Supplement to Proposal #10: Tax Retirement Income

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Legal issues regarding taxing federal, state, local and military pension income, including (1) benefits accrued prior to January 1, 1998, (2) benefits accrued from January 1, 1998 to the present, and (3) benefits accruing prospectively.

Background information:
Originally, pensions were considered gratuities which did not vest, which meant that the terms of the pension benefit could be withdrawn or amended at any time. However, in the 1940s and 1950s, in order to attract workers to state employment, many states adopted statutory or constitutional amendments that provided for contractual rights to pension benefits. The Kentucky Employees Retirement System (KERS) was created by statute in 1956 to provide for retirement benefits for state government employees. The 1956 statutes specifically exempted pension benefits from any state, county or municipal tax. Moreover, from the outset Kentucky law provided that any alteration, amendment or appeal of those statutes shall not affect the amount of benefits that had already accrued as of the time of alteration, amendment or appeal.

In 1972, Kentucky’s General Assembly enacted KRS 61.692, which holds that the pension benefits contained in KRS 61.510 to KRS 61.705 are part of an “inviolable contract,” and cannot be reduced or impaired except in limited circumstances. The Kentucky Supreme Court has held that “…the General Assembly can take no action to reduce the benefits promised to participants …” under the inviolable contract. Jones v. Board of Trustees of Kentucky Retirement Systems, 910 S.W.2d 710 (Ky. 1995). In addition, there are restrictions to states modifying contracts under the state and federal constitutions.

KRS 61.690 is the statute exempting the pension benefit from tax and is in the range of statutes covered by the inviolable contract language in KRS 61.692. The initial version of KRS 61.690(1) exempted all retirement allowances and other benefits from any state, county, or municipal tax.

In 1998, however, KRS 61.690 was amended to specifically state that retirement benefits accrued or accruing after January 1, 1998 are subject to the tax imposed by KRS 141.020, to the extent provided in KRS 141.010 and KRS 141.0215. KRS 61.690(2). Retirement benefits that accrued prior to January 1, 1998 were still exempt from tax. This change rendered retirement benefits accrued or accruing after January 1, 1998 subject to the individual income tax laws.

Litigation on the tax exemption for retirement benefits followed rulings by the United States Supreme Court that held if states chose to exempt state public pension benefits from tax, they also had to exempt federal pension benefits and military pension benefits. Davis v. Michigan Department of Treasury, 489 U.S. 803 (1989); Barker v. Kansas, 503 U.S. 594 (1992).

After those decisions, many states decided to retroactively repeal their tax exemptions for all public pension benefits. Some of these attempts were challenged in court by state pensioners, who argued that they had vested rights to their pensions. The attempts to repeal were successful in some states, unsuccessful in others. The relevant factors that seem to make a difference in a court’s analysis of the issue are (1) whether the tax exemption language was contained in the pension statutes or the taxation statutes, (2) whether there is a constitutional prohibition against a state’s ability to contractually agree to exempt income, and (3) whether there is a contract between the state and the state pensioners. All of the courts have held that, on a prospective basis, states may tax retirement benefits accruing after a certain date.

For example, the courts in North Carolina and Oregon rejected attempts to retroactively repeal the tax exemption to the extent the pension benefits had already accrued. Oregon, like Kentucky, provides for the tax exemption in the pension statutes, rather than the general taxation statutes.

Other states, such as Montana, New Mexico and Ohio, have upheld the retroactive repeal of the tax exemption with respect to pension benefits that had already accrued. A key factor in their decision was the fact that the tax exemption was only contained in the general taxation statutes, not the pension statutes. It appears that courts are unwilling to imply a right to a tax exemption if it is not expressly addressed in the pension statutes.
Georgia and Michigan have also upheld the retroactive repeal of the tax exemption with respect to pension benefits that had already accrued. The courts in both states relied heavily on constitutional provisions that prohibited the state from surrendering, suspending or contracting away any power to tax in reaching their decisions. Kentucky’s constitution does not contain a similar prohibition.

**Other States:**
Of the 41 states with a broad-based income tax, 36 offer (i) exclusions for some or all state or federal pension income, (ii) retirement income exclusions, (iii) tax credits targeted at the elderly. The five states that offer none of these are California, Nebraska, North Dakota, Rhode Island and Vermont. 27 states exclude Social Security retirement benefits from state income taxes. Federal law preempts the ability of states to tax income from Railroad Retirement.

**Conclusion:**
With respect to pension benefits that accrued prior to January 1, 1998, any effort to tax those benefits will risk a substantial legal challenge. The exemption for such benefits is contained in the pension statutes, and there is no constitutional prohibition to contractually agreeing to such an exemption. In most other circumstances, however, there is not a vested right in the terms of a statute.

With respect to pension benefits that accrued beginning January 1, 1998, all of these benefits are currently subject to some level of taxation pursuant to the pension statutes. The amount of the exemption is determined by the taxation statutes. From January 1, 1998 until January 1, 2006, the statutory exemption was $35,000. A reduction back to that exemption amount for those periods would be the easiest to defend. It is more likely that an attempt to reduce the amount of the exemption to $35,000 or a lesser amount would pass muster, although it also could be subject to legal challenge.

With respect to pension benefits that will accrue in the future, it appears there is no major legal obstacle to making them subject to income tax, with or without any exemption threshold, effective after such legislation would be passed. Courts have routinely upheld such a prospective approach.