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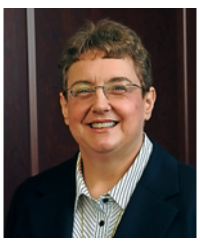
Constitutional Limitations

The U.S. Supreme Court's decision in *United States v. Carlton* turned 20 last year, but the core issue within the case remains embattled. In this article, authors Erica Horn, Madonna Schueler and Gregory Nowak discuss the *Carlton* decision and several 2014 cases on which it had an impact.

Retroactivity Revisited: Has Anything Changed?



By Erica L. Horn, Madonna E. Schueler and Gregory A. Nowak

Introduction

Last year marked the twentieth anniversary of the U.S. Supreme Court's decision in *United States v. Carlton*,[1] but the battle continues over the constitutionality of retroactive tax legislation. Taxpayers continue to fight state efforts to amend tax legislation *retroactively* based on the Due Process Clause of the Fourteenth Amendment, which provides that no state shall deprive any person of ''life, liberty, or property without due process of law.''[2] States have fought back with equal zeal, and the results have been anything but uniform. This article revisits the Court's decision in *Carlton* and then discusses 2014 state cases applying the Court's decision.

[1] 512 U.S. 26 (1994).

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Carlton Sets the Stage for Evaluating Retroactive Tax Legislation

Rendered in 1994, *United States v. Carlton* remains the seminal case on retroactive tax legislation. *Carlton* involved an amendment to the federal estate tax statute that limited the availability of a recently enacted deduction for proceeds of sales of stock to employee stock ownership plans (''ESOPs''). The Court held that retro-

[2] U.S. Const. amend. XIV, §1.

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active application of the amendment satisfied the requirements of due process in what has been described as the ''death knell'' for due process challenges to retroactive legislation.[3]

As part of the Tax Reform Act of 1986, Congress enacted a new estate tax provision applicable to any estate filing a return after Oct. 22, 1986.[4] Codified at 26 U.S.C. §2057, the new provision granted a deduction for half of the proceeds of ''any sale of employer securities by the executor of an estate'' to ''an employee stock ownership plan.''[5] Under §2057, the sale of securities had to be made prior to the date on which the estate tax return was required to be filed.[6]

The respondent, Jerry Carlton, was the executor of an estate who sought to utilize the §2057 deduction. Nineteen days prior to the due date of the estate tax return, Carlton used estate funds to purchase shares of a corporation. Two days later, Carlton sold the shares at a loss to the corporation's ESOP. When Carlton filed the estate tax return on Dec. 19, 1986, he claimed a deduction under §2057 of $5,287,000, which was half of the proceeds from the sale of stock to the ESOP. The deduction reduced the estate tax by $2,501,161.[7] Carlton stipulated that he engaged in the stock transactions solely to take advantage of the §2057 deduction.[8]

Shortly thereafter, on Jan. 5, 1987, the IRS announced that pending the enactment of clarifying legislation, it would treat the §2057 deduction as only available to estates of decedents who owned the relevant securities immediately before death. A bill to this effect was introduced in Congress, and on Dec. 22, 1987, an amendment to §2057 was enacted.[9] As amended, §2057 provided that ''to qualify for the estate tax deduction, the securities sold to an ESOP must have been 'directly owned' by the decedent 'immediately before death.' ''[10] The §2057 amendment was made effective as of October 1986, the date §2057 originally was enacted.[11]

The IRS disallowed the §2057 deduction taken by Carlton on the ground that the stock he purchased had not been owned by his decedent ''immediately before death.''[12] Carlton paid the contested tax liability, filed a claim for a refund, and then instituted a refund action in the U.S. District Court for the Central District of California. Carlton acknowledged he did not qualify for the §2057 deduction under the 1987 amendment, but argued that retroactive application of the amendment to 1986 transactions violated the Due Process Clause of the Fifth Amendment.[13] The District Court granted summary judgment in favor of the U.S., but the Ninth Circuit reversed, holding retroactive application of the amendment was unduly harsh and unconstitutional.[14] The Supreme Court granted certiorari.[15]

The Court began its analysis by noting that ''[t]his Court repeatedly has upheld retroactive tax legislation against a due process challenge.''[16] The Court noted that the due process standard to be applied to retroactive tax legislation is the same as that generally applicable to retroactive economic legislation, i.e., retroactive application of the legislation must be justified by a rational legislative purpose.[17] The Court found there was little doubt the 1987 amendment to §2057 was adopted as a curative measure. Because the pre-amendment version of §2057 contained no requirement that the decedent have owned the stock in question to qualify for the deduction for ESOP proceeds, any estate could claim the deduction by purchasing stock and immediately reselling it to an ESOP, resulting in a potential dramatic reduction, and perhaps elimination, of estate tax liability.[18] Although Congress estimated a revenue loss of approximately $300 million over a five-year period when it originally enacted §2057, because the pre-amendment version of §2057 was not limited to situations where the decedent owned the securities immediately before death, it became evident that the revenue loss from §2057 could be as much as $7 billion.[19]

