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RETROSPECTIVE TAX LAWS

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It is the purpose of this article to consider the cases in which the Supreme Court of the United States has either upheld or overthrown tax laws having retrospective operation and to deduce if possible a theory on which the various cases can be reconciled. At first glance it would appear that there is no such principle, and that on the contrary some of the decisions are contradictory to others. For example, it has been held that a gift tax cannot be retroactively applied to a gift *inter vivos* made after the enactment of a gift tax law was practically assured by the submission of a conference report thereon to Congress,[1] and yet, it has also been held Congress has power to make an income tax act applicable to income of a year *already closed.*[2]

The Constitutions of some states in terms forbid retrospective laws. For example, the Constitution of Missouri provides that no law "retrospective in its operation" can be passed by the General Assembly.[3] This provision has been held to apply to revenue laws,[4] and is the reason why Missouri cannot make an income tax law retroactive for even part of a year.

The only provisions in the Federal Constitution specifically referring to retroactivity are those forbidding *ex post facto* laws.[5] However, these have been construed to apply only to criminal and penal laws,[6] and accordingly, are not applicable to revenue laws.

[1] Untermeyer v. Anderson (1928) 276 U. S. 440, 72 L. Ed. 645.
[2] Stockdale v. Atlantic Ins. Co. (1874) 20 Wall. 323; 22 L. Ed. 348.
[3] (1875) Art. II, Sec. 15.
[4] Smith v. Dirckx (1920) 283 Mo. 188, 223 S. W. 104, 11 A. L. R. 510.
[5] Art. I, Sec. 9 and Art. I, Sec. 10.
[6] Kentucky Union Co. v. Kentucky (1911) 219 U. S. 140.

However, the States and the United States are forbidden to take property "without due process of law."[7] The Fifth Amendment also has a provision against taking private property "for public use without just compensation" which does not appear in the Fourteenth Amendment; but inasmuch as taking private property for public use without just compensation would not be "due process of law" it is believed that the problem is the same under both Amendments.[8]

So in practice the question of the validity of a retrospective Federal or state tax law (so far as affected by any provision of the *Federal* Constitution) may be reduced to the simple question of whether it operates to deprive the taxpayer of his property without due process of law.

Turning to the cases which have been decided, we find that in a number of decisions the particular instance of retroactive application has been held to be due process of law, and in a number of others it has been held to present a want of due process.

After some thought, the writer has concluded that if these decisions can be harmonized by a single doctrine it would probably be as follows: Retroactive application of a tax law is permitted only where it would not operate unfairly by attaching consequences to an act by a taxpayer which he could not reasonably have foreseen. If it should be urged that this is not far removed from saying that "retrospective tax laws are permitted only where they do not operate unfairly," the writer will at once admit the charge. It is believed, however, that the portion of the doctrine with respect to attaching unforeseen consequences is of some practical value and at all events considerable cognitation has not evolved any better test.

Let us proceed therefore to consider the decided cases in the light of the principle above propounded.

The case of *Blodgett v. Holden*[9] involved the validity of the gift tax imposed by the Revenue Act of 1924. The facts were that gifts were made on January 2, 1924, and that the gift tax provisions of the Revenue Act of 1924, under which the government

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[7] Fourteenth Amendment, Fifth Amendment, U. S. Const.

[8] Fallbrook Irrigation District v. Bradley (1896) 164 U. S. 112; Green v. Frazier (1920) 253 U. S. 233.

[9] (1927) 275 U. S. 142.

proposed to tax the gifts, did not come before Congress prior to February 25, 1924. The Court treats the case as presenting the question of the validity of the tax on a gift fully consummated before the gift tax provisions came before Congress.

The language of the principal opinion shows the train of reasoning of the Court:

> "As to the gifts which Blodgett made during January, 1924, we think the challenged enactment is arbitrary and for that reason invalid. It seems wholly unreasonable that one who, in entire good faith and *without the slightest premonition of such consequences,* made absolute disposition of his property by gifts should therefore be required to pay a charge for so doing."[9a]

It would appear therefore that *Blodgett v. Holden* is consistent with the hypothesis above propounded because a taxpayer could not have "reasonably foreseen" something of which he did not have the "slightest premonition."

