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Should States Be Allowed To Retroactively Change Tax Laws?

featuring Joe Crosby, Kendall Houghton, Stephen P. Kranz, and Diann L. Smith interviewed by Doug Sheppard

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In Raising the Bar, *State Tax Notes* commentary editor Doug Sheppard interviews four seasoned state and local tax veterans: Joe Crosby of MultiState Associates, Kendall Houghton of Alston & Bird LLP, and Stephen P. Kranz and Diann L. Smith of McDermott Will & Emery. All four interviewees were staffers with the Council On State Taxation.

In this edition, Crosby, Kranz, and Smith question whether state legislatures can retroactively change laws and suggest that courts should reject this approach. Other recent state tax cases are also discussed.

In this edition of Raising the Bar, the discussion focuses on the issue of whether state legislatures can retroactively change laws. Noting how it has manifested in cases such as *Hambleton v. Washington* and *IBM v. Department of Treasury*, Joe Crosby, Stephen P. Kranz, and Diann L. Smith question the practice and suggest that courts should reject it. The discussion also touches on *California Franchise Tax Board v. Hyatt* and *CSX Transportation Inc. v. Alabama*, which has been cited by Colorado in its response brief in *Direct Marketing Association v. Brohl*. The three further comment on a recent blog post by Joseph Henchman of the Tax Foundation that called for codification of the four-prong test in the U.S. Supreme Court's *Complete Auto* decision in relation to the dormant commerce clause doctrine.

The discussion starts with Smith addressing *Hambleton*, for which a petition for certiorari has been filed with the Supreme Court.

Diann L. Smith: The case is interesting, and I hope the U.S. Supreme Court takes it. This case addresses head-on a question that I think all of us have come up against: To what extent can a state legislature retroactively change the tax rules for taxpayers?

The case dealt with a state estate tax issue in which the state completely decoupled from the federal estate tax regime and passed their own estate tax laws. A couple of widows complied with those laws and received a tax benefit as a result. The state revenue agency challenged the tax benefit all the way up to the highest court in Washington. The court upheld the taxpayers' position, saying it's clear under the statute that the benefit exists. The court looked at the plain language.

After the taxpayers won at the highest court in Washington, the Legislature came in and retroactively changed the law for well over a decade, saying, "No, we've changed our minds. That benefit didn't exist. We didn't mean for it to exist. We didn't understand what we were doing when we decoupled from the federal government." So nobody gets this benefit that actually was in the statute. After a second round of litigation over the retroactivity issue, the tax benefit was ultimately denied. It is the validity of the retroactive change that the U.S. Supreme Court is being asked to decide.

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 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? This case puts both of those fundamental issues together in one package.

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Stephen P. Kranz: As a voter, it is shocking to me that elected officials would change the rules retroactively. I understand the need to balance budgets, protect the fisc, and make sure that the law says what elected officials meant it to say. If elected officials let those needs trample on the need for citizens to rely on the laws as they engage in economic and other activity, I hope the courts stand up to protect the U.S. Constitution and the people who put the elected officials in office. The timing of this issue for state and local tax is perfect; the case is coming up right after the Michigan Legislature retroactively repealed their participation in the Multistate Tax Compact. The resolution of the case will therefore have implications to the pending refund claims in Michigan and could end up being important in other states where *Gillette*-type litigation is pending.

Smith: We see this issue come up over and over again over the decades. You look at what happened in the *Johnson Control* case in Kentucky, where there were decades of questions regarding whether or not the state had combined reporting. After several court decisions on this issue, the legislature came in and retroactively changed the rules.

Joe Crosby: There was that case in Puerto Rico where they retroactively changed the regulation — I think it was 16 years. And what we clearly have is a changing definition of what modesty is in line with overall society, apparently.

Smith: It's pure applesauce. Joe, do you have any thoughts on the legislative perspective?

Crosby: From a legislative perspective, retroactively changing tax laws following adverse decisions is completely rational in that the legislature is protecting the fisc to the extent that the courts allow them to do so. It makes legislators' lives easier to retroactively change the law, especially when the taxpayer has already paid and is seeking a refund, than to raise new revenue to fill a budget hole from an adverse decision. If the legislature can come up with a policy justification for why they think a decision is wrong, can retroactively "clarify" what they "meant" in the first place, and the courts allow them to do so, then they'll go back and change it.

