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Retroactive Sales And Use Taxes Unconstitutional

Comptroller v. Glenn L. Martin Co.[1]

The plaintiff appellee, Martin, is the manufacturer of aircraft, aircraft parts, and missiles for use by the military. During the Korean War the Federal government engaged Martin to produce weapons to carry out its military operations. Because of its limited capital, Martin was unable to produce the aircraft in the desired quantities, so the contracts for production, two with the Navy and one with the Air Force, contained stipulations by which the govern-

[1] 216 Md. 235, 140 A. 2d 288 (1958); *cert. den.*

ment would furnish Martin with the equipment it had on hand. Those tools and equipment which could not be furnished by the government were to be acquired by Martin through its own expenditures. Under these so-called facilities contracts, all equipment was immediately, upon delivery to Martin, to become the property of the government. The government was to reimburse Martin, and the appellee was to use all such tools and equipment without cost to produce the weapons. The Air Force contract provided for government payment of all legally assessed taxes with respect to the purchases made by Martin pursuant to the contract. The Navy contracts had a similar provision under which the Federal government would reimburse Martin for all state and local taxes which Martin paid under protest.

During the period of purchases, which was from March 1, 1951 to April 30, 1954, Martin paid the sales or use tax on all tangible property acquired by it. Before Martin brought this action for a refund of the taxes paid,[2] the Court of Appeals decided *Comptroller v. Aerial Products*[3] and *Baltimore Foundry v. Comptroller*,[4] in which purchases simi-

[2] The Maryland Use Tax is complementary to the Sales Tax and only applies to those transactions upon which no sales tax has been paid. In this case both taxes are involved but they were dealt with on the basis that the exclusions applicable to the Sales Tax were also applicable to the payment of use taxes. The Sales Tax sections under which Martin paid the taxes were:

MD. CODE (1951) Art. 81, §320(d) [now 7 MD. CODE (1957) Art. 81, §324(d)], which defines "sale" as including "any transaction whereby title or possession, or both, of tangible personal property is . . . transferred . . . for consideration to any purchaser by any vendor."

MD. CODE (1951) Art. 81, Sec. 320(f) [now 7 MD. CODE (1957) Art. 81, §324(f)], defines a "retail sale" or a "sale at retail" as including ". . . the sale in any quantity or quantities of any tangible property . . ." and states:

> "Said term shall mean all sales of tangible personal property to any person for any purpose other than those in which the purpose of the purchaser is to resell the property so transferred in the form in which the same is, or is to be received by him, ..."

[3] 210 Md. 627, 124 A. 2d 805 (1956). There the appellee, a manufacturer of flares and signal products, acquired personal property for use in the manufacture of supplies under an Army contract. The court upheld the inapplicability of the Maryland sales tax to the purchases. The court said that under the terms of the facilities contract title vested in the government upon purchase by the appellee. The court further pointed out that the taxpayer was a mere licensee and said, 644: "The purpose of the Maryland Act in taxing retail sales is to impose the tax on the final purchaser or ultimate consumer and to avoid a pyramiding of the tax."

[4] 211 Md. 316, 127 A. 2d 368 (1956). In this case a taxpayer produced steel castings which were fashioned from a pattern which it purchased. When the taxpayer sold the castings the firm also sold the patterns to the purchaser at a profit. The court held the sales tax did not apply since the sole purpose of a purchaser need not be to resell to be exempt from the tax and the collateral purpose of using the patterns in the manufacture of the castings was not a basis for sustaining the sales tax on the purchases of patterns.

lar to those made by Martin were excluded from the payment of sales taxes under the statute.[5] In direct response to these decisions, the Maryland legislature in 1957 amended the sales tax statute[6] so that it would include purchases made under facilities contracts. The amendment was made retroactive to July 1, 1947, the effective date of the sales tax of that year.

The trial court found the tax imposed under the amended statute to be unconstitutional as a denial of due process because of its retroactive effect. On appeal the Court of Appeals affirmed the lower court's ruling. The Court of Appeals was faced with two problems: (1) Whether the purchases by Martin were subject to a sales tax under the original statute and (2) if not, whether the retroactive amendment was a denial of due process under the 14th Amendment of the United States Constitution[7] or a violation of Article 23 of the Maryland Declaration of Rights.[8] Relying on *Comptroller v. Aerial Products*[9] and *Baltimore Foundry v. Comptroller,*[10] the court held that purchases Martin made pursuant to the contracts were not subject to a tax under the original statute. The court, in an opinion by Chief Judge Brune, pointed out that the equipment purchased would not be subject to the tax before the amendment, even though Martin used the tools acquired to produce the aircraft and did not purchase the equipment solely for purposes of resale to the government. In dealing with the retroactive effect of the 1957 statute, the court was faced with a more difficult problem. The court classified various retroactive taxes, both state and federal, which had been sustained, and decided, since the present tax did not fall within the scope of any of these, that it was invalid under the due process clause of the 14th

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[5] MD. CODE (1951) Art. 81, §320(f) [now 7 MD. CODE (1957) Art. 81, §324(f)].

