The Constitutionality of Retroactive Taxation

The attached is a paper I did as part of my LL.M. in taxation degree at Georgetown. It is 14 years old now and, until this month, I had not looked at it since I handed it into my professor it in 1996. Given the 2010 expiration of the Estate Tax and the current discussions about whether Congress will pass legislation which reinstates the tax retroactively to cover 2010, I thought it might be useful to revisit this paper. The seminal case discussed in this paper is U.S. v. Carlton, 114 S. Ct. 2018 (2004) which addressed the constitutionality of a retroactive tax provision. I believe Carlton will be a key case to any challenge to the retroactive reinstatement of the Estate Tax to cover the year 2010.

One update on the attached paper - With regard to the challenges to the retroactive increase in Estate Tax rates completed by Congress in 1993 discussed therein, at least one court upheld such retroactive increase. See NationsBank of Texas N.A. v. U.S., (2001, CA Fed Cir) 88 AFTR 2d 2001-6580, 269 F3d 1332, *affirming* (1999, Ct Fed Cl) 84 AFTR 2d 99-5001.

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IMPROVING THE DUE PROCESS TEST FOR RETROACTIVE TAXATION

Graduate Seminar: Advanced Estate Planning

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I. Introduction

A. According to the United States Supreme Court, losing $630,000 as a result of retroactive tax legislation, is not harsh and oppressive. That was the Court's holding in *United States v. Carlton.*[1] In the last sixty years the U.S. Supreme Court has given Congress more and more freedom to tax retroactively. The *Carlton* decision extended Congress' power to retroactively tax to a point where it now appears to be virtually unlimited. There is little doubt that the Court will hold that Congress had the power to enact the retroactive tax provisions contained in Clinton's 1993 Budget Bill.[2]

This paper will analyze Congress' power to enact retroactive tax laws, discuss factors that courts should use when testing the constitutionality of retroactive taxes and suggest a standard for the due process test for determining the constitutionality of the retroactivity. The analysis will contain a thorough examination and critique of the most recent decision on retroactive taxation, *United States v. Carlton.* The paper will also test the constitutionality of the retroactive

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[1] *See United States v. Carlton,* 114 S. Ct. 2018 (1994) ("*Carlton*"), and *Carlton* Official Transcript, 1994 WL 665062. At issue in *Carlton* was an estate tax deduction for sales of estate assets to employee stock ownership plans ("ESOP") that was later repealed. The taxpayer in *Carlton* challenged the constitutionality of the retroactive application of the amendment that eliminated the tax deduction for sales to ESOPs after Carlton had sold estate assets to an ESOP at a loss. *Carlton,* 114 S. Ct. 2018. In 1986, when Congress passed the Tax Reform Act, it established a new estate tax deduction tied to an estate's sale of corporate securities to ESOPs. Tax Reform Act of 1986, Pub. L. No. 99-514, ≤1172, 100 Stat. 2085, 2513. Congress failed to specify that the stock would have had to have been owned by the individual before his or her death. Id. Jerry Carlton, as executor of the estate, sought to take advantage of this new deduction by purchasing MCI stock with estate assets and selling it to the MCI ESOP and claiming a $2.5 million estate tax deduction. *Carlton,* 114 S. Ct. at 2021. The sale to the ESOP of the stock resulted in a loss of $630,000. *Id*

[2] On August 10, 1993, President Clinton signed into law his 1993 Budget Bill the Omnibus Budget Reconciliation Act of 1993. Barbara Kircheimer, *President Signs Tax bill; Retroactivity Debate Lingers*, 60 Tax Notes 911, 911 (1993) ("Kircheimer").

estate and gift tax rate increases passed by Congress in 1993 using the due process standard articulated in *Carlton*.

B. Retroactive Taxes Generally

A statute is retroactive if it gives preenactment conduct a different legal effect from that which it would have had without the passage of the statute.[3] As the need for tax revenue increased, Congress has sought new and different ways to increase taxes.[4] Apart from raising revenue, the Government has two primary motivations to apply new tax legislation retroactively. First, is for administrative convenience reasons. It is generally, easier to calculate tax on income if the rates do not shift mid-year. Therefore, if rates are raised mid-year the increase is usually applied retroactively to January 1.[5] Second, and more importantly, the Government has a strong interest in preventing taxpayers from structuring their actions to avoid a tax that is about to be signed into law. To prevent taxpayers from avoiding incoming taxes, Congress often applies new tax legislation retroactively back to the point when the tax legislation was first introduced.

Retroactive taxes, however, may interfere with a taxpayer's ability to plan his or her financial affairs with a degree of certainty and may affect settled transactions. Taxpayers need assurance that they have paid their complete tax bill.[6] Furthermore, after a certain length of time,

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[3]Charles B. Hochman, *The Supreme Court and the Constitutionality of Retroactive Legislation*, 73 Harv. L. Rev. 692, 693 (1960) ("Hochman"). Many prospective statutes will fall within this definition, even though their date of application is not retroactive. Id.
[4]*See Blodgett v. Holden*, 275 U.S. 142 (1927), modified, 276 U.S. 594 (1928); *Untermyer v. Anderson*, 276 U.S. 440 (1928) (Brandeis, J., dissenting) (both cases holding that retroactive application of the first gift tax was unconstitutional).
[5]This is especially true with income taxes and other taxes not on completed transactions.
[6]Hochman, *supra* fn. 3, at 692-93. Hochman gives several other reasons why retroactive legislation is disfavored: 1) the fluctuations of the legislature should not be allowed to harm the people; 2) a stable past is also threatened

taxpayers should be able to feel secure that they have paid all taxes due on their income.[7] It seems especially unjust to retroactively tax settled transactions. Although retroactive taxes impose a burden on the taxpayer, the Government's interest in applying taxes retroactively may justify the imposition of that burden.[8] However, the due process clause of the constitution provides a limit on retroactive tax legislation. This paper discusses the Court's current stance on that limit and suggests an improved due process test for retroactive taxation.

II. Historical Background of Retroactive Taxation

A. The U.S. Supreme Court has generally upheld retroactive tax legislation except for a brief period of time during the 1920's and early 30's. Since 1938 the Court has approved every retroactive tax law that it has confronted.[9] Congress has passed at least fourteen retroactive tax increases.[10] Many experts and commentators believed that the Court would use

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by retroactive legislation; 3) people are guided by the statutes which the Congress passes, and retroactivity disrupts these expectations; 5) retroactivity permits lawmakers to use hindsight and to specifically target who will be affected by the legislation they have passes; and 6) common law supports the proposition that legislation is to be prospective, although the judiciary may have the right to retroactively apply its decisions. Id. Hochman's fifth reason seems particularly applicable to the retroactive tax increases passed by the Clinton Administration. In that legislation, it was known what portion of the population was the target of the retroactive increases.

[7] *See, generally*, Laurens Williams, *Retroactivity in the Federal Tax Field*, 12 U.S.C. Tax. Inst., 79, 81-82 (1960) ("Williams").

[8] *See, e.g., Pension Benefit Guar. Corp. v. R. A. Gray & Co.*, 467 U.S. 717 (1984) (description of case on page 23 of this paper)

[9] Andrew C. Weiler, *Has Due Process Struck Out? The Judicial Rubberstamping of Retroactive Economic Laws*, 42 Duke L.J. 1069, 1070 (1993) ("Weiler")

[10] The Treasury Department has published the following summary of retroactive tax rate increases and their effective dates:

1917: The Revenue Act of 1917 imposed a surtax on individuals and an excess profits tax on corporations. The Act was passed on October 3, 1917 and the rate changes applied retroactively to the 1917 calendar year.

1918: The Revenue Act of 1918 increased individual rates and corporate rates. The Act was passed on February 24, 1919 and the rate increases applied retroactively to the 1918 calendar year.

1935: The Revenue Act of 1935 increased the individual surtax rate and the corporate rate. The Act passed on August 30, 1935. The effective date for this tax was generally prospective, based on a pro ration formula, but for some corporations, it was possible that the rate could have been retroactive from July 30, 1935 to June 30, 1935.

the *Carlton* case to finally draw the line on just how far Congress can go.[11] However, as we now know those experts and commentators were wrong. Congress' power to tax retroactively continues unchecked by the Court.

1936: The Revenue Act of 1936 imposed an undistributed profits tax on corporations. The Act was passed on June 22, 1936 and the tax applied retroactively to December 31, 1935.
1938: The Revenue Act of 1938 altered the distribution of the corporate tax to make the tax more progressive. High income corporations faced a higher tax. The Act was passed on May 28, 1938 and applied retroactively to year beginning after December 31, 1937.
1940: The Revenue Act of 1940 raised corporate rates and imposed a Defense Tax on individuals. The Act was passed June 25, 1940 and was effective retroactively to December 31, 1939. The Second Revenue Act of 1940 added an additional surtax on corporations and an excess profits tax on corporations. The Act was passed October 10, 1940. Both increases were effective retroactively back to December 31, 1939.
1941: The Revenue Act of 1941, passed on September 9, 1941, increased the surtax on individuals and corporation, effective retroactively to December 31, 1940.
1942: The Revenue Act of 1942 increased the normal tax and the surtax on individuals, both retroactive to December 31, 1941. The Act also increased the corporate surtax, again retrospective to December 31, 1941.
1943: The Revenue Act of 1943 increased the excess profits tax on corporations. The Act was not passed until February 25, 1944 and the rate changes applied retroactively to December 31, 1943.
1950: The Excess Profits Tax Act of 1950 imposed an excess profits tax to taxable years ending after June 30, 1950. The Act was approved January 3, 1951.
1951: The Revenue Act of 1951 increased corporate rates both retroactively and prospectively. The rates were increased as of January 1, 1951, with further increases to take effect January 1, 1952. The Act was passed October 21, 1951.
1968: The Revenue and Expenditure Control Act of 1968 imposed a surtax on all taxpayers. For individuals, estates and trusts, the surtax was retroactive to April 1, 1968. For corporations, the surtax was retroactive to January 1, 1968. The Act was passed on October 22, 1968.
1976: Tax Reform Act of 1976 increased the alternative minim tax on individuals from 10 percent to 15 percent. The corporate alternative minimum tax was similarly increased to 15 percent. Both increases were effective after December 31, 1975. The Act was passed on October 4, 1976.
1993: The Omnibus Reconciliation Act of 1993, raised income tax rates for individuals, trusts, estates and corporations . It also raised the tax rates on estates and gifts. The Act was passed on August 10, 1993 and applied the rates retroactively to January 1, 1993.

[11] "The Supreme Court appears ready to reverse nearly 60 years of giving Congress and the states virtually unchecked power to impose taxes retroactively." David G. Savage, *High Court May Reverse Retroactively Imposed Tax*, Los Angeles Times (Home Edition), February 22, 1994, Part A, Page 1, Col. 1 ("Savage"). "Some tax experts are predicting the high court (sic) will use the case to say that Congress finally has gone too far. 'The bottom line is the Supreme Court will hold this retroactive tax unconstitutional,' predicted University of Minnesota law professor Ferdinand Schoettle." Id.

B. Distinctions Among Types of Retroactive Tax Increases

Courts and Congress often draw certain distinctions when analyzing retroactive tax legislation. One distinction commonly drawn is between types of taxes. For instance, retroactive income tax legislation is generally considered to be almost always constitutional while retroactive excise taxes may not be. The Government applies income tax changes retroactively to the first of the year since the Internal Revenue Service ("IRS") cannot easily calculate taxes due if the rates shift mid-year. Thus, allowing retroactive income tax changes eases the burden of tax administration. Retroactively taxing completed transactions is considered to theoretically violate the constitution. And since earned income during the year is not a "completed transaction", it is less offensive to retroactively raise income tax rates. Further, if Congress could not apply the tax change retroactively and were forced to wait until the next January 1 to apply the change, many taxpayers would accelerate income before that date to avoid the new higher income tax. Therefore, there is a strong interest in allowing Congress to apply income tax increases retroactively.

