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The Refund of Taxes Paid Pursuant to an Unconstitutional Tax Scheme and the Pass-on Defense: Beams Intellectual Dishonesty Threatens Every State's Budgetary Stability

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THE REFUND OF TAXES PAID PURSUANT TO AN UNCONSTITUTIONAL TAX SCHEME AND THE PASS-ON DEFENSE: BEAM'S INTELLECTUAL DISHONESTY THREATENS EVERY STATES' BUDGETARY STABILITY

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I. INTRODUCTION

In several recent cases the United States Supreme Court found certain state tax schemes to be unconstitutional.1 The Supreme Court,

however, abstained from deciding whether its ruling should be applied retroactively\(^2\) or whether the State should be required to pay the taxpayers a refund.\(^3\) Rather, the Supreme Court decided that these remedial issues would be better addressed if left to the states.\(^4\)

The right to a refund is ordinarily a matter of legislative grace.\(^5\) In other words, the right to a refund is procured only from a statute authorizing such.\(^6\) Thus, the state may choose, subject to minimum federal requirements,\(^7\) which form of remedy it will provide the taxpayer.\(^8\)

Generally, when a state wrongfully or illegally imposes a tax, the aggrieved party has several remedies available.\(^9\) Arguably, the most important remedy is an action at law to recover a refund of the illegal taxes involuntarily paid.\(^10\) Prior to *James B. Beam Distilling Co. v. Georgia*,\(^11\) when a tax statute was found to be unconstitutional, courts were given latitude in determining whether their decision invalidating the tax statute was to be given retroactive or prospective effect.\(^12\) The mere fact that the statute was invalidated on a prospective basis was considered, in a broad sense, a limited form of remedy.\(^13\)

\(^2\) This comment uses the root terms "retroactive" and "retrospective" interchangeably.


\(^4\) See Bacchus, 468 U.S. at 278; Tyler Pipe, 483 U.S. at 253; Scheiner, 483 U.S. at 297-98.

\(^5\) 84 C.J.S. Taxation § 631 (1954). In *Ward v. Love County*, 253 U.S. 17, 24 (1920), the United States Supreme Court held that the United States Constitution requires that a taxpayer be given a refund if the taxpayer paid an unconstitutional tax under duress.

\(^6\) Tatarowicz, *supra* note 3, at 125. The state legislature, however, can only compel the refund of taxes illegally collected. 84 C.J.S Taxation § 632 (1954).

\(^7\) *McKesson Corp. v. Div. of Alcoholic Bever.,* 110 S. Ct. 2238, 2258 (1990).

\(^8\) *Id.* W. Va. Code § 11-10-14 statutorily authorizes tax refunds and provides, in pertinent part: "In the case of overpayment of any tax . . . the tax commissioner shall, subject to the provisions of the article, refund to the taxpayer the amount of the overpayment . . . ."


\(^10\) *Id.* Other remedies include maintaining a suit in equity for injunctive relief against the enforcement and collection of the illegal tax, and bringing a suit under proper averments by a stockholder to restrain a corporation from voluntarily paying an alleged illegal tax. *Id.*


\(^12\) Tatarowicz, *supra* note 3, at 119.

\(^13\) *Id.*
It appears, however, that states will now be required to provide retroactive relief in those cases where taxes were paid pursuant to an unconstitutionally discriminatory tax scheme.\textsuperscript{14} In \textit{Beam}, the plaintiff requested and was denied a refund for taxes paid under an unconstitutional liquor tax. In finding that Beam was entitled to some form of retroactive relief, the Supreme Court completely disregarded the itemized analysis previously relied upon to determine whether a judicial decision was to be given prospective or retroactive effect.\textsuperscript{15} Instead, in what appears to fall just short of intellectual dishonesty, the Supreme Court based its ruling on precedent established in a similar case which, too, had apparently erred in not performing the traditional prospective/retroactive analysis.\textsuperscript{16}

The \textit{Beam} decision has the potential of significantly and adversely affecting a state’s financial stability, because tax refunds represent revenue losses.\textsuperscript{17} Based on the \textit{Beam} analysis, it now appears that refunds will be required when taxes are paid pursuant to an unconstitutionally discriminatory tax. In an effort to avoid paying these refunds, states will probably advance two primary theories. First, states will most likely continue to assert that a judicial decision which invalidates a tax scheme should be applied on a prospective-basis only.\textsuperscript{18} Not only has this strategy had some success in the past,\textsuperscript{19} but its potential for effectiveness in the future may not be as dismal as the \textit{Beam} decision would leave one to believe. The \textit{Beam} Court produced five opinions and the Supreme Court’s decision may be narrowly applied in subsequent cases.\textsuperscript{20}

Second, states will likely argue that the illegal taxes paid by business entities were passed on to the taxpayer’s customers and that any refund would amount to a windfall. This assertion is based on

\textsuperscript{15} See Chevron Oil Co. v. Huson, 404 U.S. 97 (1971).
\textsuperscript{17} Tatarowicz, supra note 3, at 117.
\textsuperscript{18} Id.
\textsuperscript{20} Lobel, supra note 14, at 581-83.
the principle of unjust enrichment. Application of the pass-on defense enables the states to keep possession of the monies collected pursuant to the unconstitutional tax statute, and effectively denies the taxpayer a refund. This strategy, too, has seen some success.

This Note begins with a brief overview of common law judicial review. Then Part III examines the evolution of prospective overruling in the American judicial system and analyzes the Supreme Court's decisions shaping this judicial mechanism. Part IV provides a comprehensive review of the Supreme Court's ruling in *James B. Beam Distilling Co. v. Georgia.* Part V examines the pass-on defense, discussing the development of the defense and its fundamental component, the tax incidence analysis. Finally, Part VI provides a summary of where it appears the Supreme Court stands on the issues of retroactive relief when taxes are paid pursuant to an unconstitutional tax scheme and the pass-on defense.

II. COMMON LAW JUDICIAL REVIEW

There was no authority at common law that provided for a court's ruling to be given a purely prospective effect; all decisions were applied retroactively. Indeed, Sir William Blackstone stated that the courts were "not delegated to pronounce a new law, but to maintain and expound the old one." Accordingly, Blackstone noted, in a case where a former ruling is "evidently contrary to reason, ... judges do not pretend to make a new law, but to vindicate the old one from misrepresentation." By virtue of this reasoning, all judicial rulings were necessarily given retroactive effect, regardless of whether the court applied settled principles of law, overruled prior decisions, or decided disputes upon which there was not clear precedent.

