



Department of Technology, Management & Budget  
Office of Retirement Services

## Update Regarding Federal Tax Implications for 3% Retiree Healthcare Contributions

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### Update Regarding Federal Tax Implications for 3% Retiree Healthcare Contributions

The Office of Retirement Services (ORS) still believes that all of the 3% Retiree Healthcare Contributions should be excluded from gross income and wages for purposes of federal income and FICA taxes. This bulletin provides an update with regard to certain positions that the Internal Revenue Service (IRS) has taken relative to the 3% Retiree Healthcare Contributions, including those that have resulted in both positive and negative results with regard to federal tax treatment. It includes a current status of the issue, a summary of both the 2010 and 2012 laws, followed by a “What you need to know” section and a detailed Overview and Analysis (attached) that sets forth some of the best arguments for favorable tax treatment. Portions of the Overview and Analysis will be used to support the upcoming Private Letter Ruling Request that ORS intends to make on behalf of the Michigan Public School Employees’ Retirement System (MPSERS). Reporting units will each have to make their own determination with regard to their federal tax analysis. For those reporting units that are advocating for favorable tax treatment on an individual basis, it is anticipated that parts of the Overview and Analysis can be used as they advocate for that position.

ORS has confirmed that certain reporting units have received determination rulings from the IRS as to refund claims that had been submitted relative to federal income and FICA taxes that had been reported, deducted, and remitted under 2010 PA 75 and 2012 PA 300, respectively. These reports suggest that the IRS has concluded—relative to the specific claims at issue—that the retiree healthcare contributions provided under 2010 PA 75 are *exempt* from federal income and FICA taxes, but in contrast, the retiree healthcare contributions provided under 2012 PA 300 contributions are *subject to* federal income and FICA taxes. As explained ahead, ORS continues to monitor this situation and is supporting the efforts of the Michigan School Business Officials, their constituents, and all MPSERS reporting units in obtaining favorable federal tax treatment for the contributions provided under both 2010 PA 75 and 2012 PA 300. What follows is a status overview of the retiree healthcare contributions at issue.

#### 2010 PA 75 contributions

2010 PA 75 required, for the first time, that members contribute toward the funding of retiree healthcare by mandating a 3% reduction in the members’ compensation (“mandatory contribution”) with such amount being remitted as an employer contribution to a retiree healthcare trust fund. Several lawsuits were filed challenging the

validity of the retiree healthcare reforms—and in particular the contributory component. A state court ruled that the healthcare reforms were unconstitutional and ordered the contributions remitted thereunder to be held in escrow pending final resolution in the courts. In the meantime—and in light of the fact that the mandatory contributions were designated to be held in escrow—reporting units made up the balance from additional employer funding sources in order to meet statutorily required retiree healthcare funding benchmarks.

Now, nearly six years since the 2010 reforms were enacted, the courts have not yet rendered a final judgment as to the constitutional challenges. Following the July 2015 remand instructions from the Michigan Supreme Court, the case is before the Michigan Court of Appeals awaiting a hearing date, which is anticipated to be held sometime in 2016 with a decision to follow soon after.

In view of the fact that the Michigan courts have not yet rendered a final judgment on the retiree healthcare contributions remitted under 2010 PA 75, the federal tax status of the retiree healthcare contributions at issue—as to both the mandatory contributions still held in escrow and also additional employer contributions made to the retiree healthcare trust in lieu of the mandatory contributions—has not been formally decided by the IRS. Nevertheless, reporting units have informed ORS that they have obtained favorable rulings from the IRS that mandatory contributions under 2010 PA 75 are considered employer contributions not subject to taxable income as wages, thereby granting a refund of federal taxes that the reporting units reported and remitted relative to those mandatory contributions.

## **2012 PA 300 contributions**

2012 PA 300 was enacted in light of the aforementioned trial court decision, which held that the 2010 PA 75 retiree healthcare reforms were unconstitutional. In regard to retiree healthcare, members were required to continue the 3% contribution *as a condition of participating in the retiree healthcare plan*—or to forego subsidized retiree healthcare coverage and instead participate in a personal healthcare fund (PHF). As with the 2010 law, the 2012 PA 300 reform measures were challenged in state court on constitutional grounds; however, the trial court ruled that the law was constitutional. On appeal, the Michigan Court of Appeals affirmed that 2012 PA 300 was constitutional and the Michigan Supreme Court issued a final decision and order to that effect in July 2015.

Although the state litigation surrounding the constitutionality of the 2012 retiree healthcare contributions has been resolved, questions remain as to whether the mandatory contributions—under both the 2012 law and the yet-to-be-settled 2010 law—are subject to federal income and FICA taxes. As indicated above, although the litigation continues as to the 2010 law, recent reports of favorable treatment in regard to certain refund claims filed by individual reporting units relative to the 2010 law suggest that the Internal Revenue Service views the mandatory contributions remitted under 2010 PA 75 to be *exempt* from federal income and FICA taxes. That said, the IRS has not yet issued a formal ruling in this regard; nor has the IRS issued a ruling as to the federal tax treatment accorded to the additional employer contributions that were remitted to the healthcare trust in lieu of mandatory contributions (that are still being held in escrow).

## **What you need to know**

- IRS has not yet issued a global determination as to the federal tax treatment of the mandatory contributions under 2010 PA 75 and 2012 PA 300, respectively.
- The mandatory contributions remitted under 2010 PA 75 are still being held in escrow; litigation continues and is currently pending before the Michigan Court of Appeals (following remand instructions from the Michigan Supreme Court in July 2015).
- Individual determinations rendered in regard to specific refund claims suggests that the IRS views the mandatory contributions remitted under 2010 PA 75 to be exempt from federal income and FICA taxes; as yet no guidance has been issued regarding the additional employer contributions that were remitted in lieu of the mandatory contributions being held in escrow by order of the court. By the same token, it appears that the IRS views the mandatory contributions remitted under **2012 PA 300 to be subject to federal income and FICA taxes.**
- Although no global determinations have yet been issued, ORS is preparing to file a private letter ruling

(PLR) on behalf of MPSERS seeking a determination that all employer contributions, including the mandatory contributions, remitted under 2010 PA 75 and 2012 PA 300 are exempt from federal income and FICA taxes.

- ORS has been and will continue to assist the Michigan School Business Officials and individual districts in advancing arguments in support of favorable federal tax treatment.
  - Districts are reminded to seek and obtain consultation with federal tax and legal professionals to assess their options and obligations under federal regulations.
  - These matters may be **time-sensitive** and could require immediate action to preserve rights and remedies.

For more information, please review the attached Overview and Analysis that has been prepared by ORS in conjunction with the forthcoming private letter ruling request that will be submitted by MPSERS.

A copy of this bulletin and the Overview and Analysis document are available on the Employer Communications page of the ORS [Employer Information](#) website.

- [R3240C\\_OverviewAndAnalysis\\_FavorableTaxTreatment\\_3percentHCC.pdf](#)

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