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Retroactive Taxation: United States v. Carlton - The Taxpayer Loses Again!, 16 N. Ill. U. L. Rev. 77 (1995)

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Retroactive Taxation: *United States v. Carlton*--The Taxpayer Loses Again!

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The Power To Tax Retroactively Is The Power
To Destroy Without Warning.[1]

INTRODUCTION

With the Republicans' resurgence of power, the issue of taxation has once again received renewed attention. Surprisingly, the debate about taxation has included a discussion and several proposals about retroactive taxation. This renewed interest can be attributed to two factors: First, the oppressive nature of retroaction taxation[2] which captured taxpayers' attention in President Clinton's Omnibus Budget Reconciliation Act of 1993,[3] and second, the Supreme Court's refusal to limit the legislature's power to tax retroactively.[4] Consequently, taxpayers have applied pressure so that the legislature will curb this abuse of power.[5]

Recently, Senator Paul Coverdell introduced a constitutional amendment that would prohibit retroactive taxation.[6] Also, the new majority in the House of Representatives has changed the voting rules on taxation.[7]

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1. *Cf.* McCulloch v. Maryland, 17 U.S. (4 Wheat.) 316, 327 (1819). "An unlimited power to tax involves, necessarily, a power to destroy; because there is a limit beyond which no institution and no property can bear taxation." *Id.*

2. "Every law that takes away, or impairs, rights vested, agreeably to existing laws, is retrospective, and is generally unjust; and may be oppressive . . . ." Calder v. Bull, 3 U.S. (3 Dall.) 386, 391 (1798). As a general rule, a law should not operate retroactively. *Id.*

3. Pub. L. No. 103-66, 107 Stat. 312 (codified as amended in scattered sections of the United States Code).

4. The Supreme Court has not stricken a retroactive tax law since 1928. *See* Untermyer v. Anderson, 276 U.S. 440 (1928).

5. J. Mark Ramseyer and Minoru Nakazato, *Tax Transitions and the Protection Racket: A Reply to Professors Graetz and Kaplan*, 75 VA. L. REV. 1155, 1171 (1989).

6. Ernie Freda, *Congress: The First 100 Days at a Glance*, Atl. Const., Jan. 6, 1995.

7. *See, e.g.*, Ronald Brownstein, *Start of Debate Also Begins War to Win Voters*, L.A. TIMES, Jan. 5, 1995.

First, the House rules change requires a three-fifths majority of the House to increase income taxes.[8] Second, the rule change bars retroactive tax increases even if three-fifths of the House were in favor of a retroactive tax bill.[9]

In Part I, this article will address the pros and cons of retroactive taxation and ultimately conclude that retroactive taxation is manifestly unfair. Part II will discuss the United States Supreme Court's latest decision on retroactive taxation, *United States v. Carlton.*[10] Part III will discuss the ramifications of the *Carlton* decision and whether any constitutional protections remain.

I. THE PROS AND CONS OF RETROACTIVE TAXATION

A. THE ARGUMENT AGAINST RETROACTIVITY

For the purpose of this article, retroactive laws are "those which take away or impair vested rights acquired under existing laws, create new obligations, impose a new duty, or attach a new disability in respect to the transactions or considerations already past."[11] The justification for abolishing retroactive taxation has taken many different, but interrelated forms.

Perhaps the most egregious aspect of retroactive taxation is that it destroys the purpose that statutory law should serve as a guide to individual behavior.[12] Congress constantly changes the tax code[13] and the taxpayer is obligated to discover and adhere to these changes. However, because of the Internal Revenue Service's interpretations of the tax code sections, taxpayers are rarely certain of all actions the IRS takes. Even if a statute is clear on its face, the IRS can always ask Congress to clarify the legislation,

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8. *Id.* (as opposed to a simple majority vote).

9. Lloyd N. Cutler, *Super-Majority Simple-Mindedness*, WASH. POST, Jan. 3, 1995 (contending that this rule change is "manifestly unconstitutional").

10. 114 S. Ct. 2018 (1994).

11. BLACK'S LAW DICTIONARY 1317 (6th ed. 1990). This article does not draw a distinction between retroactive and retrospective tax legislation. *But see* Gregory J. DeMars, *Retrospectivity and Retroactivity of Civil Legislation Reconsidered*, 10 OHIO N.U. L. REV. 253, 254-57 (defining both retrospective and retroactive and asserting that a difference exists). However, DeMars concedes that "[w]hile some scholars have noted that a difference may exist between the terms retroactive and retrospective, most courts and commentators treat the terms as synonymous." *Id.* at 254.