However, this rationale is not as applicable to retroactive increases in estate and gift taxes. The mid-year rate shift administrative convenience argument does not apply to gift and estate taxes since whatever rate was in effect at the time the gift is made or the decedent dies would govern.[12] A gift made or a person's death is a completed transaction and retroactively taxing that upsets settled transactions. A person would not plan their own demise to avoid

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[12] In effect a person's death triggering estate taxes is a "completed transaction". The National Taxpayers Union has argued that tax legislation is unconstitutional when applied retroactively to completed transactions. Savage, *supra* fn. 11.

paying an increase in the estate tax rate that will come into effect the following year. However, a person could make gifts in anticipation of an incoming increase in the gift or estate tax. Therefore, the Government does have an interest in preventing people from making these type of gifts. The general discussion and recommendations in this paper will apply to all types of taxes. But since the standards used by courts and recommended in this paper tend to restrict gift and estate tax legislation more than other types of taxes, the paper focuses on that area.

There are also some administrative difficulties with retroactive excise taxes that do not exist with retroactive income tax increases. These difficulties also apply to some extent to retroactive estate and gift taxes. As a result of these difficulties, Congress tends not to apply excise taxes retroactively. However, Congress is not reluctant to apply estate and gift taxes retroactively.

The problem with applying excise taxes retroactively is that the retroactive tax increase could potentially apply to hundreds of thousands of unrecorded completed transactions. Tracking down these transactions to collect the extra tax would not be cost effective. For example, if Congress increased the excise tax rate on tires and applied it retroactively it would be not be worthwhile to track down all the tire purchases within the period of retroactivity and collect the extra tax due. However, the Government could attempt to collect this extra tax due from the tires dealers. A recent example of this is the ten percent tax on airline tickets that expired December 31, 1995.[13] The tax was not renewed before its expiration because of the Government shutdown. The Government would not renew the tax retroactively to January 1, 1996 and attempt to collect the tax from every airline passenger that flew during the period of

[13] 26 U.S.C. ≤4261 (1995).

retroactivity. However, the Government could attempt to collect the retroactive tax due from the airlines which would leave the airlines with a major tax liability. Currently there is not legislation pending that would apply this tax retroactively. Since excise taxes cover thousands of individuals unrecorded transactions taxing them retroactively presents unique problems. Thus, the Government's general policy of not applying excise taxes retroactively is logical.

Retroactive gift taxation can also affect many unrecorded transactions. For example, if the annual gift exclusion was retroactively lowered to $5,000 this would affect all gifts of between $5,000 and $10,000 made during the period of retroactively. There would not necessarily be any record of these transactions, yet unlike with excise taxes, the Government does not have a policy of not applying gift taxation retroactively. The policy of not applying excise taxes retroactively equally applies to gift taxation.

Courts also distinguish between retroactive tax legislation that affects the rate of an existing tax versus other types of changes. Many judges and legislators believe that changes in tax rates are inherently foreseeable and therefore, taxpayers have "constructive notice" per se that tax rates may change at any time. This reasoning permits courts to disregard any real notice requirement to the taxpayer of the retroactive tax. On the other end of the continuum from changes in tax rates is enacting a retroactive "wholly new tax". The Court still believes that applying a wholly new tax retroactively is unconstitutional. Other types of retroactive tax increases such as closing a deduction fall in between these two extremes. But generally, courts consider the public to be on notice of changes in existing tax regimes.

This paper recommends that generally the due process standard for retroactive taxation should look to see if the taxpayer detrimentally relied on the pre-change tax law and whether his reliance was reasonable. The type of tax at issue or whether the taxpayer's loss resulted from a

new tax, a rate increase of an existing tax, or retroactively closing a tax deduction would be considerations in the court's analysis on whether the taxpayer's detrimentally relied on the pre-change tax law and whether his reliance was reasonable. But drawing bright lines between tax rate increase and other type of tax increases or between income taxes and excise taxes is disingenuous.[14] A taxpayer could lose thousands of dollars by detrimentally relying on an existing tax that is raised retroactively just as he could have relied on the fact that an action was not taxed at all until new tax legislation was enacted. For example, in *Carlton* Congress closed a estate tax deduction retroactively. Changing a tax deduction is considered by courts to be almost the same as raising the rate of an existing tax. Nevertheless, the taxpayer in reliance on the tax deduction entered into a transaction in which he was left with a $630,000 loss after the deduction was retroactively changed. The court should look to see if the taxpayer reasonably would have acted differently if he had known the new retroactive tax legislation was going to be enacted. If he could have, then he detrimentally relied on the old law regardless of the type of tax change that was retroactively made. Thus, a proper standard to test the constitutionality of retroactive tax legislation should be applied equally to all retroactive tax legislation.

[14] If the retroactive tax would apply to thousands of unrecorded completed transaction, such as excise taxes usually are, then the Government would be wise not to apply it retroactively because it would not be cost effective. Nevertheless, retroactive excise tax legislation would not be unconstitutional per se, rather the general test of whether the taxpayer reasonably detrimentally relied on the old law would still apply. For example, if the excise tax rate on tires was increase by 5% and applied retroactively, most individuals could not reasonably establish that they would not have purchased the tires if they would have known of the increased tax rate coming. Nevertheless, it would not be cost effective to attempt to collect this tax from the public.

C. Due Process Clause

The due process clause is the primary argument used to challenge retroactive tax legislation.[15] The Due Process attack stems from the Fifth Amendment of the Constitution

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[15] There are several possible theories a taxpayer can use to challenge retroactive taxation in court. These are: 1) the Ex Post Facto Clause (*Calder v. Bull,* 3 U.S. (3 Dall) 386 (1798)), 2) the due process clause of the Fifth Amendment *(See., e.g., Nichols v. Coolidge,* 274 U.S. 531, 542 (1927)); 3) the Contracts Clause *(See., e.g., Coolidge v. Long,* 282 U.S. 582 (1931)); 4) the Equal Protection Clause of the Fourteenth Amendment *(See, e.g., Welch v. Henry,* 305 U.S. 134 (1938)); and 5) the requirement that direct taxes be apportioned *(See, e.g., Pollock v. Farmers' Loan & Trust Co.,* 157 U.S. 429 (1895)). However, it is now clear that the Court will only consider the due process clause to be a valid challenge to retroactive legislation

1. Ex Post Facto Clause The United States Constitution forbids Congress from passing any "bill of attainer or ex post facto law". U.S. Const. art. I, s 9, Cl. 3. An ex post facto law is one which is "passed after the occurrence of a fact or the commission of an act, which retroactively changes the legal consequences or relations of such fact or deed". Black's Law Dictionary 580 (6th Ed. 1990). This provision seems to explicitly prohibit retroactive tax legislation since it would be "after-the-fact". In 1798, however, the U.S. Supreme Court held that the Ex Post Facto provision in the Constitution only applied to criminal matters. *Calder*, 3 U.S. 386. There is no textual basis for this limitation. Nevertheless, since 1798 the Court has continued to hold that the Ex Post Facto provision is not applicable to civil legislation.

Challengers to retroactive civil legislation no longer raise the Ex Post Facto provision argument. Given Justice Scalia's texualist methodology however, it would be interesting to see how he would rule on this issue. Perhaps Justice Scalia will convince the Court that the Constitution means what it says; no "after-the-fact" laws.

2. Interference With Contracts Another ground for finding retroactive taxes unconstitutional is the Constitution's prohibition of laws which interfere with private contracts. Article 1, ≤10, Clause 1 of the Constitution forbids the States from passing any law that impairs the obligation of contracts. By definition, this constitutional prohibition applied only to the states. The due process clause of the Fifth Amendment may protect the taxpayer from contract impairment by federal legislation, but the standard of review in such cases is more deferential. *Gray,* 467 U.S. 717. Therefore, the Contracts Clause was not applicable to the *Carlton* case discussed *infra* and could not be used to challenged the Clinton Tax Package since the legislation in at issue was federal. Since retroactive taxation may change the benefits parties have received from a fully consummated contract, the Constitution may prohibit retroactive tax statutes. *Coolidge,* 282 U.S. 582. However, despite some early cases, *Welch v. Henry,* 305 U.S. 134 (1938), significantly weakened the power of this challenge to retroactive taxation. In *Welch,* the Supreme Court upheld against constitutional attack a Wisconsin revenue statute which reached back two years to tax previously untaxed corporate dividends. *Id.* at 146. The Court held that the retroactive tax law did not violate the Contracts Clause since taxation is neither a penalty nor a contract liability. *Id.* Generally, retroactive tax legislation can no longer be successfully challenged using the Contract Clause of the Constitution. The taxpayer's Contracts Clause challenge in *Carlton* was dismissed at the District Court level and was not raised on appeal. *United States v. Carlton,* 972 F.2d 1051, 1055 (1992) ("First *Carlton"), reversed,* 114 S. Ct. 2018.

3. Equal Protection Clause A fourth method taxpayers can use to challenge retroactive taxation is the Equal Protection Clause of the Constitution. *Welch,* 305 U.S. at 145. The Fourteenth Amendment precludes States from denying "to any person within its jurisdiction the equal protection of the laws". U.S. Const. amend. XIV. Although this provision is not directly applicable to the federal government, the U.S. Supreme Court has found that actions of the federal government which would violate the Equal Protection Clause if taken by a state violate the due process clause of the Fifth Amendment. See, e.g., *Bollion v. Sharpe,* 347 U.S. 497, 499 (1954) (finding that the D.C. segregation laws violate due process and noting that, although the Fifth Amendment does not contain an equal protection clause, due process requires equal protection). Equal protection issues arise when taxes

which states that no person shall "be deprived of life, liberty, or property, without due process of the law".[16] The Fourteenth Amendment makes this protection applicable to the States.[17]

Tax legislation may be so "arbitrary and capricious" that it amounts to a taking without due process, in violation of the Fifth Amendment.[18] For example, in *Nichols v. Coolidge* Congress attempted to include property transfers that the decedent had made in 1907 as part of her taxable estate.[19] The estate tax at issue was passed in 1919 and applied retroactively to

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are applied retroactively because such legislation, in effect, gives lawmakers hindsight. With hindsight, Congress can target specific groups and individuals to tax. Hochman, *supra* fn. 3, at 693. When taxes are applied retroactively certain individuals or companies are often excepted from the retroactivity. This problems and the arising equal protection concerns are discussed later in this paper. The targeted groups or individuals could theoretically challenge the law since they would have not been given equal protection of the laws.

However the Court in *Welch* announced a test for Equal Protection that virtually all retroactive taxation will pass. *Welch,* 305 U.S. at 145. To determine if a retroactive tax fails to provide equal protection the Court asks whether the object of the tax "falls within a distinct class which may rationally be treated differently from other classes". *Id.* Resulting in a standard that is equal to the same "arbitrary and capricious" standard used in due process analysis. *Id* Since the tax legislation at issue in *Welch* only taxed recipients of corporate dividends who had never previously been taxed, the tax was not "hostile or oppressive" so as to deny equal protection. *Id.* at 146. Three dissenting justices in *Welch* though the act the tax legislation at issue violated the Equal Protection Clause because it was applied retroactively to a small group of select taxpayers. *Id.* The dissenters held that this application of the law was "arbitrary and discriminatory" and denied these citizens equal protection of the laws. *Id.* at 157. In recent attacks on the constitutionality of retroactive taxation, challengers do not raise an Equal Protection Clause attack because of its ineffectiveness. The taxpayer in *Carlton* did not raise an Equal Protection argument. 114 S. Ct. 2018.

4. Unapportioned Direct Tax Retroactive taxes may also be unapportioned direct taxes and in theory violate the of rule of apportionment. *See, e.g., Pollock v. Farmers Loan & Trust Co.,* 157 U.S. 429, 557 (1895). In *Pollock* an income tax was ruled an unconstitutional unapportioned direct tax since it taxed income generated from by real and personal property and was hence, a direct tax. In theory retroactively raising estate and gift tax rates would be an unapportioned direct tax. Taxes become inescapable when Congress assesses them retroactively, and these taxes may then be direct taxes, not taxes on prior events or privileges. *See, generally,* Ballard, *Retroactive Federal Taxation*, 48 Harv. L. Rev. 592, 595 (1935). For example, a tax on U.S. residents' wealth would be a direct tax within the meaning of the constitution. Therefore, it would have to be apportioned by population among the states. When all taxes have been paid, income becomes capital, which, if taxed, is taxed directly and must be apportioned. Id.

