Constitutional Limitations

Retroactive taxes generally must be limited to a modest period of retroactivity. However, with the Supreme Court’s denial of cert. in the Miller v. Johnson and General Motors cases, retroactive periods of 6 to 11 years have been allowed to stand. In this article, Erica Horn and Stephen Sherman, of Stoll Keenon Oden PLLC, examine recent state tax cases that deal with the retroactive application of curative changes to existing tax statutes, as well as retroactivity of new tax treatments. The authors discuss those factors the courts are willing to consider in determining whether due process has been violated.

Retroactive Tax Legislation: Where Is the Modesty?

BY ERICA L. HORN AND STEPHEN A. SHERMAN

I. Introduction

“States need money.” This simple sentence was the first sentence in an article published two years ago, titled Retroactivity and Refunds: Can They Really Keep Your Money? Over two years later little has changed—states still need money, and still aggressively pursue legislation to retroactively revoke refund claims. Thus, the question remains whether a state may extinguish a taxpayer’s right to refund ex post facto.

Taxpayers have fought these efforts based on the Due Process Clause of the Fourteenth Amendment, which provides “[N]or shall any State deprive any person of life, liberty, or property, without due process of law.” The U. S. Supreme Court addressed the constitutionality of retroactive tax legislation in United States v. Carlton, limiting the circumstances and time within which a state may amend tax statutes relied upon by taxpayers. To this end, a state cannot retroactively amend a tax statute without legitimate reason and prompt action, and even then may apply the statute retroactively only for a modest period. However, federal and state courts have found and exploited ambiguities in the Court’s guidance.

This article reviews the Court’s decision in Carlton and then describes recent state cases that illustrate the varying ways of understanding and applying the Court’s decision when reviewing retroactive tax statutes.

II. Carlton – Modern Test for Evaluating Retroactive Tax Legislation

While not the first case on retroactive tax legislation, United States v. Carlton is the seminal case and purports to announce the modern test for judging such legislation. The case involved an amendment to a federal estate tax statute. Adopted in October 1986, 26 U.S.C. §2057 (“Section 2057”) granted an estate tax deduction for half the proceeds of employer securities...
by the executor of an estate” to “an employee stock ownership plan.” In December 1986, Carlton, acting as an executor, purchased shares in a corporation, sold them to that company’s ESOP at a loss, and claimed a large Section 2057 deduction on the estate tax return. In December 1987, Congress amended Section 2057 to provide that, to qualify for the deduction, the securities sold to an ESOP must have been “directly owned” by the decedent “immediately before death.” Because the amendment applied retroactively, as if it were incorporated in the original 1986 provision, the Internal Revenue Service disallowed Carlton’s Section 2057 deduction. Carlton challenged the disallowance.

The amendment at issue here certainly is not properly characterized as a “wholly new tax,” and its period of retroactive effect is limited.

Finally, the Court concluded: “Because . . . retroactive application of the 1987 amendment to §2057 is rationally related to a legitimate legislative purpose, we conclude the amendment as applied to Carlton’s 1986 transactions is consistent with the Due Process Clause.”

Justice O’Connor authored an opinion in which she concurred with the judgment but questioned portions of the majority opinion. Relevant to this article, are the following statements from her opinion: “[t]he governmental interest in revising the tax laws must at some point give way to the taxpayer’s interest in finality and re- pose. 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.”

In cases decided over the last two years, state courts have taken conflicting positions on “the standard” for judging the retroactive application of a tax statute. Points of disagreement include whether Carlton enumerates a two-part test for determining if a retroactive tax violates the Due Process Clause (i.e., requiring (1) a rational purpose for the retroactivity and prompt legislation and (2) a modest period of retroactivity), or whether it merely required a rational basis for implementing the tax. Also, if retroactivity must be limited to a “modest period,” what constitutes “modest”? The Court has had two opportunities to clarify its holding in Carlton, but has passed on both. Thus, taxpayers, legislatures, and courts alike are left to struggle.

III. The Court’s Recent Passes

The Court denied petitions for writ of certiorari in both Miller v. Johnson Controls and General Motors Corp. v. Michigan Dept. of Treasury.14 The impact of these decisions was to allow statutes with retroactive periods of 6 to 11 years to stand.

