

# Taxation and Other Fiscal Impact of the Pensions Reform Bill.

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## INTRODUCTION

It is now well established that taxation does not aim at generating revenue alone. It is also used to achieve social, economic objectives such as stimulating economic growth and encouraging or discouraging a particular activity. For instance, our tax laws have been structured to encourage employers and employees to establish approved pension/retirement schemes by making their contributions tax not for the generous tax treatments of pension and retirement contributions, most of the private pension/retirement schemes in existence today might not have been established. Therefore, there is a close interaction between taxation and the supervision of pension/retirement schemes so much that in some countries they are administered by the same government agency.

This paper examines the relationship between the Pension Reform Bill (Bill), taxation and intergovernmental fiscal relationships. The paper considers the tax treatment of the existing pension schemes vis-a-vis the provisions of the Bill and concludes that the tax treatment under the Bill is far more generous. The paper also raises some specific questions and attempts to provide answers to them.

These include whether the contribution under the Bill is a tax, who bears the burden, how is the contribution treated under the tax law at the time of payment and at the time of receiving benefits, what is the interaction between the contributors and the tax authority, can the Federal Government impose obligations on the States and Local Governments on how to finance Pension Schemes of their employees, whether the revenue of States and Local Government Councils from the Federation Account can be charged with the payment of their contributions under the Bill?

### 1. AN OVERVIEW OF THE BILL

In this paper, I will not bother to elaborately discuss the existing pension system and the circumstances that inspired the initiation of the Bill. These had been competently treated by earlier papers. Therefore, only a highlight of the Bill will be provided for the purpose of the discussion in this paper.

The Bill establishes a new National Pension Commission (Commission) to regulate, supervise, and ensure the effective administration of pension matters in Nigeria.<sup>1</sup> The Commission shall have power to formulate, direct and oversee the overall policy on pension matters in Nigeria.<sup>2</sup> The functions of the Commission include "establishment of standards and guidelines for the management of the pension funds under the Scheme."<sup>3</sup> The Bill establishes a Contributory Pension Scheme for all permanent

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<sup>1</sup>Section 15(1) Pension Reform Bill (PRB).

<sup>2</sup>Section 21(a) PRB

<sup>3</sup>See generally section 22 PRB

employees both in the public and private sectors in Nigeria, except employees of a company, firm or enterprise with less than five people. However, section 1 (3) makes participation in the scheme voluntary for employees of a company, firm or enterprise with less than five people.<sup>4</sup> The contributions for any employee and employers vary as follows:

In the case of the Federal Government-

- (i) a minimum of twelve and a half per cent by the employer,
- (ii) a minimum of seven and a half per cent by the employee.

In the case of the military -

- (iii) a minimum of fifteen per cent by the employer,
- (iv) a minimum of five per cent by the employee.

In other cases -

- (v) a minimum of seven and a half per cent by the employee,
- (vi) such minimum rate, as may be agreed from time to time between the employer and employee, to be contributed by the employer provided that the rate shall not be lower than what the employer has been contributing to the existing pension scheme. In case of employers without any existing scheme, the employer's contribution "shall be as may be agreed, from time to time, between the employees and employer.

In addition to the above, an employee may make voluntary contributions over and above the prescribed percentage of his salary.<sup>5</sup>

The contributions by the employers and employees shall be paid into a retirement savings account maintained by an employee in his name with any Pension Fund Administrator of his choice.<sup>6</sup> No employee shall be entitled to make any withdrawal from his retirement savings account until he attains the age of 50 years.<sup>7</sup> An employee may transfer his account from a Pension Fund Administrator to another subject to maximum of four in a year. It is mandatory for the employer to remit its own contributions and that of the employee to a Custodian specified by the Pension Fund Administrator of the employee not later than seven days within which the employee is paid his salary.

Failure to remit the contributions shall attract a penalty of 5 per cent of the total contribution that remains unpaid for each month. In case of default by any of the three tiers of government, the amount of the contribution due shall be deducted directly from its subsequent statutory allocation.<sup>8</sup>

All the existing pension schemes before the commencement of the proposed Bill shall cease to operate.<sup>9</sup>

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<sup>4</sup>See generally, section 1 of PRB.

<sup>5</sup> Section 10 (5).

