



## U.S. Supreme Court to hear challenge to West Virginia exemption of state retirement benefits

DAVID KALL | TAX AND BENEFITS CHALLENGES | JUL 05, 2018

Last week, the U.S. Supreme Court agreed to hear a challenge to a West Virginia law that provides an income tax exemption for retirement benefits of state law enforcement officers, but does not extend the same exemption to federal law enforcement officers.

The case, *Dawson v. Steager*, addresses the doctrine of intergovernmental tax immunity, which bars states from interfering with operations of the federal government by imposing discriminatory taxes. As it relates to retirement benefits, federal law allows states to tax the pay of federal employees, but only if the tax does not discriminate against them because the federal government is the source of their pay.

The Supreme Court previously visited the intergovernmental tax immunity doctrine in the 1989 case *Davis v. Michigan Department of Treasury*. The *Davis* case struck down a Michigan law that exempted from taxable income the retirement benefits of all state employees, but not of federal employees. The court held any discrimination between state and federal retirees because of the source of their income must be "justified by significant differences between the two classes" of retirees.

### WEST VIRGINIA'S EXEMPTION SCHEME

West Virginia law fully exempts from taxable income retirement benefits received by state retirees from four plans – the Municipal Police Officers and Firefighters Retirement System, the Deputy Sheriff Retirement System, the West Virginia State Police Death, Disability and Retirement Fund, and the West Virginia State Police Retirement System. Less than 2 percent of state retirees qualify for this exemption. A smaller exemption for up to \$2,000 of retirement benefits is available to federal retirees under age 65 and to state retirees under age 65 who receive benefits from the Public Employees Retirement System and the Teachers' Retirement System. All taxpayers over age 65 may exempt up to \$8,000 from their taxable income, regardless of their retiree status.

The current case was brought by a retired U.S. Marshal, James Dawson, who contends the West Virginia exemption scheme violates the intergovernmental tax immunity doctrine because there are no significant differences between state law enforcement officers who qualify for the full exemption and federal law enforcement officers who do not. A county court granted Dawson the exemption, agreeing with him that there are no significant differences between the job responsibilities of a U.S. Marshal and those of state law enforcement officers. However, the West Virginia Supreme Court of Appeals reversed. The court noted West Virginia's full exemption is available only to a narrow class of state law enforcement officers. In addition, although federal retirees such as Dawson cannot receive the full exemption, they receive more favorable tax treatment than some state retirees and all non-government retirees. Based on the "totality of the circumstances," the court held the state's exemption scheme does not discriminate against federal retirees.

### TIME TO REVISIT THE "SIGNIFICANT DIFFERENCES" TEST?

The Supreme Court's decision to revisit the intergovernmental tax immunity doctrine by hearing *Dawson v. Steager* appears to have been influenced by an amicus brief the U.S. Solicitor General filed in support of Dawson. The court will limit its review to the legal question as framed by the amicus brief: whether the intergovernmental tax immunity doctrine prohibits West Virginia from "exempting from state taxation the retirement benefits of certain former state law-enforcement officers, without providing the same exemption for the retirement benefits of former employees of the United States Marshals Service."

Dawson is expected to argue the West Virginia high court improperly applied *Davis*. The threshold question under *Davis* is whether a state law discriminates between state and federal employees because of the source of their income. If the law is discriminatory, it can stand only if the discrimination is justified by significant differences between the state and federal employees. The West Virginia court, however, applied a "totality of the circumstances" test to determine whether the state's exemption scheme is discriminatory. In doing so, the court never reached the question of whether the discrimination is justified by significant differences between state and federal law enforcement officers.

West Virginia, on the other hand, takes the position that the state court decision was in line with the decisions of five state appeals courts that have applied *Davis*. According to the state's briefs, *Davis* prohibits "blanket" schemes that extend exemptions to all state retirees while taxing fully the income of all or a subset of federal retirees, but allows more tailored exemptions that apply to a narrow class of state retirees only. West Virginia argues that lower courts have tracked this distinction between broad and narrow exemptions, so there is no split for the Supreme Court to resolve.

The case will be heard during the Supreme Court's term that begins in October.



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