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## California – Land of “Lawless Taxation” and the “Midnight Special”: Outlier or Leader in a Growing Trend?

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California – Land of “Lawless Taxation” and the  
“Midnight Special”: Outlier or Leader in a Growing Trend?

MYSTICA M. ALEXANDER\*

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INTRODUCTION

Taxpayers in California recently found themselves the target of a retroactive grab for revenue by the Franchise Tax Board (FTB) in what has called an act of “lawless taxation” by the state of California.<sup>1</sup> The source of the conflict was the Qualified Small Business Stock credit that had been in place in California since 1993.<sup>2</sup> The tax credit, which was designed

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1. *Lawless Taxation*, WALL ST. J., Aug. 31, 2013, at 12.

2. See CAL. REV. & TAX. CODE § 18152.5 (2014).

to encourage innovation and investment in California-based enterprises, allowed business owners who had at least eighty percent of their assets and employees in California to take a credit of fifty percent of the capital gain realized on a sale of their stock.<sup>3</sup> In August 2012, the California Court of Appeals ruled that the credit was discriminatory against out-of-state taxpayers in violation of the Commerce Clause.<sup>4</sup> As a result of this ruling, the FTB made an announcement in December 2012 that it would soon be sending tax bills to all business owners who had claimed the tax credit since 2008, seeking the taxes that would have been due plus corresponding interest.<sup>5</sup> The move was expected to bring an additional \$120 million in revenue to the state straight from the pockets of taxpayers who had lawfully relied on a credit that had been in place for twenty years.<sup>6</sup>

This revenue grab by the FTB invoked the ire of taxpayers and lawmakers alike. In response to pressure from California Governor Jerry Brown, the FTB announced in February 2013 that it would temporarily refrain from collecting the back taxes.<sup>7</sup> State lawmakers, in a bipartisan effort, immediately proposed legislation to curtail this action by the FTB. These legislative proposals, Assembly Bill 1412<sup>8</sup> and Senate Bill 209,<sup>9</sup> were sent to Governor Brown on September 20, 2013 and signed into law on October 4, 2013, ensuring that the FTB could not seek retroactive taxes along with corresponding penalties from affected taxpayers.<sup>10</sup>

Absent action by the California state legislature in this instance, would it have been lawful for the FTB to retroactively collect payments from taxpayers who relied on the long-standing credit? Was this really an act of “lawless taxation?” This Article concludes that the actions of the FTB were in fact lawful, and indicative of a growing trend of retroactive taxing measures that have gained acceptance in the United States in recent years, especially as states scurry to find ways to maintain balanced budgets.

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3. *Id.*

4. *See* Cutler v. Franchise Tax Bd., 208 Cal. App. 4th 1247, 1261 (2012).

5. Ann Hodges, *FTB Notice 2012-03*, CAL. FRANCHISE TAX BD. (Dec. 21, 2012), available at [https://www.ftb.ca.gov/law/notices/2012/2012\\_03.pdf](https://www.ftb.ca.gov/law/notices/2012/2012_03.pdf).

6. John Tozzi, *California Seeks \$120 Million in Back Taxes from Small Businesses*, BLOOMBERG BUS. WK. (Feb. 6, 2013), <http://www.businessweek.com/articles/2013-02-06/california-seeks-120-million-in-back-taxes-from-small-business>.

7. *Qualified Small Business Stock (QSBS) Gains – FAQs* (Feb. 28, 2013), [https://www.ftb.ca.gov/law/Qualified\\_Small\\_Business\\_Stock\\_and\\_Cutler\\_Decision.shtml](https://www.ftb.ca.gov/law/Qualified_Small_Business_Stock_and_Cutler_Decision.shtml) (explaining the taxpayer’s right to request that the QSBS assessment be held pending legislative action).

8. A.B. 1412 (Stats. 2013, ch. 546) (Cal. 2013).

9. S.B. 209 (Stats. 2013, ch. 546) (Cal. 2013).

10. *See* Sen. Ted W. Lieu, *Governor Brown Signs Lieu-Backed Bill to End Retroactive Tax on State Entrepreneurs* (Oct. 4, 2013), <http://sd28.senate.ca.gov/news/2013-10-04-gov-brown-signs-sen-lieu-backed-bill-end-retroactive-tax-state-entrepreneurs> (last visited Mar. 23, 2014).

This Article considers the extent to which the legal system condones retroactive actions taken against taxpayers. Part I opens with a look at recent retroactive actions in California. Part II provides an introduction to retroactive laws. Part III then takes a closer look at the constitutionality of retroactive actions, with an emphasis on due process concerns. Part IV focuses that discussion specifically on retroactive *tax* actions, providing both historical insight and a discussion of more recent cases. Having demonstrated that federal constitutional safeguards and common law have done little in recent years to protect taxpayers from retroactive tax actions, this Article concludes that rather than being an outlier, California is in fact representative of a growing trend, and that neither Congress nor the judiciary can be expected to stem the tide of retroactive revenue grabs anytime soon.

### I. RETROACTIVE REACHES IN CALIFORNIA

Two California cases illustrate the extent to which the state has utilized retroactivity as a means of limiting its potential liability to pay taxpayer refund claims. The first case, *Northwest Energetic Services v. California Franchise Tax Board*,<sup>11</sup> considered the constitutionality of California's LLC fee, which imposed a levy on the total worldwide gross receipts of an LLC even if the LLC was a nonresident business with revenue from both inside and outside of the state.<sup>12</sup> Constitutionally, this fee should have been limited to the portion of gross receipts allocated to California.<sup>13</sup> As taxpayers commenced legal challenges against the fee in court, local legislators became concerned about the extent of potential refund claims to which the state would be exposed if the court were to invalidate the fee. To curb the state's liability, the Assembly passed Assembly Bill 1614, which was designed to limit the refunds to which taxpayers would be entitled in the event that the court found the gross receipts fee to be unconstitutional.<sup>14</sup> In order to limit possible refund claims, the legislature also made changes to the LLC fee structure back to 2001—a six-year period of retroactivity.<sup>15</sup> This legislation

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11. 159 Cal. App. 4th 841 (2008).

12. *Id.* at 849–50; *see also* CAL. REV. & TAX. CODE § 17942 (2014).

13. *Northwest*, 159 Cal. App. 4th at 861–62 (“For decades, state statutes that impose taxes on income earned outside the state's jurisdiction, or that fail to apportion total income in accordance with the income earned within the jurisdiction, have been held to violate the Commerce Clause.”).

