No. COA06-770 TENTH DISTRICT

NORTH CAROLINA COURT OF APPEALS

****

CHARLES HEATHERLY; THOMAS SPAMPINATO; W. EDWARD GOODALL, JR.; PAUL STAM; WAKE COUNTY TAXPAYERS ASSOCIATION; and THE NORTH CAROLINA FAMILY POLICY COUNCIL,	)	
Plaintiff Appellants,	)	
WILLIS WILLIAMS; NORTH CAROLINA FAIR SHARE; and NORTH CAROLINA COMMON SENSE FOUNDATION,	)	
Plaintiff Intervenors,	)	
v.	)	From Wake County 05 CVS 17197
STATE OF NORTH CAROLINA; CHARLES A. SANDERS, BRYAN E. BEATTY, LINDA CARLISLE, ROBERT A. FARRIS, JR., JOHN R. MCARTHUR, JIM WOODWARD, and ROBERT W. APPLETON, Members of the North Carolina Lottery Commission, in their official capacity; NORTH CAROLINA LOTTERY COMMISSION; THOMAS N. SHAHEEN, Executive Director of the North Carolina Education Lottery, in his official capacity; MICHAEL F. EASLEY, Governor of the State of North Carolina, in his official capacity; RICHARD H. MOORE, Treasurer of the State of North Carolina, in his official capacity,	)	
Defendant Appellees.	)	

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BRIEF *AMICUS CURIAE* OF THE TAX FOUNDATION

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TO THE HONORABLE NORTH CAROLINA COURT OF APPEALS:

Pursuant to this Court's July 7, 2006 order, the Tax Foundation submits this brief as *Amicus Curiae* in support of Plaintiff-Appellants.

INTEREST OF *AMICUS CURIAE*

Amicus Tax Foundation is a non-profit research organization formed in 1937 to educate taxpayers about the economic effects of the taxes borne by American citizens. In this regard, the Tax Foundation disseminates information on taxes and focuses on upholding the principles of sound tax policy, namely: simplicity, transparency, stability, neutrality, and growth-promotion. *Amicus* thus has a strong interest in this Court's ruling on whether the taxpayer protection provisions of Article II, Section 23 of the North Carolina Constitution are applicable to the passage of Chapter 18C of the North Carolina General Statutes (the "Lottery Act").

ISSUE PRESENTED

Whether the Wake County Superior Court erred in ruling that the Lottery Act did not constitute a tax, within the meaning of Article II, Section 23 of the North Carolina Constitution, when 35 percent of each lottery ticket sold is used for the general education of the schoolchildren in North Carolina, and thus has no immediate relationship to the benefit conferred to the purchaser of a lottery ticket.

SUMMARY OF ARGUMENT

The 35 percent assessment collected from the sale of each lottery ticket is a tax, because it is a mandatory payment imposed by the General Assembly to raise revenue for the education of all schoolchildren in North Carolina. Because the Wake County Superior Court improperly focused on the issue of voluntariness and neglected to consider the primary purpose of the assessment, which is to raise revenue, it did not conduct a proper balancing analysis. A ruling that the lottery is in part a tax will uphold the meaning of Article II, Section 23 of the North Carolina Constitution by ensuring transparency in the state tax system. For these reasons, the decision of the Wake County Superior Court should be reversed.

ARGUMENT

I. UNDER THE PROPER TEST, THE 35 PERCENT LOTTERY ASSESSMENT FOR EDUCATION IS A TAX.

A. THE *SAN JUAN CELLULAR* TEST IS THE PROPER TEST FOR DETERMINING IF AN ASSESSMENT IS A TAX OR A FEE.

This Court has adopted the balancing approach commonly called the *San Juan Cellular* test—articulated by then-Judge Breyer of the federal First Circuit Court of Appeals—to determine whether a government charge is a fee or a tax. *See State Farm Mutual Auto Ins. Co. v. Long*, 129 N.C. App. 164, 168, 497 S.E.2d 451, 453 (1998), *aff'd*, 350 N.C. 84, 511 S.E.2d 303 (1999). The *San Juan Cellular* court stated:

> The classic ‘tax’ is imposed by a legislature upon many, or all, citizens. It raises money, contributed to the general fund, and spent for the benefit of the entire community. The classic ‘regulatory fee’ is imposed by an agency upon those subject to its regulation. It may serve regulatory purposes by, for example, deliberately discouraging particular conduct by making it more expensive. Or, it may serve such purposes indirectly by, for example, raising money placed in a special fund to help defray the agency’s regulation-related expenses.

