Mercer Law Review

Volume 47
Number 4 *Lead Articles Edition - Rural Health Care*

Article 8

7-1996

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Recommended Citation

Haskins, Stewart (1996) "Gambling with the IRS: The Enforcement of Retroactive Tax Statutes in *United States v. Carlton*," *Mercer Law Review*: Vol. 47 : No. 4 , Article 8.
Available at: https://digitalcommons.law.mercer.edu/jour_mlr/vol47/iss4/8

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Gambling with the IRS: The Enforcement of Retroactive Tax Statutes in *United States v. Carlton*

In *United States v. Carlton*,[1] the Supreme Court rejected a Due Process challenge to the retroactive elimination of an estate tax deduction.[2] In 1986, Congress revised the Internal Revenue Code to allow a deduction under 26 U.S.C. § 2057 for half the proceeds of a sale of employer securities by the executor of an estate to an employee stock ownership plan (ESOP).[3] Jerry W. Carlton was the executor of Willametta K. Day's estate.[4] In December 1986, Carlton used estate funds to purchase MCI stock valued at $11,206,000.[5] Two days later, Carlton sold the stock to the MCI ESOP for $10,575,000, losing $631,000 in the transaction.[6] Carlton filed a timely estate tax return, claiming a deduction under section 2057 for half the proceeds of the sale of stock, which amounted to a tax liability reduction of $2,501,161.[7] In January 1987, the IRS announced it would interpret the deduction to be available only to estates of decedents who owned the securities immediately before death.[8] In February 1987, a bill was proposed in the House and Senate to codify the IRS interpretation.[9] On December 22, 1987, the amendment to section 2057 was enacted.[10] It provided that in order to qualify for the deduction, the securities sold to the ESOP must have been "directly owned" by the decedent "immediately before death."[11] The amendment was made effective as if it had been included in the original

1. 114 S. Ct. 2018 (1994).
2. *Id.* at 2024.
3. *Id.* at 2020.
4. *Id.* at 2021.
5. *Id.*
6. *Id.*
7. *Id.*
8. *Id.* (citing IRS Notice 87-13, 1987-1 Cum. Bull. 432, 442).
9. *Id.*
10. *Id.*
11. *Id.* (citing Omnibus Budget Reconciliation Act of 1987, § 10411(a), 101 Stat. 1330-432).

statute of October 1986.[12] The IRS disallowed Carlton's section 2057 deduction.[13] Carlton paid the asserted tax deficiency, plus interest, filed a claim for a refund, and initiated a refund action in the United States District Court for the Central District of California, claiming that the retroactive application of the statute violated the Due Process Clause of the Fifth Amendment.[14] The parties stipulated that if the statute could not be retroactively applied without violating the Constitution, Carlton would be entitled to a refund; else the Government would prevail.[15] The court held the tax was not so "unduly harsh and oppressive" as to violate due process and entered summary judgment for the United States.[16] The court focused on: (1) whether the statute was a "wholly new tax" or a rate change in an existing tax; and (2) whether the change (amendment) was reasonably foreseeable.[17] The court found the statute was simply a "rate change" and the change was foreseeable; therefore, the amendment did not violate the Due Process Clause.[18] The Ninth Circuit Court of Appeals reversed the district court in a two-to-one decision, using a different test than the district court.[19] The United States Supreme Court granted certiorari and reversed.[20] The Court held retroactive application of a tax statute does not violate the Due Process Clause if the application of the statute is rationally related to a legitimate legislative purpose.[21]

Retroactive laws are disfavored in the Constitution. The Constitution provides several restrictions against retroactive application of laws. Ex Post Facto laws are prohibited.[22] Bills of Attainder, laws that apply to specific individuals, are prohibited.[23] The Contract Clause prevents laws impairing contract obligations, reflecting the Framer's disapproval

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12. *Id.* Thus, while the amendment to § 2057 was enacted December 22, 1987, the amendent applied to transactions that occurred after October 1986, including Carlton's sale of stock to the MCI ESOP.

