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Opinion No. 01-056

Sales and Use Tax Exemption for Purchases Made Through TennCare

QUESTIONS

1. May the State Legislature enact a constitutionally valid exemption from the sales and use tax for purchases of medical supplies and equipment made through the TennCare program without also exempting purchases of such medical supplies and equipment made through the Medicare program?

2. If such legislation is enacted, could it also change or impact the application of the sales tax to purchases made through Medicare?

OPINIONS

1. No, the State Legislature may not constitutionally create an exemption from the sales and use tax for purchases of medical supplies and equipment made through the TennCare program without also exempting similar purchases made through the Medicare program. This office is aware of no significant differences that would justify such discriminatory treatment of recipients and healthcare providers participating in Medicare.

2. If such legislation is enacted, a successful constitutional challenge could force the State of Tennessee to extend the exemption to similar purchases made through the Medicare program.

ANALYSIS

(1)

Under the constitutional rule of tax immunity, the State of Tennessee may not tax the Federal Government. *Memphis Bank & Trust Co. v. Garner*, 459 U.S. 392, 397 (1983). In an effort to comply with this rule, Tennessee's Retailers' Sales Tax Act provides that "no sales or use tax shall be payable on account of any direct sale or lease of tangible personal property or services to the United States, or any agency thereof created by congress, for consumption or use directly by it through its own government

employees." Tenn. Code Ann. § 67-6-308 (1998). The Act similarly exempts "[a]ll sales made to the state of Tennessee or any county or municipality within the state." Tenn. Code Ann. § 67-6-329(a)(13) (1998).

Although the State of Tennessee may not "constitutionally levy a tax directly against the Government of the United States or its property without the consent of Congress," the law is well-settled that the Federal Government's "constitutional immunity does not shield private parties with whom it does business from state taxes imposed on them merely because part or all of the financial burden of the tax eventually falls on the Government." *United States v. City of Detroit*, 355 U.S. 466, 469 (1958). Rather, the State may tax these private parties as long as the State does not discriminate against the Federal Government or those with whom it deals. *Id*. at 473.

In *Memphis Bank & Trust Co. v. Garner*, 459 U.S. 392, 393 (1983), the United States Supreme Court invalidated a Tennessee law that, in imposing a tax on the net earnings of banks, defined "net earnings to include income from obligations of the United States and its instrumentalities but to exclude interest earned on the obligations of Tennessee and its political subdivisions." In invalidating the law, the Court reasoned that

> [a] state tax that imposes a greater burden on holders of federal property than on holders of similar state property impermissibly discriminates against federal obligations. . . .
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> . . . Tennessee discriminates in favor of securities issued by Tennessee and its political subdivisions and against federal obligations. The State does so by including in the tax base income from federal obligations while excluding income from otherwise comparable state and local obligations. We conclude, therefore, that the Tennessee bank tax impermissibly discriminates against the Federal Government and those with whom it deals.

Memphis Bank & Trust, 459 U.S. at 397-98 (footnote and citations omitted).

A state "may not single out those who deal with the [Federal] Government, in one capacity or another, for a tax burden not imposed on others similarly situated." *Phillips Chem. Co. v. Dumas Indep. Sch. Dist.*, 361 U.S. 376, 383 (1960). The Supreme Court has 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 v. Michigan*, 489 U.S. 803, 815 n.4 (1989). If a state adopts a tax that discriminates against those who deal with the Federal Government, while favoring those who deal with state government, the state must be able to justify this discriminatory treatment by demonstrating that significant differences exist between the two classes. *Davis v. Michigan*, 489 U.S. at 815-16; *Phillips Chem. Co.*, 361 U.S. at 383.

In *Davis v. Michigan*, 489 U.S. 803 (1989), the United States Supreme Court rejected the State of Michigan's asserted grounds for levying an income tax on Federal employees' retirement benefits while exempting state employees' retirement benefits. There, the state argued that two significant differences existed between federal and state retirees. *Davis v. Michigan*, 489 U.S. at 816. First, the state argued that "its interest in hiring and retaining qualified civil servants through the inducement of a tax exemption for retirement benefits [was] sufficient to justify the preferential treatment of its retired employees." *Id.* Second, the state argued that the exemption for state retirees was justified by "[t]he substantial differences in the value of the retirement benefits paid the two classes." *Id.* In rejecting the state's first argument, the Supreme Court explained that

> [t]his argument is wholly beside the point, . . . for it does nothing to demonstrate that there are "significant differences between the two classes" themselves; rather, it merely demonstrates that the State has a rational reason for discriminating between two similar groups of retirees. The State's interest in adopting the discriminatory tax, no matter how substantial, is simply irrelevant to an inquiry into the nature of the two classes receiving inconsistent treatment.

Id. The Court also rejected the state's second argument, opining that any differences in the relative values of the retirement benefits paid the two classes were not sufficient "to justify the type of blanket exemption at issue in this case." *Id*. at 817. 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.

