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## Back from the Dead: The Resurgence of Due Process Challenges to Retroactive Tax Legislation

Robert R. Gunning

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# Back from the Dead: The Resurgence of Due Process Challenges to Retroactive Tax Legislation

*Robert R. Gunning\**

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\* Partner, Silverstein & Pomerantz, LLP. J.D. (1993), University of California, Berkeley (Boalt Hall). B.A. (1990) College of William & Mary. *Editor's Note:* Silverstein & Pomerantz, LLP is currently handling the *River Garden* case referenced *infra* in notes 295, 300, 305, & 306.

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### INTRODUCTION

At what point does retroactive tax legislation become intolerable<sup>1</sup> and transgress constitutional limitations? Over the years, appellate courts have employed differing formulations of the criteria used to determine when a retroactive tax measure has gone too far. Although a bright-line test has yet to definitively emerge, tax measures with retroactivity periods of one year or less consistently have been upheld. Conversely, a number of tax measures containing periods of retroactivity greater than one year have been invalidated under the Due Process Clause.

In the seminal 1994 Supreme Court decision *United States v. Carlton*,<sup>2</sup> the Court held that an amendment intended to retroactively close a loophole in recently enacted federal estate tax legislation was constitutional.<sup>3</sup> Like much of the retroactive federal tax legislation that has survived constitutional scrutiny, the period of retroactivity was relatively modest (approximately one year in length).<sup>4</sup> The majority opinion declined to articulate a bright-line standard or set forth concrete, objective criteria to use in evaluating due process challenges to retroactive tax measures.

Many commentators therefore reasonably believed that *Carlton* served as the death knell for due process limitation on retroactive tax legislation.<sup>5</sup> In a concurring opinion in *Carlton*, however, Jus-

1. Judge Learned Hand framed the issue in this manner in evaluating the constitutionality of a retroactive income tax measure. *Cohan v. Comm'r of Internal Revenue*, 39 F.2d 540, 545 (2d Cir. 1930).

2. 512 U.S. 26 (1994).

3. *Carlton*, 512 U.S. at 32.

4. *Id.* at 27.

5. See, e.g., Ronald Z. Domskey, *Retroactive Taxation: United States v. Carlton—The Taxpayer Loses Again!*, 16 N. ILL. U. L. REV. 77 (1995); Faith Colson, *Constitutional Law Due Process—The Supreme Court Sounds the Death Knell for Due Process Challenges to*

tice O'Connor observed that the governmental interest in revising tax laws must at some point give way to the "taxpayer's interest in finality and repose," and that a "period of retroactivity longer than the year preceding the legislative session in which the law was enacted would raise . . . serious constitutional questions."<sup>6</sup> Since *Carlton* was decided, several state courts have relied on Justice O'Connor's concurring opinion to invalidate retroactive state and local tax measures under the Due Process Clause.<sup>7</sup> In each of these decisions, the period of retroactivity exceeded two years.<sup>8</sup> These state court decisions indicate that due process limitation on retroactive tax legislation is alive and well. The question remains: where and how to draw the line?

Consistent with Justice O'Connor's analysis, this article proposes that a presumptive line be drawn at the year preceding the legislative session in which the subject tax law is enacted. This outcome would preserve the ability of legislative bodies to promptly remedy perceived loopholes and errors in recently enacted legislation without a concomitant loss in revenue. At the federal level, it would also account for practical issues associated with the development and enactment of tax legislation. This presumption would ensure some reasonable level of finality for taxpayers and further prohibit legislation that unduly restricts taxpayer rights and remedies.

Such a one-year presumption should be rebuttable, however. For instance, under established precedent, the Due Process Clause prohibits the retroactive imposition of "wholly new taxes," regardless of the length of the look-back period.<sup>9</sup> On the other hand, tax jurisdictions should retain the ability to surmount the presumption when they can demonstrate compelling circumstances for the period of retroactivity, such as an inability to have acted sooner.

Part I of this article describes the various constitutional challenges that have been launched against retroactive tax measures. In general, only substantive due process challenges have met with any level of success. In Part II, the article traces the history of twentieth-century due process challenges to retroactive tax measures, culminating in the landmark *Carlton* decision. Although the

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*Retroactive Tax Legislation*, 27 RUTGERS L. J. 243 (1995); Laura Ricciardi, *The Aftermath of United States v. Carlton: Taxpayers Will Have to Pay for Congress's Mistakes*, 40 N.Y.L. SCH. L. REV. 599 (1996).

6. *Carlton*, 512 U.S. at 38 (O'Connor, J., concurring).

7. See *infra* Part III(C).

8. *Id.*

9. *Carlton*, 512 U.S. at 34.

formulation of the due process test evolved, *Carlton* clarified that to pass constitutional muster, a retroactive tax must (1) be levied for a legitimate, legislative purpose and (2) possess a modest period of retroactivity (“modesty doctrine”).<sup>10</sup> Part III of the article discusses the post-*Carlton* landscape. Several state courts have invalidated state and local tax measures with retroactivity periods greater than a year, while federal courts generally have upheld federal tax measures, most of which possessed retroactivity periods of less than a year. In Part IV, the article contends that tax legislation containing retroactivity periods greater than one year in length should be presumptively invalid under *Carlton*’s modesty doctrine. Lastly, Part V of the article applies this test to California’s 2004 tax amnesty legislation and concludes that the retroactive penalty provisions in the legislation are unconstitutional under the Due Process Clause.

#### I. CONSTITUTIONAL CHALLENGES TO RETROACTIVE TAX LEGISLATION

The United States Constitution neither expressly authorizes nor prohibits retroactive tax legislation.<sup>11</sup> In general, a retroactive statute is one that “takes away or impairs vested rights acquired under existing laws, or creates a new obligation, imposes a new duty, or attaches a new disability, in respect to transactions or considerations already past.”<sup>12</sup> Retroactive tax measures have run the gamut from wholly new taxes, increased tax rates, broadened tax bases, elimination of deductions and exemptions, restriction of taxpayer remedies, and enhanced penalties—all applied to prior transactions or conduct.<sup>13</sup>

Although the Constitution does not expressly prohibit retroactive tax measures, taxpayers have mounted a variety of legal chal-

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10. *Id.* at 32 (Scalia, J., concurring).

11. Several state constitutions prohibit retroactive legislation, however. *See, e.g.*, TEX. CONST. art. I, § 16 (prohibits retroactive legislation); COLO. CONST. art. II, § 11 (prohibits retrospective legislation).

12. *Landgraf v. USI Film Prods.*, 511 U.S. 244, 269 (1994) (quoting *Society for the Propagation of the Gospel v. Wheeler*, 22 F.Cas. 756, 767 (C.C.N.H. 1814)).

13. For examples of these types of retroactive taxation, *see* parts II-III, *infra*. In interpreting a statute to determine whether the legislature intended it to operate retroactively, there is a presumption against retroactivity. *Landgraf*, 511 U.S. at 265. The presumption against retroactive legislation exists because retroactive legislation typically deprives citizens of legitimate expectations and upsets settled transactions. *General Motors Corp. v. Romein*, 503 U.S. 181, 191 (1992). Nonetheless, a statute will be interpreted to apply retroactively if the text of the statute unambiguously expresses the legislature’s intent for it to apply retroactively. *Landgraf*, 511 U.S. at 272-73.

lenges to such legislation since the eighteenth century. As discussed below, most of these efforts have failed. Taxpayers have met with little success in contending that retroactive taxation violates the Ex Post Facto, Contract, Equal Protection, and Takings Clauses of the Constitution. However, taxpayers have enjoyed modest success in asserting that retroactive tax statutes violate the Due Process Clause.

### A. *The Ex Post Facto Clause*

The Ex Post Facto Clause of the Constitution prohibits Congress from passing any “bill of attainder or ex post facto law.”<sup>14</sup> The Constitution also provides “that no state shall pass any ex post facto law.”<sup>15</sup> In 1798—with refreshing candor—Justice Chase observed in *Calder v. Bull*<sup>16</sup> that this constitutional language “necessarily requires some explanation; for naked and without explanation, it is unintelligible, and means nothing.”<sup>17</sup> The opinion proceeded to explain that an ex post facto law is one that “shall not be passed concerning, and after the fact, or thing done, or action committed.”<sup>18</sup> On its face, the Ex Post Facto Clause therefore would seem to prohibit any tax statute that retroactively changes the legal or financial consequences of a prior transaction or activity.

In *Calder*, however, the Supreme Court concluded that the clause does not apply to civil statutes.<sup>19</sup> Relying on English common law, the Court held that the Ex Post Facto Clause was intended to protect individuals from punishment imposed by such laws, and it therefore determined that the clause prohibited only retrospective criminal punishment.<sup>20</sup> Accordingly, the use of the

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14. U.S. CONST. art. I, § 9.

15. U.S. CONST. art. I, § 10.

16. 3 U.S. 386, 390 (1798).

17. *Calder*, 3 U.S. at 390.

18. *Id.*

19. *Id.*

20. *Id.* at 389-90. Notably, in a prophetic passage, the Court observed:

Every law that takes away, or impairs, rights vested, agreeably to existing laws, is retrospective, and is generally unjust, and may be oppressive; and it is a good general rule, that a law should have no retrospect; but there are cases in which laws may justly, and for the benefit of the community, and also of individuals, relate to a time antecedent to the commencement.

*Id.* at 390-91.

Ex Post Facto clause as a constitutional restriction on retroactive tax legislation was rejected in the earliest days of the Republic.<sup>21</sup>

### B. *The Contract Clause*

Contract Clause challenges to retroactive tax legislation likewise have fared with scant success. The Contract Clause prohibits states from passing any law "impairing the [o]bligation of [c]ontracts."<sup>22</sup> State constitutions often contain similar provisions.<sup>23</sup> In Contract Clause challenges to retroactive tax legislation, taxpayers have contended that existing legislation has created a contract between the state and its taxpayers,<sup>24</sup> or alternatively, that the retroactive application of a tax statute has impaired existing contracts with third parties.<sup>25</sup> In retroactively amending the legislation to the taxpayer's detriment, the state impairs the contract it created with its citizens or that existed between private parties.

Aside from the *Lochner* era,<sup>26</sup> when strict scrutiny was applied to economic measures, these Contract Clause challenges to retroactive tax legislation consistently failed because courts reject the notion that the prior law created a contract between the taxpayer and the state or that the retroactive application of tax legislation impaired existing contracts.<sup>27</sup> Absent a clear indication that the legislature intended to bind itself contractually, the presumption is that "a law is not intended to create private contractual or vested rights but merely declares a policy to be pursued until the legislature shall ordain otherwise."<sup>28</sup> Moreover, even if a taxpayer can demonstrate the legislature's intent to create private contractual and vested rights, to prove a violation of the Contract Clause, the taxpayer further must show that the amendment substan-

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21. However, the Ex Post Facto Clause may be invoked to protect individuals from retroactive tax measures that impose criminal liability or punishment on past transactions.

22. U.S. CONST. art. I, § 10, cl. 1.

23. See, e.g., ARIZ. CONST. art. II, § 25.

24. See, e.g., *Baker v. Ariz. Dep't of Revenue*, 105 P.3d 1180, 1183-84 (Ariz. Ct. App. 2005).

25. See, e.g., *Coolidge v. Long*, 282 U.S. 582, 605 (1931).

26. See *infra* Part II(A).

27. *Baker*, 105 P.3d at 1183-84; cf. *Coolidge*, 282 U.S. at 605 (concluding that retroactive application of an estate tax impaired a trust deed and therefore violated the Contract Clause).

28. *Nat'l R.R. Passenger Corp. v. Atchison, Topeka & Santa Fe Ry.*, 470 U.S. 451, 465-66 (1985) (quoting *Dodge v. Board of Education*, 302 U.S. 74, 79 (1937)).

tially impaired the taxpayer's rights and was not supported by a significant and legitimate public purpose.<sup>29</sup>

### C. *The Equal Protection Clause*

The Equal Protection Clause precludes a state from denying "to any person within its jurisdiction the equal protection of the laws."<sup>30</sup> Its use to invalidate retroactive taxation was severely curtailed by a Supreme Court decision in 1938. In *Welch v. Henry*,<sup>31</sup> the taxpayer contended that a 1935 act of the Wisconsin State Legislature imposing a tax on corporate dividends received by the taxpayer in 1933, at rates and with deductions different from those applicable in that year to other types of income, violated the Equal Protection Clause.<sup>32</sup>

The 1933 legislation provided that dividends received from corporations whose principal business was attributable to Wisconsin were deductible from gross income.<sup>33</sup> By taking advantage of this deduction, the taxpayer reported no taxable net income for tax year 1933 when he filed his income tax return in 1934.<sup>34</sup> In an emergency tax measure enacted in 1935, the legislature eliminated all but \$750 of deductions on such dividends, with the deduction amendment retroactive to the 1933 and 1934 tax years.<sup>35</sup> The taxpayer asserted that the legislature's retroactive amendment, singling out a class of dividends for treatment different from other forms of income, violated his right to equal protection.<sup>36</sup>

Applying the rational basis test, the Court rejected the taxpayer's argument that the legislation violated the Equal Protection Clause. The Court held that the amended tax law was not a denial of equal protection simply because it was retroactive and that it "has never been thought that such changes involve a denial of equal protection if the new taxes could have been included in the earlier act when adopted."<sup>37</sup> In leaving the equal protection door only slightly ajar, the Court observed that a taxing statute

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29. *Baker*, 105 P.3d at 1185; see also *Energy Reserves Group, Inc. v. Kan. Power & Light Co.*, 459 U.S. 400, 411-12 (1983).