14. A.B. 1614 (Stats. 1998, ch. 351) (Cal. 2013).

15. *Id.*

was passed in the late hours of the last day of the legislative session<sup>16</sup> and so has been referred to as a “midnight special.”<sup>17</sup>

Whether such a long retroactivity period would pass constitutional muster was never determined because Governor Arnold Schwarzenegger refused to sign the legislation into law.<sup>18</sup> The following year, the state passed Assembly Bill 198, which added Section 19394 to the Revenue and Taxation Code, in part, due to concern about the outcome of the cases challenging the calculation of the LLC fee.<sup>19</sup> This legislation limited the amount of potential refund claims that LLCs could file.<sup>20</sup> Ultimately, the California Court of Appeals affirmed the decision of the San Francisco trial court that the LLC fee calculation method was unconstitutional and provided that the remedy should be a refund of all taxes paid under the Act.<sup>21</sup> But the FTB, relying on the newly enacted legislation, refused to issue full refunds to the out-of-state LLCs.<sup>22</sup> Instead, the FTB limited the refund to the “amount by which the fee paid plus any interest assessed exceeds the amount of the fee that would have been assessed” pursuant to the new fee structure.<sup>23</sup> As a result, what should have been total refund claims of \$1.3 billion has cost the state only \$280 million.<sup>24</sup>

The more recent case of *Gillette v. Franchise Tax Board*,<sup>25</sup> currently pending before the California Supreme Court, also showcases the government’s instinct to take retroactive action as a means of minimizing state monetary obligations. California had been a member of the Multistate Tax Compact since 1974.<sup>26</sup> As part of this Compact, member states agree to provide taxpayers with the option of using either the state’s own apportionment formula for apportioning income or the three-factor of equal weight (property, payroll, and sales) formula provided for in the Uniform Division of Income for Tax Purposes Act (UDITPA).<sup>27</sup> In 1993, California switched from a three-factor apportionment formula to a sales, property, and

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16. Frank Russo, *California Assembly Adjourns After Midnight*, CAL. PROGRESS REP. (Sept. 1, 2006), <http://www.californiaprogressreport.com/site/print/6635>.

17. See, e.g., Kathleen K. Wright, *Using Retroactive Taxes to Cure Budget Shortfalls*, 61 TAX L. 1153, 1154 (2008).

18. See Peter Kanter, *California’s LLC Tax: Current Litigation and Retroactive Legislation*, MORRISON & FOERSTER LLP (Mar. 21, 2007), <http://www.mofo.com/Californias-LLC-Tax-Current-Litigation-and-Retroactive-Legislation/>.

19. A.B. 198 (Stats. 2007, ch. 381) (Cal. 2013).

20. *Id.*

21. *Northwest*, 159 Cal App. 4th at 868.

22. See KATHLEEN K. WRIGHT, CALIFORNIA INCOME TAX MANUAL 286 (2008).

23. *Id.*

24. Wright, *supra* note 17, at 1153.

25. 209 Cal. App. 4th 938 (2012).

26. *Id.* at 946.

27. 3 CAL. REV. & TAX. CODE § 38001 (2006).

payroll factor formula that double-weighted the sales factor.<sup>28</sup> This revised language provided that, “Notwithstanding Section 38006 [(the Compact)], all business income shall be apportioned to this state by” the double-weighted sales method.<sup>29</sup> The FTB considered the adoption of this language to be sufficient to negate the Compact.<sup>30</sup> In 2010, the Gillette Company and its subsidiaries brought legal action against the FTB, alleging that taxpayers had the right for all periods since 1993 to continue to opt to use the Compact’s apportionment formula because California had not withdrawn from the Compact.<sup>31</sup> The Court of Appeals agreed with Gillette, resulting in the current, pending appeal to the California Supreme Court.<sup>32</sup> In 2012, concerned that a decision by the California high court in favor of the taxpayers could result in significant refund claims, the California legislature passed Senate Bill 1015 to curtail taxpayer refunds by limiting the ability of a taxpayer to file an amended return using the Compact apportionment formula.<sup>33</sup> The legislation states that a taxpayer cannot elect the Compact’s apportionment methodology on an amended return; rather, this election could only be made on a taxpayer’s originally filed return, thus retroactively limiting the taxpayer’s use of the Compact.<sup>34</sup>

The various retroactive reaches in California, while troubling, are not outliers. In fact, for reasons explained in the remainder of this Article, it is likely that such retroactive actions can withstand legal scrutiny.

## II. UNDERSTANDING RETROACTIVE ACTIONS

To fully appreciate the extent to which the current trend of retroactive tax actions pass constitutional muster, a useful starting point is a broader look at the nature of retroactive actions and the constitutional limits of such behavior.

### A. What Is Retroactive Law?

Retroactive laws are those that “apply to prior acts, events, or occurrences, and seek to impose new consequences on such past conduct.”<sup>35</sup> A retroactive law “relates back to and gives a previous transaction a legal

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28. *Gillette*, 209 Cal. App. 4th at 944.

29. *Id.* at 949.

30. *Id.*

31. *Id.* at 949–50.

32. *Id.* at 960.

33. S.B. 1015 (Stats. 2012, ch. 37) (Cal. 2012).

34. *Id.*

35. Andrew C. Weiler, *Has Due Process Struck Out? The Judicial Rubberstamping of Retroactive Economic Laws*, 42 DUKE L.J. 1069, 1076 n.27 (1993).

effect different from that which it had under the law in effect when it transpired.”<sup>36</sup> In *Society for the Propagation of the Gospel v. Wheeler*,<sup>37</sup> Justice Story interpreted Article 23 of the New Hampshire Bill of Rights, which declares that “Retrospective laws are highly injurious, oppressive, and unjust. No such laws, therefore, should be made, either for the decision of civil causes, or the punishment of offenses.”<sup>38</sup> Justice Story explained that the term applies not only to statutes which take effect prior to their time of passage, but to all rules which affect vested rights and past transactions.<sup>39</sup>

#### B. The Natural Aversion to Retroactive Actions

There is an inherent unfairness in allowing the government to “change the rules of the game” midstream. As early as 1788 in our nation’s history, James Madison observed that, “The sober people of America are weary of the fluctuating policy that has directed the public councils.”<sup>40</sup> In short, the people were indignant of sudden changes in the law and legislative interferences.<sup>41</sup> Justice Story admonished that “Retrospective laws are, indeed, generally unjust; and, as has been forcibly said, neither accord with sound legislation, nor with the fundamental principles of the social compact.”<sup>42</sup> Even the English common law shares this aversion to retroactivity, as recognized in an 1811 decision in which the court found that, “It is a principle in the English common law, as ancient as the law itself, that a statute, even of its omnipotent parliament, is not to have a retrospective effect.”<sup>43</sup> A hundred years later, this notion still had broad support, as evidenced by the following excerpt from a 1911 treatise:

Retrospective laws are . . . of questionable policy, and contrary to the general principle that legislation by which the conduct of mankind is to be regulated ought to deal with future acts, and ought not to change the character of past transactions carried on upon the faith of the then existing law.<sup>44</sup>

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36. *R & P Servs., Inc. v. Dep’t of Revenue*, 541 A.2d 432, 434 (Pa. 1958).

37. 22 F. Cas. 756 (N.H. 1814).

38. N.H. CONST. art. XXIII.

39. *Wheeler*, 22 F. Cas. at 767.

40. THE FEDERALIST NO. 44 (James Madison) (Clinton Rossiter ed., 1961).

41. THE FEDERALIST NO. 4 (John Jay) (Clinton Rossiter ed., 1961).

42. 2 JUSTICE STORY, COMMENTARIES ON THE CONSTITUTION § 1398 (5th ed. 1891).

43. *Dash v. Van Kleeck*, 7 Johns. 477, 503 (N.Y. 1811).