22. Id.
26. 1 WILLIAM BLACKSTONE, COMMENTARIES *69.
27. Id. at *70.
III. THE EVOLUTION OF PROSPECTIVE OVERRULING IN THE AMERICAN JUDICIAL SYSTEM

As the people of a young America saw the world as one filled with certainty, Blackstone's theory that laws were absolute and unchanging was readily adopted by America's judicial system. In conformity with this expectation of consistency, American courts endorsed the Blackstonian theory well into the 20th century. It seemed logical that a party who succeeded in convincing the court that the old law should be abandoned should be rewarded by having the new rule applied to his case. Today, there remain great legal minds, such as Justice Antonin Scalia, who subscribe to the theory that all judicial decisions are to be applied retroactively. Concededly, most legal scholars will agree that Blackstone's theory is not entirely invalid. Generally, courts apply Blackstone's theory of retroactive application because the court's ruling usually reflects pre-existing rules and principles.

However, the problems with universal retroactive application of judicial decisions were becoming abundantly apparent in the early to mid-1900's. In 1932, Justice Benjamin N. Cardozo noted that in some instances outmoded rules were sometimes continued because the courts did not want to frustrate the reasonable expectations of the parties before it. Critics of the Blackstonian theory argued that people who justifiably relied on the old law and conducted their

31. In his concurring opinion in *Beam*, Justice Scalia stated, "I am not so naive (nor do I think our forbears were) as to be unaware that judges in a real sense 'make' law. But they make it as judges make it, which is to say as though they were 'finding' it — discerning what the law is, rather than decreeing what it is today changed to, or what it will tomorrow be." James B. Beam Distilling Co. v. Georgia, 111 S. Ct. 2439, 2451 (1991) (emphasis in original).
33. *Beam*, 111 S. Ct. at 2442.
34. At the time, Cardozo was the Chief Justice of the New York Supreme Court of Appeals. Beryl H. Levy, *Realist Jurisprudence and Prospective OVERRULING*, 109 U. PA. L. REV. 1, 12 (1960).
35. *Id.*
lives accordingly should not be subjected to a new law. Addition-
ally, universal retroactive effect to judicial decisions overruling old
law imposes a heavy burden on the administration of justice by
allowing prior cases already decided to be relitigated.

A. The State’s Choice

In 1932, the Supreme Court began bringing down the wall of
universal retroactive application of judicial decisions. In \textit{Great
Northern Ry. v. Sunburst Oil & Refining Co.}, the Supreme Court
ruled that there was not a Federal Constitutional objection to a state
court’s choosing to apply its decision retroactively or prospectively
when the new rule declared by the state court overruled an earlier
decision. Speaking for the \textit{Sunburst} Court, Justice Cardozo stated,
‘‘[t]he choice for any state [in deciding to apply its decision ret-
roactively or to prospectively overrule] may be determined by the
juristic philosophy of the judges of her courts, their conceptions of
law, its origin and nature.’’

B. When a Court May Prospectively Overrule

The Supreme Court’s approach to prospective overruling was
first formulated in \textit{Linkletter v. Walker}. In deciding what effect
the new rule of law is to have, Justice Clark, writing the opinion
for the \textit{Linkletter} Court, stated:

Once the premise is accepted that we are neither required to apply, nor prohibited
from applying, a decision retrospectively, we must then weigh the merits and
demerits in each case by looking to the prior history of the rule in question, its
purpose and effect, and whether retrospective operation will further or retard it
operation.

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37. S.R. Shapiro, Annotation, \textit{Retroactive or Merely Prospective Operation of New Rule Adopted
by Court in Overruling Precedent Federal Cases}, 14 L. Ed. 2d 992, 1005 (1966).
38. 287 U.S. 358 (1932). Although \textit{Sunburst} is generally acknowledged as the first case to
explicitly approve of prospective overruling, other state courts had done so earlier. See Levy, \textit{supra}
ote 34, at 7-9.
41. \textit{Linkletter v. Walker}, 381 U.S. 618, 629 (1965). As to prospective overruling, the Court
noted that there was “no distinction . . . between civil and criminal litigation” in this respect. \textit{Id.}
at 627.
Once a court has balanced these equities it may, "in the interest of justice," apply its ruling prospectively. The Linkletter Court noted that a court's power to prospectively overrule applies to both criminal and civil cases. Linkletter, however, did not establish satisfactory guidelines in this difficult and confusing area. Indeed, Justice Harlan noted that the Linkletter analysis was "almost as difficult to follow as the tracks made by a beast of prey in search of its intended victim."

The Supreme Court revised its standard for prospective overruling in Chevron Oil Co. v. Huson. In Chevron, the Supreme Court set forth the following considerations in determining whether a rule of law is to be applied retroactively:

First, the decision to be applied nonretroactively 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. Second, it has been stressed that "we must . . . weigh the merits and demerits in each case by looking to the prior history of the rule in question, its purpose and effect, and whether retrospective operation will further or retard its operation. . . ." Finally, we [must weigh] the inequity imposed by retroactive application, for "[w]here a decision of this Court could produce substantial inequitable results if applied retroactively, there is ample basis in our cases for avoiding the 'injustice or hardship' by a holding of nonretroactivity."

42. Id. at 628.
43. Id. at 627.
44. Rossum, supra note 40, at 384.
47. This analysis will be referred to as the "'Chevron analysis' or the "three prong analysis.'
48. Linkletter, 381 U.S. at 629.

In Bradley v. Appalachian Power Co., 256 S.E.2d 879 (W. Va. 1979), the West Virginia Supreme Court of Appeals, while recognizing the Chevron analysis, formulated its own test to determine whether a decision should be given prospective or retroactive effect. The Bradley Court stated:

In determining whether to extend full retroactivity, the following factors are to be considered: First, the nature of the substantive issue overruled must be determined. If the issue involves a traditionally settled area of law . . . and the new rule was not clearly foreshadowed, then retroactivity is less justified. Second, where the overruled decision deals with procedural law rather than substantive, retroactivity ordinarily will be more readily accorded. Third, common law decisions, when overruled, may result in the overruling decision being given retroactive effect, since the substantive issue usually has a narrower impact and is likely to involve fewer parties. Fourth, where, on the other hand, substantial public issues are involved, arising from statutory or constitutional interpretations that represent a
C. Judicial Mechanisms Available When a Decision is Overruled

Only when a prior court decision is overruled and succeeded by a new rule of law may a court entertain assertions of nonretroactive application of the new rule. In such a case, the Supreme Court recently indicated that this choice of law problem may be resolved in one of three ways. First, the decision may be applied on a fully retroactive basis. Second, the court may overrule old law on a purely prospective basis. Finally, the court may apply the new rule to the parties in the case in which it was announced, and then apply the old rule to all others where the relevant facts of their case antedate the pronouncement. This judicial mechanism is called selective prospectivity.

