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Retroactive Taxation: A Constitutional Analysis of the Minimum Tax On IDCs†

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As a part of the Tax Reform Act of 1976,[1] Congress enacted the "minimum tax" on Intangible Drilling Costs (IDCs). This tax imposed a 15% levy on the excess of IDCs deducted in one year over the amount of the deduction that would have been allowed if such deduction had been capitalized and amortized. IDCs are generally defined as costs paid for items with no salvage value, such as costs paid to drilling contractors, location and preparation costs paid to the dirt contractor, drilling muds, etc. The tax was effective October 20, 1976, but has been retroactively applied to noncorporate entities that have paid these costs after January 1, 1976.[2]

Litigants and scholars have challenged the constitutionality of the tax on grounds ranging from equal protection to due process. This article, however, will demonstrate that the Act's invalidity, at least in reference to the noncorporate oil and gas producer who derives the bulk of his income from drilling, derives from the constitutional prohibition against retroactive legislation under the due process clause. More generally, the article will identify and clarify the chief source of the confusion surrounding the validity of all retroactive tax statutes, i.e., the courts' chronic use of categorical labels in ruling on retroactive tax statutes' validity when they in fact base their judgments on the foreseeability of the tax in question to the class of taxpayers affected.

The constitutionality of retroactive legislation per se has long been established. In the early 1930s numerous cases upheld tax legislation applied retroactively.[3] But the cases usually appear to hinge the constitutionality of such retroactivity on the kind of tax under consideration, allowing retroactivity across the board in the case of income taxes,

† This article explores what I believe to be an interesting constitutional issue regarding the Federal Tax Code. Since I am a state judge and have no opportunity to pass upon this issue or an analogous one, I feel this is a permissible exercise of scholarly analysis. It is in no way meant to be a political statement or a judicial comment, but merely a scholarly article dealing with a federal constitutional issue which is of a particular and personal interest.

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1. 26 U.S.C. §§ 56, 57(11) (1976).
2. *Id.* § 57(D).
3. Burnet v. Wells, 289 U.S. 670 (1933); Reinecke v. Smith, 289 U.S. 172 (1933); Milliken v. United States, 283 U.S. 15 (1931).

but forbidding them for other taxes, such as those on gifts or estates.

A closer reading of the cases, however, reveals that underlying the courts' distinctions based on the kind of tax are analyses focusing on the foreseeability of the tax in question by the tax-paying class affected. Thus, while retroactive income taxes are usually upheld, it is because they are generally ruled foreseeable. Retroactive gift and estate taxes fail constitutionally because they are not. Therefore, when a specific tax provision like the minimum tax on IDCs is at issue, the proper analysis should key on its foreseeability, not its label as an income tax. When properly analyzed, the minimum tax on IDCs and its effect on the noncorporate oil and gas producer is clearly unconstitutional.

The Foreseeability Test Versus the Label Technique

The foreseeability rule has not always been submerged beneath an analysis ostensibly focusing on the kind of tax under review; it was explicitly relied upon in the United States Supreme Court's opinion in *Welch v. Henry*,[4] where the Court held that the key to a retroactive tax's constitutionality was whether "the nature or amount of the tax could not reasonably have been anticipated by the taxpayer at the time of the particular voluntary act which the statute later made the taxable event."[5] The Court in *Welch* discussed the history of retroactive tax statutes, noting when and in what circumstances they had been upheld or overruled,[6] and further pointed out that in some instances a retroactive tax was declared unconstitutional when a gift or estate tax applied to transactions completed and vested before the enactment of the taxing statute.

By way of contrast, the Court observed that the tax laws upheld as valid usually were retroactive *income* taxes. The Court reasoned further that this was true only because income taxes generally were foreseeable while gift and estate taxes *generally* were not:

> Since, in each of these [gift tax] cases, the donor might freely have chosen to give, or not to give, the taxation, after the choice was made, of a gift which he might well have refrained from making had he anticipated the tax, was thought to be so arbitrary and oppressive as to be a denial of due process. . . . Similarly, a tax on the receipt of income is not comparable to a gift tax. We cannot assume that stockholders would refuse to receive corporate dividends even if they knew that their receipts would later be subjected to a new tax or to the increase of an old one. . . .[7]

4. 305 U.S. 134 (1938).
5. *Id.* at 147.
6. *Id.*
7. *Id.* at 147-48.

