MINUTES

MONTANA SENATE
52nd LEGISLATURE - REGULAR SESSION

COMMITTEE ON TAXATION

Call to Order: By Senator Mike Halligan, Chairman, on February 1, 1991, at 8:00 a.m., Room 325.

ROLL CALL

Members Present:

Mike Halligan, Chairman (D)
Dorothy Eck, Vice Chairman (D)
Robert Brown (R)
Steve Doherty (D)
Delwyn Gage (R)
John Harp (R)
Francis Koehnke (D)
Gene Thayer (R)
Thomas Towe (D)
Van Valkenburg (D)
Bill Yellowtail (D)

Members Excused: none

Staff Present: Jeff Martin (Legislative Council).

Please Note: These are summary minutes. Testimony and discussion are paraphrased and condensed.

Announcements/Discussion: none

HEARING ON SENATE BILL 226

Presentation and Opening Statement by Sponsor:

Senator John Harp, District 4, Kalispell, said he is introducing this bill at the request of the Department of Revenue and is presenting this proposal as a resolution to the problem that arose from expanding tax exemptions for federal retirees as a result of the Davis case. This proposal will solve some of the problems that occurred because of that case. One of the main components of this bill is the ability to recapture a large part of the general fund due to the Davis case. One of the largest concerns is the effect of the Davis case regarding the section of the equation dealing with exclusion from taxation of federal employees retirement income. The bill includes a threshold of $3,600. As a result of the decision, the retirees are

completely excluded from paying taxes on retirement, which is costing the general fund of the state over $14 million. Senate Bill 226 will recapture 69% of the money received prior to the Davis decision. This bill treats all taxpayers and retirees equally. The first $10,000 of retirement income will be excluded. The cap, a threshold of $35,000, is tied to the federal adjusted gross income. Senator Harp indicated he felt the proposal eliminates some of the tax breaks that the upper income taxpayers will receive if there is not a threshold of $35,000. To balance the budget, it is necessary to recapture some of the money lost because of court decisions. He indicated this bill is appropriate because everything is on a fair and equitable plane. Retirement income is the fastest growing income class. In 1987, $180 million was excluded from retirement income. In 1989, it rose to $328 million and the forecast for 1993 is roughly $480 million. He indicated something needs to be done with the growth of retirement income and the effects it will have if we continue to exclude everybody from paying taxes regardless of their ability to pay. The proposal offered by the Administration today is a progressive program, particularly with the $10,000 and $35,000 threshold. It is a middle class proposal, looking at all people, both private and public. Senator Harp indicated that 78% of all those affected will be excluded because they do not meet the $35,000 threshold. Those who most need tax relief will be receiving under the terms of the bill. This bill is a progressive, fair proposal which attempts to treat everyone on an equal basis. Regarding the issue of PERS and teachers retirement, he felt the Committee will look at the conditions of employment and employment benefits that state employees feel they have been guaranteed. Once the bill is presented to the Committee, it becomes a legislative matter.

Proponents' Testimony:

Denis Adams, Director of the Department of Revenue, stated his support of Senate Bill 226. (See Exhibit 1)

Lou Marquardt, representing Equity in Taxation, stated his support of Senate Bill 226. He said it is not exactly written the way Mr. Adams described it when he met with the House Taxation Committee, but they support the bill.

Tom Harrison, representing the Montana Society of Certified Public Accountants, said he wanted to address the nondiscriminatory portion of the bill which indicates private and public retirees would be treated equally. The Society endorses that concept. He felt the level should be determined by the legislature.

Opponents' Testimony:

Gene Huntington, Montana Retired Teachers Association, stated his opposition and noted that any solution to the Davis

case needs to deal with the benefits that teachers will receive. In general, this bill does not deal with the benefit side of the equation. He stated the Administration has given numbers which MRTA feels somewhat distort the pension levels of the public systems. He noted their average retiree receives $8,271 a year, and some of the numbers appear to give people a much higher level.

Leo Berry, Association of Montana Retired Public Employees, stated there are some advantages to this bill. It partially recaptures the tax on federal employees which was lost due to the Davis case and helps balance the budget. There are some flaws in the bill but the Association is encouraged that both the Administration and Senator Harp are willing to work to resolve some of the them. He noted the bill fails to recognize any employment relationship between the state of Montana, counties, and cities and their employees. He stated that is the fundamental issue to be debated on each of these bills. The court ruled that the tax exemption granted to public employees is a benefit of employment, and the bill takes that away; it fails to recognize that and severs the relationship. Also, it grants a $10,000 exemption if the income level is under $35,000 per household (not individually), and that severs a relationship between the employee and his tax exempt benefit. A similar bill is being drafted that he feels more equitably resolves the employment relation problem.

Ed Sheehy, retired federal employee, said prior to the bill's introduction, he discussed it with the Director of the Department of Revenue. He stated at that time his principal objection was the definition of threshold. Any threshold that does not include social security as part of the base is unfair to federal retirees, and it is unfair to the police and firemen in this state who do not have social security.