But in *Untermyer v. Anderson,*[10] above referred to, the donor of the gift proposed to be taxed could not plead ignorance of the probable consequences of his gift. The gift was made on May 23, 1924, some three months after the gift tax provisions were presented for the consideration of Congress and while the conference report on the bill was pending. This report had gone to the Senate on May 22, 1924 and three days thereafter the bill had finally passed both houses. The bill was signed by the President and became a law on June 2, 1924, which, it will be observed, was only ten days after the gift was made. It would appear that this taxpayer had much more than a "premonition" of a tax when he made his gifts. Nevertheless, the tax was held *invalid* as applied "to bona fide gifts not made in anticipation of death and fully consummated prior to June 2, 1924."

The fact that the gift was made while the taxing act was in the last stage of progress through Congress was referred to and held immaterial on the ground that any other view would present insuperable operating difficulties.

The Court considers that the future of every bill before Congress is necessarily uncertain and that a taxpayer ought not be required to guess the outcome of a pending measure.

[9a] Italics supplied.
[10] Supra, note 1.

The element of unfairness in applying the tax retroactively to gifts of the class of *Untermyer v. Anderson* is largely created by a process of argument, viz. it would be unfair to tax gifts made so long before the enactment of the tax law that the donor could not *in fact* have reasonably anticipated a tax when he made the gift and for reasons of convenience of administration *all* gifts made before the actual passage of the tax law are grouped in the exempt class because it is too hard to distinguish between various degrees of warning which a donor may have received as the law progressed through Congress. It will not do to say that the taxpayer is entitled to definitely know the amount of the tax which will be entailed by a particular act, and that it would be "unfair" otherwise, because this would apply to a retroactive change of rate on a transaction which is taxable at *some* rate when entered into. As will be seen below, this class of retrospective law is permissible.[11]

With the foregoing qualifications, we can classify *Untermeyer v. Anderson* as consistent with the "unfairness" hypotheses.

We have been considering the Federal tax on gifts as such. Let us now consider gifts which are included in the gross estate of a decedent for purposes of an estate or inheritance tax.

Nichols v. Coolidge[12] was decided on the theory that a conveyance in fee reserving a life estate in the donor was "a conveyance intended to take effect in possession or enjoyment at or after death."[13] The transfers in question had been made in 1907 at which time there was no Federal Estate tax law in effect. Thereafter the Revenue Act of February 24, 1919 was passed which included in the gross estate (among other things) the value at the death of decedent of all property "to the extent of any interest therein of which the decedent has at any time made a transfer, or with respect to which he has at any time created a trust, in contemplation of or intended to take effect in possession or enjoyment at or after his death (whether such transfer

[11] Milliken v. U. S. (1927) 274 U. S. 531, infra.

[12] Supra, note 11.

[13] Apparently the United States Supreme Court would not now consider such transfers as intended to take effect in possession or enjoyment at or after death. See Burnet v. Northern Trust Co. (1931) 283 U. S. 782 affirming (1930) 41 Fed. (2d) 732 per curiam on the authority of May v. Heiner (1930) 281 U. S. 238.

or trust is made or created before or after the passage of this act) except in case of a bona fide sale for a fair consideration in money or money's worth."

The Court held that the statute under consideration as applied to the transfers in 1907 "is arbitrary, capricious and amounts to confiscation." Since the donor in 1907 could not have reasonably anticipated the tax attempted to be imposed, it is believed that the case of *Nichols v. Coolidge* is consistent with the theory that Court will not permit retroactive application of a tax where it would attach consequences *after* the gift was in good faith completed which the donor could not reasonably have anticipated.