In concluding retroactive application of the 1987 amendment satisfied the requirements of due process, the Court made several observations.[20] First, the Court noted that ''Congress' purpose in enacting the amendment was neither illegitimate nor arbitrary.''[21] The Court noted that Congress acted to correct what it reasonably viewed as a mistake in the original provision that ''would have created a significant and unanticipated revenue loss.''[22] Second, the Court stated, ''Congress acted promptly and established only a modest period of retroactivity.''[23] The Court noted that the retroactive effect of the amendment extended for a period only slightly greater than one year.[24]

In response to Carlton's argument that he detrimentally relied on the pre-amendment version of §2057 in structuring his stock transactions in 1986, the Court found that his reliance alone was insufficient to establish a constitutional violation.[25] The Court stated, ''Tax legislation is not a promise, and a taxpayer has no vested right in the Internal Revenue Code.''[26] Similarly, the Court found Carlton's lack of notice of the amendment was not dispositive.[27] The Court also noted that the 1987 amendment could not be characterized as a ''wholly new tax,'' and its period of retroactive effect was limited.[28] The Court concluded by stating, ''Because we conclude that retroactive application of the 1987 amendment to §2057 is rationally related to a le-

[3] Faith Colson, *Constitutional Law—Due Process—The Supreme Court Sounds the Death Knell for Due Process Challenges to Retroactive Tax Legislation*, 27 Rutgers L.J. 243 (1995-1996).
[4] *Carlton*, 512 U.S. at 28.
[5] *Id.* (quoting 26 U.S.C. §2057(b)).
[6] *Id.*
[7] *Id.*
[8] *Id.* at 28-29.
[9] *Id.* at 29.
[10] *Id.* (quoting Omnibus Budget Reconciliation Act of 1987, §10411(a), 101 Stat. 1330-432).
[11] *Id.* (citing §10411(b)).
[12] *Id.*
[13] *Id.*
[14] *Id.* at 29-30.
[15] *Id.* at 30.
[16] *Id.*
[17] *Id.* at 30-31.
[18] *Id.* at 31.
[19] *Id.* at 31-32.
[20] *Id.* at 32.
[21] *Id.*
[22] *Id.*
[23] *Id.*
[24] *Id.* at 33.
[25] *Id.*
[26] *Id.*
[27] *Id.* at 34.
[28] *Id.*

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gitimate legislative purpose, we conclude that the amendment as applied to Carlton's 1986 transactions is consistent with the Due Process Clause.''[29]

Although she concurred in the majority's opinion, Justice O'Connor wrote separately to express her view that there must be some limits to Congress' ability to enact retroactive legislation. She noted, ''the Court has never intimated that Congress possesses unlimited power to 'readjust rights and burdens . . . and upset otherwise settled expectations.''[30] ''The governmental interest in revising the tax laws must at some point give way to the taxpayer's interest in finality and repose.''[31] She further stated, ''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.''[32]

In a concurrence by Justice Scalia in which Justice Thomas joined, the Court's opinion was criticized as mistakenly focusing on the period of retroactivity, because the test of substantive due process unconstitutionality in the field of retroactive tax legislation is whether the result is ''harsh and oppressive,'' and ''the critical event is the taxpayer's reliance on the incentive, and the key timing issue is whether the change occurs after the reliance; that it occurs immediately after rather than long after renders it no less harsh.''[33] Scalia went on to observe:

> The reasoning the Court applies to uphold the statute in this case guarantees that *all* retroactive tax laws will henceforth be valid. To pass constitutional muster the retroactive aspects of the statute need only be ''rationally related to a legitimate legislative purpose.'' Revenue raising is certainly a legitimate legislative purpose, see U. S. Const., Art. I, §8, cl. 1, and any law that retroactively adds a tax, removes a deduction, or increases a rate rationally furthers that goal.[34]

Scalia happily concurred in the result despite his criticism of the majority's reasoning, observing wryly, ''If I thought that 'substantive due process' were a constitutional right rather than an oxymoron, I would think it violated by bait-and-switch taxation.'';[35] but, Scalia concludes, ''I welcome this recognition that the Due Process Clause does not prevent retroactive taxes, since I believe that the Due Process Clause guarantees *no* substantive rights, but only (as it says) process.''[36]

In the years following *Carlton*, courts across the nation have come to various conclusions when understanding and applying the Court's decision. This has led courts to approve statutes with a retroactive effect of up to 10 years,[37] and to strike down statutes with a retroactive effect of approximately 16 months.[38] The decisions rendered in 2014 were no different.

2014: A Year of Ups and Downs

The past year has been a tumultuous one for rulings addressing retroactive tax legislation. The year started off promising enough when two New York tribunals ruled that retroactive application of an amendment to New York's tax laws regarding recognition of gain on the sale of intangible assets by nonresidents was unconstitutional.[39] But, in the second half of the year, a pair of cases—one from Washington and the other from Michigan[40]—brought disappointing news to tax practitioners who hoped the recent New York decisions signaled a welcome change.

