DATE: November 4, 1986

SUBJECT: Federal Medicare Legislation
REQUESTED BY: Jack McGrory, Labor Relations Assistant to the City Manager
PREPARED BY: John M. Kaheny, Deputy City Attorney

QUESTION PRESENTED

You have asked this office if section 13205 of the Budget and Reconciliation Act (Public Law 99-272, 100 Stats. 313 (1986)) which imposes mandatory medicare coverage on all City employees hired after March 31, 1986 and requires the City and the affected employees to each pay a 1.45% excise tax on annual earnings up to $42,000 is subject to a successful constitutional challenge.

CONCLUSION

We believe that although this legislation is subject to constitutional challenge under both the doctrines of implied sovereign immunity and intergovernmental tax immunity, it is doubtful that such a challenge will be successful. Assuming, however, that The City of San Diego did successfully challenge this statute on either of these grounds, Congress could still impose the medicare program on City employees and require them to pay for this coverage at the self-employed rate of 2.90%.

BACKGROUND

Before beginning a legal analysis of the effect of the mandatory coverage of medicare tax on state and local government employees, a short summary of the provisions of section 13205 of the Budget and Reconciliation Act (Public Law 99-272, 100 Stat. 313 (1986)) (the "Act") and its legislative history is appropriate.

Congress has been aware for some time that certain state and local employees, whose employing agencies are not participating in the social security system, are in fact becoming eligible for social security benefits through other outside employment. The

legislative history of the Act indicates that Congress was not concerned about the impact of this situation on social security benefits because social security benefits are prorated based on the actual contribution of the employee. However, because an employee can become eligible for full medicare coverage even if the employee's contributions are insignificant, Congress desired to correct this perceived inequity. Aware of the concerns of many states and local government agencies about the financial burden that mandatory coverage for all employees might represent, Congress made the applicable provisions of the Act prospective only and imposed them on all newly employed state and local

government employees hired after March 31, 1986. The Act extended the provisions of Internal Revenue Code sections 3101(b) and 31011(b) to these employees and employers and requires that each pay a tax rate of 1.45% on all annual earnings up to $42,000.00.

For the first time in the history of the social security system, state and local government employees and their employers are required by law to participate in at least a portion of the social security program. Prior to 1950, these employees were not even permitted to participate in the social security system. In that year, Congress amended the Social Security Act to authorize voluntary participation (by states and local governmental agencies) in the social security system with respect to old age, disability and death benefits. 42 USC 418. Section 418(g) permitted states to terminate their section 418 agreements upon giving at least two years advance notice in writing to the Secretary of Labor. California's agreement permitted it to make separate agreements with public agencies of the State of California providing for the inclusion of eligible employees in the social security program and also authorizing the agencies to withdraw upon two year's notice. The City of San Diego gave notice in January 1980 to the State of California and was permitted to formally withdraw from the social security program on January 1, 1982. In 1983, Congress amended section 418(g) to prevent termination notices that had been filed within the preceding two-year period from taking effect. This prevented states and local governmental agencies which voluntarily joined the system from withdrawing from the system even if timely termination notices had been filed. The City of San Diego, however, had by this time effectively withdrawn from the system and was not affected by this legislation. California and several local California public agencies whose option to withdraw from social security had been voided by this legislation filed suit. The Supreme Court in Bowen v. Public Agencies Opposed to Social Security Entrapment et. al., 477 US , 91 L.Ed.2d 35, 106 S.Ct. 2390 (1986) ruled that Congress acted lawfully when it revoked

the option of states and local governments to withdraw from social security on the theory that the agreement which made coverage voluntary provided that it could be amended unilaterally at any time by Congress. The net effect was that the amendment to section 418(g) made social security coverage mandatory on a contractual basis for all states and local governmental agencies which were members of the system in 1983. The City of San Diego now stands alone with Atlanta, Boston, Cleveland and the states of Alaska, Colorado, Louisiana, Maine, Massachusetts, Nevada and

Ohio and several other local public agencies in the unique position of not participating in the social security system but being required to pay the medicare tax for all new employees hired after March 31, 1986.