44. HERBERT BROOM, LEGAL MAXIMS 24 (8th ed. 1911).

Individuals should be able to plan their conduct in accordance with known legal standards.<sup>45</sup> In addition, courts have traditionally opposed retroactive laws because they create instability and can be used either to benefit or to harm selected classes of citizens.<sup>46</sup> But this early indignation began to erode and retroactive actions soon gained traction and acceptance in the legal system. As Robert DeGaudenzi has pointed out, “Notwithstanding this long tradition of judicial aversion for retroactive legislation, laws having retrospective effect are regularly enacted and upheld.”<sup>47</sup>

### III. CONSTITUTIONAL CONCERNS

While it may seem intuitive that reliance on the law should be protected, the Constitution makes no such guarantee. “And yet nothing seems more basic to the existence of a legal order than the ability to rely upon the actions of others, including the government, with some assurance.”<sup>48</sup>

#### A. Retroactivity and the Constitution

The Constitution does not contain a blanket prohibition against all types of retroactive actions by the government, but it does impose some limitations. For example, government must not take any action that would violate the Due Process Clause of the Fifth Amendment, which provides that “No person shall be . . . deprived of life, liberty, or property without due process of law.”<sup>49</sup> The Constitution also expressly prohibits ex post facto laws.<sup>50</sup> The Contract Clause, which prevents laws impairing contract obligations, states that “No State shall . . . pass any . . . Law impairing the Obligation of Contracts.”<sup>51</sup> Lastly, the Takings Clause of the Fifth Amendment, which prohibits the government taking of private property “for

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45. Charles B. Hochman, *The Supreme Court and the Constitutionality of Retroactive Legislation*, 73 HARV. L. REV. 692, 692 (1960).

46. *Id.* at 693.

47. Robert C. DeGaudenzi, *Death Is Still Certain, But Are Taxes?: An Examination of the Due Process Limitations on Retroactive Tax Legislation After Carlton v. United States*, 67 ST. JOHN’S L. REV. 327, 327 n.1 (1993).

48. W. David Slawson, *Constitutional and Legislative Considerations in Retroactive Lawmaking*, 48 CALIF. L. REV. 216, 225 (1960).

49. U.S. CONST. amend. V.

50. *Id.* art. I, § 9, cl. 3 (applicable to the federal government); *id.* § 10, cl. 1 (applicable to the States).

51. *Id.* art. I, § 10.



public use without just compensation,<sup>52</sup> has also been used to limit the government's taking of property rights.<sup>53</sup>

There are numerous reasons such constitutional safeguards exist. As one commentator explained:

Citizens should be able to plan their conduct with reasonable certainty of the legal consequences. There is a public need for stability with respect to past transactions. Retroactive laws may be passed with exact knowledge of who the law will benefit or harm, which increases the potential for corruption in the political process.<sup>54</sup>

What standard should courts apply when analyzing the constitutionality of retroactive lawmaking? The question is not an easy one and, over time, the manner in which it has been answered has evolved. As James Huffman points out, one thing is clear:

If every change in the law with a negative impact for someone were invalid because retroactive, government would indeed cease to function. But the measure of unconstitutional retroactivity cannot be the mere coincidence of detriment. A more sophisticated and discerning standard is required.<sup>55</sup>

This Article explores the limits of that standard as it has developed over time.

## B. Due Process Concerns

The Due Process Clause,<sup>56</sup> the prohibition on ex post facto laws,<sup>57</sup> the Takings Clause,<sup>58</sup> and the Contracts Clause<sup>59</sup> have all been invoked as a

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52. *Id.* amend. V.

53. See Stewart Haskins, *Gambling with the IRS: Enforcement of Retroactive Tax Statutes in United States v. Carlton*, 47 MERCER L. REV. 1163 (1996).

54. *Id.* at 1165.

55. James L. Huffman, *Retroactivity, The Rule of Law, and the Constitution*, 51 ALA. L. REV. 1095, 1116 (2000).

56. U.S. CONST. amend. V.

57. *Id.* art. I, § 9, cl. 3 (applicable to the federal government); *id.* § 10, cl. 1 (applicable to the States). Although the Constitution expressly forbids ex post facto laws, a 1798 U.S. Supreme Court decision determined that this prohibition only applied to criminal, not civil, law. See *Calder v. Bull*, 3 U.S. 386 (1798). For a more thorough treatment of ex post facto laws, see Steve Selinger, *The Case Against Civil Ex Post Facto Laws*, 15 CATO J. 191 (1995).

58. U.S. CONST. amend. V. Application of the Takings Clause requires that there first be a

defense against retroactive government actions. As will be described more fully in Part IV, the current leading Supreme Court case on retroactive tax actions focuses on whether there has been a Due Process violation.<sup>60</sup> Thus, Part III limits its focus to Due Process concerns.

### 1. Early Due Process Cases

Law students and practitioners alike crave “bright-line” tests in the law. Such tests offer exactitude and clarity. However, such bright-line tests are few and far between. In the application of the Due Process Clause to retroactive actions, a once bright-line aversion to retroactive government action soon gave way to an ever-evolving balancing test that one must cobble together from sometimes conflicting court decisions.

The Due Process Clauses of the Fifth and Fourteenth Amendments ensure that the federal and state governments do not deprive any person of “life, liberty, and property without due process of law.”<sup>61</sup> “[I]n the nineteenth century, courts regarded retroactive legislation . . . as, by definition, failing to provide adequate notice, and thus the ‘process’ that was ‘due.’ Neither the strength of the government’s interest nor the scope of the regulation was relevant.”<sup>62</sup> For example, in an early case,<sup>63</sup> the Court determined the revocation of a war risk insurance contract was unconstitutional when applied to outstanding policies.<sup>64</sup> However, it was not long before the Court started to move away from this approach and adopt a more lenient acceptance of retroactivity in the area of economic legislation.

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property right. In *County of Mobile v. Kimble*, 102 U.S. 691, 703 (1880), the U.S. Supreme Court acknowledged that taxation is distinct from the “taking” of property. A more recent decision confirms this result. See *Quarty v. United States*, 170 F. 3d. 961 (9th Cir. 1999). For a more thorough treatment of the Takings Clause, see Ann Woolhandler, *Public Rights, Private Rights, and Statutory Retroactivity*, 94 GEO. L.J. 1015 (2006).

59. U.S. CONST. art. I, § 10. Prior to the Great Depression, it was not uncommon for the Supreme Court to rely on the Contracts Clause as a means of limiting state government authority. For a more thorough treatment of this issue, see ERWIN CHERMERINSKY, *CONSTITUTIONAL LAW: PRINCIPLES AND POLICIES* 625 (3d ed. 2006). The New Deal Era cases changed this result. See, e.g., *Home Bldg. & Loan Ass’n v. Blaisdell*, 290 U.S. 398 (1934). In *Blaisdell*, the lenders argued that a Minnesota law providing an extension of time for borrowers to repay their loans and preventing lenders from foreclosing on the property violated the Contracts Clause by interfering with their private rights to their property. *Id.* at 416–17. Central to the case was the state’s argument that its action was a valid exercise of its powers given the severe economic climate. *Id.* at 420. The Supreme Court upheld the actions of the Minnesota legislature. *Id.* at 448.

60. See discussion *infra* Part IV.B.2.

61. U.S. CONST. amend. V; *id.* amend. XIV, § 1.

62. DANIEL E. TROY, *RETROACTIVE LEGISLATION* 75 (1998).

63. *Lynch v. United States*, 292 U.S. 571 (1934).

64. *Id.* at 583.

