RETROACTIVE TAXATION:A TRIUMPH OF LAW OVER ECONOMICS?
United States v. Carlton (1994)

by

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> "The reasoning the Court applies to uphold the statute in this case guarantees that *all* retroactive tax laws will henceforth be valid."
>
> Justice Scalia in an opinion concurring in the judgment of the U. S. Supreme Court in *United States v. Carlton* (1994)[1]

A significant 9-0 decision on retroactive taxation was handed down by the U.S. Supreme Court in June, 1994 in *United States v. Carlton*. It did not deal with the retroactivity of the 1993 law but it would, in appearance, be highly pertinent to any challenge to that law; yet factual peculiarities of the 1994 case and the reasoning used by the respective Justices suggest that it would not be controlling on tax retroactivity in general. This conclusion stems from the economic rationale underlying each of the opinions written in the case. Justice Scalia, who (joined by Justice Thomas) concurred only in the judgment of the Court, not the Court's opinion, may have been unduly negative in his forecast, quoted above.

Overview of the Case

The case deals with a provision of the estate tax law, 26 U.S.C. §2057, that, as adopted in October 1986, granted an estate tax deduction for half the proceeds of "any sale of employer securities by the executor of an estate" to "an employee stock ownership plan" (ESOP). The respondent,

Carlton, in December 1986, acting as an executor, purchased shares in a corporation, sold them to that company's ESOP at a loss, and claimed a large §2057 deduction on the estate tax return he was handling.

The Treasury and Congress realized that a mistake had been made in the 1986 law which had failed to require that the stock be held by the decedent *before* death in order that the deduction be available. In December 1987 §2057 was amended to provide that, to qualify for the deduction, the securities sold to an ESOP must have been "directly owned" by the decedent "immediately before death." Because the amendment applied retroactively, as if it were incorporated in the original 1986 provision, the Internal Revenue Service (IRS) disallowed Carlton's §2057 deduction. The District Court entered summary judgment against him in his ensuing refund action, rejecting his contention that the amendment's retroactive application to his transactions violated the Due Process Clause of the Fifth Amendment. The Ninth Circuit Court of Appeals reversed, holding that such application was rendered unduly harsh and oppressive, and therefore unconstitutional, by Carlton's lack of notice that §2057 would be retroactively amended and by his reasonable reliance to his detriment on pre-amendment law.

The Supreme Court held that the 1987 amendment's retroactive application to Carlton's 1986 transactions does not violate due process; that under the applicable standard, a tax statute's retroactive application must be supported by

a legitimate legislative purpose furthered by rational means, citing a 1984 case, among others; that here, Congress' purpose in enacting the retroactive 1987 amendment was neither illegitimate nor arbitrary; that §2057 was originally intended to create an incentive for stockholders to sell their companies to their employees, but the absence of a decedent-stock-ownership requirement resulted in the deduction's broad availability to virtually any estate, at an estimated loss to the Government of up to $7 billion in anticipated revenues; that, thus, Congress undoubtedly intended the amendment to correct what it reasonably viewed as a mistake in the original provision; that there is no plausible contention that it acted with an improper motive, and its decision to prevent the unanticipated revenue loss by denying the deduction to those who made purely tax-motivated stock transfers was not unreasonable; that, moreover, the amendment's retroactive application is rationally related to its legitimate purpose, since Congress acted promptly in proposing the amendment within a few months of §2057's original enactment and established a modest retroactivity period that extended only slightly longer than one year.

The Court found that the Ninth Circuit Court of Appeals' exclusive focus on the taxpayer's notice and reliance held §2057 to an unduly strict standard; and it accordingly reversed the Ninth Circuit decision.

Justice Blackmun delivered the opinion of the Court, in which Chief Justice Rehnquist and Justices Stevens, Kennedy, Souter, and Ginsburg joined. Justice O'Connor filed an opinion concurring in the judgment. Justice Scalia also filed an opinion, in which Justice Thomas joined, concurring in the judgment.

