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Research Brief

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Taxation of Pensions in Oregon: 2001 Update

Background

Until the late 1980s, Oregon Public Employees Retirement System (PERS) pensions were exempt from Oregon income tax while federal pensions were mostly taxable. In 1989 the U.S. Supreme Court ruled that state pensions could not receive better tax treatment than federal pensions (*Davis vs. Michigan*). This ruling triggered a string of court cases and legislation around the issue of taxation of pension income.

PERS Retirees

The 1991 Legislature imposed Oregon's income tax on PERS pensions and equalized the tax treatment of all pensions. The 1991 Legislature also increased PERS benefits, although not enough to fully compensate for taxation.

In 1992, the Oregon Supreme Court decided that taxing PERS benefits violated the PERS contract. Taxing the benefit is legal, but PERS members must be compensated for damages suffered from taxation. The damages were limited to benefits attributable to work performed before October 1, 1991. The court also directed the Legislature to determine how these damages should be calculated and paid. However the 1993 Legislature did not act on this issue.

The 1995 Legislature increased PERS benefits to compensate for damages (HB 3349). After extensive litigation the courts upheld HB 3349. PERS retirees received a permanent monthly benefit increase beginning January 1997 and a lump sum payment for damages back to 1991. The benefit increases were funded by payroll assessments on state and local employers.

Federal Retirees

Federal retirees sued after the 1991 Legislature's action, arguing that the PERS benefit increase was a tax benefit and thereby violated the equivalent treatment requirement under *Davis*. They lost in the Oregon Supreme Court and the U.S. Supreme Court denied review.

Following the 1995 legislation, some federal retirees again sued. They lost in both the Oregon Tax Court and in Multnomah County Circuit Court. But, on June 18, 1998, the Oregon Supreme Court reversed these decisions. The Court ruled that the HB 3349 benefits were in fact tax rebates under *Davis* and remanded the cases (*Vogl, et al., Dixon et al.*) back to the lower courts to determine the remedy for each plaintiff. In January 1999 the Tax Court approved a class action settlement reached between the state and the federal retirees. The settlement directed the Department of Revenue to make refunds for years still open under the statute of limitation (1995-1998) and for certain claims dating back to 1991 protected by declarations on file with the Department of Revenue. The Department of Revenue was also directed to seek legislation to allow refunds for years not covered under existing law, and to pay those refunds no later than June 30, 2003.

Legislation

Refunds for years open under the statute of limitation were allowed under current law. The Department of Revenue began paying these refunds in February 1999. The 1999 Legislature passed SB 1136 authorizing refunds for the tax years closed by the statue of limitation. However for budgetary reasons these refunds could not be made until after July 1, 2001. The 1999 Legislature also passed SB 260 establishing an income tax exclusion for pension income attributable to federal government service performed before October 1991.

Altogether between February 1999 and August 2001 approximately 230,000 refund checks totaling $337 million were mailed by Department of Revenue to federal retirees or their heirs in compliance with the court rulings and SB 1136. Of this total, approximately $104 million was refunded during July and August 2001.