1994

Can the Government Change Tax Laws Retroactively?

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Can the Government Change Tax Laws Retroactively?

by Matthew J. Barrett

United States
v.
Jerry W. Carlton
(Docket No. 92-1941)

Argument Date: February 28, 1994
From: The Ninth Circuit

ISSUE

Whether legislation amending an estate tax provision of the Internal Revenue Code and applied retroactively violates the Fifth Amendment's Due Process Clause when applied to a transaction which an estate entered before Congress amended the provision?

FACTS

This case concerns the federal estate tax liability of the estate of Willametta K. Day, who died on September 29, 1985. Jerry W. Carlton, executor of Day's will, sought and obtained a six-month extension until December 29, 1986 for Day's estate (the "Estate") to file its estate tax return.

During this six-month extension, Congress enacted the Tax Reform Act of 1986 ("TRA"), Pub. L. No. 99-514, 100 Stat. 2085, which became law on October 22, 1986. In Section 1172 of that legislation, Congress added Section 2057 to the Internal Revenue Code of 1986 ("Section 2057"), which authorized an estate to deduct from the decedent's gross estate one half of the proceeds of the estate's sale of qualified securities to an employee stock ownership plan ("ESOP"). 100 Stat. at 2513-15. ESOPs are qualified pension plans which invest primarily in the employer's securities. (Incidentally, Section 7304(a) of the Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, 103 Stat. 2106, 2352-2354, repealed Section 2057 for the estates of persons dying after July 12, 1989.)

Case at a Glance

This case presents an issue regarding the constitutionality of retroactive taxes. In December 1987, to correct a drafting oversight, Congress retroactively amended the requirements of a federal estate tax deduction enacted in October 1986. The Ninth Circuit, using a lenient test, invalidated the amendment's retroactive application to a December 1986 transaction. Now the case is before the Supreme Court whose decision should indicate whether the Court will relax the almost overwhelming barriers to a successful attack on retroactive taxation established by its earlier cases.

As enacted, Section 2057 did not require the stock which the estate sold to an ESOP to be owned by the decedent immediately before death. Any estate that timely filed its return after October 22, 1986, the date that the TRA became law, could claim the deduction.

Between the time that the 99th Congress passed the TRA and its adjournment, Congress considered several hundred technical and clerical amendments to the TRA and approved several. Only one proposed amendment, unrelated to this case, however, pertained to Section 2057. No bill or resolution was introduced that would have added any condition on the availability of the new deduction in Section 2057 before Congress adjourned.

Specifically relying on Section 2057, Carlton used the Estate's funds to purchase 1,500,000 shares of MCI Communications Corporation ("MCI") stock on December 10, 1986, at an average price of about $7.47 per share, for a total price of $11,206,000. Two days later, MCI's ESOP agreed to buy the shares from the Estate at $7.05 per share, or about 26 cents below the mean market price for that day. The total sales price equaled $10,575,000, or $631,000 less than the amount that the Estate paid for the shares.

Carlton timely filed the Estate's tax return and deducted $5,287,500, or one half of the total sales price, from the gross estate pursuant to the then-applicable Section 2057. The deduction reduced the reported estate tax obligation by $2,501,161.

On January 5, 1987, and January 26, 1987, respectively, the Internal Revenue Service ("IRS") issued an advance version of, and then formally published, Notice 87-13 which stated, among other things, that "[p]ending the enactment of clarifying legislation," the IRS would not recognize a deduction under Section 2057 unless the decedent had "directly owned" the securities before death. I.R.S. Notice 87-13, 1987-1 C.B. 432, 442.

A bill which contained what became Section 10411 of the Omnibus Budget Reconciliation Act of 1987, Pub. L. No.

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100-203, 101 Stat. 1330-432 to 1330-433, was introduced in both chambers of Congress on February 26, 1987. As passed on December 22, 1987, the legislation amended Section 2057 to impose additional limitations on the deduction, including a requirement that "the decedent directly owned the securities [sold to the ESOP] immediately before death." The amendment applied retroactively, as if originally enacted in the TRA on October 22, 1986.