The Economic Issue

Changing the rules of the game after economic commitments have been made is an abhorrent idea. On the face of it, the *Carlton* decision runs counter to economic doctrine that assumes the aim is to make consumption and investment decisions to maximize utility or wealth or whatever. Changing the "givens", like tax rates, after commitments have been made would generally tend to detract from an optimal result. A retroactive change would upset carefully thought-out plans; and a prevailing fear of adverse retroactive changes would tend to discourage otherwise desirable investment and consumption decisions. Even if anyone had conceived of the possibility of retroactive taxation, there was no insurance available to take care of the risk involved: there is no "derivative" to use as a hedge against this sort of contingency; and if there were, at what price?

Does this decision augur ill for the future? A close reading of the opinions of the various Justices offers a glimmer of hope.

The particular transactions here involved are perhaps also of general interest in showing the ingenuity exercised by an executor in trying to maximize an estate, entirely by legitimate means.

The Court's Opinion by Justice Blackmun

The question presented by this case is whether the retroactive application of the change in the law violates the Due Process Clause of the Fifth Amendment.

The Court states that the respondent, Jerry W. Carlton, the executor of the will of Willametta K. Day, deceased, sought to utilize the §2057 deduction; that Ms. Day died on September 29, 1985 and her estate tax return was due December 29, 1986 (after Carlton had obtained a 6-month filing extension, the sale of the securities having had to be made before the date on which the estate tax return was required to be filed, including any extensions); that on December 10, 1986, Carlton used estate funds to purchase 1.5 million shares of MCI Communications Corporation for $11,206,000, at an average price of $7.47 per share; that two days later, Carlton sold the MCI stock to the MCI ESOP for $10,575,000, at an average price of $7.05 per share; that the total sale price thus was $631,000 less than the purchase price; that when Carlton filed the estate tax return on December 29, 1986, he claimed a deduction under §2057 of $5,287,000, for half the proceeds of the sale of the stock to the MCI ESOP; and, finally, that the deduction reduced the estate tax by $2,501,161; that thus Carlton had

made a net "profit" for the estate of a substantial amount of money.

The parties had stipulated that Carlton engaged in the MCI stock transactions specifically to take advantage of the §2057 deduction.

The governing administrative ruling was made on January 5, 1987, when the Internal Revenue Service announced that, pending the enactment of clarifying legislation, it would treat the §2057 deduction as available only to estates of decedents who *owned the securities in question immediately before death.*[2] A bill to enact such an amendment to §2057 was introduced in each chamber of Congress on February 26, 1987[3], including a provision that made the change effective as if it had been included in the statute as originally enacted in October 1986; and on December 22, 1987, the amendment to §2057 was enacted.[4]

Justice Blackmun points out that the IRS disallowed the deduction claimed by Carlton under §2057 on the ground that the MCI stock had not been owned by his decedent immediately before death. Carlton paid the asserted estate tax deficiency, plus interest, filed a claim for refund, and instituted a refund action in the United States District Court for the Central District of California. He conceded that the estate did not qualify for the deduction under the 1987 amendment to §2057. He argued, however, that retroactive application of the 1987 amendment to the

estate's 1986 transactions violated the Due Process Clause of the Fifth Amendment.

The District Court rejected his argument and entered summary judgment in favor of the United States.

Then a divided panel of the Court of Appeals for the Ninth Circuit reversed.[5] The majority considered two factors paramount in determining whether retroactive application of a tax violates due process: whether the taxpayer had actual or constructive notice that the tax statute would be retroactively amended, and whether the taxpayer reasonably relied to his detriment on pre-amendment law. The Ninth Circuit concluded that both factors rendered retroactive application of the amendment in this case unduly harsh and oppressive and therefore unconstitutional.

Judge Norris of the Ninth Circuit dissented. In his view, the 1987 amendment was within the wide latitude of congressional authority to legislate retroactively in regulating economic activity. The Supreme Court granted certiorari.

Justice Blackmun points out that the Court repeatedly has upheld retroactive tax legislation against a due process challenge[6]; that some of its decisions have stated that the validity of a retroactive tax provision under the Due Process Clause depends upon whether "retroactive application is so harsh and oppressive as to transgress the constitutional limitation" (quoting an earlier case[7]).

