New York – Retroactive application of credit changes is unconstitutional

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In brief

The retroactive application of amendments enacted in 2009 to the Empire Zone Program was a violation of program recipients' due process, the Court of Appeals of New York concluded. Due process was violated because the taxpayers had no forewarning of the amendments, the length of retroactivity was excessive, and the state lacked a valid public purpose for the retroactivity. As the Court of Appeals is the highest court in the New York, affected taxpayers should consider refunds. Additionally, the decision should cause taxpayers adversely affected by retroactive tax legislation to ascertain whether retroactivity potentially runs afoul of due process based on the factors set out by the Court. [*James Square Associates LP et al. v Commissioner, New York State Department of Economic Development*, Nos. 87 – 91, (06/04/13)]

In detail

Empire Zone program and amendments

During the years at issue, under New York's Empire Zone program, certified companies located in deemed Zone areas were entitled to credits, one of which was a wage tax credit for new jobs created. Since 2000, the program required that a taxpayer's continued eligibility for program benefits depended on it meeting certain wage, employment, and investment goals. The state budget bill enacted in 2009 created two new criteria for taxpayers to meet in order to maintain their Empire Zone certificate of eligibility. The first was a determination that a certified taxpayer was not a 'shirt changer,' meaning it did not reincorporate or transfer employees or assets to a related entity in or to appear to have created new jobs or made new investments. The second was the '1:1 benefit-cost standard,' which required a business to provide "economic returns to the state in the form of total remuneration to its employees (i.e. wages and benefits) and investments in its facility greater in value to the tax benefits the business enterprise used and had refunded to it." Failure to meet either standard was grounds for decertification.

Amendments applied retroactively

While the 2009 amendments were not applicable retroactively, both the Commissioner of Economic Development and the Department of Taxation and Finance announced that the 2009 amendments to the program applied to the tax years beginning on and after January 1, 2008 (based on budget language that did not make it into the final bill). The budget bill enacted in 2010 provided that it was the New York Legislature's intent that decertifications that occurred in 2009 would be deemed to be in effect for the taxable year commencing on or after January 1, 2008.

Several taxpayers decertified for the 2008 year brought suit against the State Department of

Economic Development (State), asserting that the retroactive decertification was improper. Following trial court and Appellate Division decisions in the taxpayers' favor, the State appealed to the New York Court of Appeals, the highest court in New York.

Due process standards for retroactivity

Addressing whether the taxpayers' due process rights were violated by the retroactive application of the 2009 amendments, the New York Court of Appeals (Court) noted that "retroactivity provisions of a tax statute are not necessarily unconstitutional and are generally tolerated and considered valid if for a short period." In *Matter of Replan Dev. v. Department of Hous. Preserv. & Dev. Of City of N.Y.,* the Court laid out a test for determining whether a retroactive tax violates due process. The test looks at (1) a taxpayer's forewarning of a change in the legislation and the reasonableness of its reliance on the old law, (2) the length of the retroactive period, and (3) the public purpose for the retroactivity.

Regarding the first prong, the Court observed that the taxpayers had no warning and no opportunity at any time in 2008 to alter their behavior in anticipation of the impact of the 2009 amendments. The legislation itself was not introduced until January 2009. Official reports issued in 2004 and 2007 pointed out weaknesses in the program, but did not provide for the new criteria. The taxpayers appeared to have conducted their business affairs in a manner consistent with program's 2008 requirements, "justifiably relying on the receipt of the tax benefits that were then in effect." Accordingly, the first factor favored the taxpayers.

The parties disputed whether the retroactivity period spanned 16 or 32 months. The taxpayers claimed that the period was 32 months, from January 2008 to the August 2010 enactment date of the legislation that specifically provided for the retroactive date of certifications that took place in 2009. The state countered that the period ran for 16 months from January 2008 to the April 2009 enactment date of the new criteria. "Regardless of whether the period of retroactivity is deemed to span 16 or 32 months, the length of retroactivity should be considered excessive and weighs against the State," said the Court. The State pointed to various cases where tax laws with longer retroactivity periods were upheld. However, many of those cases concerned measures made to correct errors, where logistical issues made retroactivity necessary, or where there was a lack of detrimental reliance by taxpayers. None of these exceptions are present here, the Court observed.

Lastly, the State did not have a valid public purpose for retroactivity applying the 2009 amendments.

The legislature's only purposes were to stem program abuses and increase tax receipts. Denying tax credits to the taxpayers did nothing to spur investment, create jobs, or prevent prior 'shirt-changing.' Retroactive application of the 2009 legislation "simply punished the Program participants more harshly for behavior that already occurred and that they could not alter." The court also found that raising money for the State budget was not a particularly compelling justification. "Raising funds is the underlying purpose of taxation, and such a rationale would justify every retroactive tax law, obviating the balancing test itself."

The takeaway

The retroactive decertification measures taken by Empire State Development (ESD) took many empire zone certified businesses by surprise. There was much confusion when ESD reviewed certified businesses in 2009 and decertified noncompliant businesses retroactively to 2008. This decision presents an excellent opportunity for those businesses that were wrongfully decertified to make certain they are obtaining available zone benefits for 2008.

Let's talk

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