However, the U.S. Supreme Court has never adopted the view that a retroactive tax is an unapportioned direct tax. Andrew G. Schultz, *Graveyard Robbery in the Omnibus Budget Reconciliation Act of 1993: A modern Look at the Constitutionality of Retroactive Taxes,* 27 J. Marshall L. Rev. 775 (1994) ("Schultz"). Therefore, this type of challenge to retroactive taxation is now rarely used.

[16] U.S. Const. amend. V.

[17] U.S. Const. amend. XIV. "No State shall . . . deprive any person of life, liberty, or property, without due process of the law . . . ." Id.

[18] *Nichols,* 274 U.S. 531.

[19] *Id.* at 532.

include any transfers that a decedent had made prior to the passage of the act.[20] The Court held that the tax legislation was "arbitrary, whimsical, and burdensome" and, thus, unconstitutional.[21]

However, courts have applied various standards for due process challenges to retroactive taxes and the Supreme Court has become more receptive to retroactive application of economic legislation, especially tax legislation.[22] The test for due process in retroactive tax cases has evolved from requiring actual notice to the taxpayer of the impending new law to not considering the taxpayer at all in the analysis. For example, the Court in *Blodgett v. Holden*[23] struck down as unconstitutional a retroactive amendment to the first gift tax because the taxpayer did not have actual notice of the tax legislation. The amendment was enacted in June 1924 and applied retroactively to January 1.[24] The challenging taxpayer had made gifts during the period of retroactivity and the amended law resulted in substantial gift tax liability.[25]

The Court ruled similarly in *Untermyer v. Andersen*[26] where the same tax legislation was being challenged. In *Untermyer,* the taxpayer had made the gifts at issue in May 1924, however, rather than in January.[27] And even though the bill had been introduced in February 1924 and was debated in Congress until its passage in June, the Court still held for the taxpayer because of his lack of actual notice.[28] The Court held that the tax's application was arbitrary and that Congress acted unreasonably when it taxed a gift made by a taxpayer who did not know the ultimate

[20] *Id.* at 539.
[21] *Id.* at 542.
[22] Weiler, *supra* fn. 9, 42 Duke L.J. at 1070.
[23] 275 U.S. 142 (1927), *modified on other grounds*, 276 U.S. 594 (1928).
[24] *Id.* at 145-46.
[25] *Id.* at 146
[26] 276 U.S. 440 (1928)
[27] *Id.* at 444.
[28] *Id.* at 444-45. The statute was first presented to Congress on February 1924 and passed in the House and Senate on May 25, 1924. *Id.*

applicability of the retroactive tax statute.[29] Constructive notice of the new statute was insufficient to the *Untermyer* Court noting that the "future of every bill while before Congress is necessarily uncertain."[30]

This is to be contrasted with the *Carlton* decision in which the Court focused exclusively on the tax legislation itself rather than on the taxpayer's notice or awareness of the new law. The Government in *Carlton* did not assert that the taxpayer had notice, the Government conceded that the taxpayer entered into the transaction before the IRS or Congress provided any hint that the law would be changed.[31] The Court may have possibly implied notice to Carlton based on a constructive notice theory reasoning that "the law was too good to be true". University of Miami School of Law Professor John T. Gaubatz said that Mr. Carlton should have known he was gambling.[32] "Any really serious tax advisor at that point would have looked at the client and said, 'it appears that the code allows us to [take a fifty-percent deduction for stock sales to ESOPs], but it's too good to be true.' It was too big a giveaway . . ." The *Carlton* opinion, however, did not imply notice to the taxpayer rather, the opinion simply stated that notice to the taxpayer was not necessary to find retroactive tax legislation constitutional. Nevertheless, future retroactive tax challenges can distinguish *Carlton* by arguing that the taxpayer did have notice of the retroactive tax change since the deduction relied upon was "too good to be true". As long as the tax law relied upon by the challenging taxpayer also was not an obvious mistake, this appears to be the best way to distinguish *Carlton*.

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[29] *Id.* at 445.
[30] *Id.* at 446.
[31] *Carlton*, 114 S. Ct. at 2023.
[32] Claudia MacLacklan, *Too Good To Be True*, The National Law Journal, November 22, 1993, Pg. 37.

According to the Court's most recent test, a retroactive economic law satisfies due process if it is "supported by a legitimate legislative purpose furthered by rational means . . . judgments about the wisdom of such legislation remain within the exclusive province of the legislative and executive branches".[33] Furthermore, the Court has stated that when ruling on the constitutionality of retroactive tax legislation the court must consider the nature of the tax and circumstances in which it is laid in determining if applying the tax retroactively is so harsh and oppressive to be unconstitutional.[34] Since 1938 when this particular due process standard was announced, the Supreme Court has never sustained a due process challenge to retroactive tax legislation.[35]

This test is generally akin to what is referred to as the "rational basis" standard of review. Constitutional law provides that there are three basic standards used to test legislation: strict scrutiny, heightened scrutiny[36], and rational basis. Generally, the strict scrutiny and heightened scrutiny standards only apply if the legislation affects a fundamental right or it specifically applies to a protected group of people[37]. Fundamental rights included in this context are extremely limited.[38] The rational basis standard applies to all other kinds of legislation.[39] In

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[33]*Carlton,* 114 S. Ct. at 2022

[34]Weiler, *supra* fn. 9, 42 Duke L.J. at 1070. *United States v. Hemme,* 476 U.S. 558, 568-69 (1986).

[35]Weiler, *supra* fn. 9, 42 Duke L.J. at 1071-72.

[36]Under strict scrutiny that government must show a "compelling" interest and must show that the legislation is narrowly drawn (is the least retroactive means of accomplishing the interest). Under heightened scrutiny (AKA intermediate scrutiny) the government must show a "substantial" or "important" interest and that the legislation actually fits the purpose.

[37]For example, strict or heightened scrutiny would be used if legislation that applies differently to people based upon their race, gender or religion was challenged. See, e.g., *Yick Wo v. Hopkins*, 118 U.S. 356 (1886) (an ordinance was declared unconstitutional since it prohibited laundries in wood building but allowed city official to make exceptions. The exceptions were only granted for non-Chinese people).

[38]Fundamental rights here include: The right to vote, access to courts, right to travel, the right to marry someone of the opposite sex, the right to political candidacy, right to have and raise children, right to use birth control and the right to terminate a pregnancy. See, e.g., *Griswold v. Conn.*, 381 U.S. 479 (1965) (the state had prosecuted a clinic for giving contraceptives to a married couple. The Court held that the constitutional right to privacy included that right to use birth control).

order to satisfy the rational basis standard it is not necessary that the government establish that the legislation is narrowly tailored to accomplish the legislative goal. It is only necessary to show that the legislation might accomplish the legislative purpose. If the goal is to raise tax revenue it is therefore, only necessary that the government show that the tax legislation may possibly raise revenue. It is does not matter if there are less offensive alternatives to raise needed revenue.

In the early 1930s before the Court adopted its current standard for retroactive taxation it struck down retroactive tax legislation as violative of the due process clause of the Constitution. Specifically, in the companion cases of *Helvering v. Helmholtz*[40] and *White v. Poor*[41], the Court held that tax legislation could not be retroactively applied to irrevocable trusts since they were settled transactions. In both these cases before the enactment of the tax legislation at issue, the decedents conveyed much of their property into an irrevocable trust for the benefit of themselves and their family in a non-taxable transaction.[42] The Court held that since the irrevocable trusts had been created before enactment of the new tax law, applying the new tax to the trusts would upset settled transfers and be unconstitutional.[43]

The Court later negated this precedent in *Welch v. Henry*[44] which lowered the due process standard for retroactive tax legislation. The Court announced a test that is similar to the Court's current test to determine whether retroactive tax legislation was so harsh and oppressive as to violate due process and be unconstitutional; a court was to consider the nature of the tax and the

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[39] *Railway Express Agency v. N.Y.*, 336 U.S. 106 (1949).
[40] 296 U.S. 93, 97-98 (1935)
[41] 296 U.S. 98, 102 (1935)
[42] *White*, 296 U.S. at 99.
[43] *White*, 292 U.S. 98, *Helvering*, 296 U.S. 93.
[44] 305 U.S. 134 (1938)

circumstances in which it is laid.[45] The legislation in *Welch* was an Wisconsin income tax on dividends received from a specified category of corporations previously exempt from such taxation. The legislation was applied retroactively over a two year period to meet the dire need for unemployment relief during the Great Depression. The retroactivity, however, was challenged under the due process clause of the constitution. Applying their new test, the Court found that the nature of the tax in question could not reasonably have affected a taxpayer's actions: "We cannot assume that stockholders would refuse to receive corporate dividends even if they knew that their receipt would later be subjected to a new tax or to the increase of an old one."[46]

Presumably, one would not refuse to receive income just because his or her income tax rates were increased.[47] However, as will be seen this argument does not apply to the transaction in *Carlton*. The taxpayer in *Carlton* would not have engaged in a transaction losing $630,000 if he had known of the upcoming change in the law eliminating the deduction.

In the past fifteen years, the U.S. Supreme Court has decided four cases where the constitutionality of retroactive tax legislation was the central issue.[48] All four indicate that the Court considers due process the only remaining viable ground on which to attack retroactive taxes.[49] Furthermore, the four decisions do not offer much guidance on when a retroactive tax

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[45] *Id.* at 148

[46] *Id.* at 148

[47] This is a common argument made when upholding retroactive increases in income tax rates to January 1. ". . .even if a taxpayer knows of a change in income tax rates, it can be assumed he would not refuse to receive the income. Hochman, *supra* fn. 3, at 706-07. However, only income received from one's occupation applies to this argument. Capital gain income does not since when it is recognized is controlled by the taxpayer.

[48] *Carlton*, 114 S. Ct. 2018, *United States v. Darusmont*, 449 U.S. 292 (1981), *Gray*, 467 U.S. 717, *Hemme*, 476 U.S. 558.

[49] *See Darusmont*, 449 U.S. at 298. The Court reiterated its holding in *Welch* that taxation cannot be considered a contract liability or a penalty. *Id.* This appears to restrict attacks on Ex Post Facto and contract impairment grounds. Nonetheless, retroactive taxation is still occasionally attacked (unsuccessfully) on grounds other than the due

provision violates due process. Next this paper will analyze the *Carlton* decision and compare it with these other retroactive tax cases decided by the Court.

D. Analysis of *United States v. Carlton*

1. *Facts*

The *Carlton* case stems from Willametta Day's death in 1985. The executor of Day's will, Jerry Carlton, received a six-month extension for filing the estate tax return. With the extension, the return was due in December 1986.[50] In the interim, Congress enacted the Tax Reform Act of 1986 that added certain estate-tax deductions for returns filed after October 22, 1986. The statute added a provision that allowed a deduction of one-half the proceeds of any sale of employer securities by the executor of an estate to an ESOP.[51]

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process clause. See, e.g., *Licari v. Commissioner,* 946 F.2d 690 (9th Cir. 1991) (holding that the retroactive increase in monetary penalty for questionable deductions did not deny equal protection).

[50]The government did not challenge the validity or propriety of the filing extension.

[51]Tax Reform Act of 1986, Pub. L. No. 99-514, ≤1172, 100 Stat. 2085, 2513. As originally enacted, ≤2057 provided in part:

> (a) General Rule.--For purposes of the [estate tax], the value of the taxable estate shall be determined by deducting from the value of the gross estate an amount equal to 50% of the qualified proceeds of a qualified sale of employer securities.
> (b) Qualified Sale.--For purposes of this section, the term "qualified sale" means any sale of employer securities by the executor of an estate to--
>> (1) an employee stock ownership plan . . . or
>> (2) an eligible worker-owned cooperative.
>
> (c) Qualified Proceeds.--For the purposes of this section--
>> (1) *In general.*--The term "qualified proceeds" means the amount received by the estate from the sale of employer securities at any time before the date of which [the estate tax return] is required to be filed (including any extensions).

"Employer securities" is defined as common stock issued by the employer and readily tradable on an established securities market. I.R.C. ≤409(1).

Jerry Carlton used funds from the Day estate to buy 1.5 million shares of MCI stock for $11.2 million, and two days later sold all the shares purchased to the MCI ESOP for $10.56 million. Jerry Carlton then claimed a $5.28 million deduction on the estate tax return which reduced the estate tax due by $2.5 million.[52]

The next month, on January 5, 1987, the IRS issued a notice announcing that it was seeking to fix this unintended "loophole" in the 1986 Tax Act by making it clear that the deduction for selling securities to an ESOP is only available to estates of people who owned the securities before they died.[53] The IRS argued that this had been the intent of the provision all along. The deduction provision at issue was available for less than three months before the IRS gave notice of its intent to seek to revise the section.

