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Virginia is facing a potential $4.2 billion budget shortfall over the next two fiscal years—one of the largest shortfalls in its history. In a bid to close the gap, former Gov. Timothy Kaine issued a budget proposal that calls for a series of tax increases, including a retroactive amendment to a state law requiring the addback of deductions claimed for intangible property and interest expenses related to intangible holding companies. In this article, authors Craig D. Bell and J. Christian Tennant, of McGuireWoods LLP, argue that, based on a standard of reasonableness, the retroactive amendment violates due process and should be abandoned as unconstitutional.

The Constitutionality of Retroactive Tax Legislation in Virginia: Why Proposed Change to Add-Back Statute Violates Due Process

By Craig D. Bell

And J. Christian Tennant

Democratic National Committee Chairman Timothy Kaine's term as Virginia governor recently expired. In his wake, he left Virginia with a potential $4.2 billion budget shortfall over the next two fiscal years. This budget shortfall is one of the largest shortfalls ever in Virginia. However, the shortfall is not the only legacy Kaine leaves behind. He also proposed tax increases, the elimination of dealer compensation for collecting Virginia sales tax, and an unconstitutional change to Virginia's corporate income tax that will all be considered in the 2010 session of the Virginia General Assembly. This article focuses on the constitutionality of the Virginia corporate income tax changes in former governor Kaine's final budget.

VIRGINIA'S ADD-BACK STATUTE

In 2004, Virginia joined a number of other states by adopting legislation severely limiting the ability of corporations conducting business in Virginia to enjoy the benefits provided by the use of intellectual property or passive investment holding companies.[1] The 2004 Virginia General Assembly significantly curtailed the benefits by requiring additions to be made to federal taxable income for certain deductions claimed for intangible property and interest expenses related to

[1] Act of June 3, 2004, ch. 3, 2004 Special Session I Va. Acts 9 (codified as amended at Va. Code Ann. §§58.1-302, -402(B)(8), -402(B)(9), -1206(A)(4) (Repl. Vol. 2004)).

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intangible holding companies.[2] Corporations are required to add back to federal taxable income any interest and intangible expense directly or indirectly paid to one or more related members.[3] However, the addback is not required if the corresponding item of income is subject to a tax in another state.[4] Specifically, Va. Code Ann. §58.1-402(B)(8)(a) states:

> This addition shall not be required for any portion of the intangible expenses and costs if one of the following applies:
>
> (1) The corresponding item of income received by the related member is subject to a tax based on or measured by net income or capital imposed by Virginia, another state, or a foreign government that has entered into a comprehensive tax treaty with the United States government; . . .[5]

Since the adoption of this statute, the Virginia Tax Commissioner has issued six separate determinations that discuss the application of the ''subject to tax'' exception.[6] As Virginia does not have an independent administrative appeal process, the only opportunity taxpayers have to administratively appeal an assessment of additional taxes is to file an appeal with the Virginia Tax Commissioner.[7]

In each of the six rulings, the taxpayer appealed an assessment of additional corporate income taxes by arguing that it was entitled to exclude 100 percent of its royalty payments from the addback because the related member paid tax to other states on a portion of its income corresponding to those royalty payments.[8] The Virginia Tax Commissioner determined in each instance that only the portion of the royalty payment that was subject to tax in another state may be excluded from the addback, not 100 percent of the royalty payment.[9] To date, these six determinations are the only interpretations of the ''subject to tax'' exception as the Virginia Department of Taxation has not promulgated any regulations to implement the 2004 addback legislation.

[2] *Id*.

[3] Va. Code Ann. §58.1-402(B)(8)(a), -402(B)(9)(a) (Repl. Vol. 2009).

[4] Va. Code Ann. §§58.1-402(B)(8)(a)(1), -402(B)(9)(a)(4)(i) (Repl. Vol. 2009).

[5] Va. Code Ann. §58.1-402(B)(8)(a) (Repl. Vol. 2009).