A. Miller v. Johnson Controls15

Johnson Controls and other corporate taxpayers challenged the constitutionality of legislative amendments passed by the 2000 Regular Session of the Kentucky General Assembly. The taxpayers maintained that the legislation eliminated, in an unconstitutional manner, refund claims filed by them based on a change from separate returns to combined filings—a change required by a 1994 decision of the Kentucky Supreme Court in GTE and Subsidiaries v. Kentucky Rev. Cab.16 While unsuccessful at the trial court, the taxpayers scored a victory on appeal, with the Court of Appeals concluding that the legislation deprived taxpayers of

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11 Id. at 35.
12 Id. at 37-38 (O’Connor, J., concurring).
14 Id.
15 296 S.W.3d 392 (Ky. 2009).
16 889 S.W.2d. 788 (Ky. 1994).

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5 Id. at 30-31 (internal citations omitted).
6 Id. at 35.
7 Id. at 32.
8 Id. at 32-33.
9 Id. at 33 (internal citation omitted).
10 Id. at 34.
due process because its retroactive effect exceeded the “modest” period of retroactivity required by the Supreme Court in Carlton. The Kentucky Supreme Court reversed.

The history giving rise to this case was a long one. No later than 1972, the Kentucky Revenue Cabinet (now the “Department of Revenue”) began to rely on the definition of “business income” found at Ky. Rev. Stat. Ann. §141.120 (Kentucky’s adoption of UDITPA’s definition of “business income”) as authority to combine the income of multi-state, multi-corporate groups that the Cabinet determined to be “unitary.” The Cabinet started this combination policy by targeting selected multi-corporate taxpayers to file combined returns. Before the Cabinet acted on the refund requests during the time the Cabinet prohibited combined returns, other taxpayers filed amended returns on a combined basis to obtain a refund of the taxes they had overpaid to other taxpayers. The General Assembly effected this elimination of refund claims of Johnson Controls and many other taxpayers. Kentucky’s tax statutes were amended statutory section provided: "No later than 1972, the Kentucky Revenue Cabinet (now the “Department of Revenue”) began to rely on the definition of “business income” found at Ky. Rev. Stat. Ann. §141.120 (Kentucky’s adoption of UDITPA’s definition of “business income”) as authority to combine the income of multi-state, multi-corporate groups that the Cabinet determined to be “unitary.” The Cabinet started this combination policy by targeting selected multi-corporate taxpayers to file combined returns when combination resulted in additional tax."

In 1988, sixteen years later, the Cabinet issued an informal administrative policy, known as Revenue Policy 41P225, which declared the Cabinet would no longer accept combined returns except in the case of sham corporations. GTE Corporation challenged this policy shift and, on Dec. 22, 1994, the Kentucky Supreme Court ruled that the Cabinet’s actions were unlawful, and multi-corporate unitary groups were required to file combined returns in Kentucky.

In response to the GTE case, Johnson Controls and other taxpayers filed amended returns on a combined basis to obtain a refund of the taxes they had overpaid during the time the Cabinet prohibited combined returns. Before the Cabinet acted on the refund requests of all taxpayers, Kentucky’s tax statutes were amended to eliminate the refund claims of Johnson Controls and others. The General Assembly effected this elimination through two substantive amendments. The first amendment simply declared that the refund claims at issue would not be honored. The second retroactively precluded unitary taxpayers from filing combined income tax returns that produced refund claims. The new statutory section provided:

No corporation or group of corporations shall be allowed to file a combined return under the unitary business concept or a consolidated return for any taxable year ending before December 31, 1995, unless on or before December 22, 1994, the corporation or group of corporations filed an initial or amended return under the unitary business concept or consolidated return for a taxable year ending before December 22, 1994.

These amendments abolished the refund claims of the taxpayers for tax years ranging from approximately 1990-1994; that is, the retroactive effect of the amendments was six to ten years.

The Kentucky Supreme Court applied its version of a rational basis test to determine that the amendments did not transgress due process. The court began its analysis with Carlton, and observed: “After a painstaking analysis, the Supreme Court determined that as long as the statutory amendment was rationally related to a legitimate legislative purpose, it would not violate due process.” The court then articulated the following as its standard:

Retroactive application of a statute need only be (1) supported by a legitimate legislative purpose (2) furthered by rational means, which includes an appropriate modesty requirement.