Justice Blackmun states that the "harsh and oppressive" formulation, however, "does not differ from the prohibition against arbitrary and irrational legislation" that applies generally to enactments in the sphere of economic policy[8]; that the due process standard to be applied to tax statutes with retroactive effect, therefore, is the same as that generally applicable to retroactive economic legislation. He quotes from earlier cases:

"Provided that the retroactive application of a statute 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 . . . .

"To be sure, . . . retroactive legislation does have to meet a burden not faced by legislation that has only future effects. . . . 'The retroactive aspects of legislation, as well as the prospective aspects, must meet the test of due process, and the justifications for the latter may not suffice for the former' . . . . But that burden is met simply by showing that the retroactive application of the legislation is itself justified by a rational legislative purpose."[9]

Thus it appears that the criteria are the same for all legislation ("legitimate legislative purpose furthered by rational means") but retroactive aspects themselves must also meet those criteria.

Justice Blackmun says there is little doubt that the 1987 amendment to §2057 was adopted as a curative measure; that as enacted in October 1986, §2057 contained no requirement that the decedent have owned the stock in question to qualify for the ESOP proceeds deduction; that as a result, any estate could claim the deduction simply by buying stock in the market and immediately reselling it to an ESOP, thereby obtaining a potentially dramatic reduction in (or even elimination of) the estate tax obligation; that it seems clear that Congress did not contemplate such broad applicability of the deduction when it originally adopted §2057; that that provision was intended to create an "incentive for stockholders to sell their companies to their employees who helped them build the company rather than liquidate, sell to outsiders or have the corporation redeem their shares on behalf of existing shareholders" (quoting the Joint Committee on Taxation).[10]

Justice Blackmun states that when Congress initially enacted §2057, it estimated a revenue loss from the deduction of approximately $300 million over a 5-year period[11]; that it became evident shortly after passage of the 1986 Act, however, that the expected revenue loss under Section 2057 could be as much as $7 billion "over 20 times greater than anticipated"[12] (according to 1987 statements of Representative Rostenkowski and Senator Bentsen in 1987) because the deduction was not limited to situations in which the decedent owned the securities immediately before death.

Justice Blackmun points out that in introducing the amendment in February 1987, Senator Bentsen observed: "Congress did not intend for estates to be able to claim the deduction by virtue of purchasing stock in the market and simply reselling the stock to an ESOP . . . and Congress certainly did not anticipate a $7 billion revenue loss."[13] Justice Blackmun continues, that, as Senator Bentsen puts it, without the amendment, "taxpayers could qualify for the deductions by engaging in essentially sham transactions."[14]

[The present author must interject here that the instant transaction in the *Carlton* case is not a "sham" transaction. It is well established in the law that a transaction to minimize taxes, if otherwise legitimate, is not a "sham" transaction if the term "sham" is intended to imply anything illegal, immoral or otherwise improper. A "sham" transaction would be one that did not really take place but was simply designed to fool the tax authorities. That is not the case here. Everything was above-board and complied with the law that was in force at the time. Justice O'Connor, in her concurring opinion strongly emphasizes this view, quoting Judge Learned Hand's well-known statement.]

Justice Blackmun concludes that the 1987 amendment's retroactive application meets the requirements of due process: "In focusing exclusively on the taxpayer's notice and reliance, the Court of Appeals held the congressional enactment to an unduly strict standard. Because we conclude that retroactive application of the 1987 amendment

to §2057 is rationally related to a legitimate legislative purpose, we conclude that the amendment as applied to Carlton's 1986 transactions is consistent with the Due Process Clause."[15]

It is evident that the retroactive application of the 1987 revision is subjected to careful examination by the Court and is not automatically swept up with the revision itself as being rationally related to a legitimate legislative purpose. The substance of the revision and the retroactivity feature separately have to meet both the "rational" and "legitimate" tests before Court approval can be obtained. The mere use of taxation in response to a need for revenue is not enough.