San Juan Cellular Telephone Co. v. Public Service Comm’n of Puerto Rico, 967 F.2d 683, 685 (1st Cir. 1992) (emphasis removed). In *State Farm*, this Court specifically adopted the test from *San Juan Cellular*:

> In applying *San Juan Cellular* . . . courts have developed a three-part test considering (1) the entity that imposes the assessment; (2) the parties upon whom the assessment is imposed; and (3) whether the assessment is expended for general public purposes, or used for the regulation or benefit of the parties upon whom the assessment is imposed . . . . Where the first two factors are not dispositive, courts examining whether an assessment is a tax have tended . . . to emphasize the revenue’s ultimate use.

State Farm, 129 N.C. App. at 168, 497 S.E.2d at 453-54 (internal citations and emphasis omitted). This Court thus adopted the use of a balancing test.

To assess the third step of *San Juan Cellular*, the *State Farm* court relied upon *Prudential Health Care Plan, Inc. v. Comm’r of Ins.*, 626 S.W.2d 822, 828-30 (Tex. App. 1981). To determine whether the “ultimate use” transformed a charge on insurance companies into a tax or a fee, the court there considered (1) whether the revenues generated by the charge were placed into a separate fund; (2)

whether the charge was used only to defray the costs of regulation; and (3) whether annual adjustment to the charge was made to reflect actual costs. *Id.* at 829.

B. UNDER *SAN JUAN CELLULAR*, THE 35 PERCENT ASSESSMENT FOR EDUCATION IS A TAX.

Applying the *San Juan Cellular* test to the facts of this case leads to the conclusion that the 35 percent assessment is a tax. The assessment was imposed by the General Assembly, *see* N.C. Gen. Stat. § 18C-164, and such enactments favor the finding of a tax. *See State Farm*, 129 N.C. App. at 168, 497 S.E. 2d at 454. The assessment is also imposed on every purchaser of lottery tickets. "An assessment imposed upon a broad class of parties is more likely to be a tax . . . ." *Id.* (quoting *Bidart Brothers v. California Apple Comm'n*, 73 F.3d 925, 931 (9th Cir. 1996)).

The third prong of *San Juan Cellular* also indicates a tax. The purpose of the assessment is to raise revenue for education programs. *See* N.C. Gen. Stat. § 18C-102 ("The General Assembly declares that the purpose of this Chapter is to establish a State-operated lottery to *generate funds* . . . .") (emphasis added). Unlike a fee, the assessment does not merely create incidental revenue used for education. *Millard v. Roberts*, 202 U.S. 429, 436 (1906) (quoting 1 Story Const. § 880) ("Revenue bills . . . are those that levy taxes in the strict sense of the word and are not bills for other purposes which may incidentally create revenue."). The revenues generated are placed in a special state fund unrelated to gambling, which

also suggests taxation. *See, e.g.*, *Prudential Ins. Co. of America v. Powell*, 217 N.C. 495, 499, 8 S.E.2d 619, 621 (1940) (denying that placement in a special fund altered the status of taxes); *Britt v. City of Wilmington*, 236 N.C. 446, 452, 73 S.E.2d 289, 294 (1952) ("[The assessment is] set apart and used for a specific purpose. By whatever name called, it is in the nature of a tax."); *Club Ass'n v. Wise*, 156 F. Supp. 2d 599, 611 (S. D. W.Va. 2001), *adopted as ruling*, 293 F.3d 723, 726 (4th Cir. 2002) ("[W]hen revenue is placed in a special fund the further inquiry must be whether the money is used to benefit regulated entities . . . to defray the cost of regulation (making it resemble a 'fee') or else to benefit the general public.").

Furthermore, unlike a fee, the assessment is not intended to recoup the costs of providing a service to lottery ticket buyers. The Lottery Act provides for a charge of 8 percent to cover administrative expenses and 7 percent to compensate retailers, and 50 percent used for prizes. *See* N.C. Gen. Stat. § 18C-162. The percentage of revenue used for operating costs and prizes is capped. *Id.* Government assessments that go beyond a demand of payment for services rendered are properly classified as a tax. *Cf. N.C. Tpk. Auth. v. Pine Island, Inc.*, 265 N.C. 109, 116-17, 143 S.E.2d 319, 325 (1965) (concluding that an assessment designed just to compensate the government for the use of the service was not a tax). *See also Safety Net for Abused Persons v. Segura*, 692 So.2d 1038, 1041 (La.

