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Taxpayer challenges to retroactive state tax legislation

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In this article, the authors summarize various state court decisions over the last 20 years in which taxpayers have challenged the retroactive application of tax legislation on due process grounds and highlight the taxpayer challenges posed by those decisions.

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If taxpayers were asked to name the most significant issue in state and local taxation, it may well be the lack of fairness created by the increasing trend of retroactive state tax legislation enacted by legislatures to neutralize the revenue impact of taxpayer-favorable court decisions. Nowhere has this trend been more evident than in the authors’ home state of Michigan, where the Legislature has consistently enacted retroactive tax legislation over the last 10 years after taxpayer-favorable litigation.1

This article hopes to demonstrate that for taxpayers seeking to challenge unfair retroactive tax legislation under the due process clause (the 14th Amendment of the U.S. Constitution requires due process of law before a person can be deprived of life, liberty, or property), the current body of state tax case law has trended in an unfavorable direction. This article will discuss the 1994 U.S. Supreme Court decision in United States v. Carlton,2 four successful state court taxpayer challenges to retroactive state legislation, and nine unsuccessful state court taxpayer challenges.3

It is not the goal of this article to delve too deeply into the legal analysis of each decision.4 Instead, it is to highlight the facts associated with each case to identify consistent patterns and lay out facts for taxpayers contemplating a challenge to consider. First, an overview of the 1994 U.S. Supreme Court decision in Carlton.

I. The Carlton Decision

A. United States v. Carlton

In Carlton, the taxpayer challenged Congress’s December 1987 amendment to IRC section 2057. The amendment retroactively added new requirements for an estate tax deduction for the proceeds of sales of stock to an employee stock ownership plan. In response to the pre-amendment version of IRC section 2057 that had become effective in October 1986, the taxpayer, an executor for a decedent who had died in 1985, had purchased and sold stock to a corporate ESOP in December 1986, and then claimed an IRC section 2057 deduction for half of the proceeds on the estate’s 1985 federal tax return. In February 1987 a bill was introduced, and in December 1987 Congress amended IRC section 2057 to require that the securities sold to an ESOP have been directly owned by the decedent immediately before death. The amendment was retroactive to October 1986.

In considering whether the retroactive effect of the amendment violated the due process clause of the U.S. Constitution,5 Justice Harry Blackmun, writing for a six-member majority, noted that "the validity of a retroactive tax


3While the taxpayer wins and losses are laid out chronologically, the three recent Michigan court decisions will be discussed as a group at the end of the loss category.

4While other arguments have been raised in many of those cases by taxpayers challenging the impact of retroactive tax legislation (for example, violation of state constitutional rights or violation of separation of powers), full consideration of those issues is outside the scope of this article.

5Carlton, 512 U.S. 26 at 30. At the appellate level, the Ninth Circuit Court of Appeals considered two factors in assessing the taxpayer’s constitutional challenge: (1) whether the taxpayer had actual or constructive notice that the tax statute would be retroactively amended, and (2) whether the taxpayer reasonably relied to his detriment on pre-amendment law.
provision under the Due Process Clause depends upon whether ‘retroactive application is so harsh and oppressive as to transgress the constitutional limitation.’”6 Stating that this “harsh and oppressive” standard is the same standard generally applied to measure the constitutionality of retroactive economic legislation, the Supreme Court held that this standard is met by showing that the “retroactive application of a statute is supported by a legitimate purpose furthered by rational means.”7 In the Court’s opinion, the first part of this test was satisfied because Congress “acted to correct what it reasonably viewed as a mistake in the original 1986 provision that would have created a significant and unanticipated revenue loss.”8 The Supreme Court noted the testimony of then-Sen. Lloyd Bentsen, who observed on the introduction of the amendment that “Congress certainly did not anticipate a $7 billion revenue loss,” which was more than 20 times the anticipated $300 million revenue loss when IRC section 2057 was enacted.9

In analyzing the rational means portion of the test, the Supreme Court held that “Congress acted promptly and established only a modest period of retroactivity.”10 Since the amendment to section 2057 had been proposed within a few months of the October 1986 effective date of the provision and was enacted by December 1987, the Supreme Court stated that the retroactive effect of the amendment was a “modest period of retroactivity” because it “extended for a period only slightly greater than one year.”11 While the Court agreed that the taxpayer had detrimentally relied on IRC section 2057 before the amendment, by engaging in a transaction to purchase and sell stock to an ESOP before IRC section 2057 before the amendment, by engaging in a transaction to purchase and sell stock to an ESOP before

In her concurring opinion, Justice Sandra Day O’Connor acknowledged that Congress’s enactment of retroactive legislation to eliminate the benefit of this deduction was properly evaluated for due process purposes based on whether the statute was supported by a “‘legitimate legislative purpose furthered by rational means.”14 Relative to the first part of the test, O’Connor noted:

“Although there is also an element of arbitrariness in retroactively changing the rate of tax to which the transaction is subject, or the availability of a deduction for engaging in that transaction, our cases have recognized that Congress must be able to make such adjustments in an attempt to equalize actual revenue and projected budgetary requirements.15

Stating that Congress does not have unlimited power to disturb settled expectations, however, O’Connor expressed her view that “the governmental interest in revising the tax laws must at some point give way to the taxpayer’s interest in finality and repose.”16 In this context, O’Connor noted that in cases upholding a retroactive federal tax statute against a due process challenge, the law applied retroactively for a “relatively short period.” In her opinion, a “period of retroactivity longer than the year preceding the legislative session in which the law was enacted would raise, in my view, serious constitutional questions.”17

For more than 20 years, Carlton’s “legitimate purpose furthered by rational means” test has been the federal due process standard by which state courts have measured the constitutionality of retroactive state tax legislation. And O’Connor’s concurrence has consistently been cited (though not necessarily in a manner favorable for taxpayers) when state courts have considered whether the period of retroactivity is “modest.” Next, we will turn to the notable retroactive state tax cases over the last 20 years. Against this backdrop, patterns in the retroactive tax legislation scenarios may suggest why, unfortunately, most taxpayer challenges to retroactive tax legislation have failed.

II. Successful Taxpayer Challenges

A. Rivers v. South Carolina

Rivers v. South Carolina18 involved a challenge to the South Carolina General Assembly’s 1991 statutory amendment that eliminated the second half of a capital gains tax overpayment refund. Legislation enacted in June 1988 had

6Carlton, 512 U.S. 26 at 30 (quoting Welch v. Henry, 305 U.S. 134 (1938)).
7Id. at 30-31 (quoting Pension Benefit Guaranty Corporation v. R. A. Gray & Co., 467 U.S. 717, 729-30 (1984)).
8Carlton, 512 U.S. 26 at 32.
9Id. at 32 (citing 133 Cong. Rec. 4145, 4294).
10Id.
11Id. at 33.
12Id.
13Id. (citing Welch, 305 U.S. 134).

