5-1-1990

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Davis v. Michigan and the Doctrine of Retroactivity: States' Refund Liability for Taxation of Federal Pension Income

I. INTRODUCTION

In Davis v. Michigan Department of Treasury,¹ the Supreme Court invalidated a Michigan tax statute which treated state and federal employees’ pensions differently. The Court held that the tax discriminated against federal employees by only providing them with a limited exemption, rather than the full exemption which state employees enjoyed.² The decision in Davis will affect as many as twenty-four states,³ all of which give more favorable treatment to state employees’ pensions.

One of the most significant issues faced by these states is whether federal employees are entitled to a refund of taxes paid under tax schemes similar to the pension tax invalidated in Davis. If the effect of Davis is limited to the litigants in the case and to those whose actions accrued after the decision, then the decision applies prospectively, and refunds to federal employees would be limited to pension taxes paid after the decision in Davis was announced. If, however, the decision is also applied to past conduct, then the decision operates retroactively, and all pension taxes paid by federal employees would have to be refunded, even those paid before Davis was decided. If required to refund past taxes to federal employees, states affected by Davis would have to pay between $7.4 million and $370 million.⁴ The resolution of this issue depends both on state refund statutes and on whether Davis will be given a retroactive effect.

Part II of this note briefly examines the refund issue in the context of the lower courts’ and the Supreme Court’s decisions. Part III discusses the authority of state courts to limit the retroactive effect of a

2. The statute in question exempted all of a state employee’s pension benefits from taxation, but only the first $7,500 of a federal employee’s pension benefits on a single return, or $10,000 on a joint return. MICH. COMP. LAWS. ANN. § 206.30(1)(f) (West Supp. 1988).
decision and the applicability of state refund statutes. Finally, part IV looks at the probable treatment of the retroactivity issue raised by Davis.

II. THE REFUND ISSUE IN THE CONTEXT OF THE LOWER COURTS' AND THE SUPREME COURT'S DECISIONS

Davis, a former employee of the United States Government, petitioned for a refund of state taxes paid on his civil service pension benefits for the previous five years. After being denied relief, he filed suit in the Michigan claims court, alleging that “the State’s inconsistent treatment of state and federal retirement benefits discriminated against federal retirees in violation of 4 U.S.C. § 111.” The claims court denied relief, and the Michigan Court of Appeals affirmed. The United States Supreme Court reversed the state courts, holding that pension benefits fell squarely within the meaning of section 111 as “compensation for services rendered ‘as an officer or employee of the United States,’” and that the tax unconstitutionally discriminated against federal employees.

In determining the appropriate remedy, the Court recognized that the appellant was entitled to prospective relief from discriminatory taxation, but it declined to order how this should be accomplished. Equal treatment could be achieved “‘by withdrawal of benefits from the favored class [or] extension of benefits to the excluded class,’” a decision which Michigan state courts were in a better position to decide. The Court also declined to decide whether tax refunds for past discrimination were required, since the state conceded to giving a refund.

Although the appropriateness of tax refunds did not arise in either the state courts or the Supreme Court, refund cases resulting from Davis have required state courts to resolve this issue. Thus, states will need to determine what role they will play in deciding whether a refund should be given.

5. 109 S. Ct. at 1503.
6. Id. The Public Salary Tax Act of 1939, of which 4 U.S.C. § 111 is part, prohibits discriminatory taxation of federal employees by states. Id. at 1503-04.
9. Id. at 1508.
10. Id. at 1509 (citing Heckler v. Matthews, 465 U.S. 728, 740 (1984)).
11. Id.
12. Id. at 1508-09.
13. The issue of tax refunds did not arise in either the Michigan Court of Claims or the Court of Appeals of Michigan, since both courts held the tax on federal pensions valid.
III. THE ROLE OF STATES IN DETERMINING RETROACTIVE TREATMENT OF DECISIONS INVALIDATING TAXES

The primary issues pertinent to a refund determination are the extent of state authority to limit the retroactivity of an overruling decision, and what role a state refund statute (when one exists) should have in the determination of whether to refund taxes paid pursuant to a tax scheme invalidated by the Supreme Court.

Three cases have addressed the refund question raised by *Davis*. Federal district courts decided *Todd v. Johnson*¹⁴ and *Melof v. Hunt,*¹⁵ while the Missouri Supreme Court dealt with the refund issue in *Hackman v. Director of Revenue.*¹⁶ In *Hackman,* the court decided to follow a state refund statute in holding that a federal retiree was entitled to a refund.¹⁷ The two federal cases were both dismissed on the basis of the Tax Injunction Act,¹⁸ which requires federal courts to defer to states any injunction, levy, or assessment of taxes under state law when a “plain, speedy and efficient remedy may be had in the courts of such State.”¹⁹ Thus, all refund battles must be fought in state courts.