13. *Id.*

14. *Id.*

15. Carlton v. United States, 972 F.2d 1051, 1055 (9th Cir. 1992), *rev'd*, 114 S. Ct. 2018 (1994).

16. 972 F.2d at 1059, 1062. The district court used the standard from Welch v. Henry, 305 U.S. 134 (1938), discussed at *infra* notes 45-48.

17. *Carlton*, 972 F.2d at 1055.

18. *Id.*

19. *Id.* The court of appeals framed the test as (1) Whether the taxpayer had actual or constructive notice that the tax statute would be retroactively amended; and (2) Whether the taxpayer reasonably relied to his detriment on pre-amendment law.

20. 114 S. Ct. at 2018.

21. *Id.* at 2024.

22. U.S. CONST. art. I, § 9, cl. 3.

23. *Id.*

of retroactive laws affecting contracts.[24] The Takings Clause of the Fifth Amendment restricts retroactive laws unduly affecting property rights.[25] Most commonly, it is argued that retroactive application of a statute may violate due process rights under the Fifth Amendment.[26] There are many policy reasons for this historical disapproval of retroactive application of statutes. Citizens should be able to plan their conduct with reasonable certainty of the legal consequences. There is a public need for stability with respect to past transactions. Retroactive laws may be passed with exact knowledge of who the law will benefit or harm, which increases the potential for corruption in the political process. Despite these policy arguments, retroactive tax laws were initially upheld against constitutional challenges. In a 1874 decision, *Stockdale v. Atlantic Insurance Co.*,[27] the Court upheld a retroactive tax on corporate dividends as a "legitimate exercise of the taxing power by which a tax, which might be supposed to have expired, was revived and continued in existence for two years longer."[28] Later, in *Brushaber v. Union Pacific Railroad*,[29] the Court relied on the decision in *Stockdale* to uphold another retroactive tax statute.[30] The Court stated "the Constitution does not conflict with itself by conferring, upon the one hand, a taxing power, and taking the same power away, on the other, by the limitations of the due process clause."[31] Despite these holdings, in the early 1900s, the Court struck down some retroactive statutes as violating the Due Process Clause. In *Nichols v. Coolidge*,[32] the Court struck down a statute that taxed property conveyed before the statute was enacted.[33] The Court relied on earlier cases, including *Brushaber*, which stated that a retroactive tax statute may be "so arbitrary and capricious as to amount to confiscation and offend the Fifth Amendment."[34] In *Blodgett v. Holden*,[35] the Court used this same "arbitrary and capricious" language in striking down the retroactive application of a gift tax.[36] The Court focused on the lack of notice of the taxpayer as

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24. U.S. CONST. art I, § 10, cl. 1.
25. *Id.* amend. V.
26. *Id.*
27. 87 U.S. 323 (1874).
28. *Id.* at 333.
29. 240 U.S. 1 (1916).
30. *Id.* at 20.
31. *Id.* at 24.
32. 274 U.S. 531 (1927).
33. *Id.* at 543.
34. *Id.* at 542.
35. 275 U.S. 142 (1927).
36. *Id.* at 147.

to the retroactivity of the tax, stating the taxpayer acted "in entire good faith and without the slightest premonition of such consequence."[37] In *Untermyer v. Anderson*,[38] the Court again struck down the application of a gift tax to gifts made during the prior year.[39] The gift was made while Congress was considering the statute in question.[40] Nonetheless, the Court held the statute to be "arbitrary and invalid under the due process clause of the Fifth Amendment."[41] The Court required actual notice to the taxpayer of his tax liability.[42] The Court stated "[t]he taxpayer may justly demand to know when and how he becomes liable for taxes."[43] Other cases interpreted a statute to not apply to the taxpayers retroactively to avoid holding the statute unconstitutional.[44] The Court's early interpretations of retroactive gift and estate tax statutes dealt with a "wholly new tax." Thus, the courts primarily focused on the taxpayer's lack of notice as to future new tax laws in finding their retroactive application "arbitrary and capricious." As gift and estate tax laws became commonplace, the Court abandoned its reliance on the "actual notice" test and struck down only those retroactive statutes that were "harsh and oppressive." In *Welch v. Henry*,[45] the Court upheld a retroactive tax on dividends received some two years earlier.[46] The Court articulated a test to determine whether a retroactive tax is unconstitutional: "In each case it is necessary to consider the nature of the tax and the circumstances in which it is laid before it can be said that its retroactive application is so harsh and oppressive as to transgress the constitutional limitation."[47] The Court further explained that actual or constructive notice and timing were the most important circumstances to consider.[48] In *Estate of Ekins v. Commissioner*,[49] the Seventh Circuit Court of Appeals used this *Welch* "harsh and oppressive" standard to uphold the retroactive application of a tax on the value of an insurance policy in the decedent's estate.[50] The court focused primarily on the circumstance of the tax, which the court considered to be merely

