Retroactivity and the Estate Tax

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ABSTRACT

The estate tax was sunsetted in the Economic Growth Tax Relief Reconciliation Act (“EGTRRA”) of 2001. As a result, there is no estate tax in 2010. In 2011, the estate tax returns in full force to pre-2001 levels. The potential fiscal loss that would result from the lack of an estate tax in 2010 has led many to believe that Congress will apply some form of the estate tax to 2010 retroactively. This paper examines whether the retroactivity literature should be modified in the context of sunsetted legislation. Generally, retroactive tax legislation must pass two requirements: it must be rationally related to a legitimate legislative purpose and it must limit the retroactivity to a modest period of retroactivity. This paper contends that prior cases upholding

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retroactivity of tax statutes can be distinguished in the context of sunsetted legislation. Furthermore, this paper concludes that courts should apply a balancing test considering the benefits of retroactivity as inextricably linked to the burdens imposed by retroactivity.

INTRODUCTION
Estate tax lawyers face a dismal state of affairs. Under the current regime, no estate taxes will be assessed on an individual who dies on December 31, 2010. Yet, an individual who dies only a few minutes later on January 1, 2011, will be subject to a 55% estate tax with a $1,000,000 exemption. All the while, talk of retroactively applying some form of the estate tax looms in the background. This absurd result violates two primary goals of any tax regime: economic efficiency and horizontal equity.

First, economic efficiency represents the idea that the tax regime should not influence participants’ decisions. With respect to the estate tax, some estate lawyers have reported families keeping a parent on life support

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1 The law in 2010:
1. The estate and GST taxes are repealed;
2. The gift tax remains in effect with a $1 million lifetime exemption ($60,000 for nonresident alien donors) and a 35% top rate.
3. Assets received from a decedent dying in 2010 would take a modified carryover basis under Section 1022, rather than a basis equal to the estate tax value of the decedent’s assets; and
4. Under Section 2511(c), a transfer in trust will be treated as a gift tax for purposes, unless the trust is a wholly-owned grantor trust owned by the grantor or the grantor’s spouse.

The law after 2010:
1. The estate tax is restored with a top rate of 55%, a 5% surtax on estates over $10 million, and a $1 million applicable exclusion amount;
2. The GST tax is restored with a 55% rate and a $1 million exemption;
3. The top gift tax rate returns to 55%;
4. The state death tax credit is fully restored;
5. The date-of-death basis rules return and carryover basis is repealed;
6. Several important GST provisions would be repealed.

in late 2009 in order to receive favorable tax treatment in 2010.\footnote{Tax Prof Blog, December 30, 2009. Available at: http://taxprof.typepad.com/taxprof_blog/2009/12/estate-tax-.html ("I have two clients on life support, and the families are struggling with whether to continue heroic measures for a few more days," says Joshua Rubenstein, a lawyer with Katten Muchin Rosenman LLP in New York. "Do they want to live for the rest of their lives having made serious medical decisions based on estate-tax law?")}

Others have considered euthanasia in late 2010 to avoid the harsh 2011 regime.\footnote{Id. (stating “The situation is causing at least one person to add the prospect of euthanasia to his estate-planning mix, according to Mr. Katzenstein of Proskauer Rose. An elderly, infirm client of his recently asked whether undergoing euthanasia next year in Holland, where it’s legal, might allow his estate to dodge the tax.”)} These life and death decisions based on the estate tax are the antithesis of economic efficiency.

Second, horizontal equity represents the idea that similarly situated persons should be treated similarly by the tax code. Ideally, two people with the same estates should be taxed the same regardless of the year in which they die.\footnote{Paul L. Caron, The Costs of Estate Tax Dithering, 43 CRLR 637 (2010) (Power Point Slide 11, stating “…an elderly widow with $10 million would be able to leave $6.4 million, $7.1 million, or $10 million to her heirs, depending on when she died in the 367-day window between December 31, 2009 and January 1, 2011").} Again, differences in estate tax treatment from 2010 to 2011 are about as far from horizontal equity as imaginable.

This bizarre result sparked great discussion regarding Congress’ failure to resolve the estate tax issue. Many in the tax world assume Congress will reinstate the estate tax to apply to 2010 retroactively.\footnote{See Lee A. Sheppard, Would Estate Tax Reinstatement be Constitutional? 2010 TNT 11-4 (January 19, 2010); Chuck O'Toole, Retroactive Estate Tax May Become Part of Tax Reform Bill, Baucus Says, 2009 TNT 244-2 (December 23, 2009)} The possible retroactive implementation of the estate tax highlights arguments regarding the appropriateness of retroactivity. Nevertheless, Professors
Michael Graetz and Louis Kaplow have conclusively shown that retroactivity is not to be condemned as legal changes can be adequately predicted similar to predictions of market risk.\(^6\)

In addition, retroactive application of the estate tax highlights arguments concerning the prudence of sunsets in legislation, as the estate tax was sunsetted in the Economic Growth Tax Relief Reconciliation Act (“EGTRRA”) of 2001. Professor Rebecca Kysar has persuasively demonstrated that sunsets in legislation often lead to inefficient social outcomes.\(^7\) This article explores whether the nature of sunsets changes the retroactivity analysis through the lens of the recent estate tax sunset.

Generally, retroactive tax legislation must pass two requirements: it must be rationally related to a legitimate legislative purpose and it must limit the retroactivity to a modest period of retroactivity.\(^8\) This paper contends that prior cases upholding retroactivity of tax statutes can be distinguished in the context of sunsetted legislation. Furthermore, it advises courts to apply a balancing test considering the benefits of retroactivity as inextricably linked to the burdens. Thus, this paper suggests that courts


adapt their analysis when faced with *due process* issues regarding sunsetted legislation that is subsequently re-enacted and given retroactive application. At the very least, this paper hopes to shift the burden of proof for permitting retroactive application of sunsetted legislation to its advocates.

The remainder of this article consists of six parts. Part I introduces the relevant vocabulary, including retroactivity, sunsets, and “Retrosunstes.” Part II considers Equilibrium Theory as a framework for analyzing sunsetted legislation that is reinstituted and applied retroactively. Parts III and IV identify two of the concerns of such legislation: improper Congressional consideration of the competing interests of stability versus flexibility and the identifiable winners and losers such legislation creates. Part V distinguishes sunsetted legislation that is reinstituted and applied retroactively from case law where retroactivity of tax legislation has been upheld. Lastly, Part VI concludes that courts should adapt their analysis of *due process* claims concerning retroactivity in the context of sunsetted legislation.