In a fully retroactive application of a new rule, the decision applies to the parties of the case in which the new rule is pronounced, and to all issues subsequently coming before the court "regardless of the chronology of the factual events from which the legal rights and liabilities at issue arose."

By overruling a law on a purely prospective basis, the court applies the old law to all claims based on acts or transactions occurring

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51. Id.
52. Id.
53. Id. at 2443-44
54. Id. at 2444.
55. Id. Several commentators have noted a fourth alternative of applying a new rule: the Prospective-Prospective method. The effect of such a judicial mechanism is that the new law is applied to claims arising at some future date. In other words, the new rule of law does not go into effect the moment it is announced as in pure prospectivity. Instead, the court postpones the rule's effective date under the assumption that, in the meantime, the legislature will take this opportunity to examine the new rule and make any necessary changes before the new rule's effective date. See, DeLong, supra note 29, at 127; Note, Prospective Application of Judicial Decisions, 33 ALA. L. REV. 463, 475 (1982). In all due respect to the commentators, as the United States Supreme Court in Beam did not recognize the Prospective-Prospective method as an alternative application of a new rule of law, discussion of such a method will be limited to this footnote.
before the announcement of the new decision.\textsuperscript{57} Accordingly, the old law is applied to the parties of the case in which the new rule is promulgated. The new rule is then applied to all claims grounded on acts or transactions occurring after the new law is announced.\textsuperscript{58}

By giving a new rule a selectively prospective effect, the court applies the "new rule in the case in which it is pronounced, then returns to the old [rule] with respect to all others arising on facts predating the pronouncement."\textsuperscript{59} However, a fundamental component of the rule of law, in general, and stare decisis, in specific, is that litigants in similar situations should be treated the same.\textsuperscript{60} In light thereof, selective prospectivity as a choice of law has been abandoned in the criminal context.\textsuperscript{61} In a criminal case the new rule is to be applied retroactively to all cases, even when the new rule overturns precedent.\textsuperscript{62} Additionally, it appears selective prospectivity has never been applied or endorsed in the civil context.\textsuperscript{63}

IV. JAMES B. BEAM DISTILLING CO. V. GEORGIA

Prior to James B. Beam Distilling Co. v. Georgia,\textsuperscript{64} when the Chevron analysis favored prospectivity, a court could still give their decision retroactive effect.\textsuperscript{65} Justice Souter, however, in the plurality's opinion in Beam, asserted that the Beam decision "does limit the possible application of the Chevron . . . analysis, however irrelevant Chevron . . . may otherwise be to this case."\textsuperscript{66} Although

\begin{itemize}
  \item \textsuperscript{57} Note, supra note 55, at 470.
  \item \textsuperscript{59} Beam, 111 S. Ct. at 2444. Selective prospectivity has been called "partial prospectivity" and/or "quasi-prospectivity" by some commentators. See Dufour, supra note 58, at 329 ("Partial prospective application involves application of the new rule only to cases arising after the overruling decision, except that the decision is applied to the parties involved in the overruling case."); DeLong, supra note 29, at 127 ("Quasi-prospective overruling applies a new decision to all claims arising after the date of the new decision. Unlike the pure prospectivity method, however, the new rule also applies retroactively to the parties to the overruling decision.").
  \item \textsuperscript{60} RICHARD A. WASSERSTROM, THE JUDICIAL DECISION 70 (1961).
  \item \textsuperscript{61} Griffith v. Kentucky, 479 U.S. 314, 328 (1987).
  \item \textsuperscript{62} Id.
  \item \textsuperscript{63} Beam, 111 S. Ct. at 2445
  \item \textsuperscript{64} 111 S. Ct. 2439 (1991).
  \item \textsuperscript{65} DeLong, supra note 29, at 124.
  \item \textsuperscript{66} Id.
\end{itemize}
the Beam Court neglected to perform the Chevron analysis, it was not the first time the Supreme Court has made this blunder. In fact, in Bacchus Imports, Ltd. v. Dias, the case upon which the Beam plurality based their decision, the Chevron test was also not applied.

An understanding of the holding, reasoning, and dissention in Beam begins with a brief analysis of Bacchus.

A. Precedential Background

In 1939 Hawaii enacted a liquor tax that imposed a six percent levy on the sale or use of alcoholic beverages at the retail level. Its purpose was to defray the cost of certain governmental services, such as law enforcement which, according to the Hawaii Legislature, had increased due to an escalation in the consumption of liquor.

Since the inception of the Hawaii liquor tax, the Legislature has systematically shifted its incidence from the retailers to the wholesalers by increasing its rate from six percent to a current level of twenty percent of the wholesale price. In an attempt to encourage the development of the Hawaiian liquor industry, the Legislature enacted an exemption for okolehao from May 1971 until June 1981, and an exemption for fruit wine from May 1976 until June 1981.

The constitutionality of these exemptions were challenged by Bacchus Imports, Ltd., Paradise Beverages, Inc., Eagle Distributors, Inc., and Foremost-McKesson, Inc. (Bacchus, Paradise, Eagle, and McKesson, respectively, and the wholesalers, collectively). All were licensed as wholesale liquor dealers under Hawaii’s liquor control laws. In May 1987, Bacchus directed a letter to the State Director

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68. Beam, 111 S. Ct. at 2451.
70. In re Bacchus Imports, Ltd., 656 P.2d 724, 727 (Haw. 1982).
71. Bacchus, 468 U.S. at 265.
72. Bacchus, 656 P.2d at 727.
73. Bacchus, 468 U.S. at 265.
76. Bacchus, 656 P.2d at 726.
77. Id. at 722-28.
of Taxation protesting the excise tax assessed on its sale or use of alcoholic beverages. Subsequently, Bacchus filed a complaint pursuant to Hawaii Revised Statute § 40-35. Paradise, Eagle, and McKesson quickly followed suit with their own protest letters to the State Director of Taxation. Subsequently, each of these wholesalers also initiated a refund action.