## 2. A New Standard for Economic Legislation

The 1938 decision of the Supreme Court in *Welch v. Henry*<sup>65</sup> illustrates the increased leniency of the Court and an acceptance of retroactive actions as long as such action was not arbitrary or oppressive. In *Welch*, the state of Wisconsin adopted a tax measure in 1935 that would retroactively disallow deductions for corporate dividends received by taxpayers as of 1933.<sup>66</sup> In striking down the taxpayer's argument that such retroactive taxation violated due process, the Court made clear that the taxpayers must bear the economic burdens of government:

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.<sup>67</sup>

A more recent example of the application of this standard of review in a due process challenge to a retroactive action is *Pension Benefits Guarantee Corp. v. R.A. Gray & Co.*,<sup>68</sup> in which "the Supreme Court suggested [that] courts that analyze legislation affecting the distribution of retirement benefits should employ rational basis review."<sup>69</sup> According to the Court in *PBCG*, "the burden is on one complaining of a due process violation to establish that the legislature has acted in an arbitrary and irrational way."<sup>70</sup>

This is not to suggest that retroactive application is always permissible. As Justice O'Connor explained in *Eastern Enterprises v. Apfel*,<sup>71</sup>

Congress has considerable leeway to fashion economic legislation, including the power to affect contractual commitments between private parties. Congress also may impose retroactive liability to some degree, particularly where it is "confined to short and limited periods required by the practicalities of producing national legislation." Our decisions, however, have left

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65. 305 U.S. 134 (1938).

66. *Id.* at 141.

67. *Id.* at 146.

68. 467 U.S. 717 (1984).

69. Gavin Reinke, *When a Promise Isn't a Promise: Public Employers' Ability to Alter Pension Plans of Retired Employees*, 64 VAND. L. REV. 1673, 1687 (2011).

70. *PBCG*, 467 U.S. at 729.

71. 524 U.S. 498 (1998).

open the possibility that legislation might be unconstitutional if it imposes severe retroactive liability on a limited class of parties that could not have anticipated the liability, and the extent of that liability is substantially disproportionate to the parties' experience.<sup>72</sup>

Part IV will explore the constitutionality of retroactive actions in the tax arena.

#### IV. RETROACTIVE TAXATION TAKES MANY FORMS

Despite the skepticism and distrust of legal actions with a retroactive effect, retroactive actions in the area of taxation have a long history of withstanding constitutional challenges. Some of the means by which retroactive actions have been taken against often unsuspecting taxpayers include: (1) a retroactive tax rate increase; (2) a retroactive imposition of taxes; and (3) prospective-only application of a judicial decision declaring a law unconstitutional.<sup>73</sup>

In most cases, the Court has upheld retroactive taxation as long as the retroactive action was not *arbitrary* and the period of retroactivity was not *excessively long*.<sup>74</sup> In other cases, the Court has simply required that the retroactive changes further a "*rational legislative purpose*."<sup>75</sup> The lowering

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72. *Id.* at 528–29 (internal citation omitted).

73. *See, e.g.*, *United States v. Darusmont*, 449 U.S. 292, 300 (1981) (per curiam) (upholding the retroactive increase in the minimum tax rate applied to federal taxable income); *United States v. Hudson*, 299 U.S. 498, 501 (1937) (upholding the retroactive imposition of a new tax on profits derived from the sale of silver); *Ford Motor Credit Co. v. Dep't of Treasury*, No. 289781, 2010 Mich. App. LEXIS 71 (Mich. Ct. App. Jan. 12, 2010) (upholding the Michigan legislature's right to retroactively amend a statute in order to prevent the payment of refund claims that would otherwise have been due based on a previous judicial decision).

74. *See, e.g.*, *United States v. Carlton*, 512 U.S. 26, 27 (1994).

75. *See, e.g.*, *Kitt v. United States*, 277 F.3d 1330, 1334 (2002) (emphasis added). When Congress enacted the Roth IRA (effective January 1, 1998), it allowed taxpayers to roll their existing IRA accounts into a Roth IRA. *Id.* at 1331. However, what the statute failed to do was to include a ten percent penalty on early withdrawal from the Roth of funds transferred from the IRA. *Id.* at 1331–32. When Congress discovered the error in July 1998, it enacted a legislative fix retroactive to January 1, 1998. *Id.* at 1332. As a result of this new legislation, the plaintiffs in *Kitt* were required to pay a ten percent withdrawal penalty on the withdrawal from their IRA. *Id.* The Court explained: "[T]he validity of a retroactive tax provision under the Due Process clause depends upon whether . . . [such application] is itself justified by a rational legislative purpose. . . . We conclude that the retroactive application of the ten percent additional tax to Kitt's transaction served a rational legislative purpose and therefore is consistent with the Due Process Clause." *Id.* at 1334.

of the bar on retroactive tax actions, combined with a troubled economic climate in which states seek to adapt as many means as possible to fund local financial needs, has resulted in continued retroactive grabs on taxpayers' income. As noted by one commentator:

Remedy litigation appears to be increasing today, and that trend may be expected to continue as states toy with applying judicial decisions on a prospective basis only, enacting legislation that retroactively revokes a taxpayer's refund claims, or reversing a long-standing administrative ruling to retroactively impose tax. Thus the questions now being litigated include whether a state may remove the right to a refund after a taxpayer has already paid and whether a state may impose a tax retroactively.<sup>76</sup>

#### A. Retroactive Tax Rate Increases

The idea of a retroactive tax increase is not a new one. There have been several federal retroactive tax rate increases beginning with the Revenue Act of 1918, which retroactively increased individual and corporate rates to the start of 1918.<sup>77</sup> Another example is the Revenue Act of 1936, which retroactively increased the top individual rate to seventy-nine percent from sixty-three percent.<sup>78</sup> This was later followed by yet another retroactive increase from seventy-nine percent to ninety-one percent in 1944.<sup>79</sup> When the Revenue Reconciliation Act of 1993 was passed in August 1993, it raised the top rates for both individuals and corporations.<sup>80</sup> The rate increase was subject to much criticism because Congress made the change retroactive to January 1 of that year.<sup>81</sup> Although lawmakers and taxpayers alike released a firestorm of criticism at this retroactive application, such rate increases clearly passed constitutional muster.

State legislative tax rate increases have also become increasingly common as states use retroactive taxes to cure budget shortfalls. Table 1 shows a representative list of these increases within the past five years:

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76. Gregory A. Castanias et al., *Retroactivity and Refunds: Can They Really Keep Your Money?*, STATE TAX NOTES 419, 419–20 (Aug. 2010), available at <http://www.mofo.com/files/Uploads/Images/110816-Retroactivity-Refunds-Can-They-Really-Keep-Your-Money.pdf>.

77. Revenue Act of 1918, ch. 18, 40 Stat. 1057 (1919).

78. Revenue Act of 1936, ch. 690, 49 Stat. 1648 (1936).

79. Individual Income Tax Act of 1944, ch. 10, 58 Stat. 231 (1944).

80. Revenue Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 416.

81. *Id.*

**Table 1.**  
**Retroactive Legislative Tax Rate Increases<sup>82</sup>**

State	Increase <sup>83</sup>
California	0.25% increase in each tax bracket
Connecticut	Increased marginal rates from three (3%, 5%, and 6.5%) to six (3%, 5%, 5.5%, 6%, 6.5%, and 6.75%) <sup>84</sup>
Delaware	1% increase in top income tax rate
Hawaii	9% increase on income over \$150,000, 10% increase on income over \$175,000, and 11% increase on income over \$200,000
Illinois	Staggering 67% increase in personal income tax, raising the 3% rate to 5%
Maryland	The 5%, 5.25%, and 5.5% income levels begin at lower threshold amounts, and a new 5.75% tax bracket has been added
New Jersey	Temporary tax increase of 8% on incomes over \$400,000, 10.25% on incomes over \$500,000, and 10.75% on income over \$1,000,000
New York	Temporary increase of 8.97% on incomes over \$500,000 and 7.85% on income over \$200,000
Oregon	Temporary increase of 11% on incomes over \$250,000 and 10.8% on incomes over \$125,000
Wisconsin	New 7.75% increase on incomes over \$225,000

On Election Day 2012, California joined this group of states when voters approved Proposition 30 and increased taxes retroactively to January 1, 2012.<sup>85</sup> Taxpayers are approving retroactive taxes at the ballot box.