The parties in *Carlton* disputed whether the tax deduction provision for sales to ESOP was actually a mistake or a "loophole". Jerry Carlton argued that the intent was to allow ESOPs to be able to purchase stock at bargain prices.[54] The government argued the provision was mistakenly drafted and Congress never intended to allow decedents' estates to purchase stock after they had died and then sell the stock to an ESOP for a deduction. Two days after Jerry Carlton completed the sale to the MCI ESOP, an article in the *Wall Street Journal* noted that "this application of the statute would be the tax loophole you could drive a truck through".[55]

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[52]After the deduction, the net estate tax paid by Carlton was $18.7 million.
[53]On January 5, 1987, the IRS issued an advance version of Notice 87-13, which stated, inter alia, that "pending the enactment of clarifying legislation, the IRS would not recognize a deduction pursuant to ≤2057 unless the decedent had directly owned the securities before death." First *Carlton*, 972 F.2d at 1054. Notice 87-13 was formally published on January 26, 1987. *Id.*
[54]As a result of Jerry Carlton's transaction the MCI ESOP received $631,000 more in stock than it could have purchased on the open market. Nevertheless, a $2.5 million loss in estate taxes for a $630,000 gain to an ESOP would not seem to be what Congress intended.
[55]Allan Murray and Jeffrey H Birnbaum, *New Loophole May Help Many Beat Estate Tax*, The Wall St. J., Dec. 31, 1986, 1986 WL-WSJ 238631. The article quoted Martin Nissenbaum, a senior manager at Ernst & Winney as saying "[t]his is the loophole you could drive a truck through".

Furthermore, when this deduction was originally added Congress estimated that it would result in lost revenues of about $300 million[56] but after the tax legislation at issue was enacted, Congress determined that the Government would actually lose up to seven billion dollars in revenues as a result of the deduction.[57] The Court appeared to side with the Government in holding that the provision was a mistake.[58]

Nonetheless, the text of the statute was not ambiguous; it permitted Jerry Carlton to act just as he did. The language permitted a deduction for 50% of the value of stock sold to ESOPs by an estate.[59] There was no mention of a requirement that the stock be owned by the decedent prior to death.[60]

2. <u>The Ninth Circuit's *Carlton* Opinion</u>

The Ninth Circuit in *Carlton* held that the retroactive legislation by Congress was unconstitutional.[61] The Circuit Court struck the legislation down holding it was unduly harsh and oppressive. More specifically, the court stated that a retroactive tax law was unconstitutional if citizens had no actual or constructive notice of the new law or relied to their detriment on the law as currently written.[62] The court found that Jerry Carlton did not have any notice, actual or

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[56] *Carlton,* 114 S. Ct. at 2022.
[57] *Id.*
[58] "It seems clear that Congress did not contemplate such broad applicability of the deduction . . ." *Carlton,* 114 S. Ct. at 2018. As the Justices noted at oral argument, with the deduction as originally written, a huge estate could theoretically eliminate all tax liability. For example, if a $20,000,000 estate (estate tax due of $10,640,800) purchased $40,000,000 in MCI stock on margin on the open market and then sold it to the ESOP for the same price, under the "loophole" provision, the gross estate would be valued at $0 ($20,000,000-(50% of $40,000,000) and no estate tax would be due. It would seem highly unlikely the Congress would have intended this possible result.
[59] Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986). See fn. 52 *supra,* for text of statute.
[60] Id.
[61] First *Carlton*, 972 F.2d at 1059.
[62] *Id.*

constructive, of the proposed new law at the time he completed the MCI stock sale to the ESOP, and he had relied on the tax deduction provision creating a loss of $630,000.[63]

The test used by the Ninth Circuit required the taxpayer's reliance be reasonable and found that Carlton's actions met this element. Other counts using the same standard could have concluded that Carlton's reliance on the deduction as written was not reasonable. A loophole that could allow a person to totally eliminate all estate tax just to encourage ESOP funding appears questionable. Thus, the Supreme Court could have agreed with the Ninth Circuit's test and yet using the reasonable reliance requirement still upheld the retroactive legislation used to fix the mistake in the tax law. Nonetheless, in reversing the Ninth Circuit, the Supreme Court's opinion did not state that it found Carlton's reliance to have been unreasonable.

3. The Supreme Court's Holding

The U.S. Supreme Court reversed the Ninth Circuit stating that it had erroneously focused "exclusively on the taxpayer's notice and reliance".[64] The Court found that the Ninth Circuit had used an "unduly strict standard" and upheld the tax law using the rationally related test.[65] Justice Blackmum concluded that the tax legislation was constitutional since it was "rationally related to a legitimate legislative purpose."[66] The due process standard to be applied to tax statutes with retroactive effect is the same as that generally applicable to retroactive economic legislation:

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[63] *Id.* at 1062.
[64] *Carlton*, 114 S. Ct. at 2024.
[65] *Id.*
[66] *Id.*

> Provided that the retroactive application of a statute is supported by a legitimate legislative purpose furthered by rational means, judgment about the wisdom of such legislation remain within the exclusive province of the legislative and executive branches . . [the] burden is met simply by showing that the retroactive application of the legislation is itself justified by a rational legislative purpose.[67]

The Court held that raising revenue was a legitimate purpose.[68] The logical conclusion from this is that if the purpose of any retroactive tax legislation is to raise revenue, it is constitutional under the *Carlton* test. In his concurring opinion, Justice Scalia stated that the Court's reasoning "guarantees that all retroactive tax laws will henceforth be valid."[69] Although this may be a slight exaggeration, except for two limitations discussed below, Scalia is probably correct.[70]

Prior to the Supreme Court's decision in *Carlton,* the Court used the same test for due process as the Ninth Circuit Court of Appeals did in holding the tax legislation in *Carlton* unconstitutional; whether the legislation is "harsh and oppressive".[71] However, in the *Carlton* decision the Court announced that the "harsh and oppressive" standard did not differ from the rational basis review standard that is applied to economic legislation.[72] This may be a change in the Court's test for retroactive tax legislation.[73] Contrary to the Court's claim in *Carlton*, the "harsh and oppressive" standards and the "rationally related" standard are not the same.[74] The "harsh and oppressive" standard considers the effect of the retroactive legislation on the

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[67]*Id.* at 2022.
[68]*Id.* at 2025 & 2027.
[69]*Id.* at 2027.
[70]During oral arguments Justice Souter stated to the Government's attorney: "We can't seem to think of an example that would ever run afoul of your rule. What you are arguing is, as long as there is some public purpose to what Congress intended to do, then there is no limit." The Court (including Justice Souter) went on to hold that the Government's rule was correct. *Carlton* Official Transcript, 1994 WL 665062, pg. 14.
[71]*See, e.g., Welch,* 305 U.S. at 147. Burton, *The Constitutionality of Retroactive Changes to the Code: United States v. Carlton,* 48 Tax Lawyer 509, 511-12 (1995) ("Burton").
[72]*Carlton,* 114 S. Ct. at 2022.
[73]Burton, *supra* fn. 71, 48 Tax Lawyer at 514.
[74]Id. at 513.

tax on the sale of Plaintiff's home.[80] The Act was signed into law on October 4, 1976, and was retroactive to January 1, 1976.[81] The sale of the taxpayer's home was in July 1976 which was within the period of retroactivity.[82] The taxpayer argued that three factors were important to determine if the law violated The due process clause. These were: 1) whether the taxpayer has notice of the change at the time of the transaction; 2) whether, if the taxpayer had been given notice, he could have altered his behavior accordingly; and 3) whether the tax was a new tax or just a rate change of an existing tax.[83]

The *Darusmont* Court held that retroactivity was permissible, at least with respect to income tax statutes, to cover transactions made during the enactment process or even those made within the calendar year in which the statute was enacted.[84] The Court did not state that notice to the taxpayer was required, but nevertheless found that notice existed since the changes in question had been under discussion for over a year prior to the Act's passage.[85] The Court did not consider the taxpayer's ability to alter his behavior if given notice of the change.[86] Additionally, the Court held that the Taxpayers had failed their own three factor test, since the tax law at issue was not a wholly new tax.[87]

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[80]*Id.* at 295. The tax at issue was the minimum tax.
[81]*Id.* at 294-95.
[82]*Id.* The taxpayer had been transferred by his employer and under the tax laws that existed at the time he sold his house, he owed no minimum tax on the sale. *Id.* at 294. The retroactive application of the tax legislation at issue resulted in a tax liability of $2280. *Id.* at 295.
[83]*Id.* at 299. The Court appears to have assumed the test to be whether a tax is "so harsh and oppressive as to be a denial of due process". *Id.* This test is the same as the one used in *Welch* that retroactive tax must be "so harsh and oppressive as to transgress the constitutional limitation. 305 U.S. at 147.
[84]*Id.* at 297-98.
[85]*Id.* at 299. The Court stated that the proposed changes had been under public discussion for over a year before enactment. *Id.*
[86]*Id.* at 299.
[87]*Id.* at 300. The minimum tax had been in force since 1969, and the 1976 changes merely decreased the amount of exemption and increased the tax rate. *Id.*

taxpayer, while the "rationally related" standard only considers Congressional justification for the statute.[75]

Justice Scalia's concurring opinion in *Carlton* was critical of the majority's test for due process.

> "Although there is not much precision in the concept 'harsh and oppressive,' which is what the Court has adopted as its test of substantive due process unconstitutionality in the field of retroactive tax legislation, . . . surely it would cover a retroactive amendment that cost a taxpayer who relied on the original statute's clear meaning over $600,000.[76]

Scalia also pointed out the stark discrepancy between the Court's due process test used in *Carlton* and the due process test the Court uses for "so-called fundamental rights" and accused the Court of policymaking.[77] Scalia nonetheless agreed with the Court's holding since he believes that the Constitution does not guarantee citizens "substantive due process".[78]

E. Other Recent Retroactive Tax Cases

1. In addition to *Carlton,* there are three other retroactive tax cases decided by the Supreme Court after 1980. In *Darusmont*[79], the oldest case of the three, the taxpayer challenged the constitutionality of a provision of the Tax Reform Act of 1976 which increased the amount of

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[75] Id.
[76] *Carlton,* 114 S. Ct. at 2026.
[77] *Id.* at 2027. "The picking and choosing among various rights to be accorded 'substantive due process' protection is alone enough to arouse suspicion; but the categorical and inexplicable exclusion of so-called 'economic right' (even though the due process clause explicitly applies to 'property') unquestionably involves policy making rather than neutral legal analysis." *Id.*
[78] *Id.*
[79] *Darusmont,* 449 U.S. 292.

The Court in both *Darusmont* and *Carlton* failed to consider the taxpayer's ability to alter his or her behavior given notice of the tax. There are, however, several crucial distinctions between *Carlton* and *Darusmont*. In the latter, the taxpayer "conceded . . . that when he was considering the various ways in which he could dispose of his Texas property, he was not aware of the existence of the minimum tax".[88] The *Darusmont* Court observed that the taxpayer was "hardly in a position to claim surprise at the 1976 amendments to the minimum tax".[89] Therefore, the *Darusmont* taxpayer failed his own proposed test for due process. Both the notice and taxpayer reliance elements were not met. The Court's decision in *Darusmont* was proper.

