Latent Hazards in the Current Language of CACR 13

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As adopted by the House of Representatives, CACR 13 proposes to add to the New Hampshire Constitution the following language:

> No new tax shall be levied upon a person's income, from whatever source it is derived.

This would be inserted in Part II of the Constitution as a new, free-standing Article 5-c rather than adapting it to the pre-existing limitations on the taxing power in Articles 5 and 6. Its premise is that without such a prohibition, some future Legislature could be seriously tempted to pass some form of income tax either for policy reasons or because of a fiscal crisis. I have accepted that premise, evaluating the proposal on the assumption that it would someday be tested by a Legislature motivated to circumvent it. As will appear below, I have also concluded that the broad language of the amendment could lead to constitutional challenges of traditional types of N.H. taxes that neither the sponsors nor the public contemplate.

Despite (or perhaps because of) the proposal's simple language, if adopted in anything like its present form the amendment would start a cascade of constitutional questions that could take years to settle, and which, even if satisfactorily settled, would require the Supreme Court continually to be much more involved in reviewing tax laws and proposals than it already is. I am certain there will also be unintended consequences. Their direction will depend on how the Supreme Court defines key terms and resolves implicit dilemmas, but they include some very disturbing possibilities.

Much of the difficulty lies in failure to take into account the existing constitutional constraints on tax legislation. The rest comes from assuming that common but very abstract words have a simpler and narrower meaning than they actually do at the constitutional level.

We have made that mistake before. The last time there was a major change in New Hampshire's constitutional provisions for taxation was 1903. The amendment's language was very simple and nearly everyone thought the purpose was clear. It produced at least 40 years of legal confusion and uncertainty. As a result, a reasonably satisfactory modern business tax that was also constitutional wasn't devised until 1969. When the law finally stabilized, the New Hampshire tax system would have been shockingly unrecognizable to most of those who voted for the 1903 amendment.

This was not because of activist judges— the majority of judges who struggled through it were far more politically conservative and strict in their interpretations than those of the modern era. The judges were forced to try to fit the new amendment into an already tight logical structure. The problem was that the authors of the amendment and the voters who ratified it focused on the political issues of their day (inheritance and franchise taxes) without considering how a few casual words fit with or changed the logic of other parts of the constitutional puzzle.

Constitutional Context

Devising (or revising) a fair, workable tax of any significance that fits the economic realities of the time, is politically viable, and is also constitutional is already quite difficult in New Hampshire. In part this is because our Constitution constrains the taxing power in ways that are unique and poorly understood.

The New Hampshire Constitution specifies the only permitted subjects of taxation in Article 6 of Part II:

> The public charges of government or any part thereof may be raised by taxation upon polls, estates, <u>and other classes of property, including franchises and property when passing by will or inheritance</u>. [Underlined language added in 1903.]

You will notice there is no reference to sales, incomes, or occupations. New Hampshire is the only state in the union whose Legislature lacks the power to levy any true excise taxes. When the taxing powers of our original Constitution were copied from the first Massachusetts Constitution, the excise tax clause was intentionally omitted, and our Supreme Court has conscientiously enforced that choice ever since.

Except for the obsolete poll tax, every tax in New Hampshire must be structured as a uniform, ad valorem tax on some "class" of property. This is not trivial. Our taxes are on property, not persons. Other clauses in the Constitution (Part I, Articles 1, 10, and 12; Part II Article 5) have been uniformly interpreted to require strict equality in the tax treatment of all persons whose property is taxed.

When the dust settled on the meaning of the words "other classes of property" it was possible to tax "property in motion," property as it changed hands or changed form or use. However, it still had to be a uniform tax on some legislatively defined class of property, without reference to personal characteristics or circumstances of those obliged to pay it. (There is a little room to maneuver with personal exemptions, but very little.)

This is why graduated taxes are unconstitutional: they discriminate based on personal wealth or business size or volume. It is why we can have a business profits tax, but not a corporation income tax: all forms of business income, including that of

sole proprietorships and partnerships must be taxed at the same rate. With a little care, it is possible to have some taxes that look and work very like ordinary income or sales taxes, but when the equality rules and the limits on double taxation are taken into account, many economically and politically reasonable options are off the table. For example, between 1981 and 1993 five different attempts to correct perceived shortcomings of the Business Profits Tax were declared unconstitutional before the Business Enterprise Tax was devised.

New Hampshire's power to tax is already more constrained than that of any other state. CACR 13 would, in very broad language, introduce an additional set of limits with no apparent consideration of how they would fit with those already in place. While the unintended consequences of this new language are not entirely predictable, there are some clear hazards.

Implications of the Proposal's Language

Three essential words or phrases in CACR 13 seem simple, but, when read in the context of the rest of our Constitution and law, they guarantee trouble: "person's," "income from whatever source derived," and "new."

