Government Precommitment to Tax Incentive Subsidies: The Impact of United States v. Winstar Corp. on Retroactive Tax Legislation

Daniel S. Goldberg

I. Introduction

United States v. Winstar Corp.¹ held that the U.S. government, through its regulatory agencies, can be bound contractually by its promises to private entities who acted in reliance on those government promises and made substantial investments. As a result, later legislation that reneged on those promises constituted a breach of contract by the government for which it was liable for damages.

Winstar dealt specifically with a savings and loan acquisition and subsequent FIRREA legislation, which deprived the acquirors of the benefits of the acquisition. The government, through its agencies the Federal Savings and Loan Insurance Corporation (FSLIC) and the Federal Home Loan Bank Board (Bank Board), sought to encourage healthy thrifts and outside investors to take over ailing thrifts. It did this by permitting acquiring thrifts to record as an asset, labeled “supervisory goodwill,” the excess of the purchase price of the acquired thrift over its identifiable assets. This intangible asset was permitted to be counted in the capital of the acquiring thrift for purposes of measuring that thrift’s net worth and capital and reserves requirements.

Congress’ passage of the Financial Institution Reform, Re-

covery and Enforcement Act of 1989 (FIRREA)\(^2\) forbade this treatment, even for thrifts for whom supervisory mergers had been approved previously by the government agencies. The new legislation caused Winstar and the other thrifts who brought the case to fail the capital requirements and, therefore, to either be liquidated or to be recapitalized with new private funds.

The Supreme Court held the government to its contractual commitment to permit advantageous accounting treatment to the savings and loan associations. Accordingly, the Court ruled the government liable for damages for breaching its contract when Congress abrogated its commitment through the FIRREA legislation. In effect, the Court precluded the government from reneging on a contractual promise it made to the S&Ls through later overriding legislation.

*Winstar*'s importance reaches well beyond the savings and loan industry because it deals with, and its opinions discuss, a fundamental relationship. That fundamental relationship is between the government's power to contract with private persons and to have its promises enforced against it, and the government's power to legislate and thereby regulate society without constraint by its prior agreement. *Winstar* opens many and answers some questions regarding the reliance one can place on the government's promises.

This Article investigates the application of *Winstar* to tax legislation that is designed to create incentives for taxpayers to engage in certain desired conduct in exchange for advantageous tax treatment now and in the future. It examines the extent to which taxpayers may rely on those government promises and the policy implications that lead from that examination.

This question is particularly important at the present time, because tax reform is once again on the political agenda. It is likely that during the next Congressional session there will be significant tax changes, perhaps even a move to some form of consumption tax, which would eliminate important income tax deductions upon which many taxpayers have relied.

Tax law changes that adversely affect some taxpayers and remove benefits associated with previous investments inevitably raise the issue whether adversely affected taxpayers should be protected from the adverse effects of the legislation through transition relief. In its simplest form, transition relief involves

grandfathering pre-change investments, permitting those investments to continue to enjoy any tax benefits that were available under previous law. More ambitiously, transition relief might include compensating the taxpayer for lost value resulting from an adverse change in the tax rules.

Until recently, conventional wisdom held that transition relief was neither required nor desirable. Professors Graetz and Kaplow, in successive articles, contended that economic efficiency demands that changes be made without transition relief, and that the market for property already reflects the risk that any tax benefits associated with the property may be withdrawn without transition relief. Accordingly, transition relief represents a subsidy that augments what would normally result from the operation of a free market. Professor Graetz went one step further and suggested that transition relief creates an impediment to accomplishing horizontal equity in the tax system and, therefore, is inconsistent with fair treatment for all taxpayers. Another tax scholar has even suggested that current taxation of previously earned income might be a desirable policy course, because it would not adversely affect work or savings incentives in the future. These are not merely academic theories; the attitude eschewing transition relief was very much reflected in the Tax Reform Act of 1986, which made significant changes to the tax treatment of passive investments such as rental real estate, with only limited transition relief in the form of a four-year phase-in rule.

More recently, however, tax scholars have begun to question this conventional wisdom. Both Professor Logue, in a recent article and I, in an even earlier article, have argued that the government should guarantee grandfather treatment whenever tax incentive subsidies, and perhaps other beneficial tax provi-

5. Graetz, supra note 3, at 79-80.
9. Tax incentive subsidies are provisions enacted to induce taxpayers to engage in desired behavior or make desired investments by subsidizing the behavior or invest-
sions, are repealed or substantially reduced. This position follows from a belief that the government makes promises that are embedded in legislative tax incentive subsidies, and should keep these promises just as it would if it were bound by contract. Professor Logue's most significant contribution to the dialog lies in his belief in the efficacy of precommitment devices as a viable means of assuring transition relief and of assuring taxpayers that they will be able to enjoy the subsidy upon which they have relied. He has asserted that tax incentive subsidies can work well and efficiently only if the government can be forced to maintain those subsidies. That can be accomplished, even if the subsidies are to be made through tax benefits available to taxpayers in future years, if the government makes use of one of several precommitment devices. Logue referred to the lower court opinion in *Winstar Corp. v. United States* in fashioning such a precommitment device.

This Article, in contrast, takes the position that the government cannot effectively precommit for future years. As a result, the risk of tax changes that will affect the investment must be borne by investors and must be factored into the computation of expected return.

The Supreme Court's opinion in *Winstar*, and the concurring and dissenting opinions, sheds important light on the role and dependability of government promises and therefore on tax incentive transition relief questions. Indeed, *Winstar* is the most important Supreme Court pronouncement regarding government commitment that binds future Congresses. Accordingly, tax incentive legislation must be evaluated in light of its implications.

This Article asserts that the *Winstar* decision does not reach so far as to permit Congress to precommit to a future tax treatment because, under current law, one Congress cannot bind a future Congress in the area of taxation through mere legislation, even if that legislation purports to create contractual rights. It follows from this principle that periodic tax incentives, which rely on future Congresses being bound by the actions of a past Congress, will prove undependable because the government cannot effectively commit itself to being bound by them.

Yet, because tax incentive provisions that can be changed without transition relief are not economically efficient, it is im-

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10. *See Logue, supra* note 7, at 118.
important, in order to accomplish economic efficiency, to assure taxpayers that they will be able to obtain the promised tax treatment. It is equally important that the government not make a promise that purports to give this assurance but is thereafter repudiated. Thus, it is likely that the only means of assuring investors of the ability to enjoy the promised subsidy is to grant that subsidy on a one-time basis, rather than allowing a periodic subsidy to be enjoyed in subsequent years.

Notwithstanding its limits, Winstar is important with regard to tax legislation, because in the opinion the Court embraces the principle that the government may not unilaterally renego a promise relied upon by the intended beneficiary of the promise. Reliance is an important factor to be weighed in constraining government action. The principle of reliance should be employed in balancing interests regarding when retroactive taxation should be permissible. Although application of this principle will not likely reduce the substantial risk of nominally prospective changes that have retroactive effect, its application should preclude truly retroactive tax legislation. As a result, one-time subsidies, once received, should be inviolate. As such, they stand on a much stronger footing, and should be chosen over periodic incentives in order to maximize the efficiency of a tax incentive program.

This Article will briefly restate the underlying premise that economic efficiency requires predictability of the tax laws and effective assurance that a subsidy once offered will not be removed after the taxpayer has made the desired investment. It will explore the state of the law and scholarly writing regarding retroactive taxation prior to Winstar. It will then evaluate the precommitment device of granting contractual rights through legislation, as well as certain others, in light of the Supreme Court's decision in Winstar. Finally, it will conclude that because Congress cannot effectively precommit to the future advantageous tax treatment of an investment, the investment will be at risk with regard to future changes in the tax law. In addition, because precommitment devices are either impractical or otherwise unattainable, the only means of achieving taxpayer assurance, under either an income base or consumption base tax system, is through one-time subsidies.
II. THE IMPORTANCE OF PRECOMMITMENT: ECONOMIC EFFICIENCY AND THE PREDICTABILITY OF THE TAX LAWS

To best understand the nature of the precommitment issue, one must first understand the importance of precommitment to achieve efficiency. Subsidies that are determinable in both amount and duration, whether one-time or periodic, are more easily evaluated by prospective recipients in their investment decision process than indeterminate subsidies. Knowledge of the duration of a subsidy is necessary for accurate present value calculations. Creating uncertainty in the amount of the subsidy, such as by making a periodic subsidy uncertain in duration and subject to removal by legislative whim, is economically inefficient because it requires the government to compensate prospective recipients of the subsidy by including a risk premium in the subsidy. Inclusion of a risk premium results in overpaying for desired activities unless, of course, the subsidy is removed before its expected term has expired.11

In contrast, a subsidy that is certain in duration and not subject to removal without transition relief is predictable for its recipients. Economic efficiency is served by predictable tax subsidies (if there are to be subsidies at all) because those who act in reliance upon them need not be compensated by a risk premium for suffering uncertainty. As long as there is a risk of uncompensated termination, a subsidy cannot attain complete predictability. Periodic subsidies are most subject to this inefficiency.

