No. 317A06-2

NORTH CAROLINA SUPREME COURT

****

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; and NORTH CAROLINA)
COMMON SENSE FOUNDATION,)
)
Plaintiff-Intervenors,)
)
v.)
)
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 SUPREME COURT:

The Tax Foundation, in accordance with the attached motion for leave, submits this brief as *Amicus Curiae* in support of Plaintiff-Appellants.

INTEREST OF *AMICUS CURIAE*

The Tax Foundation is the nation's oldest tax policy research organization, founded in 1937 to educate taxpayers about sound tax policy. As a non-partisan educational institution dedicated to raising the nation's tax I.Q., our economic and policy analysis is guided by the principles of simplicity, transparency, stability, and neutrality. We aim to make information about government finance understandable, such as with our annual calculation of "Tax Freedom Day," the day of the year when taxpayers have earned enough to pay for the nation's tax burden and begin earning for themselves.

We further our mission by educating the legal community and the general public about economics and taxpayer protections, and by advocating that judicial and policy decisions on tax law promote principled tax policy. Past federal and state tax-related cases in which the Tax Foundation has participated as *amicus curiae* include *Dep't of Revenue of Kentucky v. Davis*, ___ U.S. ___ (May 19, 2008); *CSX Transportation, Inc. v. Georgia State Bd. of Equalization*, 128 S. Ct. 467 (U.S. Dec. 4, 2007); *Heatherly v. State*, ___ N.C. App. ___, 658 S.E.2d 11 (Mar. 18, 2008), and *DaimlerChrysler Corp. v. Cuno*, 547 U.S. 332 (2005).

This case involves important issues of tax policy nationally. The decision of this Court may be relied on for authority by other states confronting similar questions, and would impact states with constitutional provisions similar to Article II, Section 23 of the North Carolina Constitution. Accordingly, the Tax Foundation has an institutional interest in this case.

ISSUES PRESENTED

Whether the majority erred in affirming the trial court's holding that the Lottery Act was not a tax, and thus was not a revenue bill, such that it was not required to comply with the requirements of Article II, Section 23 of the North Carolina Constitution?

Whether the majority erred in affirming the trial court's holding that the Lottery Act did not pledge the faith of the State directly or indirectly for the payment of a debt, and thus was not a revenue bill, such that it was not required to comply with the requirements of Article II, Section 23 of the North Carolina Constitution?

SUMMARY OF ARGUMENT

The 35 percent charge collected from the sale of each lottery ticket is correctly called 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 Court of Appeals improperly focused on the issue of voluntariness and neglected to consider the primary purpose of the charge, which is to raise general revenue, it adopted a test that would insulate virtually any government charge from the taxpayer protections of Article II, Section 23 of the North Carolina Constitution. A ruling that the lottery is in part a tax will uphold the meaning of Article II, Section 23 by ensuring transparency in the state's tax system. For these reasons, the decision of the Court of Appeals should be reversed.

ARGUMENT

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

A. THE *SAN JUAN CELLULAR* TEST IS THE LEADING TEST FOR DETERMINING IF A CHARGE IS A TAX OR NOT.

To determine whether a charge is a tax, North Carolina courts have used the approach commonly called the *San Juan Cellular* test—articulated by then-Judge Breyer of the federal First Circuit Court of Appeals. *See State Farm Mut. 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) ("In applying *San Juan Cellular* to determine whether a charge is a tax . . . ."). 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.

San Juan Cellular Tel. Co. v. Pub. Serv. Comm'n of Puerto Rico, 967 F.2d 683,

685 (1st Cir. 1992) (emphasis removed). In *Long*, the North Carolina Court of Appeals and subsequently 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.

Long, 129 N.C. App. at 168, 497 S.E.2d at 453-54 (internal citations and emphasis omitted). *See also Jackson v. Leake*, 476 F. Supp. 2d 515, 521-22 (E.D.N.C. 2006) (adopting the *San Juan Cellular* analysis to determine whether a charge is a fee, tax, or something else). The *San Juan Cellular* analysis, which looks at who imposes the charge, who pays it, and what it is used for, has thus been the tool used by North Carolina courts in determining whether a charge is a tax. Many other courts have used the *San Juan Cellular* analysis for similar purposes, such as in cases involving constitutional requirements applying to taxes, or the federal Tax Injunction Act, which applies to taxes but not to fees.

