No. 16-698

IN THE

Supreme Court of the United States

INTERNATIONAL BUSINESS MACHINES CORPORATION,

Petitioner,

v.

MICHIGAN DEPARTMENT OF TREASURY,

Respondent.

On Petition for a Writ of Certiorari to the Michigan Court of Appeals

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REPLY IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI

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INTRODUCTION

Petitioner International Business Machine Corporation's Petition challenging Michigan's retroactive repeal of the Multistate Tax Compact (the Compact) presents two important issues: Can a state retroactively withdraw from a binding compact without violating the constitutional bar against the impairment of contracts? And can it change its tax laws retroactively for a period of 6½ years without violating due process?

Respondent Michigan Department of Treasury's (the Department) Brief in Opposition presents no persuasive argument that either of these questions can be answered in favor of Michigan's retroactive withdrawal from the Compact. To the contrary, the Opposition underscores the need for this Court's review.

Recognizing the difficulty in justifying this retroactive law on its merits, the Department argues for the first time that the law is not retroactive at all. The Department's theory is that by declaring that a new law merely clarifies the intended meaning of an old law, the new law is rendered not retroactive, notwithstanding that it applies to activities – or here, tax years – in the past. This so-called doctrine of legislative clarification does not exist. The statute at issue was plainly retroactive – both in effect and explicitly so. The pertinent questions, addressed below and now presented to this Court, are whether that retroactivity is permissible under the Contract Clause, and whether it is permissible under the Due Process Clause.

On Question 1, this Court's review is necessary to reaffirm that a State is bound by its contracts, and

especially by promises made to other States for the benefit of citizens, as reflected in interstate compacts.

On Question 2, the case law shows that state courts (and undoubtedly state legislatures) have had great difficulty understanding the circumstances that permit retroactive taxation under this Court's decision in *United States v. Carlton*, 512 U.S. 26 (1994). As a result state courts inconsistently apply federal constitutional standards in judging the actions of their legislatures. Nearly a quarter century after *Carlton*, it is appropriate for this Court to provide further guidance so that state legislatures may operate under a common understanding of the restraints that federal law imposes on their ability to tax retroactively.

For the reasons set forth below, this Court should grant IBM's Petition on both questions.[1]

ARGUMENT

I. The Department's Primary Theory for Sustaining the Retroactive Repeal Is Fundamentally Misguided.

As its lead argument, the Department asserts that, as a matter of state law, there was no retroactivity here at all, thereby creating an independent and adequate ground for decision

[1] The Department suggests a procedural objection to IBM's 2010 tax year claim. Even if that objection was properly preserved through appeals, it would not limit this Court's ability to grant the Petition – nor does the Department suggest that it would. The Michigan Court of Appeals ruled on the merits, and its ruling is subject to this Court's review.

barring this Court's review. Opp'n 16-17. The Department acknowledges, as it must, that the Michigan Supreme Court held in *IBM v. Dep't of Treasury*, 852 N.W.2d 865 (Mich. 2014), that the 2008 Business Tax did not repeal the Compact's apportionment election provision.[2] The Department asserts, however, that the 2014 law (the Retroactive Repeal), by which Michigan withdrew from the Compact, simply restored the original intent behind the 2008 law, which the Supreme Court had misinterpreted. The result – according to the Department – is that the Compact's apportionment election provision was, by 2014 legislative fiat, actually repealed in 2008, and thus the Retroactive Repeal was not retroactive at all. The Department's remarkable theory reflects a fundamental misunderstanding of retroactivity, whether considered through the lens of due process or under the Contracts Clause.

At bottom, the Department confuses the legislative prerogative to correct some prior interpretation of the law, which it deems incorrect – which correction is binding on the courts, if it is constitutional – with the notion that such a correction is not retroactive at all. *See* Opp'n 17-18. Nothing in the state law cases relied upon by the Department supports the Department's proposition.

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[2] The Department is wrong that no previous Michigan court had held that the Compact election was available after enactment of the 2008 Business Tax. *See Anheuser-Busch Inc. v. Dep't of Treasury*, 11-000085-MT (Mich. Ct. Claims June 6, 2013).

