Written Testimony
Senate Committee on Reforms, Restructuring, and Reinventing
May 11, 2011
Re: **HB 4361** and **HB 4480**

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In HB 4361 and HB 4480 (as passed by the House), the House proposes to tax state employee pensions[2] beginning on January 1, 2012. The legal analysis summarized below reveals that taxing state employee retirement pensions for service earned prior to January 1, 2012, would be **unconstitutional**.

The current tax exemption for state employee pensions appears in *two* statutes:

1. The State Employees' Retirement System Act (SERS Act).[3]

2. The Income Tax Act of 1967.[4]

HB 4480 would eliminate the state tax exemption in the SERS Act, effective January 1, 2012. HB 4361 would amend the Income Tax Act to tax state employee pensions for retirees born on and after January 1, 1946.

The following analysis demonstrates two separate legal bases for determining that HB 4361—insofar as it taxes retiree pensions earned before January 1, 2012—is unconstitutional.

A. The Pension Tax Is Unconstitutional under Const 1963, art 9, §24.

State employee pensions are authorized in the SERS Act. Section 40 of the SERS Act provides that the retirement benefits are not taxable:

> The right of a person to a pension, an annuity, a retirement allowance, any optional benefit, any other right accrued or accruing to any person under the provisions of this act, the various funds created by this act, and all money and investments and income of the funds, **are exempt from any state**, county, municipal, or other local **tax**. . . . [Emphasis added]

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[1] Former General Counsel, Michigan Civil Service Commission; Former Member, State Employees' Retirement Board.

[2] This analysis may also apply to some other public employee retirement plans, such as the Public School Employees Retirement Act and the Michigan Legislative Retirement System Act. In addition, federal retirees are entitled to the same favorable tax treatment as retired state employees. See, *Davis v Mich Dept of Treasury*, 489 US 803 (1989); *Davis v Mich Dept of Treasury* (on remand), 179 Mich App 683 (1989).

[3] 240 PA 1943, MCL 38.40.

[4] 1967 PA 281.

This statutory tax exemption is guaranteed by the Const 1963, article 9, § 24:

> The accrued financial benefits of each pension plan and retirement system of the state and its political subdivisions shall be a contractual obligation thereof **which shall not be diminished or impaired thereby**. . . . [Emphasis added]

The purpose of this constitutional provision was discussed by Attorney General Frank Kelly in an opinion:[5]

> This provision substituted a **contractual right to the accrued financial benefits of pension plans** of the state and its subdivisions for the common law rule that such public pension benefits were gratuitous allowances which were subject to revocation at will. . . . The intention of the framers in drafting Const 1963, art 9, § 24, is reflected in the minutes of the constitutional convention:
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> > "[T]his proposal by the committee is designed to . . . give to the employees participating in these plans a security which they do not now enjoy, **by making the accrued financial benefits of the plans contractual rights**. This, you might think, would go without saying, but several judicial determinations have been made to the effect that participants in pension plans for public employees have no vested interest in the benefits which they believe they have earned; that the municipalities and the state authorities which provide these plans provide them as a gratuity, and therefore it is within the province of the municipality or the other public employer to terminate the plan at will without regard to the benefits which have been in the judgment of the employees, earned.
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> > "Now, it is the belief of the committee that the benefits of pension plans are in a sense deferred compensation for work performed. And with respect to work performed, it is the opinion of the committee that the public employee should have a contractual right to benefits of the pension plan, which should not be diminished by the employing unit after the service has been performed. Now, this does not mean that a municipality or other public employing unit could not change the benefit structure of its pension plan so far as future employment is concerned. But what it does mean is that **once an employee has performed the service in reliance upon the then prescribed level of benefits, the employee has the contractual right to receive those benefits under the terms of the statute or ordinance prescribing the plan**. 1 Official Record, Constitutional Convention, 1961, p 770-771. (Delegate

[5] OAG 1989-1990, No 6583, pp 118, 123 (June 1, 1989).

> Van Dusen speaking for the Committee on Finance and Taxation)." [Emphasis added.]
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> Thus, Const 1963, art 9, § 24, protects the "accrued financial benefits" against impairment of contract. "Accrued financial benefits" means the right to receive a specified retirement allowance based on service performed.

At the time in 1962 when the people adopted Const 1963, art 9, § 24, Section 40 the SERS Act already contained the tax exemption. Later, when the Income Tax Act of 1967 was originally enacted, it did not expressly exempt public pensions. At that time, the Attorney General was asked if the Income Tax Act repealed the tax exemption in Section 40 of the SERS Act. The Attorney General concluded[6] that the Income Tax Act did not modify or repeal the tax exemption for state pensions found in the SERS Act. Therefore, even in the absence of a specific exemption for state pensions in the Income Tax Act, state pensions were still *not* taxable. [Subsequently, the Income Tax Act was amended for 1969 and later years to expressly exempt all state and local public retirement system benefits. Thus, since 1969, there has been no conflict between the SERS Act and the Income Tax Act.]

In 1991, the Attorney General was asked if the tax exemption in Section 40 of the SERS Act constituted "accrued financial benefits" protected by Const 1963, Art 9, § 24. The Attorney General opined[7] as follows:

1. Amending or repealing the public pension tax exemption in the Income Tax Act would not affect the statutory exemption in Section 40 of the SERS Act.

2. The legislature could repeal or limit the tax exemption for state retirees in the SERS Act, but only *prospectively* for *new* members of the retirement system. Existing state retiree benefits cannot be taxed because these benefits are "accrued financial benefits" protected by Const 1963, Art 9, § 24.