A. STATE AUTHORITY TO DEFINE LIMITS OF ADHERENCE TO PRECEDENT

The authority of states to define “limits of adherence to precedent” was recognized by the Supreme Court long ago in *Great Northern Railway v. Sunburst Oil & Refining Co.*²⁰ There, the Court recognized that states have an unlimited right to give a prospective effect to a decision.²¹ More recently, the Court determined that it should not be the body to decide the retrospective effect of its decisions in the “complex area of state tax structures” due to the possible relevance of state law on the subject.²²

However, part of the Court’s reluctance to decide whether a refund is required in cases involving invalid state taxes stems from the

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¹⁶ 771 S.W.2d 77 (Mo. 1989) (en banc).
¹⁷ *Id.* at 81. See infra notes 62-69 and accompanying text.
¹⁹ *Id.*
²⁰ 287 U.S. 358, 364 (1932); see also Loeb v. Columbia Township Trustees, 179 U.S. 472, 492 (1900); Douglass v. County of Pike, 101 U.S. 677, 687 (1879); Gelpcke v. City of Dubuque, 68 U.S. (1 Wall.) 175, 206 (1863).
²¹ *Sunburst,* 287 U.S. at 364 (“A state in defining the limits of adherence to precedent may make a choice for itself between the principle of forward operation and that of relation backward.”).
lack of opportunity the state courts in those cases had to address the issue of refunds. Whatever bounds there are on the power to limit retroactivity should be revealed in the 1990 term when the Court addresses two cases in which the state courts have fully addressed the refund issue: American Trucking Association v. Gray and Division of Alcoholic Beverages v. McKesson Corp.

B. The Role of State Refund Statutes

Although state courts have the authority to determine whether to apply a decision retroactively, many states have statutes directing the refund of taxes when the underlying tax scheme is unconstitutional. Courts that have a state refund statute have been more than willing to follow the statute rather than deal with the issue of retroactivity. For example, in Hackman, the state urged the court to address the issue of limiting retroactivity, contending that Davis should be given only prospective effect. The court, though, stated that as long as the procedural requirements of the state refund statute were met, the party was entitled to a refund, and hence, the retroactivity issue did not need to be reached.

However, the Washington Supreme Court in National Can Corp. v. Department of Revenue held just the opposite. There, the court had previously upheld Washington's multiple activities exemption to a business and occupation tax. The United States Supreme Court held this tax invalid in Tyler Pipe Industries v. Washington Department of Revenue. On remand, the taxpayers sued for a refund. The court first

23. For example, both Tyler and Bacchus involved cases where the state courts had not addressed the refund issue. In Tyler, the case had been dismissed on the pleadings in the state courts. 483 U.S. at 252-53. Likewise, the Hawaii Supreme Court in Bacchus upheld a liquor tax and thus did not need to address a refund issue. 468 U.S. at 265, 267.
26. See, e.g., First Nat'l Bank v. Commonwealth, 520 Pa. 244, 253-55, 553 A.2d 937, 942-43 (1989) (holding that taxpayer had immediate, legal right to refund pursuant to refund statute, as long as requirements of statute were met); Hackman v. Director of Revenue, 771 S.W.2d 77, 80 (Mo. 1989) (en banc) ("If this state's tax refund statutes . . . apply, then all other issues are irrelevant.") (citing National Can Corp. v. Department of Revenue, 109 Wash. 2d 878, 880, 749 P.2d, 1286, 1287 (1988)).
27. 771 S.W.2d at 80.
28. Id. at 81.
noted that Washington had a tax refund statute, but then reasoned that it could reach the statute only after it determined whether Tyler was to have a prospective or retroactive effect: "[I]f the court finds the Tyler holding is to be applied only prospectively, then for the purposes of applying the refund statutes it is as if the taxes collected pre-Tyler were constitutionally collected."\(^{31}\) The court reasoned that since Washington case law does not support the mandating of tax refunds when a tax is found to be unconstitutional, it could apply a prospectivity test to determine whether there should be a refund.\(^{32}\)