It might be argued that the payment of the risk premium buys government flexibility to alter or terminate the subsidy program mid-course, a right that could be of substantial value to the government. However, if the government expressly reserved this right and exercised it with any frequency, the risk premium required to reflect the lottery nature of the incentive program would increase substantially. Moreover, recognition by Congress of that reserved right would likely encourage exercise of the right, further increasing the required risk premium for future incentive programs.

Periodic subsidies are also subject to an additional uncertainty. Even if the duration of a periodic subsidy were assured,  

11. One could argue, however, that a risk taker might actually pay a premium, i.e., accept a lesser subsidy, in order to enter this lottery.
its value could not be because of potential changes in the structural components of the income tax, such as tax rates, income levels, and market conditions. As a result, the need for risk premiums for periodic subsidies cannot be avoided.

The inefficiency in the subsidy would likely exceed the risk premium attributable to the fact that the subsidy lacks certainty. That would occur if subsidy recipients were successful in exploiting the political process to obtain transition relief from a risk for which they had been compensated.\(^\text{12}\) For example, if taxpayers who expected a periodic subsidy to last only a short time and valued it as such using a present discount calculation were successful in keeping the subsidy in effect for a longer time, then those who found it beneficial to act even based upon the short-term calculation would receive a windfall at the government's expense.

In addition, unpredictable subsidies that are at risk of termination or reversal without transition relief would impose inefficiency costs on the economy through increased administrative costs of the tax system arising from demoralization. That is because removal or reversal of a subsidy without transition relief likely will be regarded by its recipients as unfair. Unfairness will be perceived to the extent that recipients expect the promise inherent in the subsidy to be honored until the end of its expected term, and that they do not perceive the risk of early termination as a risk already reflected in the price of the investment.\(^\text{13}\) Enforcement of a tax system that is viewed as unfair will require a good deal of coercive governmental power, which will increase administrative costs. A self-assessment system depends in large part on voluntary compliance and I would suggest that voluntary compliance would decrease as the tax system is regarded as generally more unfair.

The predictability and, therefore, the efficiency of a tax incentive subsidy depends upon whether the government can convincingly precommit to be bound by its legislative promise regarding the future tax treatment of the investment. If Congress can bind itself and future Congresses, then it can enact tax in-


\(^\text{13}\) If the risk is generally regarded as already reflected in the price, then any lack of protection through transition relief would not entail these demoralization costs.
centive legislation and assure those who rely on the legislation in making investments that the future benefits will be available to them. Investors will not thereby demand a significant premium for undertaking the risk of premature removal. The ability to precommit, therefore, allows legislators to be more flexible and creative in designing tax incentive programs.

If precommitment is not possible, on the other hand, then a significant risk premium cannot be avoided where legislation promises future and not simply present benefits to a taxpayer. Under these circumstances, legislation with promises of future benefits would be inefficient.

III. PROTECTION AGAINST RETROACTIVITY AS A MATTER OF LAW

A. THE LAW PRIOR TO WINSTAR

In the federal tax area, it is commonplace for tax legislation to be nominally prospective with retroactive effect (nominally prospective) because it adversely changes the tax treatment of an investment in the years following enactment and thereby reduces the current value of the investment. It is also not unusual for tax legislation to be retroactive, at least to the beginning of the year of enactment and sometimes even before (retroactive). The law regarding the constitutional restraints on the government's power of taxation that either imposes taxes on future years by changing the tax rules applicable to certain property, i.e., nominally prospective, or actually imposes a tax on the taxpayer's past activities, i.e., retroactive, is not well settled. Indeed, there has been no modern day challenge to the government's ability to make nominally prospective tax changes that are retroactive in effect.\textsuperscript{14} i.e., that affect tax liabilities in the current or future years arising from past transactions. Further, in \textit{United States v. Carlton},\textsuperscript{15} a taxpayer was unsuccessful in challenging a truly retroactive tax, but arguably under special

\textsuperscript{14} Levmore has taken the position that retroactive taxation, that is, legislation that exacts a tax on a previous year's income or transaction, is entirely legal. He supports his contention that retroactive taxes are legally permissible with the bold statement that "[A]lthough the Supreme Court has struck down a variety of statutes because of their retroactive effects, it has never struck down an income tax provision on this ground, and no modern court has held any federal tax provision illegal." Levmore, \textit{supra} note 6, at 270.

\textsuperscript{15} 512 U.S. 26 (1994). See discussion at notes 20 to 26, \textit{infra}, and accompanying text.
circumstances. In that case, three views were expressed (the majority and two concurring opinions) regarding the rationale for allowing retroactive taxation and its permissible limits.

B. THE RECENT CASE LAW PRIOR TO WINSTAR

The Supreme Court has made clear that Congressional authority to make retroactive changes is not unlimited and must satisfy due process requirements.\(^\text{16}\) It has left the precise limits of Congressional power unclear, however. In *United States v. Darusmont*, the Supreme Court upheld the retroactive application of the 1976 amendments (signed by the President on October 4, 1976) to the Internal Revenue Code's minimum tax provisions, which applied to transactions made in the portion of the year (July 15, 1976) prior to those amendments. The Court's opinion stated the following:

The Court consistently has held that application of an income tax statute to the entire calendar year in which the enactment took place does not *per se* violate the Due Process Clause . . . .\(^\text{17}\)

The Court also noted that the Revenue Acts of 1918 and 1926 had each applied to an entire calendar year that had expired preceding enactment, but added that "[T]his ‘retroactive’ application apparently has been confined to short and limited periods required by the practicalities of producing national legislation."\(^\text{18}\) Previous cases have justified this practice in order to include in the tax base "profits from transactions consummated

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16. *United States v. Darusmont*, 449 U.S. 292 (1981) (per curium). Curiously, a leading constitutional law text, JOHN E. NOWAK & RONALD ROTUNDA, *CONSTITUTIONAL LAW* 423 (5th ed. 1995), cites *Darusmont* for the much expanded proposition that the amendment can reach back to a year earlier than the year of enactment, a situation not presented in *Darusmont*, and that is likely subject to additional qualification. Specifically, Nowak and Rotunda state the following:

The Supreme Court has little difficulty in upholding amendments to income tax laws. Individuals should be on notice that all income may be subject to federal or state taxation at some future time. Income taxes are often modified, or tax rates increased, in order to meet revenue goals of governments. The legislative process is such that changes in the Internal Revenue Code are often considered by Congress for several months prior to their enactment. Statutes modifying the Internal Revenue Code often have a retroactive application of a year or less. The application of such tax changes to a prior tax year is rationally related to the legitimate government interest in raising revenue in accordance with current government economic policies. (emphasis added)

*Id.* at 423.

17. 449 U.S. at 297 (citing Hochman, *infra* note 31, as well as other authorities).

18. 449 U.S. at 296-97.
while the statute was in process of enactment, or within so much of the calendar year as preceded enactment . . . .” 19

The Court again permitted a retroactive change in the tax law in United States v. Carlton, 20 although under special circumstances. In Carlton the Court upheld a 1987 amendment to a tax provision originally enacted in 1986 that was designed as a “curative measure” to correct what Congress reasonably viewed as a mistake in the 1986 enactment. Congress had adopted as part of the Tax Reform Act of 1986 a special estate tax deduction in the amount of one-half of the proceeds of sale if an estate sold employer securities to an Employee Stock Ownership Plan (ESOP). Carlton, the executor of an estate, in late 1986, after the effective date of the new law, purchased shares of a company's stock and sold them to the company's ESOP, at a loss, and claimed an estate tax deduction equal to one-half of the proceeds of sale, consistent with the recently passed provision. In response to these kinds of “unintended” transactions, Congress, in December 1987, amended the statute retroactively to apply only to shares owned by the decedent “immediately before his death.”