Thus, what is “modest” or acceptable for due process purposes depends on the facts of the case, including notice, settled expectations, detrimental reliance, etc.

The court then held: “There can be no question that the legislature . . . had a legitimate governmental purpose (raising and controlling revenue) and that the statute rationally furthers this purpose.”

While the Kentucky Supreme Court’s description of the Carlton standard is not wholly objectionable, the court failed to apply the standard articulated by it. The only full statement of the court applying the criteria to the facts of the case was: “Further, to prevent a significant and unanticipated revenue loss, [Taxpayers] had not been on notice of the [Revenue Cabinet’s] intent to prohibit combined filing from 1988 when RP 41P225 was issued until 1994 when GTE was decided, and could not have had any ‘settled expectations’ to the contrary.” Needless to say, the taxpayers vehemently disagreed with this summary conclusion, but after the U.S. Supreme Court denied their petition for writ of certiorari, they reached the end of their appellate road.

B. General Motors Corp. v. Michigan Dept. of Treasury

In General Motors Corp. v. Dept. of Treas., General Motors (“GM”) challenged the Michigan legislature’s retroactive amendment of the state’s use tax statutes. GM personnel were required to drive inventory vehicles to assist in marketing, testing, research and design. The test vehicles were held by GM in its general inventory for resale and later sold to consumers. The Michigan Department of Treasury (“Treasury”), through audit enforcement, required GM to self-assess use tax on the vehicles. GM then filed refund claims for the use tax paid, based on the Michigan Court of Appeal’s decision in Betten Auto Center v. Michigan Dept. of Treas.
In Betten, the Court of Appeals issued a taxpayer favorable opinion on Aug. 1, 2006, holding that vehicles used for demonstration purposes were exempt from use tax. On Aug. 25, 2006, GM filed its first claim for a refund of use taxes paid for the period Oct. 1, 1996 to March 28, 2002, which Treasury held in abeyance pending appeal of the Betten decision to the Michigan Supreme Court.

The Michigan Supreme Court issued its order in Betten on May 28, 2007. The court affirmed a portion of a decision by the Court of Appeals that, under the resale exemption, cars sold by a new car dealer were exempt from liability for any interim use to which the dealers put the vehicles pending resale. The statute at issue in the case was Mich. Comp. Laws §205.94(1)(c), as amended by 2004 PA 172, which exempted from use tax items purchased for resale, demonstration purposes, or lending/leasing to a parochial school for driving classes. Relying upon the clear language of the statute, the court held that even though the dealers' inventories were used before resale they qualified for the resale exemption because the cars were purchased for resale and were, in fact, resold.

Thirteen days after the Michigan Supreme Court issued its decision, HB 4882, which later became 2007 PA 103, was introduced in the Michigan House of Representatives. Treasury and the Legislature clearly were concerned about the impact of the Betten decision on state revenue, which was estimated to exceed $200,000,000. The Michigan Supreme Court denied reconsideration in Betten on July 9, 2007.

On Sept. 14, 2007, GM filed its second claim for a refund of use taxes paid on its employees' use of program vehicles for the time period from March 28, 2002 to Aug. 31, 2007. Meanwhile, the Michigan House approved HB 4882 on Sept. 24, 2007, and the Michigan Senate approved the bill on Sept. 30, 2007. The Governor signed HB 4882 into law on Oct. 1, 2007, and it became 2007 PA 103. The Legislature gave the act retroactive effect by providing that the act was "retroactive and [ ] effective beginning September 30, 2002 and for all tax years that are open under the statute of limitations. . ." 

The amendment to the use tax statute provided that any property purchased for resale that was subsequently converted to taxable use in the interim was subject to the use tax. The Legislature stated that the amendment was to "clarify" that any use, including interim use, of property purchased for resale other than as passive inventory is a taxable use. The amendment expanded the use tax by imposing it upon the "person" making the taxable use, rather than the "consumer." Further, the definition of taxable use was expanded to include conversion of property to a non-exempt use.

In essence, the legislature closed every hole found by the Betten court.