14Id. at 36 (quoting General Motors Corp. v. Romein, 503 U.S. 181, 191 (1992)).
15Id. at 38.
16Id. at 37.
17Id. In a separate concurring opinion, Justice Antonin Scalia (joined by Justice Clarence Thomas) commented, “the Due Process Clause does not prevent retroactive taxes, since I believe that the Due Process Clause guarantees no substantive rights, but only (as it says) process.”
1890 S.E.2d 261 (S.C. 1997).
initially provided for a retroactive decrease in the capital gains tax (CGT) rate for capital gains realized between January 1, 1987, and January 31, 1988. A 1989 amendment limited the scope of the retroactive rate reduction to capital gains realized before June 22, 1987, and provided that any refund would be made in two equal installments, with the first installment paid when refunds were issued for the 1990 tax year and the second half paid when refunds were issued for the 1991 tax year. Taxpayers received the first half of their CGT overpayment refund; however, in 1991 the General Assembly enacted 1991 S.C. Acts 171, which altered the 1989 amendment and reduced each taxpayer’s refund by half and thus effectively eliminated the second half of their CGT overpayment refund.

The South Carolina Supreme Court initially rejected the taxpayers’ argument that Act 171 amounted to an unconstitutional taking because “ordinary takings law . . . does not apply in the context of taxing legislation,” and the taxpayers had no vested interest in the tax refund. Citing Carlton, the court noted that “tax legislation is not a promise, and a taxpayer has no vested right in the Internal Revenue Code.” The court concluded that at most “all Taxpayers may have had was a ‘settled expectation’ they would receive the refund.”

Turning to whether retroactive application of Act 171 otherwise satisfied due process, the court considered whether the period of retroactivity was “modest.” After a fairly lengthy recap of Carlton and O’Connor’s concurrence, the court noted that “the retroactivity of Act 171 far exceeds one year. In fact, depending on whether one calculates the retroactivity period back to the 1989 Amendment or to Act 658 of 1988, the period at issue is at least two years and possibly as long as three years.” In considering whether this period of retroactivity violated the due process clauses of the U.S. and South Carolina constitutions, the South Carolina Supreme Court outlined the interests that must be balanced when weighing retroactive tax legislation, stating:

The government possesses considerable power to tax and . . . collect taxes from its citizenry, and retroactive tax legislation has long been accepted as an appropriate means for achieving certain revenue goals. At some point, however, the government’s interest in meeting its revenue requirements must yield to taxpayers’ interest in finality regarding tax liabilities and credits.

The court held that that point had been reached in this case and that “under the facts and circumstances here, the retroactivity period is simply excessive.” As a result, Act 171 was held to violate the due process clause.

B. City of Modesto v. National Med Inc.

National Med Inc. (NMI) challenged the constitutionality of Modesto, California’s 2002 amendments to its business license tax ordinance and the city council’s 2003 guidelines (which were amended in 2004 to implement the amendments made to the ordinance). The amended ordinance and guidelines sought to retroactively apply an apportionment method to the taxpayer’s computation of its business license tax liability for the tax years 1996 through 2000. NMI had initially prepared its 1996 through 2000 business license tax return by making adjustments to reduce gross receipts because of the lack of any prescribed apportionment method. An audit in 2000 determined that NMI had made inappropriate gross receipts adjustments, which understated its tax. An administrative hearing was held in January 2001, and the finance director later issued a decision disallowing NMI’s gross receipts adjustments. NMI challenged this determination, and in October 2002 a trial court ruled in favor of NMI on the basis that the Modesto business license tax was unconstitutional because it lacked an apportionment provision.

Before the trial court’s adjudication of NMI’s appeal, Modesto amended its business license tax ordinance in August 2002 and directed the city council to adopt apportionment guidelines or the finance director to issue regulations. In September 2003 the city enacted a resolution adopting detailed apportionment guidelines, and in August 2004 the city amended the apportionment guidelines to make them applicable “to pending claims by the City for underpayment of tax.”

In considering whether the retroactive effect of the city’s amendment violated the taxpayers’ due process rights, the California Court of Appeal, Fifth District, quoting Carlton, stated that to “comply with due process, retroactive application of tax legislation must be supported by a legitimate legislative purpose furthered by rational means.” The court determined that the amendment was “clearly legitimate” because it was necessary to cure the constitutional defects.

However, retroactive application of the tax legislation did not meet the second part of the Carlton test because Modesto “did not act promptly” in the court’s opinion because NMI had first claimed in February 2000 that the business license tax was unlawful, and it took the city more than four years to provide a specific apportionment method.

19 Id. at 263.
20 Id.
21 Id.
22 Id. at 264.
23 Id. at 265.
24 Id.
25 Id.
27 Id. at 524.
28 Id. at 528.
29 Id.
that could apply to NMI with retroactive effect. Citing O’Connor’s concurrence in *Carlton*, the court also held that the application of the 2004 guidelines to the 1996 through the 2000 tax years, “up to eight years before those guidelines were adopted,” was not “modest.” It also determined that requiring NMI to produce documentation from up to nine years ago — documentation that NMI was otherwise not required to maintain — would place an unreasonable and unfair burden on the company, which reinforced that the retroactive application of the 2004 amendments violated the due process clause.

**C. NetJets Aviation Inc. v. Guillory**

*NetJets Aviation Inc. v. Guillory* involved a challenge to the California State Legislature’s 2007 enactment of SB 87, which assessed a personal property tax on fractionally owned aircrafts. That legislation stemmed from the Los Angeles County Assessor’s 2006 inquiry into whether fractionally owned aircraft were considered personal property subject to California’s personal property tax. This led to a determination by the State Board of Equalization that the aircraft could be taxable in California, but without a determination whether any individual aircraft had acquired a taxable situs in the state. In 2007 the Legislature enacted SB 87, extending personal property taxation to fractionally owned aircraft, and subsequently, local assessors began issuing property tax assessments, retroactive to January 1, 2002, to managers that controlled fractionally owned aircraft.

Regarding the taxpayers’ claim that the retroactive enactment of SB 87 violated their due process rights, the California Court of Appeal, Fourth District, cited *Carlton* to explain that “an amendment to a tax statute ‘adopted as a curative measure’ could potentially be applied retroactively, while a ‘wholly new tax’ may not be applied retroactively under any circumstances.” Because SB 87 materially changed California’s personal property tax laws by capturing personal property tax on fractionally owned aircraft not previously assessed and because no notice was given of a potential assessment, SB 87 could not have served as a mere clarification and was instead a “wholly new tax.”

The court distinguished this decision from other California and federal decisions that upheld retroactive application of tax legislation that limited or eliminated a deduction, as in *Carlton and River Garden Retirement Home v. Franchise Tax Board* or changed a tax rate, as in *United States v. Darusmont*. Upon concluding that SB 87 was a wholly new tax, the court determined that a “new tax assessment imposed by the Legislation may not constitutionally be applied retroactively.”

**D. James Square Associates LP v. Mullen**

The taxpayers in *James Square Associates LP v. Mullen* challenged the New York Legislature’s 2009 amendments to Gen. Mun. section 959, which added two new criteria to New York state’s economic development zones act (EZ program). A later amendment in August 2010 provided that decertifications under the additional EZ eligibility requirements added by the 2009 legislation were effective as of January 1, 2008. Following those amendments, the Department of Economic Development decertified taxpayers effective January 1, 2008, that did not satisfy one or both of the additional eligibility requirements enacted by section 959.