These same facts did not exist in *Carlton.* The Court did not conclude that Jerry Carlton had notice and in fact it was not suggested by any party to the lawsuit that he had notice.[90] Secondly, the pre-change tax law in *Carlton* actually induced the taxpayer to engage in a transaction which led him to lose $630,000. This was not the case in *Darusmont*. There the taxpayer admitted that at the time they sold their house they did not know of the minimum tax provision.[91] Because of this fact, *Darusmont* should not have been used to support the Court's decision in *Carlton.*

2. After *Darusmont,* the next case the Court decided which dealt with retroactive taxation was *Pension Benefit Guar. Corp. v. R. A. Gray & Co.*[92] Here the Court shifted its focus from the effects on the taxpayer to the purpose of the legislation. The Court found that the Multi-employer Pension Plan Amendments Act of 1980 ("MPPAA") did not violate due process

[88]First *Carlton,* 972 F.2d at 1051, citing *Darusmont,* 449 U.S. at 295. The taxpayer in *Darusmont* may have choose to rent his house out instead of selling it, if he had known he would be subject to higher taxes on it sale.
[89]First *Carlton,* 972 F.2d at 1058.
[90]The Government's only notice argument was that the taxpayer should have known the law would be changed since it was "too good to be true."
[91]*Darusmont,* 449 U.S. at 295.
[92]467 U.S. 717 (1984).

where it was applied retroactively to eliminate taxpayer evasion during the enactment process.[93] Under the MPPAA, Congress required employers to pay a sum of money to the Government if the employer withdrew from a pension plan.[94] Congress applied the act retroactively to the five month period preceding final passage of the Act to prevent taxpayers from avoiding the mandatory contribution by withdrawing the money during the law's enactment period.[95] The Court held that due process was not violated since the purpose of the retroactivity was to prevent taxpayer evasion during the interim period between proposal and enactment.[96] The Court also held that retroactive tax legislation does not violate due process where its application is based on a legitimate legislative purpose furthered by rational means.[97]

Unlike *Darusmont*, the *Gray* decision did not address the concerns of the taxpayer.[98] It only looked at Congressional justification for the retroactive application of the legislation. Retroactive tax cases since *Gray* have continued to utilize the "legitimate legislative purpose furthered by rational mean" test for due process.

The tax legislation, however, in the *Gray* case was less egregious to the taxpayer than that at issue in *Carlton*. *Carlton* relied on existing law before any announcement that it would be changed and he lost $630,000.[99] Applying a tax statute retroactively between the time of an act's

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[93] *Gray*, 467 U.S. 717.
[94] *Id.* at 725.
[95] *Id.* at 723.
[96] *Id.* at 734. The Court also rejected the taxpayer's Contract Clause violation claim since it was federal legislation. *Id.* at 733.
[97] *Id.* at 730.
[98] The Court would not consider a test which emphasized the concerns of the taxpayer. The Justices rejected the test set forth in *Nachman Corp. v. Pension Benefit Guar. Corp.*, 592 F.2d 947 (1979), *aff'd on statutory grounds*, 446 U.S. 359 (1980), which examined four factors when analyzing retroactive legislation: 1) reliance by the parties; 2) the amount of prior legislative activity in the area; 3) the equities of imposing the legislative burdens and; 4) the degree to which transitional provisions moderate the effects of the legislation. *Gray*, 467 U.S. at 727.
[99] Congress could have closed the loophole in *Carlton* equitably by providing a tax credit to taxpayers that utilized the deduction and lost money. Doing this, would have given the estate in *Carlton* a $630,000 (plus transactional costs) credit against estate taxes due to offset the loss from the transaction. By doing this, Congress would have

passage to the time its proposal to prevent taxpayer evasion is a laudable goal. Retroactivity serves a specific purpose, to prevent tax avoidance. The purpose of the retroactive legislation in *Carlton* may have been to fix a mistake.[100] Therefore, one can argue that it was similar to *Gray*. But if the purpose of the retroactivity was to raise revenue, this does not seem to rise to the legitimacy of preventing taxpayer evasion. And, indeed, the Court in *Carlton* held that raising revenue was in fact a legitimate reason for applying a tax law retroactively.[101] This part of the Court's holding eliminates any substance from the "legitimate legislative purpose" test. Preventing taxpayer evasion is a legitimate legislative purpose, raising revenue in a non-crisis situation is not.

The *Gray* retroactive provision applied back to the time the Act was first proposed, thus, one can imply constructive notice of the legislation.[102] The period of retroactivity in *Carlton* reached back beyond the date when the retroactive amendment was first announced.[103] Therefore, although notice can be implied in *Gray* it can not be in *Carlton*.

In sum, the *Gray* opinion is an example of a correctly reasoned and decided retroactive tax challenge. The period of retroactivity did go beyond the date when the retroactive tax law was proposed. The purpose of the retroactivity was to prevent taxpayer evasion in anticipation of an upcoming new tax law. The taxpayer had constructive notice of the new law, and did not detrimentally rely on the prior law. At least three of these four factors did not exist in *Carlton*. The period of retroactivity had no relation to when the new legislation was proposed, therefore,

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eliminated Jerry Carlton's detrimental reliance argument and made the retroactive law constitutional under almost any standard.

[100] *Carlton*, 114 S. Ct. at 2023.

[101] *Carlton*, 114 S. Ct. at 2024. "Retroactive application of revenue measures *is* rationally related to the legitimate governmental purpose of raising revenue". *Id.* at 2025 (emphasis added).

[102] *Gray*, 467 U.S. at 723.

[103] First *Carlton*, 972 F.2d at 1059.

the taxpayer had no notice of the impending change in the law. Additionally, Jerry Carlton relying on the old law, lost $630,000. It can be argued that a purpose was to prevent taxpayer evasion. But it can hardly be argued that the *Carlton* taxpayer (and any similar situated) was engaged in taxpayer evasion. He relied on the plain unambiguous text of the statute in effect at that time. He did not engage in the transaction knowing of an impending change in the law. Neither Congress nor the IRS had given any indication that the law would be changed in the future.[104] Therefore, the retroactivity in *Carlton* was, as the Court said, to raise revenue not to prevent taxpayer evasion.

3. The most recent retroactive tax case decided by the Court prior to *Carlton* was *United States v. Hemme*.[105] The taxpayer in *Hemme* was challenging a retroactive provision in the Tax Reform Act of 1976.[106] Prior to the Tax Reform Act of 1976, the estate and gift taxes were separate and distinct taxes.[107] A taxpayer had been allowed a $30,000 lifetime deduction on gifts made during his or her lifetime, which the taxpayer could claim at any point in his or her life.[108] Taxpayers were also able to deduct $60,000 from the value of their estates before paying an estate tax.[109] The Tax Reform Act of 1976 eliminated these two deductions but allowed instead a "unified credit".[110] The retroactive provision being challenged reduced the unified credit which a taxpayer could claim by 20% of the gifts claimed under the old gift tax

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[104]First *Carlton*, 972 F.2d at 1059.
[105]467 U.S. 558 (1986).
[106]*Id.* at 561.
[107]*Id.* at 560.
[108]*Id.*
[109]*Id.*
[110]*Id.* at 560-61.

deduction.[111] The taxpayer claimed that the Tax Reform Act of 1976 violated due process because the Act had reduced his tax deduction based on gifts made prior to the statute.[112]

In *Hemme*, the Court switched its focus back to the taxpayer rather than just on Congressional justification for retroactive legislation. "One of the relevant circumstances is whether, without notice, a statute gives a different and more oppressive legal effect to conduct undertaken before enactment of the statute."[113] The taxpayer had made gifts three years prior to his death.[114] Before the unification of the gift and estate tax the taxpayer could have claimed his $30,000 one time specific gift tax exemption as he did and had no tax liability for the gift.[115] However, since he died within three years of the gift, another Code section in effect at that time, ≤2035, would have required those gifts to be included in the taxpayer's estate and thus, he would have not be able to utilize the $30,000 lifetime gift tax exclusion.[116] Therefore, even if the tax law was not retroactively changed the taxpayer could not have utilized the gift exemption. Congress had enacted ≤2035 in order to prevent taxpayers from avoiding the estate tax by making gifts in contemplation of death.[117] In his challenge to the retroactive tax legislation the taxpayer in *Hemme* compared his situation not to that of another taxpayer subject to ≤2035, but

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[111] *Id.* at 562.
[112] *Id.* at 561.
[113] *Id.* at 569.
[114] *Id.* at 563. The taxpayer made gifts totaling $45,000 to five people and died just over two years later. *Id.* The first $15,000 consisted of five gifts of $3,000 each all exempt from taxation by virtue of a statutory annual exclusion from gift tax. *Id.*, See 26 U.S.C. ≤2503(b) (1970 ed.). The remaining $30,000 of gift was initially exempt from tax as a result of the lifetime specific gift tax exemption. *Hemme*, 476 U.S. at 563.
[115] *Hemme*, 476 U.S. at 563.
[116] *Id.* at 563, 569.
[117] *Id.* at 569. Congress required that gifts made in contemplation of death to be included in the amount of the gross estate in order to forestall any temptation to make deathbed transfers to avoid estate taxes. *Id.* Gifts made within three years of the donor's death would be deemed to have been made in contemplation of death unless the estate could establish otherwise. 26 U.S.C. ≤2035(b) (1970 ed.). The Court did not consider the fact that the taxpayer in *Hemme* might have been able to rebut this presumption.

to that of a person who did not die within three years of making the gift.[118] The Court held that the retroactive application of a tax legislation being challenged did not offend due process where the taxpayer suffered no net detriment from the retroactive enactment.[119].

Hemme correctly focused on the taxpayer. It is not unjust to uphold the constitutionality of a retroactive tax statute when the taxpayer suffers no detriment under the new statute. In *Carlton*, however, the taxpayer lost $630,000 as a result of the retroactive legislation. Therefore, in order to uphold the statute in *Carlton,* the Court did not consider the taxpayer as it did in *Hemme,* but rather, switched its focus back to Congressional justification for the legislation.

III. Current Test for Due Process and Recommendations

A. The Current Test

The *Carlton* Court stated that whether the retroactive legislation was arbitrary and capricious was irrelevant, as long as the law was for a legitimate legislative purpose furthered by rational means.[120] "Tax legislation is not a promise, and a taxpayer has no vested right in the Internal Revenue Code."[121] As said previously, the Court s did not consider notice of the tax law's retroactive changes to Jerry Carlton a requirement in testing the law's constitutionality. The Court did not attempt to establish a "constructive" notice date, or imply notice to Jerry Carlton. It merely ignored notice to the taxpayer of the changes as a requirement for a law's

[118] *Id.* at 570-71.
[119] *Id.* at 571.
[120] *Carlton,* 114 S. Ct. at 2022.
[121] *Id.* at 2023.

constitutionality.[122] . . . [W]e do not consider . . . Carlton's lack of notice regarding the 1987 amendment to be dispositive".[123]

In *Ferman v. United States*[124], the taxpayer brought an action similar to *Carlton*. Like Carlton, Ferman as executrix purchased stock on the open market after the taxpayer had died and sold it to an ESOP in order to take advantage of the estate tax deduction in ≤2057.[125] This transaction resulted in about a $50,000 loss to the estate.[126] However, unlike *Carlton* the executrix in *Ferman* purchased the stock on the market after the IRS published a news release indicating that the Service would not recognize the deduction for sales of stock to ESOPs unless the decedent owned the stock prior to death.[127] The court held that the IRS notice reasonably forewarned the executrix of the upcoming amendment and therefore, the tax legislation satisfied the due process test.[128] Given the appearance that the deduction was a mistake and the IRS notice, it seems fair to apply the tax legislation retroactively to cover the transaction in *Ferman*. In essence, Ferman's reliance on the deduction after the notice was not reasonable.

Detrimental reliance also was not a factor in the *Carlton* Court's analysis. "Although [Jerry] Carlton's reliance is uncontested . . . and the reading of the original statute on which he relied appears to have been correct . . his reliance alone is insufficient to establish a constitutional violation."[129] Given the facts of *Carlton* in order for the Court to uphold the retroactive tax

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[122]The Court may have implied notice to the taxpayer based on the "the law was too good to be true" constructive notice theory.
[123]*Carlton,* 114 S. Ct. at 2023.
[124]993 F.2d 485 (5th Cir. 1993)
[125]*Id.* at 487.
[126]*Id.*
[127]*Id.* Notice 87-13 was published on January 25, 1987 and the executrix purchased the stock on February 20-24, 1987.
[128]*Id.* at 491.
[129]*Carlton,* 114 S. Ct. at 2023.

legislation it did not use detrimental reliance as a factor in the test for constitutionality.[130] The *Carlton* taxpayer had, acting on the clear unambiguous language of the statute and without any notice of future changes in the law, purchased stock and sold the same stock two days later for a loss of $630,000, in order to take advantage of a $2.5 million deduction. The MCI ESOP would probably not have purchased the stock from Jerry Carlton without the discount on the shares resulting in the $630,000 loss. After the transaction was complete, Congress retroactively changed the tax law, denying the taxpayer the $2.5 million deduction, but leaving him with the $630,000 loss. Jerry Carlton detrimentally relied on the pre-change resulting in a loss of $630,000.