The wholesalers alleged in their complaints that the liquor tax contravened the Import-Export Clause and the Commerce Clause of the United States Constitution. The Tax Appeal Court rejected these arguments, finding the tax scheme valid. On appeal to the Supreme Court of Hawaii, the wholesalers forwarded an equal protection challenge. It, too, was rejected as the state court affirmed the decision of the Tax Appeal Court.

On appeal, the United States Supreme Court concluded that the Hawaii liquor tax exemption for okolehao and fruit wine had both the purpose and the effect of discriminating in favor of locally produced beverages and, thus, violated the Commerce Clause. By finding the Hawaii liquor tax exemptions unconstitutional, and thereby reversing the Supreme Court of Hawaii, the issue of a proper remedy was raised.

It was the State of Hawaii's contention that even if the liquor tax was unconstitutionally discriminatory, the wholesalers were not entitled to refunds because the economic incidence of the tax was

78. Id. at 728.
79. HAW. REV. STAT. § 40-35 (Supp. 1975) “authorizes a taxpayer to pay taxes under protest and to commence an action in the Tax Appeal Court for the recovery of the disputed sums.” (Quoting Bacchus, 656 P.2d at 728).
80. Bacchus, 656 P.2d at 728.
81. U.S. CONST. art. I, § 10, cl. 2, states, in pertinent part: “No State shall, without the Consent of Congress, lay any ... Duties on Imports or Exports.”
82. U.S. CONST. art. I, § 8, cl. 3, states in pertinent part: “The Congress shall have power ... [t]o regulate Commerce ... among the several States.”
83. Bacchus, 656 P.2d at 728.
84. Id.
85. Bacchus, 468 U.S. at 267. This argument was based on the wholesalers' claim that the favored treatment of okolehao and other locally produced fruit wines denied the wholesalers equal protection. Bacchus, 656 P.2d at 728.
86. Bacchus, 468 U.S. at 267.
87. Id.
88. Id. at 277.
passed on to their customers. Since the tax was not borne by the wholesalers, the State argued that the wholesalers endured no competitive injury. The wholesalers' asserted that, by virtue of the statute's unconstitutionality, the Commerce Clause required a refund of the taxes collected under the liquor tax.

The Supreme Court reached the issue by stating:

These refund issues, which are essentially issues of remedy for the imposition of a tax that unconstitutionally discriminated against interstate commerce, were not addressed by the state courts. Also, the federal constitution issues involved may well be intertwined with, or their consideration obviated by, issues of state law. Also, resolution of those issues, if required at all, may necessitate more of a record than so far has been made in this case. We are reluctant, therefore, to address them in the first instance.

Accordingly, the case was remanded to Hawaii's state courts for resolution of the issue of remedy.

**B. The Georgia Supreme Court's Holding**

In *Beam*, the plaintiff, James B. Beam Distilling Co. filed an action against the State of Georgia, seeking a refund for taxes paid pursuant to the Official Code of Georgia Annotated (hereinafter OCGA) § 3-4-60 for the years 1982, 1983, and 1984. This liquor tax was very similar to the statute found unconstitutional in *Bacchus*. In 1985, shortly after the *Bacchus* ruling, the Georgia Legislature amended OCGA § 3-4-60, ridding the statute of its unconstitutional qualities. Consequently, only those taxes paid pursuant to the pre-1985 version of OCGA § 3-4-60 were at issue in *Beam*.

89. *Id.*
90. *Id.*
91. *Id.*
92. *Id.*
93. *Id.*
94. GA. CODE ANN. § 3-4-60 (Michie 1982) imposed an increased tax on imported alcoholic beverages as opposed to alcoholic beverages manufactured in the State of Georgia.
95. *Beam*, 382 S.E.2d 95 (Ga. 1989).
96. *Id.*
97. *Id.* at 95-96.
98. *Id.*
The Supreme Court of Georgia found the purpose and the effect of the pre-1985 version of OCGA § 3-4-60 was simple economic protectionism and deemed the statute invalid under the Commerce Clause of the United States Constitution. The issue of refunds as a remedy, however, was moot as the Supreme Court of Georgia opted to apply the ruling prospectively only.

The State Court employed the three-pronged analysis of Chevron in deciding the question of prospective or retroactive application of the decision. Employing the first prong of the Chevron test, the Supreme Court of Georgia noted that had the decision been rendered prior to the 1985 amendment of OCGA §3-4-60, their ruling that the pre-1985 version of OCGA §3-4-60 was unconstitutional would have established a new principle of law. Accordingly, such a decision would have overruled "past precedent on which [the] litigants relied." Therefore, the first prong of the Chevron test supported nonretroactive application of the rule.

The second prong of the Chevron test was not applicable because the statute in question was amended in 1985.

The third prong of the Chevron test required the Supreme Court of Georgia to balance the equities imposed by retroactive application of the decision. Beam asked the Court for a $2.4 million refund, while other parties in pending lawsuits were seeking refunds totaling over $28 million on the same grounds. The Georgia Supreme Court determined that retroactive application of their decision would impose a severe financial burden on the State of Georgia and its cit-
izens,\textsuperscript{109} reasoning that "[e]conomic realities lead to the inescapable conclusion that the cost of this tax has or could have been already absorbed by the companies and passed on to Georgia consumers. Indeed, retroactive application of the ruling might well result in a windfall to the alcohol producers."\textsuperscript{110}

In light of these considerations, the Supreme Court of Georgia decided that the \textit{Chevron} analysis dictated that their decision was to be applied prospectively.\textsuperscript{111} Consequently, Beam was denied the tax refund it sought.