In considering whether the retroactive effect of the 2009 amendments was unconstitutional, the New York Court of Appeals rejected the taxpayers’ initial contention that their obligation to pay the tax, on the retroactive elimination of the tax credit under section 959, was a vested property right that would give rise to an unlawful taking or seizure of property under the takings clause of the Fifth Amendment to the U.S. Constitution. The New York Court of Appeals noted:

The test for whether a retroactive tax violates the Due Process Clause is different from the test for whether a retroactive tax is an unconstitutional taking. An aggrieved taxpayer may choose to make a claim that a retroactive tax violates the Due Process Clause under the standards in *United States v Carlton* (512 U.S. 26 [1994]) and our precedent in *Replan*... The taxpayer additionally may choose to challenge the statute under the Takings Clause, but must recognize that it is more difficult to prove that the tax amounted to ‘flagrant abuse’ and the seizure of property.

Turning to the multifactor balancing of equities test established in *Matter of Replan Development v. Department of Housing Preservation and Development of City of New York*, the court stated that the multifactor balancing of equities test is focused on fairness and the “important factors in determining whether a retroactive tax transgresses the constitutional limitation are 1) ‘the taxpayer’s forwarning of a change in the legislation and the reasonableness of [ ] reliance on the old law,’ 2) ‘the length of the retroactive period,’

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30 Id.
31 Id. at 529.
32 Id.
34 Id. at 57.
35 Id. The court also looked to the depositions, legislative analysis, and legislative history, which further reinforced its conclusion that SB 87 was a “new law that creates a new method for assessing taxes on a specific type of personal property.”
40 Id. at 380-381.
41 Id.
42 Id.
and 3) ‘the public purpose for retroactive application.’”\textsuperscript{43} Regarding the first factor, the court of appeals observed that the affected taxpayers had reasonably relied on the economic development zones as enacted, as they ‘appeared to have conducted their business affairs in a manner consistent with existing Program requirements . . . justifiably relying on the receipt of the tax benefits that were then in effect,”\textsuperscript{44} and that the taxpayers “had no warning and no opportunity at any time in 2008 to alter their behavior in anticipation of the impact of the 2009 Amendments.”\textsuperscript{45}

Relative to the second factor, the period of retroactivity, the court held that regardless of whether the period was deemed to span 16 or 32 months, it was excessive, given that it exceeded one year and in light of taxpayers’ detrimental reliance.\textsuperscript{46} Finally, with regard to the third factor, the court concluded that retroactive application of the 2009 amendments neither sought to “correct an error in the tax code as in Carlton”\textsuperscript{47} nor addressed an unexpected revenue loss. Therefore, the court determined that the legislative goal of stemming perceived abuses in the EZ program was not a legitimate public purpose to warrant the changes to be applied retroactively. Ultimately, the New York Court of Appeals ruled that the 2009 amendments to section 959 could not be applied retroactively.\textsuperscript{48}

E. Taxpayer Victory Factor

Before reviewing unsuccessful taxpayer challenges, it is worth recapping the significant factual commonalities in the four successful taxpayer due process challenges described above. Significantly, in each of the cases, little or no dispute existed before the retroactive tax amendment about the taxpayers’ expectations of how the operative pre-amendment tax law would affect them. In Rivers, taxpayers expected to be paid the second half of their 1987 refunds; in City of Modesto, the taxpayer expected that absence of an apportionment mechanism would be unlikely to completely invalidate the constitutionality of a local business license tax, and instead applied its own method to calculate its taxable in-city gross receipts; in Netjets, taxpayers expected that fractional aircraft ownership was not subject to personal property tax; and in James Square, taxpayers expected eligibility for the 2008 EZ credit to be satisfied absent application of either a 1:1 benefits-cost test and notwithstanding any so-called shirt-changing activities. While not openly acknowledged in every instance, it would appear that this overall “settled expectations” profile was essential in establishing a favorable scenario under which a state court subsequently determined that retroactive tax legislation violated Carlton.

And with these favorable initial scenarios established, the determinative elements that led to the taxpayers’ successful due process challenges can be summarized as follows:

- **Rivers.** Period of retroactivity exceeded the “one-year” standard of modesty as advocated in O’Connor’s Carlton concurrence.
- **City of Modesto.** In light of the four years between when taxpayer challenged the business licenses tax as unlawful (owing to the lack of apportionment provisions) and the city’s adoption of apportionment guidelines, the city failed to act promptly in promulgating apportionment guidelines. The fact that the taxpayer was not seeking a refund, but was instead seeking to have the apportionment methodology applied on its originally filed returns upheld, may also have weighed against a determination that the city’s efforts were sufficiently prompt. Some level of operational and detrimental reliance would also have fallen on taxpayers having to dig up old documentation.
- **James Square.** The taxpayer’s inability to adjust its activities in response to the retroactive application of the more stringent credit eligibility requirements demonstrated actual detrimental reliance more than otherwise would be reasonable with other types of retroactive tax legislation. Also, the legislative goal of eliminating perceived abuses in those seeking to qualify for the EZ credit, while laudable, was not a legitimate reason to justify retroactive application of the amendment.
- **Netjets.** Retroactive levy of the personal property tax to fractional aircraft ownership was construed as a “wholly new tax,” for which any retroactive application is void.

One additional point should be noted. For better or worse, the taxpayer success in the four cases did not turn on the existence of a vested right that potentially gave rise to an unlawful taking for which no retroactivity is permissible. In fact, the courts in Rivers and James Square opined that a refund claim is not a “vested right,” and at most, the taxpayer has a “settled expectation” that a refund claim will be paid.\textsuperscript{49}

Absent a determination that the retroactive application constitutes a wholly new tax, taxpayers should expect that the constitutionality of retroactive tax application will be measured for due process purposes solely based on whether the retroactivity is (1) supported by a legitimate legislative

\textsuperscript{43}Id. at 380 (quoting Matter of Replan Dev. v. Dept’ of Hous. Preserv. & Dev. of City of N.Y., 517 N.E.2d 200 (N.Y. 1987)).
\textsuperscript{44}Id. at 382.
\textsuperscript{45}Id.
\textsuperscript{46}Id. at 383.
\textsuperscript{47}Id. at 383.
\textsuperscript{48}Id.

\textsuperscript{49}It is worth noting that arguments based on state constitutional provision may provide a grounds for challenges to retroactive tax legislation and could potentially provide a more taxpayer-favorable standard (for example, relative to the characterization of a vested right) by which to evaluate retroactive tax legislation.
purpose, and (2) furthered by a rational means that involves a consideration of whether the legislature acted promptly and the period of retroactivity is modest. In the following cases, the reader should consider whether the state courts have addressed the second factor appropriately.

III. Unsuccessful Taxpayer Challenges

A. Monroe v. Valhalla Cemetery Company Inc.

This case involved a taxpayer’s due process challenge to the Alabama Legislature’s amendment to Ala. Code section 40-23-62 that retroactively prevented taxpayers from seeking a refund for use tax overpayment on goods they bought from out-of-state sellers and then had delivered to Alabama.\(^{50}\) A series of Alabama lower court rulings and administrative law judge rulings from 1987 through January 1997 had held that Alabama use tax could not be charged on goods purchased from out-of-state vendors and delivered into Alabama if Alabama sales tax could not be collected from the vendor.