The *National Can* decision appears to have a logical, directly contrary conclusion to *Hackman*. However, the Washington court ignores the very purpose of the state’s tax refund statute. In effect, the court renders the statute meaningless, since it can determine by "Washington case law"\(^{33}\) whether a refund should be given at all. But once the legislature has spoken, courts have a duty to apply the statute. They may interpret the statute and evaluate its constitutionality, but they cannot ignore the legislature without having invalidated the statute. The Pennsylvania Supreme Court’s statement in *First National Bank v. Commonwealth*\(^{34}\) regarding the application of their refund statute is dispositive of this issue:

The authority within the judiciary to determine the reach of its decisions does not however preclude the legislature from independently providing persons with legal rights as a result of judicial pronouncements. Where a litigant’s right to some legal remedy may be derived from statute, it would be a meaningless exercise for a court to determine whether an identical right is vested in the litigant as a result of prior decisional law.\(^{35}\)

Therefore, although state courts do have authority to limit the retroactive effect of an overruling decision, *Hackman* represents the better position that when a state statute directs the action to be taken upon a tax being declared unconstitutional, the statute should be followed, and the retroactivity and prospectivity issues need not be reached.

IV. **Probable Treatment of the Retroactivity Issue Raised by *Davis***

When a state refund statute is not available, the prospective or retroactive effect of *Davis* will need to be determined by courts to de-
cide the refund issue. The general rule is that "judicial decisions ordi­narily operate retroactively." However, the United States Supreme Court has "recognized the doctrine of nonretroactivity outside the criminal area many times, in both constitutional and nonconstitutional cases." For example, in *Chevron Oil Co. v. Huson*, the Court developed a test for determining the prospectivity of its decisions.

Although the ultimate resolution of the refund issue will likely depend on the test derived in *Chevron*, the Court hinted in *Davis* that the refund issue could be decided solely on the basis of precedent when it cited *Iowa-Des Moines National Bank v. Bennett* in support of issuing a refund. This section will first discuss the *Chevron* test, and will then consider the impact of *Bennett* on the refund issue.

A. The *Chevron* Test

The prospectivity test put forth in *Chevron* is really a synthesis of principles in previous cases which have recognized exceptions to the general retroactivity rule. The test consists of three factors: (1) the decision "must establish a new principle of law, either by overruling clear past precedent on which litigants may have relied, or by deciding an issue of first impression whose resolution was not clearly foreshadowed," (2) the Court must "weigh the merits and demerits in each case by looking to the prior history of the rule . . . , its purpose and effect, and whether retrospective operation will further or retard its operation;" and (3) "the inequity imposed by retroactive application must be weighed" (that is, when a decision would produce "substan-

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38. 404 U.S. 97 (1971). *Chevron* involved a suit for personal injuries sustained in an offshore drilling rig near Louisiana. While pretrial discovery was proceeding, the Supreme Court in an unrelated case, *Rodrigue v. Aetna Casualty & Surety Co.*, 395 U.S. 352 (1969), ruled that the admiralty doctrine of laches (which had up until that time governed actions such as plaintiff's) no longer applied to injuries occurring offshore on the Continental Shelf. Based on this ruling, the district court in *Chevron* held that Louisiana's one-year statute of limitations on personal injury actions applied and concluded that normal retroactive effect of *Rodrigue* barred plaintiff's suit, since he did not discover the seriousness of his injuries until more than two years following the accident. On appeal, the Supreme Court held that *Rodrigue* would only be applied prospectively, and that actions accruing prior to *Rodrigue* would still be governed by the admiralty laches doctrine.
39. See infra notes 42-45 and accompanying text.
40. 284 U.S. 239 (1931).
41. 109 S. Ct. at 1509.
42. 404 U.S. at 106 (citations omitted).
43. *Id.* at 106-07 (citing *Linkletter v. Walker*, 381 U.S. 618, 629 (1965)).
44. *Id.* at 107.
tial inequitable results if applied retroactively,” a holding of prospectivity is justified. This test has been widely used by state courts in dealing with the refund of taxes paid pursuant to an unconstitutional scheme.

I. New principle of law

The first prong of the test, the “new rule of law” requirement, is satisfied by deciding “an issue of first impression whose resolution was not clearly foreshadowed.” Prior to Davis, states exempted state, but not federal, employees’ pension income from taxation based on the assumption that as long as federal workers were treated at least as favorably as private sector retirees, they were not in violation of federal law. The ruling in Davis “took most state officials by surprise” since they had enacted such provisions “[f]or half a century after the passage of the Public Salary Tax Act.” The Davis ruling, then, seems to satisfy the first prong of the test.

