

No. 8267

This opinion is issued in response to a question from Jon Yunker, Director, Oregon Department of Administrative Services, concerning the state personal income tax treatment of private pension income.

QUESTION PRESENTED

Does Oregon unlawfully discriminate in taxing private pension income while:

1. Providing a pension benefit increase to Public Employees' Retirement System (PERS) retirees that is the functional equivalent of a rebate of Oregon personal income taxes attributed to their PERS pension income, and
2. Not taxing federal pension income?

ANSWER

No.

DISCUSSION

I. Background

Before 1991, Oregon exempted from state taxable income all pension income received from PERS. ORS 316.680(1)(d) (1989). The law further exempted all pension income received by retirees and their surviving spouses from non-PERS public retirement systems maintained by public employers within Oregon. ORS 316.680(1)(c) (1989). There was a limited exemption for pension income from federal retirement systems, subject to a maximum dollar limit. *Id.* There was no exemption for private pension income.

In 1989, the United States Supreme Court held that federal statutory and constitutional principles of intergovernmental tax immunity prohibit a state from providing a tax exemption for state and local government pension benefits without providing a similar exemption for federal pension benefits. *Davis v. Michigan Dept. of Treasury*, 489 US 803, 109 S Ct 1500, 103 L Ed2d 891 (1989). To comply with *Davis*, the 1991 Oregon legislature repealed the state income tax exemptions for PERS and local government pension income. Or Laws 1991, ch 823, § 3.¹ The legislature also increased PERS retirement benefits by up to 4 percent to partially compensate PERS members for the loss of the tax exemption. Or Laws 1991, ch 796.

PERS members immediately commenced a lawsuit challenging the repeal of the tax exemption. The Oregon Supreme Court held that the repeal breached the employment contract between participating public employers and PERS members to the extent it required taxation of benefits attributable to services performed before September 28, 1991, the effective date of the repeal. *Hughes v. State of Oregon*, 314 Or 1, 36, 838 P2d 1018 (1992). The *Hughes* court declined to comment on the appropriate remedy for the breach, noting that "[t]he legislature is the most appropriate branch of government in the first instance to choose among the available remedies." *Id.* at 33 n 36.

In 1993 and 1994, PERS members filed two lawsuits, subsequently consolidated, to recover damages for the breach of their employment contract. After several years of litigation, the case was settled. Pursuant to the settlement agreement, the legislature enacted PERS benefit increases that were designed to fully compensate PERS members for the loss of the tax exemption for benefits attributable to service performed before September 29, 1991. Or Laws 1995, ch 569; Or Laws 1997, ch 175.¹

Federal retirees challenged the 1995 benefit increase, alleging that it was a tax rebate that illegally favored state and local government retirees over federal retirees. The Oregon Supreme Court held that the 1995 increase was the functional equivalent of a tax rebate and that, under *Davis*, the state could not provide such a rebate without providing similar tax treatment to federal retirees.¹ *Vogl v. Dept. of Rev.*, 327 Or 193, 208, 960 P2d 373 (1998). The court declined to direct a remedy, but remanded the case to the Tax Court for further proceedings. *Id.* at 212. On remand, the case was certified as a class action and the parties agreed to a stipulated judgment, which was entered by the court. The judgment requires the Oregon Department of Revenue to refund state personal income taxes paid by members of the class to the extent those taxes were attributable to federal pension income based on services performed before September 29, 1991. In addition, the Department of Revenue must allow class members to exclude from their taxable income in future tax years all federal pension income attributable to services performed before September 29, 1991.

II. Legality of Providing Unequal Tax Treatment to Private Pension Income

State legislative power is plenary subject only to limitations imposed by the state and federal constitutions and preemptive federal statutes and regulations. *See, e.g., Latourette v. Clackamas Co. et al*, 131 Or 168, 170, 281 P 182 (1929). Accordingly, our review is confined to determining whether the disparate tax treatment afforded private pension income violates a limitation found in one of those authorities.

No federal statutes or regulations prohibit the states from treating public and private pension income differently for tax purposes. Therefore, the scope of our inquiry is limited to whether such different treatment violates any state or federal constitutional provision. Disparate tax treatment potentially implicates three constitutional limitations: (a) the tax uniformity requirements of Article I, section 32, and Article IX, section 1, of the Oregon Constitution; (b) the equal privileges and immunities guarantee in Article I, section 20, of the Oregon Constitution; and (c) the equal protection guarantee of the Fourteenth Amendment to the United States Constitution.

