Retroactive Tax Laws Are Just Wrong

by David Brunori

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In this viewpoint, Brunori reviews the impact of retroactive tax laws.

What one word comes to mind when you hear "due process"? It should be fairness. We inherently know what's right and wrong. We know when someone is being treated unfairly. And the Constitution reflects those beliefs. We think it is wrong to beat a confession out of someone. We think it is wrong to deny a person his right to worship. I bet that if you polled the American public, a vast majority would say that retroactive tax laws are wrong.

There has been a lot of discussion lately in *State Tax Notes* regarding retroactive tax laws. Timothy Noonan, Daniel Kelly, and Joshua Lawrence wrote an intriguing viewpoint on the New York Court of Appeals decision in *Caprio*. The New York Legislature enacted a law in 2010 and applied it retroactively to transactions that took place years before. The article went into great detail on how all this came about, but the bottom line is that the Caprios acted on the laws in place in 2007, the state decided in 2010 to change the law for 2007, and the Caprios challenged that, alleging that it violated the due process clause.

The court cited three factors to be weighed in determining whether a retroactive tax law violates due process:

- whether the taxpayer reasonably relied on the law as it existed when structuring the transaction and whether the taxpayer had forewarning of the change;
- the length of the period of retroactivity; and
- the strength of the public purpose behind the retroactive application of the law.

The state's highest court held for the government. However, a fair reading of the facts suggests that the Caprios relied on the existing law. The law changed several years later — that's a long time. And the state did not really identify a public purpose to justify retroactive application of the law. Apparently, due process has nothing to do with fairness in the New York court system.

In Raising the Bar in *State Tax Notes*, Joe Crosby, Kendall Houghton, Stephen P. Kranz, and Diann L. Smith examined retroactive tax laws in the context of *Hambleton v. Washington* and Michigan's *IBM v. Department of Treasury*. *Hambleton* involved a retroactive change to the state estate tax. *IBM* involved the retroactive repeal of the Multistate Tax Compact.

As readers know, these four commentators are among the best in the business. Smith said:

> We have this issue all of the time as to whether or not legislatures can retroactively change the law. What I like about this case [*Hambleton*] is it brings up two issues. One, the general concept of: Can a legislature retroactively change the statute? And two, can it retroactively overrule an existing decision from its highest court?

It should depress all of us that the issue of retroactivity arises all the time. There are two fundamental problems with changing the rules retroactively. First, it is patently unfair. People who follow the rules should not be penalized later. We would never stand for it in the criminal context. Why should we accept it for taxes? Second, retroactively changing the rules undermines confidence in the tax system. Most people try to do the right thing. Often they spend a lot of money paying lawyers and accountants to guide them to the right result. The good taxpayers might not be diligent in following the rules if those rules might change.

Kranz said, "As a voter, it is shocking to me that elected officials would change the rules retroactively." We should all feel that way. The legal standards the courts should adopt when evaluating retroactive tax law are simple. First, retroactive taxation should be upheld when a legislature makes a mistake and immediately changes the law before citizens have relied or acted on it. That happened to some extent in the Supreme Court's *Carlton* decision. But retroactive tax laws should be held in violation of the due process clause unless the government can show that the previous law was so ambiguous as to create an incentive for fraud and abuse and that the taxpayer was engaging in fraud and abuse.

The government should have a heavy burden in convincing a court of the legality of retroactive taxes. The due process clause is, after all, about fairness. ✰