Tom Bilodeau, Research Director, Montana Education Association, stated his opposition to the bill. He said this retirement benefit is part of the compensation package promised to state employees and school district employees. This bill will tax the benefits used to provide the compensation increase in 1985. Clearly, retirement benefits are part of the compensation package and can't be ignored six years later. He said the adverse impact on retirees is substantial. (See Exhibit 2)

Alvin Svalstad, American Association of Retired Persons, stated his opposition to Senate Bill 226, and his support of the Montana Teachers Association position on exemption of pensions from state taxation.

John Malee, representing the Montana Federation of Teachers, and Montana Federation of Public Employees, went on record stating their opposition to Senate Bill 226.

Jess Long, School Administrators of Montana, stated his

middle incomes and people who don't benefit in the upper income category. He said the Administration understands this and knows the people with the ability to pay and those who do not have an adequate retirement income.

Senator Towe questioned Mr. Berry regarding the difference between the estimated $20 million cost of this proposal and saving $6 - $7 million dollars without the cap.

Mr. Berry said his members don't like any part of this bill and the cap is immaterial to them. He said he understood the logic behind it the principle of a cap, but they have not discussed that issue. He said they have a fundamental problem with the concept of "household". He felt the board would not oppose a cap if it applied to an individual. There is a basic difference in the philosophy of this bill and the other bill being drafted in terms of employment relationship and an individual's tax obligations as opposed to a household.

Closing by Sponsor:

Senator Harp said he hoped the opponents of this bill will realize the impact of doing nothing as they try to balance the budget in this session. If the state has to come up with an additional $20 million to balance the budget, they better be willing to look at cuts in medicaid, reductions in school funding, and other hard decisions. He said this proposal by the Administration is fair. It puts the public and private sector on equal ground. He feels the threshold is a progressive element of this bill and it takes care of people who can least afford an additional tax increase.

HEARING ON SENATE BILL 218

Presentation and Opening Statement by Sponsor:

Senator Dorothy Eck, District 40, Bozeman, said SB 218 builds on work the Committee did in the 1989 regular and special session and is an attempt to be fair to everyone involved. She stated her belief that our tax policy is based on fairness and equity for everyone. This bill treats all federal, state, local and private retirees the same by allowing $3,600 yearly exemption. It will have a smaller impact on the general fund than would a $10,000 or $12,000 exemption. The bill also recognizes the state's obligation to compensate the retired teachers and state employees for the loss of their state income tax exemption. She said this is a benefit we have promised them and we have a moral obligation to follow through on it as far as we are legally able to do it. She noted Section 1 of the bill is the only new major section with the exception of two technical sections at the end of the bill. This bill provides a

supplemental benefit that will make the state and teacher retirees whole. With regard to the formula, Senator Eck said she has talked to people about it and has been informed it will work. She said the bill is fair to retirees with some qualifications. The formula assumes the retiree's benefits are the retiree's only income. For those with other income, this bill treats the retirement income as the first income and it is taxed at the lowest rate. She thought the Department would propose this bill. She felt it is unfortunate that when they found this bill assessed more tax than the Governor thought was appropriate to collect from retirees that he didn't make a move towards making the state retirees and future retirees whole. She stated she is encouraged by hearing the Governor is now willing to accept some changes. She felt the Committee has a chance to come up with a bill that will pass House Appropriations. Still to be looked at is a defensible method of taking this bill to court in case it becomes necessary, and she noted a statement of intent is needed. Regarding exemptions, she indicated her hope for income tax reform. She stated future impacts should be taken into consideration. The question of whether this supplemental benefit is going to remain in place and grow as salaries increase or whether some benefit in the level of salaries will start being worked into our negotiations with employees must be addressed. She stated she does not have a preference about which bill becomes the vehicle for retirement income reform. She indicated she had not received a fiscal note on SB 218 to date. However, the provision making the employees whole will amount to $3 million a year. She felt the bill is cheaper and will recapture more for the general fund than SB 226, but she noted she has not seen figures on what those caps would do.

Proponents' Testimony:

Lou Marquardt, representing Equity in Taxation, stated his support for the bill and stated private employees are currently getting a $3,600 exemption but they also pay a 5 percent surtax.

Gene Huntington, Montana Retired Teachers Association, expressed support in that it recognizes that tax benefits received by public employee retired teachers are a benefit of compensation. Regarding the idea of being made whole, this bill does not make all members whole and it would only deal with retirement benefits.

Leo Berry, Association of Montana Retired Public Employees, said they are concerned about the bill because it does not make the retirees whole. However, they support the concept of the bill and appreciate the recognition that the lost benefit will be replaced in some manner.