*A. Retroactivity*

Professor Michael Graetz, in a series of articles discussing retroactivity, argues that for investment purposes, there is no fundamental difference between market and political risk. He supports his argument by pointing to the remarkable ability of the market to adjust output to reflect

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changes in taste and technology.\textsuperscript{10}

Similarly, Professor Louis Kaplow, in \textit{An Economic Analysis of Legal Transitions}, addresses tax transition policy. Tax transition policy examines how the gains and losses caused by transition between proposed solutions and the current legal regime should be addressed.\textsuperscript{11} He argues that “generally, transitional relief is inefficient because it insulates investors from the real effects of their decisions, and thus distorts behavior.”\textsuperscript{12} As everything outside of immediate consumption may be affected by changes to current government policy,\textsuperscript{13} investors are forced to account for possible legal change. In this manner, changes in government policy are acknowledged and properly discounted at the time of investment.\textsuperscript{14} Thus, there is essentially no difference between government and market risk from a valuation perspective.\textsuperscript{15}

\textbf{B. Sunsets}

Sunsetted legislation differs from other legislation in that it “sets a date on which an agency, regulation, or statutory scheme will terminate unless affirmative action satisfying the constitutional requirements of

\begin{itemize}
\item \textsuperscript{10} Graetz \textit{supra} note 8, at 65.
\item \textsuperscript{11} See Kaplow, \textit{supra} note 8.
\item \textsuperscript{12} \textit{Id.} at 513.
\item \textsuperscript{13} \textit{Id.} at 516.
\item \textsuperscript{14} \textit{Id.} at 518 (stating “The crucial yet simple conclusion is that changes in government policy – or, more generally, changes in the prospects for reform—will affect the value of investments made prior to those changes to the extent that such changes were not fully anticipated”).
\item \textsuperscript{15} \textit{Id.} at 534.
\end{itemize}
bicameralism and presentment is taken by the legislature.”¹⁶ Sunsets are heralded as a superior form of legislation as they have a built in expiration date that forces reevaluation of the legislation’s prudence. Furthermore, under this line of reasoning, sunsets can encourage beneficial legislation that may not otherwise pass as permanent legislation because the sunset acts as a temporary trial period, allowing the legislation to be reevaluated with concrete evidence of its effects.¹⁷ Furthermore, one commentator argues that sunsets better approximate congressional outlays and therefore allow Congress to make more accurate estimations of future revenues.¹⁸

Despite these high praises, sunsets often fail to achieve their intended benefits.¹⁹ Sunsets, meant to encourage reevaluation, very rarely expire without some influence over subsequent legislation. From a rent extraction perspective, sunsets allow Congress to “find a way to convince groups to continue to pay after they have received their benefit.”²⁰ Indeed,

¹⁷ Id. at 259.
¹⁸ George Yin, Temporary-Effect Legislation, Political Accountability, and Fiscal Restraint, 84 N.Y.U. L. REV. 174, 193 (2009) (stating “the budget process should provide a mechanism that conveys to lawmakers the true cost of their legislative activity before they act…Since the official cost incorporates only the budget consequences falling within the budget window period, it systematically understates the true cost of any deficit-increasing legislation extending beyond that period. Thus, when proponents of permanent legislation go on record as having approved the official cost of such legislation, they escape responsibility for the full budgetary impact of their action. By contrast, barring estimation error, the official cost of legislation not extending beyond the end of the budget period is its true cost, and lawmakers who support such legislation must therefore internalize the full budgetary consequences of their choice”).
¹⁹ Kysar, Lasting Legislation, supra note 7.
sunsets, meant to dislodge interest groups and remove ineffective laws, actually promote rent seeking and in so doing may perpetuate ineffective laws.\textsuperscript{21} The concerns of sunsets are magnified in the context of retroactivity.

\textit{C. Sunsetted Legislation Applied Retroactively ("Retrosunsets")}

Sunsetted legislation may expire, and subsequent to expiration may be reinstated and applied retroactively. This paper labels such retroactive application of sunsetted legislation as "Retrosunsets."

The estate tax expired on January 1, 2010. If sometime in late 2010 legislation adjusting the estate tax arises and is applied retroactively to 2010, such legislation would be a Retrosunset. Retrosunsets aggregate the concerns presented by retroactive and sunsetted legislation.

\section{II. Equilibrium Theory}

Investors are able to predict the probability that a certain legal rule will be changed, just as they can account for any market risk, “such as anticipated future demand, behavior of competitors, weather patterns, and the ultimate feasibility of untested inventions.”\textsuperscript{22} Nonmarket factors such as legislative repeal are no different.

Nevertheless, Professor Kaplow acknowledges that his argument that legal change should be expected, and therefore can be properly valued, is

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{21} Kysar, \textit{Sunset Provisions, supra} note 7 at 404.
\item \textsuperscript{22} \textit{Id.}
\end{itemize}
\end{footnotesize}
misleading as a conclusion. Simply recognizing that the legal regime is dynamic does not give one clairvoyance as to what the actual changes may be, as not all legislation shares the same level of durability.\textsuperscript{23} Equilibria theory offers an interesting framework to analyze the probabilities of change and offers perspective on the appropriateness of Retrosunsets.

Indeed, while equilibria analysis acknowledges the efficiency arguments of Professors Graetz and Kaplow, it demonstrates that certain legal rules are more appropriate to rely on than others. Thus, even if a possible legal change can be properly valued, equilibira analysis posits that at a certain point of reliance, legal change may not be appropriate.\textsuperscript{24}

Within equilibrium, there exist both stable equilibria and unstable equilibria. Imagine a stability continuum with stable equilibria representing any position leaning to the left of the continuum and any position right of center reflecting unstable equilibria. On such a continuum, stable equilibria represent legal rules that are “clear, have been promulgated by a higher legal authority, have persisted over time and in a variety of specific cases