However, the Court in Davis identified a previous case that dealt with a similar tax in which both lessees of federal property and lessees of private property were taxed at the same rate, but lessees of state property paid a lesser tax. The Court invalidated the tax, concluding the tax unconstitutionally discriminated against the federal government and its lessee. Thus, a contender for a refund could assert that the Davis decision requiring equal pension tax treatment of federal and state employees may have been foreshadowed. But one case in the last

45. Id. (citing Cipriano v. City of Houma, 395 U.S. 701, 706 (1969)).
46. Whether all three factors of the test must always be satisfied for a court to apply a decision prospectively is not clear. See Arizona Governing Comm’n v. Norris, 463 U.S. 1073, 1109 (1983) (O’Connor, J., concurring), construed in First of McAlester Corp. v. Oklahoma Tax Comm’n, 709 P.2d 1026, 1034-35 (Okla. 1985).
48. 404 U.S. at 106.
49. IMPACT, supra note 4, at 5.
50. Id.
51. See Hackman v. Director of Revenue, 771 S.W.2d 77, 86 (Mo. 1989) (Welliver, J., dissenting).
53. Id. at 1507.
fifty years, being decided over twenty years ago, may not hold much weight in trying to prove that Davis was foreshadowed. This is a slight chance at best; the stronger argument appears to support the proposition that Davis established a new principle of law.

2. Retrospectivity: whether it furthers operation of the new law

The second prong of the test focuses on the practicality of implementing the new rule of law through retroactive operation. The purpose of the new law announced in Davis is "a mandate of equal treatment" for both state and federal employees' pension taxes. So the appropriate inquiry under this prong of the test is whether retroactive operation of Davis will further or hinder equal treatment of state and federal employees. Although the Court stated that this could be accomplished either by a withdrawal of the exemption from retired state employees or by an extension of the exemption to federal retirees, the Court chose to defer the remedy to the Michigan courts.

If Davis is applied retroactively, the impact of providing refunds will be to require states to appropriate significant sums of money. Thus, the fiscal impact of providing refunds could be a significant factor as states consider whether to extend the benefit to federal employees or withdraw the exemption from state pensioners. States with relatively high refund costs may be reluctant to withdraw benefits from state employees to help pay for the refund.

Although the political consequences of withdrawing the exemption from state employees may serve to slow the actions of state legislatures, states' reactions have been just the opposite. As of August 1989, thirteen of the twenty-four states have already taken legislative action to comply with Davis, while three states called special sessions for Fall 1989. Four more states will address the issue in the 1990 legislative sessions.

Though the possibility of a retroactive application apparently has not hindered the mandate of equal treatment for state and federal re-

54. Id. at 1509 (citing Heckler v. Matthews, 465 U.S. 728, 740 (1984)).
55. See supra note 4 and accompanying text.
56. See supra note 3 and accompanying text.
57. IMPACT, supra note 4, at 10-11. The states that have acted are Arizona, Colorado, Iowa, Missouri, New York, North Carolina, North Dakota, Oklahoma, Oregon, South Carolina, Virginia, West Virginia, and Wisconsin. Id. at 10. Most of these states have chosen to repeal preferences for state pension income. Id. at 27, Table 4. Georgia, Utah, and Michigan called special sessions for Fall 1989. Id. at 10. Utah repealed the exemption for state employees, but mitigated the impact by increasing retirement benefits and by providing a $7500 tax deduction for all pension income. Alabama, Kentucky, Mississippi, and New Mexico will consider the refund and exemption issues in 1990. Id. at 11-15.
tired employees, neither will it further equal treatment. Curing the discriminatory tax requires legislative action, not refunds for past discrimination. This prong of the test, therefore, is neutral, which should give the first and third prongs more weight in determining the outcome.

3. The avoidance of injustice or hardship

The third prong of Chevron consists of "weighing the equities between retroactive and prospective application" of Davis. The degree to which retroactivity would impose "substantial, inequitable results" is a fact-specific inquiry for the particular state involved. For example, Colorado estimates that its total refund cost, if refunds are required, will be $7.4 million over a three-year period. On the other end of the spectrum is Virginia, which could pay up to $370 million over three years.

Addressing this issue, the Hackman court followed the state refund statute and allowed the refund. The court rejected the state's argument that it could not make refunds which could cost over $150 million when no money had yet been appropriated by the legislature. The court determined that whether the state had appropriated the necessary funds "is not relevant to our consideration of the merits of appellants' claims." However, this case is not dispositive in jurisdictions which do not have refund statutes. The Missouri court did not have to apply a prospectivity test, and their only dealing with the magnitude of the refund was whether the money had been appropriated.

