

10-19-1990

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City Club of Portland (Portland, Or.)

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City Club of Portland (Portland, Or.), "Report on Repeals Tax Exemption, Grants Additional Benefit Payment for PERS Retirees (State Ballot Measure 3)" (1990). *City Club of Portland*. Paper 447.
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Report on

**REPEALS TAX EXEMPTION,
GRANTS ADDITIONAL BENEFIT PAYMENT FOR PERS RETIREES
(State Ballot Measure 3)**

Published in
City Club of Portland Bulletin
Vol. 71, No. 21
October 19, 1990

The City Club membership will vote on this report on October 19, 1990. Until the membership vote, the City Club does not have an official position on this report. The outcome of the membership vote will be reported in the City Club Bulletin (Vol. 71, No. 23) dated November 2, 1990.

**REPORT ON
REPEALS TAX EXEMPTION,
GRANTS ADDITIONAL BENEFIT PAYMENT FOR PERS RETIREES
(STATE BALLOT MEASURE 3)**

To the Board of Governors,
City Club of Portland:

I. INTRODUCTION

For nearly 50 years, Oregon has exempted from income taxes all pensions paid by Oregon and its political subdivisions to state and local retirees. Federal retirement pensions receive only a partial tax exemption.

In March 1989, the United States Supreme Court ruled that states may not tax state pensions differently from federal pensions. Soon thereafter the Oregon Legislature enacted House Bill 3508, which repealed the total tax exemption of Oregon state and local public pensions. In place of that exemption, HB 3508 extended to all Oregon state and local retirees a partial exemption similar to that formerly received by federal retirees.

HB 3508 also provided that retirees who are part of the state's Public Employees Retirement System (PERS) receive an increase in PERS benefits equal to the newly-imposed taxes. Most state and local public employees are members of the PERS system, but a significant number are not. HB 3508 funded the increased PERS benefits only for 1989 and 1990, while it made permanent the repeal of state and local retirees tax exemption.

After the 1989 legislative session, a group of federal retirees gathered sufficient signatures to refer HB 3508 to a statewide vote. The referral delayed implementation of HB 3508 until after the November election. A vote in favor of Ballot Measure 3 would put HB 3508 into effect. A vote against Ballot Measure 3 would nullify the statute.

Ballot language follows:

Question: Shall tax exemption for PERS pensions be repealed, and amount equaling taxes plus 11 percent interest returned to PERS retirees?

Explanation: Amends Oregon laws. Removes income tax exemption for Public Employees' Retirement System benefits paid to retired members of System. Makes general \$5,000 exclusion from taxable income apply to benefits of both federal government retirees and PERS retirees. PERS must make annual payments, funded by public employer contributions, to PERS retirees that equal previous years' income taxes on PERS retiree's benefits. Establishes Public Employees' Tax Account and appropriates \$18 million to pay employer contributions in 1989-91 fiscal period. Creates Task Force to report to legislature.

II. HISTORY AND BACKGROUND

In *Davis v. Michigan*, 489 U.S. 803 (1989), the United States Supreme Court invalidated Michigan's system of taxing pensions of public employees. Michigan exempted state retirees' pensions from taxation while subjecting federal retirees to taxation. The court held that such inconsistent treatment of state and federal pensions discriminated against federal employees, in violation of a long standing federal statute, 4 U.S.C. Section 111, which prohibits discriminatory state taxation of federal employees.

Oregon is one of several states which, like Michigan, exempts its state and local retirees' pensions from income tax while taxing the pensions of federal retirees. (See ORS 237.201 and 316.680.) The exemption for state and local retirees' pensions increased benefits to those retirees without a direct appropriation of money.

In response to the ruling in *Davis v. Michigan*, the 1989 Oregon Legislature enacted HB 3508, eliminating the exemption for state and local retirees. Under HB 3508, all federal and Oregon state and local retirees will pay taxes as follows: retirement benefits up to \$5,000 are exempt from income taxes and any benefits above \$5,000 are fully taxed. The exemption is reduced dollar-for-dollar by the amount the taxpayer's household income (excluding social security) exceeds \$30,000. Retirees under age 62 are not eligible for the exemption.