Upon auditing the Day estate tax return, the IRS applied amended Section 2057 and disallowed the claimed deduction for the sale of the MCI stock because the Estate had purchased the stock after Day's death and, therefore, Day did not own the stock "immediately before death." Carlton paid the resulting $2,501,161 estate tax deficiency, plus interest, and filed this suit for refund in the United States District Court for the Central District of California.

In an unpublished order, the district court reasoned that the retroactive restriction on the availability of the Section 2057 deduction was closer to a mere increase in the tax rate than to the enactment of a wholly new tax. Because changes in tax rates are reasonably foreseeable, the district court held that the retroactive application of the 1987 amendment to Section 2057 was not "harsh and oppressive" and did not violate due process. Accordingly, the court granted the government's motion for summary judgment.

On appeal, a divided panel of the United States Court of Appeals for the Ninth Circuit reversed. 972 F.2d 1051 (9th Cir. 1992). In determining whether retroactive application of the 1987 amendment was "unduly harsh and oppressive," the Ninth Circuit looked to two factors: (1) whether the taxpayer had actual or constructive notice that Congress would retroactively amend the statute, and (2) whether the taxpayer detrimentally and reasonably relied on the pre-amendment statute.

The Ninth Circuit concluded that, in the circumstances of this case, retroactive application of the 1987 amendment violated the Due Process Clause of the Fifth Amendment. The dissent, however, observed that, while maximum fairness to taxpayers might argue that Congress should legislate according to the majority opinion's two factors, the Supreme Court had declined to adopt such a standard as a requirement for due process. In addition, the dissent did not believe that Carlton satisfied the two factors cited by the majority because the Section 2057 deduction was "too good to be true."

The Ninth Circuit remanded the case to the district court with instructions to enter judgment in favor of Carlton. Subsequently, the Ninth Circuit denied a petition for rehearing and rejected a suggestion for rehearing *en banc* (i.e., a rehearing before all active judges in the circuit). On October 4, 1993, the Supreme Court granted the government's petition for a writ of certiorari.

BACKGROUND AND SIGNIFICANCE

The third clause of Article I, Section 9 of the Constitution provides that Congress shall not pass *ex post facto*, i.e., retroactive, laws. Although the Latin phrase *ex post facto* literally encompasses any law passed "after the fact," the Supreme Court has consistently held that the constitutional limitation of the *Ex Post Facto* Clause applies only to criminal enactments. *Collins v. Youngblood*, 497 U.S. 37, 41-42 (1990). In non-criminal areas, Congress generally enjoys wide latitude to legislate retroactively, especially when regulating economic activity. *Pension Benefit Guaranty Corp. v. R.A. Gray & Co.*, 467 U.S. 717, 729 (1984). With the *Ex Post Facto* Clause unavailable to challenge the constitutionality of retroactive non-criminal statutes, those attempting such challenges have had to turn to other provisions of the Constitution, notably the Fifth Amendment's Due Process Clause.

Outside the tax context, the Supreme Court has stated that a retroactive application of a statute regulating economic activity must be "arbitrary and irrational" to violate the Due Process Clause. *Usery v. Turner Elkhorn Mining Co.*, 428 U.S. 1, 15 (1976). In the tax context, the Court determines whether a retroactive statute violates the Due Process Clause by asking if such retroactivity "is so harsh and oppressive as to transgress the constitutional limitation." *Welch v. Henry*, 305 U.S. 134, 147 (1938). However, in *Pension Benefit*, the Court indicated that the "harsh and oppressive" standard used in the tax context "does not differ from the prohibition against arbitrary and irrational legislation that we clearly enunciated in *Turner Elkhorn*." 467 U.S. at 733.

