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BILL ANALYSIS

Senate Fiscal Agency

Lansing, Michigan 48909

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Senate Bill 473 (as passed by the Senate)  
Sponsor: Senator Norman D. Shinkle  
Committee: Finance

Date Completed: 7-24-90

**RATIONALE**

The Income Tax Act provides that persons can deduct from taxable income retirement or pension benefits received from a public system created by the State or a political subdivision, but makes no mention of Federal pensions. In effect, the Act provides that State and local pension income is deductible while Federal pension income is not. This provision was the subject of a recent U.S. Supreme Court decision, Davis v State of Michigan, which held that the tax scheme violates Federal law, in that it discriminates against Federal retirees by taxing their retirement benefits while exempting State and local pension benefits (109 S. Ct. 1500 (1989)). (For more information about the Davis case, see BACKGROUND.)

Paul Davis, a retired Federal employee, brought suit against the State seeking refunds of taxes paid from 1979 through 1984 on Federal retirement benefits, and the dispute eventually reached the U.S. Supreme Court. The Court's decision allowed Davis to collect his refund but did not grant Davis' request for prospective relief; that is, it did not prohibit the State from taxing his Federal pension in the future. Instead, the Supreme Court said that the unequal tax treatment between State and Federal retirees could be resolved by extending the State exemption for retirement benefits to all retired Federal employees (or to all retired employees, regardless of employer), or by eliminating the exemption for retired State and local employees. It further stated that Michigan courts were in a better position to determine how to comply with the mandate of equal treatment and remanded the question to the Michigan Court of Appeals. In August

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1989, the Court of Appeals held (No. 117204) that the exemption for retirement benefits should be extended to Federal retirees, unless the Legislature amends the Income Tax Act to provide a different remedy. Toward that end, the Senate passed Senate Bill 472, which would amend the Income Tax Act to allow a taxpayer to deduct from taxable income, to the extent included in Federal adjusted gross income for tax years 1985 and thereafter, retirement or pension benefits received from a public retirement system of the U.S. government. (The bill is currently in the House.)

Further, neither the U.S. Supreme Court nor the Michigan Court of Appeals addressed the issue of whether the 24,000-plus Federal retirees in Michigan other than Davis should receive refunds for taxes paid. In a recent development, the Tax Tribunal ruled on June 11, 1990, in Fonger v Department of Treasury, that the Income Tax Act's four-year period of limitations on claims for refunds took precedence over the revenue Act's 90-day period for refund claims based on the unconstitutionality of a statute. This case involved an individual who paid State income tax on Federal pension income received during tax years 1982 through 1987, and who filed amended returns requesting a refund of that tax. The Tribunal ordered refunds for 1985 to 1987, and the Department has filed an appeal of that ruling in the Michigan Court of Appeals. (For more information about the Fonger case, see BACKGROUND.)

Some people feel that since Federal retirees were taxed on the basis of a provision that was

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later ruled to discriminate against retired Federal employees, such persons should be allowed to claim refunds for those years when the taxes were paid.

## **CONTENT**

The bill would amend the revenue Act to provide that an income tax refund claim for the 1984 tax year or thereafter, for taxes paid on retirement or pension benefits from a U.S. government public retirement system, would not be subject to a provision that forbids the payment of a refund under certain circumstances, as stated in Section 27a(6). Currently, Section 27a(6) provides that a refund claim, based upon the validity of a tax law based on the laws or Constitution of the United States or the State Constitution, cannot be paid unless the claim was filed within 90 days after the date set for filing a return, or unless ordered pursuant to an appeal.

The bill specifies that claims for refunds for tax years 1988 and 1987 would be payable on or after July 1, 1990; claims for tax year 1986 would be payable on or after July 1, 1991; claims for tax year 1985 would be payable on or after July 1, 1992; and claims for tax year 1984 would be payable on or after July 1, 1993.

MCL 205.27a

## **BACKGROUND**

### **Davis v State of Michigan**

In 1984, Paul Davis filed amended income tax returns for the tax years 1979 through 1982, claiming that he was entitled to a refund because his Federal retirement benefits were not subject to State income taxation. When the refund requests were denied, Davis filed a complaint in the Michigan Court of Claims. (Refund requests for 1983 and 1984 were later added to the complaint.) The Court of Claims rejected Davis' arguments and granted summary disposition to the Michigan Department of Treasury. Davis appealed to the Michigan Court of Appeals, which affirmed the Court of Claims ruling. The Michigan Supreme Court denied Davis' application for leave to appeal.

