Manifest Injustice: More Than a Moldy Old Doctrine

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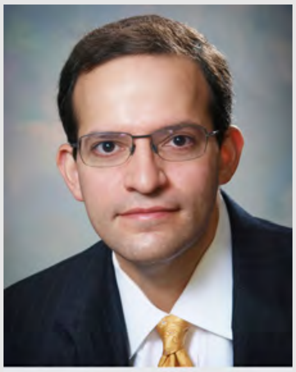

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In this edition of SALT Matters, the authors discuss the manifest injustice doctrine as a tool to use against retroactive tax legislation. They point to New Jersey as a state that has developed a doctrine that can potentially benefit taxpayers.

Introduction

At risk of falling into a Yogi Berra-esque aphorism, we tend to forget what we know until we remember it. That's one to keep up on your office wall along with a list of old legal doctrines that can make all the difference to your tax position if you pull them out at the right time and remember when and how to use them. Equitable estoppel, tolling, and recoupment; collateral estoppel; the prohibition against administrative legislation; the doctrine of consistency; the mailbox rule; the tax benefit rule; the doctrine of elections; the canons of construction; and more have all made it out of the toolbox and into a protest — sometimes with extraordinary results. But, in light of the U.S. Supreme Court's recent decision not to grant certiorari in a series of petitions stemming from Michigan's retroactive repeal of the Multistate Tax Compact,[1] one moldy old doctrine stands out: manifest injustice. In particular, we believe that all eyes should be on New Jersey, which has made manifest injustice in retroactive legislation something of an ongoing theme and has given us a roadmap for a successful argument.

The Problem With Challenging Retroactive Legislation

There is something fundamentally repugnant about the retroactive application of statutory changes. Particularly in state taxation, there is a high risk that a retroactive tax change will result in unanticipated tax obligations that could not have been accounted for in making business decisions, such as investing capital, making new hires, and determining salaries and benefits. We're not talking about a state eliminating the benefits of uncertain tax planning through the application of its equitable powers. We're talking about a state reaching back through time to take an extra slice of a taxpayer's prior-year margin, when all that

[1] *See Dot Foods Inc. v. Department of Revenue*, 215 P.3d 185 (Wash. 2009); and *IBM v. Department of Treasury*, 496 Mich. 42 (2014).

taxpayer did was reasonably rely on contemporaneously existing laws.

Though retroactive statutory changes are repugnant, there is little that taxpayers can do about it. In general, legislation is presumed to be valid and constitutional, and only a statute that is clearly contrary to the Constitution can be declared void.[2] A consistent line of U.S. Supreme Court decisions interpreting the due process clause of the 14th Amendment holds that retroactive legislation does not deprive parties of due process if the legislation "is supported by a legitimate legislative purpose furthered by rational means."[3] That standard — called the rational basis test — is the general analytical approach applied when legislation is challenged on due process grounds.[4] Under it, the retroactive application of a statutory change would be permissible so long as the state can show that the retroactive application of the change rationally related to a legitimate state purpose.[5] That is a remarkably low standard that is at odds with the strong sense that retroactive legislative changes violate fundamental fair play.

The Framework: *Gibbons v. Gibbons*

In its 1981 decision in *Gibbons v. Gibbons*, the New Jersey Supreme Court addressed a retroactive statutory change to a divorce settlement.[6] In October 1978 Mary and Felton Gibbons were divorced. At the time of the divorce, New Jersey law provided for the equal division of the couple's assets, including gift and inheritance assets. Mary Gibbons, relying on the existing law, did not seek alimony. On December 31, 1980, the equitable distribution statute was retroactively amended to exclude gift and inheritance assets, greatly reducing the amount that Mary Gibbons received under the divorce decree.