Caprio

On April 8, 2014, the Supreme Court of New York, the state's intermediate appellate court, rendered a decision in *Caprio v. New York State Department of Taxation and Finance*.[41] *Caprio* involved an amendment to New York's tax laws requiring recognition of gain on the sale of intangible assets by nonresidents. The Caprios, a married couple residing in Florida, were former owners and the sole shareholders of Tri-Maintenance & Contractors, Inc. (''TMC''), a janitorial company.[42] TMC, a New Jersey corporation that did some of its business in New York, elected to be treated as an S corporation for federal and New York tax purposes.[43] Both the Internal Revenue Code and New York state tax law allow S corporations to avoid corporate income taxes by passing income and losses to shareholders for inclusion in their individual income tax returns.[44]

On Feb. 1, 2007, the Caprios sold their stock in TMC to a third party purchaser.[45] The purchase agreement provided for the purchase price to be paid in two installments pursuant to separate promissory notes: the first payment of approximately $19.5 million was to be made on March 1, 2007, and the second payment of $500,000 was due on Feb. 1, 2008.[46] As part of the agreement, two tax elections were made: an IRC §338(h)(10) election and an IRC §453 election. The §338(h)(10) election allowed the transaction to be treated, for federal tax purposes, as a sale of TMC's assets immediately fol-

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[29] *Id.* at 35.

[30] *Id.* at 37-38 (O'Connor, J., concurring), citing *Connolly* v. *Pension Benefit Guaranty Corp.*, 475 U.S. 211, 229 (1986) (concurring opinion) (brackets omitted), quoting *Usery* v. *Turner Elkhorn Mining Co.*, 428 U.S. 1, 16 (1976).

[31] *Id.* at 37-38.

[32] *Id.* at 38.

[33] *Id.* at 40 (Scalia, J., concurring).

[34] *Id.* (emphasis in original, internal citations omitted).

[35] *Id.* at 39.

[36] *Id.* at 40 (emphasis in original) citing *TXO Production Corp.* v. *Alliance Resources Corp.*, 509 U.S. 443, 471 (1993) (Scalia, J., concurring in judgment).

[37] *See Miller v. Johnson Controls*, 296 S.W.3d 392 (Ky. 2009).

[38] *See James Sq. Assoc. LP v. Mullen*, 993 N.E.2d 374 (N.Y. 2013).

[39] *See Caprio v. New York State Dep't of Taxation and Finance*, 117 A.D.3d 168 (N.Y. Sup. Ct. 2014); *In the Matter of the Petition of Jeffrey M. and Melissa Luizza*, Determination DTA No. 824932 (N.Y. Div. Tax App. Aug. 21, 2014).

[40] *See In re Estate of Hambleton*, 335 P.3d 398 (Wash. 2014) and *Yaskawa America, Inc. v. Dep't of Treasury*, Case No. 11-000077-MT (Mich. Ct. of Claims Dec. 19, 2014).

[41] 117 A.D.3d 168 (N.Y. Sup. Ct. 2014). The Supreme Court's decision has been appealed to the New York Court of Appeals. It appears briefing of the case was completed Jan. 3, 2015.

[42] *Id.* at 170.

[43] *Id.*

[44] *Id.*

[45] *Id.* at 170-71.

[46] *Id.* at 171.

lowed by a complete liquidation of TMC.[47] Thus, TMC was deemed to have made a distribution of the promissory notes to the Caprios in the liquidation. Under the §453 election, the gain from the receipt of the promissory notes would not be taxable until cash payments were made on the notes.[48]

TMC filed federal and New York state tax returns for the short taxable year ending Feb. 1, 2007.[49] TMC reported the asset sale but did not report any realized gain on the transaction because neither TMC nor the Caprios had received any cash payments on the promissory notes by the date of the return and thus no gain was realized pursuant to the §453 election. The Caprios, however, reported gains attributable to the March 1, 2007 and Feb. 1, 2008, payments on the promissory notes on their 2007 and 2008 federal tax returns.[50]

Notably, the Caprios reported receipt of payment on the promissory notes on their 2007 and 2008 New York nonresident tax returns, but claimed the gain recognized by them did not constitute New York source income and was not subject to New York tax.[51] Under New York law at that time, gain from the sale of an intangible asset, such as stock, was not taxable to nonresidents unless the gain was properly employed in a trade or business carried on in New York. Because the TMC stock was not used in a New York trade or business, the Caprios paid no New York tax on the gains realized from payments on the promissory notes.[52]

A short time later, in 2009, the New York State Division of Tax Appeals rendered a decision in *Matter of Mintz*, which involved a similar installment sale transaction.[53] In *Mintz*, the administrative law judge held that nonresident shareholders of an S corporation do not have New York source income on their receipt of payments under an installment obligation distributed by the S corporation.[54] The Caprios' treatment of their gain from the promissory notes was consistent with the decision in *Mintz*.

In 2010, in reaction to *Mintz*, the New York Legislature amended New York tax law to provide that if a nonresident is a shareholder of an S corporation and the S corporation distributes an installment obligation pursuant to IRC §453, any gain recognized on the receipt of payments from the installment obligation for federal income tax purposes would be treated as New York source income.[55] The amendment was made retroactive to Jan. 1, 2007, more than a three and a half year period of retroactivity.[56]

Shortly after the new amendment went into effect, the Department of Taxation and Finance issued an assessment to the Caprios for approximately $775,000 as a result of the TMC transaction.[57] The Caprios initiated an action in New York County seeking a declaration that retroactive application of the 2010 amendment violated their due process rights. The court dismissed the Caprios' complaint, and they appealed.