30. U.S. CONST. amend. XIV, § 1.

31. 305 U.S. 134 (1938).

32. *Welch*, 305 U.S. at 141.

33. The Court did not decide whether such a deduction violated the Commerce Clause of the U.S. Constitution.

34. *Welch*, 305 U.S. at 141.

35. *Id.* at 141-42.

36. *Id.* at 142.

37. *Id.* at 144-45.



does not deny equal protection unless it amounts to "hostile or oppressive discrimination" against the taxpayer.<sup>38</sup> To date, no United States Supreme Court decision has upheld an equal protection challenge to a retroactive tax statute.<sup>39</sup>

#### D. *The Takings Clause*

Taxpayers have mounted several challenges to retroactive tax measures under the Takings Clause.<sup>40</sup> This clause prohibits the taking of private property for public use without just compensation.<sup>41</sup> With one exception, courts consistently have held that Congress's general exercise of its taxing power does not violate the Fifth Amendment's prohibition on takings without just compensation.<sup>42</sup> The levying of taxes does not constitute an unconstitutional taking unless the taxation is so "arbitrary as to constrain the conclusion that it was not the exertion of taxation, but a confiscation of property."<sup>43</sup>

Based on this stringent standard, taxpayer challenges to retroactive federal tax legislation under the Takings Clause generally have been defeated on the basis that Congress routinely enacts tax legislation with short and limited periods of retroactivity as a practical necessity.<sup>44</sup> Similarly, a takings challenge to a state's retroactive reduction in the amount of tax refunds failed on the theory that taxpayers did not have a vested right to the amount of the tax refund.<sup>45</sup>

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38. *Id.* at 146.

39. Similarly, lower federal and state courts generally have rejected taxpayers' equal protection challenges against retroactive tax legislation. *See, e.g., Licari v. Comm'r of Revenue*, 946 F.2d 690, 693 (9th Cir. 1991) (legislative classification supported by rational basis); *Johnson Controls, Inc. v. Rudolph*, No. 2004-CA-001566-MR, 2006 Ky. App. LEXIS 132 (Ky. Ct. App. 2006), *review granted by Rudolph v. Johnson Controls, Inc.*, No.2006-SC-0416-DG, 2007 Ky. LEXIS 195 (Ky. Oct. 24, 2007) and *Johnson Controls, Inc. v. Burnside*, No. 2007-SC-0819-DG, 2007 Ky. LEXIS 276 (Ky., Dec. 12, 2007).

40. U.S. CONST. amend. V.

41. *Id.*

42. *See Brushaber v. Union Pac. R.R. Co.*, 240 U.S. 1, 24-25 (1916); *Coleman v. Commissioner*, 791 F.2d 68, 70 (7th Cir. 1986); *Rivers v. State*, 490 S.E.2d 261, 263 (S.C. 1997). However, in *Nichols v. Coolidge*, 274 U.S. 531, 532 (1927), applying the *Brushaber* test, the Court held that the retroactive application of an amendment to the estate tax amounted to confiscation under the Takings Clause of the Fifth Amendment. No Supreme Court decision since *Nichols* has held that a retroactive tax measure violates the Takings Clause.

43. *Brushaber*, 240 U.S. at 24; *Quarty v. U.S.*, 170 F.3d 961, 970 (9th Cir. 1999).

44. *Quarty*, 170 F.3d at 970; *Kane v. U.S.*, 942 F. Supp. 23 (E.D. PA 1996).

45. *Rivers*, 490 S.E.2d at 263 (citing *Canisius College v. U.S.*, 799 F.2d 18, 25 (2d Cir. 1986)).

## II. THE DUE PROCESS CLAUSE THROUGH *UNITED STATES V. CARLTON*

In contrast to other constitutional challenges to retroactive taxation, due process challenges have met with mixed success in the federal and state courts. The Fifth Amendment of the Constitution provides that no person shall "be deprived of life, liberty, or property, without due process of the law."<sup>46</sup> While this amendment applies only to federal action, the Fourteenth Amendment applies due process protection to state action.

Due process challenges largely succeeded in the *Lochner*<sup>47</sup> era of exacting review of economic legislation. In the 1930s, the post-*Lochner* era Supreme Court generally rejected due process challenges to retroactive taxation. As will be seen, however, the vast majority of the post-*Lochner* litigation challenged tax measures with retroactivity periods of one year or less.

### A. *Successful Due Process Challenges During the Lochner Era*

In the era of strict review of economic legislation, the Court applied an actual notice test to retroactive tax legislation. Through three decisions issued in the 1920s, the Court invalidated retroactive estate tax measures because the taxpayers did not have notice of the changing tax laws at the time they made decisions pertaining to their estates.

In *Nichols v. Coolidge*,<sup>48</sup> a federal estate tax statute sought to retroactively include as part of two married decedents' gross estates the value of property that the wife had transferred to others prior to passage of the federal statute.<sup>49</sup> There was no evidence that the decedent had transferred her property to others in contemplation of death.<sup>50</sup> In holding that the retroactive application of this estate tax provision violated the taxpayer's due process rights under the Fifth Amendment, the Supreme Court noted that the "arbitrary, whimsical, and burdensome character of the challenged tax is plain enough."<sup>51</sup> Although thin in analysis, the decision appears to rest on the notion that the estate tax was a new

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46. U.S. CONST. amend. V.

47. *Lochner v. N.Y.*, 198 U.S. 45 (1905).

48. 274 U.S. 531 (1927).

49. *Id.* at 532.

50. *Id.* at 540.

51. *Id.* at 542.

tax and that its retroactive imposition to past conduct was arbitrary and capricious.<sup>52</sup>

Two other cases similarly held that the retroactive nature of the nation's first estate and gift tax statutes violated the Due Process Clause.<sup>53</sup> Both of these decisions involved the gift tax, which was to apply retroactively to prior transactions. As this tax was a "wholly new tax" imposed on transactions that were not taxable when they occurred, the Supreme Court struck the tax under the Due Process Clause.<sup>54</sup> Although not overruled, the continuing vitality of these decisions has been questioned in subsequent Supreme Court decisions.<sup>55</sup> To the extent the *Nichols* line of cases survive, they are limited to cases involving "wholly new taxes," rather than amendments to existing tax schemes that retroactively impact prior transactions.<sup>56</sup>

### B. *Unsuccessful Due Process Challenges*

Following the *Lochner* era, the Supreme Court consistently upheld retroactive federal tax legislation against due process challenges. In sustaining the legislation, the Court employed a variety of criteria, or at minimum, different formulations of the same legal standard. In the early 1930s, the Court rejected several taxpayer challenges by simply holding that all retroactive taxation was not unconstitutional.<sup>57</sup> Presumably, the Court applied some form of the palpably arbitrary test from the *Nichols* line of cases. From 1938 until 1984, the Court employed a "harsh and oppressive" standard in measuring the constitutionality of retroactive tax legislation.<sup>58</sup> Then, from 1984 to the 1994 *Carlton* decision, the Court shifted to an analysis of whether there was a "legitimate purpose" behind the retroactive tax legislation.<sup>59</sup> Critically, all of the retroactive tax cases that were before the Court during this 1930–1994 time period addressed federal tax legislation with a look-back period of less than two years, and in almost all cases, less than one.<sup>60</sup>

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52. *Id.*

53. *Blodgett v. Holden*, 275 U.S. 142 (1927); *see also Untermyer v. Anderson*, 276 U.S. 440 (1928).

54. *Blodgett*, 275 U.S. at 147; *see also Untermyer*, 276 U.S. at 445.

55. *See, e.g., Carlton*, 512 U.S. at 30-31.

56. *U.S. v. Hemme*, 476 U.S. 558, 568 (1986).

57. *See Cooper v. U.S.*, 280 U.S. 409, 411 (1930); *U.S. v. Hudson*, 299 U.S. 498, 501 (1937).

58. *See, e.g., Welch v. Henry*, 305 U.S. 134 (1938).

59. *See, e.g., Pension Benefit Guaranty Corp v. R.A. Gray & Co.*, 467 U.S. 717 (1984).

60. *See, e.g., Welch*, 305 U.S. 134; *Pension Benefit Guaranty Corp.*, 467 U.S. 717.

In most instances, the subject legislation sought to cure a defect or close a loophole that existed in legislation enacted in the previous legislative session.

1. *Denial of Taxpayer Challenges Under the Palpably Arbitrary Test*

The Court's movement away from the strict review of economic legislation in the context of retroactive taxation is perhaps best illustrated by a 1931 Court decision upholding the retroactive increase in the estate tax rate to a gift made in contemplation of death.<sup>61</sup> In *Milliken v. United States*,<sup>62</sup> the decedent gave his children corporate stock in December 1916.<sup>63</sup> When the donor died in 1920, the tax commissioner included the stock shares in the decedent's estate as a gift made in contemplation of death.<sup>64</sup> The tax rate applied to the gift was the tax rate from the Revenue Act of 1918, which was higher than the rate in the comparable revenue act from 1916.<sup>65</sup> The issue, therefore, was whether the application of the higher tax rate, retroactive from 1918 to December 1916, violated the Due Process Clause.

In denying the petitioners' challenge, the Court first contrasted the *Nichols* line of decisions because they involved gifts made and vested before passage of the statute imposing the gift tax.<sup>66</sup> In those cases, the donors had no notice that the subject of the gift would be subject to taxation at all. In contrast, the Court reasoned, the *Milliken* donor had notice that the gift made in contemplation of death would be subject to taxation, albeit at a lower rate.<sup>67</sup> The Court held that a tax is not necessarily arbitrary and invalid because it is retroactively applied and determined that it was not enough for the taxpayer to show that the gift was made before passage of the statute.<sup>68</sup> In sustaining the application of the higher tax rate to the gift transaction, the Court also relied on the underlying policy of the 1918 legislation to equalize taxation of

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61. For similar decisions distinguishing the *Nichols* line of authority, see *Cooper v. U.S.*, 280 U.S. 409, 412 (1930) (upholding income tax measure made retroactive to preceding calendar year); and *U.S. v. Hudson*, 299 U.S. 498, 501 (upholding 35-day period of retroactivity to income tax on sale of silver bullion).

62. 283 U.S. 15 (1931).

63. *Milliken*, 283 U.S. at 18-19.

64. *Id.*

65. *Id.* at 19.

66. *Id.* at 20-22.

67. *Id.* at 24.

68. *Milliken*, 283 U.S. at 21-22.

gifts made in contemplation of death with testamentary dispositions.<sup>69</sup> That intent, the Court concluded, would be undercut if gifts made in contemplation of death after the 1916 act were taxed more favorably than transfers from the donor at death.<sup>70</sup>

## 2. *The Harsh and Oppressive Test*

In continuing its movement away from strict review of economic legislation, the Court formulated a new test in *Welch v. Henry* in 1938.<sup>71</sup> The taxpayer asserted that the Wisconsin statute denied him due process of law because, in 1935, it imposed a tax on income received in 1933.<sup>72</sup> In upholding the tax against this due process challenge, the Court first relied on *Milliken's* basic premise that a tax is not necessarily unconstitutional because it is retroactive.<sup>73</sup> The Court next distinguished the *Nichols* line of gift-tax cases on the basis that those decisions "rested on the ground that the nature or amount of the tax could not reasonably have been anticipated by the taxpayer at the time of the particular voluntary act which the statute later made the taxable event."<sup>74</sup> Effectively incorporating an element of actual notice into the due process test, the Court reasoned that in the gift-tax cases, the donor may have refrained from making the gift had the donor anticipated the tax.<sup>75</sup>

The *Welch* Court then proceeded to subtly formulate a new test, which would be applied by the Court for nearly 50 years, by stating that 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."<sup>76</sup> Applying this rather nebulous "harsh and oppressive" test, the Court first analyzed the nature of the tax at issue. Because the tax was an income tax, the Court summarily assumed that a stockholder would not refuse to receive corporate dividends even if the taxpayer knew their receipt

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69. *Id.* at 23-24.

70. *Id.* at 24.

71. For a factual discussion, see *supra* Part I(C). The taxpayer also challenged the tax on the grounds that it violated his rights to equal protection of the laws. *Welch*, 305 U.S. at 141.

72. *Welch*, 305 U.S. at 146.

73. *Id.*

74. *Id.* at 147.

