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Obamacare and the 'What Is a Tax?' Issue – Part I

Steve R. Johnson
Florida State University College of Law

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by Steve R. Johnson

One of the hardiest perennials in the garden of state and local tax issues is the question whether particular revenue measures should be classified as taxes or some other type of exaction. The issue has been dispositive in numerous state and local tax cases and, befitting that significance, has been the topic of many reports in this journal.[1]

Given the frequency of the decisions and commentary, authorities cited on the issue constantly evolve. State courts, omnivorous in their search for precedents and rationales, often cite federal cases.[2] Recognizing this, a recent article in *State Tax Notes* examined decisions of the U.S. Supreme Court as to distinctions between taxes and user fees.[3]

This installment and the next installment of this column are in a similar vein. They explore a potentially new source of guidance developing in the federal courts regarding the question "what is a tax?" The new source of guidance involves the Patient Protection and Affordable Care Act of 2010 (ACA), so-called Obamacare.[4] The individual mandate portion of the ACA requires that every applicable individual (with stated exceptions) obtain a minimum of medical insurance. Any "taxpayer" who doesn't obtain that coverage must make a "shared responsibility payment" to the federal government.[5]

The payment amount is computed by using the smaller of a percent of the individual's income or the national average premium for the lowest-level insurance plan providing minimum essential coverage. The shared responsibility payment is labeled a "penalty," not a tax, but it is lodged within the Internal Revenue Code.[6]

The constitutionality of the individual mandate has been addressed in numerous federal lower court decisions, and the cases are in conflict. The U.S. Supreme Court will consider the matter this term.[7] Whether the shared responsibility payment constitutes a tax or something else is central to the litigation. The answers the federal courts give to this question could influence future state and local tax cases. Indeed, similar questions have been asked as to financing mechanisms for state medical care proposals.[8]

This installment of the column and the next installment consider this new source of guidance

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[1]*See, e.g.*, H. William Batt, "User Fees: The Nontax Revenue Alternative," *State Tax Notes*, Apr. 5, 1993, p. 787, or *93 STN 64-12*; Jennifer Carr and Cara Griffith, "Virginia's Civil Remedial Fees — An Unconstitutional Traffic Ticket?" *State Tax Notes*, Aug. 13, 2007, p. 445, *Doc 2007-18256*, or *2007 STT 157-26*; Alicia Hansen, "State-Run Lotteries as a Form of Taxation," *State Tax Notes*, Nov. 28, 2005, p. 767, *Doc 2005-22159*, or *2005 STT 227-2*; Eugene W. Harper Jr., "Funding Surface Transportation Infrastructure," *State Tax Notes*, Dec. 22, 2008, p. 787, *Doc 2008-24053*, or *2008 STT 247-1*; William Hays Weissman, "California's Fee Problem," *State Tax Notes*, July 14, 2008, p. 117, *Doc 2008-14589*, or *2008 STT 136-3*.

[2]Many previous installments of this column have documented the frequent resort of state courts to federal precedents. *E.g.*, Steve R. Johnson, "*Chevron* Deference to State Tax Agencies," *State Tax Notes*, Jan. 24, 2011, p. 285, *Doc 2010-27202*, or *2011 STT 15-2*.

[3]Jasper L. Cummings, Jr., "User Fees Versus Taxes," *State Tax Notes*, Oct. 31, 2011, p. 321, *Doc 2011-21513*, or *2011 STT 120-3*.

[4]Pub. L. No. 111-148, 124 Stat. 119 (2010).

[5]*Id. at* section 1501, *codified at* 26 U.S.C. section 5000A. For a description of the individual mandate, see Jeffery H. Kahn, "The Operation of the Individual Mandate," *Tax Notes*, Aug. 1, 2011, p. 521; *see also* Steve R. Johnson, "The Anti-Injunction Act and the Individual Mandate," *Tax Notes*, Dec. 12, 2011.

[6]26 U.S.C. section 5000A(b)-(c).

[7]*Florida ex rel. Atty. Gen. v. U.S. Dept. of Health & Human Services*, 648 F.3d 1235 (11th Cir. 2011), *cert. granted*, Nos. 11-393, 11-398, and 11-400, 80 U.S.L.W. 3198 & 3199 (Nov. 14, 2011).