\textbf{C. The United States Supreme Court’s Ruling}

Beam sought, and was granted, a writ of certiorari from the Supreme Court.\textsuperscript{112} The Supreme Court reversed, deciding that the Supreme Court of Georgia’s judgment was to be applied retroactively.\textsuperscript{113} Ironically, the plurality paid no heed to the \textit{Chevron} analysis but, yet, claimed to have based its decision on “principles of equality and stare decisis.”\textsuperscript{114}

\textbf{1. The Plurality’s Opinion}

Justice Souter delivered the plurality’s opinion, recalling that the wholesalers in \textit{Bacchus}, who prevailed on the merits of their Commerce Clause claim, were not granted outright their request for a refund of the taxes paid under the liquor tax statute which was ultimately found unconstitutional.\textsuperscript{115} Instead, the \textit{Bacchus} Court remanded the case to consider the issues of remedy, which had not been decided by the state courts or adequately developed on the record.\textsuperscript{116} Justice Souter followed with the crux of the plurality’s opinion:

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\textsuperscript{109} Id. at 97.
\textsuperscript{110} Id. (emphasis added).
\textsuperscript{111} Id.
\textsuperscript{112} 110 S. Ct. 2616 (1990).
\textsuperscript{113} Beam, 111 S. Ct. at 2448. The case was remanded to determine the appropriate remedy.
\textsuperscript{114} Id. at 2451.
\textsuperscript{115} Id. at 2445.
\textsuperscript{116} Id.
Bacchus is fairly read to hold as a choice of law that its rule should apply retroactively to the litigants then before the Court. Because the Bacchus opinion did not reserve the question whether its holding should be applied to the parties before it, it is properly understood to have followed the normal rule of retroactive application in civil cases. If the Court were to have found prospectivity as a choice-of-law matter, there would have been no need to consider the pass-through defense; if the Court had reserved the issue, the terms of the remand to consider “remedial” issues would have been incomplete. Indeed, any consideration of remedial issues necessarily implies that the precedential question has been settled to the effect that the rule of law will apply to the parties before the Court. Because the Court in Bacchus remanded the case solely for consideration of the pass-through defense, it thus should be read as having retroactively applied the rule there decided.\textsuperscript{117}

The Bacchus decision came thirteen years after Chevron.\textsuperscript{118} Regardless of the fact that the Bacchus Court neglected to perform the Chevron three prong analysis (the performance of which would have been based on “principles of equality and stare decisis”\textsuperscript{119}), the Supreme Court held that the Georgia Supreme Court was in error for refusing to apply the precedent established in Bacchus in Beam.\textsuperscript{120}

Justice White, concurring in the judgment, noted that even if the Bacchus Court was wrong in failing to perform the Chevron analysis, “that is water over the dam, irrevocably it seems to me.”\textsuperscript{121}

2. The Dissenting Opinion

Justice O’Connor, who wrote the dissenting opinion, noted that all implications and assumptions aside, the Bacchus decision was silent on the issue of retroactivity.\textsuperscript{122} By implicitly applying its rule of law retroactively without performing the Chevron analysis (as principles of equality and stare decisis dictate), Justice O’Connor contended that the Bacchus Court erred.\textsuperscript{123} Additionally, Justice O’Connor noted that had the Bacchus Court performed the Chevron analysis...
analysis, the Court would have decided that the rule should have 
been applied prospectively only. Furthermore, Justice O'Connor 
staed that "[i]f retroactive application was inequitable in Bacchus 
itsl, the [Beam] Court only hinders the cause of fairness by re-
pearing the mistake."}

V. THE PASS-ON DEFENSE

The pass-on defense may be employed by one who has wrongly 
received money from another. This typically occurs in a market-
place setting. Very simply, the recipient asserts that the payor re-
couped the money paid by increasing the cost of the goods or serv-
ices sold to subsequent purchasers. Accordingly, the recipient argues 
that it is the subsequent purchaser who bore the cost of the amount 
wrongly paid by the payor, and any recovery by the payor would 
amount to a windfall. This part of the Note analyzes the develop-
ment of the pass-on defense, its theoretical foundation, its suc-
cesses and failures, and its potential for future application.

West Virginia's refund statute reads in pertinent part: "In the 
case of overpayment of any tax . . . imposed by this article . . . the 
tax commissioner shall . . . refund to the taxpayer the amount of 
the overpayment . . . ." Clearly, there is no statutory limitation 
of refund claims. Despite this, questions have been raised as to 
whether a state with such a statute will be allowed to refund some-
thing less than the full overpayment. This objective can most easily 
be achieved by the judicial recognition of the pass-on defense.

The recent popularity of the pass-on defense has made the issue 
of remedies for the payment of unconstitutional taxes more complex. 
In light of recent Supreme Court decisions, the measure of the ap-
propriate remedy has been cast in some degree of doubt.

A. A Taxpayer's Right to a Refund

At common law, courts would not order a refund to one who voluntarily paid an unconstitutional tax, even when the taxpayer

124. Id.
125. Id. at 2452.
127. "In order for a payment of taxes to be deemed involuntary, there must be some actual or
did not have knowledge of the law's unconstitutionality.128 The state governments, too, were slow to open their treasuries and refund monies already held in their vaults.129 To do so, it was reasoned, would undermine the states' ability to conduct its affairs since the state had used or had budgeted to use all of the taxes collected or expected to be collected in the current year.130 Refunds could seriously impair the states' ability to effectively and efficiently conduct its business.131 One court noted that

unless a contrary conclusion was forced by an ironclad statute, no taxpayer should have the right to disrupt the government by demanding a refund of his money, whether paid legally or otherwise, unless the sovereign was made to know at the time the money was paid that the taxpayer would insist that the money should be refunded to him.132

Absent a specific statutory remedy providing for a refund of state taxes, states generally will not recognize any right to a refund beyond those of the common law.133 Thus, under most circumstances, absent a statute stating otherwise, illegally collected taxes are not recovered by the taxpayer unless the taxes were paid under compulsion or duress, or, in some cases, under protest.134 Fortunately, many states regulate by statute the right to recover a refund for taxes paid pursuant to an unconstitutional tax scheme,135 even when the tax was paid voluntarily or made without protest.136

threatened exercise of power possessed, or believed to be possessed, by the party exacting or receiving the payment over the person or property of the party making the payment, from which the latter has no reasonable means of immediate relief except by making payment." When May Payment of Tax or Assessment Be Regarded as Involuntary or Made Under Duress, 64 A.L.R. 9, 13 (1929). See 72 AM. JUR. 2d State and Local Taxation § 1081 (1974).

128. Tatarowicz, supra note 3, at 120. See Coleman v. Inland Gas Corp., 21 S.W.2d 1030 (Ky. 1929); 72 AM. JUR. 2d State and Local Taxation § 1087 (1974).

