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Retroactivity in State Tax Legislation

By Mary Kay Martire

Mary Kay Martire is a partner in State and Local Tax Practice Group of McDermott Will & Emery LLP. She is based in the firm's Chicago office.

Retroactivity in tax legislation is an issue of increasing concern for taxpayers and state tax practitioners alike. No legislative action in the tax arena is more inherently unfair than the retroactive amendment of a tax statute with the intended effect of increasing taxpayer liability. The practice destroys taxpayer certainty and undermines tax planning by disrupting settled expectations of liability. With increasing frequency, the practice has been used to overturn hard fought litigation victories. States have even enacted retroactive tax legislation to overturn prior guidance published by their own revenue departments. The following recent examples illustrate the problem:

Illinois – Retroactive Elimination of Business to Business Exception for Unclaimed Property

In 2017 Illinois amended Illinois' unclaimed property law as part of SB 9, the revenue bill supporting the State's fiscal year 2017-2018 budget. The amendment eliminated the business-to-business exception for unclaimed property. It includes a five year "look back" period which requires businesses to report any unclaimed property not previously reported as if SB9 had been in effect at the time the property would have been deemed abandoned. The period in question is actually eight years because of a three year dormancy period in the statute.[1] As a result, businesses that had no prior

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By Carol S. Portman

In this issue of *Tax Facts* we examine an unfortunate trend around the country: the rising inclination for lawmakers to change tax laws retroactively. Mary Kay Martire, a partner with McDermott Will and Emery, was part of the panel discussing this issue at our State and Local Tax conference last fall. (Mark September 20 on your calendars for this year's Conference!). At the Taxpayers' Federation of Illinois, we maintain that tax law changes should be prospective and that it is flat-out wrong for the government to change the rules after the fact.

Mary Kay provides several recent examples of retroactive changes, some of them quite egregious, and describes the problems caused by what was effectively a retroactive elimination of the business-to-business exemption for reporting unclaimed property here in Illinois. In a fascinating case study on how interpretations of decisions – and the importance of concurring opinions – evolve over time, she explains how a U.S. Supreme Court case involving a Congressional attempt to fix an oversight in a federal tax law has led to conflicting results, with some courts affirming and some overturning subsequent retroactive tax law changes. And she advises us to watch *South Dakota v. Wayfair*, the challenge to *Quill*, to see if the Supreme Court provides any new guidance on the question of retroactivity.

We are also reprinting TFI's Statement of Principles, the guide that we use in evaluating proposed tax law changes. Predictability is on almost every listing of the tenets of sound taxation, including ours. A retroactive tax-change obviously flies in the face of that principle. As the General Assembly prepares to move into the heavy portion of their legislative season, a gentle reminder of what tax laws should look like surely can't hurt.

warning that their business-to-business transactions would be subject to Illinois unclaimed property remittance are scrambling to find – or create – records to meet the state's retroactive filing requirements.[2]

Washington – Retroactive Repeal of 27 Year-Old B&O Tax Exemption

In 2010, the State of Washington enacted legislation retroactive 27 years to repeal an exemption from B&O tax for out-of-state companies selling consumer products that agreed to limit their in-state presence to sales solicitation by separate representatives. The taxpayer challenging the retroactivity, closely-held Illinois business corporation Dot Foods, had structured its Washington business operations in reliance on the exemption. Dot Foods even obtained a written ruling from the Washington Department of Revenue affirming that it qualified for the exemption. On May 22, 2017, the United States Supreme Court denied Dot Food's petition for certiorari from the Washington Supreme Court's decision affirming the constitutionality of the amendment.[3]

Michigan – Retroactive Withdrawal from the Multistate Tax Compact

In 2014, Michigan enacted a statute in which it retroactively withdrew from the Multistate Tax Compact as of January 1, 2008. The legislation overrode the Michigan Supreme Court's ruling in *IBM v. Department of Treasury,* 852 N.W.2d 865 (Mich. 2014) that IBM and other taxpayers were entitled to apply the Compact's three factor apportionment formula, rather than the Michigan Business Tax single sales factor formula, in calculating their 2008 tax liability. On May 22, 2017, the United States Supreme Court denied the Petition for certiorari filed by IBM and five other taxpayer/taxpayer groups seeking review of the Michigan Court of Appeals decision affirming the constitutionality of the legislation.