Id. Having concluded that the exemption violated the constitutional rule of tax immunity, the Court held that the taxpayer was entitled to a refund of the taxes paid pursuant to the state's invalid tax scheme. *Id*.

Under the Retailers' Sales Tax Act, many types of medical supplies and equipment are exempt from sales and use taxes. *See* Tenn. Code Ann. § 67-6-304 (human blood, blood plasma, and any part thereof); § 67-6-312 (insulin and any syringe used to dispense insulin); § 67-6-314 (certain orthopedic devices and prosthetics); § 67-6-316 (component parts of prescription eyewear); § 67-6-317 (ostomy products or appliances); § 67-6-318 (oxygen prescribed or recommended for human medical treatment); § 67-6-320 (prescription drugs and medicines); § 67-6-335 (dental equipment and supplies sold by dentists to patients); § 67-6-347 (repair services, including parts and labor, to equipment used in connection with medical evacuation or transport helicopters and other aircraft owned by not-for-profit

medical facilities, hospitals, and government entities) (1998). In addition, the Act exempts the sale, gift, or donation of any tangible personal property to certain nonprofit and charitable organizations, including nonprofit hospitals, homes for the aged, and organ and blood banks. Tenn. Code Ann. § 67-6-322 (1998). As your request points out, however, the Act does not contain a broad exemption covering all medical supplies and equipment, nor does it contain a specific exemption for medical supplies and equipment purchased through the TennCare or Medicare programs.

Congress created the Medicare program in 1965 as a means of providing health care to the aged and disabled. *Good Samaritan Hosp. v. Shalala*, 508 U.S. 402, 404 (1993). Under the program, participating healthcare providers are reimbursed by the Federal Government for certain costs associated with the treatment of Medicare beneficiaries. *Id.*; *Bowen v. Georgetown Univ. Hosp.*, 488 U.S. 204, 205 (1988).

In 1994, the State Legislature established the TennCare program to provide healthcare services to former Medicaid recipients and other qualified individuals. *See Baptist Hosp. v. Department of Health*, 982 S.W.2d 339, 340 n.1 (Tenn. 1998). Under TennCare, healthcare providers are paid by managed care organizations which have contracted with the State to provide services to TennCare recipients. *Id*.

Courts addressing the issue have concluded that the constitutional rule of tax immunity does not prohibit a state from assessing a tax on medical supplies and equipment sold to or by healthcare providers who participate in the Medicare program, despite the fact that the healthcare providers ultimately receive reimbursement for a portion of the purchase price from the Federal Government. *See CompuPharm-LTC v. Department of Treasury*, 570 N.W.2d 476, 479-80 (Mich. Ct. App. 1997), *appeal denied*, 584 N.W.2d 585 (Mich. 1998); *Akron Home Med. Servs., Inc. v. Lindley*, 495 N.E.2d 417, 421 (Ohio 1986). These courts reason that the Medicare recipients are the actual purchasers of the products, *Akron Home Med. Servs.*, 495 N.E.2d at 421, and that the participating healthcare providers are not instrumentalities of the Federal Government. *CompuPharm*, 570 N.W.2d at 480. Similarly, in one of its Letter Rulings, the Tennessee Department of Revenue has taken the position that, absent a specific exemption, sales of medical supplies and equipment to Medicare recipients are not exempt from sales or use taxes. Tenn. Rev. Ltr. Rul. 97-21 (June 6, 1997). The Department also has indicated in some of its Revenue Rulings that sales of medical supplies and equipment to TennCare managed care organizations (MCO's) and other TennCare contractors are not exempt from sales and use taxes. Tenn. Rev. Rul. 97-37; Tenn. Rev. Rul. 95-34 (Oct. 19, 1995). You have requested this office to address the constitutionality of a provision that would exempt from the sales and use tax purchases of medical supplies and equipment made through the TennCare program without also exempting similar purchases made through the Medicare program.

The State Legislature may not create an exemption from the sales and use tax for purchases of medical supplies and equipment made through the TennCare program without also exempting such purchases made through the Medicare program because, for purposes of this analysis, there are no

significant differences in the manner in which the two programs operate. Tennessee cannot apply different rules of tax law to TennCare than it does to the similar Medicare program.

(2)

If the State Legislature enacted an exemption favoring those who deal with the TennCare program, but not those who deal with the Medicare program, an entity belonging to the latter class could bring a lawsuit challenging the exemption on the ground that it violates the Federal Government's constitutional immunity from taxation. If the taxpayer's claim were successful, the taxpayer would be entitled to a refund of the taxes paid pursuant to the State's invalid tax scheme. This would likely result in extending the exemption to matters involving Medicare as well as TennCare. *See Lowe's Cos. v. Cardwell*, 813 S.W.2d 428, 431 (Tenn. 1991).

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