

# Issue Brief

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## Proposed Biden Retroactive Capital Gains Tax Could Be Challenged on Constitutional Grounds

### Introduction

Having resolved the [infrastructure bill](#), Congress now begins debate and consideration of the budget through a reconciliation process since that can be passed with 50 votes, bypassing the normal process that subjects legislation to filibusters.<sup>1</sup> As part of that package, the Democratic majority is considering a number of tax increase ideas: [raising the top rate to 39.6 percent](#)<sup>2</sup>, [increasing the corporate tax from 21 percent to 28 percent](#)<sup>3</sup>, [a minimum “book” profits tax](#)<sup>4</sup>, [taxing investment income as ordinary income](#)<sup>5</sup>,

<sup>1</sup> Lautz, Andrew. “Putting Senate Dems’ \$3.5 Trillion Budget Deal in Context.” National Taxpayers Union, Jul. 16, 2021, <https://www.ntu.org/publications/detail/putting-senate-dems-35-trillion-budget-deal-in-context>; Andrew Wilford, “Don’t Be Fooled by the Bipartisan, ‘Paid-For’ Infrastructure Bill,” RealClear Markets, Aug. 9, 2021, [https://www.realclearmarkets.com/articles/2021/08/09/dont\\_be\\_foiled\\_by\\_the\\_bipartisan\\_paid\\_for\\_infrastructure\\_bill\\_789069.html](https://www.realclearmarkets.com/articles/2021/08/09/dont_be_foiled_by_the_bipartisan_paid_for_infrastructure_bill_789069.html).

<sup>2</sup> Rappeport, Alan. “Biden Banks on \$3.6 Trillion Tax Hike on the Rich and Corporations.” The New York Times, May 28, 2021. <https://www.nytimes.com/2021/05/28/us/politics/tax-rising-on-rich-corporations.html>.

<sup>3</sup> Lautz, Andrew. “Eight Tax Changes Democrats Should Avoid in the Months Ahead.” National Taxpayers Union, Jan. 29, 2021, <https://www.ntu.org/publications/detail/eight-tax-changes-democrats-should-avoid-in-the-months-ahead>.

<sup>4</sup> Cochrane, Emily. “Elizabeth Warren will propose a minimum tax on the nation’s richest companies.” The New York Times, Aug. 9, 2021. <https://www.nytimes.com/2021/08/09/us/politics/elizabeth-warren-minimum-tax-corporations.html>.

<sup>5</sup> Lautz, Andrew, and Yopez, Will. “Americans Families Plan Includes Troubling Tax Provisions, Spending on Well-to-Do.” National Taxpayers Union, Apr. 29, 2021, <https://www.ntu.org/publications/detail/american-families-plan-includes-troubling-tax-provisions-spending-on-well-to-do>.

### Key Facts:



President Biden has proposed raising the top capital gains tax rate from 23.8 percent to 43.4 percent as one of several tax increase ideas for the federal budget this year.



The increase would produce real harms for people depending on capital gains income, and would make U.S. tax rates the highest in the world.



While courts have upheld retroactive taxes in some cases, it is not the legal slam dunk that proponents think it is.

[levying a 10 percent surtax on high earners](#)<sup>6</sup>, [imposing a one-time 2.5 percent wealth tax](#)<sup>7</sup>, and [imposing an annual 2 percent or 3 percent wealth tax](#).<sup>8</sup>

One idea in play is a [retroactive capital gains tax increase](#), raising the top tax rate, currently 23.8 percent, imposed on the gain from the sale of assets held longer than a year.<sup>9</sup> President Biden's budget proposal suggested raising the rate on such capital gains to 43.4 percent for households with income over \$1 million, effective for all sales on or after April 2021. This would be in addition to Biden's "[stepped-up basis](#)" [proposal](#) to impose capital gains at death above a \$1 million exemption, which would also be in addition to the existing estate tax.<sup>10</sup> Biden's capital gains proposal may serve as the starting point of the discussion for Congress.

