IN THE MAGISTRATE DIVISION
OF THE OREGON TAX COURT
Income Tax

DAVID E. and EVADNE A. HILANDS,	)	
	)	
Plaintiffs,	)	
	)	No. 991417C
v.	)	
	)	
DEPARTMENT OF REVENUE,	)	
STATE OF OREGON,	)	
	)	
Defendant.	)	**DECISION**

Plaintiffs have appealed the imposition of state income taxes on their Public Employee Retirement System (PERS) benefits for the years 1997 and 1998, arguing that the tax is unconstitutional.

At trial, plaintiffs appeared *pro se.* Defendant appeared through Ms. Nancy Grigorieff, an auditor and CPA with the Oregon Department of Revenue.

STATEMENT OF FACTS

Plaintiffs received state PERS retirement benefits in 1997 and 1998 that were taxed by Oregon. They assert that the taxation of those benefits is unconstitutional under Article I, section 10, of the U.S. Constitution, known as the contract clause. They believe the taxation of their retirement benefits impairs a contract right they had with the state to exempt from taxation their PERS retirement benefits. Defendant responds that the issue was resolved by the Oregon Supreme Court in *Hughes v. State of Oregon*, 314 Or 1, 838 P2d 1018 (1992), relative to the breach versus impairment of contract question and that any challenge to the adequacy of the remedy was resolved by the court in *Stovall v. State*, 324 Or 92, 922 P2d 646 (1996).

Also, plaintiffs opine that it is unfair and unconstitutional to exempt federal retirees from state taxes while state retirees pay federal taxes. Defendant responds that federal retirees do in fact pay state income taxes.

COURT'S ANALYSIS

The state income tax exemption historically available to PERS retirees on their PERS retirement benefits under the Public Employees Retirement Act of 1953, embodied in *former* ORS 237.201 (1989)[1], a corollary of which was later placed in the state's tax code (*see former* ORS 316.067(1)(d) (1969)), was removed by the state legislature in 1991 in response to the United States Supreme Court's decision in *Davis v. Michigan Dept. of Treasury*, 489 US 803, 109 S Ct 1500, 103 L Ed 2d 891 (1989).[2] It is the removal of the exemption that prompted plaintiffs' appeal.

As defendant notes, this very issue was addressed by the Oregon Supreme Court in the *Hughes* decision, where the court concluded that the statutory changes made by the legislature in 1991 did impair the state's contractual obligation by subjecting PERS retirement benefits earned on or before the effective date of the 1991 act (1991 Oregon Laws, chapter 823, section 1) to taxation. 314 Or at 31. The court found that the petitioners had a unilateral contract[3] with the state, that the obligation was part of the PERS contract, and that a term of that contract was that PERS retirement benefits *accrued or accruing* prior to September 29, 1991 (i.e., those benefits that had vested), were, under

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[1] Amended and renumbered as ORS 238.445 (1999).

[2] Three years later, the Oregon Supreme Court reached the same conclusion as to Oregon's PERS tax exemption. *See Ragsdale v. Dept. of Rev. (Ragsdale I)*, 312 Or 529, 823 P2d 971 (1992).

[3] The PERS contract consists of the provisions found in *former* ORS 237.001 through 237.315 (1989), *renumbered as* ORS 238.005 through 238.750 (1999).

ORS 237.201, exempt from state and local taxation. *Id*. at 20, 27 and 29.[4] Therefore, section 1 of Oregon Laws 1991, chapter 823, was declared unconstitutional and inapplicable to PERS retirement benefits earned on or before September 28, 1991. *Id*. at 31.[5]

However, Oregon Laws 1991, chapter 823, section 1, remains effective as to benefits since accrued.[6] The court explained its reasoning as follows:

> "* * *the legislature did not contract away its ability to tax PERS retirement benefits that may accrue in the future based on work not yet performed. All PERS retirement benefits accrued or accruing after September 28, 1991, as compensation for work performed after that date, are not contractually exempt from state income taxation. Thus, because the state has no contractual obligation not to tax unaccrued PERS retirement benefits for work performed after the effective date of that Act, any action by the legislature in relation to the taxation of those unaccrued benefits could not constitute an impairment or breach of a contractual obligation."