75. *Id.*

76. *Id.* at 147.

would later be subjected to tax at an increased rate.<sup>77</sup> The Court thus attempted to distinguish gift taxation, under which donors' actions presumably would be affected by tax consequences, from income taxation, under which taxpayers' actions would not be so impacted.<sup>78</sup>

After contrasting the nature of income taxation from gift taxation, the Court analyzed the period of retroactivity to determine if its application was "harsh and oppressive." The Court observed that for more than 75 years, Congress regularly enacted revenue laws to retroactively tax income received during the year preceding the session in which the taxing statute was enacted, and that such "recent transactions" could be subject to retroactive application of tax measures.<sup>79</sup> Applying this test to the Wisconsin statute, the Court noted that while the statute was enacted two years after the subject tax year, the Wisconsin State Legislature met only in odd-numbered years.<sup>80</sup> Accordingly, the 1935 legislative session was the first opportunity after the tax year in which the income was received to revise the tax laws applicable to 1933 income (reported and paid in 1934). The Court then recognized that while the Wisconsin Supreme Court had thought that the tax might "approach or reach the limit of permissible retroactivity," the Court would not say that the retroactive period in fact exceeded such limit.<sup>81</sup>

The divided *Welch* opinion represents an important turning point in retroactive tax jurisprudence. The *Welch* majority focused its analysis on the nature of the tax and the period of retroactivity to determine whether the retroactive application of the tax statute was so "harsh and oppressive" as to violate due process. To date, the period of retroactivity criteria lives on in the "modesty doctrine" articulated in *Carlton*.<sup>82</sup>

For the next 45 years, the Court heard very few constitutional challenges to retroactive tax legislation. In a 1981 per curiam decision, the Court upheld a retroactive increase in the minimum rate of income taxation and a reduction in the exemption amount.<sup>83</sup> This measure, enacted in October 1976 as part of the

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77. *Welch*, 305 U.S. at 148.

78. In today's era of income tax planning, this distinction appears naïve and rather artificial. See *id.* at 147-48.

79. *Id.* at 148-50.

80. *Id.* at 150.

81. *Id.* at 151.

82. *Carlton*, 512 U.S. at 32-33.

83. *U.S. v. Darusmont*, 449 U.S. 292 (1981).

Tax Reform Act of 1976,<sup>84</sup> applied to the 1976 tax year forward.<sup>85</sup> The Court observed that it had consistently held that application of income tax statutes to the entire calendar year in which enactment took place did not per se violate the Due Process Clause, and that this type of retroactive application, confined to short and limited periods, was "required by the practicalities of producing national legislation."<sup>86</sup> In essence, the Court held that the period of retroactivity for the income tax was modest and reasonable, and therefore, the tax itself did not transgress due process limitations.<sup>87</sup>

In upholding the retroactive application of the increased tax rate, the Court also dismissed the taxpayer's reliance on the *Nichols* line of cases as gift-tax cases impacting gifts that were completely vested before the enactment of the gift tax.<sup>88</sup> Contrary to the taxpayer's argument, the 1976 amendments to the income tax did not create a wholly new tax governed by the stricter *Nichols* analysis. Additionally, the Court applied an actual notice criterion and determined that the taxpayer had adequate notice of the proposed change in law.<sup>89</sup>

### 3. *The Legitimate Purpose Test*

In *Pension Benefit Guaranty Corp. v. R.A. Gray & Co.*<sup>90</sup> in 1984, the Court shifted from the "harsh and oppressive" standard to the "legitimate purpose" test.<sup>91</sup> While both standards analyze the length of the retroactivity period, the legitimate purpose test looks to whether a legitimate, rational purpose underlies the tax legislation, as opposed to the nature of the tax, which was the second element analyzed under the harsh and oppressive standard.

The Multiemployer Pension Plan Amendments Act of 1980 ("MPPAA")<sup>92</sup> applied withdrawal-liability provisions to employers withdrawing from pension plans during a five-month period prior

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84. Pub. L. No. 94-455 § 301 (1976).

85. *Darusmont*, 449 U.S. at 294-95.

86. *Id.* at 296-97.

87. *Id.* at 297-301. In rejecting the taxpayer's challenge, the Court also noted that the taxpayer had ample notice of the increase in the effective minimum rate because it had been under public discussion for almost a year before its enactment. *Id.* at 299. The Court also disagreed with the taxpayer's assertion that the tax was a new tax, as it only increased the tax rate and decreased allowable exemptions. *Id.* at 299-300.

88. *Id.* at 299.

89. *Id.* at 299-300.

90. 467 U.S. 717 (1984).

91. *Pension Benefit*, 467 U.S. at 717 (1984).

92. 29 U.S.C §1001 (1980).

to the statute's enactment.<sup>93</sup> The effective date of the withdrawal-liability provisions was the date on which the guaranty corporation had initially submitted its recommendations to Congress. Congress selected this date to prevent employers from avoiding the adverse consequences of withdrawal liability by withdrawing from plans while the liability was being considered by Congress.<sup>94</sup> Following approval in committee, Congress advanced the effective date of the measure by more than a year, as the date contained in earlier versions of the bill had served Congress's deterrent purpose.<sup>95</sup> Ultimately, the withdrawal-liability provisions took effect approximately five months before the statute was enacted into law.<sup>96</sup>

In analyzing the constitutional challenge, Justice Brennan, writing for a unanimous Court, relied on a 1976 decision<sup>97</sup> that applied the legitimate purpose test in upholding the retroactivity of a coal mine health and safety act.<sup>98</sup> Under this rather lenient test,<sup>99</sup> the government need only show that the retroactive application of the legislation was justified by a rational legislative purpose.<sup>100</sup> In *Pension Benefit*, the Court found this standard easily satisfied. There was a rational purpose behind the legislation because Congress was concerned that employers would have a greater incentive to withdraw from the pension funds if they knew that legislation imposing greater liability on withdrawing employers was being considered. Congress, therefore, rationally sought to prevent employers from taking advantage of lengthy legislative processes and withdrawing funds while Congress debated.<sup>101</sup>

The Court also reviewed the period of retroactivity and found that—like other legislation sustained by the Court—it was confined to a short and limited period required by practicalities associated with producing national legislation.<sup>102</sup> Therefore, the Court was “loathe to reject such a common practice when conducting the limited judicial review accorded economic legislation” under the

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93. *Pension Benefit*, 467 U.S. at 720.

94. *Id.* at 723-24.

95. *Id.* at 724-25.

96. *Id.* at 728-29.

97. *Usery v. Turner Elkhorn Mining Co.*, 428 U.S. 1 (1976).

98. *Pension Benefit*, 467 U.S. at 728-29.

99. The Court contrasted this test from the test used to determine whether a state action impairs preexisting contracts under the Contracts Clause. *Id.* at 733.

100. *Id.* at 730.

101. *Id.* at 731.

102. *Id.*



Due Process Clause.<sup>103</sup> Because the Act was made retroactive for only a five-month period and supported by a rational and legitimate purpose, it withstood the taxpayer's due process challenge.<sup>104</sup>

In rejecting the due process challenge, the Court also turned away from the actual notice test, indicating that notice of the pending legislation was irrelevant to its analysis.<sup>105</sup> The taxpayer and amici curiae had contended that the retroactive application of the MPPAA was subject to heightened judicial scrutiny because taxpayers did not have adequate notice of the changing tax ramifications.<sup>106</sup> The Court, however, expressed doubts that the retroactive application would be invalid for lack of notice even if it had been suddenly enacted by Congress.<sup>107</sup> Nevertheless, by concluding that the employers had adequate notice of the withdrawal liability through congressional debates on the MPPAA, the Court declined to state definitively whether actual notice of the legislation was a relevant factor.<sup>108</sup>

A mere two years later, however, the Court reverted to the harsh and oppressive formulation of the due process test in upholding statutory transitional estate and gift tax rules against a due process challenge.<sup>109</sup> Congress enacted the transitional rule to bridge old and new regimes of federal taxation of gifts and estates.<sup>110</sup> Its purpose was to prevent taxpayers from obtaining a windfall of double exemptions in the four-month interim period.<sup>111</sup>

The district court had revived the *Nichols* line of cases, concluding that the interim rules violated due process because they applied to gifts made before the enactment of the amending legislation.<sup>112</sup> Justice Marshall, writing for the unanimous Court, reversed and dismissed the value of *Nichols* in deciding the constitutionality of amendments affecting the operation of existing tax laws.<sup>113</sup> Once again, the Court confined the more rigorous review

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103. *Pension Benefit*, 467 U.S. at 731.

104. *Id.* at 734.

105. *Id.* at 731-32.

106. *Id.*

107. *Id.* at 732. The Court explained that such "sudden" enactment by Congress could arise through a floor amendment or rider. *Id.*

108. *Pension Benefit*, 467 U.S. at 732.

109. *Hemme*, 476 U.S. at 568.

110. *Id.* at 569-70.

111. *Id.* at 562. The taxpayer contended that the statute was retroactive. The Court did not determine the issue of whether the statutory rules were in fact retroactive in concluding that there was no due process violation. *Id.* at 571. The Court did, however, rely on retroactive tax jurisprudence throughout the opinion.

112. *Id.* at 564.

113. *Id.* at 568.

employed in *Nichols* and its progeny to the retroactive imposition of wholly new taxes. In contrast, amendments to the estate and gift tax structure were to be reviewed by considering the “nature of the tax” in determining whether its retroactive application was so “harsh and oppressive” as to violate the Due Process Clause.<sup>114</sup> Applying this test to the facts, the Court had little trouble upholding the transitional rules, particularly because the petitioners were not financially prejudiced by passage of the act—they simply were unable to avail themselves of a windfall that would have resulted in the absence of the short transitional period created by the legislation.<sup>115</sup>

### C. United States v. Carlton

In the seminal 1994 *United States v. Carlton*<sup>116</sup> decision, the Supreme Court upheld yet another estate tax amendment against a due process challenge.<sup>117</sup> The majority concluded that a 1987 amendment to the 1986 Tax Reform Act,<sup>118</sup> made retroactive to the Act’s enactment in October 1986, was valid under the Due Process Clause.<sup>119</sup> Perhaps most significantly, however, Justice O’Connor issued a concurring opinion that suggested a more objective standard for determining the permissible period of retroactivity.<sup>120</sup> In a frequently cited portion of the opinion, she wrote: “A period of retroactivity longer than the year preceding the legislative session in which the law was enacted would raise, in my view, serious constitutional questions.”<sup>121</sup> As discussed in Part IV below, several state courts have relied on this concurring opinion to invalidate state and local tax legislation with extensive periods of retroactivity, thereby reviving the use of the Due Process Clause as a limitation on retroactive tax provisions.

In the Tax Reform Act of 1986, Congress added a new estate tax provision applicable to any estate that filed a timely return after October 22, 1986 (the date of the Act’s enactment). This provision granted a deduction for certain proceeds from the sale of employer securities by an estate to an employee stock ownership plan

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114. *Hemme*, 476 U.S. at 568-69 (citing *Welch*, 305 U.S. at 147).

115. *Id.* at 570.

116. 512 U.S. 26 (1994).

117. *Carlton*, 512 U.S. at 26.

118. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986).

119. *Carlton*, 512 U.S. at 32.

120. *Id.* at 36-37 (O’Connor, J., concurring).

121. *Id.* at 38; see also *infra* Part III(C).

("ESOP"). For the sale to qualify for a deduction, the sale had to be made before the date on which the estate tax return was required to be filed, including extensions.<sup>122</sup>

Respondent Carlton, the executor of an estate, purchased 1.5 million shares of stock with estate funds on December 10, 1986.<sup>123</sup> Carlton sold the stock two days later to an ESOP, for an amount \$631,000 less than the purchase price.<sup>124</sup> When he filed the estate tax return on December 29, 1986, Carlton availed the estate of the new ESOP deduction and claimed a deduction for half of the sale proceeds.<sup>125</sup> This deduction decreased the estate tax liability by approximately \$2.5 million.<sup>126</sup>

In early 1987, recognizing the unintended loophole created by the plain language of the ESOP legislation, the IRS announced that through pending "clarifying legislation," it would permit the ESOP deduction only for estates of decedents who owned the stock before death.<sup>127</sup> On December 22, 1987, Congress enacted the amendment, which provided that the securities sold to an ESOP must have been directly owned by the decedent immediately before death to qualify for the deduction.<sup>128</sup> This amendment was made retroactive to October 22, 1986, the date of enactment of the 1986 Tax Reform Act.<sup>129</sup>

Based on the 1987 legislation, the IRS disallowed Carlton's claimed estate tax deduction.<sup>130</sup> Carlton paid the assessment and pursued a claim for refund, contending that the retroactive application of the legislation violated the Due Process Clause.<sup>131</sup> A divided panel of the Ninth Circuit Court of Appeals applied a notice test, concluding that Carlton did not have actual or constructive notice of the retroactive amendment of the statute at the time he entered into the transaction and that he thereby reasonably relied to his detriment on the legislation.<sup>132</sup> Therefore, the Ninth Circuit

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122. *Carlton*, 512 U.S. at 26. The ESOP provision was codified at 26 U.S.C. § 2057.

123. *Id.*

124. *Id.*

125. *Id.*

126. *Id.* at 28.

127. IRS Notice 87-13, 1987-1 C.B. 432 at 442.

128. *Carlton*, 512 U.S. at 29.

129. *Id.* The amending legislation was included as part of the Omnibus Budget Reconciliation Act of 1987, § 10411(a).

130. *Id.*

131. *Id.* at 27.