Treasury denied GM's refund claims based upon the retroactive legislation, and GM challenged the denial. The Michigan Court of Claims found the 11-year period of retroactivity that applied to GM violated GM's due process rights because the period was not modest. Treasury appealed.

In reviewing the decision of the Court of Claims, the Court of Appeals found the use tax amendment warranted scrutiny because the amendment was not merely curative but substantively changed the statute, and affected substantive rights and obligations. Referencing Carlton's rational basis test, the court held that retroactive legislation to "fix a leak in the state treasury" is rationally related to a legitimate legislative purpose. Acknowledging the U.S. Supreme Court opined in Carlton that "Congress imposed only a 'modest' period of retroactivity," the court found that a "modesty" requirement was not adopted in Carlton, but a limitation on the period of retroactivity is required for purposes of analyzing whether GM's due process rights were violated. The court then adopted the "facts and circumstances" test enunciated by the Kentucky Supreme Court in Johnston Controls.

The court found that the facts and circumstances of the case warranted the retroactive period for five reasons. First, the amendment was not a new tax on a long concluded transaction. Second, GM did not act in reliance on the expectation its activity would not be taxed; in fact, it continued its activity after notice the state deemed the activity taxable. Third, the legislature acted promptly in response to the Betten decision. Fourth, the five-year retroactive period was equal to the statute of limitations and did not affect finality and repose. Finally, the Court found the retroactive time period was comparable to those approved in other jurisdictions. Thus, the retroactive amendment of Michigan's use tax statutes passed constitutional muster, and the denial of GM's refund claims was affirmed. In January of 2012, GM reached the end of its appellate road.

C. The Bleak Spots

Johnson Controls and General Motors both paint a bleak picture for taxpayers challenging the retroactive application of a tax statute. Two other cases in which the legislature and taxing authority prevailed are River

34 Id.
35 Id.
37 Id. at 365.
38 Id.
39 Id.
40 Id.
41 Id. at 367.
42 Id.
43 Id.
44 Id.
45 Id. at 360.
46 Id. at 359. The period of retroactivity for GM was 11 years because GM filed refund claims extending back to 1996 and had waived the statute of limitations. Id. at 377.
47 Id. at 371-72.
48 Id. at 373.
49 Id. at 374.
50 Id. at 375, citing Miller v. Johnson Controls, 296 S.W.3d 392.
52 Id.
53 Id.
54 GM's waiver of the statute of limitations, allowing the 11-year retroactive period, was deemed to be a waiver of its due process interest in finality and repose. Id. at 376-77.
55 Id. at 377.
1. River Garden Retirement Home v. California Franch. Tax Bd. Taxpayer River Garden Retirement Home ("River Garden") challenged the retroactive denial of an income tax deduction. California Revenue and Taxation Code §24402 permitted corporate taxpayers in California to deduct a portion of dividends received from other corporations that were subject to taxation in California, but not from corporations that were not subject to California tax.58 River Garden filed tax returns in 1999 and 2000, deducting a portion of the dividends it had received in those years, pursuant to §24402.59 In 2003, §24402 was declared unconstitutional in Farmers Bros. Co. v. Franchise Tax Bd.,60 on the ground it violated the Commerce Clause of the United States Constitution, because it treated dividends from corporations subject to tax in California differently from those of corporations not subject to California tax.61 As a result of the Farmers Bros. opinion, the Franchise Tax Board ("FTB") was forced to remedy the discrimination. Rather than denying all deductions or allowing all taxpayers the deduction, the FTB announced a hybrid solution; it would allow §24402 deductions for the tax years before 1999 but would deny the deduction for tax years 1999 and beyond. River Garden was assessed additional taxes for the deductions claimed in 1999 and 2000,62 which it protested to the Board of Equalization. The Board of Equalization upheld the assessment. River Garden paid the tax in full and sued for a refund in state court. The trial court upheld the assessment and River Garden appealed.63

The Court of Appeal of California, First Appellate District, concluded the period of retroactivity for assessing additional taxes, which reached back four years from the issuance of the Farmers Bros. opinion, did not violate due process.64 In its opinion, the court described the Carlton decision in detail.65 The court acknowledged the Supreme Court's articulation of a "rational basis" standard ("the retroactive application of a statute [must be] supported by a legitimate legislative purpose furthered by rational means"),66 and the statements of the majority and Justice O'Connor regarding a "modest period of retroactivity."67 Turning to the modesty requirement, the court stated, "Our particular focus lies in determining whether the retroactive period here is sufficiently 'modest' as to pass constitutional muster."68