[6] *See* Rulings of the Virginia Tax Commissioner, P.D. 07-153 (Oct. 2, 2007); P.D. 07-217 (Dec. 20, 2007); P.D. 09-49 (April 27, 2009); P.D. 09-67 (May 13, 2009); P.D. 09-68 (May 13, 2009); and P.D. 09-96 (June 11, 2009).

[7] Va. Code Ann. §58.1-1821 (Repl. Vol. 2009).

[8] *See* Rulings of the Virginia Tax Commissioner, P.D. 07-153 (Oct. 2, 2007); P.D. 07-217 (Dec. 20, 2007); P.D. 09-49 (April 27, 2009); P.D. 09-67 (May 13, 2009); P.D. 09-68 (May 13, 2009); and P.D. 09-96 (June 11, 2009). Rulings of the Tax Commissioner do not carry any value or weight, much like private letter rulings issued by the Internal Revenue Service,and may not be relied upon by taxpayers as precedent except by the actual taxpayer who requested and received the letter ruling.

[9] *Id*.

Former Gov. Kaine's Amendment

Virginia has a peculiar budgetary schedule. Every four years, the outgoing governor[10] offers a new biennial budget and is succeeded by a new governor approximately one month later. Fast forward to the present daywhere the 2010 session of the Virginia General Assembly just convened on Jan. 13, 2010. In his proposed budget for the 2011 and 2012 fiscal years, former Gov. Kaine seeks to amend the language of Va. Code Ann. §58.1-402(B)(8)(a) as follows:

> This addition shall not be required for any portion of the intangible expenses and costs **if to the extent** that one of the following applies: **–**
>
> (1) The corresponding item of income received by the related member is subject to a tax based on or measured by net income or capital imposed by Virginia, another state, or a foreign government that has entered into a comprehensive tax treaty with the United States government; . . .[11]

This amendment would change the language of the ''subject to tax'' addback so that it is consistent with the Virginia Tax Commissioner's six rulings. Alone, the changes to the statute contained in the amendment are not unconstitutional. However former Gov. Kaine's budget applies the amendment retroactively to the 2004 taxable year.[12] This retroactivity element is unconstitutional.

CONSTITUTIONALITY OF RETROACTIVE TAX LEGISLATION

It is well settled that legislative changes to a tax statute may be applied retroactively so long as certain requirements are met. Both the U.S. Supreme Court and the Supreme Court of Virginia have issued opinions in which the retroactive application of an amendment to a tax statute was considered. In both cases, the primary concern of the courts was whether the retroactive change satisfied the Fifth Amendment's Due Process Clause requirements. The most recent opinion by the U.S. Supreme Court that discusses retroactive tax legislation is *United States v. Carlton*, 512 U.S. 26 (1994).

United States v. Carlton

United States v. Carlton involved a dispute regarding the federal estate tax. In the Tax Reform Act of 1986, a new estate tax provision granted a deduction for half the proceeds of ''any sale of employer securities by the executor of an estate'' to ''an employee stock ownership

[10] Va. Const. art. V, §1. (Virginia governors may not serve successive terms.)

[11] H.B. 29, 2010 Leg., Reg. Sess., Part 4, cl. 4 (Va. 2010); H.B. 30, 2010 Leg., Reg. Sess., Part 4, cl. 3 (Va. 2010); 2010 S.B. 29, 2010 Leg., Reg. Sess., Part 4, cl. 4 (Va. 2010); S.B. 30, 2010 Leg., Reg. Sess., Part 4, cl. 3 (Va. 2010). *See also* S.B. 407, 2010 Leg., Reg. Sess. (Va. 2010).

[12] H.B. 29, 2010 Leg., Reg. Sess., Part 4, cl. 6 (Va. 2010); H.B. 30, 2010 Leg., Reg. Sess., Part 4, cl. 4 (Va. 2010); S.B. 29, 2010 Leg., Reg. Sess., Part 4, cl. 6 (Va. 2010); S.B. 30, 2010 Leg., Reg. Sess., Part 4, cl. 4 (Va. 2010). *See also* S.B. 407, 2010 Leg., Reg. Sess. (Va. 2010).