129. Coleman, 21 S.W.2d at 1031.

130. Id.

131. Id.

132. Id.


135. Tatarowicz, supra note 3, at 125.

136. 72 AM. JUR. 2d State and Local Taxation § 1074 (1974). See W. VA. CODE § 11-10-14 (1978), which states, in pertinent part: "In the case of overpayment of any tax, . . . the tax commissioner shall, subject to the provisions of this article, refund to the taxpayer the amount of the overpayment . . . ."
As a general rule, a taxpayer must show that he bore the burden of the tax before being authorized a refund.\textsuperscript{137} Such a showing is necessary because a refund procedure without this safeguard might result in the unjust enrichment of the taxpayer.\textsuperscript{138} This equitable principle is a natural breeding ground for the pass-on defense.

In \textit{Bacchus}, the Supreme Court recognized the \textit{existence} of the pass-on defense, although the Supreme Court did not validate its application in tax refund actions.\textsuperscript{139} As discussed above, in \textit{Bacchus} the Supreme Court found that the wholesalers had paid taxes pursuant to an unconstitutional tax scheme.\textsuperscript{140} As to the wholesalers' remedy, the State of Hawaii argued that the wholesalers did not bear the cost of the tax and, instead, their customers absorbed the tax in the form of higher prices.\textsuperscript{141} Accordingly, the State argued that any refund to the wholesalers would be, in effect, a windfall.\textsuperscript{142} The State of Hawaii, where \textit{Bacchus} originated, statutorily recognized a taxpayer's right to a refund.\textsuperscript{143}

Despite Hawaii's statutes recognizing a right to a refund, the \textit{Bacchus} Court declined to rule whether the wholesalers were entitled to a refund.\textsuperscript{144} The Supreme Court remanded and ruled: "These refund issues, which are essentially issues of remedy for the imposition of a tax that unconstitutionally discriminated against interstate commerce, were not addressed by the state courts . . . . We are reluctant, therefore, to address them in the first instance."\textsuperscript{145}

The Supreme Court did not reject the pass-on defense outright and its potential for future application has caused much speculation. Accordingly, one must gain an understanding of the pass-on defense before engaging in tax refund litigation involving a commercial entity.

\textsuperscript{139} 468 U.S. 263, 277 (1984).
\textsuperscript{140} \textit{Id.} at 273.
\textsuperscript{141} \textit{Id.} at 276-77.
\textsuperscript{142} \textit{Id.}
\textsuperscript{143} \textit{Bacchus}, 656 P.2d 724, 728 (1982).
\textsuperscript{144} \textit{Bacchus}, 468 U.S. at 277.
\textsuperscript{145} \textit{Id.}
B. Development of the Pass-On Defense

The laws of restitution require that "a person who has been unjustly enriched at the expense of another [be] required to make restitution to that other."\(^1\) For instance, if a defendant illegally takes a plaintiff’s property, restitution requires that the defendant return the plaintiff’s property. "The intuitive appeal of restitution is that, by reversing the unlawful taking, a court can divest an unjust gain and replace the plaintiff’s loss . . . ."\(^2\) Complications arise, however, when this analysis incorporates a third party. The following illustrates such a situation.

As a matter of economic survival, the price a business attempts to sell its product or service is driven by, to a large degree, the expenses the business incurs. Businesses are apt to contend with new expenses, including taxes, as another cost of commerce.\(^3\) Such costs will be included in the price a business charges for its product.\(^4\) Accordingly, the successful business is able to, in an indirect manner, recover the new expense from its customers. The "pass-on" doctrine asks the question: "If that is the case, who has been injured by the new expense: the business or the customer?"\(^5\)

1. Defensive Use in Antitrust Suits

The Supreme Court had the opportunity to address the "pass-on" defense on relatively narrow grounds in *Hanover Shoe, Inc. v. United Shoe Machinery Corp.*\(^6\) Hanover was a shoe manufacturer and a customer of United, a shoe machinery manufacturer and distributor.\(^7\) Hanover filed an antitrust action against United under § 4 of the Sherman Act because United would only lease, rather than sell, its major machines to Hanover.\(^8\) The District Court found

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3. *Id.* at 878-79.
4. *Id.*
7. *Id.* at 483.
8. *Id.*
this monopolization to be illegal and determined Hanover’s damages to be the difference between what it paid United in shoe machine rentals and what it would have paid had United been willing to sell the machines.\textsuperscript{154}

United asserted that Hanover suffered no “legally cognizable injury,” alleging that the illegal overcharge was reflected in the price of their shoes.\textsuperscript{155} Additionally, United claimed that had Hanover purchased the machines, Hanover would have lowered their price by the amount of savings realized from buying rather than leasing the shoe machines.\textsuperscript{156} Thus, United contended Hanover’s profit would have been exactly the same.\textsuperscript{157}

The Supreme Court rejected United’s defense, which was purported to be grounded in the laws of economics,\textsuperscript{158} for three reasons. First, the Court noted that “[t]he general tendency of the law, in regard to damages at least, is not to go beyond the first step . . . . [The plaintiff’s] claim accrued at once in the theory of the law and it does not inquire into later events.”\textsuperscript{159}

Second, the Supreme Court decided that it was extremely improbable, if not impossible, for a court of law to accurately determine, after the fact, how much of an effect one factor had on the company’s net profits.\textsuperscript{160} The Court recognized that numerous factors influence a company’s pricing strategy.\textsuperscript{161} Accordingly, “[s]ince establishing the applicability of the passing-on defense would require a convincing showing of . . . these virtually unascertainable figures, the task [of determining how much of the overcharge was passed on] would normally prove insurmountable.”\textsuperscript{162} The Court noted that if the pass-on defense was confirmed, the use of the

\begin{center}
\textsuperscript{154} Id. at 484.
\textsuperscript{155} Id. at 487-88.
\textsuperscript{156} Id.
\textsuperscript{157} Id.
\textsuperscript{158} Id. at 492.
\textsuperscript{159} Id. at 490 n.8 (quoting Southern Pacific Co. v. Darnell-Taenzer Lumber Co., 245 U.S. 531 (1918)).
\textsuperscript{160} Hanover Shoe, 392 U.S. at 493.
\textsuperscript{161} Id.
\textsuperscript{162} Id.
\end{center}
defense would undoubtedly place a massive burden on the judicial system.\textsuperscript{163}