Opponents' Testimony:

Ed Sheehy, Jr., attorney, represents the federal employees and military retirees now suing the state of Montana for refund of taxes that were paid prior to the Davis decision. He said he is the person responsible for causing the current problem because, as a result of the lawsuit, the Department of Revenue and Mr. Sheehy stipulated that retirement income of federal employees would be exempt for tax years 1989 and 1990. After court approval, that currently is the law in Montana. This bill has a problem in that it discriminates based on income source which was the issue addressed by the U.S. Supreme Court in the Davis decision. He said as long as everyone is treated alike, he does not care what is done with exemptions. He referred to pertinent pages of the Davis decision regarding intergovernmental tax immunity. (See Exhibit 4). He indicated the Committee should consider that if the tax is source based there is a discrimination factor. He strongly urged defeat of the bill.

Tom Bilodeau, legal research director for the Montana Education Association, said while they are opposed to the bill, they recognize the attempt to make public employees harmless. However, they feel there are problems in devising a formula to adequately address the problem of making retirees held harmless in terms of balancing retirement and other incomes. He noted it is their belief that the retirement package is part of the compensation package, and anything that doesn't make those retirees whole is an additional penalty during the retirement years when salaries are already inadequate.

Dennis Burr, Montana Taxpayers Association, stated this bill seems to in some way get around a decision rather than bring state law into compliance with that decision and feels that is a bothersome concept.

John Malee, representing the Montana Federation of Teachers, and Montana Federation of Public Employees, stated their opposition to Senate Bill 218.

Jess Long, School Administrators of Montana, stated their opposition to the bill, in that they do not feel the solution to the problem is fully addressed in this bill.

Tom Ryan, stated that while not necessarily opposed to this bill, he has never seen an attempt to balance the budget on such a measly little reasoning. In other years the larger companies have been forgiven, and he stated his displeasure in attempting to balance the budget with this type of legislation.

Questions From Committee Members:

Senator Halligan asked Steve Bender, Assistant Budget Director, about the fiscal note.

Mr. Bender said the fiscal note was received last night. It appears, from what was provided by the Department of Revenue,

that, over the biennium, approximately $21.8 million of new income tax revenue will be generated by the bill. The taxes generated on state and local retirees would be about $4.5 million. The retirement system will incur some additional administrative costs to set this new system up for a net of about $17 million of new money. He noted the bill as drafted is not entirely clear where these retirement payments are coming from. He assumed the way it was drafted it was coming from the retirement trust funds, not the general fund. He has included it as a general fund impact.

Senator Gage asked, assuming these are taxable for federal tax purposes and people are made whole on the basis of what they have paid in additional state tax, does the additional amount become subject to federal tax.

Senator Eck replied in a Senate bill we cannot make an appropriation from the general fund or the income tax fund. It is done quite frequently when a bill gets to the House. In reference to making an employee whole, an employee will do better on federal tax because he will pay more state tax under this and that will be an exemption on his federal tax. On the other hand, he will get additional income from his retirement on which he will be taxed. Senator Eck restated her desire to have a statement of intent included with the bill.

Senator Towe questioned Mr. Sheehy, Jr. regarding Exhibit 4 and cost of living increase.

Mr. Sheehy said of every state that has addressed this issue, there aren't any that have done anything like this. Regarding the lawsuit, Mr. Sheehy said they would sue on the basis of a violation of 4 U.S.C., Section 111, on the basis of discrimination, and they would ask for a refund of taxes paid.

Regarding a question from Senator Thayer regarding legal problems associated with this bill, Senator Eck said the way the supplemental benefit is provided has to be carefully worded. She felt it possibly was tied too closely to our tax codes and that some bracketing system would be better and might offer some protection. She added for years we have had a policy of never putting general fund money into retirement benefits. This could be avoided by setting up a separate trust fund from income taxes.

Closing by Sponsor:

Senator Eck said she felt we are back where we were at the end of the 1989 regular and special sessions regarding making retirees absolutely whole. She thinks the difficulty in accomplishing that is probably insurmountable and the legality is questionable. She noted there is much work left to do on this issue but we have to address it in the best manner we can by providing some supplemental compensation for retirees losing the

exemption and at the same time looking at a fair exemption for everyone. She felt that we will come up with an income tax system that will exempt the first $12,000 of income for everyone, including retirees; and if we can provide a little extra for retirees, that would be fine.

Senator Halligan said no action would be taken on the pension bills for several weeks until we see what the House will do.

ADJOURNMENT

Adjournment At: 9:30 a.m.

MIKE HALLIGAN, Chairman

LYNN STALEY, Secretary

MH/ls

ROLL CALL

SENATE TAXATION COMMITTEE

DATE 2/1/91

____ LEGISLATIVE SESSION ____

NAME	PRESENT	ABSENT	EXCUSED
SEN. HALLIGAN	✓		
SEN. ECK	✓		
SEN. BROWN	✓		
SEN. DOHERTY	✓		
SEN. GAGE	✓		
SEN. HARP	✓		
SEN. KOEHNKE	✓		
SEN. THAYER	✓		
SEN. TOWE	✓		
SEN. VAN VALKENBURG	✓		
SEN. YELLOWTAIL	✓		

Each day attach to minutes.