President Biden's proposed retroactive capital gains tax increase will produce real harms. A [recent Wall Street Journal article](#) already shared one story: Paul Settle, a 64-year-old Kentucky man who has fixed up five apartment buildings and plans to retire on the proceeds, would see his savings cut in half by the proposal, even though he makes only \$75,000 per year.<sup>11</sup>

Under this proposed tax, [combined federal and state taxes](#) on capital gains would average 48 percent (itself a 66 percent increase over current law), exceed 50 percent in thirteen states and the District of Columbia, and reach 58.2 percent in New York City.<sup>12</sup> The combined average federal and state capital gains would surpass Denmark, Chile, and France to become [the highest capital gains tax rate](#) in the industrialized world.<sup>13</sup>

Moreover, such a tax hike wouldn't even accomplish the desired goal of increasing revenue. Analysts at Penn-Wharton concluded that Biden's proposed capital gains tax increase would *lower* federal revenue by \$33 billion, rather than raise the administration's estimate of \$370 billion or more.<sup>14</sup> The Penn-Wharton tax model generally produces results that are similar to those of the Congressional Budget Office, which suggests that Congress's official scorekeeper is unlikely to see a capital gains tax hike producing large amounts of revenue. Unprepared small businesses and taxpayers facing this historic economic hit retroactively will be especially hurt, particularly coming after a COVID pandemic that has devastated many of them.

## Why a Retroactive Tax?

One reason President Biden and key Democrats may want a capital gains tax increase to be retroactive is because [there are numerous studies](#) demonstrating that whenever a capital gains tax increase is about to take effect, there is a rush of sales ("realizations") and a one-time spike in capital gains tax collections, followed by multiple years of lower levels of collections.<sup>15</sup> The reverse is also true, with capital gains collections soaring in the years following a rate reduction.

<sup>6</sup> Senator Chris Van Hollen. "Van Hollen, Beyer Reintroduce Millionaires Surtax to Invest in Working Families." Jun. 10, 2021, <https://www.vanhollen.senate.gov/news/press-releases/van-hollen-beyer-reintroduce-millionaires-surtax-to-invest-in-working-families>.

<sup>7</sup> Jagoda, Naomi. "Exclusive: Democrat exploring 'patriot tax' on multimillionaires' wealth." The Hill, Jun. 14, 2021. <https://thehill.com/policy/finance/558263-exclusive-democrat-exploring-patriot-tax-on-multimillionaires-wealth>.

<sup>8</sup> Wilford, Andrew. "Warren's Recycled Wealth Tax Plan Suffers From All the Same Faults as Previous Versions." National Taxpayers Union Foundation, Apr. 1, 2021, <https://www.ntu.org/foundation/detail/warrens-recycled-wealth-tax-plan-suffers-from-all-the-same-faults-as-previous-versions>.

<sup>9</sup> Rubin, Richard. "Biden Budget Said to Assume Capital-Gains Tax Rate Increase Started in Late April," The Wall Street Journal, May 27, 2021, <https://www.wsj.com/articles/biden-budget-said-to-assume-capital-gains-tax-rate-increase-started-in-late-april-11622127432>.

<sup>10</sup> Lautz and Yopez.

<sup>11</sup> Ensign, Rachel Louise. "How a Landlord Making \$75,000 a Year Could End Up in the Millionaire Tax Bracket," The Wall Street Journal, Jul. 31, 2021, <https://www.wsj.com/articles/how-a-landlord-making-75-000-a-year-could-end-up-in-the-millionaire-tax-bracket-11627723800>.

<sup>12</sup> Watson, Garrett, and York, Erica. "Top Combined Capital Gains Tax Rates Would Average 48 Percent Under Biden's Tax Plan." Tax Foundation, Apr. 23, 2021, <https://taxfoundation.org/biden-capital-gains-tax-rates/>.

<sup>13</sup> Painter, Clifton. "Biden's Top Marginal Capital Gains Tax Rate Would Be Highest in OECD." Tax Foundation, Jul. 6, 2021, <https://taxfoundation.org/biden-capital-gains-tax-rate-oecd/>.

<sup>14</sup> Compare Penn-Wharton Budget Model, "Revenue Effects of President Biden's Capital Gains Tax Increase," Apr. 23, 2021, <https://budgetmodel.wharton.upenn.edu/issues/2021/4/23/revenue-effects-of-president-bidens-capital-gains-tax-increase> with Urban-Brookings Tax Policy Center, "An Updated Analysis of Former Vice President Biden's Tax Proposals," Nov. 6, 2020. <https://www.taxpolicycenter.org/publications/updated-analysis-former-vice-president-bidens-tax-proposals/full>.