[8]*See* Kathleen K. Wright, "Is the California Governor's Healthcare Plan Funded by a Fee or Tax?" *State Tax Notes*, Jan. 29, 2007, p. 261, *Doc 2007-1658*, or *2007 STT 20-4*.

regarding the "what is a tax?" question. This installment sets the stage by rehearsing the contexts in which the issue has arisen in state and local tax controversies, the practical stakes involved in those controversies, and the criteria courts have developed to distinguish between taxes and other types of governmental exactions. The following installment of the column will build on this foundation by exploring what the already decided ACA cases have said, and what the Supreme Court might say, about "what is a tax?" in the context of the ACA shared responsibility payment.

Contexts

Whether a given state or local levy constitutes a tax or something else has arisen in five principal contexts. They are:

- tax versus user or other fee;
- tax versus regulatory mechanism;
- tax versus civil penalty;
- tax versus criminal penalty; and
- tax versus governmental taking.

Tax Versus Fee

This category represents the largest number of classification controversies. For example, former section 17942 of the California Revenue and Taxation Code imposed what was called a fee on all limited liability companies in California. The amount of the levy was based on the LLC's gross receipts, regardless of where they were earned. In several cases, the California courts held that the measure was, in substance, a tax, not a fee. As a consequence, the measure was invalidated under the U.S. Constitution's commerce clause as an unapportioned tax.[9]

Numerous additional examples exist. For instance, the "taxes versus fees" issue has arisen regarding charges for cable modems and water, sewer, and electricity services.[10]

Tax Versus Regulatory Mechanism

Charges may be imposed on an activity not to raise revenue but to discourage the activity or to regulate the circumstances under which persons engage in it. Sumptuary or sin taxes are examples.[11] So are so-called carbon taxes, designed to reduce industrial and other practices producing specific kinds of emissions.[12]

The "tax versus regulatory measure" distinction was important in the *Bailey* cases, companion cases decided by the U.S. Supreme Court.[13] A federal statute, the child labor tax, was designed to discourage child labor, not to raise revenue. Although the measure was labeled a tax, the Court held that it was so regulatory in nature that it ceased to be a tax for constitutional purposes.[14]

A state example involves California's Childhood Lead Poisoning Prevention Act. The act imposes a charge on persons engaged in the stream of commerce of products that contain lead. The amounts assessed are administered by the state Department of Health and fund programs to detect and monitor lead poisoning in children. A company challenged the act, arguing that the payment is a tax because it neither regulates the companies and their products nor funds governmental benefits to the payors themselves. The state supreme court disagreed and upheld the exaction as a fee.[15]

Tax Versus Civil Penalty

Something denominated a tax may, in intent and substance, actually be punishment for engaging in some kinds of prohibited or discouraged conduct. Among the many situations in which this can arise is bankruptcy. For instance, the claims of states for excise taxes owed by debtors have priority status and are nondischargeable.[16] However, that treatment doesn't apply to measures that are called taxes but actually are fines.

Tax Versus Criminal Penalty

Something denominated as a tax may also be a criminal penalty or sanction. For example, Montana used to have a dangerous drug tax. It had a "remarkably high" rate of tax and "beyond question" was

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[9]*See, e.g., Ventas Finance I LLC v. Franchise Tax Bd.*, 165 Cal. App. 4th 1207 (2008), *cert. denied*, 129 S. Ct. 1917 (2009); *Northwest Energetic Serv. v. Franchise Tax Bd.*, 159 Cal. App. 4th 841 (2008). For discussion of these cases, see William Hays Weissman, "California's LLC Fee: Round 2," *State Tax Notes*, Sept. 8, 2008, p. 691, *Doc 2008-18415*, or *2008 STT 175-3*; Weissman, "California Court of Appeals Holds State LLC Fee Unconstitutional," *State Tax Notes*, Feb. 11, 2008, p. 459, *Doc 2008-2378*, or *2008 STT 29-5*; Kathleen K. Wright, "*Ventas Finance*: The Next Step in California LLC Litigation," *State Tax Notes*, Sept. 8, 2008, p. 685, *Doc 2008-18459*, or *2008 STT 175-4*.

[10]*See, e.g.*, Sylvia Dennen, "Tax or Fee — What's in a Name?" *State Tax Notes*, Aug. 13, 2007, p. 423, *Doc 2007-16733*, or *2007 STT 157-2* (citing and discussing cases from Illinois, Washington, and Massachusetts).