Justice O'Connor's Concurring Opinion

Justice O'Connor concurs in the judgment but seems to recognize quite strongly the unfavorable economic impact of tax retroactivity. Justice O'Connor fully acknowledges the governmental need for revenue and the impracticality of speeding the legislative process so as to avoid retroactivity to, say, the beginning of the year of enactment. She is sensitive, though, to the taxpayer's need for "finality and repose"[16] and the fact that "...the tax consequences of commercial transactions are a relevant, and sometimes dispositive, consideration in a taxpayer's decisions regarding the use of his capital"[17]; moreover, she is influenced by the "limited period of retroactivity"[18], that is involved in this case. In essence, there is no

blanket approval of tax retroactivity in this concurring opinion.

Justice Scalia's Concurring Opinion

Justice Scalia has some critical comments on the Court's opinion although he concurs in the result. It is evident that Justice Scalia is concerned not only with the Court's reasoning in this case but also with that in other Due Process cases. He shows great sympathy for the taxpayer involved: "Retroactively disallowing the tax benefit that the earlier law offered, without compensating those who incurred expenses in accepting that offer, seems to me harsh and oppressive by any normal measure."[19] He also recognizes the economic implications of the retroactivity: "...[T]he critical event is the taxpayer's reliance on the incentive, and the key timing issue is whether the change occurs after the reliance; that it occurs immediately after rather than long after renders it no less harsh."[20]

Nevertheless, he concurs in the Court's judgment. This stems partly from a recognition that revenue-raising is a legitimate legislative purpose, that "any law that retroactively adds a tax, removes a deduction, or increases a rate rationally furthers that goal."[21] He also states his basic belief in the nature of the Due Process Clause: "I welcome this recognition that the Due Process Clause does not prevent retroactive taxes, since I believe that the Due Process Clause guarantees *no* substantive rights, but only (as it says) process;....[22]

All considered, he makes the forecast quoted at the beginning of this paper: "The reasoning the Court applies to upholding the statute in this case guarantees that *all* retroactive tax laws will henceforth be valid."[1]

Critique

This case may not be as far-reaching as might appear. The result would seem to be unduly harsh on the petitioner; hence, one might think that if, in such a case the Court sustains retroactivity, what will it do when the effect on an individual taxpayer is relatively mild? Yet other peculiarities of this case suggest that it might not be considered a controlling precedent for other retroactive cases. Here are my reasons (without considering the possible impact of the substitution of Justice Breyer for Justice Blackmun):

(1) Important for our purposes is the emphasis that Justice Blackmun (in the Opinion in which five other Justices joined) places on Congress' "....denying the deduction to those who had made purely tax-motivated stock transfers"[23] and the fact that "....Congress acted promptly and established only a modest period of retroactivity".[24]

(2) There is no blanket approval of retroactivity in this Opinion. What is rejected is mere "reliance" and lack of "notice", though with "harsh" and "oppressive" result, as sufficient reasons to disqualify retroactivity. The fact that Congress acted "promptly" and that there was only a "modest period of retroactivity" argued for allowing the

legislation. And engaging in a transaction for tax reasons alone does not help the taxpayer at all in this case.

(3) The case deals with the financial management of an estate by its executor. It does not deal with a living taxpayer who is making investment or consumption decisions in reliance on an existing set of tax rules that were in effect when making the decisions. The desirable criterion of foreseeability of tax rules could not be met in the usual way unless we attributed perfect foresight to the decedent in making decisions for the estate while she was still alive. The decedent could hardly have arranged affairs with the knowledge that the executor would be engaging in the ESOP activities described in order to enhance the estate. She could plan to leave only the estate that she had before the executor's actions. Hence, the economic consequences of the retroactivity in terms of consumption and investment decisions by the accumulator of wealth would be nil or negligible.

(4) Another reason why it may not be a controlling precedent is that the Congress' original action was found to have been a "mistake" by the Supreme Court: It would surely be a "legitimate legislative purpose" to correct a mistake. There is no reason to believe that the retroactivity in the 1993 Omnibus tax act, for example, was a "mistake" in the same sense (although it is arguably an economic "mistake" despite the deferment provisions that were included).

(5) But what of revenues? The sovereign needs money! If maintenance of revenue is a requirement, the problem then becomes one of finding an equal-revenue source that is less harmful to the economy. For instance, an equal-revenue *prospective* increase in taxation might be found to have a less deleterious effect on consumption, saving, and investment decisions. That question would undoubtedly be considered entirely within the province of the legislature and outside the province of the courts. Yet can we say that the ready availability of a non-retroactive method of raising the same revenue would have no influence?