To be sure, *courts* state what the law is in the cases before them, including what the law was at the time of the events at issue. Such court pronouncements are generally not characterized as retroactive because interpretation and application of law to prior events is the very essence of judicial responsibility. No similar prerogative to interpret and apply existing law to prior events is granted to legislatures. Therefore, when a legislature announces a rule *now*, applicable to what happened *then*, it is acting retroactively. That is the definition of retroactivity: declaring now a principle or a rule to apply earlier. And that is exactly what Michigan's legislature did in 2014 when it purported to apply a new rule or interpretation to the 2008 through 2010 tax years.

Moreover, the Michigan Court of Appeals understood that the 2014 legislature acted retroactively by "explicitly repeal[ing] the Compact provisions effective January 1, 2008." IBM App. 53a. It went on to consider whether that retroactive repeal was permissible. *Id*. (noting the legislature's power "includes the power to *retroactively* correct the judiciary's misinterpretation of legislation." (emphasis added)). And the legislature itself (after failing to act in the years 2010 through 2013) acknowledged that it was acting retroactively in 2014: The Retroactive Repeal's text expressly declares that the 1969 Compact enactment "is repealed retroactively and effective beginning January 1, 2008."

There is no question that the 2014 enactment is retroactive. Whether that enactment violates the Constitution is a substantial issue of federal law appropriate for this Court's review.

II. Michigan's Retroactive Withdrawal from the Compact Violates the Contract Clause

The Department's Opposition touts decisions in which various state courts authorized the selective, prospective state withdrawal from the Compact's apportionment election provision and from which this Court has denied petitions for writs of certiorari. The Department suggests that those cases support the proposition that the Compact is not binding. But those cases have little to do with the issues presented here, which involve Michigan's attempted retroactive withdrawal from the Compact.[3]

There is nothing especially novel about contracting parties granting each other a unilateral right to terminate, or withdraw, prospectively. Thus, it was not entirely surprising that several courts rejected taxpayer suits seeking to bar States' prospective withdrawal, or that this Court denied certiorari. To hold that parties may withdraw from a Compact prospectively does not, however, imply that the Compact was never binding. It is far more unusual for contracting parties to grant each other the unilateral right to cancel obligations that have already matured. And it is especially difficult to believe that they would do so when their contract

[3] The Department finds it significant that various States and the Multistate Tax Commission supported prospective withdrawal from the Compact's apportionment election provision. Opp'n 8-9. However, neither the Commission nor any State has come forward to defend Michigan's claimed right to withdraw from the Compact *retroactively* on either Contract Clause or due process grounds.

contemplated the creation of obligations to third parties, such as the taxpayers here.

Thus, the issues presented here are very different from those presented in the cases cited by the Department: To hold that States may *retroactively* withdraw from the Compact would indeed require holding that the Compact was purely precatory and had never been binding at all. That proposition is simply irreconcilable with the Compact's language, purpose, and structure. *See* IBM Pet. at 17-24. The Department ignores this point, acknowledging no difference between allowing selective withdrawal from the Compact prospectively, on the one hand, and, on the other hand, permitting unilateral retroactive withdrawal that prejudices the taxpayers who were the Compact's intended beneficiaries.

The Department's course of performance argument, Opp'n 8-9, 35, suffers from the same flaw. To be sure, States have withdrawn from the Compact's apportionment provisions prospectively without objection from other States. *See* Opp'n 9, 35. But Michigan's attempt to withdraw from the Compact retroactively is unprecedented. Indeed, the Department identifies no precedent allowing for such a retroactive withdrawal from a compact in similar circumstances. And this Court's cases preclude it. IBM Pet. 23.

The same blind spot – failure to distinguish between prospective and retroactive withdrawal – is evident in the Department's discussion of the specific withdrawal provisions of this Compact. The Department asserts, as did the court below, that the Compact's explicit withdrawal procedure somehow

demonstrates that the Compact is not binding. But it actually demonstrates the opposite: That a contracting party must withdraw in order to avoid its obligations demonstrates that the contract had teeth – was binding – prior to withdrawal. Indeed, the specific withdrawal provisions of this Compact leave no doubt that withdrawal cannot operate retroactively. Article X § 2 states that "[n]o withdrawal shall affect any liability already incurred by or chargeable to a party State prior to the time of such withdrawal." Mich. Comp. Laws § 205.581(1), IBM App. 267a. In other words, States must continue to honor pre-existing liabilities even after withdrawal. That obligation is fundamentally inconsistent with the notion that the Compact is not a binding contract.