12. Charles B. Hochman, *The Supreme Court and the Constitutionality of Retroactive Legislation*, 73 HARV. L. REV. 692, 693 (1960); *cf.* Stephen R. Munzer, *Retroactive Law*, 1977 J. LEGAL STUD. 373, 392 (1977). "Yet a retroactive law is not so impoverished an instrument as a simple retroactive command." *Id.*

13. 26 U.S.C. §§ 0.01-8023.

and thus, retroactively change the law to adhere to the IRS interpretation.[14]

Closely related to the principle that taxation should guide behavior is the reliance/expectation interest compelled by the code. "[A] person should be able to plan his conduct with reasonable certainty of the legal consequences."[15] Retroactivity often defeats reliance and penalizes a taxpayer for acting in a manner which was previously permitted.[16] This is both harsh and frequently inequitable.[17]

Another criticism of retroactive taxation is the potential for abuse of the legislative process.[18] Because Congress can pass a retroactive statute with an exact knowledge of who will be affected,[19] Congress can target discrete groups upon which to either confer a tax break[20] or increase their tax burden. Therefore, retroactive taxation further distorts the legitimacy of the legislative process.[21] "[T]o the extent that a group can be powerful because its individual members can vote, contribute, or otherwise act on their own, these members need to know their interests in order to act."[22] Thus, Congress, in general, will focus retroactive taxation on unidentifiable groups who cannot quickly organize and prevent the passage of the retroactive tax measure.[23]

Another problem faced by tax advisors is the gambling that tax planners must do when an effective date is announced.[24] Even if a tax planner can guess which laws will be passed it is virtually impossible for tax

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14. United States v. Carlton, 114 S. Ct. 2018 (1994).

15. Hochman, *supra* note 12, at 692.

16. Note, *Setting Effective Dates for Tax Legislation: A Rule of Prospectivity*, 84 HARV. L. REV. 436, 439 (1970).

17. *Id.* "[I]t is impossible to quantify the cost resulting from the loss of taxpayer confidence in the taxing system due to the perceived inequities produced by retroactivity." *Id.* at 441.

18. *See* Ramseyer and Nakazato, *supra* note 5, at 1171-72 (positing that taxpayers who are adversely affected by a proposed tax change will organize if given sufficent time).

19. *See* Hochman, *supra* note 12, at 693.

20. *See* Lawrence Zelenak, *Are Rifle Shot Transition Rules and Other Ad Hoc Tax Legislation Constitutional?*, 44 TAX L. REV. 563.

21. *See* Jim Gould, *A New Fiscal Bonanza in Tax Policy: The Targeted Retroactive Tax-TRT*, Apr. 8 TAX NOTES 117. Gould sarcastically acknowledges that vast amounts of revenue could be raised through targeting "disfavored segment[s] of society." *Id.*

22. Saul Levmore, *The Case for Retroactive Taxation*, 1993 J. LEGAL STUD. 265, 281 (1993).

23. *Id.* at 280.

24. *See* Clifford L. Porter & John C. Richardson, *Retroactivity of Tax Legislation: A Report by the Committee on Tax Policy, Tax Section, New York State Bar Association*, 29 TAX LAW. 21, 25 n.19 and accompanying text (1975).

advisors to estimate the effective date.[25]

Opponents of retroactive taxation also point out that strictly prospective taxation would also simplify the legislative process.[26] Under the current system, the legislature must evaluate each provision to decide whether to apply it retroactively.[27] Thus, legislative efficiency is promulgated by prospective legislation.[28] Despite these legitimate criticisms of retroactive taxation, the United States Supreme Court, since 1928,[29] has consistently upheld Congress' retroactive tax measures.[30]

B. THE ARGUMENT FOR RETROACTIVE TAXATION

Congress undoubtedly has wide discretion in its constitutional power to tax.[31] Early on, the Supreme Court held that the Ex Post Facto Clause[32] of the Constitution only prohibits retroactive criminal laws and does not prohibit retroactive economic laws.[33]

Thus, the Supreme Court grants Congress great deference with regard to retroactive taxation. One argument in favor of retroactive economic laws is that taxpayers are on notice that tax laws are subject to change and thus have no vested right in the rate of taxation.[34] Thus, taxpayers cannot realistically rely on the status quo because of the inherent uncertainty encompassed in the tax code.[35] "Nominally prospective taxes can affect values and upset expectations every bit as much as explicitly retroactive assessments."[36]

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25. *Id.*

26. *See* Note, *supra* note 16, at 442.