<sup>6</sup>Section 12

<sup>7</sup>Section 3(1)

<sup>8</sup>See generally section 12.

<sup>9</sup> See section 9

The right to retirement benefits under the existing schemes is however not extinguished. Rather, the right will be recognised in form of retirement benefits bond established by the Commission. In the case of employees of Federal, State and Local Governments and parastatals with unfunded schemes, the bonds shall be redeemed upon retirement and added to the retirement savings account of the employee.<sup>10</sup> However, in the case of employees under funded schemes both in the public and private sector, their retirement savings account shall be credited with any funds to which the employee is due. Where there is an insufficient fund to meet this liability, the shortfall shall become a debt owed by the employer to the employee and treated with the same priority as salary owed. The employer shall notify the Commission of this development and its plan to meet the shortfall.<sup>11</sup>

Since our major task is to analyse the tax and fiscal impacts of the foregoing provisions of the Bill, it is appropriate to briefly consider the meaning of the terms "taxation" and "fiscal"

## **2. DEFINITION OF "FISCAL" AND "TAXATION".**

"Fiscal" broadly relates to public finance, that is, the management of government's revenue and taxes.<sup>12</sup> It is connected with the methods through which the government raises and manages its revenue in financing the public sector. Taxation is therefore an aspect of government's fiscal measures:

Taxation on its own part is the process by which government compulsorily transfers resources (almost always money) from private to public sector.<sup>13</sup> Akanle defined tax as "a compulsory levy imposed on a subject or upon his property by the government having authority over him."<sup>14</sup> The basic features of a tax are as follows:-

- (a) it is an imposition by a government as an attribute of sovereignty,
- (b) it is compulsory and not voluntary,
- (c) payment is not dependent upon a direct conferment of any benefit on the taxpayer. That is no element of quid pro quo,
- (d) it is an imposition made for general public good and purpose.<sup>15</sup> It is not exacted for the direct benefit of some group.<sup>16</sup> Application of the revenue will depend on the policy and priorities of the government at a particular time.

### **2.1 Are pension contributions taxes?**

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<sup>10</sup> See sections 13 and 25

<sup>11</sup> Section 13

<sup>12</sup> See Black's Law Dictionary, 7<sup>th</sup> edition, ed. B.A. Gernert West Group, 1999, p. 650

<sup>13</sup> M. J. Graetz & D.H. Schenk, *Federal Income Taxation, Principles and Policies*, 4<sup>th</sup> ed., (2001) Fend of Press, N.Y., p.1

<sup>14</sup> O. Akanle, *Nigerian Income Tax and Practice*, 1991, Centre for Business & Investment Studies Ltd.

<sup>15</sup> However, some taxes may be collected for some particular purposes. Such taxes raised to provide particular benefits are termed hypothecated taxes. They are unpopular with the Government who see these taxes as undermining its control of public expenditure. See D. Hancock, *Taxation Policy & Practice*, 3<sup>rd</sup> ed., p.13.

<sup>16</sup> Revenue from Excise taxes may be used for the direct benefit of those who pay them.

In the light of the foregoing features of taxation, are the contributions required from employers and employees under the Bill taxes? A quick answer to the question is that they are not.<sup>17</sup>

However, there are unavoidable interactions between them and the tax system. It suffices to say that employers and employees often do regard their contributions as taxes.

Generally, there is no universal answer to the question whether pension/retirement/social security contributions constitute taxes or not.

Everything depends on the content of the law under which the contributions are required. Depending on the circumstances, a contribution may be a tax or a saving. For instance, if a contribution is risks-related and determined by actuaries rather than by law, then it may qualify more as an insurance saving than a tax. A scenario when a contribution would be a tax has been painted in the following words:

“A social security fund is a tax if there is a requirement to make payments either to state funds or payments either to state funds or to a state regulated funds from which there is an obligation to pay social security benefits. In short, the payment must be mandatory and must be state regulated. If the potential payer can choose whether to make payment then it is not a tax.”<sup>18</sup>

If we go by the above, one would be tempted to conclude that the contributions under the Bill are taxes. Although payments are not made to government, the scheme is regulated by the Government and made compulsory. Not only that, it is implicit that the government has power to change the formula under which the benefits are determined in future. For instance, government could increase the age at which an employee can access the benefits from 50 to 60 years or even more.