To assess the third step of *San Juan Cellular*, the *Long* 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.

The court below inaccurately states that *San Juan Cellular* is irrelevant because it is only used to distinguish taxes and fees, and not to determine whether a charge is a tax. *Heatherly v. State*, ___ N.C. App. ___, 658 S.E.2d 11, 18 fn.5 (Mar. 18, 2008) ("[W]e are not considering here whether the lottery is a regulatory fee or a tax; we are only determining whether it is a tax. As such, the *San Juan Cellular* test is largely irrelevant to the question at hand."). This unsupported assertion directly conflicts with language from *Long*, where the court indicates that the *San Juan Cellular* test is used to determine if the charge in question is a tax or not. *See, e.g.*, *Long*, 129 N.C. App. at 167, 497 S.E.2d at 453 ("The key issue here is whether the regulatory charge is a tax"); *Id.*, 129 N.C. App. at 168, 497 S.E.2d at 453 ("In applying *San Juan Cellular* to determine whether a charge is a tax . . . ."); *Id.*, 129 N.C. App. at 172, 497 S.E.2d at 456 (Greene, J., dissenting) ("The majority holds that the insurance 'regulatory charge' . . . is 'not a tax.'").

Additionally, the Court of Appeals expressly considers whether the lottery charge's features more closely resemble a tax or a fee, undermining the entire assertion. *See Heatherly*, 658 S.E.2d at 17 ("[W]e find the payment of a toll to be

analogous to the purchase of a lottery ticket. In both instances, an individual chooses to engage in a purely voluntary activity by paying a *fee* . . . .") (emphasis added).

Other courts have also used the *San Juan Cellular* test to ascertain whether a charge is a tax or not. *See, e.g.*, *Valero Terrestrial Corp. v. Caffrey*, 205 F.3d 130, 134 (4th Cir. 2000) (applying *San Juan Cellular* to determine if a charge "qualifies" as a tax, or otherwise it is a fee); *Neinast v. Texas*, 217 F.3d 275 (5th Cir. 2000) (applying *San Juan Cellular*); *Hedgepeth v. Tennessee*, 215 F.3d 608, 612 (6th Cir. 2000) (describing *San Juan Cellular* as the "leading decision" used for "the definition of the term 'tax'"); *Bidart Bros. v. Cal. Apple Comm'n*, 73 F.3d 925, 931 (9th Cir. 1996) (applying *San Juan Cellular* test to "determin[e] whether an assessment is a tax"); *Wetzel Co. Solid Waste Auth. v. W.V. Div. of Nat. Res.*, 195 W. Va. 1, 5, 462 S.E.2d 349, 353 (1995) (describing *San Juan Cellular* test as "general consensus" for identifying a "classic tax"); *Time Warner Entertainment-Advance/Newhouse P'ship v. City of Lincoln*, 360 F. Supp. 2d 1012, 1016-17 (D. Neb. 2005) (stating that the *San Juan Cellular* test faithfully applies Blackstone's description of taxation); *Gasparo v. City of New York*, 16 F. Supp. 2d 198, 218 (E.D.N.Y. 1998) (applying *San Juan Cellular* test "[t]o determine whether a measure that raises revenue is a tax . . . ."). The *San Juan Cellular* approach is thus recognized in North Carolina and in other states as the test used to analyze whether

a given charge is a tax or not.

B. <u>UNDER *SAN JUAN CELLULAR*, THE 35 PERCENT CHARGE FOR EDUCATION IS A TAX.</u>

Applying the *San Juan Cellular* test to the facts of this case leads to the conclusion that the 35 percent charge is a tax. The charge was imposed by the General Assembly, *see* N.C. Gen. Stat. § 18C-164, and such enactments favor the finding of a tax. *See Long*, 129 N.C. App. at 168, 497 S.E. 2d at 454. The charge 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 Bros.*, 73 F.3d at 931).

The third prong of *San Juan Cellular* also indicates a tax because a non-incidental amount of revenue is generated for the General Fund. The purpose of the charge 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); *Heatherly*, 658 S.E.2d at 16 ("[T]he lottery is unquestionably intended and designed to raise revenue."); *N.C. Lottery chief adding new games to overcome revenue shortfall*, LOTTERY POST, Feb. 1, 2007, *available at* http://www.lotterypost.com/news/150099 ("'Obviously I'm in a business to raise money, and I want to raise as much as we can,' [N.C. Education Lottery Executive Director Tom] Shaheen said after a

Charlotte luncheon.”).

