Written Testimony
House Tax Policy Committee
March 16, 2011
Re: HB 4361

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In HB 4361, the Governor proposes to tax state employee pensions (among others retiree benefits).[2] The following brief review reveals that taxing current state employee pensions would be **unconstitutional**.

It is important to note the tax exemption for state employee pensions appears in *two* statutes:

1. The State Employees' Retirement System Act (SERS Act), 240 PA 1943, MCL 38.40.

2. The Income Tax Act of 1967.

HB 4361 addresses only the tax exemption in the Income Tax Act; it does not address the tax exemption in the SERS Act. More importantly, retirement benefits earned under the SERS Act are protected from legislative reduction by the Michigan Constitution, Article 9, § 24.

- Article 9, § 24, of the Michigan Constitution provides, in part, as follows:

> 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 state employee pension plan is created 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]

[1] Former General Counsel, Michigan Civil Service Commission; Former Member, State Employees' Retirement Board.
[2] This constitutional analysis may apply to other public employee retirement plans. However, my remarks are limited to the State Employees' Retirement System.

This tax exemption in Section 40 of the SERS Act was originally adopted in 1943 and remains unchanged up to today.

- When the Income Tax Act of 1967 was originally enacted, it did not expressly exempt public pensions. At that time, the Attorney General was asked if the Income Tax Act repealed the tax exemption in Section 40 of the SERS Act.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[3] 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, in 1969 PA 332, 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 Mich Const, Art 9, § 24. The Attorney General opined[4] as follows:

  (a) 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.

  (b) 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 Mich Const, Art 9, § 24.

State retirees 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 state retiree benefits for current state retirees violates Mich Const, 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* and only for *new* state employees. The legislature may not reduce current state employee pensions by amending either the Income Tax Act or the SERS Act.

If the legislature adopts amendments to tax state employee pensions, we expect the courts to hold that the amendments are unconstitutional.

[3] OAG 1967-68, No 4604, p 269 (July 26, 1968).
[4] OAG 1990-1991, No 6697 (December 18, 1991).