S T A T E O F T E N N E S S E E
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Opinion No. 03-002

Constitutionality of 2002 Amendments to Professional Privilege Tax

QUESTIONS

1(a) Does the amendment in Section 7(b) of Chapter 856 of the Public Acts of 2002 impermissibly discriminate against federal employees in favor of employees of the State of Tennessee in violation of the United States Constitution?

1(b) If the answer to 1(a) above is "yes," is Section 7(a) of Chapter 856 of the Public Acts of 2002 increasing the Professional Privilege Tax from $200 to $400 still valid, or does it also fail as a result of the unconstitutionality of Section 7(b)?

1(c) If the answer to 1(a) above is "yes," can the Department of Revenue remedy the unconstitutional result administratively by also applying the exemption to federal employees?

1(d) If the answer to 1(a) above is "yes," and the answer to 1(c) above is "no," does the exemption for employees of the State of Tennessee fail so that such employees are subject to the Professional Privilege Tax?

2(a) Are employees of Tennessee cities and counties "state employees" for purposes of Section 7(b) of Chapter 856 of the Public Acts of 2002?

2(b) If the answer to 2(a) above is "no," does the amendment in Section 7(b) of Chapter 856 of the Public Acts of 2002 impermissibly discriminate against employees of Tennessee cities and counties in favor of employees of the State of Tennessee in violation of the United States Constitution?

2(c) If the answer to 2(b) above is "yes," is Section 7(a) of Chapter 856 of the Public Acts of 2002 increasing the Professional Privilege Tax from $200 to $400 still valid, or does it also fail as a result of the unconstitutionality of Section 7(b)?

2(d) If the answer to 2(b) above is "yes," can the Department of Revenue remedy the unconstitutional result administratively by also applying the exemption to employees of Tennessee cities and counties.

2(e) If the answer to 2(b) above is "yes," and the answer to 2(d) above is "no," does the exemption for employees of the State of Tennessee fail so that such employees are subject to the Professional Privilege Tax?

OPINIONS

1(a) The exemption for full-time state employees contained in the Professional Privilege Tax statute violates the doctrine of intergovernmental tax immunity by impermissibly favoring state employees over federal employees, and thus it cannot be implemented as written.

1(b) The unconstitutionality of the exemption would not result in the invalidation of the provision increasing the Professional Privilege Tax from $200 to $400.

1(c) The unconstitutionality of the exemption likewise would not result in striking down the exemption. Instead, a successful constitutional challenge to the exemption likely would result in extending the exemption to federal employees. The Department should achieve the same result administratively by applying the exemption to federal employees.

1(d) Because the Department can administratively remedy the unconstitutional result by applying the exemption to federal employees, the exemption for state employees will remain in effect.

2(a) Employees of Tennessee cities and counties are not "state employees" for purposes of the exemption contained in the Professional Privilege Tax statutes.

2(b) The exemption for state employees does not violate equal protection principles because a rational basis exists to treat state employees differently than city and county employees.

2(c)—(e) Inasmuch as the exemption for state employees does not violate equal protection principles, the 2002 amendment to the Professional Privilege Tax will remain in effect and should be administered in accordance with the federal constitution by making it available to full-time state and federal employees, but not city and county employees.

ANALYSIS

Your questions concern application of the Professional Privilege Tax, Tenn. Code Ann. §§ 67-4-1701 to 67-4-1709, to employees of federal, state, and local governments. The Professional Privilege Tax, as its name suggests, is a tax levied on the privilege of engaging in specified vocations, professions, businesses, or occupations in the State of Tennessee. *See* Tenn. Code Ann.

§ 67-4-1702 (Supp. 2002). Until recently, the amount of the tax was $200 annually, payable on June 1 of each year. *See* Tenn. Code Ann. § 67-4-1703(a) (1998). Effective July 15, 2002, however, the General Assembly amended the Professional Privilege Tax statutes by increasing the annual tax amount from $200 to $400. *See* 2002 Tenn. Pub. Acts. 856, §§ 7(a), 14(g) (codified at Tenn. Code Ann. § 67-4-1703(a) (Supp. 2002)). At the same time, the General Assembly added a provision exempting "full-time state employees" from the tax's application. *See* 2002 Tenn. Pub. Acts 856, § 7(b) (codified at Tenn. Code Ann. § 67-4-1708(c) (Supp. 2002)). Revenues generated by the Professional Privilege Tax are "collected by the commissioner of revenue and deposited to the state general fund." Tenn. Code Ann. § 67-4-1701 (1998).

