1941
- Receives public retirement and pension benefits of $24,000.
- Is not Married

Which Tier would John fall in?

A. Tier I
B. Tier II
C. Tier III

Practice Scenario

John comes in to file his Tax Return, he:

- Was Born in 1941
- Receives public retirement and pension benefits of $24,000.
- Is not Married

Which Tier would John fall in?

A. Tier I
B. Tier II
C. Tier III

Explanation: John was born before 1946 and would into Tier I.

Practice Scenario

Ben comes in to file his Tax Return, he:

- Was Born in 1954
- Receives private retirement and pension benefits of $24,000.
- Is not Married

Which Tier would Ben fall in?

A. Tier I
B. Tier II
C. Tier III

Practice Scenario

Ben comes in to file his Tax Return, he:

- Was Born in 1954
- Receives private retirement and pension benefits of $24,000.
- Is not Married

Which Tier would Ben fall in?

A. Tier I
B. Tier II
C. Tier III

Explanation: Ben was born after 1952 and would under Tier III for the pension subtraction.

Tax Treatment – Step 2, Option 2

Option 2: Qualified Fire, Police, and Corrections Retiree Subtraction

- Certain fire, police, and corrections retirees may fully deduct, to the extent a qualifying distribution is included in AGI, retirement benefits received from Michigan service as a:
  - Public police or fire department employee,
  - State police trooper or state police sergeant
  - Corrections officer employed by a county sheriff in a county jail, work camp, or other facility maintained by a county that houses adult prisoners.

Tax Treatment – Step 2, Option 2 (cont.)

Option 2: Qualified Fire, Police, and Corrections Retiree Subtraction

- There is no limitation to the amount of a public pension deductible for these retirees
- Any public retirement deduction claimed reduces the maximum private retirement deduction
- Retirement benefits received from the Federal Employees Retirement System (FERS) that are attributable exclusively to service as a federal law enforcement officer generally qualify for the unlimited public retirement income deduction
- State law enforcement officers and employees retired from states other than Michigan are not eligible for the full deduction of public retirement income

Tax Treatment – Step 2, Option 2 (cont.)

Option 2: Qualified Fire, Police, and Corrections Retiree Subtraction

- The surviving spouse of a qualified fire, police, or corrections retiree is allowed a subtraction under this option if:
  - they filed a joint return for the tax year in which the retiree died

    and
  - claimed a retirement subtraction for that year
- Because the subtraction is 100% of the retirement benefit, the age of the older spouse is not a factor in computing the subtraction.

Tax Treatment – Step 2, Option 3

Option 3: Phase-In Subtraction

- The maximum retirement subtraction described in the table below is the private pension limit established for Tier 1 retirees. It is derived based on
  - date of birth of the taxpayer (for single/MFS returns)

    or
  - the oldest spouse (for MFJ return)

Tax Year	Retiree Date of Birth	Phase-In Subtraction
2023	Jan. 1, 1946 - Dec. 31, 1958	Up to 25%
2024	Jan. 1, 1946 - Dec. 31, 1962	Up to 50%
2025	Jan. 1, 1946 - Dec. 31, 1966	Up to 75%
2026	N/A	Up to 100%

Tax Treatment – Step 2, Option 3 (cont.)

Option 3: Phase-In Subtraction

- A taxpayer electing the Phase-In Method must reduce the maximum amount allowed for that deduction by the sum of all retirement benefits included in AGI from the following sources:
    - Military pay
    - Military pension or retirement benefits
    - Railroad retirement benefits
    - Michigan National Guard benefits
    - Federal and Michigan public retirement benefits

The taxpayer would then apply the applicable phaseout percentage depending on the tax year.

Tax Treatment – Step 2, Option 3 (cont.)

Option 3: Phase-In Subtraction

- **Example: Taxpayer Eve**

  Note: For tax year 2025, the private pension limit is $65,897 for single/MFS filers and $131,794 for MFJ filers

  - Eve, born in 1958, had a military pension distribution of $50,000 and a private retirement distribution of $12,000 in 2025.

  - To calculate her private pension limit, she must subtract the $50,000 military pension from the maximum private maximum allowed ($65,897), leaving a private retirement maximum of $15,897.
    - Eve may deduct her full military pension of $50,000,
    - And 75% of $15,897 or $11,922.75 of her $12,000 private pension.

Tax Treatment – Step 2, Option 3 (cont.)

Option 3: Phase-In Subtraction

- Surviving Spouse – If a subtraction using the Phase-In Method is claimed on a joint return in the year a spouse died and the surviving spouse has not yet remarried, the surviving spouse may use the Phase-In Method based on the older deceased spouse's year of birth and subject to the limitations applicable to a single filer

Practice Scenario

Daniel comes in to file his Tax Return, he:

- Was Born in 1951
- Receives police retirement and pension benefits of $45,000.
- Did not pay social security taxes while working

Which Tier does Daniel fall into?

A. Tier I
B. Tier II
C. Tier III

Practice Scenario

Daniel comes in to file his Tax Return, he:

- Was Born in 1951
- Receives police retirement and pension benefits of $45,000.
- Did not pay social security taxes while working

Which Tier does Daniel fall into?

A. Tier I
B. Tier II
C. Tier III

Explanation: Daniel falls into Tier II because he was born After 1946 and before 1952.

Practice Scenario

Daniel comes in to file his Tax Return, he:

- Was Born in 1951
- Receives police retirement and pension benefits of $45,000.
- Did not pay social security taxes while working

Which option would be most beneficial for Daniel to use?