Unlike a fee, toll, or other user charge, the charge does not merely cover its costs or create incidental revenue. “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.” *Millard v. Roberts*, 202 U.S. 429, 436 (1906) (quoting 1 Story Const. § 880). *See also Chicago and Nw. Transp. Co. v. Webster Co. Bd. .of Supervisors*, 71 F.3d 265, 267 (8th Cir. 1995) (“[A] government levy is a tax if it raises revenue to spend for the general public welfare.”); *Parsons v. South Dakota Lottery Comm’n*, 504 N.W.2d 593, 595-96 (S.D. 1993) (“The term [public funds] does not apply to special funds, which are collected or voluntarily contributed, for the sole benefit of the contributors, and of which the state is merely the custodian.”); *Brock v. WMATA*, 796 F.2d 481, 488 (D.C. Cir. 1986) (“A levy is properly defined as a ‘tax’ . . . when its principal purpose is to raise revenues.”).

The revenues generated are placed in a special state fund unrelated to gambling, which also suggests taxation. *See, e.g.*, *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.”); *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."); *Prudential Ins. Co. of America v. Powell*, 217 N.C. 495, 496, 8 S.E.2d 619, 621 (1940) (denying that placement in a special fund altered the status of taxes).

Furthermore, unlike a fee, the lottery charge 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 charges 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 a charge designed just to compensate the government for the use of the service was not a tax). *See also State v. Lanclos*, __ So. 2d ___, Nos. 2007-OK-0082, 2007-KA-0716, 2008 WL 928565, at *6 (La. Apr. 8, 2008) (quoting *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.'").

In stating that the "purpose behind virtually *any* fee is to raise revenue," *Heatherly*, 658 S.E.2d at 17, the court below mischaracterizes the difference between taxes and fees. The purpose of fees *is not* to raise revenue, but rather to compensate the government for services provided (*e.g.*, tolls and to some extent excise taxes on gasoline and tobacco) or cover the cost of regulation (*e.g.*, ABC charges). A charge that raises non-incidental amounts of revenue beyond the need to cover those costs is a tax. Thus, if the primary purpose of a charge is to raise revenue, especially if the revenue is for general government spending, as is the case here, it is a tax.

Concluding that a lottery charge 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 . . . ."); Alicia Hansen, *Tax Foundation Background Paper No. 54—Gambling with Tax Policy: States' Growing Reliance on Lottery Tax Revenue* 1, 17 (Jul. 2007), *at* http://tinyurl.com/5pbgbc ("The lottery is more than a controversial way to add a little money to state coffers; it is a tax and should be evaluated as such."). Analysis under *San Juan Cellular* results in that conclusion here as well, because the 35 percent charge for education is

imposed by the state upon all purchasers of a particular product, for the purpose of raising money for general public spending programs.[1]

C. UNDER OTHER LEADING TESTS FOR DETERMINING IF A CHARGE IS A TAX, THE 35 PERCENT LOTTERY CHARGE FOR EDUCATION IS A TAX.

While the *San Juan Cellular* test is the leading test for determining whether a charge is a tax, courts in some states perform a more stringent analysis due to