To that end, the court reviewed several cases allowing for lengthy periods of retroactivity,69 and also considered cases denying or limiting retroactive periods.70 The court found no clear test of modesty had been established, nor had the modesty requirement been uniformly adopted.71 Upon concluding its detailed review, the court held "Carlton does call for a modest period of retroactivity, but we do not subscribe to the view that a period longer than one year in and of itself raises serious constitutional questions. Rather . . . the modesty of the period must be assessed under the facts and circumstances of the case."72

For numerous reasons, the California court then held the period of retroactivity being applied to River Garden was modest. First, the court found that the relief provided by the FTB provided meaningful backward-looking relief by assessing tax against favored taxpayers—those receiving the unconstitutional benefit.73 Second, the FTB developed the remedy pursuant to §19393 of the California Revenue and Taxation Code, which required that deductions deemed unconstitutional be remedied via retroactive assessment of the favored taxpayers. The court found that this provision provided ample notice to taxpayers of the potential loss of the deduction.74 Third, the court stated that taxpayers have no vested right in deductions, which are a matter of legislative grace.75 Fourth, the court noted that the period of retroactivity was equal to the statute of limitations and therefore, was reasonable.76 Finally, the court held that the remedy did not impose any new obligations upon taxpayers and thereby, did not undermine the "clarity and certainty of the remedy in a man-

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58 Id. at 931-932.
59 Id. at 933.
61 River Garden, 186 Cal. App. 4th at 932.
62 Id. at 933.
63 Id.
64 Id. at 949.
65 Id. at 945-45.
66 Id. at 942, citing Carlton, 512 U.S. at 30-31.
68 Id. at 945.
70 City of Modesto v. National Med Inc., 128 Cal. App. 4th 518, 27 Cal. Rptr. 3d 215 (2005) (finding an eight year retroactive period for an amendment to a city's apportionment method was not modest and would improperly require taxpayers to produce documents otherwise not required to be maintained); Rivers v. State, 327 S.C. 271, 480 S.E.2d 261 (1997) (finding a statute which retroactively reduced a taxpayer's capital gains for a period of two to three years was not modest); and Scottsdale Princess v. Arizona Dept. of Rev., 191 Ariz. 499, 958 P.2d 15 (Cl. App. 1997) (rejecting retroactive assessments of tax as a remedy for statute in violation of constitutional uniformity, concluding the assessments were harsh and oppressive).
71 River Garden, 186 Cal. App. 4th at 947.
72 Id. at 948.
73 Id.
74 Id.
75 Id. at 949.
76 Id.
ner inconsistent with due process.”77 Thus, the court held, “For all these reasons we conclude the four-year period of retroactivity embedded in the FTB’s remedy is modest.”78

2. Caprio v. New York Dept. of Taxn. & Fin. The most recent case on retroactivity is from New York. In Caprio v. New York Dept. of Taxn. & Fin.,79 the New York Supreme Court upheld retroactive application of an amendment to New York’s tax laws regarding recognition of the gain on the sale of intangible assets by nonresidents. Philip and Phyllis Caprio (the “Caprios”) were the sole shareholders of a New York S Corporation, but were nonresidents of New York. The Caprios sold the stock of their S Corporation to a third party purchaser on Feb. 1, 2007. The purchase price was to be paid in two installments pursuant to separate promissory notes; the first was to be paid on March 1, 2007 in the amount of $19,962,080 and the second was to be paid in the amount of $500,000 on Feb. 1, 2008.80 As part of the purchase agreement, two federal tax elections were made under the Internal Revenue Code: a §338(h)(10) election and a §453 election.81 As a result of the §338(h)(10) election, the sale was deemed to have been a sale of all of the S corporation assets in exchange for the promissory notes, and the S Corporation was deemed to have made a distribution of the promissory notes to the Caprios in a deemed liquidation.82 Under the §453 installment method election, the gain from the receipt of promissory notes would only be taxable when cash payments were actually made pursuant to those notes.83