The Supreme Court upheld the retroactive application of the law to Carlton against an argument that it violated due process. Such a retroactive change was viewed by the Court as not “illegitimate nor arbitrary,” 21 and therefore satisfied the Court’s requirement that the legislation was not “arbitrary and irrational legislation” 22 but rather was “rationally related to a legitimate legislative purpose.” 23 The fact that Congress acted promptly to correct its mistake and thereby “established only a modest period of retroactivity” 24 (retroactivity extended back slightly more than one year and was proposed within a few months of the tax provision's original enactment) was a significant factor in the Court's decision that the amendment’s retroac-

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21. Id. at 32.
22. Id. at 30. The Court views this test as the equivalent of the “harsh and oppressive” test set forth in Welch v. Henry, 305 U.S. 134, 147 (1938) (“retroactive application [may be] so harsh and oppressive as to transgress the constitutional limitation [of the Due Process Clause].”)
23. Id. at 31. The Court stated that this was the same test “that applies generally to enactments in the sphere of economic policy.” Id.
24. Id. at 32.
tive application met the due process requirements. 25

Interestingly, the Court distinguished the situation in Carlton from one in which Congress had an improper motive such as "targeting estate representatives such as Carlton after deliberately inducing them to engage in ESOP transactions." 26 The retroactive reversal of a one-time tax subsidy, specifically designed to induce a taxpayer to engage in the activity desired by Congress, appears to be precisely the kind of legislation that would fail to satisfy the Court's "rational legislative purpose" test required for retroactivity, if one were to take the Court's discussion at face value.

C. THE COMMENTATORS

Professor Levmore has suggested that tax legislation is generally given wide latitude and any attempt to find particular tax legislation invalid, including retroactive tax legislation—either actual or nominally prospective—faces an up-hill battle. 27

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25. Justice O'Connor's concurring opinion would have required an even lesser standard to uphold a retroactive tax. Her due process test would require only "a legitimate legislative purpose furthered by rational means." Id. at 37. That requirement is satisfied by retroactive application of revenue measures because they are "rationally related to the legitimate governmental purpose of raising revenue." Id. That legitimate purpose must be weighed against the taxpayer's interest in finality. Thus, short periods of retroactive application are likely to satisfy Justice O'Connor's test, while "a period of retroactivity longer than the year preceding the legislative session in which the law was enacted would raise, in [her] view, serious constitutional questions." Id. at 38.

Justice Scalia's acerbic concurring opinion (with whom Justice Thomas joined) viewed the retroactive change in the tax law at issue as "bait-and-switch taxation" that was "harsh and oppressive" and therefore would be unconstitutional as a violation of substantive due process, if he "thought that 'substantive due process' were a constitutional right rather than an oxymoron . . . ." Id. at 39. The fact that there was only a modest period of retroactivity rather than a long period, in his view, would not change the harsh economic impact on the taxpayer. Justice Scalia was particularly critical of retroactivity in the case of a tax incentive provision as opposed to a general provision taxing income, because of probable taxpayer reliance on the incentive provision.

Justice Scalia concluded his analysis of retroactive taxation by overstating, I believe, the fear that the majority had eliminated future due process challenges to retroactive taxation. This conclusion does not appear to follow from the Court's discussion, particularly as it relates to tax incentive provisions.

26. Id. at 32.

27. See Levmore, supra note 6, at 270 n.12. Levmore has catalogued the various unsuccessful challenges to retroactive taxation or "retrotaxation," in his terminology, based on the Constitution's proscription of ex post facto laws, the Equal Protection Clause, the Due Process Clause or the Takings Clause, and cites Welch v. Henry, 305 U.S. 134 (1938), as an example of the Court upholding retroactive taxation. First, he views the proscription on ex post facto laws as limited to laws imposing criminal penalties and therefore inapposite to tax legislation. With regard to the Equal Protection and
Professor Graetz, in arguing in favor of nominally prospective tax legislation, also expressed the view that constitutional restraints on retroactive legislation did not present any significant obstacle. As a result, he dealt with the economic and equity aspects of nominally prospective legislation, but did not deal in any significant way with the legal or constitutional aspects of it. This prescriptive and policy treatment extended as well to obligations that Congress may have to tax subsidy recipients.

Takings Clauses, he observes that attempts based upon these arguments to disqualify a tax have all failed. Moreover, claims against retrotaxes on equal protection grounds stand in no better footing than prospective taxes in that a tax, whether retroactive or prospective, aimed at burdening a racial or ethnic minority might very well be subject to an equal protection claim, but neither type of tax aimed at large groups of past taxpayers or beneficiaries would be vulnerable to such constitutional claims. Finally, he notes that “the few cases that do strike down retrotaxes involve retroactive estate and gift tax provisions.”

Levmore, supra note 6, at 271 n.12. But the cases that struck down those taxes were old cases involving transfers that were completely vested prior to the enactment of the retroactive legislation with no notice to taxpayers and, further, all involved voluntary actions, namely making of a voluntary transfer. Because receipt of income was “somehow involuntary,” retroactivity was permitted. Id. at 271 n.12. While Levmore acknowledges that “these distinctions do not withstand scrutiny” as valid distinctions between taxes that satisfy constitutional standards and taxes that do not, there are alternative explanations for the results in the older cases even if one were not willing to acknowledge that newer cases have largely upheld the same kinds of taxes that had previously been held invalid. Levmore concludes his analysis of the case law with the following:

In short, if there is any legal case to be made against the retrotaxation schemes discussed here, it must be that explicit retrotaxation has been tried but occasionally, that previous retrotaxes have not tried to reach purposefully and exclusively to the past so much as they have represented prospective reforms with retrospective tails (designed perhaps to take away any advantage from those who knew that an enactment was forthcoming), and that no scheme has tried to reach back in a way that skipped over a more recent period.

Id. at 272.

See also Kaplow, supra note 4, at 565 n.162, which discusses the broad latitude allowed for enacting retroactive tax legislation and discusses the leading cases (prior to 1986) upholding that treatment.

28. Graetz, supra note 3, at 48. Graetz does note, however, that the Treasury Department has contended that, “in general, the repeal of code provisions that provide an incentive for certain business-related expenditures or investments in specific assets should be developed to minimize the losses to persons who made such expenditures or investments prior to the effective date of the new law. The principal technique to effectuate this policy would be to grandfather actions under current law.” U.S. DEPT. TREASURY, BLUEPRINTS FOR BASIC TAX REFORM 200 (1977). Quoted in Graetz, supra note 3, at 53.

29. For example, Graetz quotes former Assistant Commission of the Treasury for Tax Policy, Edwin S. Cohen, as arguing:

[Provisions have deliberately been kept in the tax law over many years, and they constitute standing invitations for taxpayers to erect new buildings, drill for oil, or embark on programs of charitable contributions. Even if we should conclude that
Professor Hochman, in an earlier and classic article dealing with retroactive legislation generally, also observed that Congress apparently has wide latitude to impose retroactive taxation.\(^{30}\) His discussion, however, suggests that a different conclusion might be forthcoming with regard to a tax subsidy provision that Congress designed to entice an investment and that was relied upon in making an investment. One can draw this inference from Hochman's discussion and his express observation regarding why retroactive taxation would be permissible, \textit{i.e.}, it is not unfair to impose the tax since the taxpayer in no way relied on the non-taxability of the income.\(^{31}\) Hochman concluded that the rationale for permitting retroactive taxation is that no taxpayer can generally claim that he did something that he would not otherwise have done because such a claim would require a taxpayer to argue that he would not have received the income if he had known it would be subject to the higher tax. He does, however, concede that a stronger case would be available to the taxpayer if the tax were imposed on income received several years prior to the enactment of the statute.\(^{32}\) It also follows that a different and stronger case would be presented where actual reliance was both express and intended.\(^{33}\) Levmore's dispute of these theories in the Hochman article and his later interpretation of the same cases demonstrates that there is disagreement regarding the bounds of retroactive tax legislation among the commentators just as their is in the courts.


\(^{31}\) \textit{Id.} at 707. Thus, he notes that several statutes have been upheld that taxed income received during the latter part of the year and, in one case, the removal of an exemption for dividends received almost fifteen months prior to the passage of legislation was upheld. \textit{Id.}

\(^{32}\) \textit{Id.}

\(^{33}\) This inference follows from Hochman's observation that the justification for upholding retroactive income taxation does not apply to estate and gift taxes, since the knowledge of the existence of the tax would likely or at least very well might change the taxpayer's behavior.
IV. PRECOMMITMENT BY LEGISLATING CONTRACTUAL RIGHTS AND THE WINSTAR CASE

Although case law strongly supports the proposition that nominally prospective tax legislation can override previous legislation, even if with retroactive effect, it has been suggested that it is possible for Congress to expressly bind future Congresses. Professor Logue has suggested that "contract law should provide a way to force the government to shoulder the costs of opportunistic tax transitions. One could allow taxpayers harmed by the repeal or elimination of an incentive subsidy to sue for damages under a breach-of-contract theory," with damages measured by expectation or some approximation thereof.

The Supreme Court's decision and opinions in Winstar provide an excellent lens through which conflicting theories of contractual commitment by government and the power of the sovereign to legislate can be examined and applied to the issue of retroactive taxation. In this connection, a tax incentive subsidy would be analogized to a contract, similar to the contract in Winstar, to which the government would be bound and subject to the payment of damages for a breach of the contract.