[1] The Court of Appeals is overly optimistic when it holds that the lottery does not pledge the faith of the state for repayment, even implicitly as a government-sponsored entity, because “it is difficult to envision a scenario in which the prizes claimed by winners would ever outstrip the capacity of the Lottery Commission to pay.” *Heatherly*, 658 S.E.2d at 16. It is entirely possible that a lottery insolvency could result in winners seeking payment from the state, as a quick search of some of the scandals and errors that routinely appear in the news demonstrates. *See, e.g.*, Brad Watson, *Lottery game flop stirs school fund concerns*, WFAA-TV (Jun. 22, 2007) (“As the Texas Lottery game the Texas Two Step appears to be going broke, some are concerned that may ultimately lead to dipping into school funds to pay the jackpots.”); Anne-Marie Green, *Broken Ball Prompts 2nd Pa. Lotto Drawing*, ASSOCIATED PRESS (May 2, 2007) (“State lottery officials determined that a ball broke during a televised MATCH 6 lotto drawing, prompting a second off-air drawing and a decision to pay off winning tickets for both sets of numbers.”); N.M. *Gov. signs bill to extend lottery scholarships*, LOTTERY POST, Mar. 30, 2007, *available at* http://www.lotterypost.com/news/153706 (describing how larger-than-expected New Mexico Lottery administrative costs threatened to reduce prizes or amount available for state revenue); *New York Lottery accounting method questioned*, LOTTERY POST, Jan. 30, 2007, *available at* http://www.lotterypost.com/news/149994 (“Oct. 22, 1975: Gov. Hugh Carey suspends sales after an error creates hundreds of duplicate tickets for $1.4 million Colossus game.”); *Texas Lottery chief admits jackpots were inflated*, LOTTERY POST, Jun. 27, 2005, *available at* http://www.lotterypost.com/news/115447 (describing how Texas Lottery officials overpaid jackpots as a way of keeping players interested); Dennis Hevesi, *Lottery Games Shut Down In Connecticut*, NEW YORK TIMES (May 12, 1988) (describing how a glitch enabled valid tickets to be purchased after the numbers were drawn).

strong constitutional protections in their state regarding taxes. These tend to focus on the ultimate use of a non-incidental amount of revenue for general government. Not only have these other leading tests rejected voluntariness as a guiding standard, when applied here the tests would lead to the conclusion that the charges imposed by the North Carolina Education Lottery are a tax.

1. California

California's courts have, over a series of cases, developed a framework of identifying taxes as part of implementing Proposition 218, a constitutional provision that requires new taxes, but not non-taxes, to receive approval from two-thirds of voters. *See, e.g.*, *Bay Area Cellular Tel. Co. v. City of Union City*, __ Cal.Rptr.3d ___, No. A114956, 2008 WL 1874690, at *4-8 (Cal. Ct. App. Apr. 29, 2008) (reviewing past state cases defining taxes). Guided by the purpose underlying the constitutional limitations on taxes, the courts' interpretative approach is designed "to effectuate [Proposition 218's] purposes of limiting local government revenue and enhancing taxpayer consent." *Id.* at 5.

Most recently, the California Court of Appeals held that a city-imposed charge for accessing the 911 system, paid as part of a larger collection of charges paid on phone bills, where the proceeds were deposited in a special fund to pay for the service, was a tax requiring voter approval. *See id.* at 8. The court noted that the revenues raised by the charge were used for a general government program.

"Most fundamentally there is no discrete group that is specially benefited by the imposition. The 911 system benefits every inhabitant of the City . . . . The Fee inures to the benefit of the public as a whole, not to any particular group within the public." *Id.*

Here, the 35 percent of each lottery ticket, paid as part of a larger collection of charges, are deposited in the state general fund. Similar to the California charge, the revenue from the 35 percent charge "inures to the benefit of the public as a whole, not to any particular group within the public." *Id.* The California court noted that had the 911 charge gone directly to the city's general fund, that would have made it more likely that it is a tax. *See id.* at 9 ("[T]he fact that the Fee does not raise revenues for the City's general fund does not change our conclusion….").

2. <u>Hawaii</u>

Hawaii's courts have similarly applied a test more stringent than the *San Juan Cellular* analysis, developed in cases involving charges imposed by non-legislative entities. *See, e.g.*, *Hawaii Insurers Council v. Lingle*, __ P.3d ___, No. 27840, 2008 WL 1708015, at *6-7 (Haw. App. Apr. 15, 2008) ("*Medeiros* precludes us from applying the test set forth in *San Juan Cellular*, as urged by the State."). In *Hawaii Insurers Council*, the court reviewed a charge on insurance companies that funded regulatory oversight, but surpluses of which were transferred to the General Fund. *See id.* at 1-2. In holding that the surplus portion

was an illegal tax, the court considered application of the *San Juan Cellular* test but held that the state-developed *Medeiros* test was more applicable where a charge was part-tax and part-fee. *See id.* at 6-7 (citing *State v. Medeiros*, 89 Haw. 361, 366-70, 973 P.2d 736, 741-45 (1999)).

