Aftermath of *NFIB v. Sebelius*

NewsQuarterly is pleased to present three perspectives on the Supreme Court's recent decision in *National Federation of Independent Business v. Sebelius*, 132 S. Ct. 2566 (2012) by regular contributors Jack Cummings, Steve Johnson, and David Pratt.

Health Insurance Tax (Penalty) Upheld

By Jasper L. Cummings, Jr.*

Professor Eustice used to say that an expert is one who gets the details right, but sweeps on to the grand fallacy. He usually meant a fallacy such as the deal not working economically, even though it was tax free; or at a more granular level, that you missed section 304. There are, however, even grander truths or fallacies embedded in the Supreme Court's recent rulings in *National Federation of Independent Business v. Sebelius*, 132 S. Ct. 2566 (2012). This article aims to highlight them.

We all have absorbed by now the "need to know" tax results of the decision: (1) Congress can levy a tax under the name of a penalty for not buying health insurance, and (2) somehow the Supreme Court found that the Anti-Injunction Act did not preclude a declaratory attack on a federal tax prior to payment. Neither ruling is likely to be useful in daily tax practice. Virtually all taxes our clients are concerned with are clearly labeled as taxes. Therefore, the details of how Chief Justice Roberts reached these results may not be of great practical significance. What most of us want to know is did he sweep on to the grand fallacy or the grand truth?

The Court did sweep on to the grand truth. In the context of over 200 years of Supreme Court rulings on federal taxes, the *Sebelius* holding on the taxing power clearly is in line with precedent. The best evidence that the Court swept on to the grand truth is the fact about the decision that has caused the most comment in the press: Chief Justice Roberts sided with the "liberals" on the Court, not only to uphold the tax but also to write the opinion of the Court. He would not have done that if he could have avoided it, and he was unwilling to avoid it in a way that could come back to haunt him, as the decision in *Dred Scott v. Sandford*, 60 U.S. 393 (1857), has haunted the otherwise capable Chief Justice Taney for over 150 years.

Nevertheless, some may have been surprised to learn that the federal taxing power is more powerful than the Commerce Clause (five of the Justices thought Congress lacked power to impose the tax under the Commerce Clause). And yet that is exactly what Chief Justice Marshall meant in *McCulloch v. Maryland*, 17 U.S. 316 (1819), when he said the power to tax involves the power to destroy. The understanding of that power has been dimmed by the relentless and well promoted attacks on federal taxation over the last twenty years (and on taxation in general going back to California's Proposition 13 in 1978).

For example, Congress pursued a Taxpayer Bill of Rights 2 and 3 and the Internal Revenue Service Restructuring and Reform Act of 1998 through the 1990s. These proposals and the Act contained potentially useful changes, such as the Office of the Taxpayer Advocate. But they were largely premised on tales of supposedly wide scale and systemic "abuse" of taxpayers by Service employees. One version of the Taxpayer Bill of Rights 2 even proposed to deny funding for additional Service employees unless it was passed.

In explaining the origins of the 1998 Act, former Commissioner Donald Alexander cited: "(iii) the basic anti-government stance of the 104th and 105th Congresses; (iv) adoption by some congressional leaders of a pollster's recommendation to score political points by demonizing the IRS as the symbol of intrusive government; (v) attacks on the IRS by Mr. Malcolm S. Forbes Jr. and others as a wedge with the goal of replacing our graduated income tax with a flat tax or national sales tax; …." Donald C. Alexander, *Some Musings About the IRS*, 1999 TNT 69-86 (April 12, 1999).

The resulting increasing negative reputation of federal taxation, and the various pledges of Congresspersons not to vote to increase any tax, likely induced even the Democratic members of Congress to call a tax a penalty in the Patient Protection and Affordable Care Act of 2010 and section 5000A of the Code. Evidently Congress thought it was safe to do so, because it would rely on the Commerce Clause.