DATE 2/1/91

COMMITTEE ON Taxation SB 218 SB 226

VISITORS' REGISTER

NAME	REPRESENTING	BILL #	Check One	
			Support	Oppose
John Malee	M.F.H. M.F.P.E	218-226		X
Hugo Andersen, Jr.	T.R.S.	218 & 226		X
Bonnie Andersen	T.R.S.	218-226		X
Barbara Crebo	T.R.S	218-226		X
Montez M. Briggs	P.E.R.S.	218-226		X
Denis Gebo	DOR			
Lou Marquardt	ET	218-226	X	
Fred (Ha Ha)	AARP	218-226		X
Opal Holm	RTeachers			
Dee Mauser	Self	218-226		X
Dagmar Butzell	NARFE			
Thelma Jones	NARFE			
Edward W. McCurdy	SELF	218-226		X
Mary L Craig	ET	218-226	X	
Tom Ryan	B-T	215 226		X
Ed Heinz	MT-NARFE	218-226		X
Ike Thayer	RTA	218-226		X
Mary R. Smith	NARFE	218-226		X
George H McGovern	NARFE Chap. 107 @ FI	218-226		X
B O Scanlan	NARFE Chap 107	218-226		X
Grant H. Meinert	NARFE CHAP. 107	218-226		X
Jim W Long	School Admin of MT	218-226		X
Virgil D Lindstad	AARP	218-226		X
John Kostas	NARFE	218226		X
Robert T. DeLuca	NARFE Chap. 107	218-226		X
Mel Allen Chambers	Self	218-226		X

(Please leave prepared statement with Secretary)

DATE _____

COMMITTEE ON TAXATION

VISITORS' REGISTER

NAME	REPRESENTING	BILL #	Check One	
			Support	Oppose
Dennis Burr	MT Taxpayers Assoc	218		✓
William R. Chambers	Self	218		✓
Margaret Alexy	NARFE, MSEA	218		✓
Ed Sheehy	NARFE, MSEA	218		✓
Ed Sheehy	NARFE, MSEA	226		✓
Alice Otten	NARF	218		✓
Alice Otten	NARF	226		✓
Tom Schneider	MPEA	218 226		✓ ✓
Val Matross	Ret. Teachers	216-226		✓
TOM BILODEAU	MEA	218 226		X
Tom Schneider	MPEA	SB124		X
Kay Owens	AMRPE	216-226		X
Rudard Engelhardt	"	"		X
George O. Poston	"	216-226		X
Jean Huntington	Retired Teacher		218	226
W H Hamilton Jr.		218-226	✓	
Lloyd E. Lamb, Sr.		218-226	✓	

(Please leave prepared statement with Secretary)

SENATE TAXATION
EXHIBIT NO. 1
DATE 2/1/91
BILL NO. SB 226 & 218

February 1, 1991

NOTES FOR SENATE TAX COMMITTEE HEARING ON PENSION TAXATION:

WE HAVE LOOKED AT A LOT OF OPTIONS FOR RESOLVING THE DAVIS CASE AND THE PROBLEMS IT HAS CREATED FOR THE STATE OF MONTANA AND WILL CONTINUE TO LOOK AT OTHER VARIATIONS AS THIS ISSUE WORKS IT WAY THROUGH THE LEGISLATURE.

WE SUPPORT SENATE BILL 226 BECAUSE IT ADDRESSES THREE ISSUES WHICH WE FEEL ARE VITAL IN THE RESOLUTION OF THE DAVIS CASE:

1. IT RECAPTURES THE MAJORITY OF THE GENERAL FUND LOST BY THE ACTION OF THE U.S. SUPREME COURT

2. IT TREATS ALL RETIREES WITH QUALIFIED RETIREMENT PLANS EQUALLY.

3. IT ELIMINATES THE RETIREMENT INCOME EXCLUSION FOR THOSE HOUSEHOLDS WITH ABOVE AVERAGE INCOMES. *(WE HAVE A NUMBER OF OTHER EXCLUSIONS AND CREDITS WHICH PHASE OUT AS A TAXPAYERS HOUSEHOLD INCOME INCREASES)*

SENATE BILL 226 ALSO PROVIDES A DEFINITION OF PENSION AND ANNUITY INCOME. CURRENT LAW HAS RESULTED IN A LOT OF CONFUSION AS TO WHAT QUALIFIES AS *"EXEMPT RETIREMENT INCOME"*. LAST YEAR WE TOOK A "FRIENDLY" APPEAL TO STAB IN AN ATTEMPT TO CLARIFY THE ISSUE. THE RESULT OF THE STAB DECISION WAS EVEN MORE CONFUSION THAN EXISTED PREVIOUSLY. THE DEPARTMENT WAS NOT HAPPY WITH THE DECISION AND NEITHER WAS THE TAXPAYER.