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plan.''[13] In order to qualify for the deduction, the sale of securities had to be made ''before the date on which the [estate tax] return . . . [was] required to be filed (including any extensions).''[14] As enacted in 1986, the deduction did not contain a requirement that securities must have been owned by the decedent prior to death.

In reliance on the newly created deduction, the estate's executor used estate funds to purchase 1.5 million shares of stock for $11,206,000, and two days later, sold the stock to an employee-owned stock plan (ESOP) for $10,575,000.[15] When the executor filed the estate tax return in late 1986, he claimed a deduction of $5,287,000 (one-half of the proceeds from the sale of the stock to the ESOP).[16] The deduction reduced the estate tax by $2,501,161.[17] In January 1987 (after the estate filed the estate tax return), the IRS announced that ''pending the enactment of clarifying legislation,'' it would allow the deduction only to estates of decedents who owned the securities in question immediately before death.[18] In December 1987, Congress amended the deduction to require that securities sold to an ESOP must have been ''directly owned'' by the decedent ''immediately before death.''[19] The amendment was made effective as if it had been contained in the statute as originally enacted in October 1986.[20]

It is well settled that legislative changes to a tax statute may be applied retroactively so long as certain requirements are met.

The estate challenged the retroactive application of the amendment to the deduction it claimed on the estate tax return. The issue that the U.S. Supreme Court considered was whether Fifth Amendment Due Process standards were satisfied by the retroactive application of the amendment to the estate's deduction. The standard applied by the court was whether the legislation was justified by a rational legislative purpose.[21] Ultimately, the court determined that the legislation did have a rational legislative purpose.[22]

The U.S. Supreme Court determined that the 1987 amendment was a curative measure by Congress to correct a mistake in the original 1986 provision that would have created a significant and unanticipated revenue loss.[23] Furthermore, the court found that Congress acted promptly and established only a modest period of retroactivity.[24] The amendment was proposed by the IRS in January 1987 and by Congress in February 1987, within a few months of the original enactment by Congress of the deduction.[25] Once enacted, the actual retroactive effect of the 1987 amendment extended for a period only slightly greater than one year.[26]

Colonial Pipeline v. Virginia

Almost thirty years before the court's decision in *United States v. Carlton*, the Supreme Court of Virginia considered the constitutionality of retroactive legislation in *Colonial Pipeline Co. v. Virginia*,[27] On March 19, 1964, Virginia amended a statute to impose an ad valorem tax on intangible personal property and money owned by pipeline companies, such as Colonial Pipeline Company, as of Jan. 1, 1964, and each year thereafter. The act amending the statute was an emergency act and in force from the date of its passage.[28] The imposition of the tax was a reaction to an October 1963 decision by the Virginia State Corporation Commission (SCC) in which the SCC determined that Colonial Pipeline was not subject to the ad valorem tax it was previously paying to Virginia localities.[29]

Colonial Pipeline argued to the Virginia Supreme Court that it did not know or have reason to know on Jan. 1, 1964, (tax day) that a tax would be imposed on its intangible personal property and money.[30] Furthermore, Colonial Pipeline argued that the retroactive application of the tax was unconstitutional and void.[31] The Virginia Supreme Court stated that the retroactivity of a tax statute is not unconstitutional so long as it is not arbitrary and does not disturb vested rights, impair contractual obligations, or violate due process.[32] In this case, the court decided that the only issue was whether Colonial Pipeline's due process rights were violated.[33]

The court determined that Colonial Pipeline's due process rights were not violated because the retroactive application did not extend for more than a reasonable period and that Colonial Pipeline had a reasonable expectation that the tax would be imposed.[34] The court determined that the retroactive operation did not extend for more than a reasonable period as the retroactive operation of the statute was within the current year and within three months of the date on which the statute became effective.[35] In addition, the court concluded that Colonial Pipeline should have known as a result of the SCC decision that at the next session of the Virginia General Assembly, the statute would be amended to

