Journal of Multistate Taxation and Incentives

U.S. SUPREME COURT UPDATE, Journal of Multistate Taxation and Incentives

U.S. SUPREME COURT UPDATE

By Debra Silverman Herman, Hodgson Russ LLP

U.S. SUPREME COURT UPDATE

> *By DEBRA S. HERMAN, a partner in the New York City office of the law firm of Hodgson Russ, LLP. She thanks Reesa Miles for her contributions to this column. With this issue, we welcome Debra, who takes over The Journal's coverage of the Supreme Court as it continues to grapple with state and local tax issues. She succeeds Robert L. Mahon, who, as noted in our* ***August 2012*** *issue's "From the Editors" page, joins Christian M. McBurney as co-editors-in-chief of The Journal.*

The 2011-2012 Term in Review

The U.S. Supreme Court concluded its 2011-2012 session, having decided 65 cases after hearing oral arguments and summarily reversing ten cases without a hearing. Of the petitions the Court considered this term, about 15 involved state and local tax issues. Of those state and local tax petitions, the Court agreed to hear just one case, while it denied certiorari in the other 14. During the final week of the Court's current session, it denied certiorari in the last remaining case to seek review this term. And a week after the Court ended the session, another state tax case filed a request for certiorari. Both of these cases are discussed below.

Also reviewed, briefly, below is the one opinion in a state and local tax case that the Court did issue during the 2011-2012 term, *Armour v. City of Indianapolis, Indiana.* This opinion was discussed in greater detail in this column when it was issued. And finally, after holding out until virtually the very end of the term, the Court issued its eagerly awaited decision in the challenges to the 2010 federal health care legislation (the Patient Protection and Affordable Care Act) in *National Federation of Independent Business v. Sebelius.* As discussed more fully below, the Court largely upheld the Act. While the health care case focuses primarily on issues of federal taxation, it also raises issues involving state and local taxes.

City's Forgiving Only Some Taxpayers' Liabilities Did Not Give Rise to Equal Protection Claim

In *Armour v. City of Indianapolis, Indiana,* Docket No. 11-161, 6/4/12, 132 S Ct 2073, 80 USLW 4409, 12 CDOS 6066, 2012 Daily Journal DAR 7311, 23 FLW Fed S 336, 2012 WL 1969350 , *aff'g City of Indianapolis v. Armour,* 946 NE2d 553 (Ind., 2011), the Court considered whether the City of Indianapolis (the "City") violated the Equal Protection Clause when it forgave the outstanding sewer improvement tax assessments of taxpayers choosing to pay over a multi-year installment plan, but refused to grant refunds to otherwise identically situated neighboring taxpayers who had fully paid their tax assessments in a lump sum. Notwithstanding that the taxpayers who remitted the assessments in a lump sum had actually paid between 10 and 30 times as much as their neighbors who had yet to complete their installments, the Court, in a 6-3 ruling, found that the City's decision to forgive the remaining installment payments satisfied rational basis review. That is, the City's drawing a line regarding the payments to be forgiven was rationally related to the City's legitimate interest in avoiding the administrative costs and burdens associated with administering the installment program for years to come. The Court noted that "the line that the City drew—distinguishing past payments from future obligations—is a line well known to the law." The Court analogized the forgiveness with tax amnesty programs that treat taxpayers differently based on whether payment has been made. According to the Court, "[s]tate law says nothing about forgiveness, how to design a forgiveness program, or whether or when rational distinctions in doing so are permitted. To adopt petitioners' view would risk transforming ordinary violations of ordinary state tax law into violations of the Federal Constitution."

The dissent

Chief Justice Roberts, joined by Justices Scalia and Alito, wrote a dissent declaring that he could not agree with the majority's opinion that the City's "desire to avoid administrative hassle and the ‘fiscal[] challeng[e]’ of giving back money it wanted to keep" were reasons that pass constitutional muster, "even under rational basis review." (Internal citation omitted.) The dissent concluded that the Court's decision in *Allegheny Pittsburgh Coal Co. v. County Commissioner of Webster County,* 488 US 336, 102 L Ed 2d 688 (1989) controlled. In that case, which the majority distinguished from the present matter, a tax classification failed Equal Protection rational basis scrutiny where, according to the majority, it "involved a clear state law requirement clearly and dramatically violated." While acknowledging that *Allegheny Pittsburgh* is a "rare case," the dissent

asserted that "every generation or so, a case comes along when this Court needs to say enough is enough, if the Equal Protection Clause is to retain any force in this context. *Allegheny Pittsburgh* was such a case; so is this one." In *Armour,* as in that earlier case, the dissent said, "[t]he equal protection violation is plain."