Furthermore, Article X § 3 of the Compact provides that taxpayer arbitration proceedings commenced before withdrawal – including arbitrations on apportionment issues – would continue despite the subsequent withdrawal of a party State. Mich. Comp. Laws § 205.581(1), IBM App. 267a. Although the arbitration provisions were implemented only briefly, *see United States Steel Corp. v. Multistate Tax Comm'n*, 434 U.S. 452, 492-493 (1978), their existence reaffirms two of the Compact's basic premises: The Compact was designed to create enforceable obligations to taxpayers and those obligations survive withdrawal.

The Department offers no response to any of these points. But whether the Department acknowledges it or not, there remains a fundamental difference between exiting an agreement prospectively and doing so retroactively in an effort

to extinguish preexisting obligations. The latter is at issue here.

Indeed, the basic difference between retroactive and prospective withdrawal did not escape the legislature. In 2010, Michigan rejected a proposal to withdraw retroactively from the Compact's apportionment election provision. *See* Pet. 8. Instead, the next year, following the model of withdrawal used by other States, it withdrew prospectively from January 2011 forward. *Id.* It was not until 2014 that it attempted to retroactively erase its participation in the Compact, by enacting the explicitly retroactive law at issue here. *See* IBM Pet. at 9.

Other arguments offered by the Department are similarly ill-founded. There is no dispute that Michigan entered into an agreement. By its own terms, the Compact is "enter[ed] into force" by agreement of at least seven States, effected through the States' enactment of the Compact. Mich. Comp. Laws § 205.581(1), Art. X, § 1, IBM App. 267a. Provisions regarding entry into force and effectiveness make no sense unless the Compact is binding. Indeed, Michigan said it was entering into a contract by enacting the Compact:

> The multistate tax compact is enacted into law *and entered into with all jurisdictions legally joining therein*, in the form substantially as follows[.]

Mich. Comp. Laws § 205.581(1), IBM App. 244a.

In sum, Michigan entered into a contract that was intended to be binding, especially with respect to obligations accrued prior to withdrawal. And the responsibility to construe the Compact, and

determine whether Michigan's actions violate the Contract Clause – a federal constitutional provision intended specifically to hold States to their contractual commitments – belongs to this Court. That Clause would be rendered ineffectual if courts were simply to defer to a State's declaration that it never meant to be bound.

The Department also states that under Michigan law only intended third party beneficiaries can enforce a contractual promise. It then baldly asserts, that the "Compact was established to protect the States' sovereignty—not to benefit taxpayers." Opp'n 36. But that is plainly untrue. We assume that this Court would hold that only intended beneficiaries of the Compact's provisions may enforce it. But that fits this case to a tee. The Compact's stated purposes, as enacted into law by Michigan, reflect the intention to benefit taxpayers by, among other things, "avoid[ing] duplicative taxation." IBM App. 244a. It offered taxpayers an option for calculating their taxes beyond those otherwise available under state law. In short, the apportionment election provision was explicitly intended to benefit multistate taxpayers,[4] allowing them to employ that provision, *at the expense of the State*, in calculating tax owed to Michigan.

The Department's arguments would effectively allow Michigan to negate at will a benefit that it

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[4] Contrary to Michigan's assertion, the benefits of the Compact are not conferred only on out-of-state corporations. Any corporation that does business both within and outside Michigan may elect to use the Compact's apportionment formula, regardless where its headquarters are located.

conferred on multistate taxpayers. But this Court has not hesitated to hold States to their contracts in the face of a claimed right to "retroactive repeal." *See U.S. Tr. Co. of N.Y. v. New Jersey*, 431 U.S. 1, 25 (1977) (retroactive repeal of a covenant of the compact that created the Port Authority of New York and New Jersey violated the Contract Clause). Indeed, this Court held that a State's evasion of a financial obligation is subject to increased Contract Clause scrutiny. *Id.* at 24-25.