So like you, Diann, I clearly think this is something where the Supreme Court should step in. Obviously, *Carlton* is no bar to retroactivity at the state level — at least as it's presently being interpreted by state courts.

Smith: I'm curious about legislators, because if a legislator supports a tax exemption, passes a tax exemption, and then seven years later that legislator's party is no longer in the majority, don't legislators care about the next legislative group being able to retroactively revise the intent of the past legislature?

Crosby: We know that legislatures can't bind future legislatures. You would think that future legislatures can't retroactively undo something a past legislature did in the time it did it. You wouldn't think that that would be appropriate, but apparently it is, according to many state courts.

Kranz: We have three branches of government for a reason: They are each to balance the others like a three-legged stool. It is unfortunate that the judiciary in those states have been unwilling to stand up to the legislative action that so clearly violates the Constitution and undermines the obligation of public officials to the people who put them there. If a state adopted a tax rate increase on individual income going back more than a decade, there would be a revolution at the state capitol. Just because the retroactivity is applied to dead people's estates or to business does not mean that a future legislature should be allowed to change the rules set by a past legislature.

Smith: And today that's exactly what's happening, for example, in the *IBM* set of cases in Michigan. What the states are arguing is that compacts can't bind future legislatures. Well, regardless of whether they can or not, if you're concerned about binding legislatures, it seems completely appropriate to say that future legislatures can't bind past legislatures.

A case that just got accepted at the U.S. Supreme Court — really for the second time — is the *Hyatt* case that's between California and the courts of Nevada. This case involves the gentleman who California has for decades been pursuing for personal income tax issues. He retaliated by suing California in Nevada court, which is where he says he's a resident, for tort damages. Issues involving this dispute have been at the U.S. Supreme Court before. Now the U.S. Supreme Court has accepted the case again regarding questions of a choice of law issue and sovereign immunity. The case questions whether Nevada courts must extend to sister states the same immunities that Nevada would enjoy in its own courts.

Kranz: There have been a number of states that have legislatively created the ability for their in-state taxpayers to seek adjudication in their home state regarding the validity of a foreign state's jurisdiction over that taxpayer. I don't think we've seen any of those statutes exercised, but the *Hyatt* case has the potential to kill or breathe new life into the legislative trend that came and went almost a decade ago.

Smith: Steve, in what context are those laws intended to apply?

Kranz: The judicial jurisdiction laws, as I think of them, were all adopted as part of the national sales tax nexus discussion. It was a small number of states saying: "We want our taxpayers to be able to go to our courts if another state is attempting to force them to collect tax." Joe, do you remember that? It's been years since those bills were introduced and considered, but there were a number of states that went down that path.

Crosby: I think Virginia was the first state to do that — maybe back in the early 2000s — and then, if I remember correctly, New Hampshire followed up in the wake of the *Town Fair Tire* case.

Smith: Those provisions were intended to prevent what the state saw as overreaching from the other states.

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Kranz: Exactly, to protect their taxpayers. I don't think we've seen those provisions utilized by taxpayers in the states, though, have we?

Crosby: No, I don't recall any instance — at least from any public record — of those statutes being used.

Kranz: It is a legislative trend that came and went quickly. But my point is that *Hyatt* could breathe new life into the issue or make it clear that what those states adopted is inconsistent with our subnational choice of law rules.

Crosby: As far as I know, it was just those two states.

Smith: Continuing with the Supreme Court theme, we have recently seen some fallout from the U.S. Supreme Court decision this past year in the *CSX* case. That case involved a 4-R Act issue. A lot of people saw it as limited to the railroads. Of course, the railroads care a lot about it because of the unique circumstances of having the 4-R Act. However, in that case, the U.S. Supreme Court very specifically discussed the concept of: How do you determine if there is some type of discrimination? The court said that you can look not just at the specific tax — and this helped the taxpayers in this case — but you can look at the general tax arena.

We've now seen the *CSX* case cited by the state revenue authority in the *Direct Marketing* case in Colorado for purposes of saying that there isn't any discrimination, because when you look at the sales tax reporting and collection system as a whole, the in-staters actually have a higher burden than the remote sellers. So here's an area that has nothing to do with the 4-R Act, and yet is using the *CSX* discrimination standard. I think that the concept of looking beyond just the immediate tax may be something that is starting to be routinely used — and it can work both ways. Like I said, in *CSX* it helped the taxpayer, but in other circumstances it may limit it. And it may be a way to get around some of the constraints on the compensatory tax doctrine.