At the outset, the *Gibbons* court followed the standard approach for determining whether the statutory change in question should be applied retroactively, essentially looking to the stated intent of the Legislature and whether the change was rationally related to a legitimate state purpose.[7] The court then took a step off the beaten path and stated that even if a statutory change can be applied retroactively under the rational basis test, retroactivity must be barred if it violates principles of fundamental equity and fairness such that it results in manifest injustice to an adversely affected party.[8] And, fleshing out that analysis, the court looked to whether the affected party relied to her prejudice on the law existing before the change, and whether the consequences of that reliance were so deleterious and irrevocable that it would be unfair to apply the statute retroactively.[9]

Applying that test, the New Jersey Supreme Court concluded that retroactive application of the statutory change passed the rational basis test and did not result in a manifest injustice to Mary Gibbons. Her argument rested on the claim that the application of the amended statute was unfair and inequitable because she relied on the law that existed when she brought her divorce action. Specifically, she originally sought equitable distribution of the marital assets because of what she believed was the broad scope of assets subject to equitable distribution, and therefore declined to bring an alimony claim.

However, the court rejected that argument because her reliance on the existing statute in deciding not to bring an alimony claim was not irrevocable. In coming to that conclusion, the court noted that orders pertaining to alimony or other support could be revised and altered by the court at any time, and that Mary Gibbons was not precluded from filing a claim for alimony to correct equity issues created by the retroactive application of the amended distribution statute. Did Mary Gibbons rely on the original law to her detriment? Certainly. But her ability to ameliorate the impact of that reliance prevented the retroactive application of the change from resulting in an impermissible manifest injustice.

[2] *Town of Secaucus v. Hudson County Board of Taxation*, 133 N.J. 482, 493 (1993).

[3] *See, e.g.*, *Pension Benefit Guaranty Corp. v. R.A. Gray & Co.*, 467 U.S. 717 (1984); and *United States v. Carlton*, 512 U.S. 26 (1994).

[4] *Oberhand v. Director, Division of Taxation*, 22 N.J. Tax 55 (2005).

[5] *Id.*

[6] *Gibbons v. Gibbons*, 86 N.J. 515 (1981).

[7] *Id.* at 523.

[8] *Id.*

[9] *Id.* at 522-524.

Manifest Injustice Scorecard: The *Gibbons* decision was not a win for Mary Gibbons, but it was clearly a conceptual victory for applying equitable principles and the manifest injustice doctrine in retroactive legislation cases.

A Narrow Path to Victory: *Oberhand*

The New Jersey Supreme Court expanded on its *Gibbons* manifest injustice analysis in its 2008 decision in *Oberhand v. Director, Division of Taxation*.[10] In *Oberhand*, the court considered the January 1, 2002, amendment to the federal estate tax laws, which increased the amount of property that could pass free of federal estate tax from $675,000 to $1 million. To counter the loss of state revenue from this federal change, the New Jersey State Legislature amended the state estate tax law to decouple from the federal law so that the New Jersey exemption amount would continue to be tied to the federal law in effect on December 31, 2001. That decoupling statute was passed in July of 2002, retroactive to January 1, 2002.

As with *Gibbons*, the facts in *Oberhand* were rather straightforward. Cynthia Oberhand and Eugene Seidner executed wills designed to avoid or limit the amount of federal and state estate taxes using a family trust and a marital trust. Both Oberhand and Seidner died after January 1, 2002, when Congress raised the estate tax exemption, but before July 2002, when New Jersey decoupled from the federal provisions. In January 2003, both estates filed a New Jersey estate tax return, together with a copy of the federal estate tax return, showing no taxes due. The New Jersey director of taxation concluded that the retroactive application of the decoupling amendment applied to both estates. Accordingly, the director imposed a tax against Oberhand's estate on the almost $200,000 above the $675,000 exempt amount, and imposed a tax against Seidner's estate on the approximately $70,000 above the exempt amount. The estates challenged those assessments, arguing that the retroactive application of the decoupling amendment to them was inequitable and resulted in a manifest injustice.

[10] *Oberhand*, 193 N.J. at 558.