<sup>15</sup> Eastman, Scott. "JCT Report Shows Capital Gains are Sensitive to Taxation," Tax Foundation, Sep. 25, 2019, <https://taxfoundation.org/jct-report-shows-capital-gains-are-sensitive-to-taxation/>; and Dowd, Timothy, and McClelland, Robert. "The Bunching of Capital Gains Realizations." Urban-Brookings Tax Policy Center, Feb. 7, 2017, <https://www.taxpolicycenter.org/sites/default/files/publication/138266/2001148-the-bunching-of-capital-gains-realizations.pdf>; and Lindsay, Lawrence B. "Capital Gains Rates, Realizations, and Revenues," in Martin Feldstein, "The Effects of Taxation on Capital Accumulation" (1987); and Reynolds, Alan. "The Politics and Economics of the Capital Gains Tax." Cato Institute, Aug. 3, 2018, <https://www.cato.org/blog/politics-economics-capital-gain-tax>.

Experts differ on why, but the general theory is that hiking the capital gains tax pushes people to shift from long-term investment activity toward short-term consumption activity, cashing out and spending the money since the tax rate on investing the money is the same or higher. If a tax increase is structured so that the effective date already happened months ago, investors would obviously have no chance to unload assets at favorable tax rates before the new policy kicks in.

## The Problems With Retroactivity

Aside from these undesirable economic effects, supporters of the policy face another challenge: retroactivity is not a legal slam dunk. Taxpayers may be surprised to learn that retroactive taxes are permissible at all. After all, to quote the Supreme Court in *Landgraf v. USI Film Products* (1994), “the presumption against retroactive legislation is deeply rooted in our jurisprudence... [e]lementary considerations of fairness dictate that individuals should have an opportunity to know what the law is and conform their conduct accordingly; settled expectations should not be lightly disrupted.”<sup>16</sup> In other words, you shouldn’t be expected to comply with a law before it has actually passed.

Though the constitutionality of retroactive taxation is not a settled legal issue, there’s plenty of basis to question their legality. The U.S. Constitution bans ex post facto laws that retroactively apply criminal laws.<sup>17</sup> The Fifth Amendment’s Takings Clause prevents arbitrary confiscations and deprivation of property rights except for public use and with payment of just compensation.<sup>18</sup> The Bill of Attainder clause bars legislatures from singling out people for punishment for past conduct.<sup>19</sup> The Eighth Amendment’s Excessive Fines Clause prohibits financial penalties that are, to quote the Court, “grossly disproportional to the gravity of the defendant’s offense.”<sup>20</sup> The Due Process Clause has also been interpreted to protect reliance and require fair notice, with retroactive application requiring independent justification that it is “a legitimate legislative purpose furthered by rational means.”<sup>21</sup> Finally, at least two current Supreme Court justices (Chief Justice John Roberts and Justice Sonia Sotomayor) have written that a legislature directing a court to enforce a retroactive statute will in some cases violate the separation of powers.<sup>22</sup>

Retroactive taxes violate the fundamental principles of transparency and stability. Retroactive tax increases undermine certainty in the law and the ability of taxpayers to plan their affairs by relying on the law today, not based on what legislators in the future decide the law *was*.

Retroactivity also undermines public respect for the law and belief that the system is fair. Where retroactive tax obligations have been imposed on taxpayers in the past, they have avoided substantial public and legal backlash largely because they are usually narrowly imposed on small subsets of people or businesses, and because of a general lack of public awareness that the imposition of retroactive taxes is even possible, much less that it happens.

## Are Retroactive Taxes Constitutional?

The U.S. Supreme Court has never directly addressed the question of the constitutionality of retroactive taxes, though it did come close in *United States v. Carlton* (1995).<sup>23</sup> That case dealt with a new estate tax deduction for selling stock in employee stock ownership plans that was included in the tax reform law passed in October 1986. In January 1987, the IRS announced that the deduction had a loophole in not

<sup>16</sup> *Landgraf v. USI Film Products*, 511 U.S. 244, 265-66 (1994).

<sup>17</sup> U.S. Const. art. I, sec. 9, cl. 3 (“No Bill of Attainder or ex post facto Law shall be passed.”); *Calder v. Bull*, 3 U.S. (3 Dall.) 386 (1798) (interpreting clause).