The test developed in *Medeiros* determines if a charge is a tax by considering whether non-tax features are present. The test analyzes "whether the charge (1) applies to the direct beneficiary of a particular service, (2) is allocated directly to defraying the costs of providing the service, and (3) is reasonably proportionate to the benefit received." *State v. Medeiros*, 89 Haw. 361, 367, 973 P.2d 736, 742 (1999). In *Hawaii Insurers Council*, the charge was found to be a tax because it did not satisfy any of these criteria. Under the first, not only beneficiaries paid the charge, since "regulation of the insurance industry directly benefits the public-at-large—not the insurers who pay the assessments." *Hawaii Insurers Council*, 2008 WL 1708015, at *5. The charge failed the second and third prongs because "the assessments are not allocated directly to defraying the costs of providing services to the insurers and are not reasonably proportionate to the benefits received by the insurers." *Id.* at 6.

Applying the *Medeiros* test to this case would result in a finding that the charge challenged here is a tax. The 35 percent charge fails the first prong because it is not applied only to direct beneficiaries, since all North Carolinians benefit

from the state's education system. It also fails the second and third prongs because the 35 percent charge paid by purchasers of lottery tickets is not allocated directly to the costs of providing the service, and the amounts paid by purchasers is not reasonably proportionate to the benefit received. Charging purchasers of lottery tickets $1.00 where only 65 cents goes to costs of operation and direct benefits to lottery ticket purchasers is disproportionate under the *Medeiros* analysis.

3. Louisiana

Like Hawaii, Louisiana has developed a test for determining whether a charge is a tax as part of ensuring separation of powers. In *Segura*, the Louisiana Supreme Court invalidated a charge on persons convicted of domestic violence, with the revenue being used for domestic violence prevention programs:

> Because the "fee" was not assessed to defray the expenses of litigation or to support the court system, and was a revenue raising measure designed to fund a particular social program, we found that the "fee" imposed by the statute was, in reality, a tax. We noted that [a] charge that has as its primary purpose the raising of revenue, as opposed to the regulation of public order, is a tax. Moreover, a tax is a charge that is unrelated to or materially exceeds the special benefits conferred upon those assessed. *Audubon Insurance Co. v. Bernard,* 434 So.2d 1072, 1074 (La. 1983); 4 Cooley, *The Law of Taxation,* Ch. 29, § 1784 (4th ed. 1924).

State v. Lanclos, 2008 WL 928565, at *6 (citing *Segura*, 692 So.2d at 1041). The *Segura* test was most recently applied in *Lanclos*, where the Louisiana Supreme Court held that a judicially imposed $5 "court cost" imposed on those convicted of

speeding on the Lake Pontchartrain Causeway Bridge was an unconstitutional tax. "[W]e find that police salaries and uniform equipment and maintenance is too far attenuated from the 'administration of justice,' to be considered a legitimate court cost. To hold otherwise would start us down a slippery slope, and we must draw the line at some point." *Id.* at 9.

Because 35 percent of the charge paid by North Carolina lottery ticket purchasers is used for a purpose "too far attenuated from" gambling-related regulation, operations, or activities, it is a tax. In addition to "exceed[ing] the special benefits conferred upon those assessed," the charge's primary purpose, like the invalidated charges in *Segura* and *Lanclos*, is to raise general revenue. *Id.*

II. THE VOLUNTARINESS TEST USED BY THE COURT OF APPEALS WOULD LABEL VIRTUALLY ANY EXCISE TAX A NON-TAX, AND THUS DIMINISH THE PROTECTIONS OF ARTICLE II, SECTION 23.

Although the Court of Appeals expressly declined to undertake the *San Juan Cellular* analysis, its consideration of whether the lottery charge is a tax follows that test's analysis of comparing and contrasting the features of the charge with the features of a tax. *See Heatherly*, 658 S.E.2d at 16-18. The court constructively compares the charge in this case with the charge invalidated in *Long*, a toll, a sales tax, and the ultimate purpose of the revenue. *See id.*

