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In this installment of Academic Perspectives on SALT, the authors argue that if New York's proposed Billionaire Mark-to-Market Tax Act is enacted, it should be upheld against any constitutional challenge based on retroactivity.

It is well known in tax literature that rudimentary tax planning strategies enable wealthy individuals to avoid state and federal income tax on much of their true economic income.[1] Indeed, the existing income tax has been described as being effectively optional for those who derive their income chiefly from the ownership of assets rather than the provision of services.[2] The reason is — except for a few relatively narrowly tailored deemed-realization rules[3] — both state and federal income taxes rely on the realization principle. Under realization accounting, taxpayers generally do not owe tax on economic gains until they sell their appreciated assets. Moreover, this is so even when taxpayers fund lavish lifestyles by borrowing against their appreciated assets.

Legislation under consideration in New York would limit the ability of the state's wealthiest taxpayers to escape tax in this manner. The Billionaire Mark-to-Market (MTM) Tax Act (S. 8277B/A. 10414) would require these taxpayers to reports gains and losses as they accrue, rather than upon sale or exchange as under current law.

Opponents claim that the MTM Act is unconstitutional. In a separate essay, we will explain why and how the New York Constitution authorizes accrual taxation through deemed realizations as in the MTM Act (and also as in a number of existing provisions of state income tax

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[1] *See, e.g.*, David Gamage and John R. Brooks, "Tax Now or Tax Never: Political Optionality and the Case for Current-Assessment Tax Reform" (unpublished draft manuscript on file with authors); Edward J. McCaffery, "A New Understanding of Tax," 103 *Mich. L. Rev.* 807, 920 (2005) ("Taxes on capital are easily avoided and virtually voluntary."); C. Eugene Steuerle, "Individuals Pay Very Little Individual Income Tax on Capital Income," Urban-Brookings Tax Policy Center, TaxVox blog, Sept. 6, 2018.

[2] McCaffery, *id.*

[3] IRC sections 475, 877A, and 1256.

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law).[4] Here, we evaluate the retroactivity concerns that the legislation's opponents have raised.

On its face, the MTM Act is not retroactive. A retroactive tax can be understood as one that alters one's liability for a tax year before enactment of the tax. For example, most would agree that if Congress enacted legislation in 2020 requiring taxpayers to recalculate their 2015 income tax liability with new higher rates, that measure would fit the common-sense definition of a retroactive tax. By contrast, the MTM Act would introduce a new method of income tax accounting for gains and losses for a small subset of wealthy New York taxpayers. It would apply a prospective tax at the regular state income tax rate on resident billionaires' unrealized capital gains through a deemed sale mechanism. The act's mark-to-market method of accounting is a well-established approach in federal and New York income tax law for some types of taxpayers (for example, dealers in securities) and some types of financial instructions (for example, specific futures contracts). By extending the mark-to-market accounting method to a new class of taxpayers, the MTM Act would apply more broadly than these features of existing law. The MTM Act would generate an estimated $23.3 billion in additional state revenue in 2020, and another $1.2 billion in each subsequent year.

Three features of the MTM Act could raise retroactivity issues. First, there is a question whether the state can apply a deemed-sale mechanism going forward given that this mechanism would affect gains accrued before the current tax year. Second, the act would apply to all unrealized capital gains since a billionaire became a New York resident, so in the first year it could tax the accumulated gains of many past years. Third, the MTM Act defines state residency based on a billionaire being present in the state for 183 days in 2020, and since we are now in February 2021 (as of publication), billionaire taxpayers would likely have already satisfied the residency requirement based on their past presence in the state.

[4] For a prior write-up of a portion of our analysis, see Gamage, Emmanuel Saez, and Darien Shanske, "The NY Billionaire Mark-to-Market Tax Act: Revenue, Economic, and Constitutional Analysis" (Dec. 9, 2020).

Do these provisions raise a federal or state constitutional issue? The MTM Act will likely be challenged in the courts, so it is important to resolve this question.

I. Analytic Frame

Before applying case law to the MTM Act, it would be helpful to look at the broader principles that should — and that actually do — underlie this area of law. First, when the government imposes tax or changes a tax, then that law, like all economic regulations, is subject to rational basis review.