\textsuperscript{23} Kaplow, \textit{supra} note 6 at 525.
\textsuperscript{24} Jill E. Fisch, \textit{Retroactivity and Legal Change: An Equilibrium Approach}, 110 Harv. L. Rev. 1055, 1106 (1997) (stating “Protection of reliance is more efficient in the context of a stable equilibrium because the costs of compliance with existing legal rules - predicting the legal consequences of a planned transaction - are small. Greater compliance creates uniformity and certainty in transactions, discourages opportunistic behavior, and enhances the ability of legal rules to influence primary conduct. This argument also has a normative component. Stability and predictability in the law reflect values that are worthy of independent protection”).
and have not been widely criticized or questioned,"²⁵ whereas unstable equilibria are legal rules without such support. Entrenched legislation²⁶ would be on the far left, followed by laws that have persisted over time, new legislation would fall on the center-right, to the right would lay sunsetting legislation and retrosunsets fall on the far right.²⁷

When challenged, a law in a position of stable equilibrium tends to withstand opposition and is unlikely to change.²⁸ Stable equilibria, therefore, are preferred because they minimize compliance costs and reflect a normative legal regime.²⁹ Stable equilibria minimize compliance costs in that they allow people to predict the legal ramifications of their behavior.³⁰

²⁵ *Id.* at 1103.
²⁶ Eric Posner & Adrian Vermeule, *Legislative Entrenchment: A Reappraisal*, 111 Yale L. J. 1665, 1667 (2002) (stating “By ‘entrenchment,’ then, we mean the enactment of either statutes or internal legislative rules that are binding against subsequent legislative action in the same form…On our definition, an ordinary law has some propositional content P - no bicycles in the park, for example. An entrenching statute has this propositional content plus an additional provision R which governs the conditions under which the statute may be repealed or amended. For example, R might say that P cannot be repealed or amended with less than a two-thirds majority in both the House and the Senate. Thus, an entrenching statute might say: (P) no bicycles in the park; and (R) the prohibition on bicycles in the park cannot be repealed with less than a two-thirds majority”).
²⁷ Reference Appendix 1
²⁸ Fisch, *supra* note 24 at 1100.
²⁹ *Id.* at 1106.
³⁰ Antonin Scalia, *The Rule of Laws as a Law of Rules*, 56 U. Chi. L. Rev. 1175, 1179 (1989) (stating “…another obvious advantage of establishing as soon as possible a clear, general principle of decision: predictability. Even in simpler times uncertainty has been regarded as incompatible with the Rule of Law. Rudimentary justice requires that those subject to the law must have the means of knowing what it prescribes. It is said that one of emperor Nero’s nasty practices was to post his edicts high on the columns so that they would be harder to read and easier to transgress. As laws have become more numerous, and as people have become increasingly ready to punish their adversaries in the courts, we can less and less afford protracted uncertainty regarding what the law may mean. Predictability, or as Llewellyn put it, “reckonability,” is a needful characteristic of any law worthy of the name”).
Uncertainty does offer some benefits and is appropriate in certain circumstances, as discussed in Part III. However, uncertainty, though it can be properly valued, is not socially efficient if it creates compliance costs that outweigh the benefit conferred by the uncertainty. Thus, the legal regime should generally promote stable equilibria (except in appropriate situations), and in so doing, should encourage any law in a position of unstable equilibrium to shift left on the continuum towards a position of stable equilibrium.

Given their nature, sunsets cannot be stable equilibria as they cannot persist over a period of time and withstand review in specific cases. At best, they can be considered to be in a state of unstable equilibrium because untouched, the legislation will sunset on the expiration date and disappear. Sunsetted legislation, however, rarely disappears on the expiration date. Rather, when the legislation sunsets, even though it disappears from the Code, it often has lasting effects which create uncertainty as to the future form of the law.

Imagine constructing an electrical circuit with the goal of providing enough energy to power a light bulb. Once the electrical current is flowing through the circuit, the light bulb is able to be turned on with the flip of a

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31 Richard A. Posner, The Crisis of Capitalist Democracy, 296 (Harvard University Press 2010) (stating “The greater the uncertainty, the more time it may take to learn enough about a situation to have a solid basis for investment or consumption. One pays for this valuable waiting time by accepting a zero return on a part of one’s wealth”).
When the light bulb is turned off, rather than reconstructing the circuit from scratch, a simple flick of the switch will reignite the light bulb.

Similarly, sunsetting legislation enjoys a procedural advantage over unenacted bills because it has constructed a working “circuit” as it has already made its way through “vetogates” and has satisfied budgetary requirements. Thus, unlike new legislation, extending sunsetting legislation requires a mere flick of Congress’ proverbial wrist to extend the legislation.

As a result of this procedural advantage, sunsetting legislation will most likely have some effect on new legislation, either in extending the sunset or modifying the pre-sunseted law. This creates uncertainty as to what the law will be after expiration of the sunset. For instance, the populace recognized that the estate tax was set to expire on December 31, 2009 and that 2010 would have no estate tax.

If it is widely believed that Congress will act in some way to prevent

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32 Kysar, Sunset Provisions, supra note 7 at 390-1.
33 Rebecca M. Kysar, Lasting Legislation, supra note 7, (draft on file with the author at 43) (stating “It is much easier to let a sunset expire than to repeal or amend legislation. The former requires no action and the latter requires passage in both the houses and signature by the President, not to mention various internal processes within each house, like committee review”).
34 Elizabeth Garret, Accounting for the Federal Budget and its Reform, 41 Harv. J. on Leg. 187, 197 (stating “budget accounting rules should reflect the reality that most temporary provisions are extended and never allowed to expire”).
35 Caron, supra note 4, (Power Point Slide 12 stating, “Everyone expected that the parties would eventually compromise on the exemption and rate in the run-up to 2010. President Obama and various congressional leaders last year proposed extending 2009’s exemption ($3.5 million) and top rate (45%), either permanently or as a one-year patch to give Congress time to resolve the issue. But Congress did not act, leaving taxpayers and their counsel with the current absurd state of affairs”).
the sunset from disappearing after the sunset date (through retroactive application of some form of the legislation), the uncertainty created is socially inefficient.\(^{36}\) As a result of the uncertainty, people are forced to conform their behavior so as to account for the possibility of retroactive application of new legislation.\(^{37}\) While the possibility of retroactivity can be properly valued, it is socially inefficient because in this context the benefits conferred (Congressional inaction) are outweighed by the compliance costs created.

Furthermore, Retrosunsets introduce constitutional challenges absent in general sunsettled legislation. Sunsettled legislation cannot be constitutionally challenged solely as a result of forced expiration and thus offers a level of certainty that the law in place will be upheld in court.\(^{38}\) Retroactive laws, however, can be (and often are) constitutionally challenged under the \textit{due process clause of the Fifth Amendment}.\(^{39}\) The introduction of retroactivity to sunsets, therefore, produces uncertainty as courts have not adopted a framework to evaluate retrosunsets.