Yet the Court in *Welch* made clear that the simple categorization of a tax as an income, gift, or estate tax did not determine its validity as a retroactive tax.[8] On the contrary, the Court expressly recognized that "other forms" of retroactive taxation could be upheld, even as applied to gift or estate taxes:

> [T]here are other forms of taxation whose retroactive imposition cannot be said to be similarly offensive, because their incidence is not on the voluntary act of the taxpayer. And even a retroactive gift tax has been held valid where the donor was forewarned by the statute books of the possibility of such a levy. [Citations omitted.]
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> . . .
>
> In each case it is necessary 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 so oppressive as to transgress the constitutional limitation.[9]

In short, *Welch* stressed *foreseeability* as the key to determining the validity of a retroactive tax statute. Though historically the Court has more often upheld retroactive income taxes than retroactive estate or gift taxes, the true test of the validity of a retroactive tax has always been the foreseeability of the tax and the reasonableness of taxpayer reliance on legislative inaction in the field of a given transaction.

The courts have adhered to this rule since *Untermyer v. Anderson*.[10] In striking down a retroactive gift tax in *Untermyer* as unconstitutional even though the gift was made while the bill was pending in Congress, the Supreme Court emphasized the factor of foreseeability:

> The mere fact that a gift was made while the bill containing the questioned provisions was in the last stage of progress through Congress we think is not enough . . . to relieve the legislation of the arbitrary character there ascribed to it. To accept the contrary view would produce insuperable difficulties touching interpretation and practical application of the statute, and render impossible proper understanding of the burden intended to be imposed. The taxpayer may justly demand to know when and how he becomes liable for taxes—he cannot foresee and ought not to be required to guess the outcome of pending measures. The future of every bill while before Congress is necessarily uncertain. The will of the lawmakers is not definitely expressed until final action thereon has been taken.[11]

Similarly, the Supreme Court held another gift tax unconstitutional

8. *Id.* at 147.
9. *Id.*
10. 276 U.S. 440 (1928).
11. *Id.* at 445-46.

in *Blodgett v. Holden.*[12] Relying on *Nichols v. Coolidge,*[13] the Court held: "It seems wholly unreasonable that one who, in entire good faith and without the slightest premonition of such consequence, made absolute disposition of his property by gifts should thereafter be required to pay a charge for so doing."[14]

Where retroactive taxes have been upheld, the decision sustaining their validity has been grounded in the foreseeability of such taxes and the resulting lack of taxpayer's reliance on their absence. In *Milliken v. United States,*[15] the Supreme Court upheld an estate tax providing for the inclusion of the value of property transferred in contemplation of death (prior to the statute's enactment) in the gross estate because of the enactment's similarity to existing tax statutes. The statute was constitutional because analogous earlier statutes imposed a tax on gifts made in contemplation of death and these statutes were in effect at the time of the gift "computed at the same value and rate as though the property given had been a part of the donor's estate passing at death."[16]

Had the Court in *Milliken* based its decision on simple categorization (income taxes *qua* income taxes), the tax would have been unconstitutional based on the *Nichols, Blodgett,* and *Untermyer* decisions. Instead, the Court followed its reasoning of *Welch* and stressed that foreseeability was the key issue as to a tax statute's validity. It held that the tax in question was foreseeable because of its similarity to previous and existing tax statutes. Because of such similarity, the taxpayer's actions were not adversely affected by a reasonable reliance upon the present tax structure.