1. "person's"

For well over a hundred years the U.S. Supreme Court has held that the unmodified use of the word person in, for example, the 14th Amendment, includes legal persons as well as natural persons. In regard to taxation, so has the N.H. Supreme Court. Legally, corporations are persons. This meaning is widely known by the general public and certainly would be raised during a ratification campaign. It has long been standard in legislative drafting to use the words "individual" or "natural person" when corporations, LLC's and the like are not intended. It would take a very bold bit of judicial activism for our Court to hold that the proposed amendment did not include them. If adopted and interpreted in the usual way, the amendment would almost certainly bar any new or different business taxes connected to income. While our present taxes might seem tolerable, it is folly to assume that they will remain so on the time scale of a constitution. The economic world is changing fast and may be quite different in a few years. In much less rapidly changing times, the stock in trade tax was familiar and workable at the time of our last major tax amendment, but it became a serious problem (and a drag on our economy) long before it was abolished in 1969.

The definition of person would seem to be easily corrected by revising the language of the amendment. However, if it were to be confined to natural persons we would end up in the same position. Remember, it is already unconstitutional to discriminate among persons, including artificial persons. This amendment doesn't change that. Any business tax that cannot be levied on a proprietor or partner is also forbidden on corporations or other legal persons. Our Constitution requires

taxes be on defined classes of property without discrimination among the owners or recipients or transferors of that property. What you can't do to an individual proprietor, you can't do to a corporation. Thus, even if the amendment's language were confined to natural persons, the result would be to constitutionally freeze our system of business taxes.

The only way I see out of this box would be for the Supreme Court to decide that the amendment implicitly overrode the equality and proportionality clauses, removing the prohibition on discrimination among taxpayers. Such a radical interpretation would open the door to differing tax rates for different forms of business organization (which I doubt either the sponsors or the bulk of any ratifying majority of voters would want).

2. "income, from whatever source derived"

This is apparently modeled on the 16th Amendment to the U.S. Constitution. However, that amendment was permissive, this one is restrictive, and the difference is highly significant. The U.S. Supreme Court has avoided a constitutional definition of "income" (while implying it is very broad). The Court's decisions interpret the word as used in the tax statutes without setting an outer constitutional limit.

There is a very good reason for this: there is no settled definition of income. Common definitions not only differ but often conflict. For example, definitions by distinguished economists include 1) any net increase in wealth (including unrealized gains) and 2) all gross receipts (without regard to expenditures).

Our Supreme Court has approved over a dozen legislative definitions of different kinds of income, some very broad, some extraordinarily narrow. The Court itself has never been required to define income. This is quite appropriate given the Legislature's present discretion, but with the proposed amendment the Court would be required to develop a constitutional definition and to hold the Legislature to it.

While the voting public may assume that this amendment has reference to something roughly like the federal personal income tax, that is mistaken. In fact, if that were the ultimate interpretation, the amendment could be easily circumvented. The federal income tax statutes are a matter of Congressional choice and do not come close to exhausting the authority granted in the 16th Amendment. The outer boundary has never been defined. So our Court would face a dilemma: should it try to interpret the amendment according to the likely public image of income taxes ("walks like a duck"), leaving it narrow enough to be potentially ineffective, or should it implement the extremely broad meaning logically implied its the literal language, opening up all sorts of unintended consequences?

Standing alone, the concept of "income" doesn't fit very well with New Hampshire's constitutional structure. For us, income is "property in motion," but the legal focus has always been on the property, not to or from whom the property moves. The direct incidence of a tax has never been relevant in this state. Very early it was established that, for example, the property tax could as constitutionally be levied on tenants or mortgagees as on the "owner" leaving all interested parties to work out the burden contractually through rent or interest. Similarly, the wealth of corporations could be taxed either in the hands of the corporation or in those of its shareholders. Dividends paid out are a cost of capital. The same dividend received is income. Inheritance and gift taxes are levied on either the donor or recipient largely as a matter of convenience, but they are certainly a source of income to the recipient.

The Business Enterprise Tax is on payments for capital and labor—expenses— but every one of those expenditures is gross income to some recipient. Sales-type taxes are formally levied on the buyer, but the seller collects them and they are indistinguishable in practical effect from a gross receipts tax. The N.H. Supreme Court once split 3-2 on whether a particular utility tax was a gross receipts tax on the utility or a sales tax on the customers. Under present law, that was a distinction of merely cosmetic significance, but if CACR 13 were adopted it could be a constitutionally vital difference.

If gross income is not covered by the proposed amendment, it is useless—any reasonably thoughtful person with a little experience could create an effective income tax based on a gross. Yet one person's expenditure is another person's income. If the amendment is interpreted to apply only to taxes on the recipient, then it could be circumvented by taxes on expenditures in the same manner as the Business Enterprise Tax or the Room and Meals Tax. Something very like a personal income tax could be created this way. In fact there are several well-respected proposals to turn the federal personal income tax into a consumption tax based on net expenditures by the simple expedient of exempting savings and investment from gross income.