While states are not precluded from enacting legislation with retroactive effect, there are well-recognized taxpayer protections. First, legislation is presumed to have prospective-only effect. Unless a statute expressly provides for a period of retroactivity, a substantive change in the law only will be applied on a going-forward basis.[4] This requirement ensures that a state legislature must be intentional in its decision to retroactively enforce a tax change. In contrast, court decisions are presumed to apply retroactively, as a clarification of existing law.[5]

Second, retroactive tax legislation is subject to challenge under the Due Process Clause of the United States Constitution. Much of the current debate over retroactivity in tax legislation concerns under what circumstances due process protection will be provided. May a state resort to retroactive tax legislation simply to meet its fiscal needs, or to reverse the retroactive application of a court ruling that would have a large negative impact on the state's budget? If so, what time period of retroactivity is constitutionally permissible?

The United States Supreme Court most recently addressed the subject of retroactive tax legislation in *United States v. Carlton*, 512 U.S. 26 (1994). In *Carlton*, the Court affirmed Congress's retroactive amendment of Section 2057 of the Tax Reform Act of 1986 to narrow the circumstances under which a decedent could claim a federal income tax deduction based on the sale of employee-owned stock to an employee stock ownership plan (ESOP). As originally enacted in October 1986, the law permitted any decedent's estate to purchase and sell stock to an ESOP, thereby gaining a tax deduction equal to half the proceeds of the sale. Less than three months after the law became effective, the IRS announced that it would seek clarifying legislation to limit the deduction to estates of decedents who owned the securities in question immediately before death. A bill to amend the law was introduced in February 1987, enacted in December 1987, and made effective retroactive to the bill's original enactment date.[6]

In its opinion, the majority held that the due process standard to be applied to retroactive tax legislation was whether the legislation was "supported by a legitimate legislative purpose" that was "furthered by rational means."[7] The Court upheld the constitutionality of the retroactive amendment of the §2057 deduction, concluding that Congress' purpose was neither illegitimate nor arbitrary, since it had acted to correct what it reasonably viewed as a mistake in the original 1986 provision "that would have created a significant and unanticipated revenue loss."[8] The Court noted that there was no plausible contention that Congress had acted with an improper motive, such as by targeting a particular taxpayer, and held that it "could not say" that it was unreasonable for Congress to make up the unanticipated revenue loss ($7 billion) by denying the deduction to those who had made purely tax-motivated stock transfers, rather than through general prospective taxation.[9] In support of its ruling, the Court also noted that Congress had acted promptly (the amendment was proposed within three months after the Act's original enactment) and had established only a modest (slightly more than 1 year) period of retroactivity.[10]

Two justices filed concurring opinions in *Carlton,* both in reaction to the majority's holding that a significant and unanticipated revenue loss could be a legitimate governmental purpose sufficient to justify the retroactive application of revenue measures. In retrospect, the concurring opinions are prescient, as they reflect the Justices' understanding of the importance of this issue. In her concurrence, Justice O'Connor made specific mention of Justice Learned Hand's famous quote that "[a]nyone may so arrange his affairs that his taxes shall be as low as possible; …"[11] Justice O'Connor stated that she concurred with the majority's conclusion *in light of the facts presented.* She cautioned, however, that justifying retroactive tax legislation as correcting a mistake "proves too much" and could be used to justify almost any retroactive tax change when legislators are dissatisfied with prior law, thereby undermining taxpayer's legitimate need for finality. Justice O'Connor also drew specific attention to the short period of retroactivity at issue in the *Carlton* dispute and said that in her view a period of retroactivity longer than one year would raise "serious constitutional questions."[12] While Justice O'Connor raised concerns about retroactivity, Judge Scalia had none. Justice Scalia was generally opposed to the concept of substantive due process. He wrote that he concurred with the majority's ruling because its effect was to completely undermine any substantive due process protection for taxpayers, as the majority's reasoning "guarantees that all retroactive tax laws will henceforth be valid."[13]

In recent years, as demonstrated above, States have enacted retroactive tax legislation with increasing frequency, citing *Carlton* as support for the conclusion that (as Justice Scalia suggested) any period of retroactivity may be justified simply by economic need. Courts in Washington, Michigan, Kentucky and Iowa, among others, have approved tax legislation with lengthy periods of retroactivity.[14] In contrast, courts in New York, South Carolina and California, among others, have rejected retroactive tax legislation, holding that periods of retroactivity longer than the one year period referenced by Justice O'Connor in her concurrence in *Carlton* are excessive.[15] To date, the United States Supreme Court has rejected taxpayer efforts to seek the Court's review of adverse rulings, even in highly sympathetic cases.[16] In *Hambleton*, for example, the petitioners were two widows whose estates were subjected to nearly two million dollars of back tax liability in 2013 when Washington amended its estate tax statutes retroactively to 2005 to tax trust assets held by passive lifetime beneficiaries without power under the trust to dispose of the trust assets. The taxpayers had challenged the Department of Revenue's tax position and won before the Washington Supreme Court,[17] thus triggering the legislative amendment.