When viewed in light of these cases, it becomes clear why retroactive income taxes have so often been upheld.[17] Income taxes are continuing obligations and have similar and foreseeable rates; therefore, the anticipated alteration of the details of the income tax structure does not generally change the taxpayer's behavior or reliance. In *Reinecke v. Smith,*[18] the statute merely included the income of a revocable trust in the income of the settlor for purposes of taxation. Similarly, in *Burnet v. Wells,*[19] the statute taxed to the creator of the trust so much of the income thereof as was devoted to maintaining an insurance policy

12. 275 U.S. 142 (1927).
13. 274 U.S. 531 (1927).
14. Blodgett v. Holden, 275 U.S. 142, 147 (1927).
15. 283 U.S. 15 (1930).
16. *Id.* at 22.
17. Burnet v. Wells, 289 U.S. 670 (1933); Reinecke v. Smith, 289 U.S. 172 (1933).
18. 289 U.S. 172 (1933).
19. 289 U.S. 670 (1933).

on his life. In neither of those cases would either the conduct of earning income or creating the trust have been significantly changed by the enactment of the statute. The tax merely classified as income funds generated by a trust. The primary goal of the taxpayer, creating the trust, would have occurred regardless of how the trust income was classified for tax purposes.

> In those cases [cases omitted] the issue was the validity of a tax on a transaction consummated before the enactment of the statute authorizing the exaction. In the present case the subject of the tax is not the creation of the trusts or the transfer of the corpus. . . , but the income of the trusts. . . .[20]

Moreover, the type of taxes enacted were not new or novel, and therefore could have been contemplated by the settlor of the trust had the tax treatment of the trust been the primary consideration.

One of the clearest and more recent affirmations of the *Welch* test was by the Tenth Circuit in *Shanahan v. United States*.[21] In holding a retroactive tax statute constitutional, the court held that foreseeability was the key issue and thus explained why retroactive gift and estate taxes usually constitutionally fail where income taxes prevail:

> [T]he justification for upholding retroactive income taxation does not apply to estate and gift taxes because it cannot be assumed that the taxpayer would dispose of his property in the same manner if he had known about the consequences in relation to the tax.[22]
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> . . .
>
> The test set forth in *Welch v. Henry*, supra, is to consider the nature of the tax and the circumstances in which it is laid. Retroactive operation is constitutional where it is not harsh, arbitrary or unfair. . . .[23]

The court here clearly adumbrates a theory of foreseeability that is not wholly defined in the ordinary sense of anticipation or expectation, but which instead looks at the question from the perspective of hindsight and stresses the quality of the change's impact—"harsh, arbitary or unfair"—over the degree of likelihood or unlikelihood of its enactment. The court then postulates the question, "Given this enactment's *impact*, would the taxpayer have altered his or her course of behavior?"

The court in *Shanahan* believed that gift and estate taxes were usually struck down because taxpayers would have behaved differently had

20. Reinecke v. Smith, 289 U.S. 172, 175 (1933).
21. 447 F.2d 1082 (10th Cir. 1971).
22. *Id.* at 1083.
23. *Id.* at 1084.

they foreseen the tax. On the other hand, the court reasoned that traditional income taxes, being foreseeable and continuing obligations, usually did not affect taxpayers by influencing their decision to produce income.[24] In justifying its decision by explicitly affirming the *Welch* decision,[25] this circuit adopted a test that does not determine the validity of a retroactive tax by classifying it rigidly as an income tax or gift estate tax. Instead, *Shanahan* stressed the nature and foreseeability of the tax and its fairness under the particular circumstances.

Many circuit courts have also applied the *Shanahan* foreseeability test, administered hypothetically from the perspective of hindsight, and found it to be a workable constitutional test. In *Adams Nursing Home of Williamstown, Inc. v. Mathews,*[26] the First Circuit noted the following test of foreseeability: "In any retroactivity challenge, a central question is how the challenger's conduct, or the conduct of others in his class, would have differed if the law in issue had applied from the start."[27] In *Purvis v. United States,*[28] the Ninth Circuit determined the validity of a retroactive tax statute by analyzing the nature of the tax and the circumstances in which it was laid. The court then outlined its view of foreseeability as the key to upholding the tax in question: "[W]ith the widespread *notice* given to the investing public it cannot be said that retroactive application of this tax was oppressive or harsh or confiscatory."[29]