Although from a purely conceptual point of view, the analogy is appealing, as a matter of legal analysis it likely fails in a number of respects. First, a tax subsidy provision is simply not a contract. Logue could have drawn additional support for his proposal that Congress could engraft contract notions onto legislation from National R.R. Passenger Corp. v. Atchison, T. & S.F. Ry. 470 U.S. 451, 465-66 (1985) (quoting Dodge v. Board of Educ., 302 U.S. 74, 79 (1937), to the following effect):

[A]bsent some clear indication that the legislature intends to bind itself contractually, the presumption is that "a law is not intended to create private contractual or vested rights but merely declares a policy to be pursued until the legislature shall ordain otherwise... Policies, unlike contracts, are inherently subject to revision and repeal..."

See Kaplow, supra note 4, at 564 n.160.

34. Logue, supra note 7, at 1183. He supports his contract theory with the decision in the Winstar case in the Federal Circuit. Winstar Corp. v. United States, 64 F.3d 1531 (Fed. Cir. 1995). The Federal Circuit found that the government, through the Federal Home Loan Bank Board and the Federal Savings and Loan Insurance Corporation, had entered into contracts with a number of savings and loan institutions and that Congress had broken those contracts. He then analogizes the enactment of a tax incentive subsidy to such a contract.


[A]bsent some clear indication that the legislature intends to bind itself contractually, the presumption is that "a law is not intended to create private contractual or vested rights but merely declares a policy to be pursued until the legislature shall ordain otherwise... . . . Policies, unlike contracts, are inherently subject to revision and repeal..."

See Kaplow, supra note 4, at 564 n.160.

35. See Goldberg, supra note 8, at 313-14.

36. See United States v. Carlton, 512 U.S. at 33 (citing Welch v. Henry, 305 U.S. 134, 146-147 (1938)).
negotiated contracts in *Winstar* and the more generalized legislatively enacted tax incentive subsidy, which involves no negotiation on the part of a taxpayer who partakes of the subsidy. 37

In *Winstar* there was no question that the government had bound itself by contract to the accounting treatment desired by the Thrifts. 38 The case was then resolved by the lower court as a simple breach of contract case, with the government's imposition of newly enacted FIRREA rules on the Thrifts constituting a failure by the government to perform its contractual duty. 39 Indeed, the Supreme Court's analysis on appeal was premised on the determination that the government had entered into a contract. All of the opinions then focused on whether the government should nevertheless be free to abrogate its agreement. The Supreme Court and mainstream legal scholarship acknowledge the fundamental legal distinction between a true contract and incentive legislation, 40 which Congress implicitly retains its power to amend.

Further, if a contract has been formed, would its terms preclude future legislation affecting the promised tax benefits? For

37. Logue, *supra* note 7, at 1185. It has been suggested that a contract can and should be achieved by means of the administrative process of a private letter ruling. Specifically, Professor Logue recognizes that taxpayers who seek assurance of a certain tax treatment for a transaction can obtain a private letter ruling from the Internal Revenue Service stating that the transaction will be treated in a certain way and obligating the Internal Revenue Service to follow that treatment. This administrative procedure, however, has some important exceptions. Among those exceptions is legislative change. Thus, if a taxpayer delays in consummating the transaction until after a legislative change in the tax rules upon which the ruling was based, the ruling will be of no effect. See Rev. Proc. 96-1, 1996-1 I.R.B. 8, which provides, as did its predecessor revenue procedures, that a private letter ruling will not be revoked retroactively, except in rare and unusual circumstances, provided, however, that five requirements are satisfied, including that "there has been no change in the applicable law ...." *Id.* at § 11.05(9).

Thus rulings of the Internal Revenue Service only bind the Service to treat a transaction in a certain manner to protect the taxpayer against subsequent change in the Service's interpretation of existing law. They do not protect a taxpayer who has received the private letter ruling against new legislation that is nominally prospective but has retroactive effect. For example, a taxpayer purchasing depreciable real property in 1982 could have obtained a private letter ruling that the property was depreciable over 15 years (assuming that the Service would have ruled on such a well-settled point). Such a ruling, however, would not have protected the taxpayer from the passive activity loss rules enacted by the Tax Reform Act of 1986, which effectively caused the depreciation allowances after the effective date of the law to be unusable by many taxpayers.

38. "The [lower] court found that binding contracts were made between plaintiffs and the FSLIC in each of the three merger transactions." 64 F.3d at 1539. The Court of Appeals for the Federal Circuit agreed. *Id.* at 1540-44.

39. *Id.* at 1545.

example, in Bowen v. Public Agencies Opposed to Social Security Entrapment, the Supreme Court held that Congress had the power to amend the Social Security Act to prevent states and other public employers from withdrawing from the Social Security System even though they had voluntarily entered the system and reserved the right to withdraw.

Suppose that a contract were deemed created by the government's offer embodied in tax incentive legislation and a taxpayer's acceptance by partaking of the incentive. Arguably, this could be accomplished through legislation, as Logue suggests, with language expressly providing that any taxpayer who acts in reliance on the incentive, for example, accelerated depreciation, will have a contractual right to that treatment so long as it is in force and has not been repealed as of the time the investment is made. This suggestion raises the question whether the government would be bound contractually to continue the favorable treatment. If binding the government in this manner were possible, to what terms would the government be bound? How would such a contract be interpreted? For example, suppose in the following year Congress left the recovery period intact but restricted its use against tax liability from only certain kinds of income, or, limited its use by high marginal rate taxpayers, or, made the treatment a component of the taxpayer's minimum tax computation. Would such a contract protect the taxpayer in those events?

Further, does legislating contractual rights create an actual contract beyond the legislature's power to control or regulate? The implications of the POSSE case concerning a reservation by Congress of the right of amendment, and the Winstar case would suggest not. To illustrate, suppose Congress in the ensu-

41. 477 U.S. 41 (1986) [hereinafter POSSE].
42. See Logue, supra note 7, at 1186. Logue's actual suggestion involved a tax credit rather than a deduction. His choice of tax credit, however, blurs the distinction between a periodic subsidy and a one-time subsidy. If such a credit were framed in terms of a fixed amount, creditable against tax liability in equal amounts over the succeeding, say, five years, or refundable if there were no tax liability, I would suggest that it is best viewed as a one-time subsidy paid by the government to the taxpayer and relaid to the government on an interest-free basis, for which the taxpayer receives in return a government obligation similar to a note. As such, it should be analyzed as a two-part transaction: (1) a one-time subsidy, followed by (2) a loan by the taxpayer to the government. The analysis is quite different if the tax benefit sought by the taxpayer is dependent upon other factors that may arise in the future years during which the benefit would be enjoyed.
ing legislative session repealed the provision prospectively by eliminating the availability of the special treatment for all ensuing years. The Supreme Court's discussion in *Winstar* strongly suggests that it may be beyond Congress' power to relinquish the power to legislate in this manner. Thus, even if one could concede the possibility of creating a contract through legislative action, future Congresses likely would not be precluded from making legislative changes that would breach the contracts. In that event, would a taxpayer have a right to recover damages based on a breach of contract claim? As discussed by the Supreme Court in the context of savings and loan regulation in *Winstar*, there are still several additional obstacles that must be overcome in order for a taxpayer to establish that right.

A. THE UNMISTAKABILITY DOCTRINE

First, the unmistakability doctrine, as it has been named, if applicable, would hold that contracts between the government and private parties will be recognized as unchangeable by the legislature only when the limitation on future regulatory authority is expressed in unmistakable terms. If such assurance were expressed in unmistakable terms, then, the argument goes, the government would have assumed the risk that subsequent changes in the law might prevent it from performing its part of the bargain, and would have agreed to pay damages in the event that the failure to perform caused financial injury to the taxpayer.\(^\text{43}\) Thus, subsequent legislation by Congress would not be constrained, but rather would be construed as a breach of contract for which damages should be awarded.

The unmistakability doctrine, however, is subject to several different interpretations and applications, and, as the several opinions in *Winstar* evidence, its scope is not at all clear. Fundamentally, it is not clear whether the unmistakability doctrine is a rule of law that limits the government's ability to contract away its sovereign powers, or is merely a rule of construction used to determine exactly what the government is contractually bound to do.

While the government urged the first interpretation, the several opinions in *Winstar* appear to adopt the second. Yet, the

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\(^{43}\) The above statement of the unmistakability doctrine as applied to retroactive tax legislation is a paraphrase from the Supreme Court's opinion in *Winstar*, 116 S.Ct. at 2461-63.
plurality opinion suggests that in some areas involving sovereign rights, the clarity required for the government to relinquish its powers may be so great as to make such a promise very difficult to make in an enforceable manner.