The future of Equal Protection in state tax cases.

Perhaps in the future, the standard will be something other than rational basis review but, until that time, *Armour* reinforces the majority's view that governments' costs generally trump taxpayers' costs in an inequality claim.

(For a more detailed discussion of *Armour,* see U.S. Supreme Court Update, **22 JMT 41 (August 2012)**.)

Health Care Act Is Constitutional as an Exercise of Congress's Power to Tax

On 6/28/12, in *National Federation of Independent Business v. Sebelius,* 132 S.Ct. 2566, **109 AFTR 2d 2012-2563**, 53 EBC 1513, 2012-2 USTC ¶50423 (2012), another of its many 5-4 decisions, the Supreme Court largely upheld the federal Patient Protection and Affordable Care Act (the "Act"). Signed into law in 2010, the Act is intended to increase the number of Americans covered by health insurance and to decrease the cost of health care. A central provision of the Act, the "individual mandate," requires most Americans to maintain health insurance that provides "minimum essential coverage" or pay a penalty—the "shared responsibility payment"—to the federal government (**IRC Section 5000A**). The Act provides that this penalty is to be remitted to the Internal Revenue Service with an individual's taxes, and "shall be assessed and collected in the same manner as" tax penalties assessed under **IRC Sections 6671** through 6725 (**IRC Sections 5000A(c)** and (g)(1)).

Another key aspect of the Act is the expansion of Medicaid, the government program that provides medical coverage to low-income individuals and families and certain disabled individuals. The Act expands the number of individuals that the states must cover and had provided that a state's failure to adopt the Act's increased coverage could result in a loss of all the state's federal Medicaid funding. The majority opinion, written by Chief Justice Roberts, focuses on three main substantive issues: (1) whether the individual mandate is constitutional under the Commerce Clause; (2) whether the individual mandate is constitutional as an exercise of

Congress's power to tax; and (3) whether the Medicaid expansion exceeds Congress's authority under the Spending Clause.

Individual mandate "penalty" is not a tax for Anti-Injunction Act purposes.

Before addressing the merits of the case, the Court considered whether the Anti-Injunction Act (**IRC Section 7421(a)**) barred the suit. The Court held that it did not.

The Anti-Injunction Act provides that, except as otherwise specified by statute, "no suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court by any person, whether or not such person is the person against whom such tax was assessed." Under the Anti-Injunction Act, individuals are generally precluded from challenging a tax until after the tax has been paid.

In the present case, the Court reasoned that "Congress's decision to label this exaction a ‘penalty’ rather than a ‘tax’ is significant because the Affordable Care Act describes many other exactions it creates as ‘taxes.’" Thus, the Court held that because the Act described the shared responsibility payment as a "penalty" and not a "tax," Congress did not intend the payment to be treated as a "tax" for purposes of the Anti-Injunction Act. The Court further noted that it has "applied the Anti-Injunction Act to statutorily described ‘taxes’ even where that label was inaccurate." Nevertheless, the Court made clear that the label Congress chooses for an exaction does not control whether the levy is within Congress's constitutional power to tax. As discussed below, the Court ultimately determined that while the "penalty" was not a tax for Anti-Injunction Act purposes, it was a tax for constitutional law purposes.

Significance for state taxation? Query the impact this issue has on state tax cases involving the Tax Injunction Act (28 USC §1341), a related federal statute that generally precludes federal injunctions against state taxation. That Act states: "The district courts shall not enjoin, suspend or restrain the assessment, levy or collection of any tax under State law where a plain, speedy and efficient remedy may be had in the courts of such State."

Individual mandate "penalty" is a tax for constitutional law purposes.

The Court held that the individual mandate could not be upheld as an exercise of Congress's power under the Commerce Clause because "[t]hat Clause authorizes Congress to regulate

interstate commerce, not to order individuals to engage in it." The individual mandate was upheld, however, as "legislation [that] is within Congress's power to tax." Although the statutory language refers to the "shared responsibility payment" as a "penalty," the Court held that "it is reasonable to construe what Congress has done as increasing taxes on those who have a certain amount of income, but choose to go without health insurance."