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\(^{36}\) See Posner, \textit{supra} note 31 (Arguing uncertainty forces an investor to temporarily accept a 0\% return).


\(^{38}\) Posner & Vermeule, \textit{supra} note 26 at 1685 (2002) (stating “Congress has the undisputed authority to provide that statutes will lapse after a given period…”).

III. STABILITY VS. FLEXIBILITY

The decision to create legislation through permanent or temporary legislation can be thought of as a tradeoff between stability and flexibility. On the one hand, permanent legislation offers stability and makes it easier for individuals to arrange their affairs.\(^\text{40}\) On the other hand, government should change when circumstances change and too much stability obstructs legislative flexibility.\(^\text{41}\) Legislators balance these countervailing interests through the choice of creating permanent or temporary legislation.\(^\text{42}\)

Permanent legislation, statutes that persist until repealed, are the “default.” Certain circumstances, however, require more flexibility than the norm provides. In these situations, sunsetting legislation is the appropriate form of legislation.\(^\text{43}\)

Under this line of reasoning, sunsets are sometimes appropriate. However, in such situations, by letting the sunset expire without readdressing the issue, Congress is in effect stating that the circumstances favoring flexibility have lapsed and the need for stability outweighs the original concern for flexibility. With such an implication, Congress should act before the time of expiration with any action taking effect on or before the date of expiration, whether by extension of the sunset, making the

\(^{40}\) Posner & Vermeule, supra note 26, at 1672.

\(^{41}\) Id.

\(^{42}\) Id.

\(^{43}\) Id.
sunset permanent, creating new legislation, or allowing the sunset to expire and accepting the prior legislation.

If Congress waits until after the sunset expires, however, and then subsequently addresses the issue, it circumvents the appropriate ‘window’ of consideration. Thus, retrosunsets reflect inappropriate Congressional inaction by thwarting the very purpose of the sunset. Sunsets, meant to offer greater flexibility, create a specific time period for Congress to exercise that flexibility. Outside of this time period (the life of the sunset), Congress is improperly adding instability (despite implicitly favoring stability over flexibility) by deciding not to act before the expiration of the sunset. Thus, there should be a presumption against the appropriateness of retrosunsets to encourage Congress to properly address the stability versus flexibility tradeoff.

IV. IDENTIFIABLE WINNERS AND LOSERS

A. Rent Extraction

Considered independently, sunsetted legislation and retroactive legislation each offer legislators significant opportunity for rent extraction. This is due to the fact that sunsetted legislation and retroactive taxation offer the organized, affected few, disproportionate power in the legislative process.44 Retrosunsets offer the organized minority power over the

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44 Saul Levmore, *The Case for Retroactive Taxation*, 22 J. Legal Stud. 265, 279 (1993) (Discussing retroactive taxation, “The idea is that the organized few will have power out of proportion to their number; in contrast, the majority will have trouble overcoming
majority at enactment, post enactment (pre-sunset), and when applied retroactively. Because of the temporal advantage and the opportunity for legislators to extract significant rents, retrosunsets circumvent the appropriate battle of interest groups that acts as a check on rent seeking.\textsuperscript{45} Therefore, those advocating for the use of retrosunsets should bear the burden of proving their appropriateness.

Between the date of enactment and sunset, the beneficiaries of the sunsetted legislation must continually pay rents to maintain the benefit. Indeed, Congress recognizes that once it has implemented the sunset, it has thereby created an interested, small group willing to pay rents to maintain the benefit afforded by the legislation.\textsuperscript{46} Thus, as a sunset acts as a legitimate threat to an interest group receiving a benefit from the sunsetting legislation, legislators can create an opportunity for greater rent extraction by letting the sunset lapse, and then publicly considering whether to

\textsuperscript{45} Saul Levmore, \textit{Interest Groups and the Problem with Incrementalism}, U. Pa. L. Rev. (2010) (stating “…a guarded optimist could think that there will be pressure to abide by the rule of well-matched opponents and that the outcome of such a battle is likely to be superior to the outcome that would obtain if either organized interest was able to operate at the expense of a dispersed, disorganized interest”).

\textsuperscript{46} Edward J. McCaffery, \textit{Through the Looking Glass: The Politics of Estate Tax Reform}, 4 Available at: \texttt{http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1441415&download=yes} (stating “…politicians proactively create or frame issues of high stakes to small groups. Once they have them, they have little interest in finally resolving them”).
retroactively apply the sunsetting legislation.\footnote{J. Mark Ramseyer & Minoru Nakazato, Tax Transitions and the Protection Racket: A Reply to Professors Graetz and Kaplow, 75 Va. L. Rev. 1155, 1171 (1989) (stating “If Congress signals that it may end a tax benefit, the taxpayers have an incentive to complain. Many of those who can organize effectively will then do so. They will pay honoraria, organize grass-roots political organizations, and contribute to campaigns; to protect their projects from reform, they will coax, cajole, and bribe. In so doing, some will kill tax reform altogether, some will obtain a grandfather clause for their members, and some will simply fail. To the extent they can organize, however, they will fight”).}

On top of the rents expected from general sunsets, public discourse over possible retroactivity of sunsetting legislation garners additional rents from both sides of any particular provision. In the context of a provision granting a benefit, those receiving favorable treatment will be encouraged to spend more rents on maintaining their benefit after witnessing it lapse and recognizing that retroactive application offers the chance for reenactment.\footnote{Elizabeth Garret, supra note 34 at 187 (stating “Although it seems likely that Congress will extend the estate tax repeal--and perhaps make it permanent if lawmakers can find the money to offset the revenue losses--it is not certain. So groups on both sides of the issue contribute to sympathetic candidates, hoping to succeed in the battle over what happens in 2011. The sleight of hand of expiring tax provisions that are extended for a few years regularly, but at least face some possibility of lapsing, allows legislators to extract payments from affected groups--in the estate tax example, the interest groups include the insurance industry, wealthy taxpayers, estate-tax lawyers, and large nonprofits”).}

At the same time, those in favor of expiration (and against retroactivity) are encouraged to spend greater rents than a general sunset because the sunsetting legislation has a distinct possibility of reenactment.\footnote{See supra, Part II, arguing that sunsetting legislation often has some effect on subsequent legislation.}

Additionally, all members of Congress can partake in the rent extraction, as both sides of the provision appear to have strong “cases” likely to prevail. Moreover, the public nature of the discourse offers
Congress a wider audience of possible affected constituents who may be interested in paying rents for a specific outcome.