Starting with the two-part manifest injustice analysis established in *Gibbons*, the New Jersey Supreme Court found that the decedents intentionally relied on existing laws to execute their wills in a manner that would structure their estates without incurring federal or state estate taxes on their deaths.[11] Without the retroactive application of the decoupling provision, the decedents would have owed no estate taxes if their deaths occurred before January 1, 2002, and it was only because of the retroactive application of the decoupling amendment that the decedents were subject to state estate tax assessments. However, unlike Mary Gibbons, who could have sought alimony as a corrective measure, the decedents in *Oberhand* had no opportunity to engage in alternative estate planning because their deaths occurred before the State Legislature voted to decouple from the federal exempt amount.[12]

Although those findings would have been sufficient to determine that a manifest injustice had occurred under the framework established by *Gibbons*, the New Jersey Supreme Court did not stop there. Instead, the court followed the approach of the New Jersey Tax Court in its 2005 decisions in *Oberhand* and *Rappeport*, and layered into its analysis the question whether the public interest in the retroactive application of the statutory change outweighed the affected party's reliance on previous law, and the consequences of that reliance.[13] Essentially, the third prong of the analysis provided the court with an escape valve, under which it could find that, even if the affected party had relied on prior law to its irreversible detriment, no actionable manifest injustice would exist if the general harm to the public of not retroactively applying the statutory change would outweigh the harm to the affected party.

[11] *Id.*

[12] *Id.*

[13] *Id. See Oberhand*, 22 N.J. Tax 55 (2005); and *Rappeport v. Director, Division of Taxation*, 22 N.J. Tax 422 (2005). Interestingly, in *Rappeport* the New Jersey Tax Court found in favor of the state and upheld the retroactive application of the decoupling legislation to an estate because the affected party took the action that resulted in the tax — disclaimer of his wife's estate — after the legislation was passed. The court distinguished this situation from *Oberhand* by concluding that, while the estate was established during the retroactivity period, the affected party in *Rappeport* could have acted to avoid the problem by reading the statute and declining to disclaim.

Addressing the public interest issue, the *Oberhand* court first noted that the decoupling amendment was intended to prevent a loss of revenue to the state under the then-existing statute because of federal changes.[14] However, the legislature provided no contemporaneous estimate of the projected revenue loss when the statute was passed in July 2002, and no backward-looking estimate of revenue loss between January 1, 2002, and the enactment date. Further, when revenue loss estimates were eventually prepared, they addressed only periods beginning with fiscal 2013. Accordingly, the court found that there was no evidence to support revenue loss in the period of retroactivity necessitating the retroactive application of the decoupling in light of the harm suffered by the decedents.

Manifest Injustice Scorecard: While the addition of the public interest escape valve may have muddied the waters, the *Oberhand* decision was a solid win for taxpayers seeking to challenge the application of retroactive legislation using the manifest injustice doctrine. Also, the use of the manifest injustice doctrine by the New Jersey Tax Court in *Oberhand* and *Rappeport* shows that the analytical framework established by *Gibbons* took root.

Better Odds Than Winning the Lottery: *Leger*

In September 2016 the New Jersey Tax Court issued its opinion in *Leger v. Director, Division of Taxation* addressing the application of retroactive legislation taxing lottery winnings.[15]

As with prior New Jersey manifest injustice jurisprudence, the facts in *Leger* were relatively straightforward. The taxpayer purchased a New Jersey lottery ticket for a December 29, 2008, drawing, and in early 2009 discovered that he had won the $3.5 million prize. The taxpayer initiated the process of claiming his winnings, and following his accountant's advice based on the law at that time, took the lump sum payout option, paid off debts, made gifts of cash to his siblings, contributed money to his church, bought out a business partner, paid for a business renovation, purchased investment property, and invested the remaining $300,000 in an investment account for his retirement.

When the taxpayer claimed and used his lottery winnings, New Jersey law did not include lottery winnings in gross income for personal income tax purposes. However, roughly two months later, New Jersey enacted a bill providing that New Jersey lottery winnings from prizes in an amount exceeding $10,000 were taxable gross income. The bill took effect immediately and applied retroactively to tax years beginning on or after January 1, 2009.