Of course one might say that the broad definition of income implied by use of the 16th Amendment language and the phrase "from whatever source" would block such circumvention. If a conscientious court accepted that view and followed the established logic of "property in motion," the amendment would go much farther than might be imagined. N.H. has always recognized that the outgo of one is the income of another. Inheritance or gift taxes would certainly be banned. To block what would be an income tax based on gross receipts, one would also have to ban a tax based on gross expenditures. At that point, all new sales-type or consumption taxes become unconstitutional. Once put into the context of existing N.H. law, a truly effective bar to all new income taxes must also bar all new sales taxes.

3. "new"

What would the Court consider a "new" tax? I assume a simple change of tax rate would be permitted (although that is not certain). Could the Legislature revive an old tax that had been repealed? There are a lot of old, repealed taxes, including some on income. Probably not (but that also is not certain).

The next possible line of definition might permit reduction or elimination of exemptions, deductions, or credits from existing taxes. If the only income taxes allowed were to be the interest and dividends tax and the business profits tax, I would anticipate increasing pressure to means-test the age-based exemption in the IDT and any number of pressures on the BPT.

Beyond this point the kind of change that makes a tax "new" becomes a major problem. When does different turn into new? Every New Hampshire tax is founded on a definition of a distinct class of property. The more complex taxes, such as the BPT or BET have all sorts of deductions, credits, and exclusions built into the definition of the taxable property. The N.H. Supreme Court has permitted a lot of political and economic fine-tuning by these means, accepting it as part of the Legislature's broad discretion to define "classes of property." Logically, however, each variation of the definition, the tax base, is a different classification, a different, and in one sense new, tax. However, CACR 13 would forbid any "new" tax on "a person's income." As I have explained above, one way or another, the amendment would apply to business profits taxes. If the Court says a change in the definition of the base is a new tax (a legitimate, albeit strict constructionist, position), we will not only have frozen the types of business taxes we have, but the particular provisions in effect when the amendment was adopted. A similar lock-in effect would apply to the interest and dividends tax.

One might be confident that our Court would not be so rigid, but the alternative is hardly attractive. Case by case the Court would have to determine how much variation makes a tax "new." This is an insoluble problem, as old as philosophy. The ancient Athenians argued it endlessly when they preserved a galley that had fought the Persians in the Battle of Salamis. Eventually every plank, rope, and bit of sail was replaced. Was it still the same ship? What if there were a few changes, like similar but different materials? How much change makes something new?

If the Court is deferential to the Legislature in defining "new," we could have considerably, perhaps dramatically, different taxes under the same general label. If the Court is strict, the Legislature could lose the power to improve present taxes or adjust them as economic and technological conditions change. Do we want to get an advisory opinion every time the House or Senate thinks some change in the BPT (or, depending on the breadth of the definition of income, many of our other taxes) is desirable? During the turmoil after the last major tax amendment there were sometimes as many as four advisory opinions in a single year.

Summary

1. Forbidding new taxes on "a person's income" without amending the equality clauses of the Constitution would end up forbidding any new or different taxes on business income. However, overriding those clauses would open the possibility of graduated or discriminatory taxation.

2. There is an extremely wide range of possible definitions of income. One likely to match the public's understanding (e.g. adjusted gross minus the cost of generating it plus realized capital gains— roughly that in the federal tax) would render the amendment toothless. One following the scholarly consensus about the scope of the federal income tax amendment would prohibit inheritance or gift taxes, and an unknown range of others. One broad enough to prevent circumvention by well-settled N.H. practice would also bar sales and consumption taxes.

3. There is a comparable range of definitions for "new." Except for something so novel that it is completely unlike any tax we have (or perhaps have ever had), newness is a matter of degree. Under our Constitution, changing anything in the defined base of a tax logically creates a new class of property and a new tax. However logical, this interpretation would set in stone any tax to which the amendment applied. Yet if amendment of "old" taxes were tolerated, the spirit of the proposal could be circumvented. How much change qualifies a tax as new would be a matter of degree to be judged on a case-by-case basis.

4. Most of these issues would inescapably require the Supreme Court to develop whole new bodies of constitutional law and, in respect of newness, and perhaps the definition of income, to make judgment calls where clear or even workable definitions are probably impossible.

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* My conclusions are based on study of the N.H. Constitution, actual and proposed tax laws, and Supreme Court opinions. I believe I have read every decision or advisory opinion by the Court on the taxing power— approximately 200. I have left out footnotes or other citations, but my statements of law are well supported and can be checked through my article, Constitutional Limits on New Hampshire's Taxing Power, 7 Pierce L. Rev. 251-325 (2009). I have written only for myself, not as a representative of the Law School or University.