132. *U.S. v. Carlton*, 972 F.2d 1051 (9th Cir. 1992).

majority concluded that retroactive application of the amendment was unconstitutional.<sup>133</sup>

### 1. *Justice Blackmun's Majority Opinion*

Writing for the Supreme Court majority, Justice Blackmun observed that the Court repeatedly had upheld retroactive tax legislation against due process challenges.<sup>134</sup> In an apparent effort to reconcile the different tests applied by the Court over the years, the opinion characterized the harsh and oppressive formulation<sup>135</sup> as no different than the legitimate purpose test<sup>136</sup> recently applied to tax measures and traditionally used in assessing the constitutionality of economic legislation.<sup>137</sup> The Court clarified that the due process test applicable to retroactive tax statutes is, therefore, the same as the test generally applied to retroactive economic legislation—namely, whether the retroactive application of the statute is supported by a legitimate legislative purpose furthered by rational means.<sup>138</sup>

Applying this test to the 1987 amendment, the Court first concluded that the retroactive application to October 1986 was supported by a legitimate, non-arbitrary purpose.<sup>139</sup> In particular, the retroactive application was intended to cure a drafting defect in the 1986 legislation.<sup>140</sup> Through the ESOP deduction, Congress had intended to encourage stockholders to sell their companies to their employees, rather than permit executors to drastically reduce estate tax liability by purchasing stock and immediately reselling it to an ESOP.<sup>141</sup> Indeed, the estimated revenue loss without the 1987 amendment was more than 20 times greater than anticipated.<sup>142</sup> Congress therefore did not have an improper motive in stemming the revenue loss by retroactively closing the loophole.<sup>143</sup>

Critically, in determining whether the statute was supported by rational means, the Court also analyzed the period of retroactiv-

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133. *Carlton*, 512 U.S. at 29; 972 F.2d 1051 (9th Cir. 1992).

134. *Carlton*, 512 U.S. at 30.

135. *Id.* (citing *Welch*, 305 U.S. at 147, and *Hemme*, 476 U.S. at 568-69).

136. *See Pension Benefit*, 467 U.S. at 720.

137. *Carlton*, 512 U.S. at 30.

138. *Id.* at 30-31.

139. *Id.* at 32.

140. *Id.*

141. *Id.* at 31.

142. *Carlton*, 512 U.S. at 32.

143. *Id.*

ity. The majority concluded that Congress acted promptly and established only a modest period of retroactivity.<sup>144</sup> Relying on the Court's prior decisions upholding retroactive tax legislation confined to short periods "required by the practicalities of producing national legislation,"<sup>145</sup> the Court concluded that the period of retroactivity—slightly more than one year—was modest.<sup>146</sup> In particular, the Court endorsed the *Welch* Court's prior legislative session test.<sup>147</sup> The Court also observed that the amendment had been proposed by the IRS since January 1987, only two months following the effective date of the 1986 legislation.<sup>148</sup>

Despite the relatively short period of retroactivity, it was undisputed that Carlton had no actual or constructive notice of the amendment to the ESOP deduction because he sold the stock in December 1986, prior to the IRS notice.<sup>149</sup> Critically, however, the Court determined that Carlton's lack of notice of the 1987 amendment and detrimental reliance on the original statute alone were insufficient to create a constitutional violation.<sup>150</sup> In an oft-cited statement, the majority opined that "[t]ax legislation is not a promise, and a taxpayer has no vested right in the Internal Revenue Code."<sup>151</sup>

The Court confirmed that the *Nichols* approach "has long since been discarded" and, to the extent viable, pertains only to the creation of a wholly new tax.<sup>152</sup> Moreover, in rejecting Carlton's argument that retroactive estate and gift tax legislation be analyzed under a stricter test than retroactive income tax legislation, the Court confirmed that the nature of the tax at issue is not dispositive.<sup>153</sup> The Court therefore reversed the Ninth Circuit's decision, which had relied exclusively on the notice test, and held that the retroactive application of the 1987 amendments to October 1986 satisfied the Due Process Clause.<sup>154</sup>

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144. *Id.*

145. *Id.* at 33 (citing *Darusmont*, 449 U.S. at 296-97; and *Welch*, 305 U.S. at 150).

146. *Id.* at 33.

147. *Carlton*, 512 U.S. at 33.

148. *Id.*

149. *Id.* at 28.

150. *Id.* at 34 (citing *Welch*, 305 U.S. at 134 and *Milliken*, 283 U.S. at 15).

151. *Id.* at 33.

152. *Carlton*, 512 U.S. at 34 (citing *Hemme*, 476 U.S. at 568).

153. *Id.*

154. *Id.* at 35.

## 2. Justice O'Connor's Concurrence

In a concurring opinion, Justice O'Connor criticized the majority's focus on the "curative" nature of the 1987 amendment as support for finding a legitimate purpose.<sup>155</sup> Observing that any statute amending an existing law is intended to fix a perceived problem with the existing law, Justice O'Connor concluded that retroactive application of revenue measures are by their nature rationally related to the legitimate governmental purpose of raising revenue.<sup>156</sup>

The concurring opinion acknowledged the wholly new tax exception. For instance, the retroactive application of a wholly new tax is arbitrary, even though it would raise revenue.<sup>157</sup> As the tax consequences of commercial transactions are relevant and sometimes dispositive considerations in taxpayers' business decisions, it is arbitrary to tax transactions that were not subject to taxation at the time the taxpayer entered into them.<sup>158</sup> While the retroactive application of increased tax rates or the elimination of deductions could have similar effects on taxpayers who reasonably relied on the existing legislation, the concurring opinion recognized the Court's precedent, holding that Congress must have some ability to make retroactive adjustments as a means of equalizing revenue and budgetary requirements.<sup>159</sup>

Critically, the concurring opinion also suggested that a more objective test be applied to the period of retroactivity.<sup>160</sup> Justice O'Connor first noted that "[t]he governmental interest in revising the tax laws must at some point give way to the taxpayer's interest in finality and repose."<sup>161</sup> In every case in which the Court upheld retroactive federal tax statutes against due process challenges, the law applied retroactively for only a relatively short period. Although the retroactivity periods generally were less than one year,<sup>162</sup> those periods greater than a year in length were made in the first legislative session following the tax year in question.<sup>163</sup> Therefore, Justice O'Connor stated her belief that a retroactivity

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155. *Id.* at 35 (O'Connor, J., concurring).

156. *Id.* at 37.

157. *Carlton*, 512 U.S. at 38 (O'Connor, J., concurring).

158. *Id.* at 38.

159. *Id.*

160. *Id.* at 38.

161. *Id.* at 37-38 (O'Connor, J., concurring).

162. *Carlton*, 512 U.S. at 37-38 (citing *Hemme* 476 U.S. at 568 (1 month); *Darusmont*, 449 U.S. at 292 (10 months); and *Hudson*, 299 U.S. at 501 (1 month)).

163. *Id.* (citing *Welch*, 305 U.S. at 134).

period longer than the year before the enacting legislative session would raise serious constitutional issues.<sup>164</sup> Since the 1987 amendment was enacted the year following the original legislation, given the Court's precedents, Justice O'Connor concurred that the retroactive application of the estate tax amendment did not violate due process.

### 3. *Justice Scalia's Concurrence*

Justice Scalia concurred in the judgment based on his belief that the Fifth Amendment's Due Process Clause does not protect substantive due process.<sup>165</sup> In dicta, his opinion went further by applying the actual notice and detrimental reliance test, leading to a conclusion that—if there were such a thing as substantive due process—the retroactive application of the 1987 amendment would violate it because Carlton obviously relied on the prior law to the estate's detriment.<sup>166</sup> Additionally, Justice Scalia predicted that the majority's reasoning would guarantee that *all* retroactive tax laws would henceforth be valid.<sup>167</sup> As will be seen below in Part III, this prediction proved erroneous.

## III. POST-CARLTON: THE MODESTY DOCTRINE

### A. *Retroactivity Periods of Less Than One Year Have Been Upheld*

Due process challenges to retroactive federal and state tax legislation consistently have failed in the post-*Carlton* era when the period of retroactivity was one year or less. For instance, shortly after *Carlton* was announced, the Seventh Circuit Court of Appeals upheld the constitutionality of an amendment subjecting loan proceeds received from qualified corporate pension plans to income taxation.<sup>168</sup> The period of retroactivity was limited to one month.<sup>169</sup> Nonetheless, the taxpayer asserted that the taxation of the loan proceeds in question was a "wholly new tax" and therefore invalid under the *Nichols* line of authority.<sup>170</sup> In rejecting the

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164. *Id.*

165. *Id.* at 39.

166. *Id.* at 39.

167. *Carlton*, 512 U.S. at 40 (O'Connor, J., concurring).

168. *Furlong v. Comm'r of Revenue*, 36 F.3d 25 (7th Cir. 1994).

169. *Furlong*, 36 F.3d at 27 n.2.

170. *Id.* at 28; Brief of Respondent-Appellee at 13-14, *Furlong v. Comm'r of Revenue*, No. 93-3668 (7th Cir. Mar. 14, 1994).

taxpayer's characterization of the tax measure, the court determined that the change in the income tax was reasonably foreseeable at the time the taxpayer obtained the loan proceeds, and therefore, the amendment was not a wholly new tax subject to strict scrutiny.<sup>171</sup> Relying on *Carlton*, the Court had little trouble finding that the goals of raising revenue and preventing taxpayers from taking advantage of a prospective change in the law constituted legitimate purposes for the retroactive impact of the legislation.<sup>172</sup> Further, the very limited period of retroactivity demonstrated that the legislative purpose was backed by reasonable means.<sup>173</sup>

Also at the federal level, two lower federal courts upheld the 1993 Omnibus Budget Reconciliation Act's<sup>174</sup> retroactive increase in the estate tax rate.<sup>175</sup> The period of retroactivity was eight months.<sup>176</sup> Based on *Carlton*, the courts determined that the period of retroactivity was short and limited.<sup>177</sup> The courts also relied on *Carlton* in concluding that retroactive tax legislation may be backed solely by the rational, legitimate purposes of raising revenue and promoting taxpayer equity.<sup>178</sup> As Justice O'Connor observed, the conclusion essentially validates every retroactive tax measure under the legitimate purpose test.<sup>179</sup>

Retroactive state tax measures with relatively short periods of retroactivity also have routinely been upheld since 1994. For instance, the Arizona Legislature's amendment retroactively reducing an alternative fuel tax credit was sustained over the taxpayers' due process challenge.<sup>180</sup> The amendment retroactively eliminated a tax credit equal to 30%–50% of the purchase price of the vehicle.<sup>181</sup> Under the amendment, the credit was retroactively limited to the total costs of converting a vehicle to alternative

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171. *Furlong*, 36 F.3d at 27-28.

172. *Id.* at 28.

173. *Id.* at 29.

174. Section 13208 of the Omnibus Budget Reconciliation Act of 1993 (OBRA 1993), Pub. L. No. 103-66, 107 Stat. 312, 469.

175. *Quarty v. U.S.*, 170 F.3d 961 (9th Cir. 1999); *Kane v. U.S.*, 942 F. Supp. 233 (E.D. Pa. 1996).

176. *Quarty*, 170 F.3d at 968; *Kane*, 942 F. Supp. at 234.

177. *Quarty*, 170 F.3d at 968; *Kane*, 942 F. Supp. at 234.

178. *Quarty*, 170 F.3d at 967-68 (rejecting taxpayer's argument that the increase in the estate tax rate, which was not a curative measure, impacted the determination of whether the legislation had a legitimate purpose); *Kane*, 942 F. Supp. at 234.

179. *Quarty*, 170 F.3d at 967; see *supra* note 179 and accompanying text.

180. *Baker*, 105 P.3d at 1183-84.

181. *Id.* at 1182.



fuel.<sup>182</sup> The period of retroactivity was eight months.<sup>183</sup> Rejecting the taxpayers' argument that the retroactive application of the law violated their due process rights, the Arizona Court of Appeals held that the retroactive application of the tax was backed by the legitimate legislative purpose of closing a loophole under the existing law, and further, that the eight-month period of retroactivity was modest.<sup>184</sup>

*B. Several Decisions Have Upheld Tax Legislation and Regulations Containing Retroactivity Periods of Greater Than One Year*

Following *Carlton*, several federal and state courts upheld tax legislation containing retroactivity periods greater than one year in length. In most of these cases, the courts either did not fully apply the *Carlton* modesty doctrine or upheld retroactive federal tax regulations, which generally were accorded more lenient due process review than statutes.

For instance, in *Montana Rail Link, Inc. v. United States*,<sup>185</sup> the Ninth Circuit Court of Appeals upheld the retroactive application of the Omnibus Budget Reconciliation Act of 1989 ("1989 OBRA")<sup>186</sup> to employer contributions made to the Railroad Retirement Tax Act ("RTA")<sup>187</sup> in 1987 and 1988.<sup>188</sup> Congress had retroactively barred refund claims by employers that had previously paid RRTA tax on their employer 401(k) contributions.<sup>189</sup> Without the period of retroactivity, the railroad workers' retirement funds and benefits would have been jeopardized.<sup>190</sup> Indeed, some employees had already received benefits based on the amounts paid into the funds and credited to the accounts for the period in issue.<sup>191</sup> Although the petitioners challenged the retro-

182. *Id.* The taxpayers had their four motor homes converted to alternative fuels at a combined cost of \$31,000. *Id.* Under the pre-amendment law, the taxpayers were entitled to a tax credit equal to the total cost plus \$92,750, which represented a portion of the purchase price of the vehicles. *Id.* at 1183. After the amendment, the credit amount was limited to \$31,000. *Id.* at 1182.