The legislative history of the Act is devoid of any discussion of the question of the constitutionality of a general levy of employer tax on states and local government agencies. That issue has been raised over the years in congressional debates concerning the involuntary imposition of the Social Security Act on state and local employers. It has never been addressed by any court simply because up until April 1, 1986, enrollment for state and local governmental agencies had been voluntary for all aspects of the social security program. The controversy may now be ripe for resolution and it centers on the constitutional doctrines of implied sovereign immunity and intergovernmental tax immunity.

ANALYSIS

A. Implied Sovereign Immunity

The Tenth Amendment expressly declares the constitutional policy that Congress may not exercise its power in a fashion that impairs a state's integrity or ability to function effectively in a federal system. United States v. Darby, 312 U.S. 100, 85 L.Ed. 609 (1940). To successfully challenge the constitutionality of the Act, The City of San Diego must prove that the imposition of the medicare excise tax by the federal government seriously interferes with a state or local government's ability to function by dictating the type and cost of employment benefits that state and local employees receive. Given the position of the United States Supreme Court in recent opinions on similar issues, this appears to be a heavy burden.

The Social Security Act was enacted pursuant to Congress' power to expend money in aid of the general welfare and its power to impose excise taxes. Helvering v. Davis, 301 U.S. 619, 81 L.Ed.2d 1307, 57 S.Ct. 904 (1937); Fleming v. Nestor, 363 U.S. 603, 4 L.Ed.2d 1435, 80 S.Ct. 1367 (1960). In recent years, the Supreme Court rendered two decisions concerning Congress' power under the Commerce Clause to interfere with the traditional governmental functions of the states. National League of Cities v. Usury, 426 U.S. 833, 49 L.Ed.2d 245, 96 S.Ct. 2466 (1976); Garcia v. San Antonio Metro, 469 U.S. 528, 83 L.Ed.2d 1016, 105 S.Ct. 1005 (1985). An analysis of the doctrine of state sovereignty provided by the Court in cases concerning Congress' power under the Commerce Clause is therefore helpful in predicting how the Court would rule on the present issue.

The Supreme Court (in the Garcia case) overruled its earlier

decision in National League of Cities v. Usury and held that state and local entities were subject to Fair Labor Standards Act (FLSA) even in the areas of traditional governmental functions. In deciding Garcia, the Court threw out a test developed in National League of Cities v. Usury which was designed to assist courts in defining exactly what state functions were immune from federal regulation. The Court held that there was nothing in the FLSA that was destructive of state sovereignty. A key theory which the Court used in its reasoning was James Madison's view expressed in Federalist Paper No. 46, that Congress was the instrument best designed to protect the sovereign power of the states and not the courts.

However, neither Madison nor the Supreme Court in Garcia foresaw the present situation. Forty-three states are now locked into social security because the original voluntary agreements have become mandatory pursuant to Congress' unilateral action. Unless Congress amends that provision of the Social Security Act which forbids states to withdraw, which is highly unlikely, these states now have a permanent vested right in the solvency of the system. It is clear then that states and local governments which no longer participate in social security will most likely receive little support from Congress under the present circumstances. There is no outraged Congress, as predicted by Madison, to halt the federal government's interference with state sovereignty. Therefore, the issue of state sovereignty can only be resolved by the courts. This was the position of Justice Powell in his dissent in the Garcia case. The City of San Diego's case, therefore, will rest on its ability to persuade the Supreme Court that either (1) the test developed in National League of Cities v. Usury should be reinstated as a guide in determining when Congress has the authority to impose mandatory excise taxes upon a state or local government, or (2) that the Court develop an alternative test to determine when Congress can impose excise taxes upon a state or local government in order to provide benefits for such public employees. This may be difficult

because the five members of the Court that overruled National League of Cities v. Usury are still on the Court.

B. Intergovernmental Tax Immunity

Beginning with the case of Collector v. Day, 11 Wall 113, 20 L.Ed. 122, 78 US 122 (1871), the Supreme Court has struggled with the issue of state immunity from federal taxation. That case emphasized that the states had been in existence as independent sovereigns when the constitution was adopted, and that the constitution presupposes and guarantees the continued existence

of the states as governmental bodies performing traditional sovereign functions. Since that time, however, the Supreme Court has substantially narrowed the scope of the states' immunity from federal taxation.