The transfers under discussion in *Nichols v. Coolidge* were also considered in *Coolidge v. Long*[14] in which retrospective application of the Massachusetts inheritance tax was considered. The question was whether such application to remainders already vested before the passage of the act was repugnant to due process of law under the Fourteenth Amendment and the contract clause of the Constitution, and it was held that it was.

Mr. Justice Roberts dissented on the ground that the Court had repeatedly approved the selection of the event of possession and enjoyment as the proper occasion for the imposition of an excise and as this *event* took place after the passage of the taxing act, it was not subject to the vice of retroactivity. Upon analysis, however, it would appear that this does not avoid the "fairness" principle above set out for the reason that once the irrevocable trust had been created, the grantor no longer had any opportunity to avoid the shifting of possession at a later date. To use a phrase from the opinion in another case,[15] the tax operates "to impose an unexpected liability that, if known, might have induced those concerned to avoid it, and to use their money in other ways."

An example of a retroactive tax law which was upheld is found in *Milliken v. United States*.[16] This case involved the Federal Estate tax provisions of the Revenue Act of 1918. Gifts had been made by decedent in December 1916 while the Revenue Act of 1916 was in effect and they were admittedly made "in

[14] (1931) 282 U. S. 582.
[15] Lewellyn v. Frick (1925) 268 U. S. 238.
[16] (1931) 283 U. S. 15.

contemplation of death" so as to require their inclusion in the gross estate of a decedent if decedent had died while the Act of 1916 was in effect. The rates applied by the Revenue Act of 1918 were higher than those of the 1916 Act, and it was urged that it was a violation of the due process clause to apply these higher rates to gifts completed before the effective date of the Revenue Act of 1918. It was further urged that it was objectionable to require the inclusion in an estate taxable under the 1918 Act of gifts completed before its date of enactment—regardless of the question of increased rates.

However, the Court held that the retroactive application was due process of law in both particulars.

The Court refers to the fact that gifts in contemplation of death "are motivated by the same considerations as lead to testamentary dispositions of property." From this it follows that the decedent should "expect" such a gift to be included in his gross estate when he dies, since the policy of requiring such inclusion had already been adopted in the Revenue Act of 1916 in force at the date of the gifts.

While the "fairness" principle is not stated in so many words, it is clearly hinted at in the following language of the court:[17]

> "Not only was the decedent left in *no uncertainty* that the gift he was then making was subject to the provisions of the existing statute, but in view of its well understood purpose he should be regarded as *taking his chances* of any "increase in the tax burden which might result from carrying out the established policy of taxation under which substitutes for testamentary gifts were classed and taxed with them." (Italics supplied.)

In other words, since the decedent had ample warning that he was making a transaction of a character that could be subjected to estate tax and must have known that the rates in tax laws were subject to change, it was "fair" that the gifts previously made in contemplation of death should be included in the decedent's estate and taxed at whatever rates happened to be in effect when he died.

We meet with an analogous situation in the case of an inheritance tax on property conveyed by decedent in his lifetime by

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[17] Supra, note 16, l. c. 23.

a revocable trust. *Saltonstall v. Saltonstall*[18] dealt with such a situation.

Between 1905 and 1907 one Brooks transferred certain property to trustees for the benefit of himself and wife during their lives, and then for their children. The trust instrument provided that its terms might be changed and the trust terminated, in whole or in part, by Brooks with the concurrence of one trustee. The power to alter was in fact exercised by Brooks several times during his lifetime.

When the transfers were made there were no Massachusetts statutes taxing the transfer to the children under those circumstances. Thereafter, in 1909 and in 1916 amendments were enacted which were deemed to bring the transfers within the purview of the Massachusetts transfer tax. Brooks died in 1920. The question was whether, as so interpreted, the statutes operated to take property without due process of law because they included interests which had vested prior to the enactment of the amendments.

In the Court's view, the tax is not retroactive because the thing taxed is the *succession*. The Court says:[19]

> ". . . . the gift taxed is not long since completed, but one which never passed to the beneficiaries beyond recall until the death of the donor; and the value of the gift at that operative moment, rather than at some later (sic) date is the basis of the tax."