However, the main obstacles to the classification of the contributions as taxes are threefold. First, all the contributions made in respect of a particular employee under the scheme will be paid into an account with Pension Fund Administrator of his choice in the name of the employee and be paid back to him later as benefits. Second, the employee is entitled to transfer his account from one Pension Fund Administrator to another up to four times in a year.

Third, the contributions under the Bill is designed primarily to collect funds for the benefit of a closed group of people, that is, the employees on whose behalf the contributions are made and their dependants. Income tax on its own part is an open system, mobilising funds from all those within scope of the tax and spending it as general public expenditure.<sup>19</sup> Based on the foregoing, it is submitted that the contributions under the Bill are more in the mould of compulsory savings rather than taxes.

The attitudes of the administrators employers and employees to the nature of the contributions are not the same.

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<sup>17</sup>Section 2 of the Bill unequivocally declares the objectives of the Bill thus: "assist improvident individual by ensuring that they save in order to cater for their livelihood during old age."

<sup>18</sup>R. John Hy & W.L. Waugh, Jr., *State & Local Tax Policies*, Greenwood Press, 1995, p. 38. On social security generally, see Janet Stotsky, *Payroll Taxes and the Funding of Social Security System*, in *Tax Policy Handbook* 177 (Parthasaranthi Shome ed., 1995). For instance, social security coverage of the self-employed is sometimes voluntary (e.g. Germany). 6 IBDF *European Taxation*. Supra, note 1, at 41

<sup>19</sup>R. John Hy and W.L. Waugh Jr. op.cit, p. 392.

In practice, administrators of funded pension schemes prefer the classification of contributions as savings rather than taxes in order not to avoid the negative attachment of people to taxation. However, both workers and employers often view the contributions as taxes. Most employees would prefer to collect their entire salary free of any deduction and be allowed to make their pension plan.

This is understandable considering the fact that most workers are not earning enough to make ends meet. Similarly, employers also see their contributions as taxes more particularly when they are expected to contribute a higher percentage. This is understandable since they are not the ultimate beneficiaries of the benefits to be derived under the scheme.<sup>20</sup> However, in reality the burden of the entire contribution is often borne by the employees. This is because the employer often takes into consideration his obligation (to make the contribution) before determining the employee's remuneration. Invariably, the remuneration may be reduced more or less by approximately the same amount of his contribution. A case of the birds learning how not to perch in order to avoid the hunter's arrow.

The next thing is to consider the interaction between pension contributions and the income taxes.

### **3. PERSONAL AND COMPANIES INCOME TAXES**

The Personal Income Tax is imposed on the aggregate global earning of a taxpayer from trade, business, employment, profession, vocation etc. The income tax recognises that a taxable person may have several sources of income and seeks to tax all his global income from such sources.

However, we are concerned here with the income from employment. Companies Income Tax is imposed under the Companies Income Tax Act.

The same principles substantially govern the computation and administration of both Personal and Companies Income Tax.

The process of ascertaining taxable income involves three stages: (i) computation of total income; (ii) deductions of relief; and (iii) charging income tax at the appropriate rate on the net income. Part of the reliefs allowed under the income tax law are the contributions made by employees and employers to approved pension schemes. This is by making the contributions to be tax deductible under certain circumstances.

In practice, the approval of the Joint Tax Board (JTB) is required to ensure that only contributions in furtherance of genuine schemes are allowed in order to eliminate or reduce opportunities for tax evasion through such schemes. In approving and supervising pension schemes, the JTB usually utilises the opportunity to monitor the tax compliance status of companies by requesting for the following documents, among others:

- (a) three years audited account of the company,
- (b) copy of the companies VAT registration, and

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<sup>20</sup>Placing a larger share of the contribution on the employers has some of the same political appeal as the companies income tax, i.e. it is perceived as less of an imposition to tax an employer than to tax an individual.

(c) letter from the Chairman of the State Board Internal Revenue where the company has offices confirming up to date remittance of Pay As You Earn deductions.