#### B. Retroactive Imposition of Taxes: Wholly New Tax v. Clarification?

The preliminary hurdle in analyzing the constitutionality of retroactively imposing a tax is determining whether the action represents the imposition of a “new tax law,” in which case the ability to take retroactive action may be more limited, or whether such action merely represents a legislative

82. All data contained herein has been derived from Kail Padgitt & Mark Robyn, *Some States Respond to Budget Shortfalls with Tax Increases*, TAX FOUND. (July 2009), <http://taxfoundation.org/article/some-states-respond-budget-shortfalls-tax-increases>.

83. In the interest of simplicity, the only rate increases included here are those applicable to single filers.

84. Rute Pinho, *Retroactive Income Tax Increases*, OLR RES. REP. (Jan. 24, 2012), <http://www.cga.ct.gov/2012/rpt/2012-R-0021.htm>.

85. Ashlea Ebeling, *California Voters Sock it to the Rich (and the Fate of Other State Tax Ballot Measures)*, FORBES (Nov. 8, 2012, 4:57 PM), <http://www.forbes.com/sites/ashleaebeling/2012/11/08/california-voters-sock-it-to-the-rich-and-the-fate-of-other-state-tax-ballot-measures/>.

clarification of existing law, in which case the legislature is given wide latitude to retroactively issue a clarification of legislative intent.<sup>86</sup> Distinguishing between the two is not without controversy. “There is, to be sure, a gray area between cases that have clearly approved two years of tax retroactivity and cases that have barely struck down decades of non-tax retroactivity.”<sup>87</sup>

### 1. Historical Development

As early as 1874, the Supreme Court in *Stockdale v. Atlantic Insurance Co.*<sup>88</sup> upheld a retroactive tax on corporations on dividends declared.<sup>89</sup> This tax was enacted in 1870, but applied to earnings accrued in 1869.<sup>90</sup> Taxpayers challenged the tax on the ground that its retroactive application violated their rights to due process.<sup>91</sup> In striking down the due process challenge to the tax, the Court explained:

The right of Congress to have imposed this tax by a new statute, although the measure of it was governed by the income of the past year, cannot be doubted; much less can it be doubted that it could impose such a tax on the income of the current year, though part of that year had elapsed when the statute was passed.<sup>92</sup>

Then, for a brief period in the early 1900s, the Court struck down the retroactive application of the newly enacted gift taxes as a violation of due process, finding that the taxpayer's lack of notice as to future new tax laws would make the application of those laws “arbitrary and capricious.”<sup>93</sup> *Nichols v. Coolidge*<sup>94</sup> involved the application of section 402(c) of a Revenue Act passed on February 24, 1919.<sup>95</sup> This Act required the estate of Mrs. Julia Coolidge to include the gross value of property that the decedent had already transferred to her children several years before her death because the actual

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86. ERIKA LUNDER ET AL., CONG. RES. SERV., R42791, CONSTITUTIONALITY OF RETROACTIVE TAX LEGISLATION 4 (2012).

87. James M. Puckett, *Embracing the Queen of Hearts: Deference to Retroactive Tax Rules*, 40 FLA. ST. U. L. REV. 349, 383 (2013).

88. 87 U.S. 323 (1873).

89. *Id.* at 333.

90. *Id.* at 326.

91. *Id.* at 328.

92. *Id.* at 331.

93. See Haskins, *supra* note 53, at 1165.

94. 274 U.S. 531 (1927).

95. *Id.* at 532.

conveyance of the property did not occur until her death in January 1921.<sup>96</sup> According to the Court, the retroactive application of the tax was “arbitrary, capricious[,] and amount[ed] to confiscation”<sup>97</sup> in violation of the Due Process Clause. Of particular significance in this case was the fact that this was considered a wholly new tax.<sup>98</sup>

In *Blodgett v. Holden*,<sup>99</sup> the plaintiff transferred inter vivos gifts valued at \$850,000 in January 1924 before the June 2 passage of the Estate Tax as section 319 of the Revenue Act of 1924.<sup>100</sup> The record in the case indicated that the gift tax provisions did not come before Congress for consideration until February 25 of that year, so there was no notice to the taxpayer that imposition of the gift tax could be imminent.<sup>101</sup> The Court therefore found the retroactive imposition of the gift tax to be arbitrary and invalid.<sup>102</sup>

The facts of *Untermeyer v. Anderson*<sup>103</sup> are similar to those of *Blodgett* except that Untermeyer’s gifts were made on May 23, 1924, only very shortly before the bill at issue was signed into law.<sup>104</sup> The Court focused on whether the fact that Untermeyer had notice of the pending enactment of the gift tax was sufficient to distinguish the case from *Blodgett* and allow the taxation to stand.<sup>105</sup> Finding that it did not, the Court ruled that the application of the tax to Untermeyer’s gifts was an arbitrary action in violation of due process since Untermeyer, at the time of the gift, did not have notice that the transaction would be subject to tax.<sup>106</sup> *Blodgett* and *Untermeyer* both advance the “wholly new tax” argument, and illustrate the Supreme Court’s agreement that “imposition of the tax retroactively would be unreasonable considering that the taxpayers had no notice when the gifts where [sic] made that they may be subject to tax in the future.”<sup>107</sup> By the 1930s, the Court began to shift away from the requirement of actual notice for taxpayers and instead focused on whether the retroactive application of legislation was harsh or oppressive.<sup>108</sup>

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96. *Id.* at 533.

97. *Id.* at 543.

98. *Id.* at 540–41.

99. 275 U.S. 142 (1927).

100. *Id.* at 146.

101. *Id.* at 146–47.

102. *Id.* at 147.

103. 276 U.S. 440 (1928).

104. *Id.* at 444–45.

105. *Id.* at 445.

106. *Id.* at 444–45.

107. *The Likelihood and Enforceability of a Retroactive Tax*, ASSET PROT. SOC’Y (2002), <http://www.assetprotectionsociety.org/the-likelihood-and-enforceability-of-a-retroactive-tax-2/> (last visited Mar. 29, 2014).