A. Option 1 - Tier Structure Subtraction
B. Option 2 - Qualified Fire, Police, and Corrections Retiree Subtraction
C. Option 3 - Phase-in Subtraction

Practice Scenario

Daniel comes in to file his Tax Return, he:

- Was Born in 1951
- Receives police retirement and pension benefits of $45,000.
- Did not pay social security taxes while working

Which option would be most beneficial for Daniel to use?

A. Option 1 - Tier Structure Subtraction
B. Option 2 - Qualified Fire, Police, and Corrections Retiree Subtraction
C. Option 3 - Phase-in Subtraction

Explanation: Daniel would the most from using Option 2 because there is no limit to the amount of public benefits that can be subtracted.

Recap of Surviving Spouse Rules

<u>For Option 1 (Tier Structure Subtraction) and Option 3 (Phase-In Subtraction):</u>

A surviving spouse may compute a retirement subtraction based on the date of birth of the older, deceased spouse if all of the following are true:

- A joint return was filed for the tax year in which the spouse died.
- A retirement subtraction was claimed for the year in which the spouse died.
- The surviving spouse has not since remarried.
- For Option 1, Tier 2 and Tier 3 beneficiaries, the surviving spouse has to have reached age 67 in addition to the requirements listed above.

For Option 1, Tier 2 and Tier 3 beneficiaries – If the above requirements are met, the surviving spouse may elect to take the greater of the Michigan standard deduction or the allowable retirement subtraction based on the date of birth of the older, deceased spouse.

<u>For Option 2 (Qualified Fire, Police, and Corrections Retiree Subtraction):</u>

A surviving spouse is allowed to subtract benefits earned by the deceased spouse if:

- He or she filed a joint return for the tax year in which the retiree died

  and
- Claimed a retirement subtraction for that year.

Practice Scenario

Mary comes in to file her Tax Return, she:

- Was Born in 1952
- Receives public retirement and pension benefits of $46,000.
- Bob, Mary’s deceased spouse, was born in 1944 and died in 2019.
- Receives $7,000 in surviving spouse benefits from Bob’s private pension.
- Has not remarried
- Filed jointly with Bob in 2019, claiming a subtraction for retirement and pension benefits.

What Tier does Mary fall in for the pension subtraction?

A. Tier I
B. Tier II
C. Tier III

Practice Scenario

Mary comes in to file her Tax Return, she:

- Was Born in 1952
- Receives public retirement and pension benefits of $46,000.
- Bob, Mary's deceased spouse, was born in 1944 and died in 2019.
- Receives $7,000 in surviving spouse benefits from Bob's private pension.
- Has not remarried
- Filed jointly with Bob in 2019, claiming a subtraction for retirement and pension benefits.

What Tier does Mary fall in for the pension subtraction?

A. Tier I
B. Tier II
C. Tier III

Explanation: Mary is in Tier II because she was born between 1946 and 1952.

Practice Scenario

Mary comes in to file her Tax Return, she:

- Was Born in 1952
- Receives public retirement and pension benefits of $46,000.
- Bob, Mary's deceased spouse, was born in 1944 and died in 2019.
- Receives $7,000 in surviving spouse benefits from Bob's private pension.
- Has not remarried
- Filed jointly with Bob in 2019, claiming a subtraction for retirement and pension benefits.

What Tier would Bob, Mary's Spouse, fall in for the pension subtraction?

A. Tier I
B. Tier II
C. Tier III

Practice Scenario

Mary comes in to file her Tax Return, she:

- Was Born in 1952
- Receives public retirement and pension benefits of $46,000.
- Bob, Mary's deceased spouse, was born in 1944 and died in 2019.
- Receives $7,000 in surviving spouse benefits from Bob's private pension.
- Has not remarried
- Filed jointly with Bob in 2019, claiming a subtraction for retirement and pension benefits.

What Tier would Bob, Mary's Spouse, fall in for the pension subtraction?

A. Tier I
B. Tier II
C. Tier III

Explanation: Bob would be in Tier I for the Pension subtraction, because he was born before 1946.

Practice Scenario

Mary comes in to file her Tax Return, she:

- Was Born in 1952
- Receives public retirement and pension benefits of $46,000.
- Bob, Mary’s deceased spouse, was born in 1944 and died in 2019.
- Receives $7,000 in surviving spouse benefits from Bob’s private pension.
- Has not remarried
- Filed jointly with Bob in 2019, claiming a subtraction for retirement and pension benefits.

Can Mary use the Tier I pension subtraction, rather than the Standard Deduction available to her through Tier II?

A. Yes
B. No

Practice Scenario

Mary comes in to file her Tax Return, she:

- Was Born in 1952
- Receives public retirement and pension benefits of $46,000.
- Bob, Mary's deceased spouse, was born in 1944 and died in 2019.
- Receives $7,000 in surviving spouse benefits from Bob's private pension.
- Has not remarried
- Filed jointly with Bob in 2019, claiming a subtraction for retirement and pension benefits.

Can Mary use the Tier I pension subtraction, rather than the Standard Deduction available to her through Tier II?

A. Yes

B. No

Explanation: Since Bob qualified for Tier I, Mary has not remarried, and filed a Joint return in the year of his death claiming the subtraction, Mary would be eligible to claim the Tier I Subtraction as a surviving spouse.

End of Pension Subtraction

Take a few moments with your table and discuss any questions you may have regarding this topic.