We begin by analyzing the state constitutional limitations. *See, e.g., Sterling v. Cupp*, 290 Or 611, 614, 625 P2d 123 (1981); *Cooper v. OSAA*, 52 Or App 425, 432, 629 P2d 386 (1981), *rev den* 291 Or 504, 634 P2d 1347 (1981) (citing *State v. Spada*, 286 Or 305, 594 P2d 815 (1979)). *See also* Linde, *First Things First, Rediscovering the State's Bill of Rights*, 9 Bal L Rev 379 (1980).

A. Tax Uniformity Provisions Under the Oregon Constitution

Two provisions in the Oregon Constitution require uniform taxation.¹ Article I, section 32, provides, in part, that:

all taxation shall be uniform on the same class of subjects within the territorial limits of the authority levying the tax.

Article IX, section 1, provides:

The Legislative Assembly shall, and the people through the initiative may, provide by law uniform rules of assessment and taxation. All taxes shall be levied and collected under general laws operating uniformly throughout the State.

The Oregon Supreme Court has held that tax classifications survive constitutional scrutiny under these provisions if there is a rational basis for the classification. The court explained:

What is required in assessing a constitutional challenge to classification for tax benefit is a review of the grounds for the classification to determine if it rests upon a rational basis. The legislature may make distinctions of degree having a rational basis, and when subjected to judicial scrutiny they must be presumed to rest on that basis if there is any conceivable state of facts which would support it. * * * It, however, is not sufficient to merely point out differences between the groups of taxpayers for divergent treatment. The differences justifying the attempted classification must bear a reasonable relationship to the legislative purpose.

Huckaba v. Johnson, 281 Or 23, 26, 573 P2d 305 (1978) (citations omitted).

In *Huckaba*, a federal retiree challenged an Oregon statute that provided an income tax exemption for up to \$2,400 of federal retirement income other than military retirement income. Military retirees were eligible for this exemption only after reaching age 65. Moreover, the exemption for military retirees was reduced, dollar for dollar, by any earned income received by the retiree during the taxable year. ORS 316.067(1)(c) and (3) (1975). The Department of Revenue argued that the reason for this disparate treatment was that military personnel, unlike other federal employees, were eligible for retirement after 20 years of service, regardless of age. Because military personnel generally enter the armed forces at a relatively early age, they are more likely than other federal employees to retire while still young enough to pursue a second career and to earn additional retirement benefits in that career. The court held that this rationale established a reasonable basis for the challenged law and, therefore, the disparate treatment afforded military retirees did not violate Article I, section 32, or Article IX, section 1, of the Oregon Constitution.¹ 281 Or at 28-31. The *Huckaba* court emphasized that a tax classification need not be narrowly drawn, but may instead be a general one based on characteristics typical of the affected class:

General rules are essential if a system of the magnitude and complexity of the Personal Income Tax Act is

to be administered with a modicum of efficiency, even though application of the rule may produce seemingly arbitrary consequences in some cases. A nonmilitary federal retiree may, in fact, after retirement obtain employment and create an additional retirement fund. Or conversely an Armed Forces retiree may be unable to enter a new career and be required to subsist on his military retirement pay. Making these determinations would require individualized proof as each income exclusion was claimed. The legislature could reasonably choose between a system of individualized inquiry and a general rule based on the source of the retirement benefit. The former method would introduce complexities in the administration of an already complex tax system and increase the expense of administration. The choice between these competing policies is a legislative determination and the decision to accord the benefit on the basis of an easily ascertainable criterion does not offend constitutional principles.

Id. at 30-31.

More recently, the courts have upheld Oregon's taxation of public retirement benefits paid by the state of Alaska from 1985 through 1990, even though PERS benefits were exempt from tax during that time period. *Simpson v. Dept. of Rev.*, 12 OTR 455 (1993), *aff'd* 318 Or 579, 870 P2d 824 (1994). The taxpayer in *Simpson* had argued that the failure to exempt benefits paid by Alaska's pension plan violated, among other things, Article I, section 32, of the Oregon Constitution. 12 OTR at 456. The tax court rejected the taxpayer's argument, noting:

The purpose of [the tax exemption for PERS benefits] is to reduce payroll costs to the State of Oregon. The state can reduce current salaries paid to its employees in exchange for exempting the same employees' retirement benefits from state income taxes; this is certainly within the legislature's power. This court has previously found such purpose is a "rationale [sic] predicate" for the classification.