UNDER SENATE BILL 226, THE FOLLOWING NUMBER OF HOUSEHOLDS WOULD BE ENTITLED TO THE EXCLUSION:

PERS	83%
TRS	70%
FEDERAL	73%
PRIVATE	79%

TAXPAYERS QUALIFYING FOR THE RETIREMENT INCOME EXCLUSION UNDER SENATE BILL 226 STILL HAVE AN ADVANTAGE OVER THOSE TAXPAYERS WITHOUT A RETIREMENT PLAN. THEY WILL STILL PAY LESS IN MONTANA INDIVIDUAL INCOME TAXES THAN A TAXPAYER WITH THE SAME INCOME BUT LACKING IN RETIREMENT INCOME WHICH CAN BE EXCLUDED.

SENATE TAXATION
EXHIBIT NO. 1
DATE 2/1/91
BILL NO. SB 226

IN MONTANA, ONLY 50% OF THOSE ELDERLY TAXPAYERS WHO ARE REQUIRED TO FILE INDIVIDUAL INCOME TAX RETURNS HAVE A PENSION PLAN. MANY ELDERLY DO NOT HAVE ENOUGH NON-SOCIAL SECURITY INCOME TO REQUIRE FILING A RETURN.

IT APPEARS THAT THE TREND WILL CONTINUE IN THAT A LARGE NUMBER OF MONTANANS WILL NEVER HAVE ANY PENSION PLAN. IN 1989, ONLY 15% OF THE ELIGIBLE TAXPAYERS MADE DEDUCTIBLE IRA CONTRIBUTIONS AND THE AVERAGE CONTRIBUTION WAS $1,684.

I APPRECIATE THE OPPORTUNITY TO APPEAR BEFORE THE COMMITTEE TODAY IN SUPPORT OF SENATE BILL 226. WE ARE PREPARED TO CONTINUE TO WORK WITH THE COMMITTEE ON THIS ISSUE AND ARE CERTAINLY WILLING TO CONSIDER NEW OPTIONS OR VARIATIONS AS THE COMMITTEE COMES TO GRIP WITH THIS ISSUE.

Phase out response

Phase out $30 - $35,000 $1.19 million more

Phase out $35 - 40,000 ($1.65 million) loss

Montana Education Association 1232 East Sixth Avenue • Helena, Montana 59601 • 406-442-4250

SENATE TAXATION
EXHIBIT NO. 2
DATE 2/1/91
BILL NO. SB 226

SB-226 (HARP)
MEA SAYS "NO" TO PERS & TRS PENSION TAXATION

By: Tom Bilodeau, MEA Research Director
February 1, 1991 -- Senate Taxation Cmte

This January, the 1991 Legislature begins formal discussion of proposals to tax Teacher Retirement System (TRS) and Public Employee Retirement System (PERS) pension benefits! In a very real and immediate sense, the value of both current and future TRS and PERS pensions are in jeopardy. The proposed changes in tax status of TRS and PERS retirement benefit income violate an historic trust agreement between retirees and the State of Montana. More pointedly, some of these proposals to tax public employee retirement benefits threaten to reduce the effective buying power of public employee pensions by as much as 6%.

In MEA's view, public retirees simply can't afford a new tax on fixed pensions -- pensions originally set at uncompetitively low levels due to depressed salary levels and pensions that haven't come close to meeting retirees' basic financial needs. MEA says "NO!" to pension taxation and opposes SB226.

The Governor's initial Budget proposed to abolish Montana's income tax exemption for TRS and PERS benefits and to begin taxing the very first dollar of TRS and PERS pension benefits if a "retiree household's" total income (i.e. pension plus all other income) was more than $25,000. For "retiree households" having total annual income of less than $25,000, the Governor proposed to impose a new tax on all but the first $3,600 of pension income. By mid-January and the Governor's State of the State address, the administration's proposal was changed to exempt the first $10,000 of pension benefits if the "retiree household's" total income was less than $35,000. For households having total annual income of more than $35,000, all pension income would be taxed. In somewhat modified form -- the "retiree household" category seems to have been dropped in favor of "single/married" -- SB226 presents the Governor's public pension taxation proposal.

If enacted and implemented, SB226 would effectively reduce the benefit value of a single-filing, public pensioner having $20,000 in total income (all from retirement benefits) by more than $200. The adverse benefit value impact on higher total income taxpayers -- i.e. largely those public retirees with both pension and other income -- would be substantially larger. For these career service Montana retirees, the new tax would immediately negate the nominal take-home paycheck increase resulting from the "employer pick-up and pay" pay-plan of 1985.

AARP

Bringing lifetimes of experience and leadership to serve all generations.