<sup>18</sup> U.S. Const., amendment V (“[N]or shall private property be taken for public use, without just compensation.”).

<sup>19</sup> U.S. Const. art. I, sec. 9, cl. 3 (“No Bill of Attainder or ex post facto Law shall be passed.”).

<sup>20</sup> U.S. Const., amendment VIII (“Excessive bail shall not be required, nor excessive fines imposed, nor cruel and unusual punishments inflicted.”); *United States v. Bajakajian*, 524 U.S. 321, 337 (1998).

<sup>21</sup> U.S. Const., amendment V (“No person shall...be deprived of life, liberty, or property, without due process of law.”); U.S. Const., amendment XIV (“No shall...deprive any person of life, liberty, or property, without due process of law.”); *PBGC v. R. A. Gray & Co.*, 467 U.S. 717, 729 (1984).

<sup>22</sup> See *Bank Markazi v. Peterson*, 136 S. Ct. 1310, 1329 (2016) (Roberts, C.J., dissenting).

<sup>23</sup> *United States v. Carlton*, 512 U.S. 26 (1995).

requiring that the taxpayer own the stock before dying, and that it would seek legislation to fix it. That legislation was introduced in February 1987 and passed in December 1987 with retroactive effect to the 1986 law.

The Supreme Court declined to strike down the 14 months of retroactive application, specifically citing that the period of retroactivity was “modest,” the IRS had given quick notice that it would seek a legislative fix, and that the law essentially reverted an unintended change.<sup>24</sup> Left unsaid was whether a similar change without notice and with much more than one year of retroactivity would be permissible. Justice Sandra Day O’Connor concurred separately to warn that anything more than one year would probably violate the Due Process Clause, while Justices Antonin Scalia and Clarence Thomas agreed with her, dubbing retroactive taxation to be “bait-and-switch taxation.”<sup>25</sup>

Older cases that remain valid precedent are clearer. In 1927, a 12-year period of retroactivity was struck down as “so arbitrary and capricious as to amount to confiscation,” violating due process.<sup>26</sup> The next year, the Supreme Court struck down retroactive application of the new gift tax, both for gifts made before the legislation was unveiled and after.<sup>27</sup> In 1934, a new tax on silver with 35 days of retroactive application was upheld with the Court specifically noting that it was only seven days excluding the period counting from when President Roosevelt announced he was seeking the legislation.<sup>28</sup> This may be why the White House is seeking an April 2021 effective date for the retroactive capital gains tax increase, as President Biden announced the proposal on April 28, 2021, although it was not widely publicized at the time and investors are still becoming aware of it.

Retroactive taxes have been struck down under other provisions of the Constitution. In 1887, a retroactive tax law with criminal penalties for non-compliance was invalidated under the ex post facto clause.<sup>29</sup> In 1946, the Court observed that a retroactive punishment masquerading as a tax law may run afoul of the Bill of Attainder Clause.<sup>30</sup>

At the state level, New York courts strike down anything beyond one year of retroactivity, South Carolina courts have called two or three years of retroactivity to be “simply excessive.”<sup>31</sup>

There have been horror stories of retroactive tax laws, primarily at the state level, being imposed on activity that happened years ago. The lack of recent U.S. Supreme Court guidance has erroneously convinced many state judges that there is no constitutional limit on retroactive taxation, with backwards-looking enactments of up to 27 years being upheld in Washington state. Kentucky has upheld over ten years of retroactivity, Michigan six-and-a-half years, California up to four years, and the Ninth Circuit Court of Appeals up to six years.<sup>32</sup> Arizona allows any period of retroactivity if the law is described as curative (clarifying an ambiguous law), and a number of courts have upheld such laws even when they undo judgments won by taxpayers.<sup>33</sup>

<sup>24</sup> See *id.* at 32-33.

<sup>25</sup> *Id.* at 38 (O’Connor, J., concurring in the judgment); *Id.* at 39 (Scalia, J., concurring in the judgment).

<sup>26</sup> See *Nichols v. Coolidge*, 274 U.S. 531, 542-43 (1927).

<sup>27</sup> See *Blodgett v. Holden*, 275 U.S. 142 (1927) & *Untermeyer v. Anderson*, 276 U.S. 440 (1928).