Once approved, the scheme cannot be altered or wound up by the employer without the approval of the JTB.<sup>21</sup> It is noteworthy that if a retirement benefit scheme is not approved by the JTB, it does not mean that the scheme cannot be operated the main implication is that the contributions of both the employers and employees made under it will not be allowed for tax purposes. This is likely to discourage employers and employees from embarking on such a scheme as the tax on such disallowed expenditure can be enormous.<sup>22</sup>

One of the effects of the Bill on the tax is that it will eliminate the role of the JTB in the supervision of retirement benefit schemes in Nigeria. This is because the Bill proposes to abolish all private schemes. This development is bound to jolt the JTB, which through the prolonged years of military rule had come to assume several functions beyond those assigned to it by the law. Naiyeju had envisioned a more active and robust role for the JTB in the management of pension contributions proposing in Nigeria. According to the astute tax administrator:

I personally foresee a co-ordinate effort of all regulatory bodies in the implementation of an articulated National Policy in the years ahead ... In respect of the bodies to regulate the schemes. I foresee (the body) the Secretariat of the JTB being upgraded to the status of a fully fledged department and charged with the responsibility of pooling the resources or contributions of the various contributors towards a common fund, for the purpose of disbursement to the approved social security schemes.<sup>23</sup>

Naiyeju had forcefully argued that combining the collection of contributions with that of income tax pension/retirement would make administration easier as the two can be done simultaneously. While there may be logic in the position, it is doubtful if such an arrangement will ultimately lead to efficiency. Rather, the administration of pension scheme may also become bedevilled with the same myriads of problems currently plaguing our income tax administration. In any event, whatever sympathy anyone may have for Naiyeju's prognosis, the reality which confronts us today is that there is a far more sweeping pension reform which seeks to do away with the pre existing schemes and create a monolithic scheme for both the public and private sector under the Pension Reform Bill.

### **3.1 Circumstances in which contributions are tax deductible under PITA**

The retirement benefits scheme is broadly classified into two in the Fourth Schedule of PITA. These are:

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<sup>21</sup>J.K. Naiyeju, *Modus International Law and Business quarterly*, Sept. 1997, Vol. 2, No. 3, pp. 86-7.

<sup>22</sup> Ibid. p. 89.

<sup>23</sup>J.K. Naiyeju, *op. cit.*, p. 89. He also went on to say "My visions for supervisions and retirement of retirement benefit scheme is the empowerment of a single body comprising representatives for the present regulatory bodies, but under the umbrella of the JTB, as a one stop to handle such matters. Such body could also be charged with the responsibility of collecting contributions from employers towards social security schemes."

- (i) pension funds and
- (ii) provident funds.

Pension fund is a scheme, which is held under irrevocable trust for the main object of providing non-assignable and non commutable retirement pensions or annuities for an individual (or his) or a group or individuals (or their) dependants after his or their death. Provident fund on the other hand is a scheme which is established under irrevocable trustees or a law for the main object of providing retirement benefits for an individual or his dependants, or a group of individuals or their dependants after his or their death.

There are two main distinguishing factors between a pension fund and provident fund. First, the benefits under the pension fund, as the name suggests, include pension while a provident fund involves a once and for all payment. A pension benefit is a monthly payment of certain percentage of the insurable earning of an employee. Second, the benefits under the pension fund are not assignable and commutable whereas the benefits under the provident fund may be assigned and commuted. Hence, provident funds are more flexible and could be more readily employed for tax planning purposes.

Elaborate provisions are made in the Fourth Schedule to PITA on the tax treatment of contributions of employers and employees. While the tax law seeks to encourage employers and employees to establish pension schemes and contributes towards it, it attempts to strike a balance between this objective and the need not to undermine the prospect of generating revenue from income tax. The law limits the aggregate amount of what the employer and employee can deduct irrespective of the percentage of their contributions. The tax law permits deduction up to a maximum aggregate contribution of 25 per cent of the employee's annual income by the employer and employee.<sup>24</sup> Any contribution in excess of this amount shall not be deductible.

The tax law also limits the amount of the contribution, which an individual can make. The rule in this regard is that any contribution by an employee in excess of N5,000 will not be deductible. A strict interpretation of these provisions would mean that the tax does not wish to encourage employees to contribute more than N5,000 in every fiscal year. However, as from January 2001, the Nigerian Social Insurance Trust Fund (NSITF) Board had raised the rate of contribution to 10 percent in the ratio of -- employees 3.5%, employer 6.5% subject to a ceiling of N4, 4000 per month. This means that the maximum monthly contribution under NSITF is N4.400. It is remarkable that the tax law is yet to be amended to accommodate this increase. There is therefore the need to reconcile the tax laws and the provisions of NSITF Act in this regard.

