OLR RESEARCH REPORT

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RETROACTIVE INCOME TAX INCREASES

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You asked for a discussion of the legal issues surrounding retroactive tax increases. Your question arises from the retroactive income tax increases the legislature enacted in 2011.

SUMMARY

State tax laws are generally made applicable to a tax year beginning on January 1, even though they are enacted later in the year. The date corresponds with the tax year adopted by most individuals and many corporations. Tax increases, in particular, are made effective in the January preceding their enactment to provide additional revenue in the current year. While the 2011 income tax changes are notable for the degree to which they changed the income tax's rates and structure, their retroactivity is consistent with the legislature's past practice. In fact, since the income tax was first imposed in 1991, the legislature has increased rates three times and applied each of the increases retroactively to the beginning of the tax year.

The U.S. Supreme Court has upheld the constitutionality of federal and state retroactive tax legislation on several occasions throughout the years. In its most recent decision concerning retroactive taxation, the Court upheld the retroactive application of an amendment limiting a federal estate tax deduction on the grounds that it was not harsh or arbitrary and did not have an unduly long period of retroactivity (*U.S. v.*

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Carlton, 512 U.S. 26 (1994)). In 1938, the Court upheld a Wisconsin law that retroactively disallowed an income tax deduction for certain dividend payments, rejecting arguments that the retroactivity violated the appellant's equal protection and due process rights (*Welch v. Henry*, 305 U.S. 134 (1938)).

The State Supreme Court has also addressed retroactive taxation. In *Gunther v. Dubno*, the Court upheld the constitutionality of a 1981 public act that established a (1) 5% tax on the net income of unincorporated businesses and (2) fourth method of calculating the corporation income tax. The Court rejected the plaintiff's arguments that the taxes violated their due process rights because the taxes were new, were not reasonably foreseeable, and could legitimately have been avoided by taxpayers had they been forewarned (195 Conn. 284).

RETROACTIVE STATE TAX LAWS

State tax legislation is generally enacted during a particular year and made effective for an entire tax year. For most individuals and corporations, the tax year is the calendar year. Consequently, most state tax laws, regardless of their effective dates, are made applicable to the tax year beginning on January 1.

Generally, if the legislature is enacting a tax increase, particularly a personal or corporate income tax increase, it is because the state needs additional revenue to address a budget shortfall. Thus, the practical choice, from the legislature's point of view, is to make the tax increase effective in the January preceding its enactment, rather than the one following. Delaying its application until the following tax year would mean deferring collection of taxes at the new rate for nearly two years. For example, to enact legislation providing extra revenue in 2011 and delay its application until the 2012 tax year would be to defer collection of taxes at the new rate to April 2013, when taxes on the 2012 tax year are due.

When the legislature enacts a tax increase mid-year and makes it applicable to the tax year in progress, businesses and individual taxpayers need to adjust their budgets during the remainder of the tax year. For the personal income tax increases enacted in 2011, for example, this meant that the Department of Revenue Services had to issue revised withholding tables for the 2011 tax year to "catch-up" withholding amounts for the current year. Those paying estimated taxes on a quarterly basis had to adjust their September payment to reflect the new tax rates.

HISTORY OF CONNECTICUT INCOME TAX RATE INCREASES AND DECREASES

Beginning with the act that first imposed the income tax, the General Assembly has consistently made income tax increases retroactive to the January preceding their enactment. The act that established the state income tax, PA 91-3, JSS, took effect August 22, 1991 but applied to tax years beginning on or after January 1, 1991. The act applied retroactively to the beginning on the 1991 tax year, but it imposed a lower rate for that year (1.5%) than for the following tax years (4.5%).

Since 1991, the legislature has increased or decreased the income tax six times. Table 1 describes each rate change, shows its effective date and applicable tax years, and indicates whether it applied retroactively or prospectively. All of the tax increases (occurring in 2003, 2009, and 2011) applied retroactively to the beginning of the tax year in which they were enacted. But the tax decreases vary. Two of the decreases applied prospectively (1995 and 1997) and the third applied retroactively (1997).

Table I: Connecticut's Income Tax Changes, 1991 to Present

Public Act	*Brief Description of Rate Change*	*Effective Date*	*Applicable to Tax Years on or After*	*Nature of Change*
91-3, JSS	Established the income tax (1.5% for 1991 income year; 4.5% for income years 1992 and after)	August 22, 1991	January 1, 1991	Retroactive new tax
95-160	Added 3% income tax bracket	June 1, 1995	January 1, 1996	Prospective decrease
97-309	Reduced income tax rates by increasing the amount of CT taxable income subject to 3% rate	July 1, 1997 or the final adoption of the FY 97-99 budget, whichever is later	January 1, 1998	Prospective decrease
97-322	Increased the amount of CT taxable income subject to 3% rate	July 1, 1997	January 1, 1997	Retroactive decrease
03-2	Increased rate on upper bracket from 4.5% to 5%	February 28, 2003	January 1, 2003	Retroactive increase
09-3, JSS	Increased marginal rates from 5% to 6.5% for taxable incomes over certain thresholds	September 9, 2009	January 1, 2009	Retroactive increase
11-6	• Increased the number of marginal income tax rates from three (3%, 5%, and 6.5%) to six (3%, 5%, 5.5%, 6%, 6.5%, and 6.7%) • Phased out the lowest tax bracket (3%) for taxpayers over certain income thresholds • Imposed a recapture provision for taxpayers over certain income thresholds	May 4, 2011	January 1, 2011	Retroactive increase