27. *Id.*

28. *Id.*

29. Untermyer v. Anderson, 276 U.S. 440 (1928).

30. *See infra* notes 46-50 and accompanying text (reviewing Supreme Court cases considering retroactive taxation).

31. U.S. Const. art. I, § 8, cl. 1 provides in part: "The Congress shall have Power to lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the Common Defence and general Welfare of the United States."

32. U.S. Const. art. I, § 9, cl. 3 provides in part: "No Bill of Attainder or ex post facto Law shall be passed."

33. Calder v. Bull, 3 U.S. (3 Dall.) 386 (1798).

34. *See, e.g.*, Cohan v. Comm'r, 39 F.2d 540, 545 (2nd Cir. 1930). "[The taxpayer] must be prepared for such possibilities, the system being already in operation. His is a different case from that of one who, when he takes action, has no reason to suppose that any transactions of the sort will be taxed at all." *Id.*

35. Michael J. Graetz, *Retroactivity Revisited*, 98 HARV. L. REV. 1820, 1823 (1985).

36. Levmore, *supra* note 22, at 266.

Undoubtedly, purely prospective tax changes upset expectations. However, a balance must be struck between legislative change and reasonable reliance by the taxpayer.[37] The ideal balance is to protect expectations of which the taxable event has passed.

Another rationale for retroactivity is economic efficiency.[38] Graetz asserts that because both prospective and retroactive effective dates upset expectations, "the distinctions commonly drawn between prospective and retroactive effective dates are illusory."[39] Thus, the taxpayer takes the risk of retroactive change in the tax code.[40] This argument is closely related to the idea that the legislature must have the ability to "cure" defects in legislation.[41] Thus, if taxpayers do not behave according to the legislature's expectations, then the legislature has "ample reason" to retroactively modify the statute.[42]

However, these economic arguments rely on the "assumption that the change in the law itself" is economically efficient.[43] However, both the tax code and tax changes are not efficient and this encourages irrational behavior to reduce taxes. Perhaps one of the most egregious examples was *Knetsch v. United States*,[44] in which the taxpayer prepaid interest at the rate of three and one-half percent per year (when tax rates were as high as ninety-one percent) in order to purchase annuity contracts yielding a return of only two and one-half percent (to be realized in later years when the taxpayer presumably would be in a lower tax bracket).[45] The idea that economic efficiency should be utilized in retroactive taxation and not other areas lessens the economic argument for retroactivity. There must be a point at which transactions are free from retroactive tax legislation and that point should be immediately after the taxable event has passed.

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37. Carlton v. United States, 972 F.2d 1051 (9th Cir. 1992).

38. Graetz, *supra* note 35, at 1824-25.

39. *Id.* at 1822.

40. Michael J. Graetz, *Legal Transitions: The Case of Retroactivity in Income Tax Revision*, 126 U. PA. L. REV. 47, 65 (1977). "The risks of a change in law do not seem necessarily different in kind nor in magnitude from the risks of a change in market demand or technology." *Id.*

41. For a discussion of the curative nature of retroactivity, see *infra* notes 92-94 and accompanying text.

42. *See* Stephen R. Munzer, *A Theory of Retroactive Legislation*, 61 TEX. L. REV. 425, 430 (1982).

43. Graetz, *supra* note 40, at 72.

44. 364 U.S. 361 (1960).

45. *Id.* at 362-63.