On appeal, the New York Supreme Court considered three factors in determining whether retroactive application of the 2010 amendment transgressed constitutional limitation: (1) the taxpayer's forewarning of a change in the legislation and the reasonableness of reliance on the old law; (2) the length of the retroactive period; and (3) the public purpose for retroactive application.[58] This three-factored test had recently been reaffirmed by the Court of Appeals of New York in *James Square Associates LP v. Mullen*.[59]

With respect to the first factor, the court noted the Caprios had no forewarning of the change made by the 2010 amendment, which was not even proposed until after the *Mintz* decision and long after the Caprios entered into the TMC transaction.[60] Thus, the Caprios had no opportunity to alter their behavior in anticipation of the amendment.[61] The court noted the Caprios were not required to show that they would have structured their transaction differently had they known it could subject them to New York taxation; instead, they only had to show they conducted their business affairs in a manner consistent with the previous law.[62]

Regarding the second factor, the length of the retroactive period, the court noted that short periods of retroactivity can be considered valid, but ''[e]xcessive periods of retroactivity have been held to unconstitutionally deprive taxpayers of a reasonable expectation that they will secure repose from taxation of transactions which have, in all probability, been long forgotten.''[63] The court found the period of retroactivity at issue—three and a half years—was excessive.[64] The court also noted that the 2010 amendment could fairly be characterized as a new tax as opposed to a curative measure intended to correct an error in the law; thus, the longer

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[47] *Id.*
[48] *Id.*
[49] *Id.*
[50] *Id.* at 171-72.
[51] *Id.* at 172.
[52] *Id.*
[53] *Matter of Mintz*, 2009 WL 1657395 (NY State Div. of Tax Appeals June 4, 2009).
[54] 117 A.D.3d at 172.
[55] *Id.* at 173.
[56] *Id.*
[57] *Id.*

[58] *Id.* at 174.
[59] *Id.*; *see also James Sq. Assocs. LP v. Mullen*, 993 N.E.2d 374 (N.Y. 2013). *James Square* involved New York's Economic Development Zones Act, which allowed businesses located in qualifying areas that otherwise met the statute's criteria to apply to the Department of Economic Development for a certificate of eligibility, which then could be submitted to the Department of Taxation and Finance in support of claims for tax credits. *James Sq.*, 993 N.E.2d at 376. In 2009, in an effort to curb abuses in the program, the state amended the Act to add two new criteria businesses must meet to retain their certificates of eligibility, and also required the Commissioner of Economic Development to review all certified businesses to determine if they should be decertified under the new criteria. *Id.* at 377. The Legislature again amended in the Act in 2010 to state that the decertifications pursuant to the 2009 amendments were effective as of Jan. 1, 2008. *Id.* at 378. The Governor projected the 2009 amendments would provide savings to the state of $90 million in 2009-2010. *Id.* at 377. The plaintiffs, businesses issued certificates of eligibility prior to 2008 and decertified in 2009, sought a declaration that the decertification constituted an improper retroactive application of the 2009 amendments. *Id.* at 378. Applying the three-factored test discussed *supra*, the Court held that retroactive application of the 2009 amendments violated the plaintiffs' due process rights. *Id.* at 385.
[60] *Caprio*, 117 A.D.3d at 174.
[61] *Id.*
[62] *Id.* at 176.
[63] *Id.* at 177 (quotation marks and citation omitted).
[64] *Id.*

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period of retroactivity urged by the state was not warranted.[65]

Finally, the court found the third factor, although a close question, also weighed in favor of the Caprios.[66] Although the legislative history of the amendment indicated the legislation was necessary to raise tax revenues, the court found that ''raising money for the state budget is not a particularly compelling justification and is insufficient to warrant retroactivity in a case [as here] where the other factors militate against it.''[67] Thus, the court held that retroactive application of the 2010 amendment to the Caprios resulted in a due process violation.[68]

Luizza

Slightly more than four months after the court's decision in *Caprio*, the New York Division of Tax Appeals addressed retroactive application of the same legislative amendment in *In the Matter of the Petition of Jeffrey M. and Melissa Luizza*.[69] Like the Caprios, the Luizzas were nonresidents of New York who sold their stock in a company to a third-party purchaser.[70] The parties made an election under IRC §338(h)(10) to allow the sale to be treated as a deemed sale of the company's assets followed by a deemed liquidation of the company in exchange for its stock.[71] The company had elected to be treated as an S corporation for federal tax purposes.[72]

Mr. Luizza had informed the buyer that he would consent to the §338(h)(10) election only to the extent there would be no negative federal or state tax implications for the company or him personally. Although the agreement originally contained a provision providing that the buyer would reimburse the seller for all costs and negative tax consequences of the §338(h)(10) election, this was removed upon the buyer's request that the tax cost of the §338(h)(10) election be addressed up front. In accordance with this request, Mr. Luizza and his accountants researched the federal and New York tax consequences of engaging in the proposed sale pursuant to a §338(h)(10) election. This included a review of New York tax law available in late 2007 and early 2008.[73]