Second, broad-based changes to tax systems should almost always be constitutional, at least regarding possible retroactivity concerns, despite their inevitable impact on taxpayer expectations. For instance, suppose the federal government instituted a value added tax. Such a change would have a big impact on those who have already retired on a fixed income and, for this reason, there should perhaps be transition relief. But if Congress opted to enact a value added tax without providing that relief — or not very much relief — then that would not render the tax reform unconstitutional because of the retroactive effects. Similarly, within the income tax, there is no requirement that the tax system provide for net operating loss deductions, much less that Congress cannot change those deductions. Indeed, the federal government did make NOLs less generous as part of the Tax Cuts and Jobs Act, and California just capped the use of NOLs for two years in response to the current crisis. Again, although these sorts of tax law changes can undeniably have retroactive effects, these types of retroactive effects simply do not put the constitutionality of these sorts of tax law changes into question.

There are many further examples. Consider reforms that would treat capital gains the same as ordinary income, eliminate stepped-up basis at death, or even move toward full expensing for more business investments while limiting interest payment deductions (as many in the right-of-center tax policy community advocate). All would retroactively affect many taxpayers. Nevertheless, assuming the changes satisfy rational basis, they should be constitutional. As noted, the law typically follows this principle — so cases

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challenging these broad changes as unconstitutional are rare. Any rule to the contrary would make it difficult or impossible for Congress or state legislatures to reform the tax law.

Third, though broad changes to tax systems must be permitted as a general rule, there are instances of changes that appear more problematic. These are typically amendments to specific substantive rules that affect the tax treatment of completed transactions. These changes are typically challenged as violating due process rights as unduly retroactive.

These sorts of changes to substantive rules that raise more problematic retroactivity concerns can be distinguished from the broad-based changes discussed earlier by looking to whether the amendments in question affect tax returns filed in previous years.[5] If a legal change affects a prior-year tax return in a manner that would require taxpayers to revise those returns, then this raises potentially troubling retroactivity concerns. By contrast, if a broad-based legal change has more nebulous retroactive effects that do not affect any prior-year tax returns and would not require taxpayers to revise those returns, then these effects generally do not raise constitutionality concerns. Again, this is because almost all major tax reforms create these sorts of more nebulous retroactive effects by altering the future consequences of taxpayers' past actions. Taxpayers simply do not have general reliance interests against legislators reforming the tax law.

Fourth, there is no firm rule prohibiting the narrow class of truly retroactive statutes that do affect prior-year tax returns. The retroactivity of these statutes is itself subject to rationality review and in many cases is upheld. Thus, for example, when the statute is remedial and applies to transactions not overly remote in time, the statute should be — and is — upheld. The less a statute is remedial, the farther back it goes, and the more it unsettles reasonable expectations, the more likely it should be struck down.

II. The Key Case Law Precedents

As explained, we think the case law broadly follows our analytic structure and will discuss some key cases.

A. Early Income Tax Cases

The first income tax statute passed after ratification of the 16th Amendment was retroactive by 10 months and upheld by the U.S. Supreme Court from a due process challenge in *Union Pacific Railroad*.[6] Taxpayers challenged the original income tax for taxing dividends themselves derived from earnings accumulated before there was an income tax. This challenge was rejected.[7] Taxpayers challenged the retroactive application of a new tax on dividends imposed by Wisconsin in connection with the Great Depression. This challenge was rejected and resulted in the rightfully famous dictum from Justice Harlan F. Stone:

> Taxation is neither a penalty imposed on the taxpayer nor a liability which he assumes by contract. It is but a way of apportioning the cost of government among those who in some measure are privileged to enjoy its benefits and must bear its burdens. Since no citizen enjoys immunity from that burden, its retroactive imposition does not necessarily infringe due process, and to challenge the present tax it is not enough to point out that the taxable event, the receipt of income, antedated the statute.[8]

Thus, from the earlier period of the income tax, short retroactivity periods at the time of enactment were permissible. Further, claims that taxpayers had a vested right to the treatment of their economic activities accorded by a previous tax system were rejected.

[5] We thank Susan Morse for this way of explaining the relevant doctrine.

[6] *Brushaber v. Union Pacific Railroad Co.*, 240 U.S. 1, 10 (1916).

