Coates' Canons Blog: NC Supreme Court Strikes Down Lumberton's Tax on Video Sweepstakes

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Article: https://canons.sog.unc.edu/nc-supreme-court-strikes-down-lumbertons-tax-on-video-sweepstakes/

This entry was posted on March 14, 2013 and is filed under Finance & Tax, Privilege License Taxes

Were I a gambler, I would not have bet on this result. No, I don't mean Duke's glorious trouncing of the Tar Heels on Saturday night. I mean last Friday's surprising ruling from the North Carolina Supreme Court that Lumberton's privilege license taxes on video sweepstakes were unconstitutionally high and therefore unenforceable. As a result, Lumberton will need to refund the $5,000-per-location and $2,500-per-machine taxes the city levied on video sweepstakes operators since 2010.

Why was this result so surprising? Mostly because the court abandoned its traditional deference to policy makers when evaluating the appropriateness of taxes. For decades before Friday's ruling the court had always granted elected officials great freedom to set tax rates so long as those rates were not so high as to eliminate all opportunity for the businesses subject to those taxes to operate at a profit.

I also found it surprising that the court seemingly misinterpreted Lumberton's privilege license tax system when it calculated the difference between city taxes levied on video sweepstakes and city taxes levied on other businesses. Had the court calculated this difference correctly, the outcome of the case might have been different.

Here's my take on the court's decision and what it means for other cities that levy privilege license taxes on video sweepstakes.

The Lumberton Decision

The court based its decision on the provision in Article V, Section 2(1) of the N.C. Constitution, that requires the power of taxation to be "exercised in a just and equitable manner." This clause was added to the state constitution in 1935 and had not been examined in depth by the court prior to the Lumberton case.

Historically, challenges to the amount of taxes levied by the state or local governments were resolved under a common-law (in other words, judge-made) standard that barred only "unreasonable and prohibitory" taxes. So long as a tax did not effectively prohibit an otherwise legal business by eliminating all opportunity for that business to earn a profit, the court deferred to the legislative branch on the specific tax rate. Here's a more detailed analysis of this standard of review.

In the Lumberton case, the court first concluded that it was not bound by the "unreasonable and prohibitory" common-law standard because that pre-dated the "just and equitable" constitutional provision. The court decided to replace that standard with . . . well, some other standard of review that the court didn't really define. Instead, the court basically emulated United States Supreme Court Justice Potter Stewart when he attempted to define hard-core pornography in a First Amendment case: "I know it when I see it."

Without offering an objective test to determine when a tax violates the "just and equitable" requirement, the Lumberton court concluded that the city's tax was unconstitutional because it was just too much of an outlier as compared to the city's other privilege license taxes. Specifically, the court pointed to the nearly 60,000% increase in Lumberton's privilege license taxes on video sweepstakes from 2009 to 2010 ($12.50 to a minimum tax of $7,500). The court concluded that this increase was "wholly detached from the moorings of anything reasonably resembling a just and equitable tax. If the Just and Equitable Tax clause has any substantive force, as we hold it does, it surely renders the present tax invalid."

But the court was quick to point out that not every large tax increase violates the state constitution. It requires a case-by-case analysis, said the court, which should include a look at the disparity between tax rates charged by a particular

jurisdiction on different businesses.

In the Lumberton case, the court justified its decision to strike down the city's tax on video sweepstakes in part on the "start difference between the amount of tax levied on cyber-gambling establishments and the amounts levied against other economic activities." According to the court, the city's second highest privilege license tax rate was the $500 levied on circus and animal shows. In the court's view, that $500 tax was simply too small relative to the $100,000 privilege license tax bills charged to several of the city's video sweepstakes operators.

Problem is, I don't think the court interpreted the city's privilege license tax correctly. The court ignored the fact that Lumberton levies privilege license taxes on general retail and service businesses on a gross receipts basis. Businesses taxed under this category are charged between $.25 and $1 per $1,000 of revenue, with no annual cap on their tax liabilities. A typical Super Target or Walmart store would pay tens of thousands of dollars in privilege license taxes to Lumberton each year, very similar to the privilege license taxes paid by several of Lumberton's video sweepstakes operators.

Because Lumberton's privilege license taxes on retailers were roughly equivalent to its privilege license taxes on video sweepstakes, the "stark difference" that the court identified simply didn't exist. And without that stark difference, a large part of the court's justification for its "I-know-it-when-I-see-it" conclusion also disappears.

But the court has spoken and the ruling is final. There won't be any appeal, because the case involved a state constitutional provision and not a federal one. The United States Supreme Court will not even consider hearing an appeal from a state supreme court unless the case involves a federal statute or constitutional provision.

What the Decision Means for Other Cities

The Lumberton decision does not directly affect any privilege license taxes other than those levied by Lumberton on its video sweepstakes operators. Privilege license taxes levied by other cities on video sweepstakes remain enforceable, regardless of the rate, unless and until a court rules otherwise.

That said, cities that levy privilege license taxes on video sweepstakes at rates similar to those levied by Lumberton ($5,000 per location, $2,500 per machine) are now on notice that those taxes might be held unconstitutional if they are challenged in court. I think this risk is especially acute for cities that levy substantial taxes on video sweepstakes operators but do not levy gross receipts taxes at equivalent levels on other businesses. In such a city, the "stark difference" that the court mistakenly identified in Lumberton will in fact exist and the city's video sweepstakes taxes would likely suffer the same fate as Lumberton's.

Cities that find themselves at risk of a Lumberton-like challenge might want to lower their taxes going forward. But I don't think a city may change taxes retroactively, meaning a city is probably prohibited from refunding privilege license taxes from prior years absent a legal challenge to those taxes. Cities with taxes substantially lower than those levied by Lumberton probably don't have much to worry about.

Taxes aren't the biggest issue involving video sweepstakes, of course. Law enforcement and local government officials are still wrestling over whether and how to enforce the criminal law ban that was upheld by the N.C. Supreme Court last December. The ban was intended to eliminate these businesses entirely, but that didn't happen. Many video sweepstakes operations remain open, some because they changed their sweepstakes systems to (allegedly) avoid the technical requirements of the ban and others because local law enforcement has not taken any steps to enforce the ban.

Two lawsuits have already been initiated by sweepstakes operators challenging the enforcement of the ban on their new sweepstakes systems, one in Davidson County and one in Lee County. Neither case resulted in an injunction against enforcement of the ban, but more litigation on this front is likely.

The bottom line is that video sweepstakes aren't going to disappear any time soon. Nor are the legal and policy questions associated with those businesses Stay tuned for more developments . . .

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- www.newsobserver.com/2013/03/11/2738831/duke-69-unc-53-030913.html
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