In amending the Professional Privilege Tax's provisions, the General Assembly did not define the term "state employee"; however, that term is defined elsewhere in the code as

> any person who is a state official, including members of the general assembly and legislative officials elected by the general assembly, or any person who is employed in the service of and whose compensation is payable by the state, or any person who is employed by the state whose compensation is paid in whole or in part from federal funds, but does not include any person employed on a contractual or percentage basis.

Tenn. Code Ann. § 8-42-101(3)(A) (2002); *accord* Tenn. Code Ann. § 8-27-201(g) (2002); Tenn. Code Ann. § 9-8-112(a), (c) (1999); Tenn. Code Ann. § 9-8-307(a)(1) (Supp. 2002).

Pursuant to the statutory definition of "state employee" set forth above, to qualify as a state employee, a person must be employed in the service of the state, and his compensation must be payable by the state. *See Martin v. State*, No. M1999-01642-COA-R3-CV, 2001 WL 747640, at *1 (Tenn. Ct. App. July 5, 2001) (*no perm. app. filed*). In accordance with this definition, this Office recently opined that a general sessions judge was not a full-time state employee within the meaning of the statutory exemption set forth in the Professional Privilege Tax statutes. *See* Op. Tenn. Att'y Gen. No. 02-097 (Sept. 11, 2002). We reasoned that the salary of a general sessions judge was paid by the county, not the state. We also noted prior decisions of the Tennessee Supreme Court which held, in other contexts, that a general sessions judge was a county officer rather than a state officer. *See id*. (citing *State ex rel. Winstead v. Moody*, 596 S.W.2d 811 (Tenn. 1980); *Durham v. Dismukes*, 206 Tenn. 448, 333 S.W.2d 935 (1960)). The Professional Privilege Tax statutes themselves indicate that the tax applies to professionals employed by municipal and county governments. *See* Tenn. Code Ann. § 67-4-1709 (1998) (permitting government of any county having metropolitan form of government and population in excess of 100,000 to pay tax on behalf of its professional employees).

Your request raises issues regarding the constitutionality of a tax statute that exempts state employees from its application without exempting other governmental employees. The analysis of these issues differs, of course, depending upon whether the governmental employees involved are

employed by the federal employment or by local governments, such as cities and counties. The analysis of this question with regard to federal employees begins with the doctrine of intergovernmental tax immunity, which had its genesis in *McCulloch v. Maryland*, 4 Wheat. 316, 4 L. Ed. 579 (1819). The doctrine of intergovernmental tax immunity bars taxes that are "imposed directly on one sovereign by the other." *Davis v. Michigan*, 489 U.S. 803, 811, 109 S. Ct. 1500, 1505, 103 L. Ed. 2d 891 (1989). The doctrine "is based on the need to protect each sovereign's governmental operations from undue interference by the other." *Davis*, 489 U.S. at 814, 109 S. Ct. at 1507. In furtherance of this purpose, the doctrine includes a nondiscrimination component, which "bar[s] taxes that 'operat[e] so as to discriminate against the Government or [against] those with whom [the Government] deals,'" such as its employees. *Davis*, 489 U.S. at 812, 109 S. Ct. at 1506 (quoting *United States v. City of Detroit*, 355 U.S. 466, 473, 78 S. Ct. 474, 478, 2 L. Ed. 2d 424 (1958)).