Unfortunately, Congress made not one but two strategic mistakes in the choice of labels. First, it forgot what it should have known about the great scope of the taxing power, and second it failed to pay attention to the inroads made on its Commerce Clause powers by the Rehnquist Court. For example, as to the taxing power Congress was probably unaware that when Secretary of Labor Frances Perkins asked Louis Brandeis and Harlan Fiske Stone for advice on how to fashion the unemployment

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insurance and social security legislation, they advised her to use the taxing power. Kirstin Downey, The Woman Behind the New Deal 235–36 (2009).

The taxing power and the Commerce Clause have always been the tag team of congressional powers; if the one didn't work, Congress would try the other. This occurred most famously in Congress' original efforts to curb child labor, after the Supreme Court struck down state efforts to regulate labor in *Lochner v. New York*, 198 U.S. 45 (1905). Congress first relied on direct regulation of manufacturers using child labor to produce goods that were sold across state lines and lost in *Hammer v. Dagenhart*, 247 U.S. 251 (1918). The Court thought that manufacturing was not part of interstate commerce (a view that it later reversed).

Congress tried again under the taxing power, levying an additional 10% tax on profits from manufacturing in a plant that employed child labor. But the eagle-eyed Chief Justice Taft discerned what Congress was trying to do and blocked the taxing tactic, not by holding Congress did not have the power to tax in this fashion, but by holding that the tax was not a tax. The case was *Bailey v. Drexel Furniture Co.*, 259 U.S. 20 (1922), most easily remembered as the *Child Labor Tax Case*. Chief Justice Roberts' opinion cited it prominently, but ultimately rejected its guidance.

From 1922 through 1936, the Supreme Court ruled unconstitutional five tax provisions, including the Child Labor Tax. The most important of these was the Agricultural Adjustment Act tax ruled unconstitutional by *United States v. Butler*, 297 U.S. 1 (1936). Then in 1937 the Court underwent the so-called switch in time that saved nine, and began to uphold the regulation of business, first by the states and then by the United States under the Commerce Clause.

The Court did not after 1936 have to rejuvenate the taxing power because it had never lost its power; rather the Court had just ignored it in decisions like the *Child Labor Tax Case* and *Butler*, by calling the tax a regulation that was beyond the Commerce Clause. However, back in 1904 the Court had ruled in *McCray v. United States*, 195 U.S. 27 (1904), that Congress could regulate by taxing the coloring of margarine to look like butter, solely as an exercise of the taxing power, and without regard to whether it could regulate that activity under the Commerce Clause; *McCray* has never been overruled (but was not cited in any opinion in *Sebelius*).

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The Court recognized expanded federal Commerce Clause powers from 1937 to 1995, during which years the Court did not hold unconstitutional any federal statute that was an exercise of Congress' power under the Commerce Clause. However, in 1995 in *United States v. Lopez*, 514 U.S. 549 (1995), the Court ruled that because carrying guns around schools was not economic activity, Congress could not legislate on that subject. Then in 2000 in *United States v. Morrison*, 529 U. S. 598 (2000), the Court ruled parts of the Violence Against Women Act of 1994 to exceed Congress' Commerce Clause powers. The Court's reasoning was reminiscent of its earlier reasoning that manufacturing was not part of interstate commerce.

These two decisions were not just straws in the wind; they were powerful and portentous. After a 56 year hiatus, an increasingly conservative Court was moving with determination to curtail Congress' Commerce Clause powers. It is not surprising that members of the Court knew what it was doing, but perhaps Congress did not: Supreme Court Justices have a longer time horizon than Congresspersons; they know that changing the Constitution takes time, and changing it they were and have.

Out of either ignorance of this attack and trend, or political desperation, Congress called the section 5000A tax a penalty and made its collection and enforcement substantially different from the normal pattern under the income tax, even though the tax was to be self-reported on the income tax return. Indeed, the collection procedure is so odd that the penalty almost looks voluntary, although Congress estimated that four million individuals would choose to pay it each year.

And so with enactment of the Act in 2010 the stage was set for an epic court battle, one that did not so much involve tax liability as politics. Not since the 1930s had one political party so uniformly dug in against a legislative initiative of the other party; it was obvious that no stone would be left unturned in trying to defeat or reverse not only the tax but the entire Act. For that among other reasons, the legal battle did not reflect a serious disagreement about the taxing power; rather it reflected a serious disagreement about fundamental political choices for the country.