After national media attention stemming from the January 1997 ruling “alerting taxpayers of a possible loophole,” Alabama enacted Act No. 97-301 in May 1997 amending section 40-23-62 “retroactive for all open tax years” and clarifying that current tax law exempts from use tax only that property sold at retail in Alabama on which sales tax was paid.\(^{51}\)

Valhalla had originally paid use tax from April 1994 through March 1997 on goods purchased from out-of-state vendors that did not have nexus with Alabama. Valhalla filed a complaint seeking a use tax refund immediately after the enactment of Act 97-301 on the basis that the statute’s retroactive effect violated its due process rights.\(^{52}\) The Alabama Court of Civil Appeals, citing\(^{53}\) Carlton, determined that “the legislative purpose of Act No. 97-301 was ‘neither illegitimate nor arbitrary’ or based on an improper motive.”\(^{54}\) Because Act 97-301 clarified the ambiguous interpretations of section 40-23-62, specifically, “to close a perceived loophole in Alabama’s sales and use-tax statutes,”\(^{55}\) the court found that “the retroactive provision of Act No. 97-301 [was] justified by a rational legislative purpose.”\(^{56}\) In holding that two- to three-year period of retroactivity application was modest, the court distinguished cases such as Rivers, in which a similar period of retroactivity was deemed excessive.\(^{57}\) Quoting Rivers for the premise that in “some instances, a lengthy period of retroactivity may be necessary to accomplish certain legitimate legislative ends,” the court pointedly noted that Valhalla had filed its complaint seeking a refund claim “the day after the enactment of Act No. 97-301.”\(^{58}\)

B. Enterprise Leasing Co. of Phoenix v. Arizona Department of Revenue

In Enterprise Leasing Co. of Phoenix v. Arizona Department of Revenue,\(^{59}\) taxpayers challenged, on due process grounds, the Arizona Legislature’s enactment of SB 1504, which amended a pollution control credit statute to exclude personal property attached to a motor vehicle. Originally effective on January 1, 1995, the credit provision in A.R.S. section 43-1170 was silent about whether it was available for equipment attached to motor vehicles. In December 1999 the Arizona Department of Revenue received its first claim for a pollution control credit for equipment attached to a motor vehicle. Stating an amendment was necessary “to close loopholes” and because of a potential annual revenue cost of $15 million compared with the original estimate of $2.5 million,\(^{60}\) the Legislature enacted SB 1504 in April 2000 and provided that it was retroactive to tax years beginning on or after December 31, 1994. The taxpayer filed amended returns in March 2000 seeking refunds for pollution control devices under A.R.S. section 43-1170.

In considering whether SB 1504’s retroactive effect violated the taxpayer’s due process rights, the Arizona Court of Appeals initially addressed the difference between a wholly new tax and a clarification of a previously enacted statute. The court stated that the “legislative branch has the power to explain a statute and ensure that it is not extended beyond its intended reach. It may clarify the statute by amendment if the statute is ambiguous.”\(^{61}\) The court noted that one indicator of “whether a statute is truly curative is whether the Legislature has provided specific guidance about the meaning of the amendment.”\(^{62}\) SB 1504 clarified Arizona’s pollution control credit because the original statute did not provide for the credit for equipment integrated into a motor vehicle and, in the court’s opinion, the Legislature had “stated that the revisions were intended to be ‘clarifying changes and are consistent with the Legislature’s intent when those sections were enacted.’”\(^{63}\)

Noting that “curative statutes are generally not found to violate due process on retroactivity grounds,”\(^{64}\) the Arizona Court of Appeals rejected the taxpayer’s claim that its rights vested because it filed a refund claim and stated that “a taxpayer’s right does not vest merely by filing a claim. The

\(^{50}\) Monroe v. Valhalla Cemetery Co. Inc., 749 So. 2d 470 (Ala. 1999).

\(^{51}\) Id. at 472.

\(^{52}\) Id. at 474.

\(^{53}\) Id. at 475.

\(^{54}\) Id.

\(^{55}\) Id.

\(^{56}\) Id.


\(^{58}\) Id. at 3.

\(^{59}\) Id. at 4.

\(^{60}\) Id.

\(^{61}\) Id.

\(^{62}\) Id.
department must verify or accept the claim before vesting can occur and neither occurred in this instance.63

The court also found that the taxpayer did not demonstrate any detrimental reliance on the pollution control credit as it "waited to apply [for a refund] until after the clarifying legislation was introduced and one month before the amendment was signed."64 Even if the taxpayer had demonstrated its claimed detrimental reliance on the credit, the court, quoting Carlton, stated, "reliance alone is insufficient to establish a constitutional violation."65 Noting that the amendment forestalls "an unplanned loss estimated at $15 million per year,"66 the court held this goal to be legitimate and rationally furthered by the legislation.

The court of appeals then considered whether the amendment’s five-year-plus period of retroactivity application was sufficiently modest. Noting that "O'Connor's concurrence in Carlton was not the majority opinion,"67 the court rejected any per se one-year test and said that the Carlton test provides "some leeway for a longer retroactivity so long as the Legislature acts at the earliest notice or opportunity."68 In this light, and when considering that the statute was amended in April 2000, less than one year after Arizona had received its initial pollution control refund for motor vehicles, the period of retroactivity was held to not violate due process.

C. Miller v. Johnson Controls Inc.

In this case, taxpayers challenged a 2000 Kentucky General Assembly amendment to KRS section 141.120, which prohibited the filing of combined business tax returns under the unitary business concept and eliminated refund requests arising out of the filing of a combined business tax return.69 The 2000 amendment, and a 1996 amendment, followed the 1994 Kentucky Supreme Court decision in GTE v. Revenue Cabinet Commonwealth of Kentucky,70 in which the court held that related groups of corporations could file a Kentucky combined corporate income tax return under the unitary business concept pursuant to KRS 141.120. The GTE litigation was a response to the Kentucky Revenue Cabinet’s issuance of Revenue Policy 41P225, which interpreted KRS 141.120 to provide that only separate returns could be filed beginning in 1988. For 16 years before 1988, the Kentucky Revenue Cabinet had allowed qualified businesses to choose whether to file separate returns or a combined return under the unitary business concept.

After the 1994 GTE decision and before the enactment of amendments to KRS 141.120, the taxpayers in Johnson Controls filed amended returns under the unitary business concept requesting a refund for overpaid business taxes. In 1996, in its initial response to GTE, the Kentucky General Assembly amended KRS 141.120, effective for tax years beginning on or after December 31, 1995, to clarify that nothing in the statute should be construed as allowing or requiring a combined return under the unitary business concept, and including language providing that affiliated groups could file consolidated returns.

After the 1996 amendment, the Kentucky Revenue Cabinet realized that refund claims based on GTE were creating substantial refund liabilities for tax years before 1995. In the 1998 budget bill, the General Assembly included a provision barring the payment of any refunds based on GTE, and in 2000 the legislature amended section 141.120 to expressly preclude a claim for refund for tax years before December 31, 1995, based on a change from a separate return to a combined unitary return.