U.S. SUPREME COURT DECISIONS ON RETROACTIVE TAXES

Federal Tax Law

In its most recent decision (1994) on retroactive taxation, the U.S. Supreme Court upheld the retroactive application of an amendment to a federal estate tax statute. In *U.S. v. Carlton*, the Court ruled that the retroactive application of the statute, which limited an estate tax deduction, did not constitute a due process violation. The Court established that, in determining the validity of a retroactive tax against a due process challenge, the retroactive tax must be "supported by a legitimate legislative purpose furthered by rational means."

The Court concluded that amendment's retroactive application met this due process standard based on two factors: (1) the amendment was "neither illegitimate or arbitrary" because its purpose was to correct an error and was not enacted with an improper motive and (2) "Congress acted promptly and established only a modest period of retroactivity" (*U.S. v. Carlton*, 512 U.S. 26 (1994)). Thus, it focused its decision on Congress' purpose in enacting the retroactive tax and the period of retroactivity.

The *Carlton* decision also discounted the taxpayer's arguments that (1) to his detriment, he relied on the prior law and (2) he did not receive proper notice of the change. The Court held that since "tax legislation is not a promise, and a taxpayer has no vested right in the Internal Revenue Code," lack of notice is not dispositive.

State Tax Law

Although it has not ruled recently on retroactive state taxes, in 1938 the Court upheld a Wisconsin law that retroactively disallowed an income tax deduction for certain dividend payments. At issue was a 1935 statute that imposed new taxes for the 1933 and 1934 tax years, in order to raise revenue to meet the state's growing need for unemployment relief. The appellant argued that the retroactive taxation violated the state constitution as well as the Equal Protection and Due Process clauses of the U.S. constitution (*Welch v. Henry*, 305 U.S. 134 (1938)).

The Court upheld the tax, rejecting the appellant's argument that the retroactivity constituted an equal protection violation because dividend income was treated differently than other types of income. The Court held that "taxation is but the means by which government distributes the burdens of its costs among those who enjoy benefits" and the "equal protection clause does not preclude the legislature from changing its mind in making an otherwise permissible choice of subjects of taxation." The Court also concluded that the different treatment was neither "arbitrary or capricious" and thus did not violate the equal protection clause.

Just as it did in *Carlton*, in *Welch* the Court considered the period of retroactivity and notice of the tax change in determining whether the tax change constituted a due process violation. The Court held that the retroactivity did not deny the appellant due process because the changes were enacted by the next succeeding legislature (there was no 1934 session) and that no taxpayer "in the view of well established legislative practice, both state and national… could justly assert surprise or complain of arbitrary action." The Court also noted that it agreed with the Wisconsin Supreme Court that the statute "might 'approach or reach the limit of permissible retroactivity,' " but that it did not exceed it (Carr, Jennifer and Cara Griffith. "Retroactive Taxation: A Necessary Evil." *State Tax Notes,* October 31, 2005; Holley, Ann and Sharlene Amitay. "Examining the Boundaries of Retroactive State Tax Legislation." *State Tax Notes,* September 29, 2003).

CONNECTICUT SUPREME COURT DECISION ON RETROACTIVE TAX

The State Supreme Court has also upheld retroactive state tax laws. In *Gunther v. Dubno*, the plaintiffs challenged the constitutionality of a 1981 public act that established a (1) 5% tax on the net income of unincorporated businesses with net income over a certain threshold and (2) established a fourth method of calculating the corporation income tax (195 Conn. 284). The act in question, PA 81-255, was effective July 1, 1981 and applicable to tax years beginning on or after January 1, 1981. The plaintiffs argued that these retroactive taxes violated their rights to due process because the taxes were new, were not reasonably foreseeable, and could legitimately have been avoided by taxpayers had they been forewarned. (Both taxes were subsequently repealed for tax years beginning on or after January 1, 1983.)

The Court referenced the *Welch* decision in asserting that retroactive taxation is not a per se violation of due process. It rejected the plaintiffs' argument that the taxes were new and thus not reasonably foreseeable on the basis that the corporation income tax was already in existence when the act was enacted and the state first enacted a tax on unincorporated businesses in 1921 (although it had been dormant since 1969). The Court noted that taxpayers "were on notice as early as February, 1981" of the proposed tax changes and thus could not claim surprise.

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