Hughes, 314 Or at 29.

Additionally, section 3 of 1991 Oregon Laws, chapter 823, which repealed the

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[4] Oregon Laws 1991, chapter 823, section 1 amended ORS 237.201 (1989) by adding to it subsection 2, which is the provision stating that the exemptions provided for in subsection 1 are not applicable to state income taxes. *See former* ORS 237.201 (1989), *renumbered as* ORS 238.445 (1999).

[5] Due to the fact that ORS 238.445(1) (former 237.201) covers a number of types of exemptions applicable to PERS benefits (terms of the contract), the subsection was not removed. Rather, its scope was narrowed by ORS 238.445(2). Oregon Laws 1991, chapter 823, section 1, thus, is an impairment of the PERS contract because it narrows the scope of the contract, affecting rights that have vested.

[6] This is so because the contract is unilateral, as opposed to bilateral. That is, the employees' contractual interest in the PERS benefits vests as "part of compensation for work currently performed. Employes [sic] accept and earn such future benefits by performing current labor." *Hughes*, 314 Or at 20-21 (quoting 38 Op Atty Gen 1356, 1365 (1997)). "[T]he adoption of the pension plan was an offer for a unilateral contract. Such an offer can be accepted by the tender of part performance." *Id*. at 21 (quoting *Taylor v. Mult. Dep. Sher. Ret. Bd.*, 265 Or 445, 452, 510 P2d 339 (1973)). "The distinctive features of a unilateral contract are that the offeror is the master of his offer and can withdraw it at any time before it is accepted by performance, and that while the offer is still outstanding the offeree can accept it by meeting its conditions." 17A Am Jur 2d 27-29, *Contracts*, § 5 (1991) (emphasis added).

exemption from the state's tax code (*former* ORS 316.680) was found to be a breach of the contract for which the court held that compensation may be paid in lieu of performance. *Hughes*, 314 Or at 33.

The *Hughes* court reasoned that, while Oregon Laws 1991, chapter 823, section 1, changed the terms of the PERS contract, section 3 merely amended a revenue statute that applied the tax exemption arising out of the contractual obligation. *See Hughes*, 314 Or at 33. The court found that while section 3 resulted in a breach of the *former* ORS 237.201 term of the contract, *former* ORS 316.680 was not itself an obligation of the contract. *Id*.

Having declared that Oregon Laws 1991, chapter 823, section 1, an impairment, the obligation remains on the state not to subject PERS benefits accrued or accruing on or before September 28, 1991, to personal income taxation.[7] *See id.* at 29-33. As for the breach resulting from the repeal of the exemption from the tax code, (Oregon Laws 1991, chapter 823, section 3), the court held that the state was required to compensate those retirees whose PERS benefits earned before September 29, 1991, were subjected to taxation. *See id.* The *Hughes* court left it to the legislature to fashion an appropriate remedy. *See id.* at 33 n 36.

In response to *Hughes*, the 1995 legislature enacted Oregon Laws 1995, chapter 569, amending ORS 238.375 through 238.385, increasing compensation for PERS members whose contracts were breached. *See* ORS 238.375 through 238.385 (1995)

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[7]Oregon Laws 1995, chapter 494, section 2, directed the PERS board to send lump sum checks in repayment of wrongfully taxed benefits. *See* Or Laws 1995, ch 494, § 2, *compiled as a note after* ORS 238.385 (1995).

(directing the PERS board to pay out a lump sum on January 1, 1996 and to increase future PERS benefits). The increase applied to PERS members for years in which their retirement income was not exempt and was intended as an express full and final payment of damages in acknowledgment of the breach. *See* ORS 238.375 (1999) and *Vogl v. Dept. of Rev.*, 322 Or 193, 200, 960 P2d 373 (1998). The increased monthly benefits were paid beginning February 1997 and the lump sum payment was made later that year in September.