1997) ("[A] tax is a charge that is unrelated to or materially exceeds the special benefits conferred upon those assessed."); Roger D. Colton & Michael F. Sheehan, *Raising Local Government Revenue Through Utility Franchise Charges: If the Fee Fits, Foot It*, 21 URB. LAW. 55, 63 (1989) ("If the primary intent is to raise revenues, a measure is more likely to be considered a 'tax.' If the level of the fee is totally divorced from any cost-basis, it is more likely to be deemed a 'tax.'").

Concluding that a lottery is a tax is not unprecedented. *See Club Ass'n*, 293 F.3d at 726 ("[W]e are of opinion, and decide, that the West Virginia Limited Video Lottery Act is a tax . . . ."). The proper analysis under *San Juan Cellular* results in that conclusion here as well.

II. THE WAKE COUNTY SUPERIOR COURT IMPROPERLY FOCUSED SOLELY ON THE ISSUE OF VOLUNTARINESS.

In deciding whether the assessment was a tax or a fee under Art. II, §23, the trial court below ruled that a tax was:

> (1) An enforced pecuniary charge or a levy;
> (2) To raise money for the maintenance of government;
> (3) Which has no necessary immediate relationship to benefit conferred.

Heatherly v. State, No. 05-CVS-17197, slip op. at ¶¶ 63-64 (N.C. Super. Ct. Mar. 21, 2006). The court discussed only the first part of the test—voluntariness—and ignored the remainder, which is the heart of the *San Juan Cellular* test approved by this Court. *See State Farm*, 129 N.C. App. at 168, 497 S.E.2d at 453-54.

A. UNDERSTANDING THE TERM "TAX" IN ART. II, § 23 REQUIRES CONTRASTING FEATURES OF A "TAX" WITH FEATURES OF A "FEE."

Unlike the trial court, other courts, including those in North Carolina, have focused on balancing the tax- and fee-like characteristics of the assessment at issue.[1] This careful approach requires courts to analyze all features of an assessment before reaching a conclusion. *E.g.*, *State Farm*, 129 N.C. App. At 168, 497 S.E.2d at 453-54. An analysis that considers fee-like elements without considering the more prominent tax-like elements is incomplete at best. The trial court here stopped its analysis prematurely after assessing voluntariness.

B. CONTRIBUTING 35 PERCENT OF EACH LOTTERY TICKET TO GENERAL GOVERNMENT EDUCATION SPENDING IS NOT VOLUNTARY.

Even if voluntariness were the only relevant feature, the 35 percent assessment is not voluntary. Analyzing voluntariness requires considering whether the *charge* is voluntary, not whether the *purchase of the service* is voluntary. The court below correctly stated that "no person is forced to purchase a lottery ticket."

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[1] *See, e.g.*, *State Farm*, 129 N.C. App. at 168, 497 S.E.2d at 453-54; *Valero Terrestrial Corp. v. Caffrey*, 205 F.3d 130, 134 (4th Cir. 2000) (noting that the line between tax and fee can be blurry and requires balancing); *Cumberland Farms, Inc. v. Tax Assessor, State of Me.*, 116 F.3d 943, 947 (1st Cir. 1997) ("Many imposts fall into the gray area in the center of spectrum [of taxes and fees]."); *State Petroleum Underground Storage Tank Release Comp. Bd. v. Withrow*, 579 N.E.2d 705, 708 (Ohio 1991) ("Determining . . . a fee or a tax must be done on a case-by-case basis dependent upon the facts and circumstances surrounding each assessment.").

Heatherly, No. 05-CVS-17197, at ¶ 66. But most every purchase is voluntary in this respect, and that fact would not, for instance, make a general sales tax a "fee."

The trial court's reasoning would convert nearly every assessment into a fee. "[T]he definition is stretched to its logical limits when the court concludes that a fee is voluntary because the individual complainant can avoid the fee by ceasing to engage in the activity being assessed. By that reasoning, many taxes are likewise voluntary—to avoid income taxes, a taxpayer need only stop earning income." Laurie Reynolds, *Taxes, Fees, Assessments, Dues, and the "Get What You Pay For" Model of Local Government*, 56 FLA. L. REV. 373, 412 (2004). Because of this limitation, some courts have rejected voluntariness as a factor altogether.[2]

Determining whether the *charge* is voluntary involves asking whether the charge is designed to be payment for the service. For example, revenue generated by a wage tax is used to provide many different public services which do not bestow exclusive benefits on the payor, making it an involuntary charge, and thus a tax. In contrast, a toll assessed for road use is designed to compensate the government solely for the individual's use of the underlying service: the road. *See*

[2] *See, e.g.*, *State v. Medeiros*, 973 P.2d 736, 741 (Haw. 1999) ("[T]he 'voluntariness' of the service charge or fee would seem to be essentially beside the point."); *Resolution Trust Corp. v. Lanzaro*, 658 A.2d 282, 288 (N.J. 1995) ("[A] valid fee c[an] be distinguished from an invalid tax primarily on the basis of the reasonableness of the charge in relation to the cost of providing the service."); *Bloom v. City of Ft. Collins*, 784 P.2d 304, 310-11 (Colo. 1989) ("[W]e decline to engraft a 'voluntariness' factor onto the tax-fee distinction in resolving this case.").