Nevertheless, the Supreme Court has not overturned a retroactive taxation case since 1928.[46] Taxpayers have unsuccessfully challenged retroactive taxation based upon the Contract Clause,[47] the Direct Taxation Clause,[48] and the Equal Protection Clause.[49] Thus, it appears that the only viable constitutional attack remaining is a challenge under the Substantive Due Process Clause of the Fifth Amendment.[50] What exactly violates due process in the field of retroactivity is not clear, but as a general rule, Congress will rarely be deemed to have violated the Due Process Clause under the current scrutiny of economic legislation.[51]

II. UNITED STATES V. CARLTON[52]

The facts of *Carlton* illustrate the inequities of Congress' ability to retroactively apply taxes. On December 10, 1986, Jerry Carlton, Willametta Day's executor, bought 1,500,000 shares of MCI stock at $7.47 per share.[53] On December 12, the executor sold the shares at $7.05 per share to MCI's Employee Stock Option Plan ("ESOP"), thus losing $631,000 on the transaction.[54] The ESOP deduction has been statutorily defined as "the value of the taxable estate shall be determined by deducting from the value

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46. Untermyer v. Anderson, 276 U.S. 440 (1928). *See also* Note, *supra* note 16, at 442.

47. Welch v. Henry, 305 U.S. 134, 146 (1938). "Taxation is neither a penalty imposed on the taxpayer nor a liability which he assumes by contract." *Id.* at 146. The Contracts Clause states, "No State shall . . . pass any . . . Law impairing the Obligation of Contracts . . . ." U.S. CONST. art. I, § 10, cl. 1.

48. Milliken v. United States, 283 U.S. 15 (1931). The Direct Taxation Clause states, "No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken." U.S. CONST. art. I, § 9, cl. 4.

49. *Welch*, 305 U.S. at 146. The Equal Protection Clause states, "No State shall . . . deny to any person within its jurisdiction the equal protection of the laws." U.S. CONST. amend. XIV, § 1. For an in-depth discussion of unsuccessful constitutional challenges, see Andrew G. Schultz, Note, *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, 779-86 (1994).

50. The four most recent attacks on retroactive taxation heard by the United States Supreme Court have been decided on Due Process grounds. *See* United States v. Carlton, 114 S. Ct. 2018 (1994); United States v. Hemme, 476 U.S. 558 (1986); Pension Benefit Guaranty Corp. v. Gray, 467 U.S. 717 (1984); and United States v. Darusmont, 449 U.S. 292 (1981).

51. Pension Benefit Guaranty Corp. v. Gray, 467 U.S. 717, 734 (1984).

52. 114 S. Ct. 2018 (1994).

53. *Id.* at 2021.

54. *Id.*

of the gross estate an amount equal to 50% of the qualified proceeds of a qualified sale of employer securities."[55] In filing the decedent's estate tax return, Carlton included the deduction for the ESOP loss.[56]

On January 5, 1987, the IRS issued an advance version of Notice 87-13[57] which asked for clarifying legislation on the interpretation of § 2057.[58] The IRS also stated it would require that the decedent owned the securities prior to death in order to get the deduction.[59] On February 26, 1987, a bill was introduced to amend § 2507[60] and this bill was eventually enacted on December 21, 1987.[61] The new bill required that to be eligible for the deduction, a seller must own the stock before death.[62] Thus, not only did the Day's estate lose $631,000 on the transaction, but the estate was also denied the ESOP deduction.[63]

A. THE NINTH CIRCUIT'S DECISION

The Ninth Circuit held that Congress' retroactive estate tax violated due process.[64] In doing so, the Ninth Circuit developed a two-part test "to determine whether the retroactive application of a tax is unduly harsh and oppressive."[65] The first part was whether the taxpayer had actual or constructive notice that the statute would be retroactively amended.[66] The court examined "two passing references in Congressional documents" that the government contended that Congress intended to require "decedent ownership" and concluded that Carlton did not have actual or constructive knowledge."[67]

55. 26 U.S.C. § 2057(a). Thus, the gross estate was reduced by $5,287,500 ($7.05/share x 1,500,000 million shares x .50).

56. Carlton v. United States, 972 F.2d 1051, 1054 (9th Cir. 1992).

57. 1987-1 C.B. 432 (1987), enacted as Pub. L. No. 100-103.

58. *Carlton*, 972 F.2d at 1054.

59. *Id.*

60. Section 2057(d)(1)(A) requires that "the decedent directly own[] the securities immediately before death." Section 2057 was repealed for estates of decedents who died after december 19, 1989. *See* Omnibus Budget Reconciliation Act of 1989, § 7304(a), 103 Stat. 2352.

61. *Id.*

62. *Id.*

63. *Id.*

64. Carlton v. United States, 972 F.2d 1051, 1062 (9th Cir. 1992) (2-1 decision).

65. *Id.* at 1059.