Paragraph 9 of the Fourth Schedule provides for a self-employed person who has made contributions to an approved scheme. The premium or contribution made by such a person shall be exempted from tax provided it does not exceed 10% of his total income. It is uncommon in practice to see a self-employed making contribution to an approved scheme.

### ***3.2 Tax treatment of contributions under the Bill***

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<sup>24</sup>Section 20(g) PITA and the Fourth Schedule to PITA

It is appropriate to now turn to the vision of the Bill on taxability of contributions. Section 11 of the Bill specifically provides:

*Notwithstanding anything in any enactment or law, contribution by an employer or employee to the Scheme under this Act shall form part of tax deductible expenses in the computation of tax payable by an employer or an employee under the relevant income tax law.*

The following provisions attempt to override the provisions of PITA, which limits deductible contribution provided by an employer and employee one way or the other. This is clear from the opening paragraph of the section which provides "Notwithstanding anything in an enactment or law". The provisions of the Bill in this regard therefore encourage employers and employees to contribute as much as they wish over and above the prescribed minimum. Hence, the tax treatment of contributions by both the employees and employers are generous. What is the position at the time of receiving benefits under the scheme?

The remaining part of this section will be devoted to a consideration of the tax treatment of contributions at the time of receiving the benefits under PITA and the Bill.

### **3.3 Tax treatment of benefits under PITA**

The tax law does not encourage a situation where pension or provident fund contributions will be distributed under any guise before the cessation of employment or retirement. Where an employment ceases and an employee, who has not spent a period of five years in the service of an employer, is paid any amount above three hundred thousand naira, the amount shall be deemed to be income and taxable.<sup>25</sup>

Also, the law regards any payment, whatever its form or name, made to an employee before the cessation of his employment in respect of any pension or provident fund as taxable income derived from his employment.<sup>26</sup>

Pensions and gratuities were hitherto taxable pursuant to section 3 of PITA. Gratuity was specifically exempted from taxation in 1998. Although there is yet no express provision to that effect under the tax law, an employee who has been in an approved scheme for over five years collects his benefits without suffering, any imposition of tax on such benefits.<sup>27</sup>

There was a proposal in 2001 Federal Government's Budget Speech which purported to exempt the pension received by those who are under the public pension scheme from taxation.

Although, the exception was later extended to the pension of those in the private sector, no legal basis has been provided for this under the tax laws.

However, in practice, pensions received under both the private and public schemes are exempted from taxation as a matter of concession provided the employee has been in an approved scheme for over five years.

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<sup>25</sup>Paragraph 6 of the Fourth Schedule to the PITA.

<sup>26</sup>Paragraph 8 of the Fourth Schedule to the PITA.

<sup>27</sup> See J.K. Naiyeju, op. cit. p. 88.



The approval of the Chairman of the Board of Internal Revenue is however required in some States before such payment could be made tax-free.<sup>28</sup>

In view of the foregoing it is crystal clear that the tax treatment under the Bill is far more generous than the regime under PITA. The Bill gives tax payer almost limitless opportunity for shelter as much of his taxable income as possible notwithstanding the cost to the government in terms of tax expenditure.

### **3.4 Tax treatment of benefits under the Bill.**

However, section 7 of the bill now provides a blanket tax relief to all payments received under the Bill with the exception of voluntary contribution. The section is reproduced for ease of reference:

7-(1) 'Any amount payable as a retirement benefit under this Act shall not be taxable.

(2) Notwithstanding the provisions of subsection (1) of this section, any voluntary contribution made under subsection (5) of section 10 of this Act shall be subject to tax at the point of withdrawal where the withdrawal is made before 5 years from the date the voluntary contribution was made.

The distinction between pension and gratuity under the existing scheme may no longer be relevant under the Bill as the Bill unequivocally states that "any amount payable as a retirement benefits under this Act shall not be taxable." The only taxable benefits under the Bill are those withdrawn or received within five years in respect of voluntary contributions made over and above the mandatory contributions. It will be recalled that section 10(5) gives an employee the option of making voluntary contribution in excess of the statutory limit prescribed under section 10(1).