In *Davis v. Michigan*, 489 U.S. 803, 109 S. Ct. 1500, 103 L. Ed. 2d 891 (1989), the United States Supreme Court struck down a provision of the Michigan Income Tax Act that exempted from its application the retirement benefits of state employees. The Act levied an income tax on the retirement benefits of all other employees, including federal employees. The Court held that the challenged provision "violates principles of intergovernmental tax immunity by favoring retired state . . . employees over retired federal employees." *Davis*, 489 U.S. at 817, 109 S. Ct. at 1509. In reaching this conclusion, the Court cautioned that "[t]he danger that a State is engaging in impermissible discrimination against the Federal Government is greatest when the State acts to benefit itself and those in privity with it." *Davis*, 489 U.S. at 815 n.4, 109 S. Ct. 1507 n.4. The Court indicated that, when a state's discriminatory taxing scheme is challenged, "the relevant inquiry is whether the inconsistent tax treatment is directly related to, and justified by, 'significant differences between the two classes.'" *Davis*, 489 U.S. at 816; 109 S. Ct. at 1508 (quoting *Phillips Chem. Co. v. Dumas Indep. Sch. Dist.*, 361 U.S. 376, 383, 80 S. Ct. 474, 479, 4 L. Ed. 2d 384 (1960)). The Court rejected the state's argument that the inconsistent tax treatment was justified by the fact that the state's "retirement benefits [were] significantly less munificent than those offered by the Federal Government." *Davis*, 489 U.S. at 816, 109 S. Ct. at 1508. The Court reasoned that

> [w]hile the average retired federal civil servant receives a larger pension than his state counterpart, there are undoubtedly many individual instances in which the opposite holds true. A tax exemption truly intended to account for differences in retirement benefits would not discriminate on the basis of the source of those benefits, as Michigan's statute does; rather, it would discriminate on the basis of the amount of benefits received by individual retirees.

Davis, 489 U.S. at 817, 109 S. Ct. at 1508.

In determining the appropriate remedy, the Court indicated that the constitutional claim could be resolved by one of two approaches: (1) "extending the tax exemption to retired federal employees (or to all retired employees)," or (2) "eliminating the exemption for retired state . . . employees."

Davis, 489 U.S. at 818; 109 S. Ct. at 1509. The Court left the resolution of this issue to the Michigan courts, observing that "[t]he permissibility of either approach, . . . depends in part on the severability of [the challenged provision] from the remainder of the Michigan Income Tax Act, a question of state law within the special expertise of the Michigan courts." *Id*.

In opining on the outcome of a similar constitutional challenge, this Office has stated that a taxpayer who successfully challenged such a statute "would be entitled to a refund of the taxes paid pursuant to the State's invalid tax scheme." Op. Tenn. Att'y Gen. No. 01-056 (Apr. 11, 2001). That opinion addressed the issue of whether the General Assembly could constitutionally enact an exemption from the sales and use tax for purchases of medical supplies and equipment made through the state TennCare program without extending the exemption to purchases made through the federal Medicare program. *See id*. In answering this question in the negative, we opined that a successful challenge to such legislation "would likely result in extending the exemption to matters involving Medicare as well as TennCare." *Id*. (citing *Lowe's Cos. v. Cardwell*, 813 S.W.2d 428, 431 (Tenn. 1991)).

Extension of the exemption was the remedy applied by the Tennessee Supreme Court in *Midland Bank & Trust Co. v. Olsen*, 717 S.W.2d 580 (Tenn. 1986), *cert. denied*, 479 U.S. 1103, 107 S. Ct. 1336, 94 L. Ed. 2d 186 (1987). That case involved a challenge to the statutory definition of net earnings which, for purposes of imposing corporate excise taxes, included income from federally-issued securities but excluded income from securities issued by the State of Tennessee and its political subdivisions. *Midland Bank & Trust*, 717 S.W.2d at 582. Because the tax violated the intergovernmental tax immunity doctrine, the Supreme Court was faced with the choice of either eliding the discriminatory exemption or extending the exemption to income from federal securities. *Id*. at 583. The Court chose the latter remedy, opining "that the doctrine of elision does not authorize this Court to remove the exemption of state securities contrary to express legislative direction and to subject them to taxation, even though the exemption itself has been held to be discriminatory." *Id*.