Thus, the taxpayer filed a New Jersey income tax return for the 2009 tax year that included his income from the lottery winnings. The taxpayer withdrew approximately $250,000 from his investment account to make the New Jersey income tax payment, and later filed an amended return requesting a refund. The New Jersey Division of Taxation disallowed the taxpayer's amended income tax return and denied the refund claim, and the taxpayer filed suit claiming that the retroactive application of the statutory change to tax his lottery winnings was barred because it constituted a manifest injustice.

The New Jersey Tax Court looked to *Oberhand* and weighed the competing factors of the public interest in the retroactive application of the amended statute against the taxpayer's reliance on the previous law, and the consequences of that reliance.[16]

First, the court found that the state actively induced the purchase of lottery tickets by representing that the tickets were not subject to state personal income tax. Further, the taxpayer sought professional advice from his accountant shortly after he learned that he had won the lottery. Lastly, both the taxpayer and his accountant knew that when the taxpayer claimed the prize, New Jersey law excluded lottery winnings from gross income tax. Based on those findings, the court determined that it was evident that the taxpayer had relied on previous law in making his decisions.

Next, the court looked to consequences to the taxpayer and whether those consequences were detrimental and irrevocable. Again, based on the

[14] *Id.*

[15] *Leger v. Director, Division of Taxation*, 29 N.J. Tax 354 (2016).

[16] *Id.*

facts, the tax court had little trouble concluding that the taxpayer had suffered incurable harm. Had he been aware that the state would seek to retroactively tax his lottery winnings, the taxpayer likely would have made different decisions regarding whether to take the lump sum payment and how to use the proceeds. Further, because of the retroactive legislation, the taxpayer had to withdraw roughly $250,000 from his investment account to make the unanticipated New Jersey gross income tax payment, effectively decimating his retirement investment account. Most importantly, the taxpayer had no opportunity to cure the adverse consequences that resulted from the retroactive change.

Finally, in weighing the public interest against the harm to the taxpayer, the court noted that, while the government's need to react to the developing fiscal crisis was of paramount public concern, it did not appear that the Legislature intended to tax lottery winnings before the June 29, 2009, enactment of the statute.[17] The court found that revenue from the retroactive application of the tax on lottery winnings would have been less than the projected annual revenue increase of $8 million going forward because the retroactive period was less than a year, and was insignificant compared with the $1 billion revenue package enacted the same day. Accordingly, the court found that the public interest in retroactive application of the statutory change did not outweigh the harm to the taxpayer, and ruled in the taxpayer's favor.

Manifest Injustice Scorecard: The *Leger* decision was a great win for taxpayers and for the continued use of the manifest injustice doctrine to challenge retroactive tax legislation. If ever there was a time to find that the public interest outweighed the harm to a small number of taxpayers, it would have been in relation to revenue raisers during the fiscal crisis of 2009. However, the New Jersey Tax Court admirably resisted placing state finances over equity and fairness in the application of the law.

Conclusion

While *Gibbons*, *Oberhand*, and *Leger* represent the response of only one state's courts to retroactive legislation, the approach of the New Jersey courts in applying the manifest injustice doctrine has given taxpayers a solid avenue to challenge retroactive statutory changes. And, with the U.S. Supreme Court's continued refusal to take up a state tax retroactivity case, thus emboldening state legislatures to go even further back in time to make ever more egregious retroactive changes, the manifest injustice doctrine may be a way to stem the tide. Tax professionals dealing with retroactivity issues at the state level should consider whether the courts of the jurisdiction have adopted the doctrine, the manner and timing for a manifest injustice argument (for example, as part of an administrative protest, on appeal to a court of law, etc.), and what points must be made for a successful argument. Don't leave the manifest injustice sitting in the toolbox. It's not just a moldy old doctrine. ■

[17] *Id.*