[7] *Lynch v. Hornby*, 247 U.S. 339 (1918).

[8] *Welch v. Henry*, 305 U.S. 134, 146-47 (1938).

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B. *Carlton*

The leading modern Supreme Court case on retroactivity is *Carlton*, decided in 1994.[9] The issue in *Carlton* was the constitutionality of an amendment to the Tax Reform Act of 1986 that Congress approved. As adopted in October 1986, IRC section 2057 granted an estate tax deduction for half the proceeds of "any sale of employer securities by the executor of an estate" to an employee stock ownership plan.

This provision did not limit the deduction to securities held by the decedent at the time of death. In December 1986, Carlton, acting as an executor, purchased shares in a corporation, sold them to that company's ESOP at a loss, and claimed a large 2057 deduction on the decedent's estate tax return. In December 1987, Congress amended section 2057 to provide that to qualify for the deduction, the securities sold to an ESOP must have been "directly owned" by the decedent "immediately before death." The amendment applied retroactively, as if it were incorporated in the original 1986 provision. Carlton sued for the estate, arguing that the amendment's retroactive application to his transactions violated the due process clause of the Fifth Amendment. The Ninth Circuit agreed, holding that this retroactive application was rendered unduly harsh and oppressive, and therefore unconstitutional, by Carlton's lack of notice that section 2057 would be retroactively amended and by his reasonable reliance to his detriment on pre-amendment law.

The Supreme Court unanimously reversed, holding that the 1987 amendment's retroactive application to Carlton's 1986 transactions did not violate due process. First, the Court explained that "the 'harsh and oppressive' [test for retroactive taxation, derived from *Welch v. Henry*] . . . 'does not differ from the prohibition against arbitrary and irrational legislation' that applies generally to enactments in the sphere of economic policy."[10]

The Court then explained that under the applicable standard, a tax statute's retroactive application must only be supported by a legitimate legislative purpose furthered by rational means. The Court held that Congress's purpose in enacting the 1987 amendment was neither illegitimate nor arbitrary: Section 2057 was originally intended to create an incentive for stockholders to sell their companies to their employees, but the absence of a decedent stock ownership requirement resulted in the deduction's broad availability to virtually any estate at an estimated loss to the government of up to $7 billion in anticipated revenues. Thus, the Court explained, Congress undoubtedly intended the amendment to correct what it reasonably viewed as a mistake in the original provision.

The Supreme Court stated that there was no plausible contention that Congress acted with an improper motive, and that its decision to prevent the unanticipated revenue loss by denying the deduction to those who made purely tax-motivated stock transfers was not unreasonable. Moreover, the Court held, the amendment's retroactive application was rationally related to its legitimate purpose, since Congress acted promptly in proposing the amendment within a few months of section 2057's original enactment and established a modest retroactivity period that extended only slightly longer than one year. The Court held that the circuit court's exclusive focus on the taxpayer's notice and reliance held section 2057 to an unduly strict standard.[11]

Returning to our analytic frame, the statute in question did narrowly amend the substantive tax law as to transactions completed in the past — unlike the broad changes to tax systems we canvassed in the earlier cases. Nevertheless, applying the rationality test to the retroactivity, and clearly considering the statute's remedial nature, the Court found the statute permissible.

Justice Sandra Day O'Connor wrote a concurrence for herself alone. She was concerned that the majority opinion could be read to give the government too much leeway. Her reasoning is important because it sets a kind of floor. O'Connor argued that:

> *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.* But in

[9] *United States v. Carlton*, 512 U.S. 26 (1994).

[10] *Id.* at 30 (internal citations omitted).

[11] *Id.* at 35.