[11]Traditionally, alcohol and tobacco are main targets of those taxes. Increasingly, so are adult entertainment activities. *See* Steve R. Johnson, "Taxes, Free Expression, and Adult Entertainment," *State Tax Notes*, Oct. 10, 2011, p. 103, *Doc 2011-19937*, or *2011 STT 196-5* (discussing Texas and Utah cases).

[12]*See, e.g.*, Shi-Ling Hsu, "A Prediction Market for Climate," 83 *U. Colo. L. Rev.* 101 (2011).

[13]*Bailey v. Drexel Furniture Co. ("Bailey II")*, 259 U.S. 20 (1922); *Bailey v. George ("Bailey I")*, 259 U.S. 16 (1922).

[14]*Bailey II*, 259 U.S. at 38.

[15]*Sinclair Paint Co. v. State Bd. of Equalization*, 15 Cal. 4th 866 (1997).

[16]11 U.S.C. section 507(a)(8)(E)(ii).

designed to discourage possession of illegal drugs.[17] As a result of these and other attributes, the U.S. Supreme Court held that this "tax" was actually an additional level of criminal punishment and was invalid as violative of the double jeopardy clause.[18] Similarly, the Tennessee Supreme Court held that the state's "tax" on the possession of illegal drugs exceeded the power of the legislature to enact because it "cannot be characterized as imposing either a tax on merchants, a tax on peddlers, or a tax on privileges, as authorized by [Tennessee's] constitution."[19]

Tax Versus Governmental Taking

Governments are prohibited from taking private property without paying just compensation.[20] This principle most obviously applies when government divests a private owner of title to property. But less dramatic measures also can trigger the requirement to compensate. For instance, the U.S. Supreme Court invalidated a statute that imposed tens of millions of dollars of retroactive liability for workers' health problems on a corporation that had left the business decades before the statute imposing the liability was enacted. The four justices in the plurality viewed the measure as an uncompensated taking.[21]

Taxes, of course, must be outside this compensation principle. The point of taxation is to raise money for government, which wouldn't happen if the taxpayer had to be compensated for taxes it paid. Accordingly, it becomes necessary to distinguish between genuine taxes (which trigger no duty to compensate) and measures that, in substance, are takings in the guise of taxes (which do trigger a duty).

Making this distinction "is more troublesome [analytically] than one would expect."[22] The case law on this matter is not yet extensive. However, a body of commentary on the issue exists.[23] Given the ingenuity of attorneys, it wouldn't be surprising to see the issue arise in future state and local tax cases.

Stakes

The classificatory calls described in the preceding section are not matters of idle pedantry. Significant consequences hinge on classification of an exaction as a tax or otherwise. These consequences relate to the ease of validly enacting the measure, the ease of defending it after enactment, and collateral effects.

It depends on context. Sometimes proponents of a measure want the courts to see it as a tax because that would be more conducive to the measure being upheld. As shown in the next installment of the column, that is the case regarding the shared responsibility penalty. Other times the reverse will be the case — classification of the measure as a tax will dim the prospects of the measure being upheld.

Below we consider some of the stakes of the classification choice, noting the additional substantive, procedural, and political hurdles that a tax sometimes must surmount to succeed and also noting statutory interpretation consequences.

Substantive Hurdles

Various constitutional provisions apply to taxes but not to other types of levies, or apply to taxes with different force and emphasis. The first section above noted litigation as to the California LLC "fee," which — on the fee's recharacterization as a tax — was struck down on commerce clause grounds. Other provisions of the federal Constitution also may lead to invalidation of levies characterized as taxes, including the due process and equal protection clauses.[24]

State constitutional provisions also may come into play. Many states, for instance, have constitutional provisions requiring that taxes be applied uniformly. "To be uniform, a tax must operate alike on the classes of things or property subject to it."[25] Other types of levies usually are not similarly constrained.

Procedural Hurdles

In the increasingly antitax environments that characterize some states, legislation and initiatives have enacted a variety of measures to make it harder to create or increase taxes. Those measures include requiring legislative supermajority votes, ratification by popular vote, and other procedural hurdles.

Thus, opponents of an exaction may attempt to depict it as a tax so that before enactment, it will have to surmount additional hurdles, or so that after

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[17] *Department of Revenue v. Kurth Ranch*, 511 U.S. 767, 780-81 (1994), *abrogation recognized, United States v. Warneke*, 199 F.3d 906 (1999).

