"CONSTITUTIONALITY OF A RETROACTIVE FEDERAL ESTATE TAX"

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- Federal estate tax was repealed in 2001 for decedents dying during 2010. Repeal was not an oversight. Congress made a deliberate choice in repealing the tax during 2010 albeit making it effective again on January 1, 2011.

- In December 2009, the House passed a bill retaining the tax for 2010 at the same $3.5 million exemption level at 45%; but the Senate failed to extend the tax when it convened in December.

- It is widely anticipated that Congress will extend the tax making it retroactive to January 1, 2010.

    - The question many have raised is whether a retroactive estate tax is constitutional.

- Aside from the constitutional issue, experts say retroactivity presents difficult policy issues. That is, a decedent who arranged her estate tax affairs relying on the 2001 legislation that repealed the tax during 2010 would be unable to modify her estate tax planning if she dies in 2010 but before the retroactivity occurs.

- Constitutional Issue.

    - The Supreme Court addressed the constitutional issue of retroactive estate tax legislation in a 1994 decision.[1] In Carlton, the Supreme Court tolerated a retroactive estate tax change to the Code.

    - In Carlton, there was an inadvertent loophole in 1986 estate tax legislation, which the executor took advantage of.

    - Congress corrected the loophole by making a retroactive Code change. It prohibited an estate tax deduction for certain losses incurred post-mortem as administration expenses.

    - IRS challenged the estate's Form 706 tax deduction based on the retroactive legislation. The executor appealed claiming the retroactive change was unconstitutional since it violated the due process clause.

[1] United States vs. Carlton, 512 US 26 (1994). The issue involved deducting 50% of the selling price of securities on Form 706 under §2057 as an administration expense. The securities were acquired post-mortem and sold at a loss by the Executor.

- The Court (Scalia and Thomas) held that the retroactive imposition of a **"wholly new tax"** is constitutionally precluded.

    - Congress was only trying to remedy a loophole in the 1986 legislation. It was not introducing a "wholly new tax."

    - The Court noted that the retroactivity period was of short duration, i.e., the retroactive change was made by Congress approximately one year after the transaction was consummated by the Executor.

    - Thus, the Court held that the retroactive legislative change did not violate the due process clause.

    - Rationale: Since the retroactive change did not rise to the level of a new tax and only modified an extant estate tax provision, the Court agreed with IRS and sustained disallowance of the estate tax deduction----that is, the Executor lost the deduction due to the retroactive legislative fix.

- The constitutional law experts say that the following factors will apply in determining the constitutionality of a retroactive estate tax change during 2010:

    - Early enactment of a retroactive fix will weigh in its favor;

    - The 2001 repeal of the 2010 estate tax was not a Congressional oversight—it was a deliberate choice---thus, Congress carefully examined the anticipated revenue loss; therefore, making the estate tax retroactive to January 1, 2010 may be constitutionally precluded;

    - Repeal could have a chilling effect on a decedent who prepared her estate tax affairs relying on 2010 repeal and then dies in 2010 before Congress retroactively resurrects the tax to January 1, 2010;

    - **Threshold major issue:** whether a retroactive 2010 estate tax constitutes a "wholly new tax." The experts believe that it may so constitute a prohibited retroactive change since it was deliberately intended to be repealed on January 1, 2010 and Congress incorporated the revenue loss during its deliberations in 2001. Thus, the retroactive resurrection of the estate tax to January 1, 2010 may very well constitute an unconstitutional retroactive change, i.e., a "wholly new tax."

- A Severance Provision. The experts believe that Congress should incorporate a so-called "severance provision" if the tax is made retroactive to January 1, 2010. Such a proviso could subject the legatees to a 45% income tax on their inheritance if the retroactive estate tax was found to be unconstitutional and the decedent died with more than a $3.5 million gross estate. Query: would such a new income tax on inheritances be a "wholly new tax"? Probably not say the experts since the income tax is an extant tax under the Code.

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