**B. PAYGO Increases Opportunity For Rent Extraction**

This problem is further exacerbated by a budget rule known as pay-as-you-go, or “PAYGO.” PAYGO “requires most changes to the tax law and entitlement programs to be, in the aggregate, at least deficit neutral for the forthcoming fiscal year and for certain limited time periods up to ten years into the future.” Essentially, PAYGO compels groups seeking to enact new legislation to present Congress with a budgetary offset that covers the cost of their desired provision.

The requirement to find offsets causes “those who receive tax subsidies [to] remain organized in order to fend off attacks from new funding predators.” PAYGO, therefore, allows retrosunets to become more durable than would otherwise be expected through “signaling theory.”

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50 For an explanation of PAYGO, See Kysar, *Lasting Legislation, supra* note 7, at 9 (stating “…PAYGO rules require revenue offsets for new revenue-decreasing legislation, such as mandatory spending or tax cuts. When a Congressional colleague fails to provide a revenue offset under an internal PAGO rule, opposing legislators may enforce the PAYGO rule as they do other procedural rules of Congress-by raising a “point of order. If sustained, the point of order will serve to strike the revnue-decreasing legislation from the bill”).

51 Yin, *supra* note 18, at 226-7 (further stating “In common parlance, the rule requires that any changes to such programs pay for themselves and not be debt financed as measured over such periods. Thus, for example, the rule mandates that any tax cut approved by Congress must be offset by a tax increase or an entitlement spending cut of equal or greater magnitude”).

52 Elizabeth Garret, *supra* note 19, at 522.

53 *Id.* at 538-9 (stating “…signaling, a strategy that current beneficiaries of tax expenditures use to indicate to lawmakers and other interest groups that particular offset
C. Signaling Theory: Retrosunsets Enjoy a Tremendous Advantage Over Possible Prospective Legislation

Signaling theory suggests that a credible signal of vigorous opposition by those affected by the possible offset “may be enough to remove the provision from consideration” as a tenable offset. Naturally, interest groups seeking a new provision will search for current legislation that is not aggressively defended to offset the cost of their desired provision.55

The fact that retrosunsets establish clear, identifiable winners and losers offers retrosunsets a significant advantage over standard legislation. Although prospective legislation can also produce identifiable winners and losers, the nature of retrosunsets provides certainty as to whom and to what extent those persons will be affected.56 Prospective legislation can never firmly establish who will or will not fall under a certain provision, let alone the magnitude of the consequences.

Furthermore, those affected by retrosunsets can easily ascertain the exact cost imposed by retroactivity.57 Prospective legislation, on the other

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54 Id.
55 Id. at 538.
56 Levmore, supra note 44, at 281 (stating “In short, an interesting attribute of retrotaxation is that it is likely to identify losers more specifically than would a comparable prospective tax proposal. Prospective legislation can, of course, also burden identifiable losers, and we should therefore expect some prospective proposals to pass more readily than others; my claim is simply that identifiability is important and that it is strongly correlated with retroactivity”).
57 Id. at 282 (stating “…taxes on past years or disallowing deductions already taken,
hand, is likely to be less efficiently defended as individuals are not able to properly value the possible future effects of a provision. As a result, the ability of retrosunsets to efficiently price the amount of rents to expend, coupled with the continual nature of rents common to sunsetted provisions, grant retrosunsets a strong signal to the market that they will be heavily defended if offered as an offset.\textsuperscript{58}

Consequently, rather than considering a retrosunset as a possible source of income to pay for a desired provision, groups will look to provisions defended by less organized groups. The organization and identifiability created at the outset of the sunset and furthered by the retroactive application acts as a durability snowball, with the provision becoming more and more defended, and thus, less and less likely to be considered as an offset. Legislators, therefore, will ignore these provisions as possible offsets simply for the fact that they are not offered by lobbyists as possible sources of offsetting income. Why lose a wealthy, organized

\textsuperscript{58} Michael J. Graetz & Ian Shapiro, \textit{Death by a Thousand Cuts: The Fight over Taxing Inherited Wealth}, 261-2 (Princeton University Press 261-2) (stating “Conventional analysis would attribute the lack of opposition simply to the mismatched benefits and burdens of estate tax repeal. The big beneficiaries...are small in number but they have a great deal at stake. It is therefore worth their while to commit time and money to fight. The costs of repeal, on the other hand, are widely dispersed. Even hundreds of billions of dollars in lost revenues each decade will not appreciably increase the burden for any individual taxpayer...”).
client without gaining a new one in exchange?

Shifting the burden to those who advocate for the retroactive application of sunned legislation would have two positive effects in this context. First, it would limit the potential for legislators to extract rents. Limiting rent extraction is especially desirable in this context because Congress seems to profit on the very uncertainty it creates. In traditional rent extraction situations, Congress either extracts rents from competing interests or from small groups that have significant interests.\(^{59}\) In contrast, by considering retroactive application, Congress forces the market to discount assets based on the possibility of retroactive application. Therefore, the rents received by a legislator can be seen as a direct transfer of wealth derived from the discount required by the possibility of retroactivity.

Second, shifting the burden to advocates of applying sunned legislation retroactively would force Congress to reach a point of relative permanency sooner. To believe Congress actually needs the interim period after the legislation sunsets but before it is to be reinstated retroactively to evaluate the legislation is naïve. Logically, if Congress knows at the time it allows legislation to sunset that it will reinstate the legislation and apply it

\(^{59}\) See Mancur Olson, The Logic of Collective Action: Public Goods and the Theory of Groups (1965) (Highlighting the interplay between concentration of benefits and costs in provoking groups to act in their common interest).
retroactively, it should simply make the sunset permanent.\textsuperscript{60} Indeed, delaying implementation of legislation that Congress believes to be prudent makes no rational sense.

V. \textbf{DISTINGUISHING BACKGROUND}

\textbf{A. U.S. v. Carlton}

Should a case arise concerning the retroactive application of an estate tax to 2010, the Court would have to consider a number of precedents, most notably \textit{United States v. Carlton}.\textsuperscript{61} \textit{Carlton} concerned the retroactive application of a tax statute and acts as the first line of authority regarding a \textit{due process} claim of retroactive application of a tax statute.