The Compact itself is an agreement of great importance because it helps assure fairness and avoid duplicative taxation of multistate taxpayers. This Compact – and the utility of this type of compact, under which States agree to constrain their legislative options, for the benefit of their citizens, on the understanding that other States are doing the same – would be nullified if States could simply rescind their assent retroactively, even as other States adhered to their commitments.

III. This Court's Guidance is Needed on the Permissible Scope of Retroactive Taxation

As described in IBM's Petition, the briefs of the various amici, and the vided petitions, this Court's guidance is needed on how states should determine what retroactive taxes are permissible.[5] Much of the confusion and inconsistency in the decisions of the state courts stems from ambiguity in this Court's decision in *Carlton*, and in some measure from

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[5] The large number of petitions filed with this Court on issues involving retroactivity – both past petitions and these vided petitions – highlights the importance of the issue.

Justice O'Connor's concurrence in that case, which attempted to put the Court's reference to prompt legislative action and a modest period of retroactivity into historical context.

Carlton presented a rather easy case on its facts. The amendment at issue was plainly corrective, withdrawing an inadvertently-created tax windfall. *See* IBM Pet. 26-27. More important, Congress had acted quickly to correct the unintended consequence of a recently enacted statute, and the retroactive period was very brief. Thus, the retroactivity in *Carlton* was fairly described by the majority as involving a permissibly "modest period" and by Justice O'Connor as falling within the brief corrective period historically recognized as appropriate for curative tax legislation.

It is on the importance, significance, and application of the "modest period" requirement, and the requirement that the legislature act promptly, that the inconsistency in the state courts is most apparent. IBM Pet. 33-36. That is because it is frequently easy to find some plausible justification for a retroactive tax. But courts have divided on whether the "modest period" proviso poses a separate obstacle to a retroactive tax or whether it is simply one among many considerations, and under both views, what period can be considered modest. See IBM Pet. 33-36.

It is not surprising that such confusion has arisen in the near quarter century since *Carlton*. With state courts independently considering this federal constitutional issue, applying *Carlton* to the actions of their own legislatures, it is almost

inevitable that different approaches would arise. The result is that some state courts – believing they are following this Court's directives – have given their legislatures broad license to impose retroactive taxes. At the same time, other state courts – also believing they are following this Court's directives – have tied the hands of their legislatures, constraining their ability to enact retroactive tax statutes. It is appropriate for this Court to provide guidance on the issue so that all state legislatures can play by the same federal constitutional rules in addressing their states' fiscal needs.

This is a proper case in which to provide guidance. The record is clear cut. There is no question about what prior law had been and that it was materially changed: In *IBM*, 852 N.W.2d 865, Michigan's highest court held that taxpayers had the right to use the Compact's apportionment election provision for the tax years in question. The legislature retroactively stripped taxpayers of that right.[6]

Moreover, notwithstanding the Department's contention that Michigan acted promptly (because it moved swiftly after the *IBM* decision), the record demonstrates otherwise. The legislative amendment in *Carlton* was prompt because it was proposed – by

[6] Most of the vided petitions involve refund requests by taxpayers that elected the Compact apportionment formula on amended returns. That is certainly not the case with respect to IBM, which made the election on original returns in reliance on its availability, and for tax year 2008 pursued the issue all the way to the Michigan Supreme Court, obtaining a ruling in its favor in *IBM*, 852 N.W.2d 865.

the IRS and Congress – within months of enactment of the original statute. Here, the legislature in 2010 rejected any retroactive changes to the Compact apportionment election provision, and in 2011 it made expressly prospective changes only. *See* IBM Pet. at 8. Nearly four years passed before the legislature changed its mind and imposed the Retroactive Repeal. *Id.*

Finally, there can hardly be any argument about the "modest period" requirement: A 6½ year period of retroactivity is not easily called "modest," and is well beyond the period historically accepted for corrective tax legislation. Thus, the due process issues, like the Contract Clause issues, are well presented by this Petition.

CONCLUSION

The petition should be granted.

Respectfully submitted,

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