183. *Id.* at 1187.

184. *Id.*

185. 76 F.3d 991 (9th Cir. 1996).

186. Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, 103 Stat. 2106.

187. Railroad Retirement Tax Act (RRTA), 26 U.S.C. § 3231 (1983). This act is the Social Security Act equivalent for railroad employees. *Id.*

188. *Montana Rail*, 76 F.3d at 994-95.

189. *Id.* at 993.

190. OBRA § 10206(c)(2)(A)(ii); *Id.* at 993.

191. *Montana Rail*, 76 F.3d at 993.

active application of the 1989 OBRA to their refund claims for tax years 1987 and 1988, the Act retroactively barred refund claims back to 1983, a period of up to six years.<sup>192</sup> In upholding the retroactive application of the 1989 OBRA, the Ninth Circuit focused on the harm Congress attempted to prevent in protecting the retirement funds of the railroad workers and concluded that the 1989 OBRA had a legitimate legislative purpose.<sup>193</sup>

The court did not, however, strictly apply the second prong of the *Carlton* test. Instead, it reasoned that a shorter period of retroactivity would have benefitted only some of the employees and that a period of retroactivity to 1983 salvaged all employees' retirement funds and reliance on the prior employer contributions. The court therefore concluded that the statute's period of retroactivity bore a rational relationship to the legitimate legislative purpose it was trying to achieve.<sup>194</sup>

Additionally, several lower federal court decisions have sustained federal tax regulations containing retroactivity periods longer than one year. However, those decisions emphasized that, contrary to tax statutes, which typically act prospectively, federal tax regulations are often applied retroactively.<sup>195</sup> Federal regulations are therefore governed by a more lenient standard of review under the *Carlton* modesty doctrine. For instance, the Third Circuit Court of Appeals upheld a six-year period of retroactivity contained in a Treasury Regulation.<sup>196</sup> The Court observed that under the Internal Revenue Code,<sup>197</sup> Treasury Regulations were statutorily presumed to operate retroactively.<sup>198</sup> Accordingly, a different test applies in determining whether a retroactive federal tax regulation has a modest look-back period. Specifically, courts look to whether the regulation actually effects a change in law or

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192. *Id.*

193. *Id.* at 994.

194. *Id.*

195. See, e.g., *Tate & Lyle, Inc. v. Comm'r*, 87 F.3d 99 (3d Cir. 1996); *A. Tarricone, Inc. v. U.S.*, 4 F.Supp. 2d 323 (S.D.N.Y. 1998); *E.I. du Pont de Nemours & Co. v. Comm'r*, 41 F.3d 130 (3d Cir. 1994) (upholding 15-year period of retroactive application); *Rutter v. Comm'r*, 760 F.2d 466, 468-69 (2d Cir. 1985) (upholding five-year period of retroactive application).

196. *Tate*, 87 F.3d at 107.

197. I.R.C. § 7805(b) (1998). This provision provides: "The Secretary may prescribe the extent, if any, to which any ruling or [regulation] relating to the internal revenue laws, shall be applied without retroactive effect." Congress therefore demonstrated its intent that treasury regulations are to apply retroactively, absent express language otherwise. *Tate*, 87 F.3d at 107. In 1996, Congress amended this statute to limit the Secretary's authority to impose regulations retroactively where the regulations interpreted statutory provisions enacted after 1996. *A. Tarricone, Inc.*, 4 F.Supp. 2d at 326, n.2.

198. *Tate*, 87 F.3d at 107.

policy, and whether the taxpayer detrimentally and reasonably relied on the prior regulation.<sup>199</sup> Many regulations clarify ambiguous statutes and unsettled law, and, therefore, the retroactive application of the regulation may not effect a change in law. Likewise, the existing, ambiguous law is not as likely to produce reasonable, detrimental reliance by the taxpayer.<sup>200</sup>

At the state level, at least two courts have upheld tax measures with retroactivity periods greater than one year. In *Monroe v. Valhalla Cemetery Co.*,<sup>201</sup> the Alabama Court of Civil Appeals upheld a use tax statute with a retroactivity period of two to three years.<sup>202</sup> Several administrative rulings had revealed a loophole in Alabama's sales and use tax law, whereby sales of goods delivered into the state from out-of-state vendors were not subject to the state's use tax.<sup>203</sup> In cases where the vendors had insufficient contacts with the state, no state sales tax could be lawfully applied either.<sup>204</sup> In 1997, the state enacted legislation that closed the loophole and applied the act retroactively for all open tax years.<sup>205</sup> The retroactivity provision therefore prevented taxpayers from seeking certain use tax refunds for the two- to three-year period that would otherwise have been open.<sup>206</sup> On appeal, the trial court ruled the two- to three-year period excessive and upheld the taxpayer's due process challenge.<sup>207</sup>

In reversing the trial court and rejecting the taxpayer's constitutional challenge, the state appellate court first found that there was a legitimate legislative purpose behind the act and that the legislation merely "clarified" the legislature's intent.<sup>208</sup> Second, in summary fashion, the court concluded that the period of retroactivity was modest. The court relied on Alabama precedent that had upheld a tax assessment with a retroactivity period of eight years.<sup>209</sup> Additionally, the court was swayed by the fact that with-

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199. *Id.* at 107-108; *A. Tarricone*, 4 F.Supp. 2d at 326.

200. *A. Tarricone*, 4 F.Supp. 2d at 326-27.

201. 749 So. 2d 470, 473 (Ala. Civ. App. 1999), *cert. denied*, 529 U.S. 1022 (2000) (overruled on other grounds, *Patterson v. Gladwin Corp.*, 835 So.2d 137 (Ala. 2002)).

202. *Monroe*, 749 So.2d at 475.

203. *Id.* at 472.

204. *Id.*

205. *Id.* The new legislation "clarified" that the current law exempted from use tax only that property sold at retail in Alabama on which sales tax had already been paid. Act. No. 97-301, § 2.

206. *Monroe*, 749 So.2d at 473; § 40-2A-7(c)(2).

207. *Monroe*, 749 So.2d at 473.

208. *Id.* at 474.

209. *Id.* (citing *Smith v. Sears Roebuck & Co.*, 672 So. 2d 794 (Ala. Civ. App. 1995) (court concluded legislation was a clarification); *Maples v. McDonald*, 668 So.2d 790 (Ala. Civ.

out the retroactive application of the legislation, taxpayer refunds for the open period would create a considerable strain on the state budget.<sup>210</sup>

More recently (December 2008), in *Enterprise Leasing Co. of Phoenix v. Arizona Dep't of Revenue*,<sup>211</sup> the Arizona Court of Appeals upheld a tax statute with a six-year period of retroactivity. In 1994, the Arizona State Legislature authorized a pollution control equipment income tax credit allowed against taxes incurred by a taxpayer when purchasing real or personal property that is used to control or prevent pollution.<sup>212</sup> Five years later, the Department of Revenue received its first claim for a credit for equipment attached to a motor vehicle.<sup>213</sup> It soon became apparent that the tax credit would cost the state considerably more than expected, and in April 2000, the Legislature amended the statute to provide that the credit does not apply to the purchase of any personal property attached to a motor vehicle.<sup>214</sup> In somewhat contradictory terms, the legislation provided that the amendment amounted to a "clarifying change" that (1) was "consistent with the legislature's intent when [the credit was] enacted," (2) was intended "to close loopholes," and (3) was "to apply retroactively to taxable years beginning from and after December 31, 1994."<sup>215</sup> In March 2000, the taxpayer filed refund claims, claiming the credit for personal property attached to motor vehicles.<sup>216</sup> After the claims were denied, the taxpayer challenged the retroactivity of the legislation under the substantive Due Process Clause.

The Arizona Court of Appeals first characterized the legislation as "curative" in light of the legislative statement that the amendment was a clarification of legislative intent.<sup>217</sup> Therefore, the

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App. 1995) (same)). Although these cases post-date *Carlton*, neither case cited *Carlton* or the modesty doctrine. See *Smith*, 672 So.2d at 795-800; *Maples*, 668 So.2d at 791-93. Moreover, the constitutional analysis in both cases is thin. *Id.*

210. *Monroe*, 749 So.2d at 475.

211. No. 1 CA-TX 06-0017, 2008 Ariz. App. LEXIS 168 (Ariz. Ct. App. Dec. 16, 2008). This opinion is also available on Westlaw, under 2008 WL 5237810, but the page numbers in the following citations are derived from LexisNexis. On January 22, 2009, plaintiff/appellant Enterprise Leasing Co. filed a petition for review with the Arizona Supreme Court. See CLERK OF THE COURT, ARIZONA COURT OF APPEALS, DIVISION ONE, <http://www.cofad1.state.az.us/casefiles/tx/TX060017.pdf> (last visited May 5, 2009).

212. ARIZ. REV. STAT. ANN. § 43-1170 (1994) (amended 1995, 2000, & 2005).

213. *Enterprise Leasing*, 2008 Ariz. App. LEXIS 168, at \*3.

214. 2000 Ariz. Sess. Laws 405, at \*21. The cost of the credit went from approximately \$2.5 million to \$15 million annually. *Enterprise Leasing*, 2008 Ariz. App. LEXIS 168, at \*3.

215. *Enterprise Leasing*, 2008 Ariz. App. LEXIS 168, at \*4 (internal citations omitted).

216. *Id.* at \*4.

217. *Id.* at \*6-\*8.

Court reasoned, “the amendment did not retroactively abolish a right.”<sup>218</sup> Then, relying on the *Carlton* majority opinion, the Court held that, even if the amendment was not curative, it passed constitutional muster because it was supported by a legitimate legislative purpose (fixing a perceived loophole to minimize exposure to refund claims) and was furthered by rational means.<sup>219</sup> In upholding the amendment under the modesty doctrine, the Court incorporated actual notice/detrimental reliance and vested rights issues into its analysis and relied on judicial precedent upholding tax measures with retroactivity periods longer than one year.<sup>220</sup> The Court also declined to impose a one-year “talismanic cutoff” because such a notion arose from Justice O’Connor’s concurrence in *Carlton*—not the majority opinion.<sup>221</sup> The *Enterprise* Court proceeded to observe that some leeway must exist for retroactivity longer than a year “so long as the legislature acts at the earliest notice or opportunity.”<sup>222</sup> Because the department of revenue had not received any pollution control equipment tax credit claims for motor vehicles until December 1999, the Court reasoned that the Legislature acted promptly by enacting the amendment in April 2000.<sup>223</sup>

### C. *Several State Cases Have Struck Tax Measures with Retroactivity Periods of Greater Than One Year*

In the post-*Carlton* era, at least three state appellate court decisions have held that tax measures with retroactivity periods of greater than one year violated due process.<sup>224</sup> Each of these cases cited Justice O’Connor’s *Carlton* concurrence and concluded that the tax provisions at issue violated the modesty doctrine.

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218. *Id.* at \*8. This analysis demonstrates the danger of upholding the constitutionality of “curative” retroactive tax measures. Every retroactive tax measure seeks to cure a perceived defect in existing law. If the “curative” intent is used as a judicial criterion, by attaching the label “curative” and divining the intent of a prior legislature, a legislature can ensure that the measure will pass due process scrutiny.

219. *Id.* at \*8.\*12.

220. *Enterprise Leasing*, 2008 LEXIS 168, at \*10.\*12.

221. *Id.* at \*13.

222. *Id.* at \*16.

223. *Id.* at \*16.\*17.

224. At the trial court level, on April 17, 2009, the Michigan Court of Claims relied on *Carlton*’s modesty doctrine and held that legislation seeking to retroactively invalidate refund claims dating back 11 years “clearly violated” due process. *Gen. Motors Corp. v. Dep’t of Treasury*, No. 07-151-MT (Mich. Ct. Cl. 2009).

In *Rivers v. State*,<sup>225</sup> the South Carolina Supreme Court invalidated legislation with a retroactivity period of two to three years.<sup>226</sup> A 1988 act had retroactively decreased the capital gains tax rate.<sup>227</sup> A year later, an amendment retroactively limited the period of the lower tax rate and provided that the refund would be made in two equal annual installments, with the first refund to be issued in 1990.<sup>228</sup> Then, in 1991, the legislature amended the capital gains tax yet again, this time retroactively reducing each refund by 50%. This amendment would have divested taxpayers of the one-half of their refunds they had not already received.<sup>229</sup> The litigant taxpayers, who had realized capital gains in the subject period between January 1 and June 22 of 1987, brought suit because the 1991 amendment retroactively eliminated the portion of the 1987 tax year refund they had not yet received.<sup>230</sup>

Citing Justice O'Connor's concurrence, the South Carolina Supreme Court held that the 1991 act violated both the federal and state due process clauses because the period of retroactivity was not modest.<sup>231</sup> The court determined that depending on whether the calculation of retroactivity went back to the 1989 amendment or the original 1988 legislation, the period of retroactivity was at least two (and possibly three) years in length.<sup>232</sup> In holding the legislation unconstitutional, the court observed: "At some point, however, the government's interest in meeting its revenue requirements must yield to taxpayers' interest in finality regarding tax liabilities and credits."<sup>233</sup> The *Rivers* Court determined that tipping point had been reached and that, under the facts and circumstances, the retroactivity period was "simply excessive."<sup>234</sup> In concluding that the period violated the modesty doctrine, the court qualified its holding by stating that it did not suggest that every retroactivity period of two to three years or more was per se unreasonable.<sup>235</sup>

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225. 490 S.E.2d 261 (S.C. 1997).

