Blog Post

Is there a Limit on the Retroactive Effect of State Tax Laws?

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Like the premise of *Back to the Future*, state governments are tinkering with time. To improve future budget revenues, states are enacting retroactive tax levies. Much to the disappointment of taxpayers, the U.S. Supreme Court recently denied review in several state tax cases challenging the reach of retroactive tax laws. These laws can have a pernicious effect on business climates by imposing a tax liability on past activity. Seven petitions for review involved Michigan's well-publicized retroactive repeal of an alternative apportionment method and one petition related to Washington's retroactive repeal of an exemption.

The case of *Dot Foods* involved an exemption passed by the Washington legislature in 1983. In 1997, the taxpayer obtained a ruling from the Department of Revenue confirming that it qualified for the exemption. Despite the issuance of the ruling, the Department later issued an assessment to the taxpayer denying the exemption claim. In 2009, the taxpayer received a ruling from the Washington Supreme Court confirming that is was entitled to the exemption. Within six months of this decision, the legislature, citing the financial impact of additional claims for refunds, retroactively changed the law to deny any further exemption claims.

Dot Foods filed additional refund claims based on its qualification for the disputed exemption and was

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denied. Dot Foods argued that, under the case of *United States v. Carlton*, the 27-year reach of the retroactive legislation violated the Due Process Clause of the U.S. Constitution. Although the taxpayer prevailed at trial court, the Washington Supreme Court reversed the lower court's ruling sustaining the retroactive legislation.

In *Carlton*, the Supreme Court addressed a retroactive change to the Internal Revenue Code. The majority concluded that a retroactive law change will satisfy the Due Process Clause if it is "supported by a legitimate purpose and furthered by rational means." Justice O'Connor concurred in Carlton on the basis that the retroactive period was approximately one year. Justice O'Connor went on to state that periods greater than one year would raise "serious constitutional questions" under the Due Process Clause. In the view of Justice O'Connor, a legislative body must be given time to organize and address issues involving previously-enacted laws. In the case of *Carlton*, allowing the U.S. Congress one year did not raise a concern under the Due Process Clause.

Since the *Carlton* decision in 1994, state legislatures have pushed the boundaries of retroactive tax laws. State courts have consistently upheld these law changes out of concern for state budgets. Taxpayers have routinely sought review by the Supreme Court of these adverse rulings challenging retroactive state tax laws under the Due Process Clause. However, the Court's refusal to hear such a case has only emboldened state legislatures.

The state tax policy implications for taxpayers cannot be understated. Businesses thrive when the economic environment is stable and predictable. Retroactive tax laws, if left unfettered in their reach, engender a chaotic business climate. In such an environment, a taxpayer can never truly know what its tax obligations are to a jurisdiction. States demonstrating the proclivity for passing retroactive tax laws, therefore, risk future revenues as

businesses cease operations to minimize risk. The lessons taught by Hollywood about the perils of time travel are as salient today as 1985.

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