The Supreme Court plurality opinion explained in *Winstar* that the unmistakability doctrine represents the point of intersection between two fundamental constitutional concepts. The first, articulated most recently in *POSSE*, is the proposition that one legislature may not bind the legislative authority of its successors. The other involves the concept of vested rights, which, as articulated by Justice Marshall, could not be undone after they are granted under law.

As a result of this tension, according to the Supreme Court, two distinct limitations developed to preserve state regulatory powers. The first, the reserved powers doctrine, holds that certain substantive powers of sovereignty cannot be contracted away. Included in those powers since early times was the right of taxation. As a fundamental power of sovereignty, it could not be surrendered "unless such surrender has been expressed in terms too plain to be mistaken." Thus, the unmistakability doctrine requires exceptionally clear and certain assurance that the government intended to be bound and precluded from legislative override before the legislature's powers of sovereignty would be limited by private rights. As a result, "vested rights" created by the national government could be binding on future Congresses.

The unmistakability doctrine must operate across a broad band of situations. The plurality opinion of the Supreme Court concluded that the application of the doctrine will differ according to the different kinds of obligations the government may assume and the consequences of enforcing them. At one extreme, according to the Court, are those contractual obligations that could not be recognized without effectively limiting sovereign authority. These situations would require a strict application of the unmistakability doctrine. For example, a claim for rebate under an agreement for a tax exemption should not be beyond the legislature's power to change, because to limit the legislature in that manner would effectively block the exercise of the

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44. 477 U.S. at 343.
taxing power. Therefore, the unmistakability doctrine would require the rebate grant to express in no uncertain terms that the grant would not be legislatively revoked.

At the other extreme are “humdrum supply contracts,” which the Court believes should be enforceable against the government, notwithstanding intervening legislation to the contrary without regard to the unmistakability doctrine. In the middle ground, the Court would decide the applicability of the unmistakability doctrine on the basis of how and whether the government and the contracting party allocated the risk that intervening legislation would change the parties’ rights under the contract. Thus, if the contract expressly acknowledged the risk and shifted the risk to the government, then the unmistakability doctrine would be satisfied and the contract would be respected. In *Winstar*, risk shifting was the essential ingredient of the contract, and therefore, the contract was not subject to legislative override, in the Court’s view, on the basis of the unmistakability doctrine.

Other Justices viewed the doctrine as one of ordinary contract construction. For example, Justice Breyer’s concurring opinion indicates that he would have decided the case based upon a reasonable interpretation of the actual contract as to the parties agreement regarding who would bear the risk of a performance-defeating change in the law. This determination would be made without regard to clear and definitive language as such, but rather would be made by resort to normal contract interpretation rules, in essentially the same manner as interpreting contracts between private individuals. The unmistakability standard might simply call for a higher degree of care in implying promises in contracts involving the government’s sovereign powers. In *Winstar*, however, it was apparent to Justice Breyer that the government entered into a binding promise to assume the risk of future change in the legislation and to hold the thrifts harmless from the effects of any future regulation or legislation causing a change in the accounting practices of Savings and Loans. In Justice Breyer’s view, the government should be bound to that promise.

The concurring opinion of Justice Scalia and the dissenting opinion of Chief Justice Rehnquist also viewed the unmistakability doctrine as a rule of construction, used to ascertain

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46. 116 S. Ct. 2454-55.
the intent of the parties where a government’s sovereign power is at issue. In Justice Scalia’s view, the doctrine creates a presumption that the government has not agreed to curtail its sovereign or legislative powers. The other contracting party, however, is free to prove otherwise.

Arguably, the unmistakability doctrine might be overcome with regard tax incentive legislation if the legislation contractually bound the government and clearly set forth the fact that the risk of subsequent change was to be placed upon the government and not the taxpayer. Just as in *Winstar*, where the savings and loan associations sought damages rather than exemption from the new legislation, the intended beneficiaries of tax incentive legislation might similarly seek damages if prospective legislation were to be enacted that eliminated or adversely affected their subsidy.

On the other hand, Congress’ arsenal for eliminating the benefits of prospective tax incentives, such as in classifying deductions as passive activity deductions or requiring ordinary income recapture, to name just a few, may be so large and varied as to cause preclusion of them under the unmistakability doctrine to be exceedingly difficult and therefore unlikely. Moreover, the rationale of binding the government applied in *Winstar* may not be nearly so applicable with respect to income taxation. In the Court’s view, its rule of construction in situations involving risk shifting actually furthers the interests of government, because it permits the government to bind itself and thereby induce private persons to enter into contracts with it. To cause every contract to be subject to the unmistakability doctrine, in the Court’s view, would weaken the government’s capacity to do business by injecting unwarranted uncertainty regarding the government’s commitment to carry out its side of the contract. The same considerations, however, may not prevail in the area of tax legislation. Rather, it may be crucial that Congress retain the sovereign power of taxation, unfettered, at least insofar as general legislation is concerned. As a result, contract by legislation may be unlikely to pass the Supreme Court’s unmistakability test, regardless of the language used in the legislation, because it may be inherently impermissible to read into the legislation the essential term of relinquishing sovereign power over all aspects of the income taxation. It should be noted, however, that agreements to end specific tax disputes with individual taxpayers, such as closing agreements, in con-
trast, could nevertheless be enforceable against the government in the interests of ensuring an administrable system.

B. SOVEREIGN ACTS DOCTRINE

The Supreme Court in Winstar discussed a second line of reasoning that is instructive regarding nominally prospective and retroactive taxation. The Court's analysis in Winstar viewed the government essentially in two separate roles: (1) the government as contractor and (2) the government as lawgiver.

As a lawgiver, the government possesses the sovereign power to legislate on public and general matters. Under that analysis, called the "sovereign acts doctrine," public and general legislation can override the government's own contractual obligations. The "sovereign acts doctrine" balances the government's need for freedom to legislate with its obligation to honor its contracts by requiring a distinction to be drawn between sovereign acts and acts as a contractor.

In Winstar, the plurality addressed the question of whether the governmental agencies' actions were sovereign acts or acts of a contractor and concluded that they were acts of a contractor. They were designed to protect the government's interests and as such were in the capacity of a private insurer. But, they were also done to advance the government's regulatory interests, and, therefore, were sovereign. The Court thus concluded that the fusion of these roles is so commonplace as to render the sovereign acts analysis of little use.

The Court then analyzed whether the passage of FIRREA was the act of a contractor or a sovereign act and concluded that, as applied to Winstar, it was not a sovereign act because it was not a "public and general act." Rather than being regulatory legislation, relatively free of government self-interest, FIRREA had the substantial effect of releasing the government from its contractual obligations to the savings and loan associations. That effect was not merely incidental. The government's self-interest in the legislation should preclude it from using its own actions to absolve it from liability under its previous contractual commitments to the savings and loans. The Court viewed this

47. In Horowitz v. United States, 267 U.S. 458, 461 (1925), discussed by the Court in Winstar, 116 S. Ct. at 2463, the Court held that the "public and general acts" of the sovereign are not attributable to the government as contractor so as to bar the government's right to discharge from its own contractual obligations.
holding as striking a middle course between two extremes: (1) that the government's dual roles of contractor and sovereign may never be treated as fused, a view espoused by the dissent, and (2) the second act, if legislative and public and general, may overrule the government's contractual obligation even if the government benefits from being absolved of its contractual obligations. On balance, the extent to which FIRREA relieved the government of its own contractual obligations precluded a finding of the Court that the statute was a "public and general act" for purposes of the sovereign acts defense, based upon the Court's middle ground approach. The Court also expressed the view regarding the limited utility of the sovereign acts doctrine, particularly in situations such as that involved in *Winstar*, where the government seeks to shift a risk that it contractually assumed from private parties back to those private parties.

Applying the analysis of the sovereign acts doctrine proposed in the plurality opinion, tax legislation that changes the future treatment of an investment would appear to be public and general, and, therefore, sovereign, if it is not specifically targeted at the beneficiary of the government's previous contractual commitment (assuming there is one). For example, legislation that raises future tax rates across the board should be regarded as public and general. In contrast, legislation that imposes a higher tax rate on an investment that was previously entitled to a special credit or deduction would not likely be a public and general act, because it retracts Congress' previous commitment.