In Helvering v. Gerhardt, 304 U.S. 405, 82 L.Ed. 1427, 58 S.Ct. 969 (1938) the Supreme Court held that state employees were not immune from the income tax. Although the employees were agents of the state, they were also citizens of the United States and thus their income was subject to income taxation. The Court went on to enunciate that the only advantage conceivably lost by denying the states such an immunity is that essential state functions might be obtained at a lesser cost because the employees exempt from taxation might be willing to work for smaller salaries. This was regarded as an inadequate ground for sustaining the immunity and preventing the national government from requiring these citizens to support its activities. However, in that case the Court was reviewing a tax imposed upon the employee and not upon the employer.

The most recent United States Supreme Court decision discussing the immunity of state government from federal taxation, Commonwealth of Massachusetts v. United States, 435 U.S. 444, 55 L.Ed.2d 403, 98 S.Ct. 1153 (1978), held that an annual "flat fee" aircraft registration tax which was imposed on the state of Massachusetts by the United States with respect to a helicopter which the state owned and used exclusively for police functions was a user fee and thus not immune from federal taxation. The Court reasoned that the tax was (1) nondiscriminatory, (2) based upon a fair approximation of the cost of the benefits received from the federal activities, and (3) was not excessive in relationship to the cost of the benefits supplied by the federal government. However, in this case, the Court was looking at a tax on the state as a beneficiary of a specific federal program. It can certainly be argued that The City of San Diego or any other local governmental agency (or a state) is not the beneficiary of the medicare tax. The beneficiary of the medicare tax is the employee.

Because there are no cases specifically addressing the key issue of whether or not the federal government has the authority, under the Constitution, to tax the states or local governments for a benefit which is intended to be imposed upon their employees, any challenge to the medicare legislation would most likely have to be resolved by the United States Supreme Court. The federal government will no doubt argue that the imposition of a 1.45% tax on wages up to $42,000 could in no way seriously impede a state or local government's ability to function

especially in light of the fact that most states, through their own representatives in Congress, have imposed this burden upon themselves. The City of San Diego, of course, could argue strongly that this is just a first step and that if the history of the social security tax is any guide, the medicare tax will continue to rise. However, The City of San Diego cannot argue that imposition of this tax has increased the amount of money it pays for employees' benefits because, as of July 1, 1986, the City pays a reduced amount into the Supplemental Pension Savings Plan for those employees who are covered by the medicare tax.

C. Remedy

Although, there are many methods for bringing this issue to the attention of the courts, the preferred method is to file a civil action for refund of taxes paid pursuant to the provisions of 26 USC 7422. This will give the federal district court jurisdiction over the matter pursuant to 28 USC 1340, 1346(a)(1). However, The City of San Diego must first collect and pay these excise taxes and then file a claim for refund with the Secretary of the Treasurer which, once disallowed, will make the case ripe for judicial controversy. Massachusetts v. United States, 435 U.S. at 444.

Alternate Method of Taxation

Assuming that The City of San Diego is successful in attacking the mandatory medicare excise tax as unconstitutional, Congress may still be able to impose the tax on City employees. As a result of the Social Security Amendments of 1983 (Public Law 98-21, 97 Stats. 70-71 (1983)) and the Deficit Reduction Act of 1984 (Public Law 98-369, 98 Stats. 494 (1984)) Congress imposed mandatory participation in social security upon employees of nonprofit institutions. The 1984 Act, in order to avoid any problems with the Free Exercise of Religion Clause of the First Amendment, excluded employment with a church that elects for religious reasons not to participate in the program from the definition of employment for social security purposes but changed the treatment of income derived from such employment to

self-employment income. The result is that the church does not pay the employer's share of the social security tax, but the employees pay the tax at the self-employment rate which is double the normal employee rate. Bethel Baptist Church v. the United States, 629 F.Supp. 1073 (Mid.Dist. Pa. 1986). It is therefore clear that if The City of San Diego is successful in challenging the constitutionality of the Act, Congress need only amend the Internal Revenue Code to place the entire burden on City employees, who will then have to pay the self-employment tax of 2.9% as provided by 26 USC 1401(a). This may eventually lead to

demands by the employee groups that the City raise compensation of employees in order to avoid a decrease in their take-home pay.

SUMMARY

The above discussion points out the complexity of the taxation issue and is intended to present the obvious problems and possible courses of action. However, this controversy contains serious political and constitutional issues and does not lend itself to a simple or expedient solution.

Respectfully submitted,
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By
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APPROVED:
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