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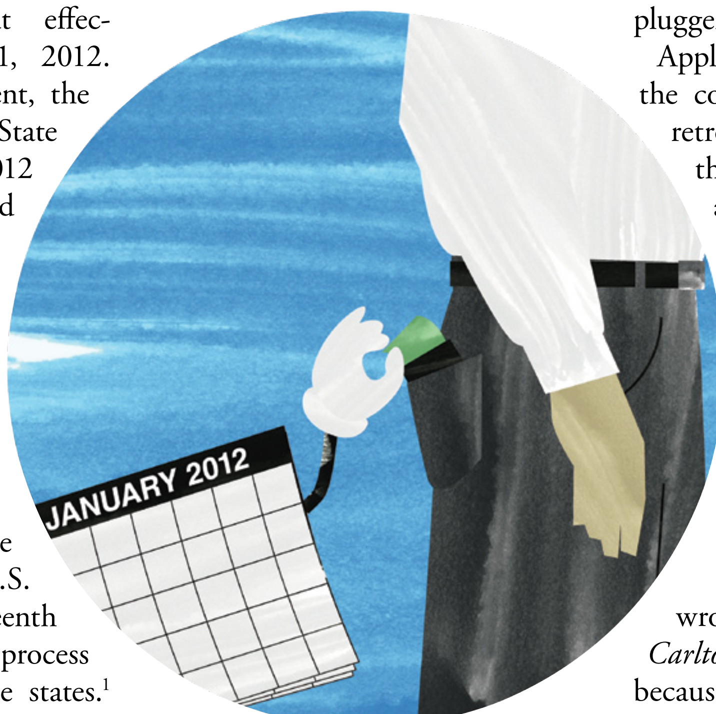
WILL RETROACTIVE PROPOSITION 30 EVER BE CHALLENGED?

by FRANK J. DOTI

California voters passed Proposition 30 in 2012 to increase for seven years the income tax rates for those making more than $250,000. The highest tax bracket, for individuals with more than $500,000 in taxable income, was increased from 9.3% to 12.3%. An additional 1% Mental Services Tax was already imposed on incomes in excess of $1 million. Proposition 30 was approved by voters on November 6, 2012, but the increased rates were made retroactive—without effective notice—to January 1, 2012. In the first official statement, the California Secretary of State announced on June 20, 2012 that the initiative qualified for the November 6 ballot.

Reliance and predictability in law are cornerstones of an efficient and just legal system. Retroactive tax laws eviscerate respect for the law and may result in a deprivation of due process of law under the Fifth Amendment of the U.S. Constitution. The Fourteenth Amendment makes this due process protection applicable to the states.[1] Proposition 30 exemplifies the inherent unfairness of a retroactive tax and may be unconstitutional. But challenging it may be a tough battle, as the United States Supreme Court has been deferential to retroactive taxes.

In *United States v. Carlton*, 512 U.S. 26 (1994), the most recent case and leading precedent, the Court held that a retroactive federal estate tax law amendment did not violate due process, and upheld the statute. An estate executor took advantage of a favorable provision in the 1986 estate tax law by purchasing corporate stock and giving the shares to an employee stock ownership plan (ESOP) so as to deduct 50% of the value of the stock. Congress made a mistake in not considering that estates would take advantage of the ESOP scheme



by purchasing corporate stock after a decedent's death. Congress intended the benefit for decedents who had owned the stock while alive. Due to a drafting error, an estimated $7 billion tax law loophole existed. The Internal Revenue Service proposed a corrective amendment on January 5, 1987. Thereafter, Congress began drafting the corrective legislation on February 26, 1987, and passed the amendment on December 22, 1987. The estate in *Carlton* took advantage of the law by purchasing and transferring shares of stock to an ESOP on December 10, 1986. Thus, the estate acted about one year before Congress passed the corrective legislation. The executor in *Carlton* therefore argued that the retroactivity of the loophole plugger violated due process.