Pine Island, 265 N.C. at 116-17, 143 S.E.2d at 325.

Here, the only compensatory charge is the 15 percent of lottery revenues that cover operating costs. While that portion could properly be classified as a fee under *Pine Island*, the 35 percent charge is a tax because the general provision of education is unrelated to the purchase of lottery tickets and bestows no exclusive benefit on the purchaser. *See, e.g.*, *State v. Davis*, 292 N.C. 147, 157, 232 S.E.2d 698, 705 (1977) (finding that charges to a user representing the actual cost of a governmental service are not taxes); *Nat'l Cable Television Ass'n v. United States*, 415 U.S. 336, 340-41 (1974) ("A fee . . . bestows a benefit on the applicant, not shared by other members of society."); *Dickson v. Jefferson Co. Bd. of Ed.*, 225 S.W.2d 672, 675 (Ky. 1949) ("[A]ny payment exacted by the state or its municipal subdivisions as a contribution toward the cost of maintaining governmental functions, where the special benefits derived from their performance is merged in the general benefit, is a tax . . . .").

Similarly, in *N.C. Ass'n. of ABC Bds. v. Hunt*, 76 N.C. App. 290, 293, 332 S.E.2d 693, 695 (1985), and unlike the lower court here, this Court looked beyond voluntariness to analyze whether the funds generated by a liquor charge were directly related to the activity that generated the funds:

> Expenditure of revenues generated from the bailment surcharge to operate the ALE Division bears a direct and reasonable relationship to enforcement of alcoholic beverage control laws. The need for this law enforcement arises out of the sale and

> distribution of alcoholic beverages . . . . The funds do not go to the general maintenance and expense of government. For these reasons the bailment surcharge is, in our view, not a tax . . . .

Id. The same cannot be said here. The 35 percent assessment goes beyond the cost of regulation, and instead raises funds for the "general maintenance and expense of government." *Id.* Had the state legalized private lotteries and imposed a 35 percent levy on tickets for general education, the charge would clearly be a tax. It is no less a tax here, where the state runs the Lottery but keeps 35 percent of the proceeds for unrelated programs.

III. A HOLDING THAT THE LOTTERY IS IN PART A TAX WILL ENHANCE THE TRANSPARENCY OF NORTH CAROLINA'S TAX SYSTEM.

The American antipathy to taxes is rooted deep in our nation's history. It is no surprise that lawmakers seek to avoid raising taxes, or at least, seek to raise revenue in ways that avoid the "tax hiker" label. Consequently, lawmakers increasingly seek to raise fees, or even classify an obvious tax as a fee. *See, e.g.*, Patrick Sweeney & Bill Salisbury, *Judge throws out cigarette fee*, ST. PAUL PIONEER PRESS (Dec. 21, 2005) ("[Governor Pawlenty] made a 2002 campaign promise to veto any tax increase, then in May backed the 75-cent cigarette charge. At the time, he insisted it be structured as a fee, not a tax."); George Skelton, *Gov.'s about-face on healthcare "fees" is more than a matter of semantics*, LOS ANGELES TIMES (Jan. 15, 2007) ("The Schwarzenegger camp has been trying out

all sorts of convoluted explanations about why the doc and hospital 'fees' aren't taxes.").

This tension appears in North Carolina's education funding debate. In 2001, the Governor said, "It's either going to have to be lottery, a lottery for education, or it's going to have to be a tax." Gary D. Robertson, *North Carolina Governor brings in Georgia officials to talk up lottery*, LOTTERY INSIDER (July 4, 2001). That fall, North Carolina lawmakers chose to raise income and sales taxes to fund education. *See* S.B. 1005, 2001 Leg., 424th Sess. (N.C. 2001). When those tax increases failed to generate sufficient funds for education, lawmakers looked to the lottery, ostensibly in an effort to fund education by "non-tax" revenue sources. *See, e.g.*, Governor Mike Easley, State of the State Address (Mar. 3, 2003) ("When you are sitting here this year, struggling with the budget, just remember that your colleagues in 39 other states have a revenue source that you do not have. That makes it more difficult for you to improve education and keep taxes down."). *See also* C.D. Kirkpatrick, *N.C. Education Leaders Plead Budget Case*, DURHAM HERALD-SUN (Jun. 5, 2002) ("Lawmakers are not going to pass another round of tax increases like they did last year and they are not going to cut education 8.3 percent or $700 million. So new revenue must be found.").