As a result of the sale and the elections, the S Corporation filed a final federal return for a short taxable year ending on Feb. 1, 2007.84 It reported the asset sale resulting from the §338(h)(10) election. Since neither the S Corporation nor the taxpayers had received any cash payments from the promissory notes by the date of the return, the asset sale did not result in the recognition of any gain on that return under the §453 installment method.85 The S Corporation filed its 2007 New York tax return in conformity with the federal return, showing no taxable gain due to the elections in place.86

The Caprios claimed that no gain was recognized when they received the promissory notes in liquidation from the S Corporation because under the §453 election, no gain is recognized until cash is received.87 On their 2007 federal tax returns, the Caprios reported gains attributable to the receipt of the March 1, 2007 payment on the promissory notes.88 On their 2008 federal tax returns, the Caprios reported the gains attribut-
about certain changes in operation of the tax laws.\textsuperscript{99} The court said a statute that creates a wholly new tax while imposing retroactive application that is not limited to a short period may run afoul of due process.\textsuperscript{100} In contrast, a retroactive tax statute that is “curative” or “clarifying” in nature, that is, one that brings about certain changes in the operation of tax laws, is less likely to transgress due process.\textsuperscript{101} After examining the legislative history of the amendment to determine its nature, the court concluded the amendment was curative and necessary to undo the decision.\textsuperscript{102}

Because the amendment was deemed curative, the court noted that to pass due process scrutiny, the retroactivity of the amendment had to be rationally related to a legitimate state purpose.\textsuperscript{103} The court reiterated its finding that the purpose of the amendment was to clarify the statute and correct the erroneous decision in \textsuperscript{104} The court then stated that the retroactive period (back to Jan. 1, 2007) was coextensive with the statute of limitations and therefore, the retroactive period was rationally related to a legitimate state purpose, i.e., to clarify that taxpayers could not rely upon Mintz.\textsuperscript{105} The court also stated that both federal and state courts have eschewed the idea of a rigid limitation for the period of retroactivity and that a three year period was not a violation of due process.\textsuperscript{106}

Finally, the court looked to whether the Caprios had relied upon the pre-amendment language to their detriment. New York courts find detrimental reliance to be an important factor in determining whether due process has been violated.\textsuperscript{107} The Division of Taxation and Finance introduced overwhelming evidence that the Caprios’ interpretation of the law did not exist at the time of their transaction.\textsuperscript{108} Indeed, the Mintz matter had not been decided.\textsuperscript{109} Therefore, the court held that the 2010 amendment was clearly within the bounds of due process because it was rationally related to a legitimate governmental purpose, had a reasonable retroactive effect, and there had been no detrimental reliance by the Caprios.\textsuperscript{110}

D. Rays of Light

Despite ongoing retroactive legislation in many jurisdictions, judicial limitations upon legislatures may be on the horizon. \textsuperscript{111} and \textsuperscript{112} are current rays of light.

\textsuperscript{99} Id. at 25 citing United States v. Hemme, 476 US 558, 568 (1986).
\textsuperscript{100} 2012 NY Slip Op. 22273 at 25.
\textsuperscript{101} Id.
\textsuperscript{102} Id. at 27.
\textsuperscript{103} Id. at 32.
\textsuperscript{104} Id. at 33.
\textsuperscript{105} Id.
\textsuperscript{106} Id. at 34.
\textsuperscript{107} Id. at 36.
\textsuperscript{108} Id. at 37-40.
\textsuperscript{109} Id. at 38.
\textsuperscript{110} Id. at 44-45.
\textsuperscript{111} 158 Wash. App. 104, 246 P.3d 211 (2010), rev’d’d 173 Wn. 2d 551, 269 P. 3d 1013 (2011). The Supreme Court of Washington reversed the court of appeals on the ground that the pre-amendment statute denied manufacturers the deduction that gave rise to Tesoro’s refund claim. As a result, the Court did not reach the issue of retroactivity. Therefore, the Court of Appeals’ ruling, to the extent it addresses retroactive legislation appears to be sound law.