Based upon New York law as it then existed, Mr. Luizza's accountants informed him there would be no additional New York tax consequences to him as a result of the §338(h)(10) election.[74] Therefore, Mr. Luizza did not require the buyer to increase the purchase price or indemnify him for any additional taxes arising out of the election.[75] The parties executed a final agreement in March 2008. The Luizzas filed a New York joint nonresident/part year resident income tax return for 2008 and reported slightly over $8,000,000 of capital gain attributable to the sale of the company stock. Based on the current New York tax law, they did not include this gain as attributable to New York sources. As previously discussed, the New York Legislature passed an amendment in 2010 requiring nonresident shareholders to recognize New York source income as a result of such a transaction.[76] The 2010 amendment was made retroactive to Jan. 1, 2007.[77]

In March 2012, the Division of Taxation issued a Notice of Deficiency against the Luizzas asserting that $184,997.36 in personal income tax and interest was due for the year 2008.[78] The Luizzas filed a petition for redetermination.[79]

To determine whether retroactive application of the 2010 amendment violated the Luizzas' due process rights, the administrative law judge applied the same three-factor test as the court in *Caprio*.[80] He first noted that neither Mr. Luizza nor his representatives had any knowledge or reason to believe in 2008 that the law on taxation of S corporations would change two years later.[81] Furthermore, the Luizzas were harmed by their reliance on the law as it existed in 2008. Because of the retroactive change in the law, Mr. Luizza did not have a chance to adjust his negotiating position. In particular, he did not demand a higher purchase price or seek indemnification from the buyer for any tax consequences of the §338(h)(10) election.[82]

The ALJ measured the length of the retroactive period from the date of the parties' stock purchase agreement to the effective date of the legislation providing for retroactive application of the amendment.[83] This resulted in a period of retroactivity of two and a half years.[84] Although he noted that ''when the legislation is intended to correct an error, longer periods of retroactivity have been upheld,'' the ALJ relied upon *Caprio* in finding the amendment was not a curative measure.[85]

Finally, the ALJ noted that, as determined by the court in *Caprio*, the purpose of the amendment's retroactive effect was to raise tax revenues by $30 million over the course of the fiscal year.[86] The ALJ found this was not a compelling reason for retroactivity.[87] Concluding that retroactive application of the amendment to the Luizzas was a violation of due process, the ALJ cancelled the Notices of Deficiency.[88]

Hambleton

If *Caprio* and *Luizza* were the high points of this past year, *Estate of Hambleton* and *Yaskawa* were the dark spots. *In re Estate of Hambleton*[89] involved retroactive application of an amendment to the State of Washing-

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[65] *Id.*
[66] *Id.*
[67] *Id.* (quotation marks and citation omitted).
[68] *Id.* at 178.
[69] Determination DTA No. 824932 (N.Y. Div. of Tax App. Aug. 21, 2014).
[70] *Id.* at 2.
[71] *Id.* at 2-3.
[72] *Id.* at 3.
[73] *Id.*
[74] *Id.* at 3-4.
[75] *Id.* at 4.

[76] *Id.*
[77] *Id.* at 4-5.
[78] *Id.* at 5.
[79] *Id.* at 1.
[80] *Id.* at 9.
[81] *Id.*
[82] *Id.* at 9-10.
[83] *Id.* at 10.
[84] *Id.*
[85] *Id.* at 10, 12.
[86] *Id.* at 12.
[87] *Id.* at 13.
[88] *Id.*
[89] 335 P.3d 398 (Wash. 2014).

ton's Estate and Transfer Tax Act.[90] The amendment allowed the Department of Revenue to tax qualified terminable interest property (''QTIP'') as part of a surviving spouse's estate.[91] A QTIP trust, created by a deceased spouse, gives the surviving spouse a life interest in the income or use of trust property.[92] QTIP trusts are advantageous because no estate tax is paid upon the death of the first spouse.[93] Instead, the property is taxed only upon the death of the surviving spouse.[94]

In 2005, after years of participating in the federal tax sharing system, the State of Washington passed a stand-alone estate tax—the Estate and Transfer Tax Act.[95] The Legislature modeled the Act after the federal estate tax regime. Federal law provides a deduction for QTIP trust assets. This allows the surviving spouse to use the trust property or receive the income it generates unreduced by front-end estate taxation. The transfer of the property is not taxed until the surviving spouse dies and the property passes to the ultimate beneficiaries. Washington's 2005 Act imposed a tax on ''every transfer of property located in Washington'' and applied prospectively to estates of decedents dying on or after May 17, 2005.[96]

In 2012, the Supreme Court of Washington decided *In re Estate of Bracken*.[97] In *Bracken*, the deceased spouses made QTIP elections under federal law before Washington passed the 2005 Act.[98] The estates argued the taxable transfers occurred when the first spouses died (which was before the 2005 Act took effect), while the Department claimed the taxable transfers occurred when the surviving spouses died (after the 2005 Act took effect).[99] The Court adopted a narrow interpretation of the word ''transfer'' and held that the only ''transfer'' occurred upon the death of the first spouses when they created the QTIP trusts.[100] Thus, the Court held the Department exceeded its authority by promulgating regulations allowing taxation of ''fictional'' transfers upon the death of the surviving spouses. Under the Court's interpretation, the only ''real'' transfer occurred upon the death of the first spouse, and the Department could not tax this transfer because it occurred prior to the effective date of the 2005 Act, which was prospective only.[101]