Applying its rational basis standard, the court in *Carlton* approved the retroactive statute and prevented the estate-taxpayer from taking advantage of an error in the original law. The majority reasoned that "[t]here is little doubt that the 1987 amendment to § 2057 was adopted as a curative measure"[2] and also noted that Congress acted promptly by establishing only a modest, one-year period of retroactivity.

Justices Scalia and Thomas wrote a concurring opinion in *Carlton*. They upheld the statute because, to them, the Due Process Clause guarantees no substantive right, but only process or procedural protection. Their opinion criticizes the majority's being too deferential to retroactive tax statutes. They retort that the majority attempted to soften the impact of the retroactivity by stating that it involved only "a modest period of retroactivity."[3] Scalia and Thomas counter by arguing that "the key timing issue is whether the change occurs after the reliance; that it occurs immediately after rather than long after renders it no less harsh."[4] So they believe that any retroactive tax statute is substantively harsh and oppressive due to possible detrimental reliance by taxpayers on the existing law.

The retroactive effect of Proposition 30 was not intended to fix a legislative drafting error as in *Carlton*. The clear purpose was the need for more revenue to reduce California's then-severe deficit position.[5] Proposition 30 was approved on November 6, 2012 but made retroactive to January 1, 2012. Although its period of retroactivity is just a little over ten months, Proposition 30 is not a curative measure as in *Carlton*. Thus, if Proposition 30 were challenged, there is reasonable doubt that the U.S. Supreme Court would rule the same way it did in *Carlton*.

In a recent case, *River Garden Retirement Home v. Franchise Tax Board*, 186 Cal. App. 4th 922 (2010), the California Court of Appeal held that the totality of circumstances surrounding a retroactive tax should be considered. Justice O'Connor, in her concurring opinion in *Carlton*, expressed 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."[6] The court in *River Garden* agreed that *Carlton* calls for a modest period of retroactivity, but did not subscribe to the view that a period longer than one year, in and of itself, is improper. Rather the court opined that the period of retroactivity must be measured against all of the facts and circumstances.

Proposition 30 increased the top income tax rate from 9.3% to 12.3%, a whopping 32% increase compared to the previous rate. Such an enormous tax rate increase may cause a court to examine more carefully the extent of the period of retroactivity under the facts and circumstances test. Courts may lessen the permissible period of retroactivity where the tax rate increases are as large as Proposition 30.

Another factor in challenging retroactivity is to reconcile a distinction made by the court in *Welch v. Henry*, 305 U.S. 134 (1938), where it showed a greater due process deference to retroactive income taxes over retroactive gift taxes. The court reasoned that receipt of income was

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not "voluntary" because individuals would not refuse income because of a pending tax increase.[7] The court contrasted this with a donor who might alter his behavior, if he were aware of a potential change to the gift tax law.

However, income tax law affects more than just salary earners who receive a recurring flow of earned income. Taxpayers do take voluntary actions to increase their wealth, such as disposing of assets and generating capital gains. Thus, the voluntary action distinction seems erroneous as a test for invalidating retroactive taxation.

More significant in *Welch* is that the court applied a lowered rational basis standard for testing retroactive tax legislation for due process purposes. The court did not apply the tougher standards of strict or heightened scrutiny. The rational basis test was more recently applied again by the court in *Carlton*. In *Welch*, the Court also stated that applying the rational basis standard requires a determination of whether the retroactive tax was truly harsh and oppressive as to amount to a taking of property without due process.[8]

Let us analyze a hypothetical to consider a consequence of the retroactivity of Proposition 30. Say a married couple sold appreciated shares in a closely held business at a gain of $20,000,000 in March 2012. They reasonably believed that the top California income tax rate was 9.3%. Much later, that same year, they learn that Proposition 30 passed with a new top rate of 12.3%. That will cost them $600,000 more in California income taxes than they expected when they sold the shares. There is a complete disregard of the taxpayers' detrimental reliance on the law that existed at the time they made a major decision to sell the shares. Perhaps they would not have made the sale or postponed it until after the seven-year applicability of Proposition 30. Alternatively, they might have moved their residency out of California if they had known of the pending law change at the time of the sale. Clearly, they have been treated unfairly by the retroactive tax to the tune of $600,000.

