

# **Connecting the Dot: Retroactive State Tax Statutes**

Michael T. Fatale,

Deputy General Counsel,

Massachusetts Department of Revenue

FTA Annual Meeting, June 4<sup>th</sup>, 2018

# Forthcoming Article

- *Connecting the Dot: Retroactive State Tax Statutes Revisit United States v. Carlton*, 86 U. Cin. L. Rev. \_\_\_ (2018)
- Focus is *Dot Foods, Inc. v. Dep't of Revenue*, 372 P.3d 747 (Wash. 2016), *cert. denied*, 137 S. Ct. 2156 (2017), which pertained to a retroactive state tax statute that reversed the analysis in a state court case

# *U.S. v. Carlton*, 512 U.S. 26 (1994)

- Executor of an estate incurs considerable expense to secure a tax deduction pursuant to the Tax Reform Act of 1986, relying upon clear statutory language without knowledge of any impending change
- 14 months after the enactment of the law, Congress retroactively eliminates the deduction
- The Supreme Court upholds the retroactive law against a due process challenge

# *Carlton* test

- SCOTUS: constitutional test is whether the retroactive tax statute is:
  1. supported by a ***legitimate legislative purpose***
  2. effected by a ***rational means***
- Protecting the governmental fisc is a “legitimate legislative purpose”

# “Rational means”

- *Carlton* “rational means” determination considers, among other things: (1) the promptness with which the legislature responds to the issue prompting the legislative action (when known) and (2) the length of the statute’s retroactivity, including in particular its “actual retroactive effect”

# *Carlton* rationale

- Focus must be on the appropriateness of the governmental action, not the reliance of the aggrieved taxpayer
- Determinations with respect to fiscal policy are rightfully and ultimately the province of the legislative process
- The political process can be generally trusted to police “unfair” tax and fiscal policy, including retroactive tax statutes

# *Carlton* rationale

- “Tax legislation is not a promise and a taxpayer has no vested right in the Internal Revenue Code.”
- “Taxation is neither a penalty imposed on the taxpayer nor a liability which he assumes by contract. It is but a way of apportioning the cost of government among those who in some measure are privileged to enjoy its benefits and must bear its burdens.”

# *Welch v. Henry*, 305 U.S. 134 (1938)

- “The equitable distribution of the costs of government through the medium of an income tax is a delicate and difficult task. In its performance experience has shown the importance of reasonable opportunity for the legislative body, in the revision of tax laws, to distribute increased costs of government among its taxpayers in the light of present need for revenue and with knowledge of the sources and amounts of the various classes of taxable income during the taxable period preceding revision.”



# *Dot Foods, Inc. v. Dep't of Revenue*

- At issue is 1983 exemption from the B&O tax
- Taxpayer obtains 1997 WA DOR letter ruling stating its entitlement, which ruling is revoked by DOR in 1999
- DOR promulgates 2000 regulation clarifying taxpayer is not entitled to the exemption, which is upheld by trial court (2006) & appeals court (2007)

## *Dot Foods, continued*

- In 2009, WA Supreme Court reverses in 5-4 decision, relying in part on WA DOR's revoked 1997 letter ruling
- Ruling will open door to refund claims by taxpayers other than the taxpayer – an estimated \$60 million revenue cost
- Governor working with legislature passes law 7 months later (2010) retroactively reversing the 2009 Court's analysis

# *Dot Foods, continued*

- WA supreme court (2016) upholds the retroactive statute under *Carlton* and SCOTUS denies petition for certiorari (2017)
- Although the statute's formal length of retroactivity is 27 years the "actual retroactive effect of the amendment *as applied to Dot Foods*" is only four years
- Actual retroactive effect as to other potentially affected taxpayers is apparently only 7 months

# Michigan “Compact cases”

- Dozens of taxpayers submit amended corporate filings seeking refunds, 2011-2015, claiming MI legislation in 2008 did not repeal Multistate Tax Compact election permitting the use of 3-factor apportionment
- Two lower courts find for MI; MI supreme court reverses in 3-1-3 decision, *IBM v. Dep’t of Treasury*, 852 N.W.2d 865 (2014)
- MI estimates the potential cost of *IBM* refunds at \$1.1 billion

# Michigan “Compact cases”

- Within 2 months of *IBM*, MI Governor working with legislature retroactively repeals the Compact election dating back to 2008
- MI supreme court upholds the retroactive statute, *Gillette v. Dept. of Treasury*, 878 N.W.2d 891 (2015)
- “[I]t is legitimate for the Legislature to amend a law that it believes the judiciary has wrongly interpreted;” the legislature merely “confirmed a tax that had been assessed and paid for many years” to prevent “a significant loss of revenue”
- SCOTUS denies several petitions for certiorari (2017)

# Actual retroactive effect?

- Cases conclude that you cannot assume that persons would cease to seek income “even if they knew that this receipt would later be subject to a new tax or the increase of an old tax.” *Welch v. Henry*, 305 U.S. 134, 148 (1938)
- Where taxpayer is filing a refund claim the suggestion is there was no detrimental reliance on the tax provision in question. *General Motors Corp. v. Dep’t of Treasury*, 803 N.W.2d 698, 712 (Mich. 2010)

# Similar federal cases

- Series of mid-1980's FICA tax cases decided by US Circuit Courts of Appeals, two of which are denied certiorari by SCOTUS; cases that upheld retroactive Congressional legislation that reversed a US Supreme Court decision that in turn invalidated an IRS revenue ruling
- *Graham & Foster v. Goodcell*, 282 U.S. 409 (1931); case upholds retroactive Congressional statute that extinguished refund claims filed by taxpayers whose taxes were improperly collected after their statutes of limitation had run

# Similar state cases

- *Caprio v. New York State Dep't of Taxation & Finance*, 37 N.E.3d 707 (N.Y. 2015) (upholding a retroactive statute that reversed the result in two lower NY court cases, with respect to gain derived from certain sales of a business)
- *Miller v. Johnson Controls, Inc.*, 296 S.W.3d 392 (Ky. 2009) (upholding a retroactive statute that denied refunds that would otherwise have been due under a prior state supreme court ruling)



# Separation of powers?

- Is generally not an issue, but could be an issue with respect to an individual taxpayer where the legislation seeks to overrule *a final* judicial decision with respect to the taxpayer for the specific tax years litigated
- Numerous state and federal cases speak to, including *Dot Foods* and *Gillette*

# Retroactive statutes; taxpayer benefit?

- Such statutes allow the legislature to make retroactive fixes that may inure to the benefit of certain classes of taxpayers. *Cf. Battaglia v. General Motors Corp.*, 169 F.2d 254 (2nd Cir. 1948), *cert. denied*, 335 U.S. 887 (1948) (upholding retroactive legislation that eliminated employee claims filed against private employers and the US Government; claims that were permitted by a prior US Supreme Court case)

# Retroactive statutes; taxpayer benefit?

- *Carlton* notion: when a statute is retroactively amended to prevent a significant revenue loss, the question of fairness is complex — and appropriate for legislative consideration — because, if the loss is not addressed through a retroactive statutory fix, the cost will ultimately be borne by taxpayers more generally, i.e., an “innocent” general public