The most fundamental of political choices in America is for or against new initiatives in federal power. Even Chief Justice Roberts admitted in his opinion that "Legislative novelty is not necessarily fatal; there is a first time for everything." 132 S. Ct. 2586. Nevertheless, the first times the federal government has asserted various powers have marked major milestones in the nation's history, usually with much attendant opposition, either on the battlefield, in the press, or in the courts. That history goes something like this:

- The Federalists (Washington, Adams, Hamilton) championed federal power because of the near disaster of a weak confederation of states.
- The Republicans (a/k/a Jeffersonians) generally said they championed state power, until federal power was needed; then President Jefferson exercised a previously unknown federal power to buy Louisiana.
- President Madison, another states' righter, fretted over the power of the federal government to build internal improvements, but finally decided to do so, to the benefit of western expansion.
- The great Jeffersonian Andrew Jackson seemed to want to limit federal power, for example by not renewing the charter of the Bank of the United States. But it turns out that was based more on politics than principle: the Bank was controlled by his political opponents, the Whigs, and the Bank actively opposed Jackson politically. But when South Carolina tried to nullify the federal tariff, Jackson had no problem exerting federal power to squash "state's rights."
- Then the Republican Party was formed out of the Whig Party and took up the cause of emancipation, which required the greatest expansion and use of federal power ever seen in the United States. The Democratic South asserted their "states' rights" in opposition to federal intervention in slave holding.
- That expansion of federal power continued through the Progressive Era in both Republican and Democratic administrations, up to the Harding–Coolidge–Hoover era, when federal power was again viewed as a bad thing, this time by Republicans.
- But the dire straits of the Depression required action of some kind at the federal level and the Democrats supplied it, producing the greatest legal struggles over federal power to date.
- The Democratic era and its use of federal power culminated in an unexpected exercise of that power in the 1960s to protect civil rights, particularly of blacks. The Civil Rights Acts of the 1960s were largely responsible not only for finally enfranchising blacks and bringing down the walls of segregation, but they also drove from the Democratic Party the solid South and many other parts of the country that had traditionally been Democratic. This insured that the Republicans would again oppose expansion of federal power as in the 1920s (but not the 1860s).
- That opposition to federal power is seen in the attacks on the health insurance tax that culminated in the *Sebelius* ruling.

Despite the high stakes politics that led to the *Sebelius* hearing, the Court, of course, was obliged to address and resolve the legal issues on legal grounds, and Chief Justice Roberts' opinion of the Court on the taxing power and Anti-Injunction Act did so. It affirmed the broad scope of the federal taxing power, with many cites and analogies. But knowing that he faced the insoluble political issue of federal power whose history is outlined above, Chief Justice Roberts in effect did what the political scientist Richard Hofstadter said governments do when faced with insoluble situations: they tend to create purely ceremonial solutions, which do not actually solve the problem but give comfort that they do. RICHARD HOFSTADTER, THE AGE OF REFORM 269 (1955).

The ceremonial solution is to let Congress call or at least sort of treat a levy as a tax, and if there is any plausibility in that formal designation, then the levy is a tax. Such plausibility largely is based on answering the question: will the levy actually raise some revenue for the government? Once a levy is determined to be a tax imposed by Congress under the taxing power, school is out. It is irrelevant whether it carries a high and burdensome rate, or raises only a relatively small amount of tax, or taxes inactivity, or has some other peculiar characteristic. If it is a tax, it is constitutional.

Chief Justice Roberts' opinion said so in just those words (132 S. Ct. 2598):

> Our precedent demonstrates that Congress had the power to impose the exaction in § 5000A under the taxing power, and that § 5000A need not be read to do more than impose a tax. That is sufficient to sustain it.

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"That is sufficient to sustain it." Those are amazing words in a time when the very concept of taxation is tainted.