[18] *Kurth Ranch, supra*, 511 U.S. at 780-81.

[19] *Waters v. Farr*, 291 S.W.3d 873, 913 (Tenn. 2009).

[20] *E.g.*, U.S. Const. amend. V.

[21] *Eastern Enterprises v. Apfel*, 524 U.S. 498, 522-537 (1998).

[22] Walter J. Blum and Harry Kalven Jr., *The Anatomy of Justice in Taxation* 4 (Univ. of Chicago Law School occasional papers 1973).

[23] *See, e.g.*, Eric A. Kades, "Drawing the Line Between Taxes and Takings: The Continuous Burdens Principle, and Its Broader Application," 97 *Nw. U.L. Rev.* 189 (2002); Saul Levmore, "Just Compensation and Just Politics," 22 *Conn. L. Rev.* 285 (1990).

[24] *See, e.g.*, Cummings, *supra* note 3, at 322 (citing cases).

[25] *Devlin v. City of Philadelphia*, 862 A.2d 1234, 1249 (Pa. 2004) (quoting *Commonwealth v. Overholt & Co.*, 200 A. 849, 853 (1938)). In many states, uniformity analysis is generally congruent with equal protection analysis. *See, e.g., Wilson Partners, L.P. v. Board of Fin. & Revenue*, 737 A.2d 1215, 1220 n.11 (1999).

enactment, its validity may be challenged for want of adherence to additional procedures.[26]

Political Hurdles

In the age of Grover Norquist, many federal, state, and local politicians are pledging not to raise taxes. That political constraint can run head-on into fiscal imperatives: the need to find revenue to pay for governmental services. A possible course between Scylla and Charybdis may be to label a new or higher levy a fee, not a tax.[27]

Statutory Interpretation

General principles of statutory construction apply to tax cases as well as cases involving other types of statutes. Some differences exist, however. One involves a pro-taxpayer constructional canon, which, although largely abandoned at the federal level, retains vigor in many states. Laws imposing taxes often are construed strictly against the state or locality and favorably to the taxpayer.[28] Accordingly, those seeking to escape a levy may try to classify it as a tax, not to achieve its invalidation but to secure a favorable interpretation of it via the pro-taxpayer presumption.

Criteria

The foregoing hopefully establishes that the "what is a tax?" question appears in many contexts and that its resolution is consequential. What then are the criteria the courts have developed to differentiate taxes from other sorts of governmental enactments?

Those seeking to escape a levy may try to classify it as a tax, not to achieve its invalidation but to secure a favorable interpretation of it via the pro-taxpayer presumption.

As a first principle, the common rule of American law — that substance usually prevails over form in matters of categorization — applies here as well. The nature of the exaction, not the label or name attached to it, is controlling.[29] Substance consists of the occasions that trigger imposition of the levy, the manner in which it is calculated and administered, the purposes to which the funds raised are put, the putative payers of the exaction, how readily they can avoid its imposition, and what property of theirs is likely to bear the burden of the levy. The weight accorded to each of those factors varies depending on the context.

Taxes are generally distinguishable from civil or criminal penalties on the following grounds. A tax "is a pecuniary burden laid upon individuals or property for the purpose of supporting the Government." In contrast, a penalty is a sanction or punishment for an unlawful act or omission.[30]

As noted in the prior section, the case law distinguishing taxes from takings is not extensive. However, a reasonable principle of distinction adverts to the property burdened by the governmental action. A taking typically affects one particular asset or group of assets. In contrast, when a taxpayer is liable for a tax, the taxpayer typically chooses the asset that will be liquidated or depleted to defray the liability. The government is indifferent about whether the levy is satisfied out of cash on hand, by withdrawing funds from a checking or savings account, or by selling tangible or intangible properties. The range of assets answerable for the burden and the range of choice available to the private party are the substantive differences.[31]

The greatest quantity of judicial decisions and commentary has sought to differentiate taxes from user and other fees. The case law differs from state to state in some particulars. In general, though:

> a tax is a forced contribution to raise revenue for the maintenance of governmental services offered to the general public. In contrast, a fee is paid in exchange for a special service, benefit, or privilege not automatically conferred upon the general public. . . . Payment of a fee is voluntary — an individual can avoid the charge by choosing not to take advantage of the service, benefit, or privilege offered.[32]

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[26]*See, e.g.*, Wright, *supra* note 8, at 261 (noting that then-Gov. Schwarzenegger argued that employer contributions to fund a proposed medical care plan was a fee, not a tax, and thus could be enacted by the Legislature without a supermajority vote).