1. Tesoro Ref. & Mkgt. Co. v. Washington Dept. of Rev. In Tesoro, taxpayer Tesoro Refining and Marketing Co. (“Tesoro”) challenged retroactive legislation denying it a deduction for amounts derived from the sale of qualifying fuels. Washington, pursuant to Wash. Rev. Code §82.04.433, permitted the deduction of the amounts derived from the sale of qualifying fuels in calculating the business and occupation (“B&O”) tax.\textsuperscript{113} Tesoro manufactured and sold bunker fuel in its refinery. Bunker fuel qualified for the deduction.\textsuperscript{114}

While Tesoro had properly collected signed deduction certificates from its buyers for each qualifying sale of fuel for the period Dec. 1, 1999 through April 30, 2004, Tesoro failed to claim the deduction. Accordingly, Tesoro filed a claim for refund which the Department of Revenue denied on the basis that the deduction was only applicable to wholesaler and retailer B&O taxes, and not manufacturer B&O tax.\textsuperscript{115} Tesoro continued to pay the B&O Tax on its qualifying fuel sales between May 1, 2004, through Dec. 31, 2007, but claimed refunds of these amounts also. In February 2008, Tesoro appealed the denial in Washington Superior Court upon the theory that manufacturers were entitled to the deduction.

In reaction to the pending suit, and the day before the trial was to begin, the Washington legislature amended §82.04.433 to clearly limit the deduction to wholesaler and retailer B&O taxes and to exclude manufacturer B&O taxes. The amendment was to apply prospectively and retroactively.\textsuperscript{116} The retroactivity was for a 24-year period, extending back to the original enactment of the B&O tax statutes. In its appeal, Tesoro challenged the retroactive application of the amendment as a violation of due process.\textsuperscript{117} The trial court found that the pre-amendment statute was limited to wholesaler and retailer B&O taxes and, therefore, denied Tesoro the refund. Because the pre-amendment statute was construed not to allow manufacturers to take the deduction, the trial court did not reach the retroactivity due process claim.\textsuperscript{118} Tesoro appealed to the Court of Appeals, which held that Tesoro was entitled to the deduction for the bunker fuel. Thus, the court had to consider whether the 24-year retroactive application of the amendment violated Due Process.

The Department of Revenue asserted that Carlton established no fixed limit on the permissible period of retroactivity and permitted the retroactive amendment.\textsuperscript{119} The court distinguished Carlton on the basis that Congress amended the statute at issue within fourteen months of its initial enactment and imposed a minimal retroactive period, whereas, in Tesoro, the legislature waited 24 years to enact the amendment at issue and imposed a 24-year retroactive period.\textsuperscript{120} The court stated that the legislature may not, 24 years after the enactment of the statute, make clarifying amend-
ments in direct conflict with the expectations of taxpayers. The court held that the amendment was not “prompt,” the retroactive period was not “modest,” and therefore, the amendment violated Tesoro’s due process rights. Furthermore, the Court found the taxpayer had reasonably relied to his detriment upon preexisting law.

The Court also held that the legislative history of the amendment clearly demonstrated improper motives. The legislative history directly referenced Tesoro’s refund suit as the motive for the amendment and to prevent the revenue loss resulting therefrom. The Court found that this type of targeting of the taxpayer was precisely the “improper motives” condemned by Carlton.

Although the Court noted that correcting a significant fiscal loss is a legitimate purpose for legislation, it found that a 24-year retroactivity period was not a reasonable measure in response to a refund suit. The retroactivity period was not sufficiently modest and therefore, the amendment could not withstand the rational basis test set forth in Carlton. Finally, the amendment also violated due process because the loss of the retroactivity period was not sufficiently modest and therefore, the amendment could not withstand the rational basis test set forth in Carlton. Finally, the amendment also violated due process because the loss of the retroactivity period was not sufficiently modest and therefore, the amendment could not withstand the rational basis test set forth in Carlton.