EXHIBIT NO. 3
DATE 2/1/91
BILL NO. SB 226

MONTANA STATE LEGISLATIVE COMMITTEE

CHAIRMAN
Mr. Fred Patten
1700 Knight
Helena, MT 59601
(406) 443-3696

VICE CHAIRMAN
Mr. Paul Stengel
Route 2, Box 3040
Miles City, MT 59301
(406) 232-0016

SECRETARY
Mrs. Dorothy Fitzpatrick
Box 174
Sunburst, MT 59482
(406) 937-2451

FEBRUARY 1, 1991

TO : SENATE TAXATION COMMITTEE.

FROM : FRED PATTEN - AMERICAN ASSOCIATION OF RETIRED PERSONS.

RE : SENATE BILL #226 - AN ACT TO RESTRUCTURE THE INCOME TAX ON PENSION BENEFITS BY EQUALIZING THE TAXATION OF ALL PENSION BENEFITS; TO PROVIDE A $10,000 EXCLUSION FROM NET INCOME FOR TAXPAYERS WITH A TOTAL FEDERAL ADJUSTED GROSS INCOME OF $35,000 OR LESS.

THE AMERICAN ASSOCIATION OF RETIRED PERSONS STAND IN OPPOSITION TO THIS BILL

WE SUPPORT THE POSITION OF THE MONTANA TEACHERS ASSOCIATION ON THE EXEMPTION

OF PENSION INCOME FROM ANY STATE TAXATION.

A.A.R.P. URGES A DO NOT PASS ON SENATE BILL #226.

SENATE TAXATION
EXHIBIT NO. 9
DATE 3/1/91
BILL NO. SB 218

the nondiscrimination component of the constitutional immunity doctrine which has, from the time of *McCulloch* v. *Maryland*, barred taxes that "operat[e] so as to discriminate against the Government or those with whom it deals." *United States* v. *City of Detroit*, 355 U. S. 466, 473 (1958). See also *McCulloch* v. *Maryland*, *supra*, at 436–437; *Miller* v. *Milwaukee*, 272 U. S. 713, 714–715 (1927); *Helvering* v. *Gerhardt*, *supra*, at 413; *Phillips Chemical Co.* v. *Dumas Independent School Dist.*, 361 U. S. 376, 385 (1960); *Memphis Bank & Trust Co.* v. *Garner*, 459 U. S. 392, 397, and n. 7 (1983).

In view of the similarity of language and purpose between the constitutional principle of nondiscrimination and the statutory nondiscrimination clause, and given that § 111 was consciously drafted against the background of the Court's tax immunity cases, it is reasonable to conclude that Congress drew upon the constitutional doctrine in defining the scope of the immunity retained in § 111. When Congress codifies a judicially defined concept, it is presumed, absent an express statement to the contrary, that Congress intended to adopt the interpretation placed on that concept by the courts. See *Midlantic National Bank* v. *New Jersey Dept. of Environmental Protection*, 474 U. S. 494, 501 (1986); *Morrissette* v. *United States*, 342 U. S. 246, 263 (1952). Hence, we conclude that the retention of immunity in § 111 is coextensive with the prohibition against discriminatory taxes embodied in the modern constitutional doctrine of intergovernmental tax immunity. Cf. *Memphis Bank & Trust*, *supra*, at 396–397 (construing 31 U. S. C. § 742, which permits only "'nondiscriminatory'" state taxation of interest on federal obligations, as "principally a restatement of the constitutional rule").

On its face, § 111 purports to be nothing more than a partial congressional consent to nondiscriminatory state taxation of federal employees. It can be argued, however, that by negative implication § 111 also constitutes an affirmative statutory grant of immunity from discriminatory state taxation in addition to, and coextensive with, the pre-existing protection afforded by the constitutional doctrine. Regardless of whether § 111 provides an independent basis for finding immunity or merely preserves the traditional constitutional prohibition against discriminatory taxes, however, the inquiry is the same. In either case, the scope of the immunity granted or retained by the nondiscrimination clause is to be determined by reference to the constitutional doctrine. Thus, the dispositive question in this case is whether the tax imposed on appellant is barred by the doctrine of intergovernmental tax immunity.

IV

It is undisputed that Michigan's tax system discriminates in favor of retired state employees and against retired federal employees. The State argues, however, that appellant is not entitled to claim the protection of the immunity doctrine, and that in any event the State's inconsistent treatment of federal and state government retirees is justified by meaningful differences between the two classes.

A

In support of its first contention, the State points out that the purpose of the immunity doctrine is to protect governments and not private entities or individuals. As a result, so long as the challenged tax does not interfere with the Federal Government's ability to perform its governmental functions, the constitutional doctrine has not been violated.