Id. at 457-8 (footnote omitted) (citing *Lindau v. Dept. of Rev.*, 10 OTR 92, 93 (1985)). The tax court further observed that the taxpayers did not challenge the taxation of retirement benefits received from private pension plans, "recognizing that they may be substantially different." 12 OTR at 457 n 3. On appeal, the Oregon Supreme Court affirmed the tax court's holding, stating that the taxpayers "have not advanced any viable legal basis supporting their contentions." 318 Or at 581.

Under *Huckaba*, the state has broad discretion to establish tax classifications as long as the distinction supporting the classifications rests on a rational basis, which "any conceivable state of facts" would support. *Huckaba*, 281 Or at 26. *Simpson* stands for the further proposition that the state may rationally decide to compensate Oregon public employees by providing a tax exemption instead of additional cash compensation or other employee benefits, while taxing non-PERS pension income. 12 OTR at 457-8, *aff'd* 318 Or 579; *see also Lindau v. Dept. of Rev.*, 10 OTR at 93. The same rationale applies to the 1995 and 1997 PERS benefit increases, which compensated PERS members for the loss of the tax exemption. Thus, we conclude that Oregon's constitutional tax uniformity provisions do not require equal tax treatment of PERS benefits and private pension income.

Under *Davis*, discussed above, federal principles of intergovernmental immunity require equal treatment of Oregon government and federal pension income. The state's decision not to tax federal pension income attributable to services performed before September 29, 1991, was for the purpose of correcting a violation of those federal law principles and complying with the terms of a court judgment. Under the circumstances, the state's decision not to tax federal pension income was manifestly rational. In contrast, the federal intergovernmental immunity principles do not require equal tax treatment of public and private pension income. Accordingly, we conclude that the state does not violate Oregon's constitutional tax uniformity provisions in providing a tax exemption for federal pension income without providing a similar exemption for private pension income.

To summarize, we conclude that the state's taxation of private pension income does not violate Article I, section 32, or Article IX, section 1, of the Oregon Constitution.

B. Equal Privileges and Immunities Under the Oregon Constitution

Article I, section 20, of the Oregon Constitution provides:

No law shall be passed granting to any citizen or class of citizens privileges, or immunities, which, upon the same terms, shall not equally belong to all citizens.

A violation of this constitutional provision requires there to be (1) a privilege or immunity, (2) which is denied to an individual or class of citizens, (3) without a rational foundation in light of the purposes of the law or program at issue.

1. Privilege or Immunity

To establish a violation of Article I, section 20, the plaintiff must first show that there is a privilege or immunity that someone else is receiving. *State v. Scott*, 96 Or App 451, 455, 773 P2d 394 (1989). Recipients of private pension income are taxed on that income, while recipients of PERS and federal pension income either are not taxed or are compensated for the tax by a commensurate increase in their pension income. Thus, private retirees are denied a privilege that is provided to PERS and federal retirees.

2. Discrimination Against a Class

The next issue is whether the taxation of private pension income constitutes a denial of a privilege to a cognizable "class" of citizens within the meaning of Article I, section 20. The Oregon Supreme Court has consistently held that laws establishing classifications do not automatically violate Article I, section 20.

[T]his court will not invalidate a law on the simple grounds that the law classifies individuals or groups of individuals. "[E]very law itself can be said to 'classify' what it covers from what it excludes." *State v. Clark, supra*, 291 Or at 240. Article I, section 20, prohibits those schemes that classify "persons or groups by virtue of characteristics which they have apart from the law in question."

Wilson v. Dept. of Rev., 302 Or 128, 131-32, 727 P2d 614 (1986).

Generally, to be cognizable under Article I, section 20, a class must be identifiable by virtue of social or personal characteristics that exist apart from the classification created by the challenged government action; classes that are created solely by the challenged law itself "are entitled to no special protection and, in fact, are not even considered to be classes for the purposes of Article I, section 20." *Sealey v. Hicks*, 309 Or 387, 397, 788 P2d 435 (1990); *see also Greist v. Phillips*, 322 Or 281, 292, 906 P2d 789 (1995); *Hale v. Port of Portland*, 308 Or 508, 524-26, 783 P2d 506 (1989). Even when an identifiable class exists, the courts generally have rejected attacks on class legislation "whenever the law leaves it open to anyone to bring himself or herself within the favored class on equal terms." *State v. Clark*, 291 Or 231, 240-41, 630 P2d 810 (1981); *see also Wilson v. Dept. of Rev.*, 302 Or at 132.