[13] *United States v. Carlton*, 512 U.S. 26, 28 (1994) (*citing* 26 U.S.C. §2057(b) (1982 ed., Supp. IV)).
[14] *Id*.
[15] *Id*. at 28.
[16] *Id*.
[17] *Id*.
[18] *Id*. at 29 (*citing* IRS Notice 87-13, 1987-1 Cum. Bull. 432, 442.).
[19] *Id*. at 29 (*citing* Omnibus Budget Reconciliation Act of 1987, §10411(a), 101 Stat. 1330-432.).
[20] *Id*. at 29 (*citing* Omnibus Budget Reconciliation Act of 1987, §10411(b), 101 Stat. 1330-432.).
[21] *Id*. at 30-31 (*quoting Pension Benefit Guar. Corp. v. R. A. Gray & Co.*, 467 U.S. 717, 729-730 (1984)(*quoting Usery v. Turner Elkhorn Mining Co.*, 428 U.S. 1, 16-17, 49 L. Ed. 2d 752, 96 S. Ct. 2882 (1976).).
[22] *Id*. at 32.
[23] *Id*.
[24] *Id*.
[25] *Id*. at 33.
[26] *Id*. at 32.
[27] *Colonial Pipeline Co. v. Virginia*, 206 Va. 517, 518, 519 (1965).
[28] *Id*.
[29] *Id*. at 522.
[30] *Id*. at 520.
[31] *Id*.
[32] *Id*. at 521.
[33] *Id*.
[34] *Id*. at 522.
[35] *Id*.

subject it to the ad valorem tax.[36] For these reasons, the Supreme Court of Virginia determined that the retroactive application of the amendment to the ad valorem tax was indeed constitutional.

Giesecke v. Virginia Dept. of Taxn.

In 1994, the Circuit Court of Fairfax County, Va., considered whether a retroactive legislative amendment to the state's tax laws was constitutional in *Giesecke v. Virginia Dept. of Taxn.*[37] In this case, the taxpayers, Hans D. and Patricia A. Giesecke, challenged the retroactive application of a change to Virginia's individual income tax credit for taxes paid to other states.[38] Prior to 1990, Virginia did not allow individuals to receive a credit for taxes paid to other states for the unincorporated business tax levied in the District of Columbia.[39] In 1990, the Supreme Court of Virginia issued an opinion in *King v. Forst*[40] that overruled this policy and allowed Virginia residents to receive a credit against their individual income tax for unincorporated business tax paid to the District of Columbia.

In the first regular session of the Virginia General Assembly after the *King v. Forst* decision, the General Assembly amended the credit retroactive to the 1987 taxable year to prohibit individuals from receiving credit for unincorporated business tax paid to the District of Columbia.[41] The Gieseckes challenged the retroactivity of this amendment.

Using the decisions in *United States v. Carlton* and *Colonial Pipeline Co. v. Virginia* as guidance, the circuit court succinctly cited the two tests enunciated in *Colonial Pipeline Co. v. Virginia* to determine whether due process considerations are satisfied by retroactive tax legislation.[42] The tests as stated by the Fairfax County Circuit Court are:''(1) Should the taxpayer reasonably have known that the statute at issue would be amended with retroactive application as to them? and (2) Whether the period of retroactive application of a tax statute is reasonable?''[43]

The Fairfax County Circuit Court determined that the Gieseckes reasonably should have known that the credit would be amended and that the period of retroactive application was reasonable.[44] From 1959 to 1989, the Virginia Department of Taxation's interpretation of the credit did not allow individuals to claim a credit for unincorporated business tax paid to the District of Columbia.[45] After *King v. Forst*, the Fairfax County Circuit Court stated that the Gieseckes should have known that that credit would be amended to reinstate the thirty year policy.[46] The Fairfax County Circuit Court said that a three year retroactive period, while longer than generally acceptable, was reasonable because at the time of the *King v. Forst* decision, the Virginia Department of Taxation's position on the credit was ''consistent and long-standing.''[47] The amendment codifying this position was enacted at the first opportunity for all open years.[48] As the General Assembly did not create a ''wholly new law,'' the retroactive period was reasonable.[49] For these reasons, the Fairfax County Circuit Court denied the Gieseckes' claim.