108. See Haskins, *supra* note 53, at 1166.



In 1931, the Court decided the case of *Milliken v. United States*.<sup>109</sup> There, the Court sanctioned the retroactive taxation of a decedent's gifts—which he had made in contemplation of death in 1916—at the increased rate that had gone into effect in 1918.<sup>110</sup> The Court found that this situation did not represent the imposition of a wholly new tax as it had in the earlier cases, and therefore the taxpayer was not without notice.<sup>111</sup> In analyzing the Court's various approaches in these early estate tax cases, Ralph Neuhoff sees the common element in the decisions to be one of fairness, in that the Court will only permit retroactive application when a taxpayer could have reasonably foreseen such an outcome.<sup>112</sup>

## 2. The *Carlton* Standard

The most recent Supreme Court case on retroactive tax legislation is *United States v. Carlton*,<sup>113</sup> decided by the Court in 1994. At issue in that case was an estate tax deduction permitted by Internal Revenue Code section 2057.<sup>114</sup> This deduction, which went into effect in October 1986, allowed an estate to deduct one-half of the sale price of employer securities that the estate sold to an employee stock ownership plan (ESOP).<sup>115</sup> In reliance on this provision, Carlton, acting as executor of the estate of Willametta Day, purchased 1.5 million shares of MCI Communications Corporation stock for \$11,206,000.<sup>116</sup> Two days later, Carlton resold this stock to the MCI ESOP for \$10,575,000, resulting in a loss of \$631,000.<sup>117</sup> Carlton then took the deduction for one-half of the sales price (\$5,287,000) on the estate return.<sup>118</sup> In January 1987, the IRS announced that it would only allow such a deduction for stock that was owned by a decedent *before* his or her death and, therefore, denied the claimed deduction for the Day estate.<sup>119</sup> In December 1987, Congress enacted legislation supporting the IRS's conclusion that such a deduction would only be available for stock owned by a decedent before death.<sup>120</sup> Carlton paid the deficiency plus interest and then

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109. 283 U.S. 15 (1931).

110. *Id.* at 18–19.

111. *Id.* at 23.

112. See Ralph Neuhoff, *Retrospective Tax Laws*, 21 ST. LOUIS L. REV. 1 (1935).

113. 512 U.S. 26.

114. *Id.* at 28.

115. *Id.* at 31.

116. *Id.* at 28.

117. *Id.*

118. *Id.*

119. *Carlton*, 512 U.S. at 29.

120. See Omnibus Budget Reconciliation Act of 1987, § 10411(a), 101 Stat. 1330-432. The statute (as amended) provided that, to qualify for the estate tax deduction, the securities sold to

filed suit in the U.S. District Court for the Central District of California, claiming that the retroactive applications of the 1987 amendments to Code section 2057 violated the Due Process Clause of the Fifth Amendment.<sup>121</sup> The District Court disagreed and awarded summary judgment to the United States.<sup>122</sup> A divided panel of the Court of Appeals for the Ninth Circuit reversed the District Court.<sup>123</sup> The majority considered two major factors in reaching its decision: (1) whether the taxpayer relied on prior law to his detriment; and (2) whether the taxpayer had actual or constructive notice of the change.<sup>124</sup>

The Supreme Court granted certiorari and reversed the Ninth Circuit.<sup>125</sup> While acknowledging that Carlton relied on the version of Code section 2057 in place at the time of the transaction, the Court did not find this persuasive, reiterating instead Justice Stone's ruling in *Welch v. Henry* that "Tax legislation is not a promise, and a taxpayer has no vested right in the Internal Revenue Code."<sup>126</sup> Further, the Court did not find Carlton's lack of notice dispositive, citing to its decision in *Milliken* that a taxpayer "should be regarded as taking his chances of any increase in the tax burden which might result from carrying out the established policy of taxation."<sup>127</sup> The Court instead found the following factors compelling: (1) the purpose of the retroactive amendment was neither illegitimate nor arbitrary; and (2) Congress acted promptly and therefore the retroactivity period was modest.<sup>128</sup> In this situation, Congress anticipated that without amendment, the loophole provided by Code section 2057 could cause a revenue loss of as much as \$7 billion, which was twenty times greater than expected.<sup>129</sup> Once Congress learned of the problem caused by the statutory language of 2057, it acted promptly to correct the statute and this retroactive application was a modest period of only slightly over one year.<sup>130</sup> The Court cited to its holding in *United States v. Darusmont*,<sup>131</sup> stating:

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an ESOP must have been "directly owned" by the decedent "immediately before death." *Id.*

121. *Carlton*, 512 U.S. at 29.

122. *Id.*

123. *Id.*

124. *Id.* at 29–30.

125. *Id.* at 30, 35.

126. *Id.* at 33; *Welch*, 305 U.S. at 146–47 ("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. Since no citizen enjoys immunity from that burden, its retroactive imposition does not necessarily infringe due process . . .").

127. *Carlton*, 512 U.S. at 34; *Milliken*, 283 U.S. at 23.

128. *Carlton*, 512 U.S. at 32.

129. *Id.*

130. *Id.* at 32–33.

131. 449 U.S. 292.

Congress “almost without exception” has given general revenue statutes effective dates prior to the dates of actual enactment. This “customary congressional practice” generally has been “confined to short and limited periods required by the practicalities of producing national legislation.”<sup>132</sup>

In separate concurrences, Justice O’Connor and Justices Scalia and Thomas offered additional insights. Justice O’Connor reiterated the due process standard—“legitimate legislative purpose furthered by rational means”<sup>133</sup>—while stressing that Congress has not been granted unlimited power to upset otherwise settled expectations.<sup>134</sup> In her view, “A period of retroactivity longer than the year preceding the legislative session in which the law was enacted would raise . . . serious constitutional questions.”<sup>135</sup> Justices Scalia and Thomas concurred in the Court’s judgment only on the basis that they did not find “substantive due process” to be a constitutional right.<sup>136</sup> According to the Justices, if they did believe that such a right existed, they would dissent from the opinion, believing the amendment to be more than a curative measure, referring to it instead as “bait-and-switch taxation.”<sup>137</sup>

### 3. Post-*Carlton* Development

In September 2012, the Supreme Court of New York upheld legislation enacted in 2010 to modify the tax rules for a non-resident S Corporation shareholder making a section 338(h)(10) election.<sup>138</sup> Essentially, New York wanted to ensure that non-residents would be subject to New York tax on the deemed sale of their assets.<sup>139</sup> The most striking feature of the retroactive legislation was the effective date. Enacted in 2010, it was effective retroactively to January 1, 2007.<sup>140</sup> The taxpayer at issue in the dispute

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132. *Id.* at 296–97; *Carlton*, 512 U.S. at 32–33.

133. 512 U.S. at 36 (O’Connor, J., concurring).

134. *Id.* at 37.

135. *Id.* at 38.

136. *Id.* at 39 (Scalia and Thomas, JJ., concurring).

137. *Id.*

138. *See Caprio v. New York State Dep’t of Taxation & Fin.*, 955 N.Y.S. 2d 734, 747 (2012). The purpose of making such an election is to treat a stock purchase as an asset purchase for taxation purposes.

139. *Id.* at 740. Existing legislation as interpreted by court decisions did not subject this transaction to tax for a non-New York resident.

140. *Id.*

challenged the constitutionality of the retroactivity in court.<sup>141</sup> Relying on both federal and New York cases that have permitted retroactive legislation, the court upheld the tax, finding that a retroactive tax should be upheld “unless it reaches so far into the past or so unfairly as to constitute a deprivation of property without due process.”<sup>142</sup> Also expressing concern with whether the retroactive legislation was harsh and oppressive, the court noted that this is a “question of degree, requiring a balancing of the equities.”<sup>143</sup>

#### 4. Administrative Retroactive Changes

Another aspect of this discussion is to what extent agencies, such as the Internal Revenue Service, have authority to engage in retroactive rulemaking. As pointed out by Chris Schmitter, administrative authority has become increasingly important, especially given the increasing amount of pressure on agencies to address the administrative aspects of new laws, such as the Patient Protection and Affordable Care Act (PPACA) and the Dodd-Frank Wall Street reform bill.<sup>144</sup> One thing is clear: if the agency is engaged in rulemaking, its ability to do so retroactively is limited.<sup>145</sup> If, instead, the retroactive rules are merely interpretive, they are more likely to pass muster, since interpretive rules are designed to clarify what the law has always meant, not establish new rules.<sup>146</sup> One approach taken by the IRS in recent years has been especially troubling. In a number of cases, the IRS has taken the position that it has administrative authority to invalidate decided cases through retroactive interpretive regulations.<sup>147</sup> These actions give “further

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141. *Id.* at 742.