In summary, a challenge to the retroactivity of other tax provisions might be able to withstand the precedent of the *Carlton* decision: There is still some indication that the economic argument might prevail in a suitable case that exceeds the limitations imposed in the various opinions rendered in this case. Perhaps a retroactivity substantially in excess of one-year that required the unscrambling of complicated consumption or investment decisions (undertaken for "real" rather than tax reasons) would qualify for rejection by a majority of the Court even with one or two changes in Court personnel. Then the triumph of law over economics would be curbed.

Justice Blackmun says, "Tax legislation is not a promise, and a taxpayer has no vested right in the Internal Revenue Code."[25] That statement is not subject to legal dispute; yet it is unfortunate when carried over to

retroactive taxation after major economic commitments have already been made. Future taxation is not predictable but surely the past can be!

ENDNOTES

1 UNITED STATES v. CARLTON, 512 U.S._____(1994), 114 S. Ct. 2018 (1994). Certiorari to the United States Court of Appeals for the Ninth Circuit. No. 92-1941. Argued February 28, 1994. Decided June 13, 1994. The quotation from Justice Scalia's concurring opinion is in 114 S. Ct. at 2027; the italics are in the original. The section on "Overview of the Case" is adapted from the Reporter of Opinions' Syllabus. All quotations from the case in this paper are taken from the S. Ct. print cited above.

2 The Court cites IRS Notice 87-13, 1987-1 Cum. Bull. 432, 442.

3 The Court cites 133 Cong. Rec. 4145 and 4293 (1987).

4 The Court cites Omnibus Budget Reconciliation Act of 1987, 10411(a), 101 Stat.1330-432.

5 972 F.2d 1051 (CA9 1992).

6 The Court cites United States v. Hemme, 476 U.S. 558 (1986); United States v. Darusmont, 449 U. S. 292 (1981); Welch v. Henry, 305 U. S. 134 (1938); United States v. Hudson, 299 U. S. 498 (1937); Milliken v. United States, 283 U. S. 15 (1931); Cooper v. United States, 280 U. S. 409 (1930).
[S.Ct. and L.Ed. citations here omitted]

7 The Court quotes Welch v. Henry, 305 U. S., at 147, as quoted in United States v. Hemme, 476 U. S., at 568-569. [S.Ct. and L.Ed. citations here omitted]

8 The Court quotes Pension Benefit Guaranty Corp. v. R. A. Gray & Co., 467 U. S. 717, 733 (1984). [S.Ct. and L.Ed. citations here omitted]

9 The Court cites Id., at 729-730, quoting Usery v. Turner Elkhorn Mining Co., 428 U. S. 1, 16-17 (1976). [S.Ct. and L.Ed. citations here omitted]

10 The Court quotes Joint Committee on Taxation, Tax Reform Proposals: Tax Treatment of Employee Stock Ownership Plans (ESOPs), 99th Cong., 2d Sess., 37 (Joint Comm. Print 1985); referring also to 132 Cong. Rec.14,507 (1986) (by Sen. Long) §2057 "allow[s]. . . an executor to reduce taxes on an estate by one-half by selling the decedent's company to an ESOP").

11 The Court cites 133 Cong. Rec. 4145 (1987) (statement of Rep. Rostenkowski); id., at 4293 (statement of Sen. Bentsen).

12 Ibid.

13 Id., at 4294

14 Ibid.

15 *U.S. v. Carlton,* op. cit., at 2024

16 Id., at 2025

17 Ibid.

18 Id., at 2026

19 Ibid.

20 Id., at 2027

21 Ibid.

22 Ibid. [The italics are in the original.] Justice Scalia cites *TXO Production Corp. v. Alliance Resources Corp.,* 509 U.S.___,___,113 S. Ct. 2711, 2715, 125 L.Ed.2d 366 (1993) (Scalia, J., concurring in judgment).

23 *U.S. v. Carlton,* op. cit., at 2024

24 Ibid.

25 Ibid.