In considering the taxpayer’s claim that the retroactively effective amendments violated its due process rights, the Kentucky Supreme Court applied Carlton.71 The court initially rejected the taxpayer’s assertion that its refund claims, based on GTE, created a property interest for which the 2000 amendment amounted to an unconstitutional taking. The court quoted Carlton for the rule that “a taxpayer has no vested right in the Internal Revenue Code” and added that taxpayers also have no vested right in the Kentucky Revenue Code.72 Absent a substantive due process right that prevents the retroactive application of tax law, the court wrote that the retroactive application “need only be (1) supported by a legitimate legislative purpose, (2) furthered by rational means which includes a modesty requirement”73 to satisfy Carlton. The court held that the first part of the test was met because the 2000 amendment was rationally related to a legitimate legislative purpose when the General Assembly enacted the amendment to “correct what it viewed as a mistake in GTE’s interpretation of the law.”74 The court further found that raising and controlling revenue by halting a significant and unanticipated revenue loss was a legitimate legislative purpose.75

Relative to the retroactivity period, the court initially noted that “eight of the nine justices [in Carlton] viewed what may ‘rationally further’ a legitimate governmental interest as being broader than the one year that only Justice O’Connor would impose as a ‘modesty’ measure.”76 The court then cited the 1996 Ninth Circuit in Montana Rail, in which the court upheld a seven-year period of retroactivity

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63 Id. at 5.
64 Id.
65 Id. at 7 (quoting Carlton, 512 U.S. at 33).
66 Id. at 5.
67 Id. at 6.
68 Id.
69 Miller v. Johnson Controls Inc., 296 S.W.3d 392 (Ky. 2009).
70 889 S.W.2d 788 (Ky. 1994).
71 Johnson Controls, 296 S.W.3d at 397.
72 Id.
73 Id. at 399.
74 Id. at 400.
75 Id.
76 Id. at 399.
77 Id.
was upheld in railroad retirement tax compensation matter.\textsuperscript{78} Based on \textit{Carlton} and \textit{Montana Rail}, the court rejected any one-year “modesty requirement.”\textsuperscript{79} Significantly, the court stated that the taxpayers “had been on notice of the revenue intent from 1988 when RP 41P225 was issued until 1994 when \textit{GTE} was decided, and could not have had any ‘settled expectations’ to the contrary.”\textsuperscript{80} And, while “due process is certainly a constitutionally protected right, it is detrimental reliance.”\textsuperscript{81} Ultimately, the lengthy period of retroactivity was upheld.

Interestingly, the Kentucky Supreme Court stated that the retroactive element of the 2000 legislation was enacted with “reasonable diligence”\textsuperscript{82} to address the potential revenue loss because “history tells us that often the development of law based on the holdings in cases takes time to go through process before the clear impact can be seen.”\textsuperscript{83} This may well have been an attempt to reconcile the General Assembly’s initial 1996 amendment to KRS 141.120, which lacked a retroactive element, with \textit{Carlton’s} suggestion that the modesty of retroactive legislation requires consideration of whether prompt legislative action was taken to address the element of the statute triggering the unexpected revenue loss.

\textbf{D. Zaber v. City of Dubuque}

In \textit{Zaber v. City of Dubuque},\textsuperscript{84} the taxpayers challenged the constitutionality of the Iowa General Assembly’s enactment of Iowa Code section 477A.7 in 2007, which retroactively ratified the ability of a municipality to assess and collect franchise fees paid for cable television services. That legislation stemmed from the Iowa Supreme Court’s 2006 decision in \textit{Kragnes v. City of Des Moines},\textsuperscript{85} which held that franchise fees assessed by Des Moines on gas and electric power services constituted an illegal tax to the extent the fees exceeded the reasonable costs of regulating the franchised activity. Pending the Iowa General Assembly’s enactment of section 477A.7, the taxpayer sued Dubuque, claiming that it had collected illegal taxes from him and other similarly situated taxpayers in the form of franchise fees for cable television services and other utility services, as determined in \textit{Kragnes}. The city denied the taxpayers refund requests based on the enactment of section 477A.7.

In addressing the taxpayers’ claim that section 477A.7 violated their due process rights, the Iowa Supreme Court initially stated that the taxpayers’ “right to a refund is not a fundamental right, and therefore, there need only be a ‘reasonable fit’ between the legislature’s purpose in ratifying the past imposition of franchise fees and the means chosen to advance that purpose.”\textsuperscript{86} The court next held that section 477A.7 was curative in nature, rather than a wholly new tax. Stating that it “has long recognized the legislature’s power to cure defects in acts by local government that are undertaken without authority or without compliance with the requirements for exercising authority,”\textsuperscript{87} the court found that it does not “make a distinction between legislation that attempts to cure the acts of officers void for informality or mistake and legislation that seeks to legalize official acts void for want of authority.”\textsuperscript{88} Because the Iowa Constitution grants municipalities the authority to levy taxes if expressly authorized by the General Assembly, the General Assembly “had the power to validate unauthorized taxes imposed prior to the enactment of 477A.7.” Based on this logic, the Iowa Supreme Court concluded that 477A.7 was curative in nature.\textsuperscript{89} Attempting to further reinforce its conclusion that section 477A.7 did not enact a new tax, the court stated that “the legislature did not enact a new tax; it ratified a prior tax that had been assessed and collected for many years before the legislature’s authorization of the tax.”\textsuperscript{90}

Having concluded that section 477A.7 was not a wholly new tax, the Iowa Supreme Court stated that due process requirements are satisfied if the retroactive application of the legislation is justified by a rational legislative purpose.\textsuperscript{91} In this case, the need “to protect the financial stability of local municipalities”\textsuperscript{92} was a sufficient purpose. Interestingly, the court noted that situations in which a government agency has previously collected and spent money associated with an unauthorized tax revenue “provides a more compelling justification for retroactivity.”\textsuperscript{93}

Turning to the retroactivity period, the court rejected any per se one-year rule (citing \textit{Montana Rail, Enterprise Leasing, and Johnson Controls}, among others) and upheld the five- and-a-half-year retroactivity period of section 477A.7 as a “reasonable fit” with the legislative purpose to safeguard the financial stability of municipalities.\textsuperscript{94}

\begin{flushright}
\textsuperscript{78}Id. at 399-400 (citing \textit{Montana Rail Link Inc. v. United States}, 76 F.3d 991 (9th Cir. 1996)).
\textsuperscript{79}Id. at 400.
\textsuperscript{80}Id.
\textsuperscript{81}Id. at 401.
\textsuperscript{82}Id.
\textsuperscript{83}Id.
\textsuperscript{84}Zaber v. City of Dubuque, 789 N.W.2d at 640 (citing \textit{Home Builders As’n of Greater Des Moines v. City of W. Des Moines}, 644 N.W.2d 339 (Iowa 2002)).
\textsuperscript{85}Id. at 640-641.
\textsuperscript{86}Id. at 641.
\textsuperscript{87}Id. at 642.
\textsuperscript{88}Id. at 645. Having acknowledged that the municipal collection was initially unauthorized, the due process distinction drawn by the Zaber court between “ratification of a past tax” and “retroactive imposition of a new tax” may be questionable. In both instances, no statutory authority existed to levy the tax during the time period at issue.
\textsuperscript{89}Id.
\textsuperscript{90}Id.
\textsuperscript{91}Id. at 646.
\textsuperscript{92}Id. at 654-655.
\end{flushright}
E. In re Estate of Hambleton

In this case, the taxpayers challenged the constitutionality of the Washington Legislature’s 2013 amendment, retroactively effective to May 17, 2005, which broadened the interpretation of a “taxable transfer” under the state’s Estate and Transfer Tax Act (Act) to include some tax qualified terminable interest property assets when a spouse had died before the enactment of the Act.\(^95\) That legislation was in response to the Washington Supreme Court’s 2012 decision in In re Estate of Bracken,\(^96\) in which the court rejected regulations adopted by the Washington DOR that had sought to tax QTIP assets on the death of the surviving spouse (after the Act took effect).\(^97\) The taxpayer plaintiffs in Estate of Hambleton were estates in which the surviving spouses died in 2006 and 2007 respectively, and each estate had sought to exclude the QTIP property from its Washington tax estate return. In both instances, the state disallowed the QTIP deduction, and ultimately each matter was stayed on appeal pending the outcome in Bracken.