The possibility that the sovereign acts analysis could preclude legislative override of previous tax incentive legislation, however, must overcome another significant obstacle. It likely applies only if the government is first bound as a contractor. In

48. Chief Justice Rehnquist, in his dissent in which Justice Ginsburg joined, viewed the plurality's standard of public and general as substantially more amorphous, and suggested that under this standard "any tax reform bill which tightens or closes tax loopholes is directed to 'government self-relief,' since it is designed to put more money into the public coffers." 116 S. Ct. 2483. He concluded that no such legislation could be a "sovereign act" of the government in the face of a taxpayer who had received previous assurance by the Internal Revenue Service of continued favorable treatment. *Id.*

Although the plurality's sovereign acts test may not be susceptible to easy application, it is unlikely to be so amorphous as to reduce every act of taxation to an act of government self-relief rather than a public act. Further, Justice Rehnquist's concern does not take account of other aspects that distinguish tax legislation from the acts of bank regulators.
the case of legislating contract rights, however, the legislation granting the benefit will likely be viewed as the act of a sovereign, regardless of the assurance given that the sovereign would not change its mind subsequently. In *Winstar* the issue was viewed in terms of whether the government as lawgiver could negate the promises made by the government as contractor. In the case of legislating contractual rights, in contrast, the government is acting solely in its capacity as lawgiver. As such, there may be no conflict between its roles, in which case, the government's powers of sovereignty should permit its promise made as a lawgiver to be retracted by its future actions as a lawgiver. Thus, incentive legislation may very well be subject to change by future legislation under the sovereign acts doctrine.

Notwithstanding the foregoing discussion, it should be recognized that the concept of contract and contractual commitment is itself somewhat slippery. For example, in the private context, a general offer by a private person to reward businesses who invest in the inner city would be enforceable by a businessman who made such an investment in reliance on the offer. Investment would constitute acceptance of the offer and the completion of a contract. Failure to tender the reward would constitute breach.\(^49\)

Although it appears unlikely that actual contracts could be made through legislation in that manner, the reasons why the law might hold offerors to their legislative promises are the same, even though there are counterbalancing reasons for a different result in the legislative context. Thus, the existence or nonexistence of an actual contract resulting from responding to a legislative incentive perhaps can be overlooked in examining the role of government commitment and the circumstances under which it can be overridden by subsequent legislative action. The *Winstar* discussion would be instructive in that circumstance.

On the other hand, the absence of an actual contract weakens the taxpayer's equities substantially, because it substantially detracts from the taxpayer's argument that the risk of subsequent legislative change, the power over which is reserved

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\(^{49}\) *Restatement (Second) of Contracts* § 45. See *Carlill v. Carbolic Smoke Ball Co.*, [1893] 1 Q.B. 256 (C.A. 1892) ("performance . . . is sufficient acceptance without the notification of it, and a person who makes an offer in an advertisement of that kind makes an offer which must be read by the light of that common sense reflection.").
by Congress, has been shifted from the taxpayer to the government. Thus, the foregoing discussion of the sovereign acts doctrine strongly indicates that future legislation could override past legislative commitments.

C. SUMMARY

In sum, to establish rights against the government as a legal matter, it is likely that those rights must be at least a matter of contract, as was the case in Winstar. Mere legislation of contract rights, though perhaps persuasive and instructive to future legislatures, likely would not constitute a binding contract on the government, at least under current case law. The lower court in Winstar reached that hurdle and overcame it in its finding that a contract did exist between the Savings and Loan Associations and the government agencies. The Supreme Court left that finding unchanged.

If that hurdle is overcome, either because an actual contract can be found, or because, as discussed above, none is necessary, the questions raised must still be addressed regarding the meaning of the contract and the conflict between enforcing contractual rights against the government but not impinging on the government’s sovereign power. The Supreme Court is itself divided on the tests that should be applied, including the scope and application of the unmistakability doctrine and the sovereign acts doctrine. Tax legislation, however, is the sovereign power most likely to be viewed as a reserved power of the sovereign and therefore subject to future change. Establishing that the risk and burden of future change has been assumed by the government likely will prove to be no easy task.

Finally, the doctrines of unmistakability and sovereign acts come into play when there is indeed a conflict between the government’s role as contractor and the government’s role as lawgiver. In a situation where a taxpayer’s rights derive from legislation and not an actual binding contract with the government, the conflict should not arise, because in both respects, the government may best be viewed as acting as a lawgiver and enjoying the rights of a sovereign. It may be bad policy, both long-term and short-term, to retract a legislative promise, but the weight of the existing Supreme Court precedent strongly indicates that it is within the purview of Congressional discretion.
Discretion by its very nature may be exercised wisely or unwisely.

The law in this area is at best unsettled, and at worst, unprotective of taxpayer reliance. More importantly, however, it is doubtful whether the prospective recipients of any new tax incentives would believe, under the current state of the law, and knowing past history, that they would be protected against opportunistic behavior in advance of actual litigation. Recall that in *Winstar*, the thrifts believed that they could rely on the government's written assurances, only to be subjected later to a completely new regulatory regime as a result of the passage of FIRREA. Taxpayers would also realize that appeal to the courts, perhaps even to the Supreme Court, would be expensive and could take many years.

This Article cannot reach a definite answer to the inquiry regarding the constitutional limits on the Congress revoking previously granted future tax benefits on which taxpayers have relied, if those limits exist at all. It does make the observation, and I believe an important one, that if legal scholars cannot agree on the permissible limits of taking away tax benefits, and the Supreme Court is divided—even where it has spoken—it is not likely that taxpayers will be able to have certainty that the promised benefits from the tax incentive provision will be realized. While there may be several theories for invalidating nominally prospective tax legislation with retroactive effect, and alternative mechanisms that may be available to strengthen a taxpayer's argument that nominally prospective tax legislation with retroactive effect should be invalidated by a court, it is highly unlikely under the current state of the law that taxpayers can obtain the kind of assurance that they would require or that counsel would likely need in order to render an opinion that a challenge to the abrogating tax legislation would be successful.


51. It does, however, express the view of the author as to one situation in which the limit should be regarded as being exceeded. *See infra* at text accompanying notes 60-62.

D. PRACTICAL ASSURANCE OF TRANSITION PROTECTION

In addition, I believe that it is impossible from a practical standpoint to give investors assurance that transition relief will be forthcoming. Unfortunately, the government in the tax area has acted opportunistically many times in the past. The absence of legal authority to invalidate the retroactive effect of subsequent legislation is particularly troublesome because taxpayers are well aware of instances where reliance on government precommitment would have been ill-placed. Most recently was the enactment in 1993 of a tax increase effective as of the begin-

53. Professor Logue has suggested other precommitment devices designed in part to gain taxpayer confidence. Specifically, Logue has suggested that “Congress could institute formal and informal procedures that would impose roadblocks to changing the tax laws in ways that are inconsistent with the optimal transition policy.” Logue, supra note 7, at 1186. This suggestion would also require that Congress create procedural roadblocks to removing the roadblocks specifically created for the tax laws. It may be this latter step that requires the greatest suspension of taxpayer belief.

Even if such roadblocks could be enacted, a point which cannot be easily conceded from a practical standpoint, interpretative problems would abound. Presumably, Logue would restrict these roadblocks to changes involving tax incentive provisions, but not to changes involving structural provisions of the Internal Revenue Code, such as tax rates, for which Congress will likely insist on unfettered control. These latter provisions involve burden-sharing issues. Roadblocks such as Logue envisions would have to distinguish between these two types of tax provisions in a world in which there is still substantial disagreement over which provisions are incentive provisions and which provisions are structural. See Goldberg, supra note 8, at 307 nn.10-15. Logue also notes that the procedural device could be served by Congressional tax-writing committees rather than Congress as a whole.

While the procedural devices envisioned by Logue may reduce the risk premium required by taxpayers taking advantage of periodic subsidies, I do not believe that those premiums could be eliminated entirely, because the devices that reasonably could be enacted would not make government opportunistic behavior sufficiently difficult. Moreover, it takes more than Congressional rules to overcome a history of government opportunistic behavior. Trust that the government will not act opportunistically in tax legislation has waned rather than increased as a result of the Tax Reform Act of 1986.

Another alternative suggested by Logue involves delegating authority to the Treasury Department and the Internal Revenue Service to design installment subsidies and empowering them to play a greater role in decisions regarding whether to extend the subsidies and under what terms. Movement of this authority from the legislative branch to the executive branch, even if feasible, appears far from likely to eliminate political influences over these tax provisions. Indeed, with every change of administration and focus and refocus on tax reform, including redefining what reform means, change is made more likely rather than less likely. The political influences may change, but they are unlikely to be eliminated. Indeed, it may even be possible that putting this kind of power in the hands of non-elected officials may insulate decisionmakers from public influence and permit them more readily to make changes without any transition relief whatsoever. In short, the decisionmaking dynamics may be different under Logue’s proposal, but there is absolutely no assurance that those differences would move in the direction envisioned by Logue.
ning of that year, an enactment that itself was not surprising because tax increases had been accomplished in this manner several times in the past\textsuperscript{54} and have been upheld by the Supreme Court.\textsuperscript{55}

Arguably, optimistic taxpayers could distinguish a rate change, involving a structural burden-sharing component of the tax law, from a nominally prospective revocation of a periodic tax incentive provision.\textsuperscript{56} Those taxpayers, however, could not so easily distinguish or ignore the enactment of the passive activity loss rules, which effectively repealed for many taxpayers the future tax benefits of investments that they had entered into in reliance on the tax subsidy provisions available prior to the enactment.\textsuperscript{57}

\textsuperscript{54} Professors Bittker and Lokken have noted that mid-year statutory changes have become so commonplace that taxpayers should come to expect them. Boris I. Bittker & Lawrence Lokken, Federal Taxation of Income, Estates and Gifts \textsuperscript{I} 3.3.4 at 3-30 to 3-31 (2d ed. 1989). See also Kaplow, supra note 4, at 525.