According to the Court, the payment could be considered a tax for three reasons: (1) "for most Americans the amount due will be far less than the price of insurance, and, by statute, it can never be more," (2) "the individual mandate contains no scienter requirement," and (3) "the payment is collected solely by the IRS through the normal means of taxation—except that the Service is *not* allowed to use those means most suggestive of a punitive sanction, such as criminal prosecution." (Emphasis in original.)

Medicaid expansion and state and local taxes.

Lastly, the Court held that the extension of Medicaid coverage was unconstitutional as written because if a state were to refuse the extension of Medicaid, it risked losing all of its existing federal Medicaid funding. If, however, such state lost only the new funding associated with the new extension provision, the Court held that the Medicaid extension would be constitutional.

The Court noted that "Congress may use its spending power to create incentives for States to act in accordance with federal policies. But when 'pressure turns into compulsion,' the legislation runs contrary to our system of federalism." (Internal citation omitted.) The Court found that the "threatened loss of over 10 percent of a State's overall budget ... is economic dragooning that leaves the States with no real option but to acquiesce in the Medicaid expansion." The Court explained: "We have upheld Congress's authority to condition the receipts of funds on the States' complying with restrictions on the use of those funds, because that is the means by which Congress ensures that the funds are spent according to its view of the 'general Welfare.'" In contrast, however, "[w]hen, for example, such conditions take the form of threats to terminate other significant independent grants, the conditions are properly viewed as a means of pressuring the States to accept policy changes."

Thus, the Court concluded: "The remedy for that constitutional violation is to preclude the Federal Government from imposing such a sanction. That remedy does not require striking down other portions of the Affordable Care Act."

The dissent.

While the majority opinion did not address state and local tax issues, the dissenting opinion did. With regard to the Medicaid expansion, Justices Scalia, Kennedy, Thomas, and Alito, writing a joint dissent, argued that if a state refused to participate in the expanded Medicaid program, and thus lost all its Medicaid funding (which is, on average, more than one-fifth of a state's expenditures), that state would more than likely be required to either drastically reduce its funding for other programs or largely increase its state taxes. Any such increase in taxes, they said, "would come on top of the federal taxes already paid by the State's citizens to fund the Medicaid program in other States."

The dissent then went on to address whether the Medicaid expansion was impermissibly coercive. Believing that it was, the dissent argued that "[e]ven if a State believes that the federal program is ineffective and inefficient, withdrawal would likely force the State to impose a huge tax increase on its residents, and this new state tax would come on top of the federal taxes already paid by residents to support subsidies to participating States." Following this assertion, the dissent, in a footnote, addressed Justice Ginsburg's view. In a concurrence, Justice Ginsburg stated, in a footnote, that "[a] State ... has no claim on the money its residents pay in federal taxes." While acknowledging this statement was "true as a formal matter," the dissent argued that "heavy federal taxation diminishes the practical ability of States to collect their own taxes."

The dissent further argued that allowing the federal government's interpretation of the anticoercion rule to stand "would permit Congress to dictate policy in areas traditionally governed primarily at the state or local level." The dissent focused on a hypothetical posed to the government at oral argument. The Court had asked whether, under the spending power, Congress could enact a law that offered each state a grant equal to the state's entire annual primary and secondary education budget in exchange for federal regulation of the school curriculum, the hiring and tenure of teachers, the drawing of school districts, the length and hours of the school day, the school calendar, a dress code for students, and rules of student discipline. The Solicitor General had responded that such a law would be allowed. The dissent argued in

response that, while a state could turn down that offer, the state's residents "would not only be required to pay the federal taxes needed to support this expensive new program, but they would also be forced to pay an equivalent amount in state taxes." But if the state were to accept the offer, it would be forfeiting its "traditional authority in the field of education."

The dissent thus concluded that the Medicaid expansion provision as written was coercive and unconstitutional. Noting that the Court had reached the same conclusion, the dissent went on to object to the Court's remedy, however. Rather than allowing states to "receive the additional Medicaid funds if they expand eligibility, but ... keep their pre-existing Medicaid funds if they do not expand eligibility," the dissent would "invalidate the Medicaid Expansion." Moreover, of course, the dissent "would find the [Patient Protection and Affordable Care] Act invalid in its entirety."

Some other state tax concerns.