66. *Id.*

67. *Id.*

The second prong of the test was whether the taxpayer reasonably and detrimentally relied upon the code.[68] The court rejected the government's argument that "any reasonable taxpayer would have known it was 'too good to be true.'"[69] The court stated that "[w]e flatly reject the government's premise that a taxpayer cannot rely on the clear and unequivocal text of the tax code, but instead must speculate on the unspoken and inchoate intentions of Congress."[70]

Moreover, the court noted that Carlton's reliance was reasonable in light of Congress' favorable treatment of ESOP's in general.[71] Last, the court rejected the government's argument that Carlton was unreasonable because Carlton should have concluded that "Congress had made a drafting error."[72]

The court then examined whether the taxpayer detrimentally relied upon the tax code.[73] The government argued that Carlton's reliance was not "truly detrimental" for two reasons.[74]

First, the government argued that the retroactive amendment simply restored the taxpayer to the position she would have been in had Congress not erred.[75] The court rejected that argument since the estate lost $631,000 on the sale at a discount to the ESOP.[76]

Second, the government contended that the sale at a discount was not a statutory prerequisite to the deduction, so the loss should not be considered in determining whether the retroactive amendment violates due process.[77] The court rejected this argument and concluded that the sale at a discount was a "necessary concession to complete the deal."[78]

The government also argued that the transaction had no substance and was thus a sham transaction.[79] The court rejected that argument and

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68. *Carlton*, 972 F.2d at 1059.

69. *Id.* at 1060.

70. *Id.*

71. *Id.*

72. *Id.* The court rejected this argument because § 2057 had "first been proposed over two and a half years before" it was finally passed. *Id.* Thus, Congress had plenty of time to make sure the statute included all relevant provisions. *Id.*

73. *Id.* at 1061.

74. *Id.*

75. *Id.*

76. *Id.*

77. *Id.*

78. *Id.*

79. *Id.* *Cf.* Bridges v. C.I.R., 325 F.2d 180 (4th Cir. 1963) (stating that "[t]he test of whether a transaction claimed to furnish the basis of income tax deduction was a sham transaction was whether what was done, apart from tax motive, was the thing intended by the statute providing for the deduction."). *Id.*

concluded that the transfer in wealth from the estate to the ESOP constituted substance and reality.[80]

B. THE SUPREME COURT'S DECISION

The Supreme Court unanimously overruled the Ninth Circuit's decision,[81] and in doing so, eliminated virtually any hope of a taxpayer successfully challenging retroactive legislation.

1. The Standard of Review: Estate and Gift Taxes versus Income Taxes

Normally, courts review economic legislation under the deferential rational relationship test.[82] However, there were several reasons why the Ninth Circuit decided that estate and gift taxes should be treated differently from income taxes with respect to due process analysis.

First, the inherent nature of estate and gift taxes is different from income taxes.[83] Additionally, the whole ESOP system is based on employee ownership which is achieved by tax incentives[84] such as § 2057. All things being equal, if ESOP's did not provide a tax advantage, taxpayers who were planning their estate would dispose of their stock in other ways. On the other hand, income taxpayers will rarely be confronted with a situation in which it is more advantageous to forego additional income. Furthermore, judicial notice of these inherent differences is embodied in the last successful constitutional challenges based upon retroactivity.[85] Second,

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80. *Carlton*, 972 F.2d at 1061-62.

81. *Carlton*, 114 S. Ct. at 2018.

82. *See* Nebbia v. New York, 291 U.S. 502 (1934). The rational relationship test, under due process, requires that the legislature have a legitimate state interest and the means (the legislation) be rationally related to that purpose. *Id.* at 510-11. Undoubtedly, Congress has a legitimate state purpose in raising revenue through taxation. To fail the second prong of the test, the legislation must be "unreasonable, arbitrary, or capricious." *Id.* at 511.

83. *See* Welch v. Henry, 305 U.S. 134, 148 (1938) "Similarly, a tax on the receipt of income is not comparable to a gift tax. We can not 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." *Id.*

84. Ronald L. Ludwig, *Design and Purpose of an ESOP: Techniques, Special Features and Incentives in Utilizing ESOPS in* TAX LAW AND ESTATE PLANNING (PLI Tax Law and Estate Planning Course Handbook Series No. J4-3678, 1995).