Article II, § 23 of the North Carolina Constitution protects North Carolina taxpayers from these types of shell games:

> The object of the provision was to prevent hasty and ill-advised legislation, by means of which the people might be deprived of their property, not for the ordinary expenses of government, but, by special taxation, for enterprises ostensibly in the name of the public good, but which might prove sources of individual injustice and injury.

Bd. of Comm'rs. of Stanley County v. Snuggs, 121 N.C. 394, 389-99, 28 S.E. 539, 540-41 (1897). This provision should apply where the North Carolina General Assembly seeks to substitute a lottery for a tax, and certainly where the law was rushed through the legislative process without sufficient deliberation. *See, e.g.*, Transcript of General Assembly Debate of Aug. 30, 2005 (Statement of Senator Fred Smith) ("Fellow Senators who are here today to talk about the lottery bill. There are two issues here. The first issue is the procedure of how we got here. The second issue is the Lottery itself. We were told last week that we were going to adjourn and we were not coming back. With reliance upon that, one member of our caucus went on his honeymoon . . . . Another member of our caucus lies sick at home.").

Enhancing transparency by labeling the Lottery a tax is also important because lottery tickets are overwhelmingly purchased by low-income taxpayers, raising questions of progressivity and regressivity best understood in the context of taxation. *See, e.g.*, *Betting on a better future?*, WILMINGTON STAR-NEWS (Aug. 6, 2006) ("[T]he new North Carolina lottery appears most popular in the part of the state that can least afford to play"). "A tax should be transparent—to the greatest

extent possible, taxpayers should know how much they are paying in taxes. . . . [Instead,] taxpayers who purchase lottery tickets will not be given specific information at the time of purchase listing the percentage of the purchase price that will go into operating costs and state coffers." Elaine Mejia, Director, N.C. Budget and Tax Center, Remarks (Mar. 30, 2005).

Ruling that the lottery is in part a tax would certainly help North Carolina citizens better understand the cost of government. While a small part of education spending, the lottery tax is a high one: for every dollar raised, 35 cents is transferred to the state for general education spending. This is not incidental revenue, and the rate is higher than eleven states'. *See Implicit Tax Rates on State Lottery Sales 2004*, TAX FOUNDATION TAX DATA (Mar. 2006) (http://www.taxfoundation.org/taxdata/show/269.html). Nationwide, lottery operating costs accounted for only 27 percent of the take; the remainder went to fund projects that were, mostly, entirely unrelated to lotteries. *See* Alicia Hansen, *Lotteries and State Fiscal Policy*, TAX FOUNDATION BACKGROUND PAPER NO. 46 1, 25 (2004) (http://www.taxfoundation.org/research/show/65.html).

If part of the Lottery is a fee, a larger part has overriding features of a tax. "User charges should cover the cost of the services provided. They should not be used to generate excess revenues that are diverted to unrelated programs or services." NAT'L CONF. OF STATE LEGISLATURES, THE APPROPRIATE ROLE OF USER

CHARGES IN STATE AND LOCAL FINANCE 13 (July 1999). If the government hides the true cost of government services, citizens are unable to make meaningful choices about public priorities. This result is inconsistent with Article II, § 23, which protects the people of North Carolina from "enterprises ostensibly in the name of the public good, but which might prove sources of individual injustice and injury." *Snuggs*, 121 N.C. at 389-99, 28 S.E. at 540-41.

CONCLUSION

For the foregoing reasons, *Amicus* respectfully requests that the decision of the court below be reversed.

Respectfully submitted, this the 19th day of January, 2007.

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CERTIFICATE OF COMPLIANCE

Pursuant to Rule 28(j) of the Rules of Appellate Procedure, counsel for the appellant certifies that the foregoing brief, which is prepared using a proportional font, is less than 3,750 words (excluding cover, indexes, tables of authorities, certificates of service, and this certificate of compliance, but including footnotes and citations), as reported by the word-processing software.

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CERTIFICATE OF SERVICE

The undersigned hereby certifies that the foregoing **Brief of *Amicus Curiae* Tax Foundation** was served upon all parties to this action by mailing via First Class U.S. Mail a copy thereof to their counsel of record at the address indicated below at this date.

This the 19th day of January, 2007.

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