Among the issues confronting the legislature in preparing to respond to *Davis v. Michigan* was whether, by enacting the exemption many years ago, the state had created a contract with state and local retirees that required it to continue the exemption. The Oregon Attorney General concluded that no such contract obligation existed with PERS members. Nonetheless, the Legislature included as part of HB 3508 a general fund appropriation increasing PERS benefits for the 1989-91 biennium. To offset the tax imposed, September PERS benefit payments will include an amount equal to the state income tax PERS retirees paid in April, plus interest at a rate of eleven percent for the period between payment of taxes and receipt of increased benefits. Only PERS employees receive the increase in benefits, not state and local retirees who are not part of the PERS system.

HB 3508 also created a legislative task force to study the issue of retirement income taxation. Because this measure was referred for a state-wide vote, the task force was not established. However, the legislative leadership created another task force that has met several times to study the taxation of retirement income. No report or action is expected to be taken by the task force until after the election.

A group of federal retirees in Oregon have already initiated lawsuits seeking to recover taxes which they claim were illegally collected in the past, based on the ruling of *Davis v. Michigan*.¹ These claims total \$61.4 million for tax years 1989 and 1990 and \$143.5 million for 1985-88. By enacting HB 3508 before the end of the 1989 session, the legislature sought to take advantage of ORS 305.765, a state statute that may limit refunds of improperly collected state taxes.

ORS 305.765 provides that when a court of last resort invalidates a tax law, the state will refund all taxes paid in or after the year in which the challenge was instituted. While the statute does not appear specifically to preclude liability for

¹ The Supreme Court in *Davis* did not address the question of refunds and retroactivity since the state of Michigan conceded that Michigan law would permit the refund sought by the plaintiffs in that case.

refunds in prior years, the Oregon Attorney General reads ORS 305.765 to authorize a refund only in or after the year in which the attack on validity was commenced in Oregon. Thus, ORS 305.765 may protect the state from liability for refunds of taxes paid by federal retirees prior to 1989, the year *Davis v. Michigan* was decided and Oregon federal retirees filed their claims for refunds. Because the statute is unclear, a reviewing court may disagree with the Attorney General's interpretation and require refund of back taxes. In addition, it is possible that federal law may supersede ORS 305.765, creating a tax refund liability in any case.

Before listing and evaluating the arguments for and against Ballot Measure 3, your Committee believes it important to summarize the issues if the measure passes and if it does not.

If Ballot Measure 3 passes:

1. Federal, state, and local government retirees' pensions will be taxed identically.
2. State and local retirees under the PERS system will receive increased PERS benefits for 1989 and 1990, offsetting the taxes. Some state and local retirees who are not part of the PERS system, such as Portland firefighters and police and most state judges, will not receive increased benefits in 1989 and 1990 to offset the tax increase.
3. Federal government retirees are expected to challenge Ballot Measure 3, claiming that it violates the spirit of the equal taxation mandate in *Davis v. Michigan* because the increase in PERS benefits cancels the new tax on PERS pensions. If Ballot Measure 3 survives this challenge, no Oregon tax refunds will be due federal retirees for 1989 or thereafter. Federal retirees may also seek a refund for tax years prior to 1989. If a court adopts the interpretation of ORS 305.765 offered by the Oregon Attorney General, no refunds will be due for tax years prior to 1989.
4. The state will incur the administrative cost of processing amended 1989 tax returns for all state and local retirees. Oregon will also incur the administrative cost of providing increased benefits to offset the taxes paid by PERS retirees in 1989 and 1990.

If Ballot Measure 3 fails:

1. Current law will be unchanged. State and local retirees will receive a full income tax exemption and federal retirees will receive only a partial income tax exemption.
2. By continuing to tax state and federal retirees differently, Oregon will fail to comply with the equal taxation mandate of *Davis v. Michigan*.
3. In a pending lawsuit, federal retirees are claiming tax refunds totalling \$61.4 million for 1989 and 1990 and, if *Davis* has retroactive effect, \$143.5 million for prior years. ORS 305.765 may protect the state against refunds for prior years, but probably would not protect against the \$61.4 million refund for 1989 and 1990.

III. ARGUMENTS IN FAVOR OF THE MEASURE

1. Ballot Measure 3 may correct Oregon's tax laws to comply with *Davis v. Michigan*.
2. Ballot Measure 3 taxes state pensions for the first time, as a step toward the equal taxation of state and federal pensions.