Using a somewhat similar analysis, the Court of Claims in *First National Bank of Dallas v. United States*[30] held that the retroactive application of a statute imposing interest equalization taxes on foreign stock acquisitions by United States citizens was not arbitrary and capricious and did not constitute deprivation of property without due process of law. In so holding, the court premised its view on the fact that in this particular tax statute there was extensive nonstatutory *notice* prior to the enactment of the retroactive tax. But unlike *Shanahan,* the focus was not on the oppressive quality of the tax from a perspective of hindsight, but rather was on the more traditional notice of foreseeability, i.e., foreseeability judged from the perspective of the taxpayer at the time of his actions. The issue was not oppression or harshness, but publication: Had the taxpayers been adequately forewarned?

24. *Id.* at 1082.
25. *Id.* at 1084.
26. 548 F.2d 1077 (1st Cir. 1977).
27. *Id.* at 1081.
28. 501 F.2d 311 (9th Cir. 1974), *cert. denied,* 420 U.S. 947 (1975).
29. *Id.* at 314.
30. 420 F.2d 725 (Ct. Cl.), *cert. denied,* 398 U.S. 950 (1970).

In discussing what it believed to be the crucial issue of notice (or foreseeability), the court noted that President Kennedy had delivered to both Houses of Congress a message in July of 1963 where he proposed an "interest equalization tax,"[31] the purpose of which was to alleviate the United States' balance of payment problem by restricting long-term capital outflow from the United States. The proposed tax was to be levied on purchases of foreign securities by United States citizens from foreign persons at an effective rate of 15% of the value of the equity securities. After the presidential message was made public, prices of stocks and bonds dropped on foreign exchanges and markets reflected a strengthening position of the dollar and a rise in the prices of United States bonds and Treasury bills. After July 1963, it became generally known among dealers and brokers in stocks and bonds, both in the United States and abroad, that the Kennedy administration had recommended that the tax be effective on July 19, 1963. The President specifically stated that the tax, once enacted, would be retroactive to the date of this address.

The Treasury Department issued a 25-page detailed explanation of the interest equalization tax and a 6-page brochure on information about that tax. The *Federal Register* of August 1963 carried a notice of the proposed effective date of the bill and meetings between representatives of the Treasury Department and those of the stock exchanges were held to procedurally implement the tax.

In upholding this tax, the court made it clear that the true test of validity of the retroactive tax statute was its foreseeability and not its characterization[32]:

> It is well settled that an income tax statute *may* be given retroactive effect without violating the Constitution. [Cases omitted.] . . .An examination of this principle reveals certain motivating considerations. . . . An income tax is levied, moreover upon the proceeds of an "involuntary act," that is, it is generally assumed that a taxpayer will generate income, rather than refrain from so doing, irrespective of the imposition of a tax upon that income. And, perhaps of greatest importance, because the income tax has become a recognized fact of life, taxpayers will presume to be on notice.[33]
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> . . .
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> Accordingly, it is our view that where there is reasonable cause to believe or expect that a tax will be imposed upon a presently nontaxable transaction, the retrospective application of such tax does not constitute a denial of due process. . . . Nor do the early

31. *Id.* at 726-27.
32. *Id.*
33. *Id.* at 729.

> tax decisions of the Supreme Court relied upon by the Plaintiff impart otherwise. See *Nichols v. Coolidge*, *Blodgett v. Holden*, *Untermyer v. Anderson*. . . . [Citations omitted.][34]

Certainly not all retroactive taxes can be accompanied by the notice that the "interest equalization tax" had. Yet, there are certain identifiable qualities that a tax may possess that will put the taxpayer constitutionally on notice. Most important, is the tax similar to an existing tax or is it a new or novel one, either in its nature or application? Two, has there been substantial notice of the pending tax to the class of taxpayers affected? Such notice could be by way of legislative debate or by media publicity. The more novel the proposed tax the greater the debate and/or publicity required. By contrast, a proposal similar to existing law would require less attention by the media or by way of legislative debate. Finally, the issue of foreseeability is one of class foreseeability, i.e., would a reasonable member of the tax-paying class affected be on notice, as opposed to a standard of individual foreseeability.