The Court's having determined that the rest of the Act could stand, another provision of the Act warrants attention from a state and local tax perspective. The Act requires employer health care plans that cover dependents to provide coverage to employees' children up to age 26 for plan years beginning after 9/2/10. The Act also amended **IRC Section 105(b)**, effective 3/30/10, to exclude from taxable income the value of employer-provided health insurance and reimbursements for medical care for an employee's child who has not attained the age 27 by the end of the tax year.

Several states have amended their tax laws, in most cases retroactively back to tax years beginning after 2010, to conform to the federal tax treatment. Prior to the enactment of this legislation, in some nonconforming states, the value of the coverage had to be included in employees' wages, increasing their taxable income and requiring additional withholding adjustments by employers. States, such as Massachusetts, that enacted retroactive legislation in 2011, generally instructed employers who reported or withheld imputed income in 2010 to issue corrected W-2 forms excluding the value of the health care coverage from the employee's wages, and in 2011 to adjust withholding amounts. See, e.g., Technical Information Release (TIR) No. 11-5, "Employer-Provided Health Care Benefits Update" (Mass. Dept. of Revenue, 7/1/11).

Court Review Sought in Refund Suit—Due Process and Intra-Class Conflicts

In *City of Des Moines, Iowa v. Kragnes,* Docket No. 12-37, petition for cert. filed 7/5/12, ruling below as *Kragnes v. City of Des Moines,* 810 NW2d 492 (Iowa, 2012), *reh'g den.* 4/6/12, a class action, the Iowa Supreme Court held that Des Moines, Iowa (the "City") illegally collected franchise fees for gas and electricity services and a refund of the excess fees was an appropriate remedy. The court also upheld the class certification, consisting of all individuals or entities who had paid an electric or gas franchise fee to the City at any time from 7/27/99 forward, notwithstanding that a significant portion of the class (i.e., property owners) stand to lose more from a possible increase in property taxes to finance the refund of the franchise fees than would be gained from that refund. The court concluded that "no fundamental conflict" existed among class members because the "heart of this case is the illegality of the franchise fee imposed by the City," and since "[e]ach of the class members paid fees that the City should not have collected, ... in this fundamental respect their claims are identical, consistent, and compatible." In addition, the court held that the Due Process Clause does not mandate that all class members have the opportunity to opt out of a class action case, even if intra-class conflict exists.

The City disagrees.

In its petition for certiorari, the City argued that, while the Iowa Supreme Court affirmed the trial court's class certification and refused to allow class members to opt out, the named plaintiff does not adequately represent the interests of the absent class members in violation of the Due Process Clause of the U.S. Constitution. The City further asserted that the state supreme court's failure to reach a result consistent with due process may be attributable to the lack of clear guidance on the requirements of due process in class action litigation when there is intra-class conflict, i.e., "the remedy being pursued by the class representative will necessarily have a negative collateral impact on a segment of the requested class." According to the City, the U.S. Supreme Court should grant the petition for certiorari in order to provide guidance to the courts on when intra-class conflict is constitutionally permissible, including when intra-class conflict can be remedied through opt-out or similar class techniques.

Specifically, the question presented for review is: "May a court in a class action, consistent with the Due Process Clause, certify a plaintiff class consisting of all payers of a municipal franchise fee, and refuse to allow class members to opt-out, when the lawsuit seeks a class-wide refund

that will necessarily have a disparate and negative impact on those class members who pay municipal property taxes?"

Certiorari Has Been Denied in:

Corboy v. Louie, Docket No. 11-336, *cert.* 6/29/12, ruling below at Hawaii S.Ct., No. 30049, 4/27/11, 2011 WL 1687364 , *reconsideration den.* 125 Haw. 38, 251 P3d 601 (2011), holding that the taxpayers lacked standing to challenge property tax exemptions granted to lessees of Hawaiian Homes Commission Act homesteads. Because the taxpayers lacked standing, the state court declined to address the taxpayers' claim that the exemption violated the Equal Protection Clause by creating an exemption available only to native Hawaiians.

(For a bit more on this case, see U.S. Supreme Court Update, **21 JMT 46 (January 2012)** .) **[]**

© 2012 Thomson Reuters/RIA. All rights reserved.

This article appears in and is reproduced with the permission of the *Journal of Multistate Taxation and Incentives*, Vol. 22, No. 6, September 2012. Published by Warren, Gorham & Lamont, an imprint of Thomson Reuters. Copyright (c) 2012 Thomson Reuters/WG&L. All rights reserved."