85. *See generally* Untermyer v. Anderson, 276 U.S. 440, 445 (1928) (invalidating the first gift tax as to a taxpayer who made a transfer before passage of the legislation but after the legislation was introduced); Blodgett v. Holden, 275 U.S. 142, 147 (1927) (invalidating the first gift tax as to a taxpayer who made a transfer before introduction of the legislation);

in 1986, the Court considered a challenge to a retroactive estate tax.[86] While the Court held that the retroactive estate tax satisfied due process,[87] the Court conducted an extensive analysis into "the nature of the tax and the circumstances in which it" was laid.[88] The Court did not specify the standard of review, but their in-depth analysis seemed to indicate that the deferential rational relationship test would not be utilized for retroactive estate and gift taxes.[89]

Nevertheless, the *Carlton* Court held that retroactive tax statutes would be held to the same standard as all retroactive economic legislation--the rational relationship standard.[90] Moreover, the Court emphatically ended any differences that may have existed between income taxes and estate and gift taxes.[91]

In *Carlton*, Congress' legitimate purpose was to correct a "mistake" in the original bill by adding a decedent ownership provision.[92] Without the decedent ownership provision, the anticipated revenue loss would have been $7 billion instead of the anticipated revenue loss of $300 million originally contemplated by Congress.

However, the Court's classification of Congress' action being one of curing a mistake leads to a very slippery slope. One commentator noted that "[m]any courts and commentators have been especially solicitous of curative statutes which retroactively correct 'mistakes' in the existing law. Unfortunately, the distinction between an unintended benefit and a repudiated policy judgment is generally difficult to draw."[93]

Nevertheless, even if this had not been curative legislation, the taxpayer would still not have prevailed. Given the current trend, the Court would have found that the purpose of "raising revenue" was sufficient to satisfy the requirements of the Due Process Clause.[94] Given the relaxed standard of the rational relationship test, it is difficult to ascertain what factors, if any,

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Nichols v. Coolidge, 274 U.S. 531, 543 (1927) (invalidating an estate tax as to a decedent who was required to include in their gross estate the value of transferred property prior to the passage of the act).

86. United States v. Hemme, 476 U.S. 558 (1986).

87. *Id.* at 572.

88. *Id.* at 569.

89. See *infra* notes 95-112 for a discussion of notice in retroactive tax cases.

90. United States v. Carlton, 114 S. Ct. 2018, 2022 (1994).

91. *Id.* at 2024 (stating that the successfully challenged estate and gift tax cases do not "stand for the proposition that retroactivity is permitted with respect to income taxes, but prohibited with respect to gift and estate taxes."). *Id.*

92. *Id.* at 2022.

93. *See* Note, *supra* note 16, at 440.

94. *Carlton*, 114 S. Ct. at 2025 (O'Connor, J., concurring).

comprise a successful challenge to a retroactive tax measure. The *Carlton* court severely curtailed certain factors which had been of analytical importance in the past.

2. Notice Provisions

The Supreme Court has previously wrestled with the relevance of notice in challenges based on retroactivity, but the Court has been less than consistent on the importance of issuing advance notice to the taxpayer. Consequently, it is not surprising that the Ninth Circuit placed considerable emphasis on the lack of notice.

In 1981, the Supreme Court decided *United States v. Darusmont*,[95] the first of the modern-day retroactivity cases. The court assumed, for purposes of argument, that notice was relevant.[96] Nevertheless, the Court found that the taxpayer had ample advance notice because both the House and Senate proposals contained retroactive effective dates.[97]

In *Pension Benefit Guaranty Corp. v. Gray*,[98] the Court also assumed that notice was relevant.[99] Once again, the Court held that the proposed legislation with retroactive effective dates provided "ample notice."[100] However, the Court retreated on the idea of a notice requirement by stating that "[w]e have doubts however, that retroactive application of the MPPAA [Multiemployer Pension Plan Amendments Act of 1980] would be invalid under the Due Process Clause for lack of notice even if it was suddenly enacted by Congress without any period of deliberation."[101]

In *United States v. Hemme*,[102] the Court further muddied the waters on the issue of notice.[103] The Court stated that "[o]ne 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

95. United States v. Darusmont, 449 U.S. 292 (1981).

96. *Id.* at 299.

97. *Id.* (stating further that the rate increase had been "under public discussion for almost a year before its enactment").