Under this provision, if an employee, for instance, voluntarily contributes 20 per cent of his income over the prescribed percentage, the benefit received by him in respect of those voluntary contributions will be taxable if he makes a withdrawal within five years. The purpose, of this provision to my mind, is to prevent a situation, whereby an employee who is close to the retirement age of 60 years (perhaps 59 years old) decides to make large voluntary contributions in order to shelter part of his taxable income.

In some other parts of the world, pensions and gratuities are taxable.

Perhaps, when the pension system becomes well established and relatively efficient in Nigeria, government may choose to tax gratuity and pension depending on its revenue need. The generous tax under the Bill may attract the interest of the Ministry of Finance sooner than later.

The remaining part of this paper will be devoted to a brief analysis of the fiscal aspect of the Bill.

## **4. FISCAL IMPACTS**

Generally, pension/retirement contributions usually have a great potential on revenue mobilisation effort of the government. In United States of America, for instance, social security is not only generally regarded as a tax; it is the highest source of tax revenue the Federal Government. The scope of proposed scheme under the Bill is massive. As we have seen, it covers "any employment in Nigeria" and

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<sup>28</sup>For instance, Lagos State.

hence, virtually everyone who is in permanent employment both in the public and private sector except those are working with an organization or firm with less than five employees.<sup>29</sup> This will bring enormous revenue the control of the Commission and greatly assist the Federal Government function of economic stabilization. Although the management of scheme under the Bill is supposed to be privatized, the Federal Government, May in future, change it's the pension policy and bring the management under its agency.

As pointed out earlier, the public sector coverage under the Bill includes the Federal, State and Local Government. The implication of this is that the Federal Government is trying to impose responsibilities which require huge financial commitments on the State and Local Governments without taking into account their policy preferences on the matter and without consulting them. The greatest hindrance to the success of the proposed bill if enacted into law is that some of States may challenge the powers of the Federal Government to dictate to them how to structure the pension plan for their staff within the limits of their resources.

The Bill is realistic enough to anticipate that the three levels of government and the Federal Capital Territory may default in the payments of their monthly contributions. The solution proffered under section 12(8) to the effect that the amount shall be deducted from their statutory allocation is remarkable in many ways.<sup>30</sup> Whilst it might be easy to make such deduction where the default is by the State and Local Governments, the Federal Government 'may be able to use its control over the management of the Federation Account to withhold the unremitted amount from the allocations due to the States and Local Governments. What would happen, where the default is by the Federal Government? Who is going to police the police?

It is worth asking whether it is constitutional for the Federal Government to unilaterally dictate to the States and Local Governments the manner in which they will spend their allocation from the Federation Account. The Supreme Court had made it clear in the case of *A.G. Federation v. A. G. Abia & 36 Ors. (No. 2)*<sup>31</sup> popularly called the *Resource Control Case* that the Federal Government is a Trustee of the revenue in the Federation Account and has a duty to account to the other stakeholders. It is submitted with respect that where a State or Local Government has not voluntarily charged its revenue in the Federation Account to any payment, it will be unconstitutional for the Federal Government to do so for any purpose no matter how altruistic or laudable.

## 5. CONCLUSION

No one can seriously deny that many aspects of our national life and policies including pension in the public sector are in dire need of reform. There are however several concerns on the approached proposed in the pension reform bill. Some of these concerns include whether the federal government has jurisdictional competence to establish a mandatory pension scheme for the private sector under 1999 Constitution, and the propriety of abolishing all private schemes. However, there is no serious tax related concern especially from the point of view of the employers and employees. As we have seen, the tax treatment of contributions and benefits under the Bill is more generous than under the existing scheme. This however may be of concern to the government in future especially where the government desires to minimise it's to tax expenditure on pensions. This is because the exemptions

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<sup>29</sup>Section I of the Bill.

<sup>30</sup> See section 12(8).

<sup>31</sup> [2002] 6 NWLR (Part 764) page 542.

being granted to contributions and benefits under pension schemes are more or less like transfer of revenue from the public purse to a close group of beneficiaries. The JTB will also certainly not be favourably disposed to the reform because it is going to eclipse its present role relating to pension administration in Nigeria.

From the foregoing, it can be seen that there are great challenges ahead for the successful implementation of the Bill. It also requires political will and cooperation among the three levels of government. The question is whether they can overcome some of these challenges without amending the Constitution? It is doubtful.