Finally, the third rationale for rejecting the pass-on defense was that antitrust actions would be rendered ineffective to a large degree.\textsuperscript{164} The Court noted:

\begin{quote}
[If] buyers are subjected to the passing-on defense, those who buy from them would also have to meet the challenge that they passed on the higher price to their customers. These ultimate consumers, in today's case the buyers of single pairs of shoes, would have only a tiny stake in a lawsuit and little interest in attempting a class action. In consequence, those who violate the antitrust laws by price fixing or monopolizing would retain the fruits of their illegality because no one was available who would bring suit against them.\textsuperscript{165}
\end{quote}

2. Offensive Use in Antitrust Suits

The Supreme Court, in \textit{Illinois Brick Co. v. State of Illinois},\textsuperscript{166} had the opportunity to evaluate the merits of the offensive assertion of the pass-on defense by a third party purchaser. Illinois Brick manufactured and distributed concrete block in the Greater Chicago area, selling the concrete blocks to masonry contractors who had submitted bids to general contractors.\textsuperscript{167} These same general contractors, in turn, submitted bids to customers such as the State of Illinois.\textsuperscript{168} The concrete blocks passed through two separate levels of distribution before reaching the State of Illinois.\textsuperscript{169}

The State brought an antitrust action, alleging that Illinois Brick engaged in a "combination and conspiracy to fix the prices of concrete block in violation of § 1 of the Sherman Act."\textsuperscript{170} The State of Illinois alleged that the price it paid for the concrete block was more than $3 million higher as a direct result of Illinois Brick's price-fixing scheme.\textsuperscript{171} The State argued that at least part of the

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{163} Id.
\item \textsuperscript{164} Id. at 494.
\item \textsuperscript{165} Id.
\item \textsuperscript{166} 431 U.S. 720 (1977).
\item \textsuperscript{167} Id. at 726.
\item \textsuperscript{168} Id.
\item \textsuperscript{169} Id.
\item \textsuperscript{170} Id.
\item \textsuperscript{171} Id. at 727
\end{itemize}
\end{footnotesize}
illegal overcharges were not absorbed by the first two levels of distribution but, rather, passed on to the State of Illinois. 172

The Supreme Court first considered whether to recognize this offensive use of the pass-on defense while continuing to allow the defensive use of the pass-on defense (as established in Hanover Shoe 173), provided the direct and indirect purchasers were not suing the defendant in the same case. 174 This consideration was rejected for two reasons. 175 First, by allowing the offensive use of the pass-on defense in addition to the defensive use, the defendants would be exposed to multiple liability. The Court noted that “overlapping recoveries are certain to result from the two lawsuits unless the indirect purchaser is unable to establish any pass-on whatsoever.” 176

Second, “the evidentiary complexities and uncertainties involved in the defensive use of pass-on against a direct purchaser are multiplied in the offensive use of pass-on by a plaintiff several steps removed from the defendant in the chain of distribution.” 177 Such proceedings would greatly complicate and reduce the effectiveness of the judicial system. 178

Upon determining that a finding in favor of the State of Illinois (and thereby an affirmance of the offensive use of the pass-on defense) could not coincide with the rule in Hanover Shoe, the Supreme Court was faced with the choice of overruling or at least narrowly limiting the Hanover Shoe decision, or denying the offensive use of the pass-on defense. 179 The Supreme Court opted the former.

The Illinois Brick Court conceded that the Hanover Shoe rule could possibly deny recovery to indirect purchasers who had actually been injured. 180 However, the Court reasoned that the legislative pur-
pose of the antitrust law under § 4 of the Sherman Act "is better served by holding direct purchasers to be injured to the full extent of the overcharge paid by them than by attempting to apportion the overcharge among all that may have absorbed a part of it." 181

3. Defensive Use in Actions for Tax Refunds

In *McKesson Corp. v. Division of Alcoholic Beverages*, 182 the Supreme Court had the opportunity to explain a state's obligation to provide retroactive relief and to analyze the applicability of the pass-on defense. Until 1985, Florida's liquor excise tax scheme provided rate reductions to manufacturers, distributors, and, in some cases, vendors of alcoholic beverages that were manufactured from certain "Florida-grown" citrus and other agricultural crops, and then bottled in Florida. 183 On the heels of *Bacchus*, 184 which found a similar levy unconstitutional, the Florida Legislature made cosmetic changes to the tax scheme. 185 However, these changes did not effect the tax substantially. 186

McKesson, a licensed wholesale distributor of alcoholic beverages, did not qualify for the rate reduction. 187 In June 1986, McKesson filed suit for declaratory and injunctive relief, and a refund on the ground that the liquor tax was unconstitutional as being violative of the Commerce Clause. 188 In the meantime, McKesson continued to make the monthly tax payment pursuant to the statute. 189 Although the Supreme Court of Florida agreed that the liquor tax was unconstitutional, the court opted to apply the ruling prospectively. 190 The state court reasoned that "[n]ot only was the tax preference scheme implemented ... in good faith ... if given a refund

181. *Id.*
187. *Id.*
188. *Id.*
189. *Id.*
190. *McKesson*, 524 So. 2d at 1010.
[McKesson] would in all probability receive a windfall, since the cost of the tax has likely been passed on to their customers.191

The Due Process Clause of the Fourteenth Amendment requires states to provide procedural safeguards against unlawful exactions.192 A state need not provide predeprivation safeguards;193 indeed, a state may utilize various sanctions and summary remedies to persuade taxpayers to submit payments prior to resolution of the tax assessment dispute.194 Florida, the Supreme Court noted, employed these tactics so that liquor distributors would make timely payments before their protests were heard and resolved.195 In such a case, it may be said that the tax was paid under duress "in the sense that the State has not provided the taxpayer with a fair and meaningful predeprivation procedure."196 The Supreme Court held the following:

To satisfy the requirements of the Due Process Clause, therefore, in this refund action the State must provide the taxpayers with, not only a fair opportunity to challenge the accuracy and legal validity of their tax obligation, but also "a clear and certain remedy" for any erroneous or unlawful tax collection to ensure that the opportunity to contest the tax is a meaningful one.197

Such a requirement imposed a duty on Florida to provide relief to McKesson, ranging from refunding the difference between the tax it paid and the amount it would have paid had McKesson been extended the same rate reductions that its competitors received, to levying an offsetting charge to previously favored distributors.198 "The State is free to choose which form of relief it will provide, so long as that relief satisfies the minimum federal requirements."199

191. Id.
194. McKesson, 110 S. Ct. at 2250-51.
195. Id. at 2251.
197. McKesson, 110 S. Ct. at 2251.
198. Id. at 2252.
199. Id. at 2258
As the State Court called for prospective application of its ruling, the State Court did not discuss the merits of the pass-on defense, although stating that if McKesson were authorized a refund, such a refund would represent a windfall for McKesson "since the cost of the tax has likely been passed on to their customers." The Supreme Court found this statement to be pure speculation, and recognized that determining how much of a particular cost is passed on to the next level in the chain of distribution requires a "highly sophisticated theoretical and factual inquiry." It appears that the Supreme Court has left the door open for those asserting the pass-on defense.