\textsuperscript{55} See text accompanying notes 16-19, supra.

\textsuperscript{56} Indeed, judicial authority has focused on rate changes in approving retroactivity. See, e.g., Cohan v. Commissioner, 39 F.2d 540, 545 (2d Cir. 1930), cited in United States v. Darusmont, 449 U.S. 292, 298 (1994).

\textsuperscript{57} I.R.C. § 469, enacted by the Tax Reform Act of 1986, Pub. L. No. 99-514, § 501(a), 100 Stat. 2085, 2233 (1986). The passive activity loss rules, in general, deal with the tax treatment of a taxpayer who has only minor involvement in a trade or business or who owns rental property. They preclude a taxpayer from using losses from a passive activity, that is, (1) an activity involving a trade or business in which the taxpayer does not "materially participate," i.e., has only minor involvement (I.R.C. § 469(c)(1)), or (2) any rental activity (I.R.C. § 469(c)(2)), to offset nonpassive income. Nonpassive income includes income from salaries, investments, and other sources other than passive activities as defined in the statute. The rules relating to rental activities were relaxed somewhat in 1993 for real estate professionals, but that relaxation came years after the impact of the subsidy removal was felt. I.R.C. § 469(c)(7), Pub. L. No. 103-66, § 13143, 107 Stat. 312, 440 (1993).

The effect of the passive loss rules has been to preclude taxpayers from offsetting earned income and investment income from stocks, bonds, and bank and money market accounts ("portfolio income") with real estate and other tax shelter losses. By precluding the use of those losses in a nominally prospective manner, Congress in 1986 effectively removed the tax subsidy retroactively, from those activities. Indeed, because even cash operating losses from real estate and other tax shelter investments and actual reductions in value in the investments through deterioration or obsolescence cannot be used to offset nonpassive income until the investment is sold or discontinued, the anti-shelter rules not only removed the subsidy but in many cases imposed a penalty on the activity.

No attempt was made to compensate property owners for either the loss of the subsidy or the loss in market value of the property. Indeed, Congress, when it enacted the Tax Reform Act of 1986, appeared to recognize the importance of transition rules in preventing some inequity, but in the final enactment failed to provide adequate protection. The passive loss statute contained special effective dates and phase-in provisions. On their face, those rules appeared to exclude current owners of real estate and other passive activities from much of the impact of the new rules. Generally, the passive activ-
Nevertheless, Logue suggests that it may be in Congress' interest to pursue the optimal transition policy of providing full transition relief to adversely affected taxpayers. That is because lawmakers' concern for the government's reputation and integrity would keep them in line. Thus self-interest would cause the government to refrain from opportunistic behavior. Taxpayers, believing that the government would act in its own long-term self-interest, would have confidence in the continuation of a periodic subsidy enacted by Congress.

This conclusion appears unlikely. Generally, tax revisions and repeal of incentive provisions are motivated by the government's desire to correct earlier policy errors or bring to an end an incentive that appeared richer than was necessary to induce recipients to engage in desired conduct. Repeal is generally justified with an appeal to achievement of horizontal equity. There is no reason to suspect that in the ensuing political skirmish involving repeal of the subsidy, the moral high ground will be claimed by those seeking to continue what will have been attacked as a tax giveaway. Indeed, history has shown that where the stakes are high enough, retroactivity without adequate transition relief has won the day.

Moreover, the history of those governmental transgressions will not soon be forgotten, so that even if the lawmakers acting in the name of government trust choose not to act opportunistically and believe that the government will act in that manner, their expectation is unlikely to be believed by the taxpayers at large, absent some constraining legal commitment on the part of the government.

As a result, demand for risk premiums from prospective tax subsidy recipients are inevitable, no matter how well-meaning

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ity loss rules were effective for years beginning after 1986. However, the rules were phased in for certain post effective date losses. Passive losses from a "pre-enactment interest" (an interest held on the date of enactment (Oct. 22, 1986) or acquired thereafter but pursuant to a written "binding contract" in effect on such date and at all times thereafter) were disallowed in the transition years to the extent of 35% in 1987, the year following enactment, 60% in 1988, 80% in 1989 and 90% in 1990. These phase-in rules, however, interacted with two other important changes enacted under Tax Reform Act of 1986: the alternative minimum tax and the investment interest limitation on deductions. Passive activity losses that were allowable under the phase-in were of no tax benefit to an investor. Most important, by eliminating the subsidy entirely for prospective purchasers of the property, the legislation greatly reduced the resale value of the property, which was dependent on the subsidy.
legislators may be when they enacted the original incentive provision. Accordingly, I conclude that one-time or up-front tax subsidy payments can best assure an economically efficient subsidy that does not require the payment of a risk premium.

V. ASSURANCE OF RETAINING THE FULL SUBSIDY UNDER ONE-TIME OR UP-FRONT SUBSIDIES

A tax incentive subsidy provision that is designed to provide a one-time or up-front subsidy rather than a periodic or installment subsidy should give the protection of the bargain to a taxpayer who partakes of the subsidy. Under current case law, particularly in light of Winstar, it is very unlikely that Congress could retroactively repeal the subsidy and reach back into the year in which the subsidy was received by the taxpayer and recapture it from a taxpayer who acted completely in conformity with and in reliance upon the express tax subsidy provision. Such an attempt at recapture could take the form of a targeted tax in a future year, specifically targeted against only those taxpayers who had taken advantage of a tax subsidy in the past. Such a tax should not be constitutionally permissible. Although there is no authority directly on point, the Court's discussion in several recent cases, including Carlton and Winstar, is instructive and provides a clear implication that this legislation would cross the bounds of Due Process protection and be constitutionally invalid. Further, as time passed following the taxpayer's investment induced by the incentive provision, the taxpayer's assurance against retroactive repeal would become even stronger. The Court in Carlton only countenanced retroactive change for a short period following the close of the taxpayer's year, perhaps only a few

58. With a one-time subsidy, a prospective effective date on repeal would appear to provide full transition protection for those who had invested in reliance on the provision. In that manner, Logue correctly points out that such a subsidy "essentially comes with a built-in grandfather clause." Logue, supra note 7, at 1193. Logue also suggests the use of termination dates on subsidies. Id. at 1191. Rather than viewing this suggestion as a separate policy suggestion, I believe it is more properly viewed as a special case of the others. The nature of the termination dates makes it psychologically less likely that a government needs to act earlier than the termination date, unless the termination date is many years in advance, in which case the existence of a termination date is of no moment.

59. Compare Logue, supra note 7, at 1193 (asserting the contrary).
60. See United States v. Carlton, 512 U.S. at 33 for discussion.
61. See supra, text accompanying note 26.
months.\textsuperscript{62}  

The Supreme Court's discussion of property rights in the context of legislative expectation in the \textit{POSSE}\textsuperscript{63} case also supports this conclusion. Specifically, in \textit{POSSE}, the Supreme Court found that Social Security represented a regulatory program over which Congress retained the power of control and amendment of its provisions to provide for the general welfare.\textsuperscript{64} As a result, elimination of a recipient's contractual rights to future benefits or choices did not rise to the level of a taking of property, within the meaning of the Fifth Amendment.\textsuperscript{65}

In contrast, a levy on a taxpayer's accumulated wealth under the guise of a tax on past income appears to be the taking of a vested right. The Supreme Court took pains to distinguish its result in \textit{POSSE} from the taking of a vested right.\textsuperscript{66} Although the metaphysical distinction between income and property is a difficult one, the law must sometimes make it, and the tax law has done so many times in the past.\textsuperscript{67} I would suggest that a previous year's income becomes property when the year closes under our annual accounting system, and if not at that time, then after the time by which the taxpayer must self-assess the tax, \textit{i.e.}, the date set for filing an income tax return for the previous year's income.

\textsuperscript{62} United States v. Carlton, 512 U.S. at 33.


\textsuperscript{64} Id. at 55.

\textsuperscript{65} Id.