[27]*See, e.g.*, Dennen, *supra* note 10, at 427. ("State legislators are understandably concerned about being perceived as tax raisers, and it is tempting to call something a fee rather than a tax when extra revenue is needed.")

[28]*See, e.g., Employment Security Div. v. Shiloh Trust*, 460 S.W.2d 66, 70 (Ark. 1970); *see generally* Steve R. Johnson, "Pro-Taxpayer Interpretation of State-Local Tax Laws," *State Tax Notes*, Feb. 9, 2009, p. 441, *Doc 2009-1826*, or *2009 STT 25-2*.

[29]*See, e.g., City of New York v. Feiring*, 313 U.S. 283, 285 (1941); *Industrial Comm. of Arizona v. Camilli*, 94 F.3d 1330, 1331 (9th Cir. 1996); *Weekes v. City of Oakland*, 21 Cal. 3d. 386, 392 (1978).

[30]*United States v. Reorganized CF & I Fabricators of Utah, Inc.*, 518 U.S. 213, 224 (1996); *see also United States v. LaFranca*, 282 U.S. 568, 572 (1931).

[31]*See* Kades, *supra* note 23, at 193-198.

[32]*Executive Aircraft Consulting, Inc. v. City of Newton*, 252 Kan. 421, 427 (1993); *see also Rockers v. Kansas Turnpike Auth.*, 991 P.2d 889, 894 (Kan. 1999) (relying on *Executive*

(Footnote continued on next page.)

Under an alternative formulation, levies constitute fees, not taxes, if:

> (1) they are charged in exchange for a particular governmental service which benefits the party paying the fee in a manner not shared by other members of society; (2) they are paid by choice, in that the party paying the fee has the option of not utilizing the governmental service and thereby avoiding the charge; and (3) the charges are collected not to raise revenues but to compensate the governmental entity providing the services for its expenses.[33]

There is always play in the joints, however, when general principles are applied to particular contexts, especially ones that present mixed characteristics. That is in part why there are so many "what is a tax?" cases and why their resolution often is so vexing.

Accordingly, the points of difference identified in the general principles often become matters of degree, not of kind. For example, voluntariness is an attribute of fees, but "voluntariness need not be complete."[34]

Similarly, fees are charged to support or defray the cost of specific benefits conferred on particular payers, but the connections could be reasonable and need not be absolute. Thus, characterization as a fee likely will be achieved as long as (1) the exaction does not exceed the reasonable costs of providing the benefit, (2) a reasonable basis exists for distributing those costs among the various payers, (3) the exactions reasonably relate to the purpose, and (4) the payer and the purpose are reasonably related.[35]

Conclusion

The stage has been set. We have noted the diverse contexts in which the "what is a tax?" question arises and the practical consequences at stake in the resolution of the issue. We also have described the principles and criteria that the courts have developed to guide resolution of those controversies.

The ACA case law confirms some of the established wisdom as to these principles and criteria but modifies or calls others of them into doubt. Building on the foundation we have laid, the next installment of this column will explore the ACA case law. ☆

Interpretation Matters is a column by Steve R. Johnson, University Professor of Law at the Florida State University College of Law. He can be contacted at sjohnson@lawfsu.edu.

Aircraft in holding that tolls are not taxes but are fees for the privilege of using a turnpike and for defraying the cost of providing the service).

[33]*Emerson College v. Boston*, 462 N.E.2d 1098, 1105 (1984) (quoting *National Cable Television Ass'n v. United States*, 415 U.S. 336, 341 (1974)) (citations omitted).

[34]Cummings, *supra* note 3, at 321 n.7. Cummings cites one case in which "the Court acknowledged that the plaintiff might have preferred not to use the [required process] and pay for [it]; nevertheless, the payment was a valid user fee." *Id.* (discussing *United States v. Sperry Corp.*, 493 U.S. 52 (1989)).

[35]Frank Shafroth, "The Burning Issue of Taxes and Fees," *State Tax Notes*, July 28, 2008, p. 274, *Doc 2008-16160*, or *2008 STT 146-5* (discussing *Sinclair Paint*, 15 Cal. 4th 866, and *California Ass'n of Prof'l Scientists v. Dept. of Fish & Game*, 79 Cal. App. 4th 935 (2000)).