

Remarks Summarizing SERA/NARFE/AARP Friend of the Court Brief

August 10, 2011

In May the legislature passed, and the Governor signed, amendments to the Income Tax Act, the State Employee Retirement Act, and other public pension system laws that repeal the pension tax exemption for retirees born after 1945. The Governor requested and the Michigan Supreme Court granted oral argument to the Attorney General and other interested parties to brief the high court on four questions. The first two questions deal with the constitutionality of the tax on public pensions; our joint friend of the court brief addresses these first two questions only.

Since 1943, state employees have been assured a tax-free pension as a benefit of their employment with the state. Twenty years later, the voters of Michigan ratified a Constitutional provision that enshrined tax-free public pensions as a contractual obligation that could not be diminished or impaired by the state. In 1989, federal employees who are Michigan residents obtained a U.S. Supreme Court decision saying they were entitled to the same tax exemption for their pensions as state employees.

As of September 30, 2010, there were 108,799 active and retired members in the two state employee retirement plans, a Tier I defined benefit plan and a Tier 2 defined contribution plan. The retirement benefits of these 108,799 employees and retirees are currently exempt from state income tax under both the general Income Tax Act and the specific State Employee Retirement Act, but that would change January 1, 2012, under the changes in PA 38 and PA 41 amending the two acts.

The Michigan State Employee Retirees Association Coordinating Council, the National Active and Retired Federal Employees, and AARP contend in their joint friend of the court brief filed with the Michigan Supreme Court yesterday that the public employee pension tax exemptions in current law are “accrued financial benefits” contractually guaranteed by the Michigan Constitution of 1963 in Article 9, § 24. Under the new PA 38 and PA 41, Tier 1 state retirees born after 1945 will pay an estimated \$20 million annually in additional income taxes.

Act 38 and Act 41 also diminish the vested contractual rights of all state employees and retirees born after 1945, and violate the Constitutional provision prohibiting impairment of contracts in both the Michigan and federal Constitutions. (Const 1963, art 1, § 10; and US Const, art I, § 10.)

Currently, there are about 127,100 federal civilian employees and retirees (about 47,000 retirees and 80,100 active employees) in the State of Michigan. Likewise, they will also pay an estimated \$20 million annually in additional income taxes.

Our friend of the court brief gives examples of the individual income tax increases retirees will experience if these laws are allowed to stand.

PA 41 repeals the state employee pension tax exemption effective, January 1, 2012, for all Tier 1 (defined benefit) state employees and retirees. However, the legislature did not repeal the tax exemption for Tier 2 (defined contribution) state retirees, setting up an unexplained differential tax treatment of pension benefits under the two state retirement plans. Over half of current state employees are in the Tier 2 defined contribution pension plan and will not be subject to the pension tax when they retire. Whether this was a drafting error or intentional, we do not know.

Our brief acknowledges that legislation challenged on constitutional grounds is presumed constitutional absent a clear showing to the contrary. But when a statute palpably violates the Constitution as here, the statute must give way to the intent of the people when they adopted the Constitution.

Additionally, our brief acknowledges that the proponents of the pension tax will try to rely on Article 9, section 2 of the Michigan Constitution which says that “The power of taxation can never be surrendered, suspended, or contracted away.” Under the rules of constitutional interpretation, if two provisions are in conflict, the court must try to harmonize them. It has already been found that the legislature has the power to grant and classify tax exemptions, and a pension tax exemption is not surrendering or contracting away the power of taxation. Our brief takes the position that the legislature has the power to eliminate the tax exemptions for future state employee retirement benefits after January 1, 2012, the effective date of the act, but it is limited by Article 9, section 24 in applying the repeal of the tax exemption to current public

retirees or current public employees' accrued employment before January 1, 2012. An example is an employee with 20 years of service as of December 31, 2011. Earnings of that employee contributing toward a pension ten years later (after 30 years of service) could be taxed on the pension generated by the later 10 years of service, but not the first 20 years of service.

As applied to any earnings before January 1, 2012, we believe Act 38, Act 41, and the other acts eliminating the pension tax exemption for other public employees are unconstitutional.

Our friend of the court brief reveals that most of the case law about pensions and impairment of contracts under Article 1, section 10 involves the judicial pension system. That case law supports our position the pension tax as applied to earnings before January 1, 2012, unconstitutionally impairs contracts. We expect the justices to carefully consider these cases as applied to their fellow public employees' pensions and consistently apply the principles the high court has enunciated over the years.

Our friend of the court brief notes also that state employees have invested nearly \$400 million of their own savings over the last ten years in buying additional service time in reliance on the constitutional and statutory guarantee in effect at the time of purchase that pension income derived from this purchased service time would not be taxed. Each employee born after 1945 and buying such service time has a signed contract with the state that will be impaired by removal of the pension tax exemption if that service time involved earnings before January 1, 2012.

In summary, the State Employee Retirees Association, the National Active and Retired Federal Employees, and AARP contend there are constitutional flaws in the new laws repealing the public pension tax exemption. These provisions must be nullified and we trust that the high court will agree with us.

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