The opinion of the Court goes on to explain that the Court knows full well that taxes regulate, sometimes as their principal purpose. Indeed Chief Justice Roberts broadly implied that if Congress had just called the health insurance penalty a tax, the decision could have been issued summarily. He stated (132 S. Ct. 2597–98):

> Suppose Congress enacted a statute providing that every taxpayer who owns a house without energy efficient windows must pay $50 to the IRS. The amount due is adjusted based on factors such as taxable income and joint filing status, and is paid along with the taxpayer's income tax return. Those whose income is below the filing threshold need not pay. The required payment is not called a "tax," a "penalty," or anything else. No one would doubt that this law imposed a tax, and was within Congress's power to tax. That conclusion should not change simply because Congress used the word "penalty" to describe the payment. Interpreting such a law to be a tax would hardly "[i]mpos[e] a tax through judicial legislation."

Because the health insurance levy is projected to raise some revenue for the government, and bears some similarity to the income tax in terms of reporting and collection, the Court found it to be a tax despite Congress' failure to call it a tax.

However, the opinion went on to deal with three other principal arguments made by the tax's opponents. First it dealt with the assertion that the health insurance tax failed a three part test said to have been used in the *Child Labor Tax Case*: (1) does the tax impose an "exceedingly heavy burden," (2) does liability depend on scienter, and (3) is the tax collected by the tax collection agency or some other agency? The Court found the health insurance tax passed this test.

There will be a tendency for future users of the *Sebelius* opinion to read this part of the opinion to state a holding that is the law of tax identification, but it does not. The opinion earlier stated its holding that the health insurance tax was a tax principally because it possessed the "essential feature of any tax: it produces at least some revenue for the Government." In addition, it had other subordinate features of a tax: it will be reported on the income tax return; liability will be subject to some conditions like those applied to the income tax; the law is located in Title 26; and assessment and collection is somewhat similar to that of the income tax.

Conversely, the *Child Labor Tax Case* was not concerned with any of these factors, even though the tax there sat on top of the existing income tax, was administered by the Service and would have collected some revenue for the government. At most the Court ruled that the health insurance tax would have passed what it described as the *Child Labor Tax Case* test, not that it would have been unconstitutional if it had not.

The remaining two arguments addressed by the opinion of the Court were the ever popular direct tax argument, and the newly discovered broccoli defense to taxation (if they can make you pay this tax they can make you eat broccoli). The Chief Justice dealt with the charge that the health insurance tax is a direct tax, which should have been apportioned among the states based on population, with a ceremonial test even more brief than the one applied to finding a tax: if it is not a tax on property or a tax on heads (capitation tax), which are the two kinds of tax previously ruled to be direct taxes, then it is not a direct tax.

The last time the Supreme Court went beyond this sort of ceremonial test for direct taxes was 1895. In *Pollock* the Court discovered that it could apply economic theory to discern that a tax on income from property was actually a tax on property. *Pollock v. Farmers' Loan & Trust Co.*, 157 U.S. 429 (1895), *aff'd on reh'g*, 158 U.S. 601 (1895). Hence *Pollock* was the original substance over form case in federal income taxation, predating *Gregory v. Helvering* by 40 years. The history of *Pollock* and its aftermath is a cautionary tale, and it seems that Chief Justice Roberts took account of the caution.

That attack on the income tax enacted in 1894 was not motivated by the general dislike of taxes and government that motivated the attack on the health insurance tax, but rather by dislike of the particular type of tax: an income tax. An income tax takes profits from business and can only indirectly be passed along to consumers and others. In other words it directly affects the bottom line and that is why corporations later came to call their tax departments "profit centers."

Conversely, the primary federal taxes up to 1894 had been tariffs, excise, and other consumption taxes, that mostly fell on the ultimate consumers of goods, individuals (plus the episodic apportioned direct tax). Therefore a shift towards an income tax and away from consumption taxes was perceived as a great threat to monied interests.

But the defeat of the income tax in 1895 did not hold. Only 14 years later Congress tried again and enacted an income tax on corporations. The Court upheld it in *Flint v. Stone Tracy Co.*, 220 U.S. 107 (1911). And two years after that ruling the Sixteenth Amendment made way for the income tax of 1913, which allowed income tax revenues to begin to take the place of tariffs, which could be and were lowered, and of excises, including the excise taxes on alcohol, which also dried up with Prohibition.