In 2013, in response to *Bracken*, the Washington Legislature amended the 2005 Act to broaden the definition of ''transfer'' and tax QTIP assets upon the death of the surviving spouse.[102] The Legislature provided that the amendments would apply retroactivity to all estates of decedents dying on or after May 17, 2005.[103] The amendments also modified the definition of ''Washington taxable estate'' and clarified the intent of the Legislature to include QTIP trusts created before 2005 in the surviving spouse's Washington taxable estate if the surviving spouse died after the 2005 Act's effective date.[104]

It was in this context that the Supreme Court of Washington decided *In re Estate of Hambleton*. The case involved two estates—the Estate of Hambleton and the Estate of Macbride.[105] Both estates involved a decedent who died prior to the effective date of the 2005 Act and left a QTIP trust for the benefit of his surviving spouse. The surviving spouses died after 2005.[106] The Department argued Washington estate tax was due on the value of the QTIP trusts in the surviving spouses' taxable estates.

The estates challenged the 2013 amendments on several grounds, including the argument that retroactive application of the 2013 amendments violated the Due Process Clause.[107] The Court considered two factors in determining whether retroactive application of the amendments resulted in a due process violation, including whether (1) the Legislature had a legitimate purpose for the retroactive amendments, and (2) the period of retroactivity was rationally related to the purpose.[108]

The Court found the purpose of the 2013 amendments was ''to restore parity between married couples and unmarried individuals by not allowing married individuals to avoid or greatly reduce their potential Washington estate tax liability, restore parity between QTIP property and other property eligible for the marital deduction, and prevent the adverse fiscal impacts of the *Bracken* decision.''[109] The Court acknowledged the purpose of the 2013 amendments was largely economic, but noted that ''[p]reventing unanticipated and significant fiscal shortfall is a legitimate purpose for amending tax legislation.''[110]

The Court also found the period of retroactivity—***eight years***—was rationally related to preventing the fiscal shortfall because it provided the necessary funds and was directly linked with the purpose of the amendment, which was to remedy the effects of the *Bracken* decision.[111] The Court held that any period less than eight years would be arbitrary because it would allow some estates to escape the tax while similarly situated estates would be subject to the tax.[112]

The Court rejected the estates' argument that the 2013 amendments imposed a wholly new tax.[113] The Court noted, ''Washington has long received revenue from estate taxes, and the taxpayers had 'reason to suppose' that the state would tax shifting interests in assets upon death. Therefore, *Carlton*'s rational basis test applies.''[114]

The Court also rejected the estates' claim that applying the amendments retroactively was unconstitutional because it impaired a vested right acquired under existing law.[115] The Court noted that the estate tax did not

[90] *Id.* 402-03, 405.
[91] *Id.* at 403.
[92] *Id.* (citing 26 U.S.C. §2056(b)(7)(B)(i)-(ii)).
[93] *Id.*
[94] *Id.*
[95] *Id.*
[96] *Id.* at 404.
[97] 290 P.3d 99 (2012). The claims of other estates faced with the same issue were consolidated in this case.
[98] *In re Estate of Hambleton*, 335 P.3d at 404.
[99] *Id.*
[100] *Id.*
[101] *Id.*
[102] *Id.* at 404-05.
[103] *Id.* at 405.
[104] *Id.*
[105] *Id.*
[106] *Id.*
[107] *Id.* at 406.
[108] *Id.* at 409.
[109] *Id.* at 411 (citation and markings omitted and emphasis added).
[110] *Id.*
[111] *Id.*
[112] *Id.*
[113] *Id.* at 412.
[114] *Id.* (citation omitted).
[115] *Id.*

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deprive the remaindermen of their interest in the property or alter the nature of that interest. It simply taxed the transfer of assets. Additionally, the Court found the estates had no vested right in Washington's pre-2005 tax scheme.[116]

Because the Court found the 2013 amendments served a legitimate purpose and the period of retroactivity was rationally related to that purpose, the Court held that applying the amendments to the estates was not a violation of due process.[117]

Yaskawa America, Inc.

Most recently, the Michigan Court of Claims decided the retroactivity issue in *Yaskawa America, Inc. v. Department of Treasury*.[118] *Yaskawa* was one of many cases pending in the Michigan Court of Claims involving taxpayers seeking refunds under the Michigan Business Tax (''MBT'') Act based on an election to use the three-factor apportionment formula under the Multistate Tax Compact (''Compact'') as opposed to the single, sales-factor apportionment formula set forth in the MBT. This question was decided in favor of taxpayers by the Supreme Court of Michigan in July 2014 in *IBM v. Department of Treasury*.[119] It is the actions of Michigan Legislature before and after the *IBM* decision that raise the question of the constitutionality of retroactive statutes. For purposes of background, a discussion of the *IBM* case follows.