226. *Rivers*, 490 S.E.2d 261.

227. *Id.* at 262; Act No. 658, 1988 S.C. Acts 658, Part II § 27. The legislation reduced the tax rate for the period January 1, 1987, through January 31, 1988.

228. *Rivers*, 490 S.E.2d at 262. The period was reduced to the time between January 1, 1987 and June 22, 1987.

229. *Id.* Act. No. 171, 1991 S.C. Acts 171, Part II, § 6.

230. *Rivers*, 490 S.E.2d at 262.

231. *Id.* at 263-64.

232. *Id.* at 265.

233. *Id.*

234. *Id.*

235. *Rivers*, 490 S.E.2d at 265 n.4.

In the 2005 decision *City of Modesto v. National Med, Inc.*,<sup>236</sup> the California Court of Appeal held that a city's attempt to retroactively impose revenue apportionment guidelines in an effort to moot out a pending refund claim violated the modesty doctrine.<sup>237</sup> A trial court had previously held that the city's business license tax ordinance was unconstitutional as applied to the taxpayer because it imposed tax on business activities occurring outside of the city.<sup>238</sup> Following the ruling, the city amended its business license tax ordinance in 2002 to provide for apportionment.<sup>239</sup> More than a year later, in September 2003, the city council enacted apportionment guidelines.<sup>240</sup> The city sought to retroactively impose the ordinance amendment and the apportionment guidelines to all tax refund claims, including pending claims.<sup>241</sup> The retroactive application of the 2002 amendment and the 2003 apportionment guidelines would therefore have had the effect of substantially reducing the tax refund the petitioner would receive for the tax years at issue (1996–2000).<sup>242</sup> Then, in 2004, in an attempt to cover the tax deficiency assessment the city had previously issued to the petitioner, the city enacted yet another set of apportionment guidelines, seeking to impose the guidelines retroactively to all pending assessments.<sup>243</sup>

The California appellate court held that the city's attempt to retroactively impose the apportionment amendment and guidelines violated *Carlton's* modesty doctrine because the retroactive application was four to eight years in the past.<sup>244</sup> The taxpayer had first claimed in February 2000 that the business license tax was unconstitutional. The city did not amend its ordinance to provide for apportionment until August 2002. A year passed before the city enacted its first set of apportionment guidelines, and then another year passed before the city promulgated guidelines in an attempt to impact the pending assessment.<sup>245</sup> In an under-

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236. 27 Cal. Rptr. 3d 215 (Cal. Ct. App. 2005).

237. *Modesto*, 27 Cal. Rptr. 3d at 217.

238. *Id.* at 217. The ordinance's failure to apportion in-city and out-of-city gross receipts violated the requirements of equal protection and due process because the tax discriminated against inter-city business. *Id.* at 219 (citing *City of Los Angeles v. Shell Oil Co.*, 4 Cal.3d 108 (1971)).

239. *Id.* at 218.

240. *Id.*

241. *Id.* at 219.

242. *Modesto*, 27 Cal. Rptr. 3d at 217, 220.

243. *Id.* at 221.

244. *Id.* at 222.

245. *Id.*

statement, the court concluded that “the City cannot be found to have acted promptly.”<sup>246</sup>

Moreover, in addition to finding that the city did not act promptly, the court held that the total period of retroactivity was not modest. The city sought to impose the 2004 guidelines retroactively up to eight years.<sup>247</sup> Noting that California courts have upheld the retroactive application of tax laws only where the retroactivity was limited to the current tax year,<sup>248</sup> and citing the O'Connor *Carlton* concurrence, the *City of Modesto* Court concluded that the period of retroactivity violated the modesty doctrine.

Lastly, in *Johnson Controls, Inc. v. Rudolph*,<sup>249</sup> decided in 2006, the Kentucky Court of Appeals determined that the Commonwealth's efforts to retroactively eliminate taxpayers' pending administrative claims for overpayment of income tax violated the taxpayers' right to due process.<sup>250</sup> A 1994 decision of the Kentucky Supreme Court had overturned the Kentucky Revenue Cabinet's policy of not permitting unitary income tax returns.<sup>251</sup> The taxpayers thereafter filed amended income tax returns and sought refunds of taxes overpaid as a result of the Commonwealth's unlawful policy of prohibiting unitary returns.<sup>252</sup> These refund claims languished at the administrative level until 2000, when the legislature, alarmed at the growing size of the refund claims, passed H.B. 541,<sup>253</sup> which sought to extinguish all refund claims filed from December 22, 1994, to December 31, 1995, that were based on a change from initially filed separate returns to combined returns.<sup>254</sup>

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246. *Id.*

247. *Modesto*, 27 Cal. Rptr. 3d at 222.

248. *Id.* (citing *Gutknecht v. City of Sausalito*, 117 Cal. Rptr. 782 (Cal. Ct. App. 1974)).

249. No. 2004-CA-001566-MR, 2006 Ky. App. LEXIS 132 (Ky. Ct. App. 2006).

250. 2006 Ky. App. LEXIS 132 at \*31 (Ky. Ct. App. 2006) (review granted by *Rudolph v. Johnson Controls, Inc.*, No.2006-SC-0416-DG, 2007 Ky. LEXIS 195 (Ky. Oct. 24, 2007) and *Johnson Controls, Inc. v. Burnside*, No. 2007-SC-0819-DG, 2007 Ky. LEXIS 276 (Ky., Dec. 12, 2007)). *Johnson*, No. 2006 Ky. App. LEXIS 132.

251. *GTE v. Revenue Cabinet*, 889 S.W.2d 788, 790 (Ky. 1994). A *unitary business* is “[a] business that has subsidiaries in other states or countries and that calculates its state income tax by determining what portion of a subsidiary's income is attributable to activities within the state, and paying taxes on that percentage.” BLACK'S LAW DICTIONARY 1281 (8th ed. 2004). A *unitary tax* is “[a] tax of income earned locally by a business that transacts business through an affiliated company outside the state or country.” BLACK'S LAW DICTIONARY 1223 (8th ed. 2004).

252. *Johnson Controls*, 2006 Ky. App. LEXIS 132 at \*3.

253. H.B. 541, Gen. Assem., Reg.Sess (Ky.2000).

254. *Johnson Controls*, 2006 Ky. App. LEXIS 132 at \*5. H.B. 541 amended KY. REV. STAT. ANN. § 141.200(9) (West 2005) to provide that “no claim for refund or credit of a tax



The Kentucky Court of Appeals applied *Carlton*'s two-part test<sup>255</sup> and concluded that the five- to nine-year period of retroactivity in H.B. 541 was excessive.<sup>256</sup> The court first concluded that the act was enacted for the legitimate purpose of preventing a significant revenue loss.<sup>257</sup> However, the court held that while "no hard and fast rule exists for what is or is not a permissibly modest period of retroactivity . . . Justice O'Connor's concurring opinion in *Carlton* sets forth a bright line one-year limitation on the permissible period of retroactivity for a taxation statute."<sup>258</sup> The court therefore held that H.B. 541's period of retroactivity violated the modesty doctrine.<sup>259</sup> In so holding, the court observed that, had the general assembly enacted the act in 1996—its first session following the 1994 decision—the outcome of the appeal "may well have been different."<sup>260</sup>

The Commonwealth appealed the *Johnson Controls* decision to the Kentucky Supreme Court, where the case is still pending.<sup>261</sup>

#### IV. TOWARD A BRIGHT LINE — A ONE-YEAR REBUTTABLE PRESUMPTION

Three state court decisions—*Rivers*, *City of Modesto*, and *Johnson Controls*—invalidated tax measures containing retroactivity periods longer than one year. These decisions have established that *Carlton* did not represent the end of due process as a limitation on retroactive tax legislation, as some commentators believed.<sup>262</sup> Indeed, Justice O'Connor's concurrence, cited by all

overpayment for any taxable year ending on or before December 31, 1995, made by an amended return or any other method after December 22, 1994, and based on a change from any initially filed separate return or returns to a combined return under the unitary business concept or to a consolidated return, shall be effective or recognized for any purpose." *Id.* at \*5-6. A consolidated return is "[a] return that reflects combined financial information for a group of affiliated corporations." BLACK'S LAW DICTIONARY 1226 (8th ed. 2004). This legislation would have had the effect of retroactively defeating all such refund claims. *Johnson Controls*, 2006 Ky. App. LEXIS 132 at \*5. Legislation passed in 1996 had abolished unitary returns for 1996 and subsequent tax years. *Id.* at \*4.

255. *Johnson Controls*, 2006 Ky. App. LEXIS 132 at \*18. The court rejected the state's argument that there was no modesty doctrine in *Carlton*. *Id.* at \*19 n. 32.

256. *Id.* at \*21-22 n. 37.

257. *Id.* at \*19-20.

258. *Id.* at \*21 n. 36.

259. *Id.* at \*24-25. The Court cited *Rivers*, *supra* note 212, and *City of Modesto*, *supra* note 223, with approval.

260. *Johnson Controls*, 2006 Ky. App. LEXIS 132 at \*24.

261. *See supra* note 237.

262. Immediately after *Carlton*, many articles, notes, and comments were published, several predicting the unfettered use of retroactive tax measures in the post-*Carlton* era. *See supra* note 3.

three state courts, revived application of the Due Process Clause to retroactive tax measures by suggesting that retroactive tax legislation that extends beyond the year preceding the enactment of the tax legislation violates taxpayers' rights to substantive due process. This section of the article proposes that Justice O'Connor's analysis become firmly embedded into judicial scrutiny of retroactive tax measures.

*A. Tax Legislation Retroactive to the Year Preceding the Passage of the Legislation Is Presumptively Constitutional*

With few exceptions, tax measures containing retroactivity periods of roughly one year or less have been sustained over constitutional challenges. The courts have made it clear that no legitimate basis exists to assert that tax legislation applied retroactively is inherently unconstitutional. When the legislation contains a modest look-back period of approximately one year or less, the judiciary has almost universally determined that the period of retroactivity was legitimate and reasonable under the Due Process Clause and therefore was not so harsh as to transgress constitutional limitations. It is therefore reasonable to interpret the jurisprudence as affording a rebuttable presumption of constitutionality to tax legislation applying retroactively to only the calendar year preceding the legislation.<sup>263</sup>

Upholding tax legislation with a period of retroactivity of about one year or less gives Congress, as well as state and local legislative bodies, the ability to promptly cure perceived loopholes and defects in tax legislation without suffering a significant loss in revenue. This presumption also accounts for the practicalities of producing national legislation and allows Congress the authority to prevent parties from undermining the ends Congress is attempting to achieve by acting before the legislation takes effect.

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263. The recently proposed "AIG bonus tax" legislation seeks to impose a surtax on certain bonuses paid after December 31, 2008, to any executive earning in excess of \$250,000—if the bonus was paid by a company that received \$5 billion or more in taxpayer dollars from the Troubled Asset Relief Program. JEANNE SAHADI, CNNMONEY.COM, BONUS TAX: FEELS GOOD, BUT IS IT? (March 20, 2009), [http://money.cnn.tv/2009/03/19/news/economy/bonus\\_tax\\_policy/index.htm](http://money.cnn.tv/2009/03/19/news/economy/bonus_tax_policy/index.htm); RICHARD A. EPSTEIN, THE WALL STREET JOURNAL ONLINE, IS THE BONUS TAX UNCONSTITUTIONAL? (March 26, 2009), <http://online.wsj.com/article/SB123802257323941925.html>. While one could argue that the surtax is a "wholly new tax," the period of retroactivity (assuming congressional passage in 2009) would be less than a year and therefore presumptively constitutional under this test. The legislation is potentially subject to other constitutional challenges, such as Bill of Attainder and Equal Protection challenges. See Epstein, *supra*, note 263.

Although such legislation often undermines taxpayer expectations, the relatively limited period of retroactivity diminishes this unfairness and interference with reasonable expectations. Furthermore, a relatively modest period of retroactivity included in a measure intended to amend recently enacted legislation minimizes the likelihood that a taxpayer has detrimentally and reasonably relied on the prior version of the law.