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> keeping with Congress's practice of limiting the retroactive effect of revenue measures (a practice that may reflect Congress's sensitivity to the due process problems that would be raised by overreaching), the December 1987, amendment to 2057 was made retroactive only to October 1986. Given our precedents and the limited period of retroactivity, I concur in the judgment of the Court that applying the amended statute to respondent Carlton did not violate due process.[12]

Since *Carlton*, the Court has declined to revisit the retroactivity issue regarding state tax laws, despite repeated attempts to persuade it to do so.[13] In nontax contexts, the Court approved longer periods of retroactivity; for example, O'Connor herself approved a six-year retroactive law in *General Motors* in the context of employers' obligations to pay workers' compensation benefits.[14]

Other courts have approved much longer retroactivity periods. For example, in *Tesoro Refining,* a Washington appeals court held that an amendment to tax law with 24 years' retroactive effect unconstitutional. The state supreme court reversed on grounds that the newly enacted law merely clarified preexisting law and thus was not a retroactive change at all.[15]

[12] *Id.* at 41 (emphasis added). Note, however, that Justice Antonin Scalia concurred as well and would apparently have approved unlimited retroactivity: "The reasoning the Court applies to uphold the statute in this case guarantees that all retroactive tax laws will henceforth be valid. . . . I welcome this recognition that the Due Process Clause does not prevent retroactive taxes."

[13] See most recently *Dot Foods Inc. v. Department of Revenue*, 372 P.3d 747 (Wash. 2016), *cert. denied,* 137 S. Ct. 2156 (2017) and six consolidated cases from Michigan pertaining to the Multistate Tax Compact that were filed for 22 companies: *Sonoco Products Co. v. Michigan Department of Treasury*, 137 S. Ct. 2157 (2017); *Skadden, Arps, Slate, Meagher & Flom LLP v. Department of Treasury*, 137 S. Ct. 2157 (2017); *Gillette Commercial Operations North America v. Department of Treasury*, 137 S. Ct. 2157 (2017); *International Business Machines Corp. v. Department of Treasury*, 137 S. Ct. 2157 (2017); *Goodyear Tire and Rubber Co. v. Department of Treasury*, 137 S. Ct. 2157 (2017); and *DIRECTV Group Holdings LLC v. Department of Treasury*, 137 S. Ct. 2157 (2017). The petitions in the consolidated Michigan cases all derived from the Michigan Court of Appeals' decision in *Gillette Commercial Operations North America v. Department of Treasury*, 878 N.W.2d 891 (Mich. Ct. App. 2015), *rev. denied*, 880 N.W.2d 230 (Mich. 2016), *cert. denied,* 137 S. Ct. 2157 (2017).

[14] *General Motors Corp. v. Romein*, 503 U.S. 181 (1992) (unanimous opinion by Justice O'Connor).

[15] *Tesoro Refining and Marketing Co. v. Department of Revenue*, No. 85556-1. (Wash. Sup. Ct. 2012).

C. Subpart F and MTM cases

In response to policy concerns regarding evasion or more accurate measuring of income, Congress has added many provisions to the IRC that tax undistributed profits or economic income. Not surprisingly, given the earlier precedents permitting Congress to subject new types of income to tax, even income not previously taxed, taxpayer challenges to those provisions have been unsuccessful. For example, courts have approved of the foreign personal holding company regime, enacted in 1937 to tax the undistributed profits of foreign "incorporated pocketbooks" controlled by U.S. residents, and the subpart F regime (1962), which taxes specific undistributed income of controlled foreign corporations.[16] Mark-to-market regimes in the IRC include sections 475 (MTM for securities dealers), 1256 (MTM for some contracts), and 1296 (elective MTM for publicly traded passive foreign investment companies). Only section 1256 was challenged on constitutional grounds, and the Ninth Circuit held that because the taxpayer could have realized his gains on any given day, MTM was constitutional.[17]

D. New York Case Law

The New York courts also apply the *Carlton* test, though the Court of Appeals has its own test for constitutionality under the due process clause of the state constitution.[18] As to the New York test, courts look to three factors: (1) "the taxpayer's forewarning of a change in the legislation and the reasonableness of . . . reliance on the old law," (2) "the length of the retroactive period," and (3) "the public purpose for retroactive application."[19]

In a recent case applying retroactivity, the Court of Appeals considered legislation meant to correct a strained — but not wholly implausible

[16] *See Eder v. Commissioner,* 138 F.2d 27 (2nd Cir. 1943) (upholding foreign personal holding company regime); *Garlock Inc. v. Commissioner*, 489 F.2d 197 (2d Cir. 1973) (upholding subpart F).

[17] *Murphy v. United States*, 992 F.2d 929 (9th Cir. 1993).