The court departs from the *San Juan Cellular* analysis by pre-supposing what the analysis is supposed to help determine: that the charge is a tax. By

referring several times to the "voluntary" nature of the lottery charges, the court effectively reaches its conclusion before conducting any analysis. *See id.* at 17 fn.5 ("[T]he charge imposed in *Long* was compulsory, not voluntary, and was imposed by the Commissioner of Insurance, a state agency, as part of the cost of doing business in North Carolina"); *Id.* ("In both instances [paying a toll and buying a lottery ticket], an individual chooses to engage in a purely voluntary activity by paying a fee; in neither case can the government be said to be 'levying' or 'enforcing' a charge against citizens"); *Id.* ("A sales tax, by contrast, is a cost of conducting business in North Carolina and is imposed on all members of the general population; it can hardly be considered to be 'voluntary' under any practical definition of the term."); *Id.* at 17-18 ("Given the voluntary nature of participation in the lottery, we find that the Lottery Act does not 'impose any tax upon the people of the state.'"). The Court of Appeals test could simply be characterized as voluntary = not tax, involuntary = tax.

This analysis is inadequate for two major reasons. First, any government-imposed charge except a head tax can be characterized as "voluntary" since essentially every decision to purchase a good or service is voluntarily undertaken. A "voluntariness" framework could, with little effort, prove that excise taxes on cigarettes, liquor, and gasoline, and even payroll, property, sales, and income taxes, are a result of "voluntary" decisions to buy products and earn income and

thus are not taxes. What matters is not whether the *purchase* is voluntary, but whether the *charge* is voluntary, and here it is not. Second, government officials defending taxes usually rely on the voluntariness factor precisely for this reason—once applied, it virtually ensures that the charge will be found not to be a tax. Courts in other states have recognized this deficiency and have declined to put any weight on the voluntariness factor, focusing instead on the purpose of the charge and what the revenues are used for, following *San Juan Cellular* and similar tests.

A. A DEFINITION OF "TAX" BASED ON VOLUNTARINESS IS INADEQUATE BECAUSE IT GUARANTEES THAT THE EXAMINED CHARGE WILL BE FOUND NOT TO BE A TAX.

Even if voluntariness were the only relevant feature, the 35 percent charge 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 "participation in the lottery [is] freely undertaken by citizens of their own volition." *Id.* at 17. But most every purchase is voluntary in this respect.

This reasoning would convert nearly every assessment into a non-tax. "[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, courts that have considered the issue have rejected voluntariness as a defining factor. *See, e.g.*, *State v. Medeiros*, 89 Haw. at 367, 973 P.2d at 742 ("[T]he 'voluntariness' of the service charge or fee would seem to be essentially beside the point."); *Resolution Trust Corp. v. Lanzaro*, 140 N.J. 244, 255 658 A.2d 282 (1995) (citing *Mass. v. United States*, 435 U.S. 444 (1978)) ("[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, 311 fn.8 (Colo. 1989) ("[W]e decline to engraft a 'voluntariness' factor onto the tax-fee distinction in resolving this case."); *In re Cottage Grove Hosp.*, 265 B.R. 241, 245 (Bkrtcy. D. Or. 2001) ("[I]t has been held that in the context of 'excise' taxes, the 'voluntariness' prong is a red herring, and is, in essence, inapplicable.").

As one example, California courts have rejected a voluntariness approach. In *Bay Area Cellular*, 2008 WL 1874690, the court rejected the city's argument that the charge was not a tax because payment was voluntarily undertaken by customers who chose to sign up for phone service. "[I]t is not imposed in exchange for the voluntary decision to seek a governmental service, but is instead imposed in response to the decision to seek telephone service from a private provider. . . .

Here, the fee is not based on actual or estimated use of emergency services, but simply on the presence of a telephone line, whether or not that line is ever used to call the City's emergency communication system." *Id.*, at *10-11.

The court thus recognized that a person signing up for telephone service is voluntarily paying for that service, not for taxes embedded into the price. North Carolina lottery players voluntarily seek to play the lottery, just as North Carolinians voluntarily earn income, pay for goods and services, and purchase cigarettes, liquor, and gasoline. These voluntarily undertaken transactions, however, are for the underlying products and not for the embedded taxes.

The court below unconvincingly attempts to limit the scope of its conclusion. *See Heatherly*, 658 S.E.2d at 17 ("A sales tax, by contrast, is a cost of conducting business in North Carolina and is imposed on all members of the general population; it can hardly be considered to be 'voluntary' under any practical definition of the term."). But because most services and many goods are exempted from the sales tax in North Carolina, its scope is far more limited than the court asserts. *See, e.g.*, John L. Mikesell, *State Retail Sales Tax Burdens, Reliance, and Breadth in Fiscal 2003*, STATE TAX NOTES 125 (Jul. 12, 2004) (estimating that North Carolina's sales tax applies to only 37.4 percent of transactions, lower that the national median of 43.3 percent).