142. *Id.* at 743.

143. *Id.* (internal citations omitted).

144. Chris Schmitter, *Going Back in Time: The Search for Retroactive Rulemaking Power in Statutory Deadlines*, 97 MINN. L. REV. 1114, 1115 (2013).

145. *See, e.g.*, Geoffrey C. Weien, Note, *Retroactive Rulemaking*, 30 HARV. J.L. & PUB. POL'Y 749, 756–57 (2007) (discussing the tendency of courts to cite the principle of fair notice as a reason for barring retroactive rulemaking). For a thorough treatment of an agency's ability to engage in retroactive rulemaking when the agency is given a specific deadline by Congress in which to act and fails to meet that deadline, *see generally* Schmitter, *supra* note 144.

146. *See, e.g.*, Puckett, *supra* note 87, at 367.

147. *See, e.g.*, *Intermountain Ins. Serv. of Vail, LLC v. Comm'r*, No. 10-1204, 2012 U.S. App. LEXIS 11811 (D.C. Cir. June 11, 2012). In *Intermountain*, the D.C. Circuit found that the IRS had the ability to issue regulations that interpreted the law in such a way that the regulations effectively overruled a recent decision by the Tax Court on the contested Code provisions. At issue was whether an overstatement of basis was an omission of income under Code sections 6501(e) and 6229 for purposes of extending the normal three-year statute of limitations to six years. On September 1, 2009, the Tax Court ruled that it was not. On September 28 of that same year, the IRS issued two temporary interpretive regulations that

credence to claims that the agency and the Treasury Department . . . are pushing the boundaries of their regulatory powers to an extent never before seen.”<sup>148</sup> For the time being, however, that position has been unable to advance. In April 2012, the Supreme Court ruled that IRS regulations will not be given deference in situations in which the Court has already decided that Congressional intent is clear and there is no ambiguity for the regulations to resolve.<sup>149</sup>

### C. Application of a Statute That Has Been Declared Unconstitutional

Taxing measures that run afoul of constitutional limitations, and are struck down on judicial challenge, bring up the question of what remedies are available to taxpayers who have paid an unconstitutional tax. Answering this question necessitates a determination of whether the decision will be applied prospectively or retroactively. Retroactive application is the general rule and would allow those who had been required to pay an unconstitutional tax a right to a refund of such taxes.<sup>150</sup> However, recognizing that such application could leave states financially vulnerable and that numerous refund claims could detrimentally affect a state’s financial stability, courts have allowed the states flexibility in crafting taxpayer relief. As the Court in *McKesson Corp. v. Division of Alcoholic Beverages & Tobacco* made clear, there are a variety of approaches available to the taxing authority, and while a state must provide a taxpayer with meaningful relief, a state may consider the impact of any refunds on state financial stability:

We agree that, within our due process jurisprudence, state interests traditionally have played, and may play, some role in shaping the contours of the relief that the state must provide to illegally or erroneously deprived taxpayers . . . . States have a legitimate interest in sound fiscal planning and . . . this interest is sufficiently weighty to allow States to withhold predeprivation relief for allegedly unlawful tax assessments, providing postdeprivation relief only.<sup>151</sup>

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said that this would be an omission of gross income. Relying on Code section 7805(b), which gives the IRS authority to issue regulations with retroactive effect, the IRS imposed the regulations retroactively.

148. Andrew Pruitt, *Judicial Deference to Retroactive Interpretive Treasury Regulations*, 79 GEO. WASH. L. REV. 1558, 1559 (2011).

149. See *United States v. Home Concrete & Supply, LLC*, 132 S. Ct. 1836, 1844 (2012).

150. *McKesson v. Div. of Alcoholic Beverages & Tobacco*, 496 U.S. 18, 31 (2011).

151. *Id.* at 50.

In addition to the California cases described in Part I, in a series of recent cases in other states, state legislatures have taken retroactive actions either to eliminate or to diminish pending taxpayer refund claims. In most of these cases, Supreme Court review was requested and certiorari was denied.

In *Revenue Cabinet v. Asworth Corp.*,<sup>152</sup> the Court of Appeals of Kentucky considered whether the due process clause was violated when state legislation was retroactively applied to taxpayer refund claims to deny taxpayer's interest on pending claims.<sup>153</sup> In that case, the taxpayer corporations filed tax returns in Kentucky, which were later amended seeking a refund of an overpayment along with corresponding interest.<sup>154</sup> While the refund claims were pending, the Kentucky legislature passed retroactive legislation that potentially shortened the period for which a taxpayer could accrue interest on overpayments and also decreased the rate of that interest.<sup>155</sup> The taxpayer argued that such action violated due process, but the court found that it did not because it furthered a legitimate governmental purpose of raising revenue in accordance with the Supreme Court's decision in *Carlton*.<sup>156</sup> The taxpayers sought Supreme Court review, but this was denied.<sup>157</sup>

*Ford Motor Credit Co. v. Department of Treasury*<sup>158</sup> involved actions of the Michigan legislature that retroactively amended the meaning of the term "persons."<sup>159</sup> This amendment resulted in a denial of pending refund claims filed by the Ford Motor Company seeking a refund resulting from a bad debt deduction.<sup>160</sup> The Court of Appeals of Michigan ruled that the retroactive action of the legislature was a clarification of legislative intent.<sup>161</sup> According to the court, "Once the intention of the legislature is discovered, it prevails over any conflicting rule of statutory construction."<sup>162</sup> The Supreme Court also denied certiorari in this case.<sup>163</sup>

The center of the dispute in *Miller v. Johnson Controls, Inc.*<sup>164</sup> was the ability of corporations to file consolidated returns under the unitary business

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152. Nos. 2007-CA-002549-MR & 2008-CA-000023-MR, 2009 Ky. App. LEXIS 229 (Ky. App. Nov. 20, 2009).

153. *Id.* at \*20.

154. *Id.* at \*3-4.

155. *Id.* at \*19.

156. *Id.* at \*21.

157. *Id.*, cert. denied 131 S. Ct. 1720 (2011).

158. 2010 Mich. App. LEXIS 5088.

159. Brief for Respondent at 5, *Ford Motor Credit Co. v. Dep't of Treasury*, 131 S. Ct. 1000 (2011) (No. 10-481).

160. *Id.* at 5-6.

161. *Ford*, 2010 Mich. App. LEXIS 71, at \*1-2.

162. *Id.*

163. *Id.*, cert. denied 131 S. Ct. 1000 (2011).