In addressing the taxpayers’ due process claim, the Washington Supreme Court stated that the rational basis standard is measured by whether the “legislature has a legitimate purpose for the retroactive amendment, and the period of retroactivity is rationally related to that purpose.”\(^98\) Citing Carlton for the standard that “preventing unanticipated and significant fiscal shortfall is a legitimate purpose,”\(^99\) the court held that “like the legitimate purpose in Carlton, the purpose of the 2013 amendment is largely economic.”\(^100\) The court cited with approval the DOR fiscal note to the 2013 amendment, noting that the legislation was anticipated to:

increase revenues to the education legacy trust account by an estimated $118.4 million in Fiscal Year 2014. The estimated revenue increase reflects the retroactive clarifications of the definitions of “transfer” and “Washington taxable estate” to conform to the Department’s interpretation, thereby eliminating any refund claims resulting from the recent court decision, other than for the Estate of Bracken.\(^101\)

The court also found that the eight-year period of retroactivity was rationally related to preventing the fiscal short-

fall and cited other decisions, including Montana Rail and Enterprise Leasing, as support for this decision.\(^102\) In this regard, the court wrote:

The amendment applies to all estates since our State enacted the Act. This period of retroactivity is not arbitrary. However, any period less than eight years would be arbitrary. It would allow some estates to escape the tax while similarly situated estates would be subject to it. Additionally, the eight-year period of retroactivity is not far outside other retroactive periods that courts have accepted.\(^103\)

F. Caprio v. New York State Department of Taxation

Caprio v. New York State Department of Taxation,\(^104\) involved taxpayers’ challenge to the retroactive effect of the 2010 amendments to Tax Law section 632(a)(2), which were enacted by the New York Legislature following the New York State Tax Appeals Tribunal’s decision in Matter of Gabriel S. Baum,\(^105\) and the Division of Tax Appeals Administrative Law Judge Unit decision Matter of Mintz.\(^106\) In Matter of Baum, the tribunal held that the stock sale in question was in fact a stock sale for New York tax purposes (that is, nontaxable to nonresidents) notwithstanding an election by subchapter S shareholders under IRC section 338(h)(10) to treat their sale of stock as an asset sale of the S corporation. In Matter of Mintz, an ALJ held that nontresident shareholders of a New York S corporation did not realize New York-source income on their receipt of payments under an installment obligation that had previously been received by the S corporation in exchange for its assets and subsequently distributed to shareholders in exchange for their stock on the corporation’s liquidation.

The 2010 amendments to Tax Law section 632(a)(2) stated that if an S corporation distributed an installment obligation under IRC section 453(h)(1)(A), or if the S corporation shareholders made a deemed asset sale election under IRC section 338(h)(10), “any gain recognized on the receipt of payments from the installment obligation . . . [or] on the deemed asset sale for federal income tax purposes will be treated as New York source income.” The amendments were made retroactive to all tax years beginning on or after January 1, 2007, effectively creating a three-and-a-half-year period of retroactivity.

In 2007 the taxpayers in Caprio sold the stock of their subchapter S corporation in an IRC section 338(h)(10) deemed asset sale, for which they used the IRC section 453(h)(1)(A) installment method for federal income tax purposes. Taxpayers challenged the retroactive application

\(^95\) In re Estate of Hambleton, 335 P.3d 398 (Wash. 2014).
\(^96\) 290 P.3d 99 (Wash. 2012).
\(^97\) In re Estate of Hambleton, 335 P.3d at 403-404. The result of Bracken was that the state could not tax QTIP trusts by spouses dying before the 2005 enactment of the Act because the spouse did not make a state-specific QTIP election.
\(^98\) Id. at 409. The taxpayers also raised separation of powers, impairment of contract, and other Washington state constitutional challenges, each of which was rejected by the Washington Supreme Court.
\(^99\) Id. at 411.
\(^100\) Id.
\(^101\) Id.
\(^102\) Id.
\(^103\) Id.
\(^104\) 37 N.E.3d 707 (N.Y. 2015).
of 2010 amendments as unconstitutional, as applied to them, under the due process clauses of the U.S. and New York constitutions.

The New York Court of Appeals noted that whether a retroactive tax violates the due process clause is determined under the Carlton standards and the New York Court of Appeals’ balancing of equities test established in Replan and later applied in James Square. That test considers "(1) the taxpayers’ forewarning of a change in the legislation and the reasonableness of . . . reliance on the old law," (2) "the length of the retroactive period," and (3) "the public purpose for retroactive application."\(^{107}\) Quoting Carlton, the court reiterated that "lack of notice regarding an amendment and reliance upon even a correct reading of an original statute ‘is insufficient to establish a constitutional violation [because] [tax] legislation is not a promise, and a taxpayer has no vested right in the Internal Revenue Code.’"\(^{108}\)

According to the court, the taxpayers’ reading of the law at the time of the transaction in 2007 could not be deemed reasonable, stating:

Plaintiffs relied upon an untested interpretation of the prior law — unsupported by any actual experience, practice or professional advice — that is in conflict with the foundational purposes of S corporations, which permit shareholders to avoid paying corporate taxes by paying the taxes themselves, not to completely avoid paying any state taxes, as plaintiffs seek to do here. Acceptance of plaintiffs’ interpretation of the pre-amendment law would require that we discredit the legislative findings articulated in the amended statute that long-standing policies of DTF required taxpayers to pay proportionate state income taxes on deemed asset sale gains, whether or not they delayed reporting those gains through installment reporting.\(^{109}\)

Having failed to establish that Mintz and Baum correctly reflected New York’s pre-amendment policy regarding taxation of gain derived from installment obligations issued in connection with a deemed asset sale, the court also held that the remaining factors of the balancing of equities test favored upholding the retroactivity of the 2010 amendments.\(^{110}\) Regarding the length of the retroactivity period, the court determined that the curative nature of the amendment to correct an administrative error and avoid an unexpected loss of revenue, coupled with a period of retroactive application limited to open tax years, resulted in no due process violation. The court also held that the third factor of the balancing of equities test favored upholding the retroactive application of the 2010 amendment to Tax Law section 632(a)(2) because the State Legislature “was not acting merely to increase tax receipts, but to prevent unanticipated and unintended consequences arising from erroneous administrative determinations that were contrary to long-standing . . . policies.”\(^{111}\)

G. GMAC LLC v. Department of Treasury

GMAC LLC v. Department of Treasury\(^{112}\) involved taxpayers’ challenge to the Michigan Legislature’s enactment of 2007 Mich. P.A. 105 of the Michigan Sales Tax Act, which retroactively narrowed the scope of a bad debt deduction under MCL section 205.54i in response to the Michigan Court of Appeal’s 2006 decision in DaimlerChrysler Services North America LLC v. Department of Treasury.\(^{113}\) In DaimlerChrysler, the Michigan Court of Appeals held that DaimlerChrysler acted as the taxpayer in the transactions involving retail installment contracts with vehicle dealerships, and thus the company was entitled to recover overpayment of sales tax stemming from uncollectible bad debts associated with the installment contracts. Based on the outcome of DaimlerChrysler, the taxpayers filed an initial refund request on September 21, 2007, and a second refund request on December 20, 2007. On October 1, 2007, Michigan enacted P.A. 105, which retroactively amended MCL section 205.54i to exclude financing providers under the definition of a taxpayer as it applies to the bad debt provision.

