

SFA

BILL ANALYSIS

Senate Fiscal Agency

Lansing, Michigan 48909

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Senate Bill 472 (as passed by the Senate)

Sponsor: Senator Doug Carl

Committee: Finance

Date Completed: 1-9-90

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 1989 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). (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 either 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, 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. It has been suggested that the Act be amended to conform with the decision of the Court of Appeals and allow Federal retirees to exempt their pensions.

Further, it has been pointed out that the allowable deduction for private pension income has not been changed since it was placed in the Act in 1974. Persons can deduct from taxable income up to \$7,500 for a single return, and \$10,000 for a joint return, of private pension income. Some have suggested that these amounts should be raised to reflect increases in inflation since 1974.

CONTENT

The bill 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 also would increase the allowable deduction for private pension income. Currently, persons can deduct from taxable income up to \$7,500 for a single return, and \$10,000 for a joint return, of private pension income. The bill would allow persons to deduct up to \$17,400 for a single return and \$23,000 for a joint return, and index the deduction to inflation for succeeding years.

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BACKGROUND

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.

FISCAL IMPACT

The bill would have an indeterminate fiscal impact. Exempting Federal pension income from the Michigan income tax base leads to a reduction of State General Fund/General Purpose revenues of between \$6 million and \$8 million per year. Since a court order in the Davis v Michigan case already has exempted Federal pension income from the State income tax, this provision would not result in a further reduction in revenues.

The bill also would allow refunds for past taxes paid from 1985 to July of 1989. The revenue loss from this provision would depend on the number of taxpayers filing amended returns, the number of years the amended returns covered, and the Treasury Department's interpretation of the Court of Appeals ruling in Davis v Michigan. Should all taxpayers be granted refunds for the full period for which an amended return could be filed, State General Fund/General Purpose revenues would be reduced by \$20 million to \$25 million in FY 1989-90.

Increasing the allowable deduction for private pension income to \$17,400 for a single return, and \$23,000 for a joint return, would result in a revenue loss to the State of \$10 million to \$20 million per year.

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. The bill would codify this decision of the Court of Appeals.

In addition, the bill would allow Federal retirees who have had to pay State income tax on their benefits to claim refunds for tax years 1985 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 Income Tax Act is amended or the Department of Treasury decides to grant refunds on the basis of the Supreme Court decision. (Note: The Department of Treasury granted refunds to Federal retirees for tax year 1988, if individual retirees applied for a refund by July 17, 1988, or 90 days after the original filing date of April 17, 1988. Tax years prior to 1985 are not in question because of the statute of limitations; after the expiration of four years from the date set for the filing of an original return a person cannot claim a refund of any amount paid to the Department of Treasury, unless the statute of limitations is suspended for reasons stated in the Act.)

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 within the statute of limitations allowed for refunds. 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.

Supporting Argument

The bill would "make whole" the deduction for private pension income. In 1974, the deduction was placed in the Act to allow for the exclusion of \$7,500 for a single return, \$10,000 for a joint return, from taxable income. These amounts have not changed since that time. It is only fair that these amounts be raised by the

rate of inflation that has occurred in the last 15 years, in order to make the deduction reflect a value similar to its worth in 1974, and index the deduction to inflation for succeeding years.

Response: Why should the State tie itself, forever, to the level of a deduction that was established in 1974? Before that time there was no deduction for private pension income. Simply put, raising the deduction to the levels required by the bill would cause a major revenue loss for the State, with little justification as to why such an action should be taken.

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.

Response: Regarding retroactive refunds, the State should simply admit its mistake and treat all Federal retirees the same as Davis, or at least the same as Davis in respect to the last four tax years. The question of retroactive refunds may, at some point in the future, be

answered judicially for the State if it doesn't allow refunds for previous years. Some states have denied retroactive refunds, and have been challenged in court.

Opposing Argument

The bill does not address, or offer a remedy to, the taxation of private pensions. If Federal pensions were judged to be treated unequally by the Income Tax Act, why shouldn't the mandate of equal treatment also apply to private pension income? Perhaps a solution to the subject of taxation of pensions would be to tax all pensions--State, local, Federal, and private--but at a lower effective rate than is currently applied to private pensions because of the inclusion of government employees.

Response: State, local, and Federal governments, as employers, have a right to offer incentives to attract and to keep employees, one of which can be the exemption from taxation of retirement benefits.

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Analysis First

See SB 472