

LATE TESTIMONY

WRITTEN ONLY

TESTIMONY BY KALBERT K. YOUNG
DIRECTOR, DEPARTMENT OF BUDGET AND FINANCE
STATE OF HAWAII
TO THE HOUSE COMMITTEE ON FINANCE
ON
SENATE BILL NO. 570, S.D. 2, PROPOSED H.D. 1

April 4, 2011

RELATING TO TAXATION

Senate Bill No. 570, S.D. 2, Proposed H.D. 1, amends Chapters 88 and 235, HRS, to preserve the exemption from income taxes of employer-funded pension income of taxpayers with federal adjusted gross income (AGI) of: 1) less than \$100,000 for a taxpayer filing a single return or a married person filing separately; 2) less than \$150,000 for a taxpayer filing as a head of household; or 3) less than \$200,000 for a taxpayer filing a joint return or as a surviving spouse. The bill also preserves the deduction for State taxes paid for the same taxpayers. The preservation of the pension income exemption and the State income tax deduction is applicable for tax years beginning after December 31, 2010, and is made permanent. The bill also limits the amount of itemized deductions that may be claimed by taxpayers and delays the standard deduction and personal exemptions increases approved under Act 60, SLH 2009.

The Department of Budget and Finance supports the intent of this proposal. However, we strongly believe that lower exclusion thresholds on pension incomes than provided for in this bill need to be considered to address the general fund budget shortfall. We also believe that the State income tax deduction should be totally repealed, but that the repeal should be phased-in for taxpayers whose federal AGIs are less than the thresholds established in the bill.

We defer to the Department of Taxation regarding technical issues of the bill.



**TESTIMONY OF
THE DEPARTMENT OF THE ATTORNEY GENERAL
TWENTY-SIXTH LEGISLATURE, 2011**

ON THE FOLLOWING MEASURE:

S.B. NO. 570, S.D. 2, PROPOSED H.D. 1, RELATING TO TAXATION.

BEFORE THE:

HOUSE COMMITTEE ON FINANCE

LATE TESTIMONY

DATE: Monday, April 4, 2011 TIME: 2:00 p.m.

LOCATION: State Capitol, Room 308

TESTIFIER(S): David M. Louie, Attorney General, or
Mary Bahng Yokota, Deputy Attorney General

Chair Oshiro and Members of the Committee:

This testimony concerns the proposed House Draft 1 of Senate Bill No. 570, which is similar to S.B. No. 162, S.B. No. 1319, and H.B. No. 1092, which impose Hawaii's income tax on pension income.

Part I of the proposed House Draft 1, could be the subject of a constitutional legal attack. Should this bill become law in this proposed form, it could be challenged, the outcome would not be certain, and the Attorney General would defend it as is the Attorney General's duty. Court decisions in other states cut both ways. The law would be presumed to be constitutional, however, it could take years to litigate the issue through the Hawaii court system and subject the State to "refund" lawsuits if the bill is found unconstitutional.

That being said, we want to be clear that the Department of the Attorney General is not recommending that you should not pass the bill. As noted, court decisions on this issue have gone both ways, and it is certainly possible that even if a constitutional challenge is raised, it may fail. We are bringing the possibility of a legal challenge to your attention for the sole purpose of making sure that you have as much

information as possible available to you as you consider this bill. Indeed, it is worth noting that any bill passed by the Legislature could be subject to legal challenge (whether or not such a challenge is well-founded). Where - as here - the outcome of such a challenge is uncertain, that alone may not be reason enough not to pass the bill.

Insofar as House Draft 1 would impose Hawaii's net income tax on the pensions, annuities and retirement allowances of retired State and county employees and their beneficiaries who have incomes over certain dollar thresholds, which at present are non-taxable¹, it could be the potential subject of a legal challenge on the grounds that they may violate article XVI, section 2 of the Hawaii Constitution, or may impair the Contracts Clause of the U.S. Constitution.

Article XVI, section 2 of the Hawaii Constitution provides:

EMPLOYEES' RETIREMENT SYSTEM

Section 2. Membership in any employees' retirement system of the State or any political subdivision thereof shall be a contractual relationship, the accrued benefits of which shall not be diminished or impaired. [Ren Const Con 1978 and election Nov 7, 1978] (emphasis added).

An attempt to subject pensions, annuities, and retirement allowances of retired Oregon State employees to state personal income taxation was the subject of a legal challenge under an Oregon statute that exempted such retirement benefits from state, county, and municipal taxes "heretofore or hereafter imposed" and an analogous Oregon constitutional provision barring the impairment of contracts.² In Hughes v. State, 838 P.2d 1018 (Or. 1992), the Oregon Supreme Court held that a

¹ See section 88-91, Hawaii Revised Statutes.

² Article I, section 21 of the Oregon Constitution provides in part "No ex-post facto law, or law impairing the obligation of contracts shall ever be passed . . . ,"

provision in Oregon's employees' retirement law exempting pensions, annuities, and retirement allowances from taxation³ was a term of the Oregon Public Employees' Retirement System (PERS) "contract" with state employees. Hughes, 838 P.2d. at 1032-1033. The Court held that the Oregon Legislature's amendment of that provision to remove the exemption "breached" the PERS contract by taxing retirement benefits for work accrued or accruing before the change in the law. Hughes, 838 P.2d at 1035.

Recent Hawaii Supreme Court decisions suggest that the holding in the Hughes decision, while not binding, might be found persuasive by Hawaii Courts. In Kaho'ohanohano v. State, 114 Hawaii 302, 342 (2007), our Supreme Court stated the framers' intent underlying article XVI, section 2 of the Hawaii Constitution was to deprive the legislature of the right to reduce benefits of state employees as to past services to the State.