But the dissent in Hackman concluded that if the Chevron test did need to be applied, the equities weighed in favor of prospectivity. Judge Welliver balanced the benefit of a refund to "a select group of taxpayers" versus the burden placed upon all taxpayers in having to give priority to the refund rather than needed services such as education, health, and law enforcement. He concluded that since the taxes were not "illegally assessed," and since the refund "will not add anything to the implementation of [Davis]," the benefits of the refund did

58. Hackman v. Director of Revenue, 771 S.W.2d 77, 86 (Mo. 1989) (Welliver, J., dissenting).
60. Impact, supra note 4 at 12.
61. Id. at 18.
62. Hackman, 771 S.W.2d at 82.
63. Id.
64. Id. at 86-87 (Welliver, J., dissenting).
65. Id.
66. Id. "These taxes were legal in all of the . . . states involved until the Court's announcement of the new principle of law in Davis." Id. at 88.
not justify retroactive treatment. 67

It is not clear, though, that a refund in Hackman would require the sacrificing of other services as Judge Welliver contends. The court noted that over $228 million had been generally appropriated for refunding overpayment of taxes, which may include those required by Davis. 68 Considering the fact that the appropriation was open-ended, 69 and that the Davis refund would cost approximately $160 million, 70 there appears to be enough money to handle the refund without foregoing other services. Therefore, it is difficult to use this case as a measure of what other courts may decide. The third prong of the test will thus remain an issue to be decided by each court as it is encountered.

B. The Implications of Iowa-Des Moines National Bank v. Bennett

Although an analysis of the Chevron test seems to favor prospective application of Davis, the Court's reference in Davis to Bennett 71 may provide a quick, simple answer favoring retroactivity. Bennett involved a tax on the shares of a national bank's stock at greater rates than were applied to shares of competing domestic corporations. 72 The tax itself was not discriminatory—it applied the same rates to both national bank stock and domestic corporate stock. The inequity resulted from an inaccurate assessment by the county auditor, resulting in a lower assessment on the domestic corporations. 73 The Supreme Court held that petitioners had a right to equal treatment, and whether the state still had power to equalize treatment by compelling the domestic corporations to pay the higher rate was immaterial. 74 "[I]t is well settled that a taxpayer who has been subjected to discriminatory taxation through the favoring of others in violation of federal law, cannot be required himself to assume the burden of seeking an increase of the taxes which the others should have paid." 75 What the Court did here is only one step more than it did in Davis; it determined that its decision should have retroactive application. As in Davis, the Court declined to devise the remedy which the state should follow in the future (withdrawing or extending the benefit). By referring to Bennett in support of the state's conclusion that Davis should receive a refund, the Court in

67. Id.
68. 771 S.W.2d at 82 n.4.
69. Id.
70. IMPACT, supra note 4, at 15.
71. 284 U.S. 239 (1931)
72. Id. at 241.
73. Id. at 241-42.
74. Id. at 247.
75. Id.
Davis implied that this would be the appropriate course for all federal retirees in the same situation as Davis.

The application of Bennett to the Davis decision, though, is not without its problems. First, the Bennett tax was not unconstitutional. A mere clerical error caused the disparate treatment between the bank and the domestic corporations. Second, there were only two banks which had been harmed by the error, and only one state was involved. In Davis, there are over 1.3 million federal retirees across twenty-four states who have been treated unequally.\(^76\) True, the net effect was unequal tax treatment in both cases. However, applying Bennett to the Davis decision would ignore the more recent precedents in Tyler and Bacchus\(^77\) that defer to states the refund determination. At best, Bennett may provide support for a ruling of retroactivity derived from applying the Chevron test, but it should not be given much precedential effect on its own.

V. Conclusion

Barring the existence of state refund statutes, the Chevron criteria provide the framework from which to attack the refund issue. Davis clearly seems to be a new rule of law, with broad implications both in terms of the number of states it affects and in the magnitude of its impact. Because retroactive treatment of Davis will neither further nor retard the mandate of equal treatment, the second prong of the Chevron test does not shed any light on the prospectivity analysis. Hence, the third factor of the test will weigh most heavily in determining whether to give a refund, and will provide the focus of the majority of litigation that states will face. Further, the authority of the Bennett decision should be limited to more of a support role in the event of a ruling for retroactivity, not as a case which could stand on its own to support retrospective treatment of Davis.

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77. See supra notes 22-23 and accompanying text.