\textsuperscript{66} The Court appeared quite clear in its view that property was beyond the power of Congress to take without due process, a view that the Court traced back to the Sinking Fund Cases, United States v. Gallatin, 99 U.S. 700 (1878), from which the Court quoted with approval. The Court stated the following:  

In the Sinking-Fund Cases, the Court did observe that Congress' exercise of the reserved power "has a limit" in that Congress could not rely on that power to "take away property already acquired under the operation of the charter, or to deprive the corporation of the fruits actually reduced to possession of contracts lawfully made." 99 U.S. at 720, 25 L.Ed. 496. Similarly, other decisions have held that Congress does not have the power to repudiate its own debts, which constitute "property" to the lender, simply in order to save money. Ferry v. United States, 294 U.S. at 350-351, 55 S.Ct., at 434-35; see Lynch v. United States, 292 U.S. at 576-77, 54 S.Ct., at 842." Id. at 55.

\textsuperscript{67} See, \textit{e.g.}, Helvinger v. Horst, 311 U.S. 112 (1940) (taxpayer who gave his son interest coupons detached from negotiable bonds owned by the taxpayer was taxable on the interest collected by his son when the coupons matured) and Hort v. Commissioner, 313 U.S. 28 (1941) (entire payment received by owner of property from lessee in cancellation of lease constituted income rather than return of capital). \textit{See generally}, BITTEKER \& LOKKEN, supra note 54, § 75.3.3.
Hochman’s analysis also provides support for this view regarding the invulnerability of a one-time subsidy once obtained. Hochman has observed various factors in different areas of retroactive legislation, generally, that have influenced the courts in their upholding or striking down attempts at retroactive legislation. He stated that “the Court has consistently held that not all retrospective statutes are unconstitutional, but only those which, upon a balancing of the considerations on both sides, are felt to be unreasonable.”

In attempting “to discover those factors which lead the Court to uphold some statutes and to declare others unconstitutional,” he has discerned a guiding principle that a statute may not abrogate “vested rights,” which he interprets as the interests of a party who has changed his position in reliance upon existing law and which would cause the retrospective act to effectively defeat the reasonable expectations of the party. (Hochman observes that this “surprise” factor is generally held to be critical). This principle, however, is not absolute but rather must be weighed against the public interests to be served by the statute or by its repeal, as the case may be. Thus, Hochman concludes that there are three factors that must be weighed against one another in any particular case: “[1] the nature and strength of the public interest served by the statute, [2] the extent to which the statute modifies or abrogates an asserted pre-enactment right, and [3] the nature of the right which the statute alters.” In a sense, the first of these factors might be viewed as the importance to the government of raising revenue, correcting a mistake, or ending a perceived abuse, and the last two of these factors in the tax context might be viewed as the interests of the taxpayer in reliance, basic fairness, and property rights. The Supreme Court’s decision in Winstar emphasizes the importance given by the Supreme Court to reliance on past governmental actions.

Even Levmore acknowledged in his defense of truly retroactive taxation that (1) the further back one reaches, the stronger the intuition is that the tax will be viewed as invalid because it is “further from, and perhaps out of the reach of, later law;” a

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68. Hochman, supra note 30, at 694-95.
69. Id. at 695-96.
70. Id. at 697.
71. Levmore, supra note 6, at 268-69.
point confirmed by the Supreme Court in *Carlton*,\textsuperscript{72} (2) "in large part, past calendar periods are treated as completed and are not revisited in tax law,"\textsuperscript{73} and (3) intuition also seems to suggest an ordering of retroactivity, that is, a tax that reaches back to a previous year to deny a deduction currently taken then is far more retroactive than one that raises next year's tax in such a way that reduces the value of a taxpayer's previously acquired assets (although Levmore explicitly disagrees with this aspect of traditional retroactivity analysis).

Viewed in the Hochman framework, precommitment by legislation adds weight to the taxpayer equity side and reduces the public interest side. Specifically, precommitment by contract increases the taxpayers' equities by making it easier for the taxpayer to demonstrate a reasonable reliance interest on the government’s previous action. It diminishes the public interest in making the change because it helps to establish that the public has received adequate consideration for the foregone revenue.\textsuperscript{74} Yet, these equities must overcome the government's substantial interest in collecting tax in the present or future years on the basis of concurrent income, a well acknowledged necessary power of a sovereign.

In contrast, the government has much less interest in taking away a previously granted tax subsidy for a year that has passed. Allowing the taxpayer to keep the one-time subsidy does not challenge sovereignty in nearly the same way as allowing the taxpayer to keep enjoying the periodic subsidy because the sovereign has already had the opportunity to levy the tax and has chosen not to. Thus, on the basis of the weighing of factors, reversal of a one-time tax subsidy would face a much higher obstacle, indeed, I would suggest an insurmountable obstacle, than the nominally prospective repeal of a periodic subsidy.

Equally important, however, is the fact that taxpayers are more likely to believe government assurances about one-time subsidies than periodic subsidies. In this connection, Congress has never attempted to repeal a tax incentive for a year that

\textsuperscript{72} United States v. Carlton, 512 U.S. 26 (1994).

\textsuperscript{73} Levmore, supra note 6, at 268-69.

\textsuperscript{74} Logue's procedural safeguard suggestion and delegation of authority suggestion, both discussed in note 53 supra, are more mechanical, attempting to make government's change of course more difficult, thereby reducing the public benefit associated with the change.
has passed\textsuperscript{75} and even in the most notable tax legislation with retroactive effect, the passive activity loss rules in the Tax Reform Act of 1986,\textsuperscript{76} Congress refrained from "recapturing" tax benefits enjoyed in previous years, but rather restricted the impact of the tax legislation to future years. It even refrained from changing depreciation recovery periods for property already placed in service. Even Professor Levmore, who actually pronounced the desirability of truly retroactive tax legislation, apparently concedes the unlikeliness of enactment\textsuperscript{77} and gives not a single example of truly retroactive tax legislation.

Taxpayers would also be cognizant of the administrative difficulty of revising the subsidy by identifying the members of the recipient group and selecting their previously filed tax returns for special assessments, even if that were legally permissible. Thus, as a practical matter, a one-time or up-front subsidy is extremely unlikely to be repealed retroactively.

In contrast, the precommitment devices face a sliding scale. They can make it less likely that the government will act opportunistically, but not impossible, and perhaps not even believably unlikely, particularly when a legislature desiring nominally prospective change will be prepared to make the argument that a great public interest needs to be served by a change in the tax law in the name of "reform."

Thus, taxpayers who are prospective takers of a one-time subsidy would likely regard the subsidy as completely predictable because it will be received in hand virtually immediately,\textsuperscript{78} at a time prior to any likely reversal of Congressional policy. Once the year of receipt is closed, both legal and historical analysis suggest that reversal would be unlikely.

VI. CONCLUSION

Nominally prospective tax legislation with retroactive effect appears to be permissible under current case law. Precommitment devices may strengthen the argument against abrogation, but even legislating contract rights is unlikely to bind future

\textsuperscript{75} Carlton might seem to be an exception to this statement, but the Court clearly viewed it as the correction of a mistake. United States \textit{v.} Carlton, 512 U.S. 29-31.
\textsuperscript{76} See supra, note 57.
\textsuperscript{77} Levmore, \textit{supra} note 6, at 270, 305-07.
\textsuperscript{78} Actually, it will be obtained at the time taxes would ordinarily be due for the taxable year.
Congress or give aggrieved taxpayers a cause of action for damages. In contrast, one-time subsidies are likely protected from retroactive repeal.

Moreover, these policy alternatives stand on a different footing from a practical standpoint as well. Prospective investors are more likely to believe in the assurance that they will be able to retain a one-time tax subsidy received in the year of investment than that they will be entitled to continued receipt of a periodic or installment subsidy several years after they have made the investment. Congress' opportunistic behavior in the Tax Reform Act of 1986 would serve to confirm that belief.

Consider, for example, a prospective homeowner who purchases a house with a large mortgage, the interest on which is deductible under current tax law. The current income tax law, however, is subject to change, at least for future years, and the deduction could be eliminated. Moreover, if a consumption or flat tax were adopted, the deduction likely would also be eliminated. Consider the taxpayer's likely response if given a choice between a cash subsidy equal to the present value of future tax deductions in lieu of the tax deductions themselves (recaptured in part with interest in the event the house is sold prematurely) or Congress' assurance of the continuation of the deductibility of home mortgage interest payments, by legislative precommitment or otherwise.

Finally, even if retroactive tax legislation that would effectively reverse and require repayment of an already obtained tax subsidy is a possibility, the probability is vastly smaller than the probability of the discontinuance of a periodic or installment subsidy to be received over future years. It follows, therefore, that the risk premium likely required by a one-time or up-front subsidy would be significantly smaller (perhaps zero) than the premium likely required to induce the taxpayer to make use of a periodic or installment subsidy. Government precommitment does not appear to be a viable solution to government opportunism.

79. See I.R.C. § 163(h) for current allowance of and limitations on this deduction.