In the Tax Reform Act of 1986, Congress granted a deduction for half the proceeds of “any sale of employer securities by the executor of an estate” to “any employee stock ownership plan (“ESOP”).”\textsuperscript{62} Failing to anticipate clever estate tax lawyers, the statute did not prevent executors from purchasing securities and immediately selling those securities to an ESOP.\textsuperscript{63}

\textit{Carlton}, the executor of the will of Willametta K. Day, used estate funds to purchase 1.5 million shares of MCI for $11,206,000 on December

\textsuperscript{60} Ramseyer & Nakazato, \textit{supra} note 47, at 1175 (stating “In a first-best world where Congress relentlessly improves the law and where no one tries to influence what Congress does, Congress can adopt any transitional strategy and no one will ever be worse for it. In a second best world of lobbyists and inefficient tax reform, tax-guaranteed strategies are often the best for society and the worst for legislators. And we live in a second-best-world…”).

\textsuperscript{61} \textit{Carlton}, 512 U.S. 26.

\textsuperscript{62} \textit{Id.} at 28.

\textsuperscript{63} \textit{Id.}
Carlton sold the shares two weeks later, receiving $10,575,000 and deducted $5,287,000, or half of the proceeds of the sale of the stock to the MCI ESOP. The deduction saved the estate $2,501,161 in taxes.

On January 5, 1987, the Internal Revenue Service ("IRS") recognized the possible exploitation of §2057 and announced that “pending the enactment of clarifying legislation,” it would treat the § 2057 deduction as available only to estates of decedents who owned the ESOP securities immediately before death. Acting quickly, both houses of Congress introduced bills to enact an amendment so limiting § 2057 on February 26, 1987. The amendment was enacted on December 22, 1987 and provided that to qualify for the estate tax deduction, the securities sold to an ESOP must have been “directly owned” by the decedent “immediately before death.”

The amendment was applied retroactively, being made effective as if it were contained in the statute as originally enacted in Tax Reform Act of 1986. Thus, from the time Carlton first purchased the shares, within a month he was notified that legislation would be implemented correcting the statute, within two months both houses of Congress introduced bills, and within fourteen months the amendment was fully enacted.

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64 Id.
65 Id. at 29.
66 Id.
67 Id.
68 Id.
The IRS disallowed the deduction claimed by Carlton under §2057 because the MCI stock had not been owned by his decedent “immediately before death.” Carlton brought suit arguing that the retroactive application of the 1987 amendment to the transactions of 1986 violated the Due Process Clause of the Fifth Amendment.

The Supreme Court reversed the Ninth Circuit’s ruling (that the retroactivity was unduly harsh and oppressive and therefore unconstitutional) and upheld the retroactive application of the amendment. The majority reasoned that the due process standard to be applied to tax statutes with retroactive effect is the same as that generally applicable to retroactive legislation. That is, first, retroactive legislation must have a rational legislative purpose, a burden not imposed on prospective legislation. In other words, statutes “adjusting the burdens and benefits of economic life come to the court with a presumption of constitutionality, and…the burden is on one complaining of a due process violation to establish that the legislature has acted in an arbitrary and irrational way.”

Second, Congress must “act[] promptly” and establish only a “modest period of retroactivity.”

In Nations Bank v. United States, a taxpayer challenged Congress’

69 Id.
70 Nations Bank v. United States, 269 F.3d 1332, 1336 (Fed. Cir. 2001) (Citing Usery v. Turner Elkhorn Mining Co., 428 U.S. 1, 15, 49 L. Ed. 2d 752, 96 S. Ct. 2882 (1976)).
71 Carlton, 512 U.S. 26, 32.
retroactive application of an estate tax rate increase in the enactment of OBRA. The Nations Bank court argued that treating similarly situated taxpayers similarly (“horizontal equity”) was a “rational legislative purpose.” The disappearance of the estate tax for one year followed by its return in full force, as mentioned early, is the antithesis of horizontal equity. Nevertheless, the estate tax saga may be distinguished from the legislative acts in Carlton and Nations Bank.

B. Retrosunsets Can be Distinguished From Curative Acts

The Carlton Court acknowledged that the 1987 amendment to § 2057 was adopted as a curative measure. Curative acts are statutes that are applied retroactively to adjust existing legislation to conform to the putative intent of the legislature. Though retroactive in the strictest sense, curative acts are a special form of retroactive legislation because, instead of being scrutinized, they have been routinely upheld for decades. One commentator has argued that the rationale may be that such legislation is permissible because the legislature is simply clarifying what it meant in the legislation all along.

Retrosunsets, on the other hand, can be distinguished from curative acts in Carlton and Nations Bank.

73 Id. at 1337.
75 Id.
76 Id.
acts and should require a higher level of justification. This section looks to Congressional intent and compromise as well as applies equilibrium analysis to demonstrate that retrosunsets should be avoided whereas curative acts are generally benign. Thus, the curative amendment of §2057 in Carlton has little applicability to the possible retroactive application of non-curative legislation, such as the estate tax to 2010.

1. Congressional Intent and Unintended Fiscal Loss

   Clearly, Congress did not anticipate such broad applicability of the deduction allowed by §2057 upon enactment. When initially enacted, Congress estimated a revenue loss from the deduction of approximately $300 million over a 5-year period. With possible exploitation, though, it quickly became evident that the expected revenue loss could be as much as $7 billion, over 20 times greater than anticipated by Congress at the time of enactment.