Among its various challenges, the taxpayers alleged that the retroactive effect of P.A. 105 violated due process because taxpayers had accrued a vested right in the pre-amendment version of MCL section 205.54i.\(^{114}\) The Michigan Court of Appeals disagreed, stating:

A right cannot be considered a vested right, unless it is something more than such a mere expectation as may be based upon an anticipated continuance of the present general laws; it must have become a title, legal or equitable, to the present or future enjoyment of property, or to the present or future enforcement of a demand, or a legal exemption from a demand made by another.\(^{115}\)

Against this backdrop, the court stated that a “taxpayer does not have a vested right in a tax statute or in the continuance of any tax law,”\(^{116}\) and held that the taxpayers did not have a vested right in the continuance of MCL section 205.54i.\(^{117}\) After extensively recapping Carlton, the court further held that the seven-year retroactivity period did not violate Carlton’s “modest period of retroactivity”

\(^{107}\) Caprio, 37 N.E.3d at 713 (quoting James Square Associates, 993 N.E.2d at 380).
\(^{108}\) Id. (quoting Carlton, 512 U.S. at 33).
\(^{109}\) Id. at 714.
\(^{110}\) Id. at 716.

\(^{111}\) Id. at 717.
\(^{114}\) GMAC LLC, 781 N.W.2d at 318-319.
\(^{115}\) Id. at 319 (quoting Cusick v. Feldpausch, 243 N.W. 226, 226 (Mich. 1932)).
\(^{116}\) Id. (citing City of Detroit v. Walker, 520 N.W.2d 135, 145 (Mich. 1994)).
\(^{117}\) GMAC, 781 N.W.2d at 310 at 319.
limitation. Relative to the measurement period itself, the court stated that the company’s “reliance on the Carlton decision is misplaced” as it was “not challenging the retroactive amendment to MCL 205.54i” but instead “the Legislature’s disapproval and corrective action with regard to the DaimlerChrysler decision.”121

**H. General Motors Corp. v. Department of Treasury**

In _General Motors Corp. v. Department of Treasury_, taxpayers challenged the Michigan Legislature’s 2007 enactment of MCL section 205.94 of the Michigan Use Tax Act to deny a resale exemption for vehicles used by employees before sale. This legislation stemmed from the Michigan Supreme Court’s 2007 decision in _Betten Auto Center v. Department of Treasury_, affirming an appellate court holding that new car dealerships were exempt from remitting use tax on vehicles used before their resale. Pending the resolution of _Betten_, General Motors filed its first use tax refund request on August 25, 2006, for tax remitted from October 1, 1996, through March 26, 2002; GM filed its second use tax refund request on September 14, 2007, for tax remitted from March 26, 2002, through August 31, 2007. On October 1, 2007, the Michigan Legislature enacted P.A. 103, which retroactively amended MCL section 205.94 to deny a resale use tax exemption for vehicles used by employees before sale.

Considering whether the retroactive effect of P.A. 103 violated the taxpayer’s due process rights under _Carlton_, the Michigan Court of Appeals, quoting its due process analysis in _GMAC_, determined that GM’s use tax refund request was merely an expectation that its refund request might succeed based on _Betten_ but not a vested right in its refund request.122 The court stated that “GM’s claim rests on the theory that it held a vested [choice] in action — its refund claim — and relies on cases involving rights of action . . . But this case involves a tax — not a right of action.”123

The court next determined that the retroactive amendment satisfied the first _Carlton_ criterion for permissible retroactive tax legislation (that is, that the purpose was neither “illegitimate nor arbitrary”).124 In that regard, the court stated a “legislature’s action to mend a leak in the public treasury or tax revenue — whether created by poor drafting of legislation in the first instance or by a judicial decision with retroactive legislation has almost universally been recognized as ‘rationally related to a legitimate legislative purpose.’”125

The court then determined that the retroactive application of P.A. 103 satisfied the _Carlton_ modesty requirement, citing the Kentucky Supreme Court in _Johnson Controls for the premise that retroactivity period analysis is “determined on a case-by-case basis considering the totality of the facts and circumstances.”126 Using this test, the court determined that P.A. 103 did not create a wholly new tax,127 that GM did not act in reliance on the existence (or lack thereof) of the availability of the resale exemption for employee-used vehicles, that the Michigan Legislature responded promptly to _Betten_, and that the period of retroactivity was “nominal” as it applied to GM.128 Thus, the court ruled that the retroactive application of P.A. 103 satisfied due process requirements.129

**I. Gillette Commercial Operations North America & Subsidiaries v. Department of Treasury**

_Gillette_ involved taxpayers’ challenge to the enactment of 2014 Mich. P.A. 282, which retroactively rescinded Michigan’s membership in the Multistate Tax Compact (compact), effective to January 1, 2008.130 That legislation stemmed from the Michigan Supreme Court’s July 2014 decision in _IBM v. Department of Treasury_,131 which affirmed an appellate court holding that a taxpayer could elect to compute its Michigan business tax (MBT) liability for the 2008 tax year under the compact’s three-factor apportionment formula or the MBT’s sales-factor only apportionment formula. The Michigan Legislature subsequently enacted P.A. 282 on September 11, 2014, which retroactively repealed the compact effective January 1, 2008. Thus, taxpayers were required to calculate their MBT liability under its sales-factor only apportionment formula.

Gillette and other taxpayers challenged the retroactive effect of P.A. 282 and whether it violated their due process rights under the U.S. and Michigan constitutions.132 The Michigan Court of Appeals began its due process analysis by

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118 Id. at 320. In its opinion, the court noted that taxpayers’ brief acknowledged that “the prior version of MCL 205.54i was not the impetus for this lawsuit, but rather, ‘[plaintiffs] filed their sales tax refund claims based on the Court of Appeals’ 2006 decision in DaimlerChrysler.’”


120 731 N.W.2d 424 (Mich. 2007).

121 _General Motors_, 803 N.W.2d 698 at 709.

122 Id.

123 Id. at 709-710.

124 Id.

125 Id. at 711.

126 Id. at 712. In rejecting the amendment’s creation of a wholly new tax, the court noted that “GM never sought to contest its liability for the use taxes it paid for years until after the _Betten_ decision, which extended a hope that such a refund claim might be successful.”

127 Id. The Michigan Court of Appeals determined that five years, not necessarily the 11 years associated with the earliest year of GM’s initial refund request, was the period of retroactive effect.

128 _General Motors Corp._, 803 N.W.2d at 712.


130 852 N.W.2d 865 (Mich. 2014).

131 Plaintiffs also contended that P.A. 282 violated the contract clause of both the U.S. and Michigan constitutions, the separation of powers clause of the Michigan Constitution, and the commerce clause (Footnote continued on next page).
noting that both federal and state courts have “uniformly held that retroactive modification of tax statutes does not offend due process considerations so long as there is a legitimate legislative purpose that is furthered by a rational means” and that the existence of a vested right is necessary to establish a due process violation. Noting prior Michigan jurisprudence concerning retroactive tax legislation, the court reiterated that in order for a taxpayer to be vested, the “right must be more than a mere expectation based on the anticipated continuance of the present laws.”