After the *Carlton* opinion the current test for retroactive tax is whether the legislation is rationally related to a legitimate legislative purpose. It is not necessary to consider notice of the new law to the taxpayer nor the laws effect on the taxpayer.

In addition to not providing taxpayers with the necessary due process protection against unconstitutional retroactive taxation, the Court's current test also increases the effect that lobbyists can have on tax legislation. If Congress is given almost full deference to pass retroactive taxation then taxpayers or groups of taxpayers with effective lobbyists will be better able to escape the retroactivity of the law. On the other hand, if the due process test used took into account the taxpayers' detrimental reliance and notice as suggested, taxpayers without lobbyists would not be at such a disadvantage. For example, in 1993 when the Administration

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[130] The Court discussed detrimental reliance somewhat at oral argument. From the colloquy it appears that the Court just does not consider $600,000 to be much detriment. Court: "And you say $600,000 is harsh and oppressive? . . . if--the $600,000 is balanced against the extent of this . . . estate . . .I mean, to get such an advantage, it seems that $600,000 really wasn't a whole lot--wasn't a very large loss. *Carlton* Official Transcript, 1994 WL 665062, Pg. 31-32. Apparently, the Court measured the $600,000 loss against the attempted $2.5 million deduction and the estate of over $18 million and determined that $600,000 is a relatively small number.

attempted to retroactively remove a tax break for companies emerging from bankruptcy protection, a coalition of banks and accounting firms lobbied hard to protect the tax break.[131] They succeeded; the legislation's effective date was changed to prospective rather than retroactive. Also in 1989 First Interstate Bank and Chemical Bank each were rewarded for their extensive lobbying efforts by being exempted from a new holding company regulation.[132] And finally, in the early eighties lobbyists were successful in preventing the retroactive application of new restrictions on private-purpose tax-exempt bonds.[133] The lobbyists here were the well-healed municipal bond dealers as well as state and local governments.

Taxpayers without a special interest group representing their interests may not be able to prevent Congress from taxing them retroactively. But if the Court used a due process standard that actually limited Congress' power to tax retroactively, companies and politically savvy taxpayers would no longer have this advantage.

B. 1993 Retroactive Tax Legislation

On August 10, 1993, President Clinton signed into law his 1993 Budget Bill, the Omnibus Budget Reconciliation Act of 1993 ("Clinton's Tax Package" or "1993 Act"). The 1993 Act created new upper brackets for estate, gift and income taxes. Specifically, under Clinton's Tax Package, two additional estate and gift tax rates were added: a 53% rate applicable

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[131] Kathleen M. Berry, Investor's Business Daily, Page 4 (August 17, 1993)
[132] Lisa Dunlap, Houston Business Journal, Vol 18, No 48, Sec. 1, Pg. 1 (May 8, 1989)
[133] Craig T. Ferris, The Bond Buyer, Pg. 1 (November 22, 1983)

to gross estates over $2,500,000 and a 55% rate applicable to gross estates over $3,000,000.[134] These rates were applied retroactively to January 1, 1993.[135]

The estate tax rates and brackets in Clinton's Tax Package were the same as they were between 1983 and December 31, 1992, however the 53-55% top rates expired on December 31, 1992. Clinton's Tax Package, just made the 53-55% rates permanent beginning January 1, 1993.[136] Therefore, with the retroactivity, the 53-55% rates never lapsed. The people affected by the challenged retroactivity are decedents with estates over $2,500,000 that died between January 1 and August 10, 1993. This legislation was in effect only a change in the tax rates. And as discussed previously, many courts imply notice to all taxpayers of possible changes in tax rates. Therefore, a taxpayer could not claim lack of notice or detrimental reliance on the old lower rates.

Although a test that provides the taxpayer with more due process protection should be used by the courts, the Government's interests must be considered as well. Generally, the Government's interests are administrative convenience of tax collection and preventing tax evasion. Banning all retroactive tax increases would make tax collection more difficult for the IRS. If Congress could not apply tax legislation retroactively, it would have to deal with the administration of a mid-year tax increase unless the effective date of the law was January 1 following the law's enactment. For example, if the 1993 Act was not applied retroactively to the

[134]Section 13208(a), Omnibus Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 312, 469, amended code ≤2001(c). Section 13208 also increased the basic Generation Skipping Transfer Tax rate from 50% to 55%. The GSST provision is beyond the scope of this paper although the same due process standard should be used to test its constitutionality.

[135]The period of retroactivity of the 1993 Act actually included the last few weeks of the Bush Administration. Omnibus Budget Reconciliation Act of 1993 ≤≤13201, 13208, 13221, 26 U.S.C. ≤≤1, 11, 2001 (1993). It is estimated that about 1,000 individuals in the upper estate tax brackets died within the period of retroactivity. *The Phony Retroactive Scare*, N.Y. Times, Aug. 16, 1993, at A16.

[136]Section 13208(a), *supra* fn. 134.

first of the year, many upper income taxpayers would have been taxed at two different rates, one on money earned between January 1 and August 10, 1993 and one on money earned between August 10 and December 31, 1993. Tax computation and collection would require more effort with the mid-year shift in rates. Nevertheless, an increase in income tax rates occurring on January 1 or on August 10 is not really any different. In either case you must determine the income earned prior and after a certain date. Additional work would be required by the IRS and by taxpayers if the rate increase occurred mid-year. This added burden should be considered but taxpayer's due process rights should not be trampled to avoid this inconvenience.

On the other hand, the Government's other interest is more significant. With the mid-year shift in rates taxpayers would cause income to be recognized before the new law's effective date as much as possible to avoid its consequences.[137] Without the power to apply tax legislation retroactively the Government's ability to prevent this type of behavior is limited.

The "ease of administration argument", however, does not apply to estate and gift taxes. The same administrative problems do not exist for the IRS if estate and gift tax rates are changed mid-year. The rate in effect at the time the person died or the gift was made would govern. However, the government's interest to prevent taxpayers from taking certain actions to avoid an incoming tax increase does equally apply to gift taxes since people could make gifts sooner to avoid the higher tax. Estate taxes could be exempted from the retroactivity, however, since people would not plan their own demise to avoid incoming higher estate tax rates.

[137]For example, taxpayers would sell assets with capital gains, and would exercise in the money options. Indeed, many executives, expecting a rise in income taxes, exercised their options immediately after Clinton was elected.

The retroactivity of the 1993 Act was fairly controversial when proposed.[138] As a result congressional leaders introduced legislation to repeal the retroactive tax provisions and have proposed constitutional amendments that would ban retroactive tax increases.[139]

Immediately after the 1993 Act was signed into law by President Clinton, the National Taxpayers Union ("NTU") and the Landmark Legal Foundation brought suit challenging the law's constitutionality.[140] Nevertheless, given legal precedent, the challenge is a long shot and the *Carlton* decision likely dealt the fatal blow to the NTU's suit.

One bill that was introduced as a result of the reaction to the 1993 Act would prohibit the House and Senate from considering tax legislation that increases taxes in years prior to year the legislation is enacted.[141] The bill accomplishes this by establishing a point of order that prohibits the introduction of said retroactive tax legislation.[142] Furthermore, to waive the point of order requires a supermajority or three-fifths of the legislature.[143] However, a majority of the

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[138] *See, e.g., Repeal Retroactivity!,* Wall St. J., Aug. 10, 1993, at A12.

[139] *See, e.g., Efforts Are Under Way to Strip Out Retroactive Application of Tax Hike,* Daily Tax Rep., Aug. 10, 1993, at 65. On August 6, 1993, Representative Richard Armey (R-Texas) introduced a bill (HR 2913) that would eliminate the retroactive tax provisions of the budget bill. Id. at 66. Republicans introduced similar legislation to repeal the provisions. Id. On August 6, 1993, Senators Paul Coverdell (R-GA) and John McCain (R-AZ) proposed a constitutional amendment banning retroactive taxes (SJRes 120). Id. Senator Bob Bennett also proposed a constitutional amendment to prohibit retroactive taxation. Dina ElBoghdady, *Bennett Introduces bill to Ban Retroactive Taxes,* States News Services, Aug. 5, 1993,. The proposed amendment states that: "No Federal tax shall be imposed for the period before the date of enactment of the tax." Id.

[140] The case was filed on August 27, 1993 (*National Taxpayer's Union, Inc. v. United States,* No. 93-1796 (D.D.C. 1993)). It challenges the retroactivity of the estate and gift tax provisions in the 1993 Act, claiming that the tax provisions violate the Constitution's prohibitions against unapportioned direct taxation, the takings clause of the Fifth Amendment, and the due process clause of the Fifth Amendment. The income tax provisions of the 1993 Act have not been challenged. The government's motion to dismiss because of lack of jurisdiction was granted. *See National Taxpayers Union, Inc. v. United States,* 862 F. Supp. 531 (D.C. Dist. 1994), *affirmed,* 68 F.3d 1428 (DC Cir. 1995). The National Taxpayers Union is considering other routes of challenging the law. Pat Buchanan and his organization American Cause announced that they would be legally challenging the 1993 Act's retroactivity. David A. Coia, *Buchanan to Sue Over Retroactive Tax Boost,* Wash. Times, Aug. 12, 1993, at A4.

[141] 1995 S. 94; 104 S. 94. Full Text in 95 Tax Notes Today 239-40, *Americans For Tax Reform's Testimony at Senate Hearing on Retroactive Tax Increases* (December 7, 1995)

[142] Id.

[143] Id.

legislature could simply repeal this law revoking the point of order and then introduce retroactive tax legislation which could then be passed with a simple majority of Congress. Thus, the supermajority requirement is ineffectual.

Nevertheless, requiring a supermajority to pass a retroactive tax provision is a possible compromise solution that may partially meet the taxpayer's and the Government's interests. A supermajority of Congress might not approve a retroactive tax increase unless the legislation's goal was to prevent clear tax evasion or there was a desperate need for revenue. Thus, this could provide taxpayers with heightened protection against retroactive taxes. Conversely, by prohibiting tax legislation from reaching back beyond January 1 of the year the law is enacted, this bill severely limits the Governments ability to reduce taxpayer evasion and ease tax calculations for taxpayers. For example in *Carlton* the mistake in the law was discovered in late 1986 but the curative legislation was not enacted until midway into 1987. Under this proposed bill the tax legislation's retroactive effect would be limited to January 1, 1987. Therefore, many taxpayers could have taken advantage of the mistake in the Code like Carlton did.

The bill also does not protect taxpayers adequately. There could be situations where the language of the bill is complied with yet a taxpayer's due process rights violated. For example, tax legislation that lowered the unified credit to $50,000 and applied retroactively to January 1 of the year the law was passed would not run afoul of this bill. Yet any taxpayer would died or made gifts of over $185,000 during the period of retroactivity would not be protected. These taxpayers would have detrimentally relied upon the old unified credit amount and the bill would not provide them with the requisite due process under the constitution.

In any event, in order to establish a supermajority requirement to pass retroactive taxes a constitutional amendment would have to be passed. The retroactive tax controversy could be better solved if the Supreme Court would specify that it is an unconstitutional violation of the due process clause if a taxpayer reasonably detrimentally relies on a existing tax law that is changed retroactively.

C. The Current Test Continued: Problems and Recommendations

1. Notice

Whether notice to the taxpayer of the new retroactive tax law is a consideration in the due process test is unclear. While some lower courts have cited the presence or absence of notice when determining the constitutionality of a retroactive law,[144] the Supreme Court questions or ignores its relevance.[145] In cases where the Supreme Court discusses notice, it appears to assume that the taxpayer had actual or constructive notice.[146] The Court accepts that the citizenry receives constructive notice of pending changes in the law by a retroactive provision's mere existence as a bill anywhere in the legislative process.[147] A purpose of implying constructive

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[144] First *Carlton*, 972 F.2d 1051; *Wiggins v. Commissioner*, 904 F.2d 311, 314 (5th Cir. 1990); *Estate of Elkins v. Commissioner*, 797 F.2d 481, 483-84 (7th Cir. 1986). *Westick v. Commissioner*, 636 F.2d 291 (10th Cir. 1980).