This presumption of constitutionality is merely a rebuttable presumption, however. First, a wholly new tax applied retroactively violates due process regardless of the length of the period of retroactivity. Wholly new retroactive taxes were invalidated in the *Nichols* line of authority (invalidating new estate and gift tax provisions applied retroactively).<sup>264</sup> The courts have confined the *Nichols* analysis to wholly new retroactive taxes.<sup>265</sup> The issue of what constitutes a “wholly new tax” is not entirely clear, however, and courts generally have rejected taxpayer contentions that the tax legislation in question represents such a tax.<sup>266</sup> Certainly, a tax that did not previously exist in any form would qualify as a wholly new tax. Wyoming, for instance, currently has no income tax and would therefore not be permitted to retroactively impose such a tax under the wholly new tax doctrine. Likewise, a state legislature or municipality would not be permitted to retroactively impose sales or use tax on transactions that were plainly outside the scope of the tax at the time they occurred.

A second, non-constitutional exception to the presumptive validity of tax measures containing modest periods of retroactivity lies in New Jersey’s current application of the common-law “manifest injustice” doctrine to retroactive taxation.<sup>267</sup> The doctrine of manifest injustice is “designed to prevent unfair results that do not necessarily violate any constitutional provision.”<sup>268</sup> In February 2008, a divided New Jersey Supreme Court struck down a state estate tax amendment with a retroactive period of six months.<sup>269</sup> The taxpayers had abandoned their constitutional challenges to the measure during the appeal process, and they instead argued that application of the amendment to the subject estates was unfair and inequitable because the decedents were unable to change

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264. See *supra* Part II(A).

265. See, e.g., *Carlton*, 512 U.S. at 30-31; *Hemme*, 476 U.S. at 568.

266. See, e.g., *Darusmont*, 449 U.S. at 299-300.

267. *Oberhand v. Dir. Div. of Taxation*, 940 A.2d 1202, 1209 (N.J. 2008).

268. *Id.* at 1210 (citations omitted).

269. *Id.* at 1211.

their wills and thereby had their reasonable expectations defeated.<sup>270</sup> In striking the amendment under the manifest injustice doctrine, the plurality concluded that the public interest in diminishing the loss in revenue was outweighed by the patently reasonable reliance of the decedents on the prior law and that it would be harsh and unfair to apply the amendment retroactively.<sup>271</sup>

The dissent observed that other courts, including the United States Supreme Court, applied the doctrine of manifest injustice only in the determination of whether a statute was in fact retroactive.<sup>272</sup> Where the legislative intent to apply a law retroactively is clear, a court should apply the law as written, subject to constitutional limitations.<sup>273</sup> However, if it is unclear whether a legislative body intended a statute to operate retroactively, the doctrine of manifest injustice requires the statute to apply prospectively only. The doctrine only constitutes a canon of statutory interpretation, reasoned the dissent.<sup>274</sup>

The New Jersey judiciary's use of the doctrine of manifest injustice as a substantive legal theory to invalidate retroactive legislation, while novel and enhancing settled expectations, appears at odds with the United States Supreme Court's precedent and the historical use of the doctrine as a canon of statutory construction.<sup>275</sup> Accordingly, while the doctrine may continue to be successfully employed in New Jersey to invalidate inequitable retroactive tax legislation, it is unlikely it will be extended to other state or federal courts.

Lastly, it should be noted that retroactive taxation with limited periods of retroactivity may violate state constitutional provisions prohibiting all forms of retrospective legislation. For instance, a Colorado constitutional provision prohibits both *ex post facto* and retrospective civil legislation.<sup>276</sup> In general, legislation is retrospective if it "destroys or impairs vested rights acquired under existing laws, or creates a new obligation, imposes a new duty, or attaches a new disability, in respect to transactions or considerations already past."<sup>277</sup> By their nature, retroactive tax measures

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270. *Id.* at 1207, 1211.

271. *Id.* at 1211.

272. *Oberhand*, 940 A.2d at 1215 (Long, J., dissenting) (citing *U.S. v. Schooner Peggy*, 5 U.S. (1 Cranch) 103 (1801)).

273. *Id.* at 1212; *Bradley v. Richmond School Board*, 416 U.S. 696, 711 (1974).

274. *Oberhand*, 940 A.2d at 1215-16.

275. *Id.* (Long, J., dissenting) (discussing history of doctrine).

276. *See supra* note 5 and accompanying text.

277. *Landgraf*, 511 U.S. at 269 (internal citation omitted).

create new obligations or impose new duties with respect to transactions or considerations already past.<sup>278</sup> Therefore, in states with constitutional provisions prohibiting retrospective legislation, a retroactive tax measure may survive federal substantive due process scrutiny, only to be invalidated as unconstitutional retrospective legislation under state law.

*B. Tax Legislation Containing a Period of Retroactivity Extending Beyond the Year Preceding the Legislation Is Presumptively Unconstitutional*

On the other end of the spectrum, tax legislation enacted in the post-*Carlton* era containing periods of retroactivity greater than one year often has been invalidated under the Due Process Clause.<sup>279</sup>

Admittedly, several post-*Carlton* decisions have upheld retroactive tax legislation containing periods of retroactivity in excess of one year. In *Montana Rail Link*, the Ninth Circuit upheld the retroactive application of the 1989 OBRA, where the period of retroactivity was up to six years. There, however, the court did not rigorously apply the modesty doctrine from *Carlton* and was plainly animated by the need to protect the retirement funds of railroad workers.<sup>280</sup> Additionally, in *Monroe*, the Alabama appellate court relied on two 1995 state court decisions in concluding that the two- to three-year period of retroactivity did not violate the Due Process Clause. However, neither of the 1995 state court decisions relied on by *Monroe* applied *Carlton's* modesty doctrine. Moreover, the courts reasoned that the subject legislation clarified the exemption statutes at issue and therefore may not have been retroactive at all.<sup>281</sup>

In the pending *Enterprise Leasing* litigation, the Arizona Court of Appeals applied *Carlton's* modesty doctrine and concluded that a six-year period of retroactivity passed constitutional muster.<sup>282</sup> Although the court determined it was not bound by Justice

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278. Although tax legislation is not a promise and does not necessarily create vested rights (see, e.g., *Carlton*, 512 U.S. at 33), it is difficult to argue that tax measures that impose greater liability to prior acts and transactions do not impose new duties or obligations with respect to past transactions. One potential exception is income tax provisions made retroactive to the same calendar year, prior to filing of the return, provided that the taxpayer did not take any action in reliance on the former state of the law.

279. See *supra* Part III(C).

280. See *supra* note 193 and accompanying text.

281. See *supra* note 207 and accompanying text.

282. See *supra* notes 211-18 and accompanying text.

O'Connor's one-year analysis, in sustaining the legislation, the court relied on the fact that the Legislature did not become aware of the potential application of the tax credits to motor vehicles until approximately six months before the enactment of the subject legislation.<sup>283</sup>

Although the post-*Carlton* decisions do not unanimously provide that tax legislation with retroactive periods exceeding a year are presumptively invalid, the decisions addressing the constitutionality of retroactive tax statutes generally line up on either side of the one-year threshold.<sup>284</sup> Further, *Rivers*, *City of Modesto*, and *Johnson Controls* each contain a more robust analysis of the modesty doctrine and are the better reasoned authorities, providing a sound legal and policy basis for a presumptive one-year standard.

In general, retroactive legislation undermines the ability of individuals and companies to act in their own interests, to avoid acting in ways that will harm them, and to plan their conduct "with reasonable certainty of the legal consequences."<sup>285</sup> Retroactive legislation therefore has always been considered unfair.<sup>286</sup> Retroactive tax legislation is no different. By their nature, retroactive tax measures are considered unjust, as they defeat taxpayers' reasonable reliance on the law as it existed at the time of the action in question. Thus, they should be limited and used sparingly. While the retroactive application of particular tax measures may advance the common good and rectify a previously made error in legislation, tax jurisdictions should be required to act promptly or face the prospect that the retroactivity passes the point that most reasonable people "would think tolerable."<sup>287</sup>

Moreover, notions of fundamental fairness and fair dealing warrant the adoption of a rebuttable presumption that tax legislation with a retroactivity period greater than the year preceding the legislation is unconstitutional. In the vast majority of cases up-

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283. See *supra* notes 217-23 and accompanying text. The fact that the department had not received a refund claim until such date does not establish that the Legislature had no reason to know of the issue before the claim was filed.

284. As do the majority of cases decided before *Carlton*. See *supra* Parts III(A)-(C), *cf. Canisius Coll. v. U.S.*, 799 F.2d 18, 26-27 (2d Cir. 1986) (upholding law retroactively validating FICA taxes contributed four years earlier, based on lack of taxpayer reliance and vested interests); *Licari v. Comm'r of Revenue*, 946 F.2d 690, 695 (9th Cir. 1991) (upholding four-year period of retroactivity of enhanced penalties to under-reporting, in part, because penalties already existed at time for intentional under-reporting).

285. Charles B. Hochman, *The Supreme Court and the Constitutionality of Retroactive Legislation*, 73 HARV. L. REV. 692 (1960).

286. *Id.*; Elmer E. Smead, *The Rule Against Retroactive Legislation: A Basic Principle of Jurisprudence*, 20 MINN. L. REV. 775 (1936).

287. See *supra* note 1 and accompanying text.

holding retroactive tax legislation, the legislative body enacted the legislation at the first session following the period in question. In *Welch*, for instance, although the period of retroactivity was between one and two years, the Supreme Court upheld the legislation because the Wisconsin State Legislature met every other year and enacted the legislation at the legislative session immediately following the tax year in question.<sup>288</sup>

As Justice O'Connor observed in 1994 and Judge Learned Hand noted in 1930, at some point, taxpayers should achieve finality and be assured that the tax consequences of prior transactions will not change to their detriment. Moreover, retroactive legislation must serve both a legitimate purpose and be reasonably related to its ends. With a presumptive one-year period of retroactivity, legislative bodies have the ability to retroactively correct mistakes and close loopholes, provided that they act promptly. Presumptively invalidating tax legislation with longer periods of retroactivity helps to ensure that legislative bodies will not unduly delay retroactive amendments to the detriment of taxpayers.

Tax jurisdictions should be permitted the opportunity to surmount the rebuttable presumption, however. The presumption emanates from *Carlton's* second prong of the due process test—whether the legislation was supported by rational means.<sup>289</sup> As articulated by Justice O'Connor and the three post-*Carlton* state courts that have struck retroactive tax legislation, such legislation is supported by rational means if it contains a relatively modest period of retroactivity. In *City of Modesto*, the California Court of Appeal observed that the legislative body must act promptly for a retroactive tax measure to be supported by rational means.<sup>290</sup>

The presumptive one-year look-back period is an attempt to draw the line in a reasonable location. Of course, what is reasonable depends on the circumstances, and government entities must be afforded the ability to demonstrate that a retroactive tax measure's extension beyond the year preceding the legislation's enactment is reasonable. The desire to stem revenue loss or to solve a budget crisis is not sufficient, as such goals are embedded in *Carlton's* first prong of whether the retroactive tax legislation was enacted for a legitimate purpose. To overcome the one-year presumption, the government should be required to show that it could not have acted sooner.

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288. See *supra* note 80 and accompanying text.

289. *Carlton*, 512 U.S. at 32.

290. *City of Modesto*, 128 Cal. App. 4th at 529.

Furthermore, the government should not be permitted to surmount the presumption by enacting retroactive legislation within a year of an adverse appellate decision. Legislative bodies have either actual or constructive notice when taxpayers commence litigation to challenge a tax measure. If the legislative branch believes that the taxpayers may succeed and open the doors to refund claims for other taxpayers, it should act promptly to rectify any perceived defects in the legislation, rather than await the result of the litigation and then attempt to retroactively slam the door on taxpayer refund claims.<sup>291</sup> In short, if a legislature enacts tax legislation that proves to be unconstitutional or otherwise invalid, it should not be permitted to await the result and retroactively cure the defect without providing a remedy to aggrieved taxpayers. On the other hand, if a legislative body can demonstrate that it had no objective reason to be aware of a legal infirmity in tax legislation and that it was unable to have acted sooner,<sup>292</sup> it should be permitted to overcome the presumption of unconstitutionality if the tax law's period of retroactivity exceeds one year.

## V. CALIFORNIA TAX AMNESTY ACT

In 2004, California enacted a tax amnesty program that offered individual and corporate taxpayers amnesty from penalties and criminal action for certain underpaid sales, use, income, and franchise tax liabilities.<sup>293</sup> The amnesty program ran from February 1, 2005, through March 31, 2005, and permitted taxpayers to seek

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291. See *supra* note 183 and accompanying text.

292. For instance, in the *Enterprise Leasing* litigation, to surmount the presumption of unconstitutionality created by the six-year period of retroactivity, the state could assert that it had no reason to be aware of the motor vehicle loophole in the existing tax credit legislation until the first such credit was claimed in December 1999, only months before the enactment of the amending legislation. See *supra* notes 212-14 and accompanying text. In response, the taxpayer could assert that the text of the original legislation reasonably permitted application of the credit to personal property attached to motor vehicles, and therefore, the legislature should have been aware of the issue. The parties could present evidence at trial regarding the issue of whether the Legislature could have acted sooner.