In 2008, the Michigan Legislature enacted the MBT.[120] The MBT imposed two main taxes: the business income tax and the modified gross receipts tax. The MBT did not expressly repeal the Compact. The MBT was short-lived, and in 2012, Michigan returned to a corporate income tax.[121]

In 2009, IBM—a corporation based in New York but with business activity worldwide, including Michigan—filed its Michigan Business Tax annual return for the 2008 tax year, and elected to use the Compact's three-factor apportionment formula to apportion its business income tax base and modified gross receipts tax base.[122] This resulted in a refund of $5.9 million.[123] The Department of Treasury (''Treasury'') refused to issue IBM a refund in this amount, arguing IBM could not elect to use the Compact's apportionment formula and was required to use the MBT's single-factor apportionment formula. Under the MBT's apportionment formula, IBM's refund was reduced by $4.7 million to $1.2 million.[124]

IBM filed a complaint in the Court of Claims, which ruled in favor of the Department.[125] The Court of Appeals affirmed.[126] IBM sought and was granted leave to appeal to the Michigan Supreme Court.[127]

The Michigan Supreme Court ruled that IBM was permitted to use the Compact's three-factor apportionment formula in calculating its 2008 tax liability.[128] The Court found the MBT's apportionment and the Compact's election provisions were *in pari materia* and could be harmonized.[129] Importantly, the Court found the Legislature did not impliedly repeal the Compact's election provision when it enacted the MBT in 2008.[130] Central to the Court's finding was the fact that the Legislature expressly repealed the Compact's election provision on May 25, 2011 to provide that, effective Jan. 1, 2011, all taxpayers subject to the MBT were required to use the MBT's single-factor apportionment formula and could not use the three-factor apportionment formula in the Compact.[131] The Court noted, ''There is no dispute that the Legislature specifically intended to retroactively repeal the Compact's election provision for taxpayers subject to the [MBT] beginning Jan. 1, 2011. The Legislature could have—but did not—extend this retroactive repeal to the start date of the [MBT].''[132]

Numerous refund actions were filed by taxpayers electing to use the Compact's apportionment formula for tax years 2008 through 2010. Then, on Sept. 11, 2014, in response to *IBM*, the Legislature enacted 2014 PA 282, which retroactively repealed the Compact provisions to Jan. 1, 2008, and mandated use of the single-factor apportionment formula in the MBT. This brings us to *Yaskawa*.[133]

Yaskawa timely filed its 2009 MBT return, on which Yaskawa elected to apportion its business income and modified gross receipts tax basis using the three-factor apportionment formula under the Compact. On Oct. 4, 2012, Treasury issued a decision rejecting Yaskawa's use of the Compact formula. Yaskawa timely filed a complaint in the Court of Claims on Dec. 11, 2012. The court entered an order holding the case in abeyance pending the Supreme Court's decision in *IBM*. On July 28, 2014, following the Supreme Court's decision, the Court of Claims entered an order lifting the stay and ordering Treasury to file a brief ''regarding why *[IBM]* is not controlling in this case and why judgment should not be entered in favor of the plaintiff.'' Both Treasury and Yaskawa briefed the question submitted by the court. The Court of Claims never ruled on that issue.[134]

Instead, on Oct. 10, 2014, the Court of Claims entered a show cause order requesting Yaskawa show cause as to ''why judgment should not be entered in favor of Treasury in light of the retroactive effect of 2014 PA 282.'' Yaskawa responded that such a judgment would be premature as a factual record needed to be developed upon which the court could then base its decision, but further argued that the legislation violated the withdrawal provisions of the Compact, various provisions of the Michigan Constitution, and the due process clause, equal protection clause, commerce clause, con-

[116] *Id.*
[117] *Id.*
[118] Case No. 11-000077-MT (Mich. Ct. Claims Dec. 19, 2014). On the same day, the court rendered a nearly identical decision in *Ingram Micro, Inc. & Subsidiaries v. Dep't of Treasury,* Case No. 11-000035-MT. The decision of the Court of Claims has been appealed to the Michigan Court of Appeals, Docket No. 325475.
[119] 852 N.W.2d 865 (Mich. 2014).
[120] *Id.* at 870.
[121] *Id.*
[122] *Id.*
[123] *Id.*
[124] *Id.*
[125] *Id.* at 868-69.
[126] *Id.* at 869.
[127] *Id.*
[128] *Id.* at 880-81.
[129] *Id.* at 875.
[130] *Id.* at 875-76.
[131] *Id.*
[132] *Id.* at 876.
[133] *Yaskawa*, Case No. 11-000077-MT.
[134] *Id.*

tracts clause, and first amendment of the U.S. Constitution.[135]

Despite Yaskawa's objection, the Court of Claims held PA 282 retroactively applied to its case and to all pending refund actions filed in reliance on the Compact's elective, three-factor apportionment formula.[136] Relying on *Carlton* and the decision of the Michigan Court of Appeals in *Gen. Motors Corp. v Dep't of Treasury*, [137] the court found no due process violation because (1) taxpayers have no vested interest in tax laws and therefore no valid claim that an interest in ''life, liberty, or property'' has been deprived by retroactive application of PA 282; (2) the legislature had a legitimate purpose for giving the statute retroactive effect; and (3) the period of retroactivity was rationally related to that purpose.[138]