In other words, *Pollock* was nothing more than a holding action pursued by reactionary elements. *Pollock* wholly ignored a fundamental and practical test for a direct tax that Chief Justice Roberts' opinion alluded to: can the tax be apportioned to the state in practice? If not, then it could not be a direct tax, because to treat it as a direct tax would mean such a tax could never be levied; and nothing justifies stripping Congress of part of its taxing power.

We forget how direct taxes were supposed to work. For example, to finance the War of 1812 and the Civil War, Congress needed large one-time tax collections of, say, $20 million. So Congress would levy a direct tax on land value. It would look to the census, which counted slaves as 3/5 of a person, and determine the number of persons in each state on that basis. From those numbers it could apportion the $20 million based on the percentage of a state's population to the total population. The state would then try to collect that amount of money from landowners, based on local property values. At the state level this operated very much like the ad valorem tax system that states were already using, which is, of course, how the Founders intended direct taxes to work.

Such a system could not work for a tax measured by those who do not buy health insurance. What would Congress have to do? Determine that last year four million people did not buy health insurance and that it needed to collect some amount with respect to each of the four million? Then would it apportion that amount among the states and direct them to collect it from…. What? From the four million people or from land value? If it were to be collected from the four million people, then it might turn out that a hugely disproportionate part of the four million live in certain areas, like say Idaho, where perhaps they don't like to follow federal rules. The more non buyers in a state, the lower the tax per non buyer in that state, which introduces a second illogical apportionment mechanism on top of the census apportionment. Such a system would never be pursued in real life, which is exactly why tax protesters like to use the direct tax argument. It is the ultimate total tax avoidance argument.

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Finally, the opinion addressed the broccoli theory as applied to taxes. Chief Justice Roberts' opinion—speaking for himself only—had already opined that Congress lacks power under the Commerce Clause to regulate by imposing a penalty on inactivity. It is not really necessary to defend or attack that reasoning because it is his alone; no other Justice, not even the four conservative dissenters, joined his opinion. The four may feel the same way, and vote the same way, but there is no opinion of the Court holding that Congress wholly lacks Commerce Clause power to regulate inactivity.

But when the plaintiffs made the same argument as to the taxing power, the Chief Justice rejected it out of hand. First he observed that the Constitution itself contemplated a tax on inactivity by referring to capitation taxes, a tax on just being an individual. Then he made the quite cogent observation that even without that example, it was not inconsistent to find a taxing power where there was no Commerce Clause power: the reason goes back to the expansiveness of the federal taxing power—whereas the Commerce Clause power runs wide, the taxing power runs deep.

This requires some explanation. The opinion points out that as a legislature with enumerated powers Congress must have wide authority to write laws that are necessary and proper to carry out those enumerated powers. In other words, if you can't do much you have to be able to do a lot of the limited things you can do. That is why once a Commerce Clause nexus is found (*e.g.*, manufacturing is or is not interstate commerce), Congress can do most anything. Conversely, about the only thing Congress can do under the taxing power is tax (although the Necessary and Proper Clause obviously can be relied on for collection mechanisms, etc.). Therefore the Court was justified in not applying the broccoli theory to tax even though Chief Justice Roberts would apply it to the Commerce Clause.

So the Court swept on to the grand truth as to the taxing power. Whether or not it got the details right will be debated in many academic journals, but in the end that does not matter. The Supreme Court can say that black is white and pretty much have its way. It owns not only the ball but the playing field. The only thing that does matter about the details is parsing between the results and holding of the opinion of the Court, which are entitled to stare decisis effect in lower courts, and the reasoning of the opinion of the Court, which is not necessarily entitled to stare decisis.

The holding as to the Anti-Injunction Act is that if Congress does not call it a tax or otherwise indicate it is to be treated as a Title 26 tax for Anti-Injunction Act purposes, it is not, and so the Anti-Injunction Act does not apply.

The holding as to the taxing power is that if a levy imposed by Congress has the tendency to raise revenue for the government and has undefined minimal indicia of other taxes (not limited to resemblance to income taxes), then it is a tax under the taxing power; if it is not levied on property value or so much per head it is not a direct tax; and federal taxes can be triggered by inaction. ■