2. NetJets Aviation Inc. v. Guillory. In NetJets Aviation Inc. v. Guillory, NetJets Aviation Inc. (“NetJets”) was the manager of fractionally owned aircraft. NetJets made fractional shares of aircraft available for purchase, obtained pilots and insurance, maintained the aircraft, and administered leasing agreements. NetJets retained possession of the aircraft after selling the interests. The purchasers of the fractional interests had to enter into various agreements: (1) an agreement to purchase the interest which limited the right to transfer the interest, vested control over the aircraft to the NetJets, and allowed NetJets to sell more interests; (2) a management agreement giving NetJets exclusive management rights, agreeing to pay NetJets a management fee, and NetJets agreed to provide a pilot, maintain the aircraft, and retained the right to use the aircraft; (3) an ownership agreement in which the owner agrees to only use the aircraft in the fractional ownership program; and (4) a master interchange agreement stating that each owner will participate in the fractional program and that the aircraft on which the owner is on the title will be used in the program. Simply stated, NetJets maintained significant control over the aircraft fleet used in the fractional interest program.

Prior to 2007, California taxed general aviation aircraft as personal property in the county in which they were hangared and commercial aircraft were taxed based on an allocation formula considering the departures and landings within California. Pursuant to California Constitution Article XIII §1, all nonexempt property in California is taxable. Therefore, even fractionally owned aircraft were subject to taxation. However, due to the hybrid ownership of the NetJets fleet, no tax had been imposed in California prior to 2007.

In 2007, the California legislature enacted §§1160 and 1161 of the Revenue and Taxation Code to tax fractionally owned aircraft. The tax on the fractionally owned aircraft was imposed upon the manager in control of the fleet. The tax was allocated amongst the various counties in California based upon an allocation factor determined dividing the number of departures and landings in the county by the total number of departures and landings made worldwide in the year. The assessment of taxes was made retroactive for all tax years a fractionally owned aircraft was not assessed in California. The retrospective period therefore could extend indefinitely.

NetJets was assessed personal property tax on its fleet by various county assessors extending back to Jan. 1, 2002, a five year retroactive period. NetJets filed suit challenging the assessments and the 2007 legislation asserting that the tax upon fractionally owned aircraft was a “wholly new tax” that could not be imposed retroactively. The trial court found the retroactive application of the law to be unconstitutional because the law imposed a “new tax.” It was not a “clarifying amendment.” As a result, the trial court held the law could not be imposed retroactively. The assessors appealed to the Court of Appeals.

The Court of Appeals stated that if legislation is merely clarifying then retroactive application will not violate due process; however, if the legislation imposes a wholly new tax, it may not be retroactively imposed. Relying heavily upon the legislative history of the newly enacted statutes, the Court of Appeals affirmed the trial court. The legislative history demonstrated that the regime for taxing fractionally owned aircraft was a novel concept and that prior to its enactment such aircraft were not subject to tax. The appellate court noted that in 2006 the aircraft advisory subcommittee of the California Assessors’ Association called for “special legislation . . . in order for these fractionally owned aircraft to be assessed.” Due to the classification of the tax as “special legislation” and “a new body of law to assess fractionally owned aircraft,” the court found that the statutes at issue were new law and not clarifying amendments.

After determining the statutes imposed a new tax, the court examined whether the retroactive imposition of the tax was constitutional. The Court found no case

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121 Id. at 118.
122 Id. at 118-119.
123 Id. at 119.
124 Id.
125 Id.
127 Id. at 33-34.
128 Id.
129 Id. at 34.
130 Id. at 35.
131 Id. at 36.
132 Id.
133 Id.
134 Id. at 37.
135 Id. at 38-39.
136 Id. at 54.
137 Id.
138 Id. at 54-55.
139 Id. at 54-56.
law allowing for retroactive imposition of a new tax. Relying upon Supreme Court precedent and without any case law to the contrary, the court held imposition of a retroactive new tax was unconstitutional.140

The assessors asserted the rationale of River Garden to uphold the retroactive application of the tax. The court distinguished River Garden noting that a deduction was at issue in River Garden, not the imposition of a wholly new tax.141 The court held cases addressing changes to existing statutes, changes in tax rates, and limits on tax deductions were inapplicable to NetJet’s case.142 A petition for review is pending at the California Supreme Court.

IV. Conclusion

Retroactive application of tax statutes has been permissible for at least 70 years and is here to stay. Although most courts likely will continue to condone retroactive taxation, do Tesoro and NetJets mark the beginning of a new era? Will courts begin to apply Carlton more broadly to stop the inherent unfairness associated with legislation applied retroactively? Only time will tell.

141 207 Cal. App. 4th at 57-58.
142 Id. at 58.