The Retroactive Minimum Tax on IDCs

It is clear that there was extensive publicity surrounding the Tax Reform Act of 1976, and IDC provisions gained particular notoriety.[35] Certainly the oil industry was on alert that some sort of tax on intangible drilling expenses was imminent. Yet the bill debated in Congress and reported in the news media was of a very different *character* than the one finally passed. In particular, the bill the industry anticipated would not have affected those engaged in the oil industry as a primary occupation. Rather, the proposed bill was aimed only at those who used oil and gas investments as a means to shelter unrelated income derived from other sources.

The original House bill, H.R. 10612, was reported on November 12, 1975.[36] The committee report accompanying that bill made it clear that it would not affect the oil producer who derived his primary living from oil and gas operations:

> In the case of an oil and gas drilling venture, the primary item which generates losses for taxpayers seeking to shelter unrelated income from tax is the deduction for intangible drilling and development costs. The allowance of an immediate deduction for intangible drilling and development costs enables taxpayers to invest in a

34. *Id.* at 730.
35. See *infra* text accompanying notes 39-43.
36. H.R. REP. No. 658, 94th Cong., 2d Sess., *reprinted in* 1976 U.S. CODE CONG. & AD. NEWS 2948-49.

> drilling venture in one year and obtain a deferral of income taxes on much or all of their income from other sources in that year because of the losses of the drilling venture generated by the deduction for the intangible drilling costs.
>
> Allowing a current deduction for intangible drilling costs is usually justified on the grounds that it provides an incentive for the discovery of needed reserves of oil and gas. For this purpose the deduction for intangibles can be an efficient incentive (relative to other tax incentives) since it directly encourages new drilling. However, the use of these deductions to reduce income taxes on unrelated income allows investing taxpayers to pay a much lower proportion of their overall income in taxes than is paid by other taxpayers.
>
> Furthermore, allowing these deductions to reduce taxes on unrelated income has in many cases led to these investments being marketed solely for their tax advantages rather than on the basis of the underlying soundness of the investment. This distorts the workings of the market system and may tempt taxpayers to throw away their money in unwise ventures in an attempt to reduce income tax payments. . . .
>
> To prevent taxpayers from sheltering unrelated income from current taxation, your committee believes it is appropriate to apply LAL to the intangible drilling and development costs for oil and gas properties. . . .[37]

The language and intent of the original House bill clearly aimed at denying the full deduction for intangible drilling expenses to those not deriving their principal income from the oil business. This is why oil producers viewed the tax as limited to *income unrelated to oil and gas revenues*. In other words, the intent of the bill was to tax investors who do not earn their primary income by drilling for oil and gas. Thus, those whose primary income was derived from the drilling of oil wells had no prior notice that the bill was to be applicable to them. Indeed, the rationale of the bill was aimed *solely* at those whose primary income was unrelated to the oil and gas business.

Similarly, the original Senate proposal would not have applied the tax to revenues derived from oil and gas sources. The original Senate Report accompanying H.R. 10612 only applied the tax to income unrelated to oil and gas revenues. As reported on June 10 and July 20, 1976,[38] the Senate version did not apply to those whose primary business was drilling for oil and gas:

37. *Id.*

38. S. Doc. No. 939, 94th Cong., 2d Sess., *reprinted in* 1976 U.S. CODE CONG. & AD. NEWS 3546-47.

> Intangible drilling expenses in excess of related income.—The Committee amendment also adds an item of tax preference for accelerated intangible drilling expenses on oil and gas wells in excess of related income. . . .[39]
>
> Related income from oil and gas, which reduces the amount of intangible drilling costs included in the minimum tax base, includes gross income from oil and gas production (as defined for purposes of computing the deduction for percentage depletion) less deductions for other than the deduction for accelerated intangible drilling expenses. (Related income is computed by deducting non-accelerated and intangible drilling costs). . . .[40]

From the time the proposed tax was introduced in Congress through September 13, 1976, the oil producer was not on notice that the tax would apply to his income so long as that income was oil and gas-related and the intangible drilling expenses did not exceed that income. But the bill was suddenly amended in Conference Committee to eliminate the "unrelated" provision, thereby changing the tax's entire purpose and scope.