37. *Id.*
38. 276 U.S. 440 (1928).
39. *Id.* at 445.
40. *Id.*
41. *Id.*
42. *Id.*
43. *Id.*
44. *See* Helvering v. Helmholz, 296 U.S. 93 (1935); White v. Poor, 296 U.S. 98 (1935).
45. 305 U.S. 134 (1938).
46. *Id.* at 150-51.
47. *Id.* at 147.
48. *Id.* at 148.
49. 797 F.2d 481 (7th Cir. 1986).
50. *Id.* at 485.

a change in an existing tax.[51] Thus, the court held the taxpayer had "constructive notice" of the retroactive statute because life insurance policies historically were included under estate taxes.[52] Unlike the earlier cases, the court did not address or consider the taxpayer's actual expectations. The Seventh Circuit also employed this type of analysis in *Reed v. United States*.[53] In *Reed* the court focused on the nature of the tax, which it characterized as a mere change in an existing tax, to uphold the retroactive elimination of an estate tax exclusion for gifts made within three years of death.[54] Rejecting the actual notice test of the earlier cases, the court held the decedent had "constructive notice" that at least part of the gift would be taxed.[55] The court did not find that changing this existing tax was "so harsh or oppressive as to be invalid."[56] The Supreme Court has also relied on the *Welch* "harsh and oppressive" standard, focusing on the characterization or nature of the tax. In *United States v. Darusmont*,[57] the Court upheld retroactive application of an income tax statute to the entire calendar year in which enactment took place.[58] The Court held that the statute in question did not create a "new tax."[59] In addition, according to the Court, the taxpayer had "ample advance notice of the increase in the effective minimum rate."[60] Thus, the tax was not so "harsh and oppressive as to be a denial of due process."[61] In *United States v. Hemme*,[62] the Court again focused on the nature of the tax in upholding the retroactive application of gift and estate statutes.[63] The Court found that the taxpayers were no worse off than they would have been without the enactment of the new statute.[64] Thus, the Court reversed the district court, which had held that the statute was "arbitrary and capricious," relying on *Untermyer*.[65] The Court distinguished *Untermyer* and used the *Welch* test to hold that the statute was not "so oppressive as to

51. *Id.* at 484.
52. *Id.* at 485.
53. 743 F.2d 481 (7th Cir. 1984).
54. *Id.* at 485.
55. *Id.* at 486 n.4.
56. *Id.* at 485.
57. 449 U.S. 292 (1981).
58. *Id.* at 297.
59. *Id.* at 300.
60. *Id.* at 299.
61. *Id.*
62. 476 U.S. 558 (1986).
63. *Id.* at 559.
64. *Id.* at 570.
65. *Id.* at 564.