The court found that *Carlton* and *Gen Motors* specifically rejected the notion that a taxpayer has a vested right in tax legislation.[139] Thus, according to the court, ''no taxpayer has a vested right in a tax refund based on the continuation of the Compact election provisions, and any due process claim must fail.''[140] Furthermore, the court found the Legislature had a legitimate purpose in enacting PA 282: to protect state revenues.[141] The court pointed to the Senate Fiscal Agency's legislative analysis, which projected that approximately $1.1 billion in refunds would be paid as a result of the *IBM* decision.[142] The court found the purpose of PA 282 was to fix a legislative error and prevent the potential loss of over $1 billion of MBT revenues.[143]

Finally, the court found that in addition to having a legitimate purpose of preventing ''a catastrophic fiscal shortfall,'' PA 282 was a rational means of furthering that purpose because the retroactive period—approximately six years—was ''modest'' as tested against the ''totality of the circumstances.''[144] Using the same factors used in *Gen. Motors*, the court considered (1) whether PA 282 created a ''wholly new tax''; (2) whether the taxpayer acted in reliance on an expectation its activity would not be taxed; (3) how promptly the Legislature acted to correct the problem leading to the loss in revenue; and (4) the period of time to which PA 282 retroactively applied.[145]

First, the court concluded PA 282 did not create a ''wholly new tax'' but *confirmed* that the single-factor apportionment formula under the MBT was mandatory and an election to use the Compact's three-factor apportionment formula could not be made.[146] Second, the court found there could be no valid claim a taxpayer acted in reliance on an expectation its income would be apportioned using the three-factor apportionment formula because the states have wide latitude in selecting an apportionment methodology.[147] This rationale, however, ignored the fact that the three-factor election was found to have been applicable to the tax years at issue by the Supreme Court in *IBM*, and that the taxpayer had been denied the ability to present factual evidence demonstrating its own reliance on the ability to make that election in choosing to conduct business within the State of Michigan. The court also noted that, under *Carlton*, even detrimental reliance does not necessarily result in a constitutional violation.[148]

Third, the court found the Legislature acted promptly to correct its error, as the Legislature was not aware the statute enacting the MBT was defective (by not repealing the Compact's election provision) until the Court's decision in *IBM*.[149] Two months after *IBM* was decided, PA 282 was enacted into law.[150] Fourth and finally, the court found the period of PA 282's retroactive effect was modest, particularly in light of other retroactive periods Michigan and other courts have upheld, including retroactive periods of ten years or more.[151]

Post-Yaskawa

Although the court's decision in *Yaskawa* dealt a blow to taxpayers, the battle is far from over. Other cases involving the constitutionality of PA 282, including an action involving IBM for a tax year subsequent to the 2008 tax addressed by the Michigan Supreme Court,[152] have been consolidated with Yaskawa's appeal at the Michigan Court of Appeals. At the time of publication a motion for remand was pending in these consolidated cases requesting the Court to remand the cases for the development of a factual record concerning the reliance of the taxpayers on their expectation of their ability to make the Compact election, the discriminatory motive of the Michigan legislature in enacting the retroactive repeal of the Compact, and the contradictory actions of the state of Michigan in the years following the purported retroactive repeal of the Compact as a governing member of the Multistate Tax Commission. *Yaskawa* and other similar cases may give the Michigan Supreme Court the opportunity to rule upon the constitutionality of legislation retroactively extinguishing a taxpayer's refund claims, hopefully with the benefit of a fully developed factual record demonstrating the extent of the taxpayers' reliance in the expectation of making the Compact election to demonstrate that the balancing test in *Carlton* was violated. And if taxpayers are lucky, perhaps even the U.S. Supreme Court will weigh in.

Conclusion

Twenty years after *Carlton*, it seems more questions than answers remain on the constitutionality of retroac-

[135] *Yaskawa*, Plaintiff's Response to Oct. 10, 2014 Show Cause Order.
[136] *Id.*
[137] 803 N.W.2d 698 (Mich. Ct. App. 2010).
[138] *Yaskawa*, Case No. 11-000077-MT at 16-21.
[139] *Id.* at 17.
[140] *Id.*
[141] *Id.* at 18.
[142] *Id.*
[143] *Id.*
[144] *Id.*at 19.
[145] *Id.*
[146] *Id.* at 19-20.
[147] *Id.* at 20.
[148] *Id.*
[149] *Id.*
[150] *Id.*
[151] *Id.* at 21. The court also held PA 282 did not transgress other constitutional limitations such as separation of powers, the Commerce Clause and the First Amendment Petition Clause. *Id.* at 21-26.
[152] *International Business Machines Corporation v. Department of Treasury,* Michigan Court of Appeals, Docket No. 325484.

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tive tax legislation. And if 2014 is any indication, these issues are here to stay. States continue to reach drastically different results while each claiming to apply ''the standard'' set forth in *Carlton*. In the same year, one court approved an eight year period of retroactivity with seemingly no hesitation, while another criticized a two and half year retroactive period as excessive. Some courts have found that preventing a fiscal shortfall is a legitimate purpose justifying a statute's retroactive application, while others have noted that raising revenue is not a particularly compelling justification. In the midst of all the confusion, taxpayers are left to wonder whether these differences can be explained. Perhaps, by the time another article is written on this subject, the U.S. Supreme Court will have offered some guidance in this murky area of the law.