293. CAL. REV. & TAX CODE §§ 7072 & 19732 (2004). The amnesty program was created by SB 1100, and signed into law on August 16, 2004. The amnesty portion of the legislation permitted taxpayers to avoid penalties and any criminal prosecution by paying all past due taxes, plus interest. CAL. REV. & TAX CODE § 7072(a). The benefits of the amnesty program were available to all taxpayers with tax liabilities that resulted from the non-filing of returns, underreported income on filed returns, claimed excessive deductions, or any unpaid tax liabilities from previously determined amounts. *Id.* at § 7073(a)-(b). The benefits were not available to taxpayers who were under, or had been given notice that they were under, criminal tax investigation or who had a civil tax proceeding initiated against them. *Id.* at 7072(b).



amnesty for any taxable year through and including 2002.<sup>294</sup> Any payment made under the amnesty program was purportedly non-refundable.<sup>295</sup>

In addition to offering the carrot of penalty waiver and relief from criminal prosecution, the amnesty program wielded a big stick. Unlike most tax amnesty programs, the California amnesty legislation created and applied a significant new penalty to certain taxpayers who did not participate in the amnesty program, including taxpayers who did not become aware of liabilities until after the amnesty period ended. This penalty is imposed on amounts that were "due and payable" on the last day of the amnesty period, as well as on amounts that become "due and payable" after March 31, 2005.<sup>296</sup> The penalty amount is equal to 50% of the interest on tax deficiencies, calculated on the interest due from the original due date of the return to March 31, 2005.<sup>297</sup> Additionally, for sales and use taxes, taxpayers who were eligible for the amnesty program but did not participate were subject to penalties at double the normal rate.<sup>298</sup> The legislation also provided the State Board of Equalization ("SBOE") with an extended statute of limitations of 10 years to make a deficiency determination.<sup>299</sup> For franchise tax purposes, the legislation retroactively increased the accuracy related penalty for "substantial understatement of income tax" from 20% to 40%.<sup>300</sup> As the open audit period on corporate taxpayers often extends many years, a penalty tied to interest amounts could exceed the actual tax liability for the years in question.

To make the penalties even more draconian, the Franchise Tax Board ("FTB") has interpreted this penalty to apply to every income and franchise tax deficiency for taxable years prior to 2003 and existing on March 31, 2005, regardless of whether the deficiency was known (or should have been known) during the am-

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294. CAL. REV. & TAX CODE §§ 7071 & 19731 (2009).

295. CAL. REV. & TAX CODE §§ 7074(d) & 19777.5(c) (2009).

296. CAL. REV. & TAX CODE §§ 7074(a) & 19777.5(a). The issue of when a tax amount is "due and payable" is currently being litigated in *River Garden Ret. Home v. Franchise Tax Bd.*, No. A123316 (Cal. Ct. App., 1st App. Dist., Div. 4, filed November 6, 2008).

297. CAL. REV. & TAX CODE §§ 7074(a) & 19777.5(a) (2009). The amount of the penalty is calculated on the interest due from the original due date of the return to March 31, 2005.

298. CAL. REV. & TAX CODE § 7073(c) (2009). This provision resulted in non-fraud related penalties being increased to 20% of the tax owed.

299. CAL. REV. & TAX CODE § 7073(d) (2009). The regular statute of limitations for the SBOE to make sales and use tax assessments is three years. CAL. REV. & TAX CODE § 6487 (2009).

300. CAL. REV. & TAX CODE § 19164(a)(1) (2009).

nesty period.<sup>301</sup> This interpretation has the effect of imposing retroactive strict liability on taxpayers. Even if a taxpayer were unaware of a prior-year tax deficiency during the two-month amnesty program, if the taxpayer elected not to participate in the program, the legislation sought to retroactively apply a penalty to the tax deficiency in an amount potentially greater than the underlying tax liability.

Moreover, the amnesty program purports to prohibit taxpayers from challenging any amnesty penalty assessments on franchise taxes, whether through a protest after assessment or through a refund claim after payment.<sup>302</sup> This absence of remedy and the terms of the program have placed taxpayers in a precarious position. Many alleged tax deficiencies and assessments are the result of a good-faith disagreement between the tax jurisdiction and the taxpayer. For taxpayers who believed that they might have a potential liability for tax years beginning before 2003 (even if they believed in good faith that they did not), the amnesty program essentially asked them to concede the tax, waive all rights to a refund, and pay the tax or be subject to a severe penalty for the years in question. Even worse, taxpayers who were unaware of a potential liability for tax years beginning before 2003 were also subject to application of the penalty for the older years.

Faced with the choice of harsh retroactive penalties or the waiver of appeal and refund rights, many taxpayers made protective payments to the FTB outside the amnesty program, both to avoid penalties and to ensure the legal ability to pursue a refund of the payments if it was later determined that the tax, or any portion of it, was in fact not due. These protective payments greatly exceeded the amnesty program revenue. While the amnesty program collected \$550 million in revenue, taxpayers paid \$3.555 billion in protective payments.<sup>303</sup> Because these payments were often made on legitimately disputed items, the state will be required to return many of the protective payments, with interest.<sup>304</sup>

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301. See *River Garden*, No. A123316; see also Jennifer Carr & Cara Griffith, *California's Amnesty Program – A 'Gift' Taxpayers Would Prefer Not to Receive*, STATE TAX NOTES, July 24, 2006, at 257, p. /16/. The FTB interpreted the statutory language "each taxable year for which amnesty could have been requested" to mean any and all years beginning before January 1, 2003. *Id.* at /4/.

302. CAL. REV. & TAX CODE § 19777.5(d) and (e) (2009).

303. Lenny Goldberg, *Amnesty Discussions at FTB Generate New Data*, STATE TAX NOTES, July 18, 2005 at 193. The \$3.5 billion in protective payments was generated from 646 corporate taxpayers with an average of nearly six years per taxpayer in dispute. *Id.*

304. See *id.*

The absence of a statutory remedy for recovery of the amnesty penalty plainly violates procedural due process. California's amnesty legislation purports to deprive taxpayers of a pre-deprivation remedy (ability to challenge an assessment) and a post-deprivation remedy (ability to pay and maintain a refund claim). The failure of the state to provide either form of remedy is a patent violation of procedural due process.<sup>305</sup>

More critically for purposes of this article, the legislation violates substantive due process based on the analysis in Part IV. The legislation imposes the amnesty penalty, as of March 31, 2005, on taxpayers that owed a tax for any year beginning before January 1, 2003.<sup>306</sup> Particularly for a large corporate taxpayer, whose open tax periods may exceed the standard four-year statute of limitations, the amnesty penalty may increase tax-related liabilities for many years.<sup>307</sup> During these years, the amnesty program and concomitant penalty did not exist. In seeking to significantly increase taxpayer liability for these past periods, the amnesty legislation constitutes a retroactive tax measure subject to scrutiny under substantive due process.

In attempting to impose an enhanced penalty on tax years before 2003, the 2004 amnesty legislation seeks to impose a tax-related liability with a period of retroactivity in excess of the year prior to the year the legislation was enacted (2004). Under the test advocated in Part IV, *supra*, the period of retroactivity is excessive, and the legislation presumptively violates substantive due process. Indeed, the amnesty legislation's period of retroactivity is similar in length to, and in certain circumstances may even exceed, the period of retroactivity that prompted the courts in *City of Modesto* (up to eight years in length) and *Johnson Controls* (up to nine years) to declare the legislation unconstitutional. Moreover, the retroactivity period of the amnesty legislation will in almost every instance exceed the two- to three-year retroactivity period

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305. In the seminal tax remedies case, the U.S. Supreme Court held that states must afford taxpayers with a clear and certain remedy—either pre-deprivation or post-deprivation, under the Due Process Clause of the Fourteenth Amendment. *McKesson Corp. v. Div. of Alcoholic Beverages & Tobacco*, 496 U.S. 18, 36 (1990).

306. CAL. REV. & TAX CODE § 19777.5. Several taxpayers have challenged the constitutionality of the amnesty legislation. For instance, in *River Garden*, No. A123316, among other arguments, the taxpayer has alleged that the amnesty legislation violated both procedural and substantive due process.

307. Generally, the statute of limitations for franchise tax assessments is four years from the date the return was filed. CAL. REV. & TAX CODE § 19057(a) (2004). In *River Garden*, the amnesty penalty could apply to tax years 1999-2000, resulting in a seven-year period of retroactivity. *River Garden*, No. A123316.

found excessive by the *Rivers* Court. California taxpayers who filed their initial sales, use, income, and franchise tax returns years ago in good faith<sup>308</sup> should not be burdened with onerous tax-related obligations that did not exist at the time they filed their returns.

The retroactive application of the amnesty-related penalty is therefore presumptively unconstitutional. Moreover, several exacerbating factors make it unlikely that the state could overcome the presumption. First, unlike the federal legislation upheld in *Carlton*, the tax-amnesty legislation did not seek to close a loophole or correct a drafting error made in prior legislation. Rather, it sought to raise revenue in 2005 by imposing severe penalties on taxpayers who underreported sales, use, income, or franchise tax liability for tax years prior to 2003.

Second, the legislation seeks to apply an increased tax penalty. The Ninth Circuit Court of Appeals has held that legislation which retroactively imposes a tax penalty warrants stricter scrutiny than legislation retroactively increasing tax liability.<sup>309</sup> Application of a more searching substantive due process standard to the amnesty legislation enhances the likelihood that it will be struck as unconstitutional.

Third, California courts have already consistently applied a one-year standard to retroactive tax legislation. *City of Modesto* observed that, in general, California courts have upheld the retroactive application of tax laws only where the retroactivity was limited to the current tax year.<sup>310</sup> Coupled with the nature of the retroactive tax penalty and its potentially long retroactive reach, it is likely a California appellate court will invalidate the amnesty penalty if challenged under substantive due process.

The FTB and several commentators have expressed the opinion that the amnesty legislation may not be unconstitutional because taxpayers had the opportunity during the amnesty period to correct past reporting mistakes and therefore avoid the amnesty penalty, either through payment under the amnesty program or by making a protective payment outside the amnesty program but within the two-month window.<sup>311</sup> Under this view, the amnesty

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308. Without the amnesty legislation, California taxpayers who are found to have prepared fraudulent returns lose protection of the statute of limitations and are subject to penalties equal to 75% of the liability. CAL. REV. & TAX CODE §§ 19164(c) & 19087 (2009).

309. *Licari*, 946 F.2d at 695.

310. 128 Cal. App. 4th at 529 (citing *Gutknecht*, 43 Cal. App. 3d at 282).

311. See, e.g., Jennifer Carr & Cara Griffith, *California's Amnesty Program – A 'Gift' Taxpayers Would Prefer Not to Receive* STATE TAX NOTES, July 24, 2006 at 257.

legislation may not be retroactive at all, or if so, retroactive for only a modest period.

This characterization of the amnesty program and penalty fails for at least two critical reasons. First, in denying taxpayers any ability to obtain a refund of tax overpaid to the FTB under the auspices of the amnesty program, the amnesty program does not really afford taxpayers a meaningful choice to avoid retroactive penalties. A taxpayer with a legitimate filing position will understandably be reluctant to concede the tax and delinquent interest at issue and waive any right to litigate the validity of its position. The legal ability to avoid the imposition of the retroactive penalty is therefore a hollow option to those taxpayers possessing a good-faith justification for their filing positions.

Second, the ability of taxpayers to file protective payments outside the amnesty program—therefore retaining the legal ability to seek a refund of overpaid tax while avoiding the nonpayment penalty—does not sufficiently eliminate the harsh and unreasonable nature of the amnesty legislation. The penalty applies to all taxpayers found to have underpaid their income or franchise taxes prior to 2003, even those who had no idea that a potential delinquency existed at the end of the amnesty window. These taxpayers obviously had no reason to make a protective payment during the two-month amnesty period and, therefore, lacked the ability to avoid imposition of the penalty to past reporting periods.

Moreover, even those taxpayers who believe that they will have some potential underpayment liability for prior years will, in general, be uncertain as to the amount of tax liability at issue. It is the rare case when corporate taxpayers can isolate a particular issue and calculate the potential liability with precision. Oftentimes, there are competing issues within a given return, with some issues potentially offering the ability to offset a deficiency in another area. Accordingly, while a protective payment could partially eliminate the application of the penalty, the penalty will still be imposed retroactively on the assessed balance. Although taxpayers theoretically could grossly overpay the potential liability to insure against the penalty, such a payment would (1) deprive the taxpayer of the use of the funds during the audit and appeal, which often lasts years; (2) create a host of accounting-related is-

sues; and (3) potentially subject the taxpayer to greater tax liability than it actually had.<sup>312</sup>

### CONCLUSION

Tax legislation that contains a retroactive period greater than one year, such as California's Tax Amnesty Act, passes the point that most reasonable people would consider tolerable. The period of retroactivity is not narrowly tailored to accommodate the competing interests of the state and taxpayers, the latter of whom, at some point, should be free to move on without threat of enhanced tax or penalty consequences for prior transactions. While rigid application of a one-year period is mechanical and overly simplistic, a presumptive one-year period is consistent with judicial precedent, and further, the presumption draws a reasonable line that enhances certainty for tax jurisdictions and taxpayers alike.

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312. The old adage that possession is nine-tenths of the law often appropriately describes the difficulty in obtaining a recovery of overpaid taxes.