<sup>28</sup> See *United States v. Hudson*, 299 U.S. 498 (1937), citing *Stockdale v. Insurance Cos.*, 87 U.S. 331 (1873) (“As respects income tax statutes, it long has been the practice of Congress to make them retroactive for relatively short periods so as to include profits from transactions consummated while the statute was in process of enactment, or within so much of the calendar year as preceded the enactment, and repeated decisions of this Court have recognized this practice and sustained it as consistent with the due process of law clause of the Constitution.”).

<sup>29</sup> *Burgess v. Salmon*, 97 U.S. 381 (1878).

<sup>30</sup> *United States v. Lovett*, 328 U.S. 303 (1946).

<sup>31</sup> See *James Square Assoc., LP v. Mullen*, 993 N.E. 2d 374, 383 (N.Y. 2013); *Rivers v. State*, 490 S.2d 261, 265 (S.C. 1997).

<sup>32</sup> See *Dot Foods, Inc. v. Dep’t of Revenue*, 372 P.3d 747 (Wash. 2016); *In re Estate of Hambleton*, 335 P.3d 398 (Wash. 2014), *cert. denied*, 136 S. Ct. 318 (2015); *River Garden Ret. Home v. Franchise Tax Bd.*, 113 Cal. Rptr.3d 62, 80 (Cal. Ct. App. 2010); *Miller v. Johnson Controls, Inc.*, 296 S.W.3d 392 (Ky. 2009); *Quarty v. United States*, 170 F.3d 961 (9th Cir. 1999); *Mont. Rail Link, Inc. v. United States*, 76 F.3d 991, 994 (9th Cir. 1996).

<sup>33</sup> See, e.g., *Caprio v. N.Y. State Dep’t of Taxation & Fin.*, 37 N.E. 3d 707 (N.Y. 2015); *Miller v. Johnson Controls, Inc.*, 296 S.W.3d 392 (Ky. 2009); *Allegis Realty Investors v. Novak*, 860 N.E.2d 255 (Ill. 2006); *Ainley Kennels & Fabrication, Inc. v. City of Dubuque*, 888 N.W.2d 680 (Table), 2016 WL 5480688 (Iowa Ct. App. Sep. 28, 2016); *Jefferson Cnty. Comm’n v. Edwards*, 49 So.3d 685 (Ala. 2010); *U.S. Bancorp v. Dep’t of Revenue*, 103 P.3d 85 (Ore. 2004); *Gen. Motors Corp. v. Dep’t of Treasury*, 803 N.W.2d 698 (Mich. Ct. App. 2010); *Gillette Commercial Operations N. Am. & Subsidiaries v. Dep’t of Treasury*, 878 N.2d 891 (Mich. Ct. App. 2015).

Many of these states uphold retroactivity automatically if the state says the purpose is to avoid revenue losses, which is essentially giving the government an automatic win. Sometimes the government is blatant about reversing its own regulation from decades earlier and then demanding back taxes for the intervening years.<sup>34</sup> Often, retroactive assessments are thrown in by auditors or state tax authorities to give them negotiating leverage to push the taxpayer to settle on other claims. Consequently, very few retroactivity cases make it to trial or appeals because taxpayers just want to get the unpleasant process over with, or authorities settle before it gets as far as a pro-taxpayer court decision.

## Conclusion

[NTUF's Taxpayer Defense Center was formed](#) in part to rectify this imbalance against taxpayers and to assist taxpayers without the means or ability to pursue retroactivity cases all the way to a favorable decision.<sup>35</sup> Absent outside help, the vast majority of taxpayers are vulnerable to being intimidated into settling or paying assessed obligations even if the law is in their favor.

Retroactive taxes are bad policy and unconstitutional, and unless President Biden and Congress drop the concept, NTUF will seek opportunities to defend taxpayers from retroactive taxes all the way to the U.S. Supreme Court.

## About the Author

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<sup>34</sup> See, e.g., *Triple-S Management Corp. v. Municipal Revenue Collection Center*, cert. denied, 561 U.S. 1037 (2010). See, e.g., *Triple-S Management Corp. v. Municipal Revenue Collection Center*, cert. denied, 561 U.S. 1037 (2010).

<sup>35</sup> Bishop-Henchman, Joe. "Introducing the Taxpayer Defense Center." National Taxpayers Union Foundation, Jun. 18, 2010, <https://www.ntu.org/foundation/detail/introducing-the-taxpayer-defense-center>.



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