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State Tax: Waiting for Relief from Retroactivity

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Retroactivity is an endemic problem in the state tax world. The past year has seen retroactive repeal of the ***Multistate Tax Compact (MTC)*** in Michigan, as well as significant retroactivity issues in New York, New Jersey and Virginia. Relief appeared to be on the way until the ***Supreme Court*** of the United States denied *certiorari* in a Washington estate tax case, ***Hambleton v. Washington*****,** on October 13, 2015. The Supreme Court's decision came just two weeks after the Michigan Court of Appeals upheld a retroactive period of almost seven years.

The *Hambleton* petition urged the Supreme Court to take the case in order to resolve the uncertainty of "how long is too long" when it comes to retroactive taxes, citing multiple examples of past and ongoing litigation in which lower courts have taken divergent approaches to the length of permissible retroactivity. For example, the petition cited the ongoing litigation in Michigan over the MTC's apportionment election. In July 2014, in *International Business Machines Corp. v. Michigan Department of Treasury*, the Michigan Supreme Court held that IBM could apportion its income using the so-called "MTC election," which allowed a taxpayer to use a three-factor formula consisting of property, payroll and receipts to apportion income, rather than the state's standard formula. 852 N.W.2d 865 (Mich. 2014). In September 2014, however, the Michigan legislature retroactively repealed the MTC election and effectively overturned the *IBM* decision. Fifty taxpayers challenged the retroactive repeal, and those cases were consolidated.

On September 29, 2015, the Michigan Court of Appeals upheld the retroactive repeal of the MTC election in the consolidated cases. *Gillette Commercial Operations N. Am. & Subsidiaries v. Dep't of Treasury, et al*, Dkt. No. 325258 (Mich. Ct. Claims, Sep. 29, 2015). While the case included several state and federal constitutional and statutory issues, this article will focus on the due process clause.

The due process clause (theoretically) prohibits retroactive laws, because persons must be able to know what the law is, and retroactive law changes prevent a person from having that knowledge. The Supreme Court of the United States' primary case regarding when due process prohibits a retroactive law is *U.S. v. Carlton*, 512 U.S. 26 (1994). In *Carlton*, the Supreme Court established a two-part test to determine whether the retroactive effect of a law is allowed under the due process clause. First, the legislature's act must be neither arbitrary nor illegitimate. Second, the legislature must act promptly and only enact a "modest" period of retroactivity.

In *Gillette*, the Michigan Court of Appeals determined that a six-and-a-half-year period of retroactivity was modest. It is not clear why this length of time was deemed modest, but many other Michigan cases uphold laws with retroactive periods of similar length. Outside of *Carlton*, which approved a retroactive period of one year, the Supreme Court has given little guidance on the definition of “modest.”

Taxpayers were sorely disappointed when *Hambleton* was denied *certiorari,* because it is hard to imagine a more sympathetic situation for a due process retroactivity challenge to a state tax. The *Hambleton* case involved two widows’ estates. As stated in the petition:

> Helen Hambleton died in 2006, and Jessie Macbride died in 2007. Each was the passive lifetime beneficiary of a trust established in her deceased husband’s estate, and neither possessed a power under the trust instrument to dispose of the trust assets. Under the Washington estate tax law at the time of their deaths, the tax did not apply to the value of those trust assets. In 2013, however, the Washington Legislature amended the estate tax statutes retroactively back to 2005, exposing their estates to nearly two million dollars of back taxes.

In 2005, Washington State enacted an estate tax that was intended to operate on a standalone basis, separate from the federal estate tax. In interpreting the new law, the Washington Department of Revenue issued regulations that the transfer of property from the petitioners’ husbands to the petitioners through a Qualified Terminable Interest Property (QTIP) trust was not subject to the Washington estate tax. The Department subsequently reversed its position and assessed tax. Petitioners, along with other estates, challenged the Department’s position and won in Washington Supreme Court (*In re Estate of Bracken*, 290 P.3d 99 (Wash. 2012)).

In 2013, the Washington legislature amended the estate tax to retroactively adopt the Department’s position, going back to 2005. The petitioners challenged this new law and again fought to the Washington Supreme Court, which this time held in favor of the Department and concluded that the retroactive change satisfied the due process clause under a rational basis standard. This chain of events is inherently unfair and, if allowed, potentially subjects taxpayers to new tax liabilities at any time.

Although disappointing, the Supreme Court of the United States’ denial of *certiorar*i in *Hambleton* is not surprising. The Supreme Court has declined previous opportunities to review retroactive state tax impositions (*see*, *e.g*., *Miller v. Johnson Controls, Inc*., 296 S.W.3d 392 (Ky. 2009), *cert. denied*, 560 U.S. 935 (2010)). The *Gillette* case will continue up the chain in Michigan and likely will be appealed to the Supreme Court of the United States, regardless of who prevails in the Michigan Supreme Court. As explained in the *Hambleton certiorari* petition and the supporting *amicus* briefs, the Supreme Court needs to revisit the retroactivity issue and act as a check as states continue to aggressively seek ways to raise additional revenue.

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