APPLYING DUE PROCESS STANDARDS TO KAINE'S LEGISLATIVE PROPOSAL

Using the succinct two-part test enunciated in *Giesecke v. Virginia Dept. of Taxn.* is the best method to determine if former Gov. Kaine's proposed changes to the addback are constitutional. First, should Virginia corporate taxpayers reasonably know that the add-back statute would be retroactively amended? Based on conversations with the parties directly involved in adopting the 2004 addback statute, the answer to this question is clearly ''no.'' The statutes in question in *Colonial Pipeline v. Virginia* and *Giesecke v. Virginia Dept. of Taxn.* were both amended due to judicial opinions that altered the interpretation of each statute.

With respect to the 2004 add-back statute, there has been no judicial interpretation or any other interpretation by a government official that a taxpayer may exclude 100 percent of its royalty payments from the addback because a related member paid tax to other states on a portion of its income corresponding to those royalty payments. In fact, the only official interpretation available are the six rulings from the Virginia Tax Commissioner that state that only the portion of the royalty payment that was subject to tax in another state may be excluded from the addback, not 100 percent of the royalty payment. If the Tax Commissioner believes that she is interpreting the statute correctly, there is no need to amend the statute and no reason for Virginia taxpayers to know that the statute would be amended retroactively.

There is absolutely no reason for Virginia taxpayers to know that the statute would be amended retroactively.

In *United States v. Carlton*, the U.S. Supreme Court had slightly different facts, as the retroactive amendment was necessary to correct an oversight by Congress when it originally enacted the deduction at issue in that case. Was there an oversight when the add-back statute was enacted in 2004? No oversight was mentioned in the six published rulings by the Virginia Tax Commissioner. She interprets the statute as currently written to allow only the portion of the royalty payment that was subject to tax in another state to be excluded from the addback. In other words, her interpretation of the statute would not change even with the proposed amendment.

[36] *Id.*
[37] *Giesecke v. Virginia Dept. of Taxn.*, 34 Va. Cir 455 (Fairfax County, 1994).
[38] *Id.*
[39] *Id.* at 460.
[40] *King v. Forst*, 239 Va. 557 (1990).
[41] *Giesecke*, 34 Va. Cir at 457.
[42] *Id.* at 459.
[43] *Id.*
[44] *Id.*
[45] *Id.* at 456
[46] *Id.* at 459.
[47] *Id.* at 460.
[48] *Id.* at 460-461.
[49] *Id.* at 460.

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In addition, in the five concluded sessions of the General Assembly since the add-back statute was enacted, no amendment to the statute of any sort has even been introduced. The Virginia Tax Commissioner released her first two official interpretations of the statute in 2007,and still no legislation was introduced in the two legislative sessions held in 2008 and 2009. If there was a need to ''correct'' the statute, the correction surely would have been introduced prior to the recently convened 2010 legislative session. There is absolutely no reason for Virginia taxpayers to know that the statute would be amended retroactively. This legislation fails the first prong of the two-part due process test.

With the legislation failing the first prong of the due process test, it is not necessary to examine whether it satisfies the second due process test as the legislation is already unconstitutional. In any event, the legislation also fails the second prong of the due process test. The question to be asked under the second prong of the test is whether the period of retroactive application of the legislation is reasonable. The legislation applies retroactively to six taxable years. The Virginia Department of Taxation has stated that the retroactivity will only affect three open taxable years.[50] This is not true. Of the four rulings of the Tax Commissioner issued in 2009, three of the rulings address the taxpayer's 2004 through 2006 taxable years.[51] Taxpayers are allowed to challenge a tax assessment in the circuit court in Virginia on the later of three years from the date of assessment or up to one year from the date that the Tax Commissioner issues a ruling on the administrative appeal of the assessment.[52] As of the date of this article, these three taxpayers have six open years that would be affected by this unconstitutional legislation should the taxpayers choose to challenge the Tax Commissioner's ruling in circuit court.