The U.S. Supreme Court reversed the Michigan

Court of Appeals, concluding that "the Michigan Income Tax Act violates principles of intergovernmental tax immunity by favoring retired state and local government employees over retired federal employees". The Court found that the constitutional doctrine of intergovernmental tax immunity, which is based on the need to protect each sovereign's governmental operations from undue influence by the other, embodied Section 111 of the Federal Public Salary Tax Act of 1939 (4 U.S.C. 111). In relevant part, Section 111 provides, "The United States consents to the taxation of pay or compensation for personal service as an officer or employee of the United States...by a duly constituted taxing authority having jurisdiction, if the taxation does not discriminate against the officer or employee because of the source of the pay or compensation." (Emphasis added.) According to the Court, "the overall meaning of Section 111 is unmistakable: it waives whatever immunity past and present federal employees would otherwise enjoy from state taxation of salaries, retirement benefits, and other forms of compensation paid on account of their employment with the Federal Government, except to the extent that such taxation discriminates on account of the source of the compensation".

As the Court pointed out, it was undisputed that Michigan's tax system discriminated in favor of retired State employees and against retired Federal employees. The relevant inquiry then became whether the inconsistent tax treatment was directly related to and justified by significant differences between the two classes, and the Court found that it was not.

### **Fonger v Department of Treasury**

George F. Fonger was a retired Federal employee who received a Federal pension during tax years 1982 through 1987, and filed Michigan income tax returns upon which he reported that income and paid State income tax. On or about May 30, 1989, Fonger filed amended returns with the Department, requesting a refund of all Michigan income tax paid on his Federal pension for 1982 through 1987. On November 1, 1989, the Department denied Fonger's requests as untimely filed, on the ground that all refund requests based on

claims that a statute is unconstitutional must be filed within 90 days of the due date of a return, under Section 27a(6) of the revenue Act. (According to the Tax Tribunal's opinion, the Department has denied some 7,000 similar claims, relying upon the 90-day clause of Section 27a(6). Reportedly, 5,000-6,000 of these denials have been appealed to the Tribunal.)

As articulated by the Tribunal, the precise issue before it was whether a 90-day limitation period, a four-year period, or no refund period at all governed the issuance of refunds. The Tribunal held that the four-year refund provision in Section 441 of the Income Tax Act was applicable. That section permits a taxpayer, who has paid a tax that he or she claims was not due, to petition for a refund within four years of the date set for filing the return or the date the tax was paid. The Tribunal held that Section 441 took precedence over the 90-day period in the revenue Act because Section 402 of the Income Tax Act states that the administration of income taxes is to be through the revenue Act unless a conflict exists between the two laws, in which case the Income Tax Act governs. The Tribunal found that such a conflict did exist, "because one act has a provision that creates an exception to the general refund rule, while the other act does not envisage such a bifurcation...". The Tribunal therefore held that Section 441 of the Income Tax Act applied to any refund claim, including those based upon the unconstitutionality of a statute.

In its judgment, the Tribunal ordered that refunds for Fonger be issued for the 1985, 1986, and 1987 tax years; for the tax years 1982 through 1984, no refunds need be issued if the Department determines that taxes were paid after the respective due dates, "whereupon refunds shall issue on the basis of the 4-year limitation period contained in MCL 205.441". The Department has appealed this decision in the Court of Appeals, and the judgment is stayed pending the appeal.

### FISCAL IMPACT

The bill would have an indeterminate fiscal impact. To date, the Department of Treasury has denied refunds filed after July 17, 1989, the 90-day filing deadline imposed by Michigan

law. Should all taxpayers be granted refunds for the full period for which an amended return can be filed, State General Fund/General Purpose revenues would be reduced by a total of \$20 million to \$25 million over the next four years. The U.S. Supreme Court has heard oral arguments in two cases that might have an impact on S.B. 473. The Court may invalidate restrictions on refunds similar to those currently contained in Section 27a(6). In this case, since refunds would have to be allowed, S.B. 473 would have no fiscal impact.