98. 467 U.S. 717 (1984).

99. *Id.* at 732.

100. *Id.*

101. *Id.* at 731-32. This extends the view that Congress should be able to retroactively apply measures so that taxpayers will not be able to transfer assets, and thus, diminish the economic benefit of a change in tax policy. In addition, the MPPAA was enacted into law at 29 U.S.C. §§ 1381-1461.

102. 476 U.S. 558 (1986).

103. *Id.* Interestingly enough, *Hemme* involved a challenge to the retroactively overhaul of gift and estate taxes. *Id.* at 560.

statute."[104] However, the Court concluded that the taxpayer "was no worse off than" he would have been without the retroactive measure.[105] Thus, the Court did not extensively consider the importance of notice.

Finally, the *Carlton* Court put an end to the notice debate.[106] In *Carlton*, the taxpayer did not have any type of notice, not even the loose constructive notice of pending legislation.[107] Nevertheless, the Court held that lack of notice is not dispositive under due process analysis.[108]

Conspicuously, however, the Court did not rely on the modern-day retroactive tax cases.[109] Rather, the Court relied on cases that marked the change in judicial review in economic legislation from the *Lochner* era.[110] Thus, the taxpayer is always on notice that the tax rate may increase.[111] Consequently, notice will never inure to the benefit of the taxpayer, but can undermine a successful constitutional challenge.[112]

3. Detrimental Reliance

Similarly, the *Carlton* Court held that "reliance alone is insufficient to establish a constitutional violation."[113] The Court further stated that "Taxation is neither a penalty imposed on the taxpayer nor a liability" assumed by contract.[114] Rather, taxation is merely a way of apportioning the costs of government.[115]

However, a mere change in the structure of taxation is not enough to mount a successful challenge.[116] The change in taxation must place the

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104. *Id.* at 569.

105. *Id.* at 570.

106. 114 S. Ct. 2018 (1994).

107. *Id.* at 2023.

108. *Id.*

109. For this proposition, the Court did not rely on any of the three cases decided since 1980: United States v. Hemme, 476 U.S. 558 (1986); Pension Benefit Guaranty Corp. v. Gray, 467 U.S. 717 (1984); United States v. Darusmont, 449 U.S. 292 (1981).

110. The Court cited Welch v. Henry, 305 U.S. 134 (1938) and Milliken v. United States, 283 U.S. 15 (1931). *See also* Lochner v. New York, 198 U.S. 45 (1905). *Lochner* is typical of the Supreme Court's more stringent review of economic legislation in the early twentieth century.

111. *Carlton*, 114 S. Ct. at 2023 (citing Milliken v. United States, 283 U.S. 15 (1931)).

112. Pension Benefit Guaranty Corp. v. Gray, 467 U.S. 717 (1984) (stating that the taxpayers had "ample notice").

113. *Id.*

114. *Id.* (citing Welch v. Henry, 305 U.S. at 1466-67).

115. *Id.*

116. United States v. Hemme, 476 U.S. 558, 570 (1986).

taxpayer in a worse position than if the retroactive legislation was never passed.[117] In *Hemme*, the Court denied the constitutional challenge because the taxpayer still paid $655.16 less than if the retroactive legislation had not been passed.[118]

4. Sham Transactions

Not only did the *Carlton* Court employ the deferential rational basis test, the Court also characterized the transaction as a purely tax-motivated sham transaction.[119] Consequently, the Court held that Congress acted reasonably in retroactively amending the tax so that "innocent" taxpayers would not have to bear the brunt of recuperating the loss in revenue.[120]

This characterization further impedes a successful constitutional challenge. Congress should bear the responsibility of formulating accurate tax legislation. Justice O'Connor criticized this characterization in her concurrence in *Carlton*, noting that because of the inherent nature of taxation, taxpayers can be expected to employ legitimate tax avoidance plans.[121] Furthermore, this "sham transaction" in *Carlton*, resulted in a $631,000 loss to the taxpayer and $631,000 increase in wealth to the ESOP.[122] Nevertheless, this amorphous concept will certainly be utilized by the government in any future challenges based on retroactivity.

III. REMAINING CONSTITUTIONAL PROTECTIONS

Despite the negative ramifications of the *Carlton* decision, there are at least two viable constitutional challenges available to taxpayers. The *Carlton* Court severely curtailed the cases that successfully challenged retroactivity, but the Court did not completely overturn them.

