TAX EXECUTIVES INSTITUTE, INC.

State and Local Tax Policy Statement
Regarding Retroactive Legislation

Tax Executives Institute, Inc. (TEI) maintains that sound tax policy and administration require governments to provide taxpayers with certainty and fairness. These principles are not satisfied when legislatures are permitted to enact retroactive tax legislation without meaningful limits.

The Due Process Clauses of the U.S. and state constitutions protect against the deprivation of life, liberty, or property without due process of law. Retroactive tax legislation, which changes the tax rules applicable to past years, has the potential to violate this right.

The U.S. Supreme Court has repeatedly stated that retroactive legislation "presents problems of unfairness because it can deprive citizens of legitimate expectations and upset settled transactions."[1] Thus, the standards applied to retroactive legislation are higher than those applied to prospective legislation.[2]

The U.S. Supreme Court held retroactive tax legislation must be "supported by a legitimate legislative purpose furthered by rational means" in *United States v. Carlton*.[3] The Court held the test was satisfied in that case, finding: (1) the legislative purpose was not "illegitimate" or "arbitrary" because it fixed a drafting error, and (2) the legislature acted "promptly" and "established only a modest period of retroactivity" of slightly greater than one year.[4] Since *Carlton*, lower courts have upheld retroactive tax legislation that does not meet the standard of fairness espoused in that case.

TEI maintains taxpayers must be able to rely upon the legislation and regulations in existence when business transactions and other taxable events occur for a tax system to be fair and perceived as fair. Governments may change their tax policies and laws, but fairness demands that these changes be enforced prospectively, especially if they will have significant financial effects on taxpayers. Moreover, even when governments possess the authority to change tax laws retroactively, legislatures should exercise that power sparingly and within narrow limits.

Retroactive tax legislation is particularly suspect when it overrules a judicial decision. Under a system of divided government, the legislature is charged with writing the laws, the executive branch is charged with administering them, and

[1] *Eastern Enterprises v. Apfel*, 524 U.S. 498, 501 (1998) (citing *General Motors Corp v. Romein*, 503 U.S. 181 (1992)).
[2] *Pension Benefit Guarantee Corp. v R.A. Gray & Co.*, 467 U.S. 717, 729-730 (1984).
[3] 512 U.S. 26, 30-31 (1994).
[4] *Id*. at 32.

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courts are charged with interpreting them as written. It is always within a legislature's province to change tax laws prospectively in response to a judicial decision. However, doing so retroactively after a court has interpreted the law cannot be reconciled with basic tenets of sound tax policy and administration because it disrupts taxpayer expectations.

Indeed, taxpayers will be discouraged from challenging an adverse decision from a taxing agency in court if legislatures have unlimited discretion to overrule court decisions they dislike. There is little reason for taxpayers to spend the time and considerable expense to seek judicial redress if the legislature can change the law retroactively. Providing state legislatures unfettered power to overrule court decisions thus undermines the division of power among the three branches of government, and the checks and balances the judiciary confers.

In addition, allowing state legislatures to retroactively overrule taxpayer-favorable decisions wastes judicial resources. There is no need for a court to spend its time and resources to decide a case that will be overturned by a state legislature. Legislatures have an obligation to amend legislation promptly rather than litigating questionable issues and rendering judicial decisions obsolete via retroactive legislation.

Under Accounting Standards Codification (ASC) 740, many taxpayers are required to recognize for financial statement purposes the amount of income taxes payable or receivable based on the outcome in the court of last resort. Legislative action that can reverse a court's decision retroactively undermines a taxpayer's ability to provide appropriate guidance for financial statement purposes under ASC 740.

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