### ARGUMENTS

#### Supporting Argument

The U.S. Supreme Court in the Davis case found that the provision in the Income Tax Act that exempted from taxation the retirement benefits of State and local retirees, but not Federal retirees, violated Federal law. The decision granted Davis refunds for taxes paid on Federal pension income for the years in question, but denied his request to prohibit the State from taxing Federal pensions in the future, so long as equal treatment was given to State and Federal retirees. The decision remanded the case to the Michigan Court of Appeals to comply with the mandate of equal treatment, suggesting that the case could be resolved either by extending the tax exemption to all State, local, and Federal pension income, or by eliminating the exemption for retired State and local employees. The Court of Appeals found that the exemption should be extended to Federal retirees. Senate Bill 472 would codify this decision of the Court of Appeals.

Senate Bill 473 would allow Federal retirees who have had to pay State income tax on their benefits to claim refunds for tax years 1984 and thereafter. While the U.S. Supreme Court's Davis decision granted refunds to Davis, it did not address the situation of other Federal retirees who have paid income taxes on their Federal pensions. This means, in effect, that virtually nobody except Davis will be able to receive a refund for previous tax years, unless the revenue Act is amended.

Although the Department of Treasury granted refunds to Federal retirees for tax year 1988, if individual retirees applied for a refund by July 17, 1989 (90 days after the original filing date

of April 17, 1989), the Department has denied refund claims that did not meet the 90-day deadline. While the Tax Tribunal reversed this policy for George Fonger, that decision is on appeal, and refunds to some 7,000 other Federal retirees have been denied by the Department. The bill would extend the Tribunal's decision in Fonger by making the 90-day deadline inapplicable to claims for refunds of taxes paid on Federal pension income for the 1984 tax year and thereafter.

Finally, a simple matter of fairness demands that those Federal retirees who have had to pay taxes on their pensions be allowed to claim refunds, by filing amended returns. The Supreme Court decision found the tax treatment of Federal retirees unequal to that allowed State and local retirees and a violation of Federal law. To deny those Federal retirees a remedy for the taxes they were illegally required to pay would be a perpetuation of that illegality.

#### Opposing Argument

The Davis case has forced numerous states to address the question of unequal tax treatment between State and Federal retirees. According to State Policy Reports (vol. 7, issue 9), 19 states will be affected by the decision. The Department of Treasury testified that 10 states have reacted by eliminating tax exemptions for retired state and local pensioners. It must be reiterated that the Davis decision demanded equal treatment for Federal retirees, but did not demand that those retirees be granted exemptions. While the Appeals Court ruled that Federal retirees should be granted the exemption, it also pointed out that if the Legislature disagreed with its assessment, the Legislature could amend the Act in a different way. Also, the decision did not order refunds, other than for Davis himself, for retirees who paid income taxes on their pensions. While it can be argued that fairness dictates that the decision should apply to those in situations similar to Davis, it can also be argued that the laws should be presumed valid until the time a court decides to throw them out, and such a decision should be applied prospectively. Since the provision to tax Federal pensions has been in place for many years, the State presumed that it had the right to collect the tax and distribute the revenue according to dictates at that time. Allowing retroactive refunds would,

in effect, require the State to find revenue to pay for money collected and spent long ago, money that the State thought it had legally collected.

#### Opposing Argument

The bill is objectionable for several reasons. First, litigation is pending on the issue of whether the State will have to pay retroactive refunds, and this decision should be viewed before the Legislature passes a law to require refunds. Second, the bill would simply be too expensive. Why should the State cut worthy programs from the budget and then, in effect, grant a special tax break for a group of residents whose only claim to warrant such attention is that they had the good fortune to work for the Federal government and retire with a Federal pension? Finally, the bill is misdirected because it does nothing for private sector pensioners. What is needed, instead of allowing this benefit for Federal retirees, is for both public and private retirement benefits to receive identical treatment under the tax laws. Perhaps a solution to the subject of taxation of pensions would be to tax all pensions--State Federal, local, and private--but at a lower effective rate than is currently applied to private pensions because of the inclusion of public employees.

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