117. *Id.* at 571.

118. *Id.*

119. *Carlton*, 114 S. Ct. at 2022-23.

120. *Id.* at 2023.

121. *Id.* at 2024 (O'Connor, J., concurring). "[A] transaction, otherwise within an exception of the tax law, does not lose its immunity, because it is actuated by a desire to avoid, or, if one choose, to evade taxation. Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes." *Id.* (citing Helvering v. Gregory, 69 F.2d 809, 810 (2nd Cir. 1934) (citations omitted), *aff'd*, 293 U.S. 465 (1935).

122. Carlton v. United States, 972 F.2d 1051, 1061-62 (9th Cir. 1992).

A. A WHOLLY NEW TAX

One exception that remains from the successful challenges on retroactivity is the prohibition on retroactive "wholly new taxes."[123] Taxpayers have not been successful in using this attack, because the recent tax changes have only amended the broad categories of income, gift, and estate taxes.[124]

Nevertheless, some current tax ideas, if retroactively applied, might not survive a constitutional challenge. For example, Congress could not pass the VAT (value added tax) or a national sales tax on February 1 and then make it retroactive to the first of the year.[125]

B. THE RECENT TRANSACTION LIMITATION

Despite the broad discretion Congress possesses within the field of retroactive taxation, Congress does not have an unlimited time frame within which it can retroactively tax.[126] Congress is limited "to short and limited periods required by the practicalities of producing national legislation."[127] The Court has consistently held that it is not per se unconstitutional for a tax measure to retroactively encompass the entire calendar year in which the statute was enacted.[128]

The longest time frame in which the Court upheld a retroactive measure was three years.[129] In that case, *Welch v. Henry*,[130] the Wisconsin legis-

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123. United States v. Carlton, 114 S. Ct. 2018, 2024 (1994). "Blodgett and Untermyer, which involved the Nation's first gift tax, essentially have been limited to situations involving "the creation of a wholly new tax."

124. *See, e.g.*, United States v. Darusmont, 449 U.S. 292, 300 (1981) (holding that the minimum tax is only an "addition to" to the regular income tax and thus, not a wholly new tax).

125. One state court has examined the question of wholly new taxes: Gunther v. Comm'r, 487 A.2d 1080 (Conn. 1985). In *Gunther*, the court examined a tax statute that laid dormant for twelve years before it was revived retroactively. *Id.* at 1090. The court held that due process was not violated because it was not a "new" tax since it had existed at one time. *Id.*

126. *Carlton*, 114 S. Ct. at 2025 (O'Connor, J., concurring). "The government interest in revising the tax laws must at some point give way to the taxpayer's interest in finality and repose." *Id.*

127. *Id.* at 2026-27 (O'Connor, J., concurring). This principle embraces the idea that taxpayers should not be able to thwart tax change while the legislation is pending.

128. *Id.* at 2027 (O'Connor, J., concurring).

129. *See* Welch v. Henry, 305 U.S. 134, 141 (1938).

130. 305 U.S. 134 (1938).

lature increased the taxes for the years 1933 and 1934 in 1935.[131] However, *Welch* was exceptional because at that time, the Wisconsin legislature only met bi-annually in odd-numbered years.[132]

The more likely limitation is two years, measured by the year of enactment plus the preceding calendar year.[133] A valid retroactive measure "must be taken to include the receipt of income during the year of the legislation session preceding that of its enactment."[134] Since legislatures meet annually, two years would be the limit. "A period of retroactivity longer than the year preceding the legislative session in which the law enacted would raise, in my view, serious constitutional questions."[135]

CONCLUSION

The *Carlton* decision seriously undermines many of the arguments put forth by taxpayers challenging retroactive taxation. Nevertheless, a few attacks remain that may prove successful in future challenges. Unfortunately for the taxpayer, apparently the best protection against retroactive taxation is legislative self-restraint.

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131. *Id.*

132. *Id.* at 150.

133. *Carlton*, 114 S. Ct. at 2025 (O'Connor, J., concurring). Thus, at the outer limits, the enactment date would be Dec. 31, 19X1 and the retroactive effective date would be Jan. 1, 19X0.

134. *Welch*, 305 U.S. at 150.

135. *Carlton*, 114 S. Ct. at 2026 (O'Connor, J., concurring).