It is true that intergovernmental tax immunity is based on the need to protect each sovereign's governmental operations from undue interference by the other. *Graves*, 306 U. S., at 481; *McCulloch* v. *Maryland*, 4 Wheat., at 435–436. It does not follow that private entities or individuals who are subjected to discriminatory taxation on account of their dealings with a sovereign cannot themselves receive the protection of the constitutional doctrine. Indeed, the opposite is to the contrary. In *Phillips Chemical Co.*, *supra*, for example, we considered a private corporation's claim that a state tax discriminated against private lessees of federal land. We concluded that the tax "discriminate[d] unconstitutionally against the United States *and its lessee*," and accordingly held that the tax could not be exacted. 361 U. S., at 387 (emphasis added). See also *Memphis Bank & Trust*, *supra*; *Moses Lake Homes, Inc.*, v. *Grant County*, 365 U. S. 744 (1961); *Collector* v. *Day*, 11 Wall. 113 (1871); *Dobbins* v. *Commissioners of Erie County*, 16 Pet. 435 (1842). The State offers no reasons for departing from this settled rule, and we decline to do so.[4]

B

Under our precedents, "[t]he imposition of a heavier tax burden on [those who deal with one sovereign] than is imposed on [those who deal with the other] must be justified by significant differences between the two classes." *Phillips Chemical Co.* v. *Dumas Independent School Dist.*, 361 U. S., at 383. In determining whether this standard of justification has been met, it is inappropriate to rely solely on the mode of analysis developed in our equal protection cases. We have previously observed that "our decisions in [the equal protection] field are not necessarily controlling where problems of intergovernmental tax immunity are involved," because "the Government's interests must be weighed in the balance." *Id.*, at 385. Instead, the relevant inquiry is whether the inconsistent tax treatment is directly related to and justified by "significant differences between the two classes." *Id.*, at 383–385.

The State points to two allegedly significant differences between federal and state retirees. First, the State suggests that its interest in hiring and retaining qualified civil servants through the inducement of a tax exemption for retirement benefits is sufficient to justify the preferential treat-

[4] The dissent argues that this tax is nondiscriminatory, and thus constitutional, because it "draws no distinction between the federal employees or retirees and the vast majority of voters in the State." *Post*, at ——. In *Phillips Chemical Co.*, however, we faced that precise situation: an equal tax burden was imposed on lessees of private, tax-exempt property and lessees of federal property, while lessees of state property paid a lesser tax, or in some circumstances none at all. Although we concluded that "[u]nder these circumstances, there appears to be no discrimination between the Government's lessees and lessees of private property," 361 U. S., at 381, we nonetheless invalidated the State's tax. This result is consistent with the underlying rationale for the doctrine of intergovernmental tax immunity. The danger that a State is engaging in impermissible discrimination against the Federal Government is greatest when the State acts to benefit itself and those in privity with it. As we observed in *Phillips Chemical Co.*, "it does not seem too much to require that the State treat those who deal with the Government as well as it treats those with whom it deals itself." *Id.*, at 385.

We also take issue with the dissent's assertion that "it is peculiarly inappropriate to focus solely on the treatment of state governmental employees" because "[t]he State may always compensate in pay or salary for what it assesses in taxes." *Post*, at ——. In order to provide the same after-tax benefits to all retired state employees by means of increased salaries or benefit payments instead of a tax exemption, the State would have to increase its outlays by more than the cost of the current tax exemption, since the increased payments to retirees would result in higher federal income tax payments in some circumstances. This fact serves to illustrate the impact on the Federal Government of the State's discriminatory tax exemption for state retirees. Taxes enacted to reduce the State's employment costs at the expense of the federal treasury are the type of discriminatory legislation that the doctrine of intergovernmental tax immunity is intended to bar.

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ment of its retired employees. This argument is wholly beside the point, however, for it does nothing to demonstrate that there are "significant differences between the two classes" themselves; rather, it merely demonstrates that the State has a rational reason for discriminating between two similar groups of retirees. The State's interest in adopting the discriminatory tax, no matter how substantial, is simply irrelevant to an inquiry into the nature of the two classes receiving inconsistent treatment. See *id.*, at 384.

Second, the State argues that its retirement benefits are significantly less munificent than those offered by the Federal Government, in terms of vesting requirements, rate of accrual, and computation of benefit amounts. The substantial differences in the value of the retirement benefits paid the two classes should, in the State's view, justify the inconsistent tax treatment.

Even assuming the State's estimate of the relative value of state and federal retirement benefits is generally correct, we do not believe this difference suffices to justify the type of blanket exemption at issue in this case. While the average retired federal civil servant receives a larger pension than his state counterpart, there are undoubtedly many individual instances in which the opposite holds true. A tax exemption truly intended to account for differences in retirement benefits would not discriminate on the basis of the source of those benefits, as Michigan's statute does; rather, it would discriminate on the basis of the amount of benefits received by individual retirees. Cf. *Phillips Chemical Co.*, *supra*, at 384–385 (rejecting proffered rationale for State's unfavorable tax treatment of lessees of federal property, because an evenhanded application of the rationale would have resulted in inclusion of some lessees of State property in the disfavored class as well).