[6] MD. LAWS 1957, Ch. 3 [now Art. 81, §324(f)], *ibid.* The amended sales tax statute defined sale at retail as including:

> "Sales of tangible personal property . . . to any person who will use the same as facilities, tools, tooling, machinery or equipment (including, but not limited to dies, molds and patterns) even though such person intends to transfer and/or does transfer title to such property or service either before or after such person uses the facilities, tools, tooling, machinery or equipment."

[7] U. S. Const. Amend. XIV, §1.

[8] MD. DECLARATION OF RIGHTS, Art. 23:

> "That no man ought to be taken or imprisoned or disseized of his freehold, liberties or privileges, or outlawed, or exiled, or, in any manner, destroyed, or deprived of his life, liberty or property, but by the judgment of his peers, or by the Law of the land."

[9] 210 Md. 627, 124 A. 2d 805 (1956).

[10] 211 Md. 316, 127 A. 2d 368 (1956).

Amendment of the Federal Constitution[11] and Article 23 of the Maryland Declaration of Rights.[12] The court, in its classification, pointed to cases in which retroactive taxes were sustained because they taxed the income received from transactions which had occurred prior to the enactment of the tax but which were, nevertheless, in the recent past. The court did not include the present tax in this "recent transactions" area,[13] since the extent of retroactivity (three to six years) was held to be too great in length of time to be termed recent. Nor would the court uphold the present tax on the ground that it came within the ratification doctrine,[14] (where a defect in the authority of the state to collect the tax was subsequently validated by legislative action) since the court held the questioned retroactive tax provisions to be new enactments rather than an attempt at legislative ratification. Since the Court of Appeals decided the validity of the tax solely on the basis of whether its retroactive effect was a denial of due process, the court found it unnecessary to decide the issue of intergovernmental immunity from taxation.

In deciding the validity of a retroactive tax two problems seem to be given weight in determining whether such a tax will be sustained. First, the type of tax involved may be important in determining whether the retroactivity will or will not be upheld, and secondly, the degree of retroactivity may be important.

As to type of tax, in the area of gift and estate taxes, the courts have generally taken the position that to impose a retroactive tax on a transfer is so arbitrary and unreasonable as to be a denial of due process. In *Nichols v. Coolidge,*[15] the decedent transferred property under an irrevocable trust in 1907. Under the terms of the trust, the settlors retained a life estate. However, in 1917, the settlors assigned their entire interest in the property to their children, the remaindermen under the trust. Upon the decedent's death in 1921, the government imposed an estate tax on the 1907 transaction under the Revenue Act of 1918. The Supreme Court struck down the tax as a violation of due

[11] *Supra*, n. 7.

[12] *Supra*, n. 8.

[13] Brushaber v. Union Pac. R.R. Co., 240 U. S. 1 (1916); Lynch v. Hornby, 247 U. S. 339 (1918); Cooper v. United States, 280 U. S. 409 (1930); Welch v. Henry, 305 U.S. 134, 118 A.L.R. 1142 (1938).

[14] United States v. Heinszen & Co., 206 U. S. 370 (1907); Chuoco Tiaco v. Forbes, 228 U. S. 549 (1913).

[15] 274 U. S. 531 (1927). Also see Blodgett v. Holden, 275 U. S. 142 (1927); Untermyer v. Anderson, 276 U. S. 440 (1928); Coolidge v. Long, 282 U. S. 582 (1931).

process. Since the taxpayer had no knowledge of the tax at the time of the transfer, he did not have the opportunity to refrain from making the transfer as he might have done had he been able to anticipate the tax. That this rule is not absolute however, is illustrated in *Milliken v. United States.*[16] There the court found no problem in sustaining the validity of the Revenue Act of 1920, which taxed gifts made in contemplation of death. Although the gift was made in 1916, the court held the 1920 tax applicable, since the donor knew the gift was subject to the tax when he made it and the only change was an increase in the rate of the tax. Retroactive taxes on income are less susceptible to this argument than are retroactive gift and estate taxes. There the courts take a somewhat different view because the tax is not imposed on a single voluntary act of the taxpayer, but on the results of activity over a more extended period of time. The courts have concluded that a taxpayer would probably still continue to earn or receive income by the same method, even if he could have anticipated a retroactive tax.[17] This seems to be one reason the courts have generally sustained the retroactive application of income tax statutes.