On April 17, 2018, the Supreme Court will hear argument in *South Dakota v. Wayfair, Inc.*, Docket 17-494. The central question presented by the case is whether the Supreme Court should abrogate *Quill Corp. v. North Dakota's* physical presence requirement for sales tax. However, retroactivity also has been a subject of discussion in the briefs filed by the parties/amici. While the South Dakota statute in question prohibits the State from imposing an economic nexus standard retroactively, it remains to be seen how other states would respond to a ruling in favor of South Dakota. In their Brief in Opposition to South Dakota's Petition for Writ of Certiorari, Respondents express concern that "a ruling by the Court that the *Quill* rule is invalid will expose all remote sellers that have relied on the rule to retroactive liability in dozens, if not hundreds, or even thousands of jurisdictions."[18] In their Brief of *Amici Curiae* Law Professors and Economists In Support of Petitioner, *Amici* disagree, stating that concern over retroactivity has "no basis" because the South Dakota statute prohibits retroactive application of the law change and the Court "can – if it chooses – grant South Dakota all the relief that the state requests while making its ruling in this case purely prospective."[19] After repeated efforts to gain review of adverse rulings focused exclusively on the issue of retroactivity, perhaps taxpayers will obtain some relief – or at least further guidance – from the Supreme Court in its *Wayfair* ruling.

Endnotes

[1] Some experts have argued the previous five year dormancy would apply, making the total retroactive period ten years. The Office of the Treasurer, which is charged with administering the unclaimed property laws, has taken the position that eight years is correct.

[2] TFI supports SB 2604, which would reinstate the business to business exemption.

[3] *Dot Foods, Inc. v. Dept. of Revenue for the State of Washington,* Docket No. 16-308.

[4] *Allegis Realty Investors v. Novak,* 860 N.E.2d 246, 253 (Ill. 2006).

[5] *Exelon Corp. v. Dept. of Revenue,* 917 N.E.2d 899, 911 (Ill. 2009) ("Generally, judicial decisions are given retroactive as well as prospective effect.")

[6] 512 U.S. at 28-9.

[7] 512 U.S. at 30.

[8] 512 U.S. at 32.

[9] *Id*.

[10] 512 U.S. at 32-3.

[11] 512 U.S. at 36.

[12] 512 U.S. at 38.

[13] 512 U.S. at 40. Similarly, the majority opinion noted that the Court had repeatedly upheld retroactive tax legislation, citing *United States v. Hemme,* 476 U.S. 558 (1986); *United States v. Darusmont*, 449 U.S. 292 (1981); *Welch v. Henry*, 305 U.S. 134 (1938); *United State v. Hudson*, 299 U.S. 498 (1937); *Milliken v. United States*, 283 U.S. 15 (1931); and *Cooper v. United States*, 280 U.S. 409 (1930).

[14] *In re Estate of Hambleton,* 335 P.3 398 (Wash. 2014), *cert. denied,* 136 S. Ct. 318 *2915) (holding that an eight-year retroactive period is permissible when necessary to prevent an "unanticipated and significant fiscal shortfall"); *Miller v. Johnson Controls, Inc.,* 296 S.W.3d 392 (Ky. 2009), *cert. denied,* 560 U.S. 935 (2010) (upholding a retroactive amendment to corporate tax statutes in 2000 that barred the filing of combined tax returns under the unitary business concept for years prior to 1995); *Zaber v. City of Dubuque,*789 N.W.2d 634 (Iowa 2010); *see also Montana Rail Link, Inc. v. United States.,* 76 F.3d 991 (9th Cir. 1996).

[15] *James Square Assocs. LP v. Mullen,* 993 N.E.2d 374, 382 (N.Y. 2013) (holding that a retroactive tax period of only 16 to 32 months should be considered excessive); *Rivers v. State,* 490 S.E.2d 261 (S.C. 1997) (invalidating a tax amendment with a two to three-year retroactive period); *City of Modesto v. Nat'l Med., Inc.,* 128 Cal. App. 4th 516 (2005) (invalidating an amendment with an eight-year period of retroactivity that the City waited two years to adopt).