This 1995 benefit increase was in addition to an earlier increase (up to four percent) granted by the legislature in 1991, just days after it repealed the exemption. *See* Or Laws 1991, ch 796, § 2, *amending* ORS 237.001-.315 (directing the PERS board to apply increases to retirement benefits).

Both benefit increases have been upheld by the courts as to PERS retirees. The 1991 benefit increase was upheld as compensation rather than an impermissible tax rebate. *See Ragsdale v. Dept. of Rev. (Ragsdale II*), 321 Or 216, 895 P2d 1348 (1995), *cert den* 516 US 1011, 116 S Ct 569 (1995); *see generally* Or Laws 1991, ch 796.[8] *Stovall v. State,* 324 Or 92, 922 P2d 646 (1996), found that both benefit increases discussed above (Oregon Laws 1991, chapter 796, and Oregon Laws 1995, chapter 569), were valid legislative enactments as to PERS members, intended to compensate PERS retirees for loss of the tax exemption. *See Stovall,* 324 Or at 128.

Returning to plaintiffs' argument that they are entitled to an exemption of their PERS

[8] In addition, Oregon Laws 1991, chapter 823, section 5, amending ORS 316.157 provided for a credit for retirement income against taxes otherwise due (up to nine percent). This provision was not challenged by federal retirees, presumably because it was not limited in its application only to PERS members.

retirement benefits, the Supreme Court flatly rejected that claim in *Vogl*, where it said: “[p]laintiffs as PERS retirees are not entitled to the declaration that their PERS income is exempt from state income taxation.” *Vogl*, 327 Or at 211. The *Vogl* court did find the 1995 benefit increase an impermissible tax rebate in violation of the doctrine of intergovernmental tax immunity as it operated against federal retirees. On remand to the Oregon Tax Court, the parties settled the dispute as those federal retirees based on the state’s agreement to make payments to those individuals.

Stepping back, the situation relative to PERS retirees is as follows: benefits earned before the effective date of the 1991 legislation (which repealed the exemption for PERS retirement benefits) continue to be exempt from state income taxes. Benefits accrued or accruing after that date are subject to tax because the state’s contractual obligation only extended to benefits earned (“accrued or accruing”) and since the promise was pursuant to a unilateral contract the state was free to terminate the offer as to unearned benefits at any time. It did so in 1991. The state rectified the problems brought about by the 1991 repeal by making lump sum payments to PERS retirees whose benefits, earned on or before September 28, 1991, were nonetheless taxed by the state. In addition, subsequent benefit increases have eliminated much of the impact of the exemption repeal. However, as to plaintiffs' appeal, the state never committed itself to a tax exemption for PERS retirement benefits in perpetuity and the court has previously rejected taxpayer requests for declaration to the contrary.

CONCLUSION

Plaintiffs are not entitled to a declaration that their PERS retirement benefits are exempt from state taxation. Benefits accrued or accruing on or before September 28, 1991, are exempt. Benefits earned thereafter are not. As to plaintiffs' assertion that federal retirees do not pay state income taxes to Oregon while state retirees do so pay, that is simply not the law.

IT IS THE DECISION OF THIS COURT that plaintiffs' appeal is denied.

Dated this _____ day of November, 2000.

DAN ROBINSON
MAGISTRATE

IF YOU WANT TO APPEAL THIS DECISION, FILE A COMPLAINT IN THE REGULAR DIVISION OF THE OREGON TAX COURT, FOURTH FLOOR, 1241 STATE ST., SALEM, OR 97310. YOUR COMPLAINT MUST BE SUBMITTED WITHIN 60 DAYS AFTER THE DATE OF THE DECISION OR THIS DECISION BECOMES FINAL AND CANNOT BE CHANGED.

THIS DOCUMENT WAS SIGNED BY MAGISTRATE DAN ROBINSON ON NOVEMBER 3, 2000. THE COURT FILED THIS DOCUMENT ON NOVEMBER 3, 2000.