Of course this reasoning in one sense avoids retroactivity, but if the statute is deemed retroactive, then it is consistent with the "fairness" principle because the power of the settlor to revoke the trust renders it fair to tax the transfer. While the tax in this case was on the beneficiaries, it is believed that the rule would be the same in case of a tax on the power to transmit upon death as is the case with the Federal Estate Tax, and that the opportunity which the decedent has in case of a revocable trust to alter the situation if it is not to his liking renders it permissible to impose an estate tax on the assets of a revocable trust by a law enacted at any time before the death of the decedent.

Another example of a retroactive estate tax which is probably

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[18] (1928) 276 U. S. 260.

[19] Supra, note 18, l. c. 271.

permissible is the tax on proceeds of life insurance policies taken out prior to the enactment of the tax where the assured has retained the right to change the beneficiary . This situation was not directly passed upon in *Chase National Bank v. United States*[20] for the reason that the policies in question in that case were taken out in 1922 and the Act under which they were taxed was passed November 23, 1921. However, the Court plainly considers that where a decedent retains a legal interest in life insurance policies which gave him the power of disposition of them and their proceeds, the taxable transfer occurs at the date of the decedent's death. If this be so it would be immaterial that the policies were taken out prior to the passage of the law.

That this is so follows from *Reinecke v. Northern Trust Co.*[21] Here the court was considering certain revocable trusts which had been created by the decedent in 1903 and 1910 respectively, prior to the enactment of the Revenue Act of 1921 under which the assets of the trusts were included in the gross estate of the decedent for Federal Estate tax. Objection was made that this was not due process of law because retroactive. The answer of the Court was that in *Chase National Bank v. United States* (supra) decided on the same day, the decision rested upon the ground "that a transfer made subject to a power of revocation in the transferror, terminable at his death is not complete until his death."[22]

This shows that in cases where the transfer occurs at the death, when a power to revoke terminates, it is not material when the revocable situation was created, be it a trust or a life insurance policy with the retained powers.

The foregoing process of argument was used by the Board of Tax Appeals in *Louis M. Weiller et al. Trustees.*[23]

A general power of appointment resembles a revocable trust in this, that the donee of the power has a right which is tantamount to ownership and accordingly there is nothing "unfair" in applying a tax to the exercise (or even the non-exercise) of the power even though the tax is imposed by a law enacted after the power is vested in the donee of the power.

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[20] (1929) 278 U. S. 327.
[21] (1929) 278 U. S. 339.
[22] Supra, note 21, l. c. 345.

After the law is enacted, the donee of the power of appointment still has a chance to exercise his own choice and is not taken by surprise.

The ruling on exercise of a power of appointment is found in *Lee v. Commissioner.*[24]

The Federal Government has not attempted to tax the *nonexercise* of a general power of appointment so there has been no occasion for this power to be adjudicated with respect to either a prospective or retroactive law, but on principle the ruling would probably be the same as on the *exercise* of the power.

The "fairness" principle met a somewhat more severe test in connection with the estate tax upon the interest of the decedent in an estate in joint tenancy created proior to the enactment of the Federal Estate Tax Act of 1916.

In the case of *Gwinn v. Commissioner*[25] the decedent and her son had acquired certain property in 1915 by equal contributions. The title was taken as joint tenants with right of survivorship. The interest of the decedent was subjected to federal estate tax under the Revenue Act of June 2, 1924. It was urged that it was arbitrary and a violation of the due process clause of the Fifth Amendment to tax the interest which had vested before the enactment of the first Federal Estate Tax Act. The Court answers this contention with the statement that the rights of the possible survivor were not irrevocably fixed in 1915 when the joint tenancy was created, because the joint estate might have been terminated by voluntary conveyance by either party, through proceedings for partition or by an involuntary alienation under an execution. Therefore the death was held to be the "generating source" of accessions of property rights that could be taxed by a law enacted after the joint tenancy was created.