Although these principles are easily articulated, their application to specific cases can be problematic. The Supreme Court's analysis of "true classes" under Article I, section 20, has not been entirely clear or consistent. *See Neher v. Chartier*, 124 Or App 220, 225-26 n 3 (summarizing cases), 862 P2d 1307 (1993), *rev'd* 319 Or 417, 879 P2d 156 (1994). Based on the current status of the law, we believe it is an open question whether the Supreme Court would consider such groups as "private retirees," "federal retirees" and "PERS retirees" to be "true classes." *Compare State ex rel Huddleston v. Sawyer*, 324 Or 597, 932 P2d 1145 (1997) and *Wilson v. Dept. of Rev.*, 302 Or 128, with *Sealey v. Hicks*, 309 Or 387. We need not step into this quagmire because our analysis of the third element of Article I, section 20, is determinative. Therefore, we will assume, solely for purposes of reaching an analysis of the third element, that these groups are cognizable classes under Article I, section 20.

3. Rational Basis Test

We next consider whether anything about the source of the private retirees' pension income justifies the discriminatory tax treatment. A discriminatory classification violates Article I, section 20, only if it "either is impermissibly based on persons' immutable characteristics and reflects 'invidious' social or political premises or has no rational foundation in light of the enabling statute's purposes." *Northwest Advancement v. Bureau of Labor*, 96 Or App 133, 142, 772 P2d 943, *rev den* 308 Or 315 (1989). The tax classification at issue here is based on the source of the taxpayer's pension income and therefore does not constitute "invidious" discrimination based on immutable personal characteristics of the disfavored class. *See* Letter of Advice dated October 14, 1985, to Raymond P. Thorne, Administrator, Employment Division (OP-5878) at 3 (distinction based upon tax rates does not create suspect class). The issue, therefore, is whether the classification lacks a rational foundation in light of its purposes. *See Huckaba v. Johnson*, 281 Or at 26.

For the reasons discussed in Part IIA above, there is a rational basis for providing favorable tax treatment to federal and PERS pension income while taxing private pension income. The Oregon Supreme Court has applied the same rational basis test to determine whether discriminatory tax treatment of pension income violates Article I, section 20. *Huckaba*, 281 Or 23. Because there is a rational basis for the disparate tax treatment afforded private retirees, we conclude that the disparity does not violate Article I, section 20, of the Oregon Constitution.

C. Equal Protection Under the United States Constitution

The Equal Protection Clause of the Fourteenth Amendment to the United States Constitution provides that "No State shall * * * deny to any person within its jurisdiction the equal protection of the laws." The Oregon Supreme Court has noted:

The equal protection of the laws required by the Fourteenth Amendment does not prevent states from resorting to classifications for the purposes of legislation and they have a wide range of discretion in that regard * * * if the classification is reasonable, not arbitrary and rests upon some ground of difference having a fair and substantial relation to the object of the legislation, so that persons similarly situated shall be treated alike. *This latitude is notably wide in classifications for purposes of taxation.*

Dutton Lbr. Corp. v. Tax Com., 228 Or 525, 539, 365 P2d 867 (1961) (citations omitted, emphasis added) (citing *Royster Guano Co. v. Virginia*, 253 US 412, 40 S Ct 560, 64 L Ed 989, 990 (1920)).

Oregon courts generally find a classification to be constitutional under the federal equal protection clause if it is constitutional under Article I, section 20, of the Oregon Constitution. *See, e.g., State v. Freeland*, 295 Or 367, 370, 667 P2d 509 (1983) ("The test of unequal treatment under Or. Const. art. I, § 20, is not always the same as the tests articulated from time to time under the federal equal protection clause, although the clauses are sufficiently similar that compliance with article I, section 20 usually will also satisfy the 14th amendment"); *State v. Clark*, 291 Or at 243 ("for most purposes analysis under Article I, section 20 and under the federal equal protection clause will coincide"); *Cooper v. OSAA*, 52 Or App at 432 (scope of Article I, section 20, and the federal equal protection clause are generally the same). For the reasons discussed above, we find that the tax classification at issue here rests on a rational basis, and we therefore conclude that the disparate tax treatment afforded private pension income does not violate the Equal Protection Clause of the Fourteenth Amendment to the United States Constitution.

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