transgress the constitutional limitation."[66] In *Milliken v. United States*,[67] the Court again distinguished the earlier line of cases applying the actual notice test.[68] In *Milliken* the Court upheld the retroactive taxing of gifts made before the statute was passed.[69] "[I]t does not suffice to say that the gift antedated the statute. It is necessary to consider the nature of the tax and of the decedent's gift."[70] In considering those circumstances, the Court found that the tax was not a "wholly new tax" but merely a change in the tax rate and therefore not unconstitutional.[71] Indeed, the Court stated that the taxpayer "should be regarded as taking his chances of any increases in the tax burden."[72] The cases applying the "harsh and oppressive" test of *Welch* upheld the retroactive statutes, usually characterizing them as a "change in the tax rate" as opposed to a "wholly new tax." In addition, the Court emphasized that actual notice was not required, pointing out that constructive notice was usually present because the federal government has retroactively changed tax statutes in the past. For the past sixty years, the Welch standard was the predominate test used to uphold retroactive tax legislation. However, in a few cases the Court framed the test slightly different. One such case is *Pension Benefit Guaranty Corp. v. R.A. Gray & Co.*[73] There, the Court focused on legislative intent, instead of parties' expectations or the nature of the tax, in upholding retroactive application of provisions governing the withdrawal from employer pension plans.[74] The Court stated that due process is met by "showing that the retroactive application of the legislation is itself justified by a rational legislative purpose."[75] This is the test typically used to evaluate economic legislation.[76] It focuses on the intent of the enacting legislature, rather than the "nature and circumstances" of the statute as proscribed by the *Welch* standard.[77] This test had not been previously applied to tax statutes, but the Court considered the test to be similar to the "harsh and oppressive" test from *Welch*.[78] Most recently, this formulation was used by the Ninth Circuit Court of

66. *Id.* at 568-69.
67. 283 U.S. 15 (1931).
68. *Id.* at 21.
69. *Id.* at 22.
70. *Id.*
71. *Id.* at 24.
72. *Id.* at 23.
73. 467 U.S. 717 (1984).
74. *Id.* at 730.
75. *Id.*
76. *See, e.g.*, Williamson v. Lee Optical, 348 U.S. 483 (1955).
77. *Pension Benefit Guaranty*, 467 U.S. at 732.
78. *Id.* at 733.

Appeals in *Licari v. Commissioner*[79] to uphold a retroactive tax statute that increased the penalty for taxpayer's understatement of tax liability.[80] The court in *Licari* applied both the *Welch* test and the legitimate legislative purpose test of *Pension Guaranty*.[81] First, the court looked at the nature of the tax and held that the statute in question was a "penalty," not a tax.[82] In addition, the statute merely increased the rate or percentage of the penalty.[83] Second, the court used the *Pension Guaranty* test, focusing on the legislature's intent, to uphold the retroactive application of the increased penalty.[84] Noting that legislation that adjusts economic burdens and benefits is entitled to a "presumption of constitutionality," the court held that the statute in question fell within that category of legislation.[85] Thus, the court found that the statute was not "harsh and oppressive" and further that it was "rationally related to a legitimate government purpose."[86] As the decision in *Licari* demonstrated, the courts were uncertain as to the due process standard to be applied to tax statutes with retroactive effect.

In *Carlton v. United States*,[87] the Court began its analysis by stating that retroactive tax laws have historically been upheld.[88] The Court explained that the *Welch* "harsh and oppressive" standard is really the same as applied to other economic legislation.[89] According to the Court, the test is whether "the retroactive application of a statute is supported by a legitimate legislative purpose furthered by rational means."[90] This formulation of the test was then applied to Carlton's actions and the statute in question. The Court found that the purpose of the amendment was not illegitimate or arbitrary.[91] The Court felt Congress was "correcting a mistake."[92] This was supported by the legislative history and the dramatic increase in the amount of predicted revenue loss.[93]

79. 946 F.2d 690 (9th Cir. 1991).
80. *Id.* at 694-95.
81. *Id.* at 693.
82. *Id.* at 694.
83. *Id.*
84. *Id.* at 694-95.
85. *Id.* at 694.
86. *Id.* at 695.
87. 114 S. Ct. at 2018.
88. *Id.* at 2021.
89. *Id.* at 2022.
90. *Id.*
91. *Id.* at 2023.
92. *Id.*
93. *Id.* The Court noted that without the revised provision of the statute, the predicted revenue loss would increase from approximately $300 million to $7 billion during a five-year period. *Id.*