It would be expected that an estate by the entirety would be in the same situation as an estate in joint tenancy. *Griswold v. Helvering*[26] presented this question. The estate had been created

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[23] (1930) 18 B. T. A. 1121. See also to same effect William A. Cushman et al. Executors (1930) 19 B. T. A. 1012 and Prentice Hall Fed. Tax Service (1935) Par. 23,201-A.

[24] (1932) 57 Fed. (2d) 399. Certiorari denied by Supreme Court of United States May 31, 1932, 286 U. S. 563.

[25] (1932) 287 U. S. 224.

[26] (1933) 290 U. S. 56.

in 1909 and the tax was imposed under the Revenue Act of November 23, 1921. The Court says that the sole question is whether the application of the statute gives it a "retroactive effect."

The Court says:[27]

"Under the statute the death of decedent is the event in respect of which the tax is laid. It is the existence of the joint tenancy at the time, and not its creation at the earlier date, which furnishes the basis for the tax. By the judgment under review, only half of the value, that is to say, the value of decedent's interest, has been included, leaving the survivor's interest unaffected. After the creation of the joint tenancy, and until his death, decedent retained his interest in, and control over, half of the property. Cessation of that interest and control at death presented the proper occasion for the imposition of a tax. . . . The statute as applied does not lay a tax in respect of an event already past, but in respect of one yet to happen."

It will be seen that the "fairness" principle is avoided here because the Court does not treat the statute as retroactive. But if it is deemed retroactive, the fairness of the tax would seem to depend upon the power of the tenants by the entirety to alter their situation *after* the taxing statute was enacted. This feature of the case which was stressed by the Court in *Gwinn v. Commissioner*[28] is ignored here. However, it is certainly true that the two tenants by the entirety could have altered the situation by acting collectively and this is probably enough to "save the day" under the "fairness" principle, namely that the imposition of the tax after the event must not operate to take the taxpayer unawares and impose consequences that he could not have foreseen and might have avoided if forewarned.

When we come to income taxation the Court has viewed the matter from a somewhat different angle. There is no objection in the mind of the Court to retroactive *income tax* laws, at least where the income is fairly recent. This may be due to the supposition that a person will obtain what income he can regardless of the obligation to pay an income tax on it. Therefore "fairness" does not demand that the taxpayer be given an opportunity to refrain from earning income because presumably he would

[27] Supra, note 26, l. c. 58.
[28] Supra, note 25.

want the income, regardless. At all events the Supreme Court of the United States is firmly committed to the doctrine that retroactivity is no objection to an income tax (at least as applied to recent income).[29]

The "fairness" principle receives a rather severe test in the case of *Brunet v. Wells*.[30] In this case an irrevocable trust had been created for the purpose of paying premiums on insurance on the life of the donor and the beneficiaries were members of donor's family. The question was whether the income from the trust could be included in donor's income for purposes of the federal income tax. It was held that such income could be so taxed. The premiums on the insurance were deemed "personal expenses" of the donor and it was thought not to be unfair to tax him on the income devoted to their payment, although this was done by a law passed after the trust was created. It might be urged that because the donor could no longer change the situation which he had created before the law was passed, he was visited with consequences which he could not have foreseen and that the principle of fairness was violated. A possible answer is that this is analogous to the gift in contemplation of death (*Milliken v. United States*, supra) and the donor had placed himself "beyond the pale" by an attempted evasion.

CONCLUSION

From the foregoing it would appear that the decided cases are in harmony with the doctrine that a tax can be retroactive only when it does not thereby attach consequences to an act which the taxpayer could not reasonably have foreseen, but this doctrine leaves considerable room for interpretation as to what consequences should have been anticipated by the taxpayer from a particular act.

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[29] Stockdale v. Atlantic Ins. Co. (1874) 20 Wall. 323, Brushaber v. Union Pacific Ry. Co., (1916) 240 U. S. 1, l. c. 20. Practically all of the Revenue Acts have been at least partially retroactive and some have applied to income of years already closed.

[30] (1933) 289 U. S. 670.