In *Blodgett v. Holden*, 275 U.S. 142 (1927), the U.S. Supreme Court dealt with the first gift tax enacted by Congress on June 2, 1924. The gift tax was made retroactive to January 1, 1924. Taxpayer Blodgett made gifts in January 1924 and was assessed a gift tax. He argued that the tax was retroactive and violated due process of law. The court ruled that:

> It seems wholly unreasonable that one who, in entire good faith and without the slightest premonition of such consequence, made absolute disposition of his property by gifts should thereafter be required to pay a charge for so doing . . . . So far as the Revenue Act of 1924 undertakes to impose a tax because of the gifts made during January, 1924, it is arbitrary and invalid under the due process clause of the Fifth Amendment.[9]

The U.S. Supreme Court ruled similarly in *Untermyer v. Andersen,* 276 U.S. 142 (1927), where the same retroactive gift tax statute was challenged. The taxpayer had made gifts in May 1924, after the new gift tax bill had been introduced in Congress in February of 1924. Although the bill had been introduced and presumably known to the taxpayer when he made the gifts, the Court still held that there was a lack of due process because the bill had yet to be enacted. Thus, constructive notice of a possible new tax statute was insufficient to withstand a due process challenge.

Proposition 30 did not become law until November 6, 2012. The first time the initiative was officially announced was on June 20, 2012, when it qualified for the November ballot. Based on *Untermyer,* the key date for taxpayer notice of a statute is when it actually becomes law. For Proposition 30, that was November 6, 2012. Going back to the June 20, 2012 announcement would be insufficient constructive notice of the possibility that the law would be enacted. Consequently, the tainted period of retroactivity of Proposition 30 is a little more than ten months from November 6, 2012 back to January 1, 2012. In measuring the severity of retroactive taxes, however, courts may not be as circumspect of an amendment of an already existing tax compared to a brand new tax.

Even under *Carlton,* which seems to be deferential to retroactive taxes, we have to factor in the curative nature of the retroactive tax in that case compared to the sole revenue raising purpose of Proposition 30. *Carlton* did not involve retroactive and substantial income tax rate increases. Courts may find that the lack of notice of the severe tax rate increases of Proposition 30 is too harsh and oppressive. In contrast to *Carlton*, California taxpayers would not be taking advantage of an unintended loophole.

Statutory tax law must provide a fair guide to taxpayers so they can make reasoned decisions on personal investment strategies. The above hypothetical taxpayers, who sold closely held shares under the pre-Proposition 30 tax regime, should not have been later hoodwinked by a retroactive tax increase.

No taxpayer has yet challenged Proposition 30's retroactive impact, at least not in a way that is public information. The California statute of limitations for filing a refund claim is generally four years from the date a tax return was filed. The earliest calendar tax year that Proposition 30 applies to is 2012. The four-year statute will run on April 15, 2017 for a timely filed 2012 California income tax return. So there is about two years left for an action to be filed. A taxpayer who has been challenged in an audit by the California Franchise Tax Board would not have to wait out the four years.

Admittedly, it is difficult to challenge a retroactive income tax law, especially when it is retroactive for a period not exceeding one year. Potential challengers also have to consider the high costs and publicity associated with litigation. Nevertheless, our Constitution protects us from state action that is taken without appropriate consideration of due process of law. In my opinion, as applied to pre-November 6, 2012 realized taxable income, there is a reasonable prospect that Proposition 30 is unconstitutional.

ENDNOTES

(1) *Duncan v. Louisiana*, 391 U.S. 145, 147 (1968).

(2) *United States v. Carlton*, 512 U.S. 26, 31 (1994).

(3) *Id.* at 40.

(4) *Id.*

(5) *See* Cal. Sec'y of State, Prop 30 Temporary Taxes to Fund Education (Official Title and Summary), *available at* http://voterguide.sos.ca.gov/past/2012/general/propositions/30/title-summary.htm.

(6) *Id.* at 38.

(7) *Welch v. Henry*, 305 US. 134, 147 (1938).

(8) *See id.*

(9) *Blodgett v. Holden*, 275 U.S. 142, 147 (1927).

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