V

For these reasons, we conclude 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 State having conceded that a refund is appropriate in these circumstances, see Brief for Appellees 63, to the extent appellant has paid taxes pursuant to this invalid tax scheme, he is entitled to a refund. See *Iowa-Des Moines Bank* v. *Bennett*, 284 U. S. 239, 247 (1931).

Appellant also seeks prospective relief from discriminatory taxation. With respect to this claim, however, we are not in the best position to ascertain the appropriate remedy. While invalidation of Michigan's income tax law in its entirety obviously would eliminate the constitutional violation, the Constitution does not require such a drastic solution. We have recognized, in cases involving invalid classifications in the distribution of government benefits, that the appropriate remedy "is a *mandate* of equal treatment, a result that can be accomplished by withdrawal of benefits from the favored class as well as by extension of benefits to the excluded class." *Heckler* v. *Mathews*, 465 U. S. 728, 740 (1984). See *Iowa-Des Moines Bank*, *supra*, at 247; see also *Welsh* v. *United States*, 398 U. S. 333, 361 (1970) (Harlan, J., concurring in judgment).

In this case, appellant's claim could be resolved either by extending the tax exemption to retired federal employees (or to all retired employees), or by eliminating the exemption for retired state and local government employees. The latter approach, of course, could be construed as the direct imposition of a state tax, a remedy beyond the power of a federal court. See *Moses Lake Homes, Inc.* v. *Grant County*, 365 U. S., at 752 ("Federal courts may not assess or levy taxes"). The permissibility of either approach, moreover, depends in part on the severability of a portion of § 206.30(1)(c) from the remainder of the Michigan Income Tax Act, a question of state law within the special expertise of the Michigan courts. See *Louis K. Liggett Co.* v. *Lee*, 288 U. S. 517, 559 (1933). It follows that the Michigan courts are in the best position to determine how to comply with the mandate of equal treatment. The judgment of the Court of Appeals is reversed, and the case remanded for further proceedings not inconsistent with this opinion.

It is so ordered.

JUSTICE STEVENS, dissenting.

The States can tax federal employees or private parties who do business with the United States so long as the tax does not discriminate against the United States. *South Carolina* v. *Baker*, 485 U. S. ——, —— (1988); *United States* v. *County of Fresno*, 429 U. S. 452, 462 (1977). The Court today strikes down a state tax that applies equally to the vast majority of Michigan residents, including federal employees, because it treats retired state employees differently from retired federal employees. The Court's holding is not supported by the rationale for the intergovernmental immunity doctrine and is not compelled by our previous decisions. I cannot join the unjustified, court-imposed restriction on a State's power to administer its own affairs.

The constitutional doctrine of intergovernmental immunity, Justice Frankfurter explained, "finds its explanation and justification . . . in avoiding the potentialities of friction and furthering the smooth operation of complicated governmental machinery." *City of Detroit* v. *Murray Corp.*, 355 U. S. 489, 504 (1958). To protect the smooth operation of dual governments in a federal system, it was at one time thought necessary to prohibit state taxation of the salaries of officers and employees of the United States, *Dobbins* v. *Commissioners of Erie County*, 16 Pet. 435 (1842), as well as federal taxation of the salaries of state officials. *Collector* v. *Day*, 11 Wall. 113 (1871). The Court has since forsworn such "wooden formalism." *Washington* v. *United States*, 460 U. S. 536, 544 (1983).

The nondiscrimination rule recognizes the fact that the Federal Government has no voice in the policy decisions made by the several States. The Federal Government's protection against state taxation that singles out federal agencies for special burdens is therefore provided by the Supremacy Clause of the Federal Constitution, the doctrine of intergovernmental tax immunity, and statutes such as 4 U. S. C. § 111.[1] When the tax burden is shared equally by federal agents and the vast majority of a State's citizens, however, the nondiscrimination principle is not applicable and constitutional protection is not necessary. As the Court explained in *United States* v. *County of Fresno*:

> "The rule to be derived from the Court's more recent decisions, then, is that the economic burden on a federal function of a state tax imposed on those who deal with the Federal Government does not render the tax unconstitutional so long as the tax is imposed equally on the other similarly situated constituents of the State. This rule returns to the original intent of *M'Culloch* v. *Maryland*. The political check against abuse of the

[1] The legislative history of 4 U. S. C. § 111 correctly describes the purpose of the nondiscrimination principle as "[t]o protect the Federal Government against the unlikely possibility of State and local taxation of compensation of Federal officers and employees which is aimed at, or threatens the efficient operation of, the Federal Government." H. R. Rep. No. 26, 76th Cong., 1st Sess., 5 (1939); S. Rep. No. 112, 76th Cong., 1st Sess., 12 (1939).