Insight

Wither the estate tax? An interview with Rick Grafmeyer

RICK GRAFMEYER | JUNE 15, 2010

Under current law the estate tax is eliminated for 2010, but come 2011 we jump back to pre-2001 rates of 55 percent, with an exemption of $1.5 million. Many in Congress have pledged a retroactive tax for 2010, yet questions of the Constitutionality of this remain. Rick Grafmayer, an American Action Forum expert on tax policy and partner at Capitol Tax Partners, answers a few of our questions.

What is Congress' recent history with retroactive tax increases?

Rick: In August 1993 both individual top rates and corporate top rates were increased by President Bill Clinton in the Revenue Reconciliation Act. However, the rates were effective for years beginning after December 31, 1992. To help ease the pain of a retroactive tax increase, individual taxpayers (but not corporate taxpayers) were permitted to pay the portion of their taxes attributable to the rate increases for 1993 in three equal installments (April 15, 1994, April 17, 1995, and April 15, 1996). This is the obvious retroactive tax increase that first comes to mind. There have been others which are less obvious as they are not pure rate increase and the 1993 Act was, such as the changes made to ESOPs and then litigated in the MCI / Carlton case – but most of these indirect retroactive increases have been done in the corporate tax area.

And how does the Supreme Court come down on retroactive tax increases?

Rick: The Supreme Court has given the legislature wide latitude to mandate retroactive tax increases, and Congress has exercised this freedom by routinely making its rate increases retroactive. Opinions by the justices contain many references to retroactive tax increases. Justice Louis Brandeis, dissenting in Utermyer v. Anderson (1928), detailed 15 retroactive tax increases occurring between 1861 and 1926. Justice Harlan Fiske Stone, in a 1938 case, Welch v. Henry, noted that for more than 75 years it had been the "familiar legislative practice of Congress" to make income tax rate increases apply for the entire year in which the increase was enacted and sometimes farther back than that.

But what about the Constitution's ex post facto restrictions and due process violations?

Rick: There are two main constitutional challenges to the retroactive portions of tax plans. First, an ex post facto law is one that is "done, made, or formulated after the fact, retroactive". This alone makes the Clinton-passed tax increases an ex post facto law. But, courts have long held that ex post factor language only applies to criminal or penal instances. Because tax laws are not considered to be either, they are unaffected by the provision.

The second challenge to retroactive taxes is that they violate the due process clause of the Fifth Amendment. In the words of Senator Jack Danforth (R-MO), *"nder the due process clause, the constitutional test is exactly the same test [applied] politically to tax laws — the test of fairness. The issue under the due process clause is whether the provision in the law is fundamentally unfair." The Supreme Court has heard many cases challenging the due process of tax law. Cases dating back to 1928 indicated that any retroactive application of a tax is a plain violation of due process. But more recently the Court backed away from that position and* *instead endorsed the legitimacy of such laws, finding that as long as the law can be characterized as a rational means to a legitimate constitutional end, the Court will defer to the will of the legislature. The sticking point however has been notice. Fairness is achieved when individuals subject to the law are aware of its existence.*

To ensure fairness in the context of a retroactive tax, the proper question to ask is: Were the taxpayers, on the date of proposed application, somehow on notice or aware that such a change in the tax law could or would be made? If they were, fairness would be achieved since the taxpayer knew, or should have known, that his activities, at the time they were conducted, might be subject to a higher tax. In the absence of such notice, due process would be offended by the tax.

Have taxpayers challenged a tax change using the due process clause?

Rick: This was raised in Carlton v. United States, the most recent due process challenge to the retroactive application of a tax. Carlton involved the retroactive application of an estate tax. Specifically, the executor of an estate purchased and then agreed to sell shares of stock to an Employee Stock Ownership Plan (an "ESOP" as defined in 26 U.S.C. 2057). Pursuant to the Internal Revenue Code, the executor, in making such a transaction, was entitled to deduct one half of the proceeds from the gross estate. Soon after this transaction, the IRS announced that this deduction was only allowed if the decedent directly owned the securities before death, which the estate involved in Carlton did not. This IRS interpretation, which was eventually codified into law, cost the taxpayer $2,501,161, plus interest.

The Appeals Court applied a modified due process standard to review the law. Under this standard, the court is to "consider the nature of the tax and the circumstances in which it is laid before it can be said that its retroactive application is so harsh and oppressive as to transgress the constitutional limitation." The Carlton court struck down the retroactive application of the law as applied to that taxpayer despite this very deferential review. Crucial to the court's decision was the fact that the taxpayer had not been afforded adequate notice of the change in the law's application. This fact, combined with the taxpayer's justifiable reliance on the existing interpretation and the unconscionable result that followed, swayed the Court to hold that due process was indeed violated by the law's retroactive application. However, unfortunately, the U.S. Supreme Court found for the Government and permitted the retroactive tax increase.

The estate tax rate is zero for 2010, are estates still required to report something to the IRS?

Rick: Form 706, the Estate Tax Return, is normally required to be filed within 9 months of the date of death with a possible 6-month extension of that time frame. However, this Form 706 is no longer required after 2009. In its place, Code section 6018 provides for the filing of an informational return which is required for any transfer of property from a decedent for which the fair market value exceeds the dollar amount described in Code section 1022(b)(2)(B) — which is currently $1.3 million. The information return describes the property transferred, the fair market value, the basis of the property and the holding period for the property.

Are attorneys currently worried about a retroactive tax increase?

Rick: Estate attorneys are freaking out, but more because they don't know how to plan for elderly persons. I don't think anyone is genuinely worried about a retroactive tax increase. However, what they are worried about is if legislation provides executors the option to apply either "old" law – current rate of zero – or whatever the new estate tax law would be. The problem with such an option is that the right answer for an estate may depend on the type of property a beneficiary may be receiving. For example, take an estate of $10 million and date of death as of today. If one child is receiving $5 million of BP stock, it is doubtful that this asset has appreciated much during the decedent's life due to recent events, and thus step-up in basis may not be important. But if another child is to receive their Manhattan condo worth $5 million, the step-up in basis may be very important to this beneficiary. Attorneys don't know how to handle such an estate under the possibility of an option as an executor should take all the beneficiaries into account when tax decisions for the estate. Thus, the option approach is a real problem for estate planning and administration.