[18] *James Square Associates LP v. Mullen*, 21 N.Y.3d 233, 247-48 (2013) ("An aggrieved taxpayer may choose to make a claim that a retroactive tax violates the Due Process Clause under the standards in *United States v. Carlton*, 512 U.S. 26, 114 S.Ct. 2018, 129 L.Ed.2d 22 (1994) and our precedent in Replan.").

[19] *Id.* at 246, citing *Matter of Replan Development v. Department of Housing Preservation and Development*, 70 N.Y.2d 451, 456 (1987).

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— reading of the New York state personal income tax that permitted taxpayers to avoid paying the tax on their sale of an S corporation that made an election under IRC 338(h)(10).[20] The taxpayer-friendly reading had persuaded two tax tribunals, occasioning the need for legislation.[21] Despite the related lower court victories, the appellate court found that the taxpayer's aggressive reading of the tax law was not reasonable given long-standing understandings of the previous statute. The court further held that the Legislature's curative purpose to be rational and a three-and-a-half-year retroactivity period reflecting open tax years was not excessive — thus upholding the retroactive statute.

On the other side of the ledger, the Court of Appeals in 2013 found that retroactive changes to a tax credit program were not permissible. The court found that there was limited forewarning and too long a retroactive period even though the retroactive period was arguably only 16 months, but it was the third factor that was "dispositive" because "the legislature did not have an important public purpose to make the law retroactive. It was not attempting to correct an error in the tax code as in *Carlton*, or to prevent 'the loss of [single-room-occupancy] housing and to discourage the precipitous eviction of tenants' as in *Replan* [a retroactivity case the state won]. . . . Retroactively denying tax credits to plaintiffs did nothing to spur investment, to create jobs, or to prevent prior abuse of the credit. The retroactive application of the 2009 Amendments simply punished the Program participants more harshly for behavior that already occurred and that they could not alter."[22]

New York constitutional common law therefore reflects the principle that retroactive revocation of specific benefits can be found unconstitutional, but there is more leeway when taxpayers do not have reasonable reliance or when the statute is curative.

[20] Note that the prospective application of the income tax to deemed assets sales under IRC section 338(h)(10) was challenged as, in effect, subjecting intangible property to an ad valorem property tax in violation of Article XVI, section 3 of the New York Constitution. That claim was rejected in *Burton v. Department of Taxation and Finance*, 25 N.Y.3d 732; 16 N.Y.S.3d 215; 37 N.E.3d 718 (2015).

[21] *Caprio v. Department of Taxation and Finance*, 25 N.Y.3d 744, 749; 37 N.E.3d 707, 711 (2015).

[22] *James Square Associates*, 21 N.Y.3d at 249-50; 993 N.E.2d 374, 383 (2013).

E. *Moore* and the Transition Tax

Another recent example at the federal level was the transition tax imposed in 2017 on the accumulated offshore earnings of U.S.-based multinationals. The TCJA imposed a one-time tax at 8 percent on illiquid assets and 15.5 percent on liquid assets accumulated by the CFCs of U.S. multinational enterprises. This tax applied to earnings accumulated offshore between 1986 and 2017, which amounted to over $3 trillion.

A district court recently rejected a constitutional challenge to the transition tax based on retroactivity.[23] The government argued that the transition tax should not really be analyzed as retroactive at all so much as a change to a new tax system. The district court rejected this argument, but nonetheless upheld the tax under *Carlton*. First, the court reasoned that it was rational for Congress to transition to a territorial system and, as part of that transition, subject earnings to tax that were subject to tax under the previous system if distributed, but would otherwise never be taxed under the old system. The old system created an incentive for these earnings to accumulate abroad, which made the statute in part remedial. Given these reasonable purposes, choosing a retroactive period back to the last major tax overhaul (1986) was reasonable.

F. Assessment of the Cases

Generally, this survey of the case precedents — including New York case precedents — indicates that the current law governing retroactivity is broadly consistent with our normative prescription: There is no vested right in the tax system as such, including as to the realization requirement. Thus, the retroactive effects of broad-based tax law changes generally do not raise significant constitutional concerns, especially when no prior-year tax returns are affected. As to narrow tax law changes upon which there could have been specific reliance, short periods of retroactivity imposed within a year of the enactment of tax legislation are still generally permitted. By contrast, the retroactive revocation of specific tax benefits on which

[23] *See, e.g., Moore v. United States*, Case No. C19-1539-JCC (W.D. Wash. 2020).