[145] *Sperry*, 493 U.S. at 64-65 (Supreme Court did not engage in any examination of notice when upholding a retroactive fee imposed on the users of a claims tribunal); *Gray*, 467 U.S. at 731-32 ("We have doubts, however, that retroactive application of the MPPAA would be invalid under the due process clause for lack of notice even if it was suddenly enacted by Congress without any period of deliberate consideration. . ."); *Darusmont*, 449 U.S. at 299 (notice may or may not be a requirement); *Hemme*, 476 U.S. 558 (notice may be one of the relevant circumstances in determining if a statute has an oppressive legal effect).

[146] *See Gray*, 467 U.S. at 732, *Darusmont*, 449 U.S. at 299.

[147] *Gray*, 467 U.S. at 732.

notice at this stage is to prevent taxpayers from exploiting this window of opportunity between a bill's introduction and its actual enactment.[148] Nevertheless, a bill's chance of being actually enacted as law is precarious at best; bills are often altered, not passed or never brought to a vote.[149] It is bad policy to encourage citizens to do something or not do something based on a bill that will likely never become law.

But requiring actual notice to the taxpayer of the new tax law allows taxpayers that are aware of the pending legislation to take steps to avoid the new tax. Thus, a test for due process in the retroactive taxation area should deem notice to taxpayers of the impending new law at some stage of the legislative process. The issue is at what stage should notice be implied: when a presidential candidate states that he or she believes that the mortgage interest deduction should be eliminated or when the bill appears to have enough votes in Congress for it to pass. A disadvantage of implying constructive notice to taxpayers at some point in the legislative process is that it puts politically savvy taxpayers at an advantage. Generally, corporations and wealthy individuals will be informed first of possible new tax law changes and will be able to act on this information.

As a result of implying notice to the citizenry of pending laws several "stages" of notice have emerged over the years. The first stage is an announcement made by an agent of the Government that certain legislation will be pursued.[150] For example, in *Carlton* approximately three months after the law was enacted the IRS announced that it would seek to change the law

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[148] *Untermyer*, 276 U.S. at 450-51.
[149] *See Untermyer*, 276 U.S. at 446.
[150] *Purvis v. United States*, 501 F.2d 311, 314 (9th Cir. 1974), *cert. denied*, 420 U.S. 947 (1975) (holding that the taxpayer had adequate notice of the retroactive application of a tax on purchases by Americans of foreign securities because the period of retroactivity applied back only to the time when President Kennedy originally proposed the law).

and close the "loophole".[151] The second stage is when the bill is introduced in committee. And the third stage of notice is when the bill is actually enacted. In reality, at each stage more of the citizenry receives actual notice of the proposed law. Some courts and commentators believe that notice should not be implied at the very least before the first stage (announcement) and others believe that notice should not be implied until the second or third stages. The majority of courts that have addressed the notice issue presume notice to the taxpayer unless the new tax law imposes a wholly new tax.[152] Therefore, the reasoning of the Ninth Circuit in *Carlton* may have been against the weight of authority on this issue. As stated, many courts presume notice on the basis that changes in tax-rates are by their nature foreseeable.[153] In *Carlton* the first formal stage of notice occurred *after* the taxpayer had completed the transaction to the ESOP.[154] Assuming that notice was ever a part of the Court's due process test, it appears the requirement has been entirely eliminated by the Supreme Court in *Carlton*.

President Clinton first announced his deficit reduction plan on February 17, 1993.[155] Arguably, this was the first notice of possible retroactive tax increases. It was not until April 8, 1993, however, that the Clinton Administration first announced the specific retroactive provisions.[156] The April date clearly could be construed as providing constructive notice to taxpayers of the upcoming changes in the law. The bill was enacted into law on August 10, 1993.[157] Therefore, like the taxpayer in *Carlton,* people that died prior to President Clinton's

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[151] *See* IRS Notice 87-13, 1987-1 Cum.Bull. 432, 442.
[152] Weiler, *supra* fn. 9, 42 Duke L.J. at 1114.
[153] Id.
[154] First *Carlton,* 972 F.2d at 1054.
[155] White House, *White House Release Justifies Retroactive Increases in OBRA 1993,* Tax Notes Today, Aug. 20, 1993, at 15.
[156] Stephen C. Glazier, *Tax bill: Retroactive, Unconstitutional . . .,* Wall St. J., Aug. 5, 1993, at A12.
[157] Kircheimer, *supra* fn. 2, at 911.

February announcement had no notice of the change under any standard.[158] People dying between the April announcement and the law's enactment had various degrees of notice. However, whether notice of the new law would have resulted in taxpayers altering their behavior is difficult to determine and is discussed thoroughly below.

Applying the *Carlton* Court's reasoning to the NTU's challenge to the 1993 Act, the Court may ignore the notice issue and declare the law constitutional. The Government, however, cannot use the "too good to be true" constructive notice argument like it did in *Carlton*.[159] In *Carlton*, the loophole could have theoretically been used to eliminate all estate taxes owed. This could have indicated to the taxpayer that the tax provision was a mistake by Congress. But this is not the case with the tax rate increases on estates contained in the 1993 Act. The Government should not assume that taxpayers who died between January 1, 1993 and February 17, 1993 had constructive notice of the higher rates.[160] Thus, a court would have to ignore any notice requirement in order to uphold the constitutionality of the 1993 Act's retroactive tax increases. However, as mentioned in above, the majority of courts will presume notice of increases in tax rates to taxpayers.[161] Therefore, the Court will not a problem presuming notice to taxpayers of the 1993 Act rate increases.[162]

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[158]Earlier notice could be implied from Presidential Candidate Clinton's statements about the people who benefitted the most in the 1980s paying their fair share of taxes. But this seems to be a bit extreme.
[159]*Carlton* Official Transcript, 1994 WL 665062 at 22.
[160]If taxpayers had actual notice of the future rise in estate tax rates, then they could not claim lack of notice and detrimental reliance. Those taxpayers dying prior to January 1, 1993, fell into the higher estate tax rates anyway since those rates did not expire until December 31, 1992. Those taxpayers that died after the February 17, 1993 announcement probably had notice of the new rates and could not claim detrimental reliance on the 50% estate tax rate.
[161]These courts reason that a change in the rate of a tax is by its very nature reasonably foreseeable, whereas the imposition of a wholly new tax may not be so. This is especially true with income tax rates. Therefore, the Court can reason similarly holding that the retroactive increase in the estate tax rate by the 1993 Act were reasonably foreseeable and notice is satisfied. However, this same logic did not apply to the facts in *Carlton*.
[162]*Wiggins*, 904 F.2d at 314, *Elkins*, 797 F.2d at 484; *Fein v. United States*, 730 F.2d 1211, 1213 (8th Cir. 1984), *cert. denied*, 469 U.S. 858 (1984).

In summary, the Court in *Carlton* either did not consider the notice requirement as necessary for the due process test or implied notice based on the argument that the loophole was "too good to be true" and the taxpayer should have known it would be altered. Applying the Court's approaches to the 1993 Act's increase on estates of people who died before the new law was announced, the Court can satisfy the notice requirement by either: 1) not considering it as an element of the due process test as it has in previous cases, or 2) imply constructive notice based on the fact the changes in tax rates are always reasonably foreseeable.[163] Using either option the Court will not hold the 1993 Act unconstitutional based upon lack of notice to taxpayers.

2. Detrimental Reliance

An additional element some courts consider part of the due process test for constitutionality is detrimental reliance. The Ninth Circuit in *Carlton* considered the paramount factors in determining whether the tax legislation was unduly harsh and oppressive to be: 1) whether the taxpayer had actual or constructive notice; and 2) whether the taxpayer relied to his detriment on the tax legislation before it was altered.[164] Finding that the taxpayer in *Carlton* did not have notice and relied on the old tax legislation to his detriment, the Ninth Circuit struck the new tax legislation down.[165]

The Fifth Amendment of the Constitution requires due process if there is deprivation of "life, liberty, or property".[166] Conversely, due process is not required if there is no deprivation of

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[163]*See* Weiler, *supra* fn. 9, 42 Duke L.J. at 1114.
[164]First *Carlton*, 972 F.2d at 1059.
[165]First *Carlton*, 972 F.2d 1051.
[166]U.S. Const. amend V.

"life, liberty, or property. The text of the due process clause itself requires courts to focus on detriment to the taxpayer, at least as a threshold requirement, as a factor in the test for the constitutionality of retroactive tax legislation. It plainly says that if life, liberty, or property is deprived from the taxpayer, due process is required.[167] It also seems logical, therefore, that deprivation would be a factor in the actual due process test, not just a threshold requirement for the test. Nonetheless, the Court has still held that it is not required to consider deprivation of the taxpayer in its test for due process.[168] This seems to be contrary to the text of the Constitution.

Important to the detrimental reliance analysis is whether the taxpayer engaged in voluntary conduct.[169] In *Welch* the taxpayer argued that retroactive changes to laws that affect citizens' voluntary acts are more offensive to due process than those that affect merely involuntary conduct.[170] Voluntary conduct may be more indicative of reliance, but there are situations where inaction in reliance upon an existing law could be equally detrimental. For example, assume that the unified credit was lowered from $192,800[171] to $50,000 and this change was applied retroactively to the first of the year. Individuals in reliance on the $192,800 credit whose estates were less than $600,000 may not have engaged in estate planning.[172] If these individuals died within the period of retroactivity, they would have involuntarily relied to their detriment on the prior law. Therefore, it appears that the distinction between involuntary conduct versus voluntary conduct when analyzing detrimental reliance is unsound. The test

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[167]Id.

[168]*Carlton*, 114 S. Ct. at 2023. Although the Court said, ". . . reliance alone is insufficient to establish a constitutional violation", the holding of the case says that detrimental reliance is given almost no weight in the Court's due process analysis.

[169]*See, generally*, Weiler, *supra* fn. 9, 42 Duke L.J. at 1115.

[170]*Welch*, 305 U.S. at 147.

[171]I.R.C. ≤2010(a).

[172]Estate tax due on a $600,000 estate is $192,800 which is reduced to $0 by the unified credit in the same amount.

should simply determine if the taxpayer detrimentally relied on the pre-change law; whether the detriment is from action or inaction is not determinative.

The due process test for retroactive taxes should consider whether the taxpayer's reliance on the old law was reasonable. In doing this taxpayers' due process rights can be protected while minimizing interference with the Government's interests. Generally, normal tax rates could be raised without causing detrimental reliance and Congress could allow deductions for losses incurred in reliance on old laws. For example, given the facts in *Carlton* the retroactive legislation may not have been unconstitutional since the taxpayer's reliance may not have been reasonable, Congress also could have protected taxpayers' rights by providing a deduction for losses incurred in reliance on the old law.

As discussed previously, the legislative history revealed that when the *Carlton* tax legislation was originally added, Congress estimated that the deduction would result in a loss in revenues of about $300 million.[173] But after the tax deduction was added, Congress determined that the Federal Government would actually lose up to seven billion dollars in revenues as a result of the "loophole".[174] In order to prevent this loss of revenue, Congress closed the loophole retroactively.[175] This is strong evidence that the statute as originally enacted was in fact a mistake as the Government claimed rather than a legitimate deduction to encourage sales to ESOPs as the executor in *Carlton* claimed. The test for retroactive legislation should consider whether or not a "mistake" was being corrected. If the law relied upon was a mistake, than the taxpayer's reliance may not have been reasonable. But the opinion in *Carlton* did not state that

[173] *Carlton*, 114 S. Ct. at 2022.
[174] *Id.*
[175] Omnibus Budget Reconciliation Act of 1987, ≤ 10411(a), 101 Stat. 1330-432 (enacted December 22, 1987).

the Court relied upon the fact that the legislation was a mistake. A better test for due process would have heavily weighed this fact in determining whether Carlton's reliance was reasonable.

The Ninth Circuit's test in *Carlton* considered if citizens had actual or constructive notice of the new law or relied to their detriment on the law as currently written.[176] And although this test is better than the not considering the taxpayer at all, it is still incorrect. The better test would only look to see if the taxpayer detrimentally relied on the old legislation and that the reliance was reasonable. Whether the taxpayer had at least constructive notice would still be a major consideration but that fact only goes to whether the taxpayer's reliance was reasonable. In other words, if the taxpayer had constructive notice that a deduction was going to be eliminated than any reliance on that deduction would not be reasonable.