   Similar to the unintended fiscal loss in Carlton, Kitt v. United States was a case concerning conversion of a traditional Individual Retirement Account (“IRA”) into the newly created Roth IRA (effective January 1, 1998).77 Traditionally, if the owner of an IRA withdrew from his/her IRA for a non-retirement related purpose on or before reaching a certain age, a ten percent tax was imposed on the withdrawal.78 When Congress created the Roth IRA, it allowed traditional IRA holders to “roll over” their

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77 Kitt v. United States, 277 F.3d 1330 (Fed. Circ. 2002).
78 Id. at 1331.
accounts into Roth IRAs.\textsuperscript{79}

The manner in which the legislation was written, however, allowed an individual to roll over and then immediately withdraw funds for a non-retirement purpose without paying the ten percent tax.\textsuperscript{80} Congress discovered this unintended consequence in July of 1998 and subjected such withdrawals to the ten percent tax, applied retroactively to January 1, 1998.\textsuperscript{81} The court followed \textit{Carlton} and upheld the retroactivity against the Due Process Claim.\textsuperscript{82}

2. Curative Acts as Unstable Equilibria

Curative acts, such as the amendments \textit{Carlton} and \textit{Kitts}, can be seen as unstable equilibria. Carlton, the executor of the estate, knew, or should have known, that although the transaction was within the letter of the law, it was not a result Congress anticipated.\textsuperscript{83} Even a cursory glance of the legislative history of §2057 would have clued Carlton that the statute may be amended to close the loophole causing the massive, unanticipated revenue losses. In fact, Treasury has made it clear that revenue effects of

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\textsuperscript{79} Id.
\textsuperscript{80} Id. at 1331-2.
\textsuperscript{81} Id. at 1332.
\textsuperscript{82} Id. at 1335 (stating “Although \textit{Carlton} involved different provisions of the Internal Revenue Code and a different factual situation, the reasoning and analysis of that decision are equally applicable here and call for the same conclusion: the retroactive application of the ten percent additional tax does not violate due process”).
\textsuperscript{83} Of course, this argument is problematic as it assumes that the taxpayer is in a better position than Congress to determine the validity of the law. See Faith Colson, \textit{Constitutional Law Due Process – The Supreme Court Sounds the Death Knell For Due Process Challenges to Retroactive Tax Legislation}, 27 Rutgers L. J. 243 (1995-1996) (Stating “This argument is problematic because it puts the taxpayer in the position of determining whether the law is valid or not-a determination that is not easily made”).
tax legislation are as equally important as a “fair interpretation” of the wording of the law.\textsuperscript{84} Thus, although Carlton’s interpretation of the statute may have been fair, when the unintended revenue loss is incorporated into his interpretation (and given equal weight as his fair interpretation), Carlton’s interpretation was clearly incorrect.

As a result, in late 1986, when Carlton bought and sold the ESOP shares, §2057 was in a state of unstable equilibrium.\textsuperscript{85} Likewise, the Kitts court admitted that if Congress “had been aware that the legislation excepted from the ten percent additional tax” persons rolling over “it undoubtedly would have changed the statute to subject them to the tax.”\textsuperscript{86} Recognizing the instability of the statutes in Carlton and Kitts, along with their being curative acts, retroactive application of the amendments warranted little concern from an efficiency perspective.

\textsuperscript{84} Stephen F. Gertzman, Federal Tax Accounting, (2010 Student Edition) 1.03[2] (stating “For example, significant effort was made to make the 1986 Act revenue neutral, i.e., to make certain that reductions in rates and other reductions in tax would be offset by increases in revenue so that the net result of the 1986 Act would be maintain the level of total revenues, not to increase it or decrease it. Towards this end, the Treasury has made it clear that in drafting regulations, the effects on revenue are just as important as a fair interpretation of the law”)(emphasis added).

\textsuperscript{85} “That provision was intended to create an “incentive for stockholders to sell their companies to their employees who helped them build the company rather than liquidate, sell to outsiders or have the corporation redeem their shares on behalf of existing shareholders.” Joint Committee on Taxation, Tax Reform Proposals: Tax Treatment of Employee Stock Ownership Plans (ESOPs), 99th Cong., 2d Sess., 37 (Joint Comm. Print 1985); see also 132 Cong. Rec. 14507 (1986) (statement of Sen. Long) ( §2057 “allows . . . an executor to reduce taxes on an estate by one-half by selling the decedent's company to an ESOP”). When Congress initially enacted §2057, it estimated a revenue loss from the deduction of approximately $ 300 million over a 5-year period. See 133 Cong. Rec. 4145 (1987) (statement of Rep. Rostenkowski).”

\textsuperscript{86} Kitt, 277 F.3d 1330, 1335.
3. Retrosunsets Further Congressional Compromise

Retrosunsets, though, draw great concerns from an efficiency standpoint. Retrosunsets are neither instances of tax loopholes nor Congressional oversight. For instance, an individual planning her estate in 2010 would be furthering Congress’ explicit compromise of the EGTRRA of 2001, a declining estate tax from 2001 to 2009, followed by disappearance of the estate tax in 2010, along with its full revival in 2011.

The 2001-2011 scheme reflects the inevitability of political compromise in tax legislation. Purely curative measures, however, do not reflect any Congressional compromise. Quite the opposite, they reflect congressional oversight and may even work to the detriment of a congressional compromise.

For instance, imagine five key Congressmen not in favor of §2057 were convinced to vote for the legislation if it only cost $300 million. These legislators would have certainly voted against §2057 if they knew that in actuality it would cost $7 billion. Thus, retroactivity allows the legislation to reflect the Congressional compromise, furthering the idea that

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87 Howard M. Zaritsky, supra note 1, (stating “Unless Congress retroactively reinstates the estate and GST taxes in the first few months of 2010, estate planners will face the most difficult time within which they have ever practiced. Clients want certainty, and estate planners will have none to offer them. We can only do our best to plan within the bizarre rules that Congress has given us”).

“the correction of obvious legislative errors or oversights is not to supplant the legislative will, but to make that will effective.”

Retroactive application of a new estate tax in 2011, on the other hand, would have less justification than the amendments in Carlton and Kitts or a statute encouraging undesirable tax planning (addressed below), because it would not work to further Congress’ intent or compromise.

Thus, curative acts are a necessary form of unstable equilibria; whereas, retrosunstes are not inevitable, but rather quite easily avoidable. The legislature may overlook or fail to anticipate a possible exploitation of a statute from time to time and thus may be forced to fix the loophole at a later date and apply the fix retroactively.

C. Undesirable Tax Planning

Another legitimate reason tax statutes are often applied retroactively is to prevent undesirable tax planning prior to enactment of legislation. Naturally, it takes Congress months from the date an idea is first introduced to the date the legislation is enacted. Retroactivity, therefore, is often necessary “to prevent the revenue loss that would result if taxpayers, aware of a likely impending change in the law, were permitted to order their affairs freely to avoid the effect of the change.”