The measure passed September 16, 1976 without the unrelated income provision and became effective October 20, 1976. Therefore, the industry was not on notice or forewarned that the tax would apply to it during the better part of the 1976 tax year. In fact, it did not learn that the tax would apply to it until the tax year was three-fourths over.

Moreover, the media treatment of the tax did not forewarn the industry that the tax was applicable to it. To the contrary, the tax was characterized as being aimed at only those using the oil and gas business to shelter "unrelated income":

"The bill also eliminates some of the most egregious of the shelters. . . ."[41]

"The issues involved were of surpassing complexity, and the possible outcomes made a big difference to the various types of wealthy investor taxpayers and tax-sheltered investments.

"The well-off doctor or lawyer who has some capital gains, . . . used to be able to reduce his tax to a nominal amount. But no more. . . ."[42]

"It trimmed back allowances for special tax 'shelters' in real estate, cattle raising, oil and gas drilling. . . ."[43]

39. *Id.* at 3546.
40. *Id.* at 3547.
41. Washington Post, Sept. 13, 1976, at A22, col. 1.
42. *Id.*
43. 174 NEW REPUBLIC 3-4 (June 26, 1976).

"It takes dead aim at several tax 'preferences' previously granted to help well-heeled investors 'shelter' their income from the IRS . . . the axe fell hardest on individuals investing in oil and gas drilling programs. . . . In the past, a *doctor* sinking $100,000.00 into an oil drilling program for example, could deduct his full investment. . . ."[44]

"restricts use of shelters in real estate, farms, oil and gas drillings, movies. . . ."[45]

Conclusion

The tax on excess intangible drilling expenses was originally aimed at those who invested "unrelated" income in oil and gas operations to shelter such income. The bill was not to apply to those primarily involved in the oil and gas business, who had very little or no "unrelated" income. Moreover, the bill was introduced into Congress with language affecting only unrelated income and was debated in Congress and reported in the news media with such language for three-fourths of the tax year. Only in late September was the bill suddenly redirected and applied to related income.

The foregoing analysis offers compelling reasons why the "minimum tax" should not constitutionally apply to the oil and gas producer who derives the majority of his income from this industry. Yet the merit of the suggested approach to judging retroactive tax statutes should go beyond the example at issue: the most fundamental concept implicit in due process is notice. Although retroactive tax statutes will always give rise to concern regarding whether the class affected has notice, the test of foreseeability is an analytically and historically sound way to deal with that concern while still allowing Congress the flexibility it must have in exercising the taxing power.

Editor's Note: In December 1982, the Court of Appeals for the Tenth Circuit upheld the constitutionality of retroactive minimum taxation of intangible drilling costs.[46] The taxpayer, a sole proprietorship, had actively lobbied in Washington, D.C., concerning the Tax Reform Act of 1976. In early 1976 the taxpayer became convinced that the proposed minimum tax would not be imposed upon independent oil and gas producers and commenced drilling operations prior to the passage of the Act. The court rejected taxpayer's argument, based on the fact that imposition of the tax was not foreseeable to him at the time drilling operations commenced. The court reasoned that because the addition of IDCs as an item of minimum taxation had been discussed since

44. Ruby, *Adding Up The New Tax Bill*, NEWSWEEK, Sept. 20, 1976, at 67.
45. BUSINESS WEEK, Sept. 27, 1976, at 27-28.
46. Ward v. United States, 695 F.2d 1351 (10th Cir. 1982).

the original House Ways and Means Committee report, dated November 12, 1975, taxpayer could not argue that he had absolutely no reason to expect that the transaction would be taxed.[47] The court went on to hold that the minimum tax on IDCs was an income, rather than an excise, tax, and, hence, was not deductible as a business expense.[48]

47. *Id.*
48. *Id.* at 1355.