Now, in HB 4361 and HB 4480, the House has proposed to do precisely what Const 1963, art 9, §2, was enacted to prevent: *diminishing state employee pensions after they have been earned.*

State employees earned their pensions under (1) a statutory retirement plan that specifically prohibited reducing their retirement benefits by state taxation and (2) a constitution that guaranteed those retirement benefits. Thus, any effort by the legislature to reduce retirement benefits for current state retirees violates Const 1963, Art 9, § 24, whether it is attempted by amending the Income Tax Act or the SERS Act.

The legislature may tax state employee pensions, but may do so only *prospectively* for new employees and for benefits that accrue after January 1, 2012. The legislature may not tax pension payments earned by state service prior to January 1, 2012, or by members of the state retirement system hired before January 1, 2012. If the legislature amends both the Income Tax

[6] OAG 1967-68, No 4604, p 269 (July 26, 1968).

[7] OAG 1990-1991, No 6697 (December 18, 1991).

Act and the SERS Act to permit taxation of pension benefits, the tax will be payable only on pension payments earned by new state employees hired after January 1, 2012.

B. The Pension Tax Is Unconstitutional under US Const, art 1, § 10, and Const 1963, art 1, § 10.

There is a second, independent constitutional basis for rejecting taxes on state employee pensions. Both the US and Michigan constitutions prohibit the legislature from enacting any law that impairs existing contractual obligations:

> US Const, art 1, §10: "No State shall . . . pass any Bill of Attainder, ex post facto Law, or Law impairing the Obligation of Contracts . . ."
>
> Const 1963, art 1, §10: "No bill of attainder, ex post facto law or law impairing the obligation of contract shall be enacted."

Since Const 1963, art 9, § 24, unambiguously creates a contractual right to the pensions authorized in the SERS Act, the legislature cannot lawfully enact HB 4361 and HB 4480 since they diminish and impair that contractual right.

Obviously, the statutory tax exemption was intended to ensure that state employees received 100 percent of their accrued pension after retirement and that future legislatures could not raid the pension funds by taxing pensions to reduce them after-the-fact. Even if the legislature were not permitted to tax state employee pensions, the retirees would be entitled to contractual damages equal to the amount of the tax.

C. What are the Administration's Legal Arguments for Taxing State Employee Pensions?

The administration has not released any written legal analysis to support taxing state employee pensions. However, the Lt. Governor Calley testified before joint legislative committees and suggested the following three legal reasons the legislature may constitutionally tax state employee pensions:

Reason 1: The administration suggested that the Michigan Supreme Court decision in *Studier v Mich Public School Employees' Retirement System*[8] somehow permits the state to tax state employee pensions.

We disagree that the *Studier* decision applies to state employee pensions. Basically, *Studier* dealt with retiree health care benefits, not retiree pensions, and therefore the *Studier* analysis and decision simply does not address retiree pensions.

The *Studier* plaintiffs[9] argued two constitutional reasons why the legislature cannot change retiree health care benefits.

[8] 472 Mich 642 (2005).

A. The plaintiffs first argued that teacher retiree health care benefits are "accrued financial benefits" protected by Const 1963, art 9, §24.

- In its decision, the *Studier* court held that retiree health care benefits are not "accrued financial benefits" covered by Mich Const, art 9, §24. Hence, health care benefits are not protected by Const 1963, art 9, §24.

- In contrast, no one doubts that state employee pensions are explicitly "accrued financial benefits" protected by Const 1963, art 9, § 24. Therefore, the holding in *Studier* is not applicable to state employee retiree pensions.

B. The plaintiffs alternatively argued that the teachers' retirement act created a contractual right by public school retirees to receive health care benefits that could not be altered without violating US Const, art 1, §10, and Mich Const, art 1, §10.

- In its decision, the *Studier* court looked for, but *did not find*, any express statutory language that created a contractual right in the health care benefits. As a result, the *Studier* court held that the legislature was free to change the health care benefits of public school retirees without violating either the US or Michigan constitutions.

- In contrast, when considering state employee pensions that are protected by Const 1963, art 9, § 24, that very constitutional provision expressly provides that the protected pension payments are a "contractual obligation" which cannot be "diminished or impaired" by the legislature. Thus, the statutory guarantee in the SERS Act that accrued pension benefits will not be taxed is, by virtue of the express language of Mich Const, art 9, §24, *an explicit contractual obligation* of the state. Therefore, the state cannot tax existing retiree pensions without violating US Const, art 1, §10, and Mich Const, art 1, §10.

Reason 2: The administration also suggested that Const 1963, art 9, § 2, prohibits the state from surrendering its taxing authority under *any* circumstances.

Const 1963, art 9, § 2, provides as follows:

> The power of taxation shall never be surrendered, suspended or contracted away

Here, the administration suggests that Const 1963, art 9, §2, supersedes art 9, §24, and therefore art 9, §24, cannot prevent the legislature from taxing pensions. However, the courts must attempt to ensure that both constitutional provisions are implemented, not just the administration's choice.

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[9] The plaintiffs were public school teacher retirees.

The administration is also suggesting that an earlier legislature cannot bind the current legislature's decision to tax state employee pensions. In fact, the *Studier* analysis addresses the power of one legislature to bind a later legislature. The *Studier* court expressly recognized that it is possible for the legislature to create contractual rights that are constitutionally guaranteed and bind future legislatures.[10]

Reason 3: The administration disagrees with the Attorney General opinions regarding the protections afforded by Const 1963, art 9, § 24, cited above.

We find no legal basis for rejecting the Attorney General opinions.

Thus, nothing in the administration's comments to date addresses or undermines the legal conclusion that it would be unconstitutional for the legislature to tax state employee pensions.

[10] 472 Mich at 660-661.