Similar to curative acts, retroactive application of a statute to

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90 Fein v. United States, 730 F.2d 1211, 1212 (8th Cir., 1984).
prevent undesirable tax planning reflects Congressional compromise. In enacting legislation that taxes income in a new or different way, one could hope Congress is aligning the tax code closer to a normative regime. Assuming this is true, retrosunsets extend the period before the legal regime comes closer to the normative regime. This extension of the period of unstable equilibria when not necessary is socially inefficient. Thus, retrosunsets should not share the same level of deference as curative acts.

Wishful thinking aside, Congress expects to earn a certain amount of revenues based on a new tax provision. In a PAYGO regime, where Congress is limited in its expenditures by its revenues, Congress spends the amount of revenues it expects to receive from any new tax provision. Retroactive application of a statute to prevent undesirable tax planning, therefore, reflects the expected incoming revenue as well as the offsetting spending that was adopted by Congress. Retroactivity in this sense ensures that Congress is spending money it legitimately expects to receive.

D. ‘Modesty’ of Retroactivity Inextricably Linked to Burden
To withstand due process claims, Congress must “act[] promptly” and establish “only modest period[s] of retroactivity.” Furthermore, the Carlton court noted that retroactivity “generally has been ‘confined to short and limited periods required by the practicalities of producing national

\footnote{Carlton, 512 U.S. 26, 32 (“...our cases have recognized that Congress must be able to make such...[retroactive] adjustments in an attempt to equalize actual revenue and projected budgetary requirements.”) (O’Connor, J., concurring).}

\footnote{Id. at 32.}
The modesty of retroactivity is inextricably linked to the burdens imposed by the legislation. Clearly, Congress cannot be left powerless to adjust the Code with yearly tinkering “that is necessary to prevent losses of revenue and secure the national fiscal goal.”94 At some point, however, “the governmental interest in revising the tax laws must…give way to the taxpayer’s interest in finality and repose.”95 Retrosunsets, amounting to more than just yearly tinkering, may be an example of when the taxpayer’s interest in finality and repose outweighs the government’s interest in revising the tax laws.

Unstable equilibria are bound to arise from time to time in the form of curative acts. These curative acts are a justifiable use of unstable equilibria as they align the tax code closer to the intended regime at the earliest possible time, when the loophole is first discovered. Retrosunsets, on the other hand, are not an inevitable result of legislation, but rather congressional procrastination and are an unjustified use of unstable equilibria. Judge Plager, in his vigorous dissent in Nations Bank, noted that “Congress is perfectly capable of raising all the revenue it needs without making its tax laws reach backward, taking property from citizens based on

93 Id. at 32-3, (citing Welch v. Henry, 305 US 134, 83 L. Ed. 87, 59 S. Ct. 121 (1938)).
95 Carlton, 512 U.S. 26, 37-8 (O’Connor, J., concurring).
events that, at the time they occurred, were not subject to the new law.” 96

Even more egregious is the case where Congress was perfectly capable of
addressing the disappearing estate tax for over eight years before it expired
on January 1, 2010.

The court in Nations Bank argued that “the Supreme Court in
Carlton…did not limit the retroactive application of revenue measures
solely to enactments with a curative purpose.” 97 Rather, the court reasoned
that in the particular instance, “the benefits of a ‘modest’ retroactive
application outweighed the burdens.” 98 Presumably, therefore, the court
factored in the curative nature of the amendment when measuring the
burdens and finding the retroactivity to be sufficiently modest (and if they
did not, this paper suggests that they should have).

As discussed above, curative acts are generally more benign than
non-curative legislation. A curative act would have a low burden in that it
is highly foreseeable and offers a large benefit of aligning the tax code with
legislative intent and reflecting Congressional compromise.

On the other hand, non-curative legislation should increase the
burden side of the equation, and therefore requires greater benefits to
outweigh the burdens of “modest” retroactive application. The benefit
achieved with retroactive legislation in Carlton and Kitts (fixing unintended

96 Nations Bank, 269 F.3d 1332, 1339 (Plager, J., dissenting).
97 Id.
98 Id.
fiscal loss) and NationsBank (horizontal equity), therefore, may not be sufficient to justify retroactive application of the estate tax fourteen months after expiration. With the estate tax posing much greater burdens than the other acts discussed, the fourteen months of retroactivity adopted as the rule of thumb after Carlton clearly is not the proper timetable for ‘modest.’ How much the fourteen months should be lessened as a result of the greater burdens is subject to debate and must follow a facts and circumstances test for each particular scenario. This paper simply seeks to highlight that courts should recognize that the modesty of fourteen months was based on an act that is generally benign in nature, and that the appropriate period of retroactivity must be adjusted to reflect the increased burdens imposed by the specific legislation at issue.

1. Kitts: An Inappropriate Examination of ‘Modesty’

The Kitts court exemplifies the failure of courts to properly balance the benefits and burdens of retroactivity in determining the modesty of retroactivity. When addressing whether Congress acted promptly and established only a modest period of retroactivity, the Kitts court simply stated: “Indeed the retroactive period of this legislation was substantially shorter than the retroactive period upheld in Carlton: here only seven months, as against fourteen months in Carlton.”

This is an inappropriate application of the “modest period of

99 Kitt, 277 F.3d 1330, 1335.
retroactivity” analysis put forth in Carlton. The conclusory finding in Kitts circumvents the proper analysis (a balancing test) and renders the “modest period of retroactivity” analysis a simple greater than or less than fourteen months evaluation.

Fourteen months was not decided as the line of demarcation between appropriate and inappropriate retroactivity. Rather, it was appropriate given the nature and burdens of the legislation being applied retroactively in Carlton. Clearly, each unique situation warrants its own balancing test comparing the benefits and burdens of retroactivity with reference to the particular facts and circumstances.

VI. CONCLUSION
The lapse of the estate tax in 2010 and discussion of retroactively applying some form of the estate tax to 2010 has brought forth questions concerning the appropriateness of retroactivity as well as sunsets. This paper concludes that courts should reevaluate their analysis of due process claims concerning retroactivity in the context of sunsetted legislation. In addition, this paper hopes to shift the burden of proof for permitting retroactive application of sunsetted legislation to its proponents.

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### Appendix 1

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<th>Rely heavily</th>
<th>Can rely</th>
<th>Less reliance; proper valuation</th>
<th>Properly valued; inefficient</th>
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<tr>
<th>Entrenched legislation</th>
<th>Clear, promulgated by a higher authority, have persisted over time and in a variety of cases and have not been widely criticized</th>
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Stable Equilibria

Unstable equilibria