Steve and Joe, any other updates on the *Direct Marketing* issues?

Kranz: No, and I'm thinking through whether the application of *CSX*'s discrimination standard will have an impact on, for instance, the Internet Tax Freedom Act and its discrimination standard. And there are obviously other federal bills drafted or introduced that apply or would apply, if adopted, a similar discrimination standard to state tax imposition. So it'll be interesting to see how this plays out and whether the analysis we thought needed to be made to apply federal laws in the SALT context needs to be adjusted.

Diann, was the *CSX* decision itself really focused on the statutory language of the 4-R Act, or does the court go further than that?

Smith: That's what they brought up, but then some of the cases that the U.S. Supreme Court cited regarding discrimination were outside of the 4-R Act.

Kranz: So the decision could be read as — and this is a legal phrase — mushing together constitutional discrimination standards with a federal statutory regime.

Smith: Exactly, exactly. And of course, now it's been remanded for this factual determination of whether — when you look at the tax system as a whole — there's discrimination. Whatever decision there is will not be requested for Supreme Court review, until the Supreme Court at some point in the future may look at this again as to what exactly constitutes discrimination — whether it's under the 4-R Act or whether they look beyond that.

Kranz: Well, the good news is that after decades of us working in the state tax world with little U.S. Supreme Court guidance, we're now seeing a rash of cases decided that are changing the landscape and providing much-needed clarity to an area of the law that was written decades ago and lacks the type of certainty that our modern-day financial statement reporting regime demands.

Smith: Yeah, let's hope they keep it up.

Crosby: Did you see Joseph Henchman's blog in the wake of David Brunori's column agreeing with Justices [Antonin] Scalia and [Clarence] Thomas that the dormant commerce clause should be eliminated?[1] Henchman disagreed with Brunori's contention and said one way to end this debate over the dormant commerce clause for tax purposes is just to have Congress codify the four-prong test in *Complete Auto*.[2]

Smith: I did not see that. It's an interesting question about this ongoing battle about the existence of a negative commerce clause. To the extent that we have seen Congress not be able to pass anything, even in the sales tax arena, I just don't see how the country can leave interstate commerce regulation completely up to the individual state; we can't say, "States, you can do whatever you want. Only Congress can tell you no." That just doesn't seem — when you look at the current political process — to be a realistic concept.

Crosby: I think you're right. What I thought was interesting, though, is *Complete Auto*, unlike many decisions, is amenable to codification. The way it is written with the four-pronged test, you could easily codify that, as opposed to — Diann, as you'll painfully recall — the discussions regarding how to statutorily codify what we all thought was the law prior to the Sixth Circuit Court decision that ended up being vacated in *Cuno* and trying to codify that. This one would seem fairly clear-cut.

I just thought it more humorous than anything else, because it would force — instead of having seven justices, basically, considering tax cases, we'd get all nine of them. Because the Congress would have said, "Hey, we actually

[1]*See* David Brunori, "You Know Scalia's Right," *State Tax Notes*, May 25, 2015, p. 597.

[2]*See* Joseph Henchman, "The Limits of State Tax Powers: A Modest Reply to Justice Scalia," The Tax Foundation Tax Policy Blog, May 27, 2015.

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like this case so much we're going to say that's what the commerce clause does say, and now you have to interpret it based on that."

Smith: And of course, what would be really interesting is whether or not Congress then chose a burden of proof, because if they didn't, there's a lower burden of proof for taxpayers if there's a statute versus challenging something as unconstitutional. So I think that would be awesome.

Crosby: That would be. But I agree with you — unlikely to happen. I thought it was an interesting idea, though.

Smith: I think it's certainly interesting, and it would show how the courts and the Congress could play off of each other in a useful manner. You know, here we've got decades now of seeing how the U.S. Supreme Court's ruling in *Complete Auto* is applied, so if Congress came in, they would have those decades of tax cases to help them craft the codification of it and take away the controversy of whether the negative commerce clause should ever be applied. ✰

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