A problem with this proposed due process test is that it may require analyzing each individual taxpayer's situation to see if he or she reasonably detrimentally relied on the prior tax law. However, a constructive notice date could be established that would apply to all taxpayers unless the Government could establish an earlier date for a specific taxpayer. Further, whether the relied upon law was an obvious mistake and therefore any reliance on it would have been unreasonable could also be decided in one case and applied to all taxpayers. Therefore, the only issue left for each individual taxpayer would be whether or not he actually detrimentally relied on the old law. Since this is a basic factual question handling each case individually is possible. Under this test most taxpayers could not establish detrimental reliance on old income tax rates there, mass litigation would not result when rates were raised retroactively.

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[176] *First Carlton*, 972 F.2d 1051.

Under the Court's current test it apparently will not invalidate retroactive tax legislation even if the taxpayer can establish detrimental reliance.[177] *Carlton* presented a clear case of detrimental reliance yet the Court upheld the law, ignoring any detrimental reliance. Therefore, given the Court's holding in *Carlton* the Court will not strike down the 1993 Act's retroactive estate tax increase based upon detrimental reliance.

Even assuming that detrimental reliance is a element of the Court's due process test for retroactive tax legislation, the 1993 Act will still likely be upheld, since it will be difficult for a taxpayer to show detrimental reliance on the old 50% estate and gift tax rates. Many commentators that believe the 1993 Act's retroactive estate tax increases are unconstitutional state arguendo that there is detrimental reliance on the part of the taxpayer.[178] These commentators state that the taxpayer could have engaged in more tax planning or somehow they relied to their detriment on the old 50% rate before they died or made a gift.[179] The commentators do not actually apply the detrimental reliance standard to the 1993 Act since the results do not back their position.[180]

Carlton provided a prime example of detrimental reliance as the Ninth Circuit Court of Appeals recognized. The taxpayer, relying on the old unambiguous legislation, engaged in a transaction that eventually cost him $630,000.[181] To show that same type of reliance with the 1993 Act is difficult. The taxpayer must show that they relied on the old tax law to their detriment. What would a taxpayer that was in a 55% or 53% bracket do that he or she would not

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[177] *Carlton,* 114 S. Ct. at 2023.

[178] *See, e.g.,* Schultz, *supra* fn. 15, 27 J. Marshall L. Rev. at 14. "With retroactive estate and gift taxes, a taxpayer may have taken different action if he had known of the increased tax rate". Id. However, Schultz did not offer examples of what actions taxpayers may have taken differently.

[179] Id.

[180] Id.

[181] *Carlton,* 114 S. Ct. at 2021-22.

do in a 50% bracket? One can conjure up theoretical examples such as the taxpayer would have left all their money to charity if he or she would have known that more than half would have gone to the government. But in reality most taxpayers in a 55% estate tax bracket would do exactly the same tax planning that they would in a 50% bracket. Furthermore, wealthy taxpayers already engaged in estate tax planning prior to January 1, 1993 were planning for the higher 53-55% brackets that were in effect between 1983 and 1992.[182] It is highly unlikely that they altered their planning between January 1 and August 10, 1993 as a result of the new 50% bracket.

Nevertheless, a few somewhat realistic scenarios of detrimental reliance on the 50% estate tax bracket can be made. A taxpayer could have engaged in estate tax planning in reliance on the 50% bracket and died before being able to revise their planning. For example, assume a taxpayer had ten children and she planned her estate in January 1993 when the top estate tax bracket was 50%. The taxpayer planned her estate so that each child would receive approximately $10 million after taxes and after a specific bequest or outright inter vivos gifts to charity of $50 million. The taxpayer died on February 1, 1993, and the 1993 Act is later applied retroactively to that time. With the new 53-55% brackets in the 1993 Act each of the taxpayer's children would receive almost one million dollars less than the taxpayer had planned.[183] In this situation the taxpayer relied to her detriment on the tax brackets before they were retroactively amended. Nevertheless, assuming that the Court considered detrimental reliance to be an element of the due process test, since this scenario is unlikely to actually occur,[184] and the

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[182] *See* I.R.C. ≤2001(c)(2)(D), repealed.
[183] Under the 50% rate each of the ten children would receive $10,022,520 and under the 1993 Act each child would receive $9,035,920.
[184] It would be an usual estate plan that left a specific bequest to charity and the residual to the decedent's heirs where the decedent desired her heirs to receive a specific amount.

detrimental reliance is only that the children received about ten percent less than taxpayer had planned, this may not be sufficient to render the legislation unconstitutional.

Another possible scenario where taxpayers could have detrimentally relied on the 50% estate and gift tax brackets is if a taxpayer purchased an insurance policy to cover estate taxes on his family farm, real estate, or business. If the taxpayer figured his estate tax that would be due at the 50% bracket, the policy purchased may not be large enough to cover the taxes due at death. For example, assume a seventy year old taxpayer owned a closely held business valued at $50 million. In January 1993 he sold a 49% stake of his business to purchase an insurance policy to cover estate taxes due on his death. The taxpayer's goal was for the insurance proceeds to pay the estate taxes so that his business could remain in his family and not have to be sold off at his death. The taxpayer figured the estate taxes due on his death at the 50% bracket currently in effect; amounting to $24,775,800. In reliance, the taxpayer purchased a $25 million dollar policy. the taxpayer then died on February 1, 1993 and the 1993 Act is later applied retroactively to that time. As a result of the 1993 Act's higher brackets, the taxpayer's estate owes $2,365,000 more in taxes. Since his heirs do not have this money, they are forced to sell the family business to pay the taxes owed.[185] Although this example may be sufficiently detrimental, it still is fairly unlikely to actually occur. Thus, unless a taxpayer can actually establish this scenario, the element of detrimental reliance cannot likely be established in a challenge to the constitutionality of the Clinton Tax Package.

In sum, given the Court's analysis in *Carlton,* detrimental reliance will likely not be considered by the Court in the challenge to the 1993 Act. But even if it was considered, it is

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[185]Note that this example does not consider the effect of I.R.C. §§ 2032A, 6161 & 6166.

unlikely that a taxpayer could establish actual sufficient detrimental reliance to render the law unconstitutional. Taxpayers' actions simply would be the same whether they were in a 50% bracket or a 55% bracket.

D. Remaining Limitations on Congress' Power to Tax Retroactively

Given the Court's recent history on retroactive tax challenges, it is difficult to envision a retroactive tax law that would be held unconstitutional. The final section of this paper will analyze two hypothetical retroactive tax laws under the current state of the law, and discuss the remaining limitations of congressional power to tax retroactively.

Imagine that the Government needs to balance its budget and reduce the national debt in order to stem a currency crisis. In response, a law is enacted that adds an additional 75% tax bracket that applies to gifts and estates over $5 million. Additionally, Congress makes this provision retroactive to January 1 of the year it was enacted. The only difference between this and the 1993 Act is one of degree; a 5% increase versus a 25%. Under the Court's current test, this hypothetical law will be upheld if it: 1) serves a legitimate legislative purpose that; 2) is furthered by rational means.[186] Raising revenue is a legitimate legislative purpose.[187] And as long as Congress acts promptly and keeps the period of retroactivity reasonable, the retroactive statute is "rationally related". Justice O'Connor, in her concurring opinion, stated that "retroactive application of revenue measures *is* rationally related to the legitimate governmental

[186] *Carlton*, 114 S. Ct. at 2022.
[187] *Id.* at 2024.

purpose of raising revenue".[188] This appears to say that retroactive tax laws meet the two part test per se. Therefore, just like the 1993 Act will be held constitutional so would this hypothetical law. In both the hypothetical and in the 1993 Act, however, the taxpayer would likely not have changed his or her actions based on the increased tax rate. Again the same basic planning would be done for someone in a 50% rate than someone in a 75% rate. The taxpayer could not show detrimental reliance on the old brackets. Therefore, the Court would be correct in finding this hypothetical law not violative of due process.

On the other hand, what if Congress, reacting to the same hypothetical currency crisis, lowered the estate tax credit from $192,800 to $50,000 and applied that statute retroactive to the first of the year? This legislation would affect thousands of taxpayers' "settled transactions". Taxpayers who thought they would not owe estate or gift tax since their estates or gifts were under $600,000 would be shocked to discover that they could owe up to $142,800 in tax. More importantly, however, is the fact that if the taxpayers had known of the coming retroactive tax law, he or she would have likely not gifted more than $185,000, or would have engaged in various estate planning techniques to minimize their estate and gift taxes.[189] Unlike raising estate tax rates from 50% to 55% or even to 75%, taxpayers actually could have taken steps to avoid the increased tax in the second hypothetical.

If the Court considered notice to the taxpayer of the hypothetical law or the law's effect on the taxpayer, it would probably hold it violates of the due process clause. But *Carlton* may have eliminated notice and the law's affect on the taxpayer as elements to consider. Thus, this

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[188] *Carlton,* 114 S. Ct. at 2025 (emphasis added).

[189] With a $50,000 credit those individuals with estates valued over $185,000 would likely use exemption equivalent trusts, annual gifting programs, and other techniques to decrease estates taxes.

hypothetical law may also be upheld since it would be "rationally related to the legitimate governmental purpose of raising revenue".[190]

1. Period of Retroactivity

The *Carlton* Court suggested that any period of retroactivity must be "modest".[191] It has yet to be tested how long "modest" is, but the Court may consider a time period up to two years to be modest. The retroactive period in the *Carlton* case was just over one year.[192]

In O'Connor's concurring opinion in *Carlton* she stated that retroactive periods over a year would raise "serious constitutional questions."[193] The majority, however, would probably allow a retroactive period of at least two years.

2. Wholly New Tax

Congress cannot apply a "wholly new tax" retroactively.[194] "Even though . . .[a retroactive] tax would surely serve to raise money . . .[b]ecause of the tax consequences of commercial transactions are a relevant, and sometimes dispositive, consideration in a taxpayer's decisions regarding the use of his capital, it is arbitrary to tax transactions that were not subject to taxation at the time the taxpayer entered into them".[195] When Congress enacted the first gift tax

[190] *Carlton,* 114 S. Ct. at 2025.
[191] *Id.* at 2026.
[192] Burton, *supra* fn. 71, 48 Tax Lawyer at 509-10.
[193] *Carlton,* 114 S. Ct. at 2026.
[194] *Hemme*, 476 U.S. at 568.
[195] *Carlton*, 114 S. Ct. at 2025, *citing, Welch,* 305 U.S. at 147.

and applied it retroactively, it was struck down as a wholly new tax.[196] Although the "wholly new tax" limit still exists, policy seems to no longer support this limitation. If the Court is not going to consider the detrimental reliance of the taxpayer in its test for due process, then why not allow retroactive application of a wholly new tax? In both *Carlton*[197] and *Darusmont*[198], the taxpayers had engaged in completed transactions which were later taxed by retroactive legislation. Therefore, given the Court's reasoning there is no justification for the Court to continue limiting the application of a wholly new tax retroactively.

V. Conclusion

The due process test for retroactive tax legislation should focus on the taxpayer, not solely on Congressional justification. It is unreasonable to test for due process by focusing exclusively on factors other than the laws' effect on the taxpayer. The crux of the Court's test should be detrimental reliance. If the taxpayer detrimentally relied by taking action or being induced not to take action based on an existing tax law, that tax law should not later be changed to his or her permanent detriment. Whether or not the taxpayer had notice, actual or constructive, of the upcoming change would determine if he or she reasonably relied on the existing tax law.

On the other hand, even if the retroactive tax law results in greater tax liability, due process should not be violated if the taxpayer would not have altered his or her behavior given knowledge of the impending tax increase. If there were no reasonable actions that the taxpayer

[196] *See Nichols*, 274 U.S. 531.
[197] 114 S. Ct. 2018.
[198] 449 U.S. 292.

would have taken had he or she known of the incoming new tax law, then the taxpayer would not be able to prove detrimental reliance. This is the situation with the retroactive increases contained in the 1993 Act. Thus, under this proposed test the Supreme Court's reasoning in *Carlton* is erroneous, but the 1993 Act retroactive tax increases should be upheld.