However, the Supreme Court noted that any benefit McKesson received by successfully passing the unconstitutional portion of the liquor tax to its customers was most likely negated by a loss in sales due to its higher sales price or by having to incur other costs (e.g., advertising) in an effort to maintain its market share. This pass-on of the tax "furthers the very competitive disadvantage constituting the Commerce Clause violation that rendered the deprivation unlawful in the first place." C. Tax Incidence Analysis

Tax incidence analysis is the study of who bears the burden of a particular tax. "The ability of the intermediate purchaser to pass the added burden down the distributive chain will depend greatly upon the relative elasticities of supply and demand for his product, that is, the responsiveness to price changes of quantities supplied and demanded." "The standard formula used for computing cost absorption by firms in an industry is given by dividing the absolute

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200. McKesson, 524 So. 2d at 1010.
201. McKesson, 110 S. Ct. at 2255.
202. Id. at 2256.
203. Id. The Supreme Court noted that even if such an unconstitutional tax scheme were to drive a business out of the market, the State's obligation under the Due Process Clause may be limited to providing the taxpayer a refund of the excess taxes collected under the illegal scheme. Id. at 2256 n.33.
205. Id.
value of the price elasticity of demand\textsuperscript{206} by the sum of the absolute values of the price elasticity of demand and the price elasticity of supply.\textsuperscript{207} This can be expressed by the equation:

\[
A = \frac{\text{Ed}}{\text{Ed} + \text{Es}}
\]

where:

\(A\) = Absorption of a cost of increase by a firm
\(\text{Ed}\) = Change in quantity demanded given a change in price
\(\text{Es}\) = Change in quantity supplied given a change in price\textsuperscript{208}

Incidence analysis is an accepted method of approximating how much of a new tax is passed on to consumers who demand the product, provided one is able to ascertain the elasticities of supply and demand of the product in question.\textsuperscript{209} Unfortunately, accurately determining these elasticities is a difficult task since there is no method that will measure them directly.\textsuperscript{210} Consequently, the elasticities of supply and demand for other products must be measured and then employed to estimate the elasticities for the product in question.\textsuperscript{211}

In the mid-1980's the Office of Hearings and Appeals (OHA) was given the task of determining who bore the impact of certain crude oil overcharges.\textsuperscript{212} Among the marginal economic analyses employed in making the determination was the incidence analysis described above.\textsuperscript{213} The OHA concluded that these analyses, which rested upon assumptions and estimations, provided the best possible indication of the extent to which the domestic crude oil refining industry bore the impact of the overcharges.\textsuperscript{214}

\textsuperscript{206} The price elasticity of demand is defined as the percentage change in the quantity demand for a given percentage change in price. Lobel, supra note 14, at 583 n.27.
\textsuperscript{207} See CCH Federal Energy Guidelines ¶ 90,507 & 90,631 (1985) (Stripper Well Litigation).
\textsuperscript{208} Id.
\textsuperscript{209} Id.
\textsuperscript{210} Id.
\textsuperscript{211} Id.
\textsuperscript{212} The Dept. of Energy Stripper Well Exemption Litigation, M.D.L. 378 (D. Kansas)
\textsuperscript{213} CCH Federal Energy Guidelines ¶ 90,631 (1985).
\textsuperscript{214} Id. at ¶ 90,639.
Although the economic analyses were able to accurately estimate the extent of the rise in prices when the refining industry experienced a small crude oil cost increase, the OHA found that the analyses did not provide insight as to how much of the cost was incurred by any particular firm.\textsuperscript{215} To ascertain the extent to which a particular refiner passed on the impact of the overcharges, the OHA noted that “a number of factors specific to the operations of that refiner must be analyzed.”\textsuperscript{216} Unfortunately, the OHA stated that “no methodology that would accomplish analyses of these factors” was known, “and no party in this proceeding has suggested such a methodology.”\textsuperscript{217}

VI. CONCLUSION

In *James B. Distilling Co. v. Georgia*, the United States Supreme Court ruled that when taxpayers pay taxes pursuant to an unconstitutional tax scheme, they are entitled to some form of retroactive relief. The *Beam* Court, however, left the responsibility of determining what relief is appropriate to the state courts.

Prior to *Beam*, courts applied the three prong analysis developed in *Chevron Oil Co. v. Huson* to determine whether a tax ruling adverse to a state on constitutional grounds should be applied prospectively or retroactively. The *Chevron* analysis took into consideration, among other things, the inequity imposed on a state by a retroactive application of the ruling. Accordingly, prior to *Beam*, if the issuance of a refund in a case where a tax scheme was unconstitutional would place a state in a dire financial condition, the court could apply its ruling prospectively. This would have the effect of denying the taxpayer a refund. With *Beam*, courts have no such prerogative and must apply these types of tax rulings retroactively.

With little hope of curtailing the economic disaster that could result from a large, mandatory tax refund, the states will probably assert the pass-on defense. The pass-on defense has been discredited for many reasons — the most important arguably being that it is

\textsuperscript{215} *Id.*

\textsuperscript{216} *Id.*

\textsuperscript{217} *Id.*
too difficult, if not impossible, to prove what amount of the tax was passed on to consumers. Consequentially, the pass-on defense will provide the states little or no help, and the states will probably be forced to provide full tax refunds.

In the shadow of more prominent social and political issues that have appeared in the national headlines, have determined political elections, and have divided the courts, the Beam decision, by way of its financial impact, may silently have the most significant effect on us all.

*Edmund J. Rollo*