In addition, there was no evidence of an improper motive on Congress' behalf to target estates for additional taxes.[94] The Court also pointed out the amendment was enacted quickly and the period of retroactivity was only slighter greater than one year.[95] Rejecting the rationale used by the Ninth Circuit Court of Appeals in holding the statute unconstitutional, the Court stated that proof of reliance by the taxpayer is "insufficient to establish a constitutional violation."[96] "Tax legislation is not a promise, and a taxpayer has no vested rights in the Internal Revenue Code."[97] Rejecting the taxpayer's detrimental reliance policy argument, the Court stated that principle is not limited to retroactive statutes.[98] According to the Court, individuals may rely upon future expectations that are disturbed by prospective legislation.[99] Carlton's lack of notice was also not dispositive.[100] Citing *Milliken*, the Court essentially held that a taxpayer pays his money and takes his chances.[101] Finally, the Court held that the *Nichols* era "actual notice" cases relied on by the court of appeals have limited precedential value, primarily because "exacting review of economic legislation" has been discarded and discredited.[102] Moreover, according to the Court, those cases are distinguishable because they dealt with a "wholly new tax," rather than changes in an existing tax.[103] This was similar to the reasoning employed by the district court in upholding the statute.[104] Because of these factors, the Court found that the court of appeals held the amendment to an unduly strict standard.[105] Instead, the Court looked to the legislative intent and concluded that the retroactive application of the amendment is rationally related to a legitimate

94. *Id.*
95. *Id.*
96. *Id.* at 2024.
97. *Id.* at 2023.
98. *Id.*
99. *Id.*
100. *Id.*
101. *Id.* According to the Court, "a taxpayer 'should be regarded as taking his chances of any increase in the tax burden which might result from carrying out the established policy of taxation.'" *Id.* (citing Milliken v. United States, 283 U.S. at 23).
102. *Id.* The court relied on Ferguson v. Skrupa, 372 U.S. 726, 730 (1963), where the Court stated "[t]he doctrine . . . that due process authorizes courts to hold laws unconstitutional when they believe the legislature has acted unwisely has long since been discarded."
103. *Carlton*, 114 S. Ct. at 2024.
104. *See supra* notes 16-18 for a discussion of the district court's analysis.
105. *Carlton*, 114 U.S. at 2024.

legislative purpose.[106] Therefore, the amendment did not violate Carlton's rights under the Due Process Clause.[107]

The holding in *Carlton* is not limited to section 2057. Instead, the Court announced a new due process standard for evaluating tax statutes with a retroactive effect, which is the same standard used for retroactive economic legislation—there must be a legitimate legislative purpose furthered by rational means. Is there any scrutiny or judicial review of retroactive tax laws left after *Carlton*? A tax statute would presumably always satisfy the Court's "low scrutiny" due process test, since all tax statutes are for the "legitimate purpose" of generating revenue and retroactive taxation is rationally related to that purpose. Indeed, the Court distinguished or discredited the few older cases that did invalidate retroactive tax statutes. Thus, it appears that taxpayers can not rely on the Due Process Clause to protect them from retroactive tax legislation. In fact, this is exactly what Scalia argued for in his concurrence: "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."[108] However, this lack of protection has some alarming implications. Taxpayers will be unable to rely on existing tax laws, undermining the public's confidence in the federal government. In addition, tax decisionmakers must try to predict what future statutory changes could be applied retroactively. Could professional tax advisers be held liable for failing to notify their clients of potential retroactive changes? Given the many changes to the Internal Revenue Code and the complexities of the issues involved, tax adviser liability is a real possibility for the adviser who does not fulfill his obligation to keep abreast of not only the changes in the Code, but the potential future changes that could be applied retroactively. As the Court stated in *Carlton*, "a taxpayer should be regarded as taking his chances of any increase in the tax burden."[109] To prevent the taxpayer from losing at the IRS gambling casino, the Court should have continued to apply the *Welch* standard to retroactive tax legislation. While the "harsh and oppressive" test was by no means a black letter standard, the emphasis was properly placed on the nature and circumstances of the tax and its impact on the taxpayer, instead of speculating as to the legislators' motives in passing the statute. Use of the *Welch* test would have avoided the unjust result that occurred in this case. "Retroactively disallowing the tax benefit that the earlier law offered, without

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106. *Id.*
107. *Id.*
108. *Id.* at 2027 (Scalia, J., concurring in judgment).
109. *Id.* at 2023.

compensating those who incurred expenses in accepting that offer, seems to me harsh and oppressive by any normal measure."[110]

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110. *Id.* at 2027 (Scalia, J., concurring in judgment).