Is the sales tax involved in this case closer to the income tax or the gift tax, with respect to the nature and impact of the tax? A businessman will usually find it easy to pass on a sales or use tax to his customers through a corresponding increase in the price charged.[18] When a sales tax is retroactively imposed, the businessman will be hurt

[16] 283 U. S. 15 (1931).

[17] Welch v. Henry, 305 U. S. 134, 118 A. L. R. 1142 (1938). In this case, the state of Wisconsin imposed an income tax on corporate dividends which had previously been allowed to be deducted from gross income. The statute was retroactively applied to such income received in 1933. The chief objection to the statute was that the taxpayer had to bear a burden of which he had no warning and could not foresee. The Supreme Court sustained the validity of the tax saying, 148: "We can not assume that stockholders would refuse to receive corporate dividends even if they knew that their receipt would later be subjected to a new tax or to the increase of an old one." Also see Neuhoff, *Retrospective Tax Laws*, 21 St. L. Law Rev. 1 (1935).

[18] The Martin Company did not have this problem since it provided in its contracts with the Federal Government that the Federal would reimburse it for any sales or use taxes legally imposed. Thus, the actual effect of the decision is that the Federal Government will get the benefit of the refund of taxes in issue. In consequence, the money in question will go to the Federal Government rather than to the State of Maryland. It was, of course, only proper that the Court of Appeals did not take this factor into consideration. In deciding whether the retroactive sales and use taxes imposed by the 1957 amendment were unconstitutional, the impact of such taxes on the average taxpayer should be the criterion, not the peculiar situation of the Martin Company in this case.

in that he will have lost the opportunity to shift the burden of the tax to his customers. With an income tax, however, it is not as easy to shift its impact to others, and, for this reason, a retroactive imposition of an income tax seems less harsh than a retroactive imposition of sales and use taxes. The practical distinction between the impact of an income tax and the impact of sales and use taxes adds support to the result reached by the Court of Appeals in applying the more rigorous approach of the Supreme Court cases in the gift and estate tax area as compared to the approach in the income tax area.

As to the degree of retroactivity to which a tax may be constitutionally imposed,[19] the courts have been quick to point out that a tax is not unconstitutional merely because it has a retroactive effect;[20] yet, it is obvious that the legislative power to tax retroactively should not be unlimited. If retroactivity were unlimited, a resulting tax could be so oppressive as to bankrupt the taxpayer upon whom the levy was made.[21] Although the courts have not laid down a specific point in time beyond which the legislature may not pass, they have pointed out that taxing statutes which are retroactive for short periods are not objectionable.[22] However, as the degree of retroactivity increases, the courts have a more difficult time in sustaining such a tax. For example, even in the instant case, a taxpayer's financial position may have altered so radically so as to make payment a burden.[23] Extreme retroactive periods are held un-

[19] In considering the validity of a retroactive tax, the degree of retroactivity generally plays a secondary role, since the type of tax may itself determine whether or not it will be upheld. This can best be illustrated by the gift cases where even a short retroactive period is not upheld. See Untermyer v. Anderson, 276 U. S. 440 (1928).

[20] Wagner v. Baltimore, 239 U. S. 207 (1915); Welch v. Henry, 305 U. S. 134, 118 A.L.R. 1142 (1938); Match Co. v. State Tax Comm., 175 Md. 234, 200 A. 365 (1938).

[21] See Commonwealth v. Budd, 379 Pa. 159, 108 A. 2d 563, 568 (1954), where the court said:

> "It is obvious, however, that there must be some limitation on the right of a legislative body to pass laws imposing taxes retroactively, for otherwise a legislature could constitutionally impose new or increased taxes retroactively for a period of 25 or 50 years which would be so onerous or confiscatory and unjust as to bankrupt the individuals or corporations thus taxed."

[22] Welch v. Henry, 305 U.S. 134, 118 A.L.R. 1142 (1938); Brushaber v. Union Pac. R.R. Co., 240 U.S. 1 (1916).

[23] In Wilgard Realty Co v. Commissioner of Internal Rev., 127 F. 2d 514 (2nd Cir. 1942), the court sustained an income tax amendment that had been made retroactive seven years. In that case, however, the retroactive application of the amendment did not defeat the taxpayer's expectations at the time of the original transaction. Indeed, it merely required the taxpayer to continue to treat the transaction, tax-wise in the same way he had originally treated it. Had the retroactive amendment been ineffective, the taxpayer would have received an unjustified tax advantage.

constitutional. This is brought out by the result reached in *People v. Graves*,[24] where the Court of Appeals of New York found a sixteen year retroactive tax on income received from foreign realty to be a denial of due process.

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[24] 280 N. Y. 405, 21 N. E. 2d 371 (1939).