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taxpayers reasonably relied and that require taxpayers to revise prior-year tax returns is generally disfavored, but may still be permitted — especially with a remedial purpose.

G. Application to the MTM Act

Where does the MTM Act stand in regard to retroactivity?

First, its residency provision falls squarely within even O'Connor's criteria for permitted retroactivity, since the MTM Act applies only to 2020 New York residents.

Second, as to the prospective shift to an MTM system, this is permissible because taxpayers have no vested rights in the prior tax system and this shift does not affect any prior-year tax returns.

Third, the taxation of previously accumulated gains in the first year should be permissible for the same reasons: This is just a deemed-sale mechanism that does not affect any prior-year tax returns, but only changes the rules for tax returns that will be filed for the 2020 tax year; those tax returns cannot be filed until 2021. (Some taxpayers may have already filed tax returns for 2020 before its enactment, but assuming that the MTM Act is enacted before the end of 2021, this would just be a reasonable retroactive period of one year or less for 2020 tax returns.)

Alternatively, the constitutionality of the first year of the MTM Act tax can be analyzed by analogy with the transition tax. It is true that going forward, the New York measure would tax gain that occurred in that tax year, while the first-year tax would tax gain that has occurred over many years. Yet, like the worldwide earnings that could have been taxed in *Moore*, the unrealized gains at issue here represent income that could have been taxed when it was earned.[24] Further, also like the transition tax, New York can (and should) reasonably shift to MTM because, as with the old worldwide system, it incentivized deferral. The shift to MTM is thus remedial too. Further, and even better for the MTM transition, New York is transitioning *toward* taxing unrealized gains, hence not taxing these gains would result in an inequitable windfall that it can ill afford at the moment. Reducing increasing levels of inequality, equalizing treatment among the wealthy, and ending deferral to cope with an unprecedented emergency would all seem to count as important and rational purposes.

Given that the New York test follows that of the federal common law, New York courts might also just analyze the tax law under rational basis review as a general change to the tax system. Nevertheless, applying New York's three-part test, we arrive at a similar result. First, in contrast to *James Square Associates*, in which after the taxpayer changed its behavior to obtain tax credits and the court held that the Legislature could not retroactively take them away, here there has been no such reliance on a realization rule: Taxpayers have already received the benefit of deferral and the Legislature would only be ending that going forward. Therefore, there is no reliance except on a static tax system, which is not reasonable.

Second, including all accumulated gains is necessary to achieve many of the statute's important goals. Further, the 10-year deferral option at a reasonable rate of interest essentially means that the deferral is being included ratably. It is hard to characterize such a regime as "harsh and oppressive" for a billionaire, who is likely to still make money during the deferral. Third, as noted, the Legislature had important purposes in ending the deferral regime — one of which is remedial.

Tension between the first and third prongs also weighs in favor of constitutionality. Suppose the taxpayers strongly insist that they never expected to pay anything on their accumulated gains ever, and therefore that they had inadequate warning. That may be true, but there was no specific reliance — no change in behavior analogous to making investments to get a tax credit. Thus, we think this argument should be rejected as legally irrelevant but note that, to the extent it is true (that is, vast amounts of income were not going to be taxed under the old system), then that only strengthens the remedial purpose of the law.

III. Conclusion

If the New York MTM Act is enacted, some billionaires are likely to challenge it in court, but it

[24] This is why objections to the MTM Act based on New York constitutional prohibitions on wealth taxation are frivolous, because unrealized gains are income, not wealth.

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would almost certainly be upheld against any constitutional challenge based on retroactivity. In that case, it could be a model for other states and for the federal government if it seeks to move away from the outdated realization requirement, as U.S. Sen. Ron Wyden, D-Ore., has proposed to do.[25] ■

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[25] *See* U.S. Senate Committee on Finance, "Wyden Unveils Proposal to Fix Broken Tax Code, Equalize Treatment of Wages and Wealth, Protect Social Security," Sept. 12, 2019.

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