164. 296 S.W.3d 392 (Ky. 2009).

principle.<sup>165</sup> The corporate taxpayers in that case had originally filed separate returns, but a 1994 ruling by the Supreme Court of Kentucky authorized consolidated return filings for unitary businesses.<sup>166</sup> As a result of that ruling, taxpayers filed amended consolidated returns seeking a refund of overpaid tax.<sup>167</sup> Recognizing that the court's ruling would result in a barrage of amended consolidated return filings seeking a refund, the Kentucky legislature retroactively modified the statute to bar the filing of this type of consolidated return and also to bar the payment of any refunds due on this type of amended return.<sup>168</sup> The court upheld the retroactive amendments made in 1996 and 2000 as an exercise of the state's revenue-raising function that served a legitimate government purpose.<sup>169</sup> The lone dissent in the case had this to say:

This corporate tax case presents a rather straightforward question: how aggressively may the General Assembly legislate after-the-fact in an effort to retain tax monies which this court has held were collected in contravention of state law? . . . Generally, a sovereign must provide "meaningful relief" in the form of a refund of the invalidly collected taxes and, while there is some latitude to legislate tax law retroactively, that power must be exercised promptly for a legitimate purpose and for a modest period. The 2000 Kentucky General Assembly exceeded the bounds of due process when it passed H.B. 541 in an effort to undo entirely this Court's ruling over five years earlier . . . . Neither the complete ban of all outstanding tax refund claims associated with the . . . case nor the retroactive rewrite of state tax law to condone the retention of corporate taxes invalidly collected five to twelve years previously passes constitutional muster.<sup>170</sup>

The Supreme Court once again denied certiorari.<sup>171</sup>

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165. *Id.* at 393.

166. *Id.* at 394.

167. *Id.*

168. *Id.*

169. *Id.* at 397.

170. *Miller*, 296 S.W.3d at 407 (Abramson, J., dissenting).

171. *Id.*, *cert. denied* 130 S. Ct. 3324 (2010).

A more recent case to note is *General Motors Corp. v. Department of the Treasury*,<sup>172</sup> in which the court gave Michigan wide latitude to enact retroactive legislation that denied the taxpayer a refund of overpaid taxes.<sup>173</sup> The Michigan Department of Treasury required General Motors (GM) to pay use taxes on vehicles that it purchased for its employees to use as demonstration vehicles.<sup>174</sup> GM paid such taxes for many years, until a decision by the Michigan Supreme Court<sup>175</sup> determined that cars purchased as demos were exempt from the use tax under the sale for resale exemption.<sup>176</sup> While that case was pending, GM filed a refund claim, in August 2006, seeking a refund of approximately \$65 million for the period of 1996 through March 2002.<sup>177</sup> The court issued its decision in May 2007.<sup>178</sup> In September 2007, GM filed a second refund claim seeking approximately \$51 million for the period of March 2002 through August 2007.<sup>179</sup> In the interim, the state was concerned by estimates that the court's decision carried a potential one time cost to the state of \$250 million and ongoing costs of \$29.2 million.<sup>180</sup> In June 2007, Michigan state lawmakers introduced House Bill 4882 into law, which retroactively modified the use tax law to clarify that purchases of demo vehicles such as those paid by GM would remain subject to taxation.<sup>181</sup> This proposed legislation became law in October 2007 and the legislature decreed that it would have retroactive effect dating back five years to 2002 and beyond to the extent a statute of limitations period remained open for a taxpayer.<sup>182</sup> In effect, the legislation retroactively prohibited GM's refund claims. The Appeals Court of Michigan, relying heavily on the Supreme Court's decision in *Carlton*, determined that this action by the Michigan legislature did not violate GM's due process rights.<sup>183</sup> The court explained:

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

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172. 803 N.W.2d 698 (Mich. Ct. App. 2010).

173. *Id.* at 719–20.

174. *Id.* at 703.

175. *Betten Auto Ctr., Inc. v. Dep't of Treasury*, 478 Mich. 864 (2007).

176. *Id.*

177. *GMC*, 803 N.W.2d at 703.

178. *Betten*, 478 Mich. at 864.

179. *GMC*, 803 N.W.2d at 706.

180. *Id.*

181. *Id.*

182. *Id.* at 707–08.

183. *Id.* at 712.



recognized as “rationally related to a legitimate legislative purpose.”<sup>184</sup>

The Supreme Court denied certiorari in the case in 2012, allowing the state court’s approval of a five-year retroactivity period to stand.<sup>185</sup>

Commenting on the ability of state legislatures to pass legislation to make clarifications to the law as a result of an unfavorable judicial outcome, Robert Gunning has observed:

If the legislative branch believes that the taxpayers may succeed and open the doors to refund claims for other taxpayers, it should act promptly to rectify any perceived defects in the legislation, rather than await the result of the litigation and then attempt to retroactively slam the door on taxpayer refund claims.<sup>186</sup>

The Supreme Court’s repeated refusal to grant certiorari in cases challenging state retroactive takings will no doubt help to perpetuate the ever-lengthening periods of retroactive takings.

#### CONCLUSION

“The Great Recession that began in December 2007 has made for difficult times for American state and local governments, as with most all entities and individuals.”<sup>187</sup> The landscape of retroactive revenue grabs is vast and no doubt fueled, in part, by state financial needs. In the absence of an express constitutional provision prohibiting retroactive actions, the question remains whether there are any limits on the extent to which taxpayers can be expected to incur retroactive costs. Supreme Court decisions on retroactive actions go back almost as far as the start of our nation’s history, and yet provide no sense of clarity that will help taxpayers to plan for or guard against a retroactive taking. The Supreme Court has consistently broadened its acceptance of retroactive actions in the area of taxation. Although early cases sometimes looked to whether taxpayers had adequate notice of a change or whether the retroactivity period was short

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184. *Id.* at 710; *Carlton*, 521 U.S. at 35.

185. *GMC*, 803 N.W.2d 698, *cert. denied* 2012 U.S. LEXIS 1004 (2012).

186. Robert R. Gunning, *Back from the Dead: The Resurgence of Due Process Challenges to Retroactive Tax Legislation*, 47 DUQ. L. REV. 291, 329 (2009).

187. John L. Mikesell & Daniel R. Mullins, *State and Local Revenue Yield and Stability in Great Recession: The Virtues of Cyclical Versus Secular Adequacy and the Necessity of Policy Responses*, 102 ANN. CONF. OF TAX’N, NAT’L TAX ASS’N PROC. 246 (2009).

(generally within one year), this approach has gradually given way to a more lenient standard. The driving factor in recent cases tends to be the *Carlton* Court's rational basis standard, a low standard of judicial scrutiny.<sup>188</sup> The generally accepted one-year standard has given way to cases that condone two-, three-, and even five-year retroactivity periods, although no bright line test has emerged. The United States Supreme Court seems content to sit on the sidelines as due process rights are increasingly stripped away.

At present there remains no litmus test for assessing the constitutionality of a retroactive revenue grab. "There is much play in the joints between two years' retroactivity and two decades' retroactivity that the Court's precedents do not squarely address. [As] Justice Scalia observes, . . . the reasoning the court applies [in *Carlton*] to uphold the statute in this case guarantees that all [sic] retroactive laws will henceforth be valid."<sup>189</sup> While this is certainly an exaggeration by Justice Scalia, there is little doubt that the Supreme Court's adoption of the rational basis standard of review in such cases and the Court's failure to clearly define a "modest period of retroactivity"<sup>190</sup> inevitably leads to the conclusion that for taxpayers facing retroactive changes that result in additional tax liabilities or the denial of refund claims, relief is nowhere in sight. California's "lawless taxation" and "midnight special" are only a glimpse of what is yet to come.

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188. See LUNDER ET AL., *supra* note 86, at 1–2.

189. Puckett, *supra* note 87, at 378.

190. *Carlton*, 521 U.S. at 32.