Regardless of whether the legislation would affect three or six taxable years, the retroactive period is unreasonable. In *United States v. Carlton*, the retroactive period was slightly more than one year, which the court characterized as modest.[53] The retroactive period in *Colonial Pipeline* was reasonable as the retroactive operation of the statute was within the current year and within three months of the date on which the statute became effective.[54]

In *Giesecke*, the retroactive period was three years, which the circuit court admitted was longer than generally acceptable.[55] However, the legislation in controversy in *Giesecke* was a reaction to a Virginia Supreme Court decision that invalidated a long-standing 30-year-old policy of the Virginia Department of Taxation.[56]

The retroactive period of the current legislative proposal will be six years for some taxpayers. If the legislative proposal is enacted, it will be approximately six years from the date the add-back statute was originally enacted. Not only was there no prompt action to amend the add-back statute after enactment, there has been no legislative action of any kind. Simply put, there is nothing reasonable about the retroactive period covered by this legislation. The legislative proposal fails the second prong of the due process test.

The U.S. Supreme Court in *United States v. Carlton* stated the due process standard differently. Under the *United States v. Carlton* standard, the question is whether the amended add-back language is justified by a rational legislative purpose. Application of former Gov. Kaine's proposal shows there is no purpose to this amendment other than making a change to the existing statute to ensure that it conforms to the Virginia Tax Commissioner's intent and generates much-needed revenue to help decrease a $4.2 billion budget shortfall. Is that a rational legislative purpose? If the amendment is only applied on a prospective basis, it is rational. Applied retroactively to six taxable years, the purpose loses its rationality. In fact, the retroactivity makes it arbitrary.

The retroactive application of the amendment to the add-back statute fails every due process test.

No judicial authority in Virginia has levied an opinion on the proper application of the ''subject to tax'' safe harbor. For all former Gov. Kaine and the Virginia Department of Taxation know, Virginia judicial authorities may agree with the current application of statute as currently written. To presuppose that the Virginia Tax Commissioner's application of the safe harbor may be overturned and thus retroactively amend the statute is arbitrary at best. There is no question that this legislation would fail to satisfy the due process standard as set forth by the U.S. Supreme Court in *United States v. Carlton*.

CONCLUSION

The retroactive application of the amendment to the add-back statute fails every due process test. It is unquestionably unconstitutional. The obvious impetus for making these changes retroactive is to protect against any potential revenue loss should a Virginia court decide that the Virginia Tax Commissioner's interpretation of the ''subject to tax'' exception is incorrect. If the Tax Commissioner's interpretation is ever overturned in court and retroactive legislation is introduced at that time, the same due process standards should be applied at that time. However, no such judicial decision exists, and without an intervening judicial opinion concerning the application of the ''subject to tax'' exception, the possibility of that decision should not be considered.

If a future negative (from the state's perspective) judicial decision could be considered, the Virginia General Assembly might be allowed to retroactively amend any tax statute it sees fit. Obviously, if the Virginia General Assembly began retroactively amending tax statutes at will, such actions would be unconstitutional. As such, the retroactive amendment to the add-back statute proposed by former Gov. Kaine is unconstitutional, and this provision of his budget should be removed immediately so the substantive tax policy implications of the legislative proposal may be properly considered.

[50] Based on a conversation with a senior official at the Virginia Department of Taxation.

[51] The fourth ruling addresses the taxpayer's 2005 through 2007 taxable years.

[52] Va. Code Ann. §58.1-1825(A) (Repl. Vol. 2009).

[53] *United States v. Carlton* 512 U.S. at 32.

[54] *Colonial Pipeline Co. v. Virginia*, 206 Va. at 522.

[55] *Giesecke v. Virginia Dept. of Taxn.*, 34 Va. Cir. at 460.

[56] *Id*.

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