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# Retroactive Tax Legislation Undermines The Rule Of Law

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One of the most important tax issues of the day is currently pending before the United States Supreme Court: When is retroactive tax legislation so patently unfair that it violates the due process clause of the U.S. Constitution? Taxpayers in two state tax cases, Dot Foods Inc. v. Wash. Department of Revenue; and Sonoco Products Company, et. al., v. Michigan Department of Treasury[1] are asking the U.S. Supreme Court to review state court decisions upholding the constitutionality of retroactive tax legislation enacted after (and effectively reversing) state Supreme Court decisions in favor of taxpayers on the interpretation of the original legislation.

In rejecting taxpayers' challenges to the retroactive tax legislation, the Washington and Michigan courts sanctioned retroactivity periods of a mind-boggling 27 years and 6.5 years, respectively. The U.S. Supreme Court has asked for additional briefing from the states and will likely decide in April whether to accept these cases.

The facts in both cases are remarkably similar. In Dot Foods, Washington enacted a statute in 1983 that provided a tax exemption for certain out-of-state sellers from the state's business and occupation tax ("B&O"). For many years, the Washington Department of Revenue allowed the taxpayer to qualify for this B&O exemption. In 1999, however, without any intervening statutory change, the DOR changed its interpretation of the statute and denied the exemption to the taxpayer.

The issue was litigated, and in 2009 the Washington Supreme Court ruled in favor of the taxpayer, holding it was still eligible to use the exemption. Shortly thereafter, in 2010, the Washington Legislature enacted an amendment to reverse the Washington Supreme Court's decision and retroactively change the 1983 statute to avoid "large and devastating revenue losses." Litigation again ensued, and in 2016, the Washington Supreme Court ruled that the retroactive statute was valid and did not violate the taxpayer's rights under the due process clause of the Fourteenth Amendment.

The Michigan cases date back to 2007. In that year, Michigan enacted the Michigan Business Tax (effective for 2008), which included a provision for apportioning business income utilizing a single sales factor formula. However, the new statute left intact another law that provided

Michigan taxpayers the right to elect to apportion business income using a different formula — the Multistate Tax Compact's equally weighted, three-factor (property, payroll and sales) method.

In July 2014, following years of litigation by over 50 taxpayers, the Michigan Supreme Court upheld the taxpayers' right to elect to use the compact's apportionment method under the Michigan Business Tax. Two months later, in September 2014, after notification of a possible revenue loss of $1.1 billion (virtually all of which was related to out-of-state businesses), the Michigan Legislature repealed the compact and its election retroactively six-and-one-half years to 2008. In 2015, the Michigan Appeals Court upheld the retroactive legislation as constitutional under the due process clause. The Michigan Supreme Court declined to review the case.

The U.S. Supreme Court last addressed the constitutionality of retroactive tax legislation in 1994 in U.S. v. Carlton. In Carlton, the court upheld retroactive legislation in limited circumstances so long as the legislation was enacted for a "legitimate legislative purpose" and the legislature "acted promptly and established only a modest period of retroactivity." In Carlton, this limited period was slightly more than one year, and the U.S. Supreme Court has never upheld retroactive tax legislation going back more than two years.

However, since Carlton, the states have turned this narrow exception into a virtually unlimited blank check. Over the last two decades, more than 40 court decisions have been issued on retroactive tax legislation. The vast majority of these decisions (85 percent) have upheld the constitutionality of the retroactive tax legislation, tilting heavily to the state's position even where the retroactivity periods greatly exceeded the short "corrective" period sanctioned by the Carlton court. Indeed, state courts have upheld retroactivity periods of four years or more in one-half of these post-Carlton cases, and retroactivity periods of six years or more in one-third of these cases.

Moreover, many of the state court justifications for upholding long retroactive periods have completely disregarded the more limiting fact pattern and holding in Carlton. In Dot Foods, the Washington Supreme Court upheld a retroactivity period of 27 years by commenting cavalierly, "[Dot's] contention that a 27-year retroactivity period is per se unconstitutional is belied by the fact that we [previously] upheld a retroactive amendment that occurred 37 years after the statute was originally enacted. …"

Just as perversely, the Michigan Court of Appeals in the Michigan retroactivity cases effectively redefined the term "prompt" as used by the Carlton court to be meaningless. To the Michigan court, "prompt" was based not on the lengthy six-and-one-half year gap between the retroactive legislation and the original legislation, but rather the much shorter two-month gap between the Michigan Supreme Court's decision in favor of the taxpayers on the interpretation of the original legislation and the Michigan Legislature's enactment of retroactive legislation reversing that outcome. Based on these deviations from Carlton, it is difficult to imagine any retroactive tax legislation that would fail to pass constitutional muster, rendering the Carlton precedent obsolete.