In the last Supreme Court decision involving a due process challenge to the retroactive operation of federal tax legislation, the Court recognized a distinction between legislation which brings about changes in operation of the tax laws and legislation which creates a wholly new tax. *United States v. Hemme*, 476 U.S. 558, 568 (1986); *see also United States v. Darusmont*, 449 U.S. 292, 299 (1981).

In *Darusmont*, the Court upheld the retroactive application of a new income tax provision signed on October 4, 1976 to a transaction consummated on July 15, 1976. The proposed change, however, had been under public discussion for almost a year before its enactment. The Supreme Court described retroactive application of general revenue statutes as "a customary congressional practice." The Court acknowledged that "the practicalities of producing national legislation" required and permitted retroactive application "confined to short and limited periods." 449 U.S. at 296-97.

In this case, the government stresses that the harshness or fairness of taxation is peculiarly a social and political judgment, which the legislature, not the judiciary, should make. The government maintains that it met the burden for sustaining retroactive legislation under the Due Process Clause by showing that a rational legislative purpose justified the retroactive amendment to Section 2057.

The government admits that the original language of Section 2057 did not limit the deduction to instances where the decedent owned the qualified securities at the time of death. The resulting tax benefits, therefore, potentially applied to any estate that purchased qualified securities on the open market and resold the securities to an ESOP. However, under the government's view of the circumstances surrounding the original legislation, Congress did not intend the statute to apply to transactions which had no purpose other than tax avoidance.

The government argues, accordingly, that the 1987 amendment represents a rational method of accomplishing a legitimate governmental purpose. The government reasons that legislation designed to cure errors in the drafting of earlier legislation and to close loopholes unintentionally created during the legislative process advances the public interest and qualifies for retroactive, as well as prospective, application.

The government also argues that the change in Section 2057 at issue in this case does not constitute a retroactive imposition of a wholly new tax. The estate tax existed before Congress added Section 2057, and the 1987 amendment to Section 2057 merely limited the Section 2057 deduction which, the government observes, did not even exist at the time of Day's death.

In response, Carlton argues that the "harsh and oppressive" test requires the Court to consider both the object of the legislation and its effect on the taxpayer. Carlton begins by arguing that Section 2057 was only one of the extraordinary tax benefits that Congress used to encourage the growth of ESOPs. Thus, Carlton maintains that Section 2057's original language was neither unusual nor surprising.

Carlton asserts that the facts in this case stand in stark contrast to the cases which the government has cited to support retroactive changes. Initially, Carlton argues that the Estate could not have foreseen the retroactive amendments to Section 2057. The parties stipulated that Section 2057's original language did not contain the requirement that the decedent directly own the securities sold to the ESOP immediately before death. The parties also stipulated that neither the several hundred potential amendments which Congress considered nor the several changes which Congress added to the TRA before adjourning pertained to this requirement. Additionally, the IRS did not issue the advance version of Notice 87-13 until after the Estate had already purchased and resold the MCI stock to the company's ESOP.

Carlton also emphasizes that the Estate suffered actual injury by selling the shares to the ESOP for $631,000 less than the Estate purchased the shares. Here, Carlton points to the parties' stipulation that, if Carlton had not expected the Section 2057 deduction, the ESOP would not have been able to purchase the stock at a price about 26 cents per share below the mean market price on the day that the Estate sold the shares to the ESOP. Because the original legislation induced the use of estate funds to pursue the public goal of ESOP funding, Carlton argues that due process prevents the government from denying the Estate the benefit that induced the transaction.

The Court's decision may affect other estates which entered into similar transactions with ESOPs, including those that completed transactions after the IRS issued a notice of proposed statutory changes but before introduction of the amending legislation in Congress. After the Ninth Circuit's decision in this case, the Fifth Circuit upheld the retroactive application of the Section 2057 amendment to an estate's purchase and sale of stock after the IRS issued Notice 87-13. *Ferman v. United States*, 993 F.2d 485 (5th Cir. 1993), *petition for cert. filed*, 62 U.S.L.W. 3299 (U.S. Oct. 12, 1993). Significantly, the Ninth Circuit majority alluded to this point by noting that it might have reached a different conclusion if the Estate had consummated the transactions after January 5, 1987, the date the IRS issued the advance version of Notice 87-13.