3. If a contract precluding taxation of PERS pensions exists, Ballot Measure 3 honors that contract for the years 1989 and 1990 by providing a refund mechanism.
4. Enactment of Ballot Measure 3 may protect Oregon from having to refund taxes collected from federal retirees before its enactment.

IV. ARGUMENTS IN OPPOSITION OF THE MEASURE

1. Ballot Measure 3 may not correct Oregon's tax laws to comply with *Davis v. Michigan*. The offset mechanism for PERS may violate the spirit of equal tax treatment.
2. The passage of Ballot Measure 3 may result in more lawsuits by state and federal retirees than if it did not pass.
3. The passage of Ballot Measure 3 will result in some administrative burdens involving the filing of amended returns by, and the payment of extra benefits to PERS retirees.
4. By increasing benefit payments to only PERS retirees for 1989 and 1990, Ballot Measure 3 may be viewed as unfair to non-PERS state and local retirees.

V. DISCUSSION

Ballot Measure 3 presents Oregon voters with a choice between retaining a tax structure that is unquestionably in violation of federal law and enacting a new scheme the effects of which are clouded by pending and possible litigation. Given these two less-than-desirable alternatives, it is a consideration of the costs to the State of Oregon that tips the balance in favor of Ballot Measure 3. Ballot Measure 3 also begins the process toward equal taxation of federal, state and local pensions.

Passage of Ballot Measure 3 does not directly affect federal retirees' claims for \$143.5 million in refunds on tax years prior to 1989. The validity of these claims depends on interpretation of ORS 305.765 and the possibility of federal supremacy. Nonetheless, passage of Ballot Measure 3 means that federal retirees' claims may not rise to the \$200 million reached by adding 1989 and 1990 refunds.

It is also possible that state and local retirees may challenge Ballot Measure 3, arguing that it violates an implied contract between them and the state prohibiting taxation on their pensions. Based on the Attorney General's opinion that no such contract exists, your Committee has concluded that Ballot Measure 3 is likely to survive this challenge.

Ballot Measure 3 does make a start toward equal taxation of federal, state and local pensions. It is a deeply flawed "fix," however. The offsetting increased benefits that PERS retirees will receive seems to violate the spirit of equal taxation of federal and state retirees. Some also view as unfair the fact that non-PERS state and local employees do not receive the increase in benefits to offset the increased taxes that PERS retirees will receive. Moreover, the mechanism for increasing the benefits to PERS retirees in 1989 and 1990 is unwieldy and creates unnecessary administrative burdens.

VI. CONCLUSIONS

Notwithstanding these flaws, your Committee concluded that Ballot Measure 3, as a step in the direction of equal taxation and a means to reduce the risk of 1989 and 1990 tax refunds, should be enacted. Your Committee recommends that, during the next session, the Legislature search for a way to meet the requirement of equal taxation with a tax law that is both fiscally responsible and fair to all retirees.

VII. RECOMMENDATION

Your Committee respectfully recommends a "yes" vote on Ballot Measure 3.

Respectfully submitted,

L. Barton Alexander
Joy Arns
James Casterline
Marlys Chapman
Gregory Englund
Sanford Landress
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Lori Irish Bauman, Chair

Approved by the Research Board on September 26, 1990 for transmittal to the Board of Governors. Approved by the Board of Governors on October 1, 1990 for publication and distribution to the membership, and for presentation and vote on October 19, 1990.

APPENDIX A

Persons Interviewed

- Jane Cease, State Senator, Co-Chair, Joint Legislative Committee on Tax Equality of Retirement Benefits, and Co-Chair, Joint Interim Legislative Task Force on Retirement Income
- Barbara Clark, Auditor, City of Portland
- Ted Demezas, opponent
- Phil Keisling, State Representative, Co-Chair, Joint Legislative Interim Task Force on Retirement Income
- John Lobdell, opponent
- Walt McCollum, opponent
- Chuck Mendenhall, Oregon Public Employees Union
- Ed Schroeder, Chairman of Board, Oregon Public Employees Retirement System
- Deborah Sievert, Senior Management Auditor, City of Portland
- Jack Sollis, proponent
- Elizabeth Stockdale, Assistant Attorney General, Oregon Department of Justice
- Parks Walker, Chief Petitioner
- Sheryl Wilson, Director, Oregon Public Employees Retirement System
- Richard C. Yates, Economist, Legislative Revenue Office

APPENDIX B

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