The second test established by Carlton is that retroactive legislation must have a "legitimate legislative purpose." This has also been circumvented by the states. Far too frequently, state courts have held that preventing any significant revenue loss can satisfy the "legitimate legislative purpose" test. However, tax litigation decided in favor of a taxpayer will invariably result in revenue losses for a state. If revenue loss is the only justification necessary for supporting retroactive tax legislation, then no taxpayer is safe from having a sound court decision subsequently reversed retroactively through legislative action.

In an alarming subtrend, since Carlton, one-third of the retroactive tax legislation cases involved a state court sustaining the constitutionality of a retroactive law enacted after a court (frequently the same court) ruled in favor of the taxpayer on the merits of the underlying tax dispute (as occurred in Dot Foods and the Michigan retroactivity cases). By contrast, in Carlton, the Supreme Court did not sustain retroactive legislation that Congress enacted to overturn the court's prior decision. The court only upheld corrective legislation initiated prior to the ensuing litigation.

Thus, unlike many of the subsequent state tax cases, in Carlton the underlying legislative intent of the original legislation was never litigated or adjudicated in favor of a taxpayer by any federal court prior to the passage of the retroactive legislation. Quite the opposite, the Carlton court analyzed Congress' original intent and sided with the government, concluding that the retroactive legislation corrected a drafting "mistake" in the original legislation.

While the post-Carlton retroactivity cases raise significant due process issues, they also highlight separation of powers concerns between the legislative and judicial branches of government. After all, what is the purpose of judicial review if legislatures can overrule courts' decisions with retroactive legislation? This problem is exacerbated by the passage of time because the legislature enacting the retroactive legislation likely comprises an almost completely different membership than the legislature that enacted the original legislation.

In the Michigan cases, the turnover in the Michigan Legislature between the date of the original legislation in 2008 and the retroactive legislation in 2014 was 85 percent. In Dot Foods, the turnover in Washington's legislature from the date of the original legislation in 1983 to the retroactive legislation in 2010 was 99 percent. By contrast, in Carlton, only 12 percent of Congress turned over between the 99th session that enacted the original tax legislation and the 100th session that clarified that law.

Something is seriously amiss with representative democracy when subsequent legislatures with significantly different legislators are allowed to divine the intent of legislation enacted by a prior legislature. Nonetheless, in the absence of further review by the U.S. Supreme Court, state courts will continue to whittle away the limited Carlton exception to retroactive tax legislation and rubber stamp virtually all such "corrective" legislation.

The due process clause is fundamentally about fair play. If taxpayers cannot rely on the statutory law in effect at the time they file their returns, then taxpayers will lose trust in the tax laws and the voluntary compliance system will falter. How can a government ask taxpayers to voluntarily comply in a tax system where the rules can change long after the tax reporting period has closed, and where government losses or taxpayer wins in litigation can be arbitrarily reversed by retroactive tax legislation?

Upholding retroactive tax legislation subject only to a state's unfettered discretion to behave reasonably undermines the rule of law and makes a mockery of due process protections afforded to taxpayers under the U.S. Constitution. Retroactive tax legislation of more than a "modest" duration violates numerous principles of sound jurisprudence including fairness, equality, certainty, reliance and finality.

In the absence of additional guidance from the court, retroactive tax legislation will continue to be standard practice for state legislatures seeking to "clarify" previously enacted statutes and overturn what they perceive to be unfavorable outcomes in tax litigation. While some states, such as Michigan and Washington, have repeatedly enacted retroactive tax legislation, their actions have not been isolated. At least 20 states have enacted retroactive tax legislation since Carlton. In the reported cases, the median period of retroactivity has been around four years — more than triple the period found permissible in Carlton.

Hopefully, the U.S. Supreme Court will take note of this disturbing trend which is eviscerating the Carlton precedent and undermining the rule of law. The U.S. Supreme Court should grant writs of certiorari in the Dot Foods and Michigan cases to provide clearer guidance to states and taxpayers on the constitutionally acceptable purposes and time limits for retroactive tax legislation.

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*[1] No. 16-308, cert. pending 2017 (Dot Foods); No. 16-687, 16-688, 16-697, 16-698, 16-699, and 16-736, cert. pending 2017 (the Michigan cases). The citations for all other facts in this article can be found in the amicus curiae briefs filed by the Council On State Taxation (COST) in support of petitioners' writs of certiorari to the U.S. Supreme Court in the two cases listed above.*