



## OREGON LEGISLATIVE POLICY, RESEARCH, & COMMITTEE SERVICES

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### ***Issue Brief: Government Retirement Income & Taxation***

Until the late 1980s, the pensions of PERS retirees were exempt from state income taxes. The state allowed only partial exemptions from income taxation for federal retirement benefits and no special exemptions for private retirement benefits. However, a 1989 U.S. Supreme Court ruling (*Davis v. Michigan*, 49 US 803 (1989)) required that states treat taxation of federal and state retirement benefits in an equal manner, putting Oregon in violation of federal law. For nearly ten years, the courts and the Oregon legislature have addressed this retirement benefit taxation issue.

In response to the U.S. Supreme Court decision, the 1989 legislature changed Oregon law to begin full taxation of both state and federal pensions (HB 3508). The measure also increased PERS benefits to local and state retirees to roughly offset the loss of benefits due to taxation. The 1989 bill was placed on the ballot by voter referendum and was defeated in the November 1990 general election.

A group of federal retirees filed suit to recover the income taxes they had been forced to pay (*Ragsdale v. Department of Revenue*, 11 OTR 440 (1990)). In 1990, the Oregon Tax Court ruled that income tax refunds were due to federal retirees. The issue was appealed to the Oregon Supreme Court, which in 1992 affirmed the lower court decision and held refunds were due to federal retirees for 1988 and 1989, but not for preceding years. In 1992, the Oregon Department of Revenue issued the required refunds to federal retirees, and all government retirement benefits were exempted from income taxation in 1990.

The 1991 legislature decided to tax all government retirement income (HB 2352). The measure included a low-income tax credit for all pensions (private and public). The legislature also enacted a one to four percent benefit increase for PERS retirees to partially offset the impact of taxation (SB 656). The legislation included an automatic remand to the Oregon Supreme Court for a ruling on whether the constitution would allow taxation of PERS retirement benefits.

The 1991 law was challenged and in August 1992 the Oregon Supreme Court ruled (*Hughes v. State of Oregon*, 314 Or 1 (1992)) that the state could legally tax PERS benefits. However, the court determined the imposition of income taxes was a breach of the workers' contractual rights, and that PERS retirees had to be compensated for taxes they paid on benefits that were attributable to service before the effective date of the Act (September 28, 1991). The court required a remedy for the PERS retirees but did not provide specifics in its ruling. Although the 1993 legislature did not craft a remedy, it authorized all lawsuits by PERS retirees seeking damages under the 1992 *Hughes* decision to be appealed directly to the Oregon Supreme Court.

In another suit brought by a federal retiree, the Oregon Supreme Court ruled that the 1991 increased benefits provided to PERS retirees did not violate federal law requiring equal taxation of federal and state retirees.

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### Summary of State Income Taxation of Retirement Benefits

	Federal Government	PERS Government	Private
1987 and before	Taxed	Exempt	Taxed
1988	Refunded	Exempt	Taxed
1989	Refunded	Exempt	Taxed
1990	Exempt	Exempt	Taxed
1991 and after	Taxed *	Taxed *	Taxed*

\* with tax credit allowed

Source: Legislative Revenue Office

The 1995 legislature addressed the remedy to PERS retirees by passing HB 3349. The measure provided a one-time retroactive payment to PERS retirees as compensation for taxation on their benefits from tax year 1991 (plus interest). The payment was to be made from the PERS Fund. The measure also increased future benefit payments to offset future taxation of benefits. An increase in state and local PERS employer contributions was slated to pay for the remedy.

In light of HB 3349, the Marion County Circuit Court ruled (*Stovall v. State of Oregon*, Marion County C.C. 94C10334) that the PERS Fund could not be used for a state General Fund obligation. The court also ruled that local governments could not be required to pay for the remedy, effectively stopping the implementation of HB 3349. The ruling was immediately appealed to the Oregon Supreme Court.

The Oregon Supreme Court (August 1996) overturned the lower court decision in *Stovall*, reinstated the HB 3349 remedy, and remanded several minor issues to the lower court for resolution. In 1997, the legislature clarified the administration of the refunds, and later in the year the circuit court settled the remainder of the *Stovall* issues. Retroactive benefit payments were mailed to current state retirees in late 1997 and benefit increases to PERS retirees were implemented effective January 1997.

In June 1998, the Oregon Supreme Court ruled that the 1995 remedy provided to PERS retirees amounted to a "tax rebate," effectively violating federal law because the same remedy was not provided to federal retirees (*Vogl v. State of Oregon*, 326 Or \_\_\_ (1998)). The Supreme Court declared that similar compensation was due to federal retirees, and remanded the case back to the Oregon Tax Court to determine the remedy.

The Tax Court will determine the amount of taxes to refund to John Vogl, the plaintiff in the case. Once this determination is made, the Oregon Department of Revenue will address the appeals already filed by other federal retirees and then issue refunds to other federal retirees as they are applied for. The refunds will be paid out of the current biennium's income tax collections.

#### Further Information:

- **Tax Refunds/General Tax Information** : Oregon Department of Revenue, 503-378-4988
- **PERS Retiree Information** : Oregon Public Employees Retirement System, 503-598-7377
- **Revenue Estimates**: Jim Scherzinger, Legislative Revenue Office, 503-986-1266

*A more detailed chronology with citations is available by calling (503) 986-1627*