In Everson v. State, 122 Hawaii 402 (2010), the Court construed article XVI, section 2 such that the term "accrued benefits" included not only "pension" benefits but retiree health benefits. The Court rejected an argument that the Hawaii Constitution protects only benefits provided by the Employees' Retirement System, stating "it is those "accrued benefits" arising from membership in an ERS, and not simply those benefits provided by an ERS, that is protected by article XVI, section 2." Everson, 104 Hawaii at 416.

It is not clear whether the Hawaii Supreme Court would find that the non-taxability of State and county employee retirement benefits is an "accrued benefit" similar to retiree health

³ The statute (O.R.S. 237.201) was amended in 1991 to except Oregon personal income taxation from the exemption.

benefits or whether the current law exempting those benefits from taxation is part of the "contract" between ERS members and the State as the court in the Hughes decision found.

In the Hughes decision, the Oregon Supreme Court briefly discussed the argument that Oregon's sovereign power to tax could not be contracted away by the Oregon Legislature so as to preserve the State's power to tax state employee retirement benefits. In Hughes, the Court found that such a suggestion could not be found within the language or history of Oregon's "Contracts Clause." Hughes, 838 P.2d at 1025. However, in contrast, Hawaii's Constitution expressly recognizes that "[t]he power of taxation shall never be surrendered, suspended or contracted away." See Haw. Const. Art. VI, §1. As such, in Tax Appeal of Director of Taxation v. Medical Underwriters of California, 115 Hawaii 180, 366 (1997), the Court recognized that the power to tax is a sovereign power that was not subject to the doctrine of "estoppel."

For example, the Georgia Supreme Court upheld a state enactment that subjected previously exempt retirement benefits to state income tax because the Georgia Constitution denied to the Georgia Legislature the power to surrender the sovereign right of the state to tax. Parrish v. Employees' Retirement System of Georgia, 398 S.E.2d 353 (Ga. 1990). Significantly, the Hawaii Supreme Court in both the Kaho'ohanohano and Everson decisions did not have the opportunity to consider article VI, section 1 of the Hawaii Constitution when it examined the respective legal challenges under article XVI, section 2 of the Hawaii Constitution.

Court decisions in New Mexico and Montana reach opposite conclusions to that reached in Hughes. See Pierce v. State of Mexico, 910 P.2d 288 (N.M. 1995) and Sheehy v. Public Employees

Retirement Div., 864 P.2d 762 (Mont. 1993). The Pierce and Sheehy decisions, however, did not involve a constitutional provision similar to article XVI, section 2 of the Hawaii Constitution, and the Hawaii Supreme Court's decisions in Kaho'ohano and Everson cast doubt on whether they would be found persuasive by Hawaii courts.

A legal challenge by retired State and county employees concerning the matters discussed in this memorandum could be obviated by making the amendments effective on a prospective basis only, i.e., to future members of the ERS.

LATE TESTIMONY



Hawaii Chapter, MOAA
P.O. Box 1185
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Testimony of Thomas Smyth, President
Military Officers Association of America, Hawaii Chapter

Before the Committee on Finance

Monday, April 4, 2011, 2:00 pm, Room 308

SB 570 SD 2 (Proposed HD 1) Relating to Taxation

Chair Oshiro, Vice Chair Lee and Committee Members

Our chapter of 400 retired and currently serving officers of the Uniformed Services continues to oppose taxation of all pensions based narrowly on Federal Adjusted Gross Income thresholds.

As we testified at your February 25 hearing on Proposed HD 1 (A & B) of the Administration Bill, HB 1092, we feel that imposition of the AGI is going to unfairly penalize those who, in many instances, already pay federal and state income tax on much of their retirement income.

We again note that since Social Security payments are federally taxed they are part of that gross income basis and would then be taxed additionally by the state, even though proponents of this approach continue to say Social Security would not be state taxed. It is also not clear whether disability retired pay would be taxed and whether the thresholds would be indexed for inflation.

We remain concerned that some continue to say only 10 states do not tax pensions. That is very misleading. Eight states have no personal income tax and 2 others only tax dividend and interest income. But 13 states with income tax do not tax military pensions and another 20 states provide military pension exclusions with either dollar amounts or age exemptions, from 55 to 65 years of age. Other states exclude full disability income, similar to those above a certain age. Still other states only tax military retired pay for those retiring after a certain date. As you may have noted from the 50-state data I provided with our previous testimony, comparison with other states is complex.

If Hawaii taxes military retired pay as part of a blanket pension tax law, it will certainly become known as a “military-unfriendly” state at a time when the Department of Defense is one of the most significant contributors to our economy and we go out of our way to welcome military personnel, their families and the money they spend.

I can’t speak for all retirees but I know from my personal experience and that of my nearly 500 members that we do, in fact, “give-back” to the community a lot. Many of you are aware of the hundreds of community activities led by, or supported by retired military personnel. They served their country and state while in military service and most continue to serve in retirement. It should also be noted that these retirees take little from the community. Their children are not school age and they seldom use human services and health services paid for by their taxes.

Finally, the consensus of the members of my chapter is that if these draconian taxes are put in place immediately and without any prior warning, many will leave the state and few will retire here. That means a significant loss of state revenue as they spend their discretionary income somewhere else. We ask again that this revenue loss, which is measurable, should be factored into the fiscal equation that so far is only counting revenue gain from new taxation. There is a “cost-benefit” ratio analysis needed before a major mistake is made using false calculations.

Thank you for the opportunity to provide testimony.