A person could refrain from purchasing items subject to the sales tax if he or

she so chose, just as a person could refrain from purchasing gasoline, cigarettes, or liquor. This does not change the fact that the charges imposed by the state on these sales are taxes. While all must be paid by any member of the general population who engages in the transaction, none could be said to be "imposed on all members of the general population." Not even the income tax is so imposed, as many people do not pay it. *See, e.g.*, Scott A. Hodge, *Tax Foundation Fiscal Fact No. 27—Number of Americans Outside the Income Tax System Continues to Grow*, (Jun. 2005), *available at* http://tinyurl.com/568ft9 ("[R]oughly 15 million individuals and families earned some income last year but not enough to be required to file a tax return."). When one considers the fact that not even sales and income taxes are paid by all members of the general population, a literal application of the Court of Appeals' framework would leave only a head tax imposed on all citizens subject to Article II, Section 23. It is difficult to see how the voluntariness approach of the court below can produce a workable distinction between those charges subject to Article II, Section 23 and those that are not.

B. CONTRIBUTING 35 PERCENT OF EACH LOTTERY TICKET'S PURCHASE PRICE TO GENERAL GOVERNMENT SPENDING ON EDUCATION IS NOT VOLUNTARY.

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 Pine Island*, 265 N.C. at 116-17, 143 S.E.2d at 325. What matters for distinguishing taxes from non-taxes is not the "voluntary" or "involuntary" nature of the transaction, but the ultimate use of the revenue.

Here, the only compensatory charge is the 15 percent of lottery revenues that cover operation 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 Educ.*, 311 Ky. 781, 786, 225 S.W.2d 672, 675 (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, the court went 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 charge goes beyond the cost of regulation, and instead raises funds for the "general maintenance and expense of government." *Id.*

Article II, Section 23 is meant to restrain the state's ability to raise revenue without abiding by taxpayer protections. If the state can escape these requirements merely by recasting the formal terminology used to describe the revenue, the protections are stripped of their meaning. For instance, if the state were to establish a monopoly on gasoline stations and use the "profits" for road building and maintenance, the "voluntary" nature of the gasoline purchases would convert the gasoline excise tax into something else, even though the force of law is the same and the economic effect is identical. Here, had the state legalized private lotteries and imposed a 35 percent levy on tickets for general education, the charge would 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 something else. *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 temporary tax increases expired, lawmakers chose the lottery to expand school funding, ostensibly in an effort to fund education by "non-tax" revenue sources. *See, e.g.*, Gov. 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."). The 35 percent charge is also severable from the smooth operation of the Lottery, further demonstrating the tax-like nature of the charge. *See Heatherly*, 658 S.E.2d at 16 fn.4 ("[A]n ostensible remedy to Plaintiffs' tax claim would be to strike that part of the bill directing funds to benefit education.").

Article II, Section 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 Co. v. Snuggs, 121 N.C. 394, 398-99, 28 S.E. 539, 540-41 (1897). This provision should apply where the North Carolina General Assembly seeks to substitute for a previous 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 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: it is equivalent to a 39.2 percent tax on lottery operation, with the money transferred to the state for general education spending. This is not incidental revenue, and the rate is 23rd highest out of 43 states. *See Tax Foundation Tax Data—Implicit Tax Rates on State Lottery Sales 2006* (Aug. 2007), *available at* http://tinyurl.com/3t5ec9. 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, *Tax Foundation Background Paper No. 54—Gambling with Tax Policy: States' Growing Reliance on Lottery Tax Revenue* 1, 19 (Jul. 2007), *available at* http://tinyurl.com/5pbgbc. Average U.S. state lottery sales in 2006 were $546 per household, more than the revenue raised by state corporate income taxes ($425 per household) and just over a third of revenue raised by North Carolina's state sales tax ($1,454 per household). *See* TAX FOUNDATION, 2008 FACTS & FIGURES: HOW DOES YOUR STATE COMPARE? 1, 17-26 (2008).

If part of the Lottery charge is a voluntary transaction to cover the cost of a

service, then part of it 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*, 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 19th day of May, 2008.

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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.

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