While the doctrine of intergovernmental tax immunity prohibits the state from passing legislation that discriminates against the federal government or its employees, the doctrine does not prohibit the state from passing legislation that treats state employees differently than city or county employees for some purposes. Instead, analysis of the constitutionality of the exemption with regard to city and county employees depends upon equal protection principles. Our Supreme Court has explained that "[s]tates have the right to adjust their systems of taxation in all proper and reasonable ways and [that] the courts will not invalidate a tax statute on the basis of equal protection so long as the classification and selection are reasonable." *Genesco, Inc. v. Woods*, 578 S.W.2d 639, 641 (Tenn. 1979). The test is "whether the statute rests on a reasonable basis." *Id*. In matters of taxation, "[t]he burden of showing that a classification is unreasonable and arbitrary is placed upon the individual challenging the statute; and if any state of facts can reasonably be conceived to justify the classification or if the unreasonableness of the class is fairly debatable, the statute must be upheld." *Beaman Bottling Co. v. Huddleston*, No. 01A01-9512-CH-00567, 1996 WL 417100, at *4 (Tenn. Ct. App. July 26, 1996) (*no perm. app. filed*) (quoting *Bates v. Alexander*, 749 S.W.2d 742,

743 (Tenn. 1988)). A litigant "must satisfy a very difficult burden in order to prove that [a] tax statute violates the equal protection clause." *Beaman Bottling Co.*, 1996 WL 417100, at *4.

Because constitutional equal protection provisions require only "that there be 'some relevance to the purpose for which the classification is made,'" the Legislature "may impose special burdens upon defined classes in order to achieve permissible ends." *Genesco*, 578 S.W.2d at 641 (quoting *Rinaldi v. Yeager*, 384 U.S. 305, 309, 86 S. Ct. 1497, 1499 (1966)). A classification, even a discriminatory one, will not be invalidated on equal protection grounds "if any state of facts reasonably can be conceived that would sustain it." *Snow v. City of Memphis*, 527 S.W.2d 55, 65 (Tenn. 1975) (quoting *Allied Stores of Ohio, Inc. v. Bowers*, 358 U.S. 522, 528, 79 S. Ct. 437, 441 1950)). No equal protection violation occurs "[i]f the selection or classification is neither capricious nor arbitrary, and rests upon some reasonable consideration of difference or policy." *Snow*, 527 S.W.2d at 65 (quoting *Allied Stores*, 358 U.S. at 527, 79 S. Ct. at 441). Rather than requiring the existence of significant differences between the two classes, as does the doctrine of intergovernmental tax immunity, equal protection principles merely require the existence of "any possible reason or justification" for the classification's creation. *Genesco*, 578 S.W.2d at 641.

1(a) The exemption for full-time state employees contained in the Professional Privilege Tax statute is unconstitutional because it violates the doctrine of intergovernmental tax immunity. The exemption impermissibly favors state employees over federal employees. Such inconsistent tax treatment can be justified only by significant differences between the two classes, none of which appear or have been suggested to this Office. Any perceived or actual disparity in salary or compensation levels cannot justify such inconsistent treatment.

1(b)—(d) The unconstitutionality of the exemption would not result in the invalidation of any provision of the Professional Privilege Tax statutes, including the 2002 amendment that increased the annual tax to $400 and exempted state employees. It is the opinion of this Office that a successful constitutional challenge to the exemption instead would result in extending the exemption to federal employees. Thus, the Department of Revenue should remedy the statute's constitutional infirmity by extending the exemption to federal employees.

2(a) City and county employees are not employed in the service of the state, and their compensation is not paid by the state. Accordingly, employees of Tennessee cities and counties are not "state employees" for purposes of the exemption contained in the Professional Privilege Tax statutes. The tax still applies to professionals who are employed by municipal and county governments.

2(b)—(e) A rational basis exists to treat state employees differently than city and county employees for purposes of this tax exemption. Revenues generated by the Professional Privilege Tax go to the State of Tennessee and are deposited into the state's general fund. The Legislature could have concluded that state employees, by virtue of their employment with the state, make other contributions to the State of Tennessee that equal or exceed the $400 tax paid by other professionals. Accordingly, the exemption does not violate equal protection principles.

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