The Court's decision also could affect two provisions which retroactively raise taxes in the Revenue Reconciliation Act of 1993 ("RRA"), Pub. L. No. 103-66, 107 Stat. 416, which President Clinton signed on August 10, 1993. First, the RRA increases the federal income tax rates for more than one million upper-income taxpayers retroactive to January 1, 1993. Second, RRA retroactively raises estate tax rates on estates of decedents who died after December 31, 1992 to the rates that existed in 1992.

On August 27, 1993, the National Taxpayers Union, Inc. and the Landmark Legal Foundation filed suit in the United States District Court for the District of Columbia, Docket No. 93-1796, challenging the retroactive increase in the estate tax rates. Clearly, the district court will be looking to the Court's decision in this case in deciding that challenge to the RRA.

ARGUMENTS

For the United States *(Counsel of Record: Drew S. Days, III, Solicitor General, Department of Justice, Washington, DC 20530; (202) 514-2217):*

1. The 1987 amendment to Section 2057 satisfies the requirements of due process because the legislation constitutes a rational means to further a legitimate legislative purpose.
2. The due process formula which the Ninth Circuit applied lacks a foundation in the Constitution.

For Jerry W. Carlton *(Counsel of Record: Russell G. Allen; O'Melveny & Myers, 610 Newport Center Drive, Suite 1700, Newport Beach, CA 92660; (714) 669-6901):*

1. Due process limits harsh and oppressive retroactive taxation.
2. The retroactive restrictions on the Section 2057 deduction exceeded the due process limitation because nothing in the provision or its legislative history forecast the retroactive restrictions.
3. The circumstances distinguish this case from other cases in which the Supreme Court has upheld retroactive taxation.

AMICUS BRIEFS

In Support of Jerry W. Carlton

The American Cause *(Counsel of Record: Alan P. Dye, 1747 Pennsylvania Avenue, NW, Suite 1000, Washington, DC 20006; (202) 785-9500)*;

Joint brief of Anthony C. Morici, Jr., as Executor of the Estate of Carol M. McNamee, and Eileen McNamee and Anthony C. Morici, Jr., as Trustees of the Carol M. McNamee Trust Agreement *(Counsel of Record: Charles C. Marson, 220 Montgomery Street, Suite 800, San Francisco, CA 94104; (415) 398-6230);*

Joint brief of the Washington Legal Foundation; United States Senators Pete Domenici, Larry E. Craig, John McCain, Slade Gorton, Bob Smith, Trent Lott, Conrad Burns, Kay Bailey Hutchison, Connie Mack, Dan Coats, Jesse Helms, Robert F. Bennett, William V. Roth, Jr., Malcolm Wallop, Dirk Kempthorne, Strom Thurmond, Paul D. Coverdell, Christopher S. Bond, Orrin Hatch, Alfonse M. D'Amato, Ted Stevens, and Don Nickles; United States Representatives Newt Gingrich, Chris Cox, Gerald Solomon, Dana Rohrabacher, Robert K. Dornan, Deborah Pryce, Jack Kingston, Bill Baker, Peter T. King, John Boehner, Steve Buyer, Jim Bunning, Bob Walker, Joe Knollenberg, Cass Ballenger, Mel Hancock, Rod Grams, Tom Ewing, Tom Bliley, and Elton Gallegly; Governor Kirk Fordice of Mississippi; and the Allied Educational Foundation *(Counsel of Record: Joseph E. Schmitz; Paul, Hastings, Janofsky & Walker, 1299 Pennsylvania Avenue, NW, Washington, DC 20004; (202) 508-9500).*