Regarding the issue of whether the Michigan Legislature had a legitimate purpose to give retroactive effect to P.A. 282, the court held that this was satisfied based on the stated legislative goal of preventing a significant revenue loss associated with compact-based revenue claims, as well as the legislative motivation to correct a perceived misinterpretation of the application of the compact provisions of Michigan law. The court also determined that retroactive application of P.A. 282 was a rational means to further those legitimate purposes. Significant to this conclusion was the court’s determination that “no doubt” existed that the Legislature acted promptly to correct its error (measured relative to IBM), and that the “six and one-half year retroactive period was sufficiently modest relative to time frames of other retroactive legislation that have been upheld by Michigan courts, federal courts, and other state courts.” Interestingly, the court of appeals failed to address what due process significance, if any, should be given to the Legislature’s amendment to MCL section 205.581 in May 2011, which provided that beginning January 1, 2011, “a taxpayer subject to the Michigan Business Tax Act . . . shall not apportion or allocate” in accordance with the compact.

The appeals court also addressed the taxpayers’ contention that Michigan’s participation “under the Compact in the period from 2008 through 2010 by paying dues, voting, participating in the Commission leadership and meetings, and exchanging confidential taxpayer information,” demonstrated detrimental reliance on the compact and eliminated the possibility for retroactive repeal. The court rejected the taxpayers’ argument, stating that the taxpayers “failed to provide any law establishing the relevancy of such evidence, and since the statutory and constitutional issues raised are legal issues . . . we fail to see how Michigan’s participation in the Commission impacts the legal import of the statute.”

IV. Where Does This Leave Taxpayers?

What lessons can be deduced from these nine unsuccessful taxpayer cases (all but one decided in the last eight years) challenging the retroactive application of tax legislation on a due process basis? At the risk of overgeneralizing, it appears that the common factual theme exhibited in the four taxpayer wins and arguably missing from the nine taxpayer losses, is the existence of “settled expectations” (prior to the application of the retroactive statutory amendment) about how the pre-amendment law would affect the taxpayer. When a disputed interpretation has existed, however, state tax courts have consistently ruled that retroactive tax legislation will meet the Carlton test for a “legitimate legislative purpose furthered by a rational means,” regardless of how meritorious the taxpayer’s disputed position may have been found as borne out by the first legal challenge.

Against that backdrop, state courts can be expected to continue to hold that the anticipated revenue loss is a legitimate legislative purpose and that the retroactive period of the necessary amendment is otherwise modest so long as it directly relates to the potential period for which refunds will be paid out. Under such application of the legitimate purpose test, any retroactive tax amendment (of nearly any retroactivity period) to correct an interpretation dispute could conceivably survive due process challenge. This appears to strain the common understanding of the “modest period of retroactivity” approved of in Carlton.

While Carlton acknowledged that retroactive legislation seeking to address a significant and unanticipated revenue loss is a reasonable legislative purpose, it seems that the greatest issue in most of the recent state court rulings against taxpayers is a misreading of the Carlton due process requirement that the legislature “acted promptly” to address the perceived error or misinterpretation in the statute.

Both the majority and O’Connor’s Carlton concurrence favorably noted that Congress had amended the estate tax deduction at its earliest opportunity once the IRS and Congress were apprised of the flaw and potential revenue loss and that this occurred soon after its effective date.

Footnote continued on next page.

132Gillette, slip op. at 22 (citing Carlton). The court noted that a taxpayer’s reliance on a view of a law, “even a correct view of the law,” does not prevent the legislature from retroactively amending a law.
133Id. at 24.
134Id. Construing the taxpayer’s claims for refunds based on the IBM decision in a similar light, the court rejected the taxpayers’ contention that the “continuation of the Compact’s apportionment provision” rose to a vested right.
135Id. at 26.
136Id.
138Gillette at 27.
139Id.
140Arguably, a reading of the cases (for example, Valhalla, GM, and GMAC) may show that challenges to retroactive tax legislation are more readily rejected when the taxpayer challenging the retroactive application of the tax commenced its challenge by filing claims for refunds shortly after successful first litigation. O’Connor’s concurrence in Carlton noting that a “period of retroactivity longer than the year preceding the legislative session in which the law [to which the retroactive amendment applies] was enacted would raise, in my view, serious constitutional questions” has
Accordingly, one could argue that states should be held to the same standard, specifically one that requires the state revenue agency to ascertain (ideally, within a legislative session) whether taxpayers have identified a potential misinterpretation of the statute. Revenue agencies may be in a good position to identify trends based on filed returns as well as audit taxpayers to further elicit possible interpretations that conflict with purported legislative intent. Instances in which a revenue agency waits until the initial lead case has progressed through all levels of appeals and then the legislative branch enacts retroactive tax legislation could be subject to a due process challenge based on the idea expressed in O’Connor’s concurrence that the state’s interest in revising the tax law “must at some point give way to the taxpayer’s interest in finality and repose.”

The 2015 Gillette decision from the Michigan Court of Appeals may provide the best opportunity for the U.S. Supreme Court to revisit this due process issue. The notion that the Michigan Legislature acted at its “earliest opportunity” with the 2014 enactment of P.A. 282 repealing the compact election retroactive to January 1, 2008, could be subject to taxpayer challenge. The court failed to address how the Legislature’s actions in 2014 could be reconciled with its May 2011 amendment to the then-effective Michigan provisions that eliminated the compact election beginning January 1, 2011. Assuming that the DOR was on notice of the potential compact-based refund claims and the potentially significant refund payouts, the Legislature’s “earliest opportunity” response to this disputed issue was expressed in the May 2011 amendment (more than three years before IBM and the enactment of P.A. 282), clarifying and curing the compact election provision with a modest period of retroactivity to January 1, 2011. Any second bites of the apple more than three years later and after the IBM litigation upheld taxpayers’ original interpretation could be challenged as a due process matter. This type of case may be enough to generate the interest of the U.S. Supreme Court.

In the meantime, what can a taxpayer do, particularly if a dispute exists regarding the interpretation of a state tax statute? One consideration may be taking the lead on the litigation over the disputed interpretation and otherwise not having the dispute held in abeyance while the lead case plays itself out. While certainly no guarantee, a taxpayer with a favorable court ruling on the original dispute stands a better chance of challenging retroactive tax legislation, at least on a separation of powers-type argument. Recognizing that this may not be feasible or cost-effective, a second consideration may be to actively enlist taxpayer coalitions, state bars, accounting associations, and industry groups to try to head off retroactive legislation before it is introduced at the state capitol. State legislation to correct errors or uncertainty in a tax statute is often a laudable goal. Good tax policy seeks to limit inefficiencies and reward good actors — both taxpayers and revenue agencies. The retroactive application of curative legislation for an extended period solely to defeat the purported cost of refunds associated with taxpayer-favorable litigation (particularly years after the state revenue agency was aware of the potential issue) is susceptible to due process challenges. State revenue agencies should consider addressing tax disputes with taxpayers promptly and engaging in available curative avenues as expediently as possible.

As of the date of this article, the Michigan Supreme Court is considering the taxpayer’s application for leave to appeal. If the Michigan Supreme Court refuses to take the appeal, taxpayers potentially could petition the U.S. Supreme Court for a writ of certiorari. Unfortunately, Johnson Controls suggests that state legislatures do indeed receive a “second bite of the apple” regarding retroactive tax legislation if the extent of the potential revenue loss was arguably unclear at the time of the legislature’s first response to a taxpayer-favorable court decision.