[16] For example, on May 22, 2017, the Court rejected eight petitioners for certiorari filed by taxpayers seeking relief from retroactive tax legislation, including *Dot Foods, IBM,* and the following six petitions filed by taxpayers aggrieved by Michigan's retroactive withdrawal from the Multistate Tax Compact: *Sonoco Products Co., et al. v. Michigan Dept. of Treasury,* No. 16-687; *Skadden, Arps, Slate, Etc. v. Michigan Dept. of Treasury,* No. 16-688; *Gillette Commercial Operations v. Michigan Dept. of Treasury,* No. 16-697; *Goodyear, et al. v. Michigan Dept. of Treasury,* No. 16-699; and *DirectTV Group Holdings v. Michigan Dept. of Treasury,* No. 16-736.

[17] *In re Estate of Bracken,* 290 P.3d 99 (Wash. 2012).

[18] *South Dakota v. Wayfair,* Docket 17-494, Resp'ts' Brief in Opp'n at 35.

[19] *Id.,* Brief of *Amici Curiae* Law Professors and Economists in Support of Petitioner, pp. 6-7. The *Amici* parties also assert that "no state or municipality has suggested that it will seek to collect sales taxes on past transactions from remote retailers," and assert that "dormant Commerce Clause precedents that go unchallenged in this case would likely prevent any jurisdiction from doing so." *Id.* at 7.

Taxpayers' Federation of Illinois Statement of Principles

The Taxpayers' Federation of Illinois supports sound tax policy and fiscal practices that encourage economic growth in Illinois. The tenets of sound tax policy can be articulated in a number of different ways. The Taxpayers' Federation of Illinois evaluates Illinois' overall state and local tax structure and individual tax provisions using the following guideposts:

Adequacy. A tax structure must raise enough revenue to properly fund government operations. Decisions about the scope and level of government services are outside the scope of tax policy, except to the extent overall tax burdens become unsustainably high. Tax revenues need to reflect economic growth, which usually requires that tax collections be balanced across multiple tax types. Income, property, and sales taxes are the most common tax types relied on by state and local governments.

Stability/Predictability. From the taxpayer's perspective, tax liabilities should not fluctuate dramatically from year to year. From the government's perspective, the same is true of revenues. Similarly, both taxpayers and governments function best when their future tax liabilities and collections can be projected with some degree of confidence. "The most damaging thing you can do to any businessman in America is to keep him in doubt, and to keep him guessing, on what our tax policy is." That was true when President Lyndon Johnson said it in 1964, and it remains true today.

Equity/Fairness. Equity has two dimensions: horizontal equity and vertical equity. Horizontal equity compares similarly situated taxpayers. Vertical equity compares tax burdens across taxpayer income or wealth brackets. Identical houses situated side-by-side should have the same property tax bill; that is horizontal equity. A third, more valuable house should have a higher tax bill commensurate with the higher value; that is vertical equity. Both actual and perceived fairness are important.

Collectibility/Transparency/Simplicity. These interrelated principles apply primarily to tax administration and, although they are generally noncontroversial, are too often overlooked. Voluntary compliance is an essential ingredient in most state and local tax structures; these principles help maintain taxpayer confidence in and compliance with the system. In addition, if a tax is easy to comply with and easy to collect it is also less costly to do so, and more funds are available for other business and government needs.

Efficiency. This is sometimes considered an aspect of equity. Taxes should be imposed without distorting economic behavior; the tax code should not pick winners and losers. The notion of a broad base and low rate is a manifestation of the efficiency principle. Similarly, the tax compliance and administration processes should not be unnecessarily inefficient and costly (which is frequently a consequence of violating the simplicity principle).

Taxes matter. Individuals and businesses make decisions every day about where to live, to invest, to expand. Illinois' overall business climate and economic prospects are critical factors in those decisions. Our tax structure and each taxpayer's anticipated tax liabilities are certainly not the only piece of the puzzle, but they play an important role in the process. Individual tax provisions and our tax code as a whole should adhere as closely as possible to these principles. The Taxpayers' Federation of Illinois supports those measures that do so, and opposes those that do not comport with good tax policy.

Illinois Tax Facts

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Taxpayers' Federation of Illinois
430 East Vine Street, Suite A
Springfield, IL 62703
V. 217.522.6818

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