VIEWPOINT
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Due Process Analysis of Proposed Retroactive Changes to the ERC

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In this article, the authors examine two provisions of the current draft of the Tax Relief for American Families and Workers Act that would apply retroactively; consider possible taxpayer arguments that the provisions would contradict due process jurisprudence; and argue that Congress could avoid these constitutional issues by enacting the legislation prospectively.

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On January 16 members of the House Ways and Means Committee unveiled a framework for legislation titled the Tax Relief for American Families and Workers Act of 2024 (H.R. 7024).[1] Draft legislation was released on January 17. If enacted, the draft legislation would expand the child tax credit and accelerate deductions for certain research and development expenses, along with other changes that generally would not be expected to increase revenue. To pay for these measures, legislators also proposed changes to the employee retention credit regime, including an accelerated deadline for filing ERC claims, which the Congressional Budget Office determined would decrease outlays by $17.8 billion and raise $60.8 billion in revenue.[2] At the time of this writing, the House of Representatives had passed the legislation and the Senate was considering it.

This article examines two provisions of the current draft that would apply retroactively and considers arguments that taxpayers might make that those provisions would be inconsistent with due process jurisprudence.[3] We believe Congress could avoid these constitutional issues by enacting the legislation prospectively.

The bill does a few things concerning the ERC[4]:

1. It implements an accelerated deadline of January 31 to file all ERC claims, regardless of the date the bill ultimately passes. For reference, the current deadline to file ERC claims is April 15 for credits arising from quarters in 2020 and April 15, 2025, for credits arising from quarters in 2021.
2. It defines a broad class of ERC return preparers and other service providers as "COVID-ERTC promoters."[5] This is directed at parties who charged fees based on the refund or credit amount and those whose gross receipts from ERC-related services were over certain thresholds.[6] The

[1] Ways and Means Committee, "Technical Summary, Tax Relief for American Families and Workers Act of 2024" (Jan. 16, 2024).

[2] *See* CBO, "CBO Cost Estimate, H.R. 7024" (Jan. 25, 2024).

[3] This article focuses on due process challenges to retroactive tax legislation because those challenges have, historically, enjoyed the most traction in the courts. It does not address other constitutional theories taxpayers have occasionally advanced in opposition to that legislation (*e.g.*, equal protection, taking without just compensation, or the prohibition against ex post facto laws).

[4] H.R. 7024, section 602.

[5] *Id.* at section 602(e)(1).

[6] *Id.*

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bill contains aggregation rules, a carveout for professional employer organizations, and rules for short tax years. Since we're examining the legislation, we will use the newly coined terminology "COVID-ERTC promoters" solely for the purposes of this article.

3. Retroactive to March 12, 2020 (when the ERC was first available), it increases penalties for COVID-ERTC promoters under section 6701's penalty regime. Section 6701 penalizes any person "(1) who aids or assists in, procures, or advises with respect to the preparation or presentation of any portion of a return, affidavit, claim, or other document, (2) who knows (or has reason to believe) that such portion will be used in connection with any material matter arising under the internal revenue laws, and (3) who knows that such portion (if so used) would result in an understatement of the liability for tax of another person." Under current law, the penalty is $1,000 per document ($10,000 if the taxpayer is a corporation), although only one penalty may apply per client. The proposed legislation would increase this amount, solely for COVID-ERTC promoters, to the greater of (1) 75 percent of the COVID-ERTC promoter's gross income derived or to be derived from the aid or assistance or (2) $200,000 ($10,000 for a client that is a natural person).
4. It applies due diligence requirements to COVID-ERTC promoters comparable to existing requirements that apply to the child tax credit, earned income tax credit, and American opportunity tax credit. Due diligence would only be required for claims filed after enactment of the bill. Failure to meet these due diligence requirements would satisfy the knowledge requirement of section 6701 for any claims filed when due diligence was required and carry its own penalty.
5. It creates recordkeeping and disclosure requirements for COVID-ERTC promoters under the "listed transaction" regime beginning 90 days after enactment, exposing COVID-ERTC promoters to yet another penalty.
6. It would give the IRS a six-year period of limitations for the assessment of any taxes or penalties attributable to an ERC claim. Specifically, the bill would extend the assessment period until six years after the latest of "(A) the date on which the original return which includes the calendar quarter with respect to which such credit is determined is filed, (B) the date on which such return is treated as filed under section 6501(b)(2), or (C) the date on which the claim for credit or refund with respect to such credit is made."[7]

For this article, we address points 1 and 3 because the retroactively accelerated filing deadline and enhanced section 6701 penalty might face challenges from taxpayers claiming violations of their due process rights. In our view, any acceleration of the filing deadline and any increased or revised penalties targeting particular taxpayers or COVID-ERTC promoters should be enacted prospectively. Of course, a prospective penalty, when combined with a terminated ERC regime, would seemingly have little (if any) applicability. Still, as discussed below, retroactively penalizing so-called COVID-ERTC promoters poses constitutional concerns.

Retroactive Tax Laws Versus Due Process

The courts have often accepted retroactive tax legislation, but this particular legislation presents some unique issues.

While taxpayers have frequently challenged retroactive legislation as violating the right to due process,[8] the Supreme Court long ago wrote that "since no citizen enjoys immunity from" the burden of taxation, "its retroactive imposition does not necessarily infringe due process."[9]

[7] *Id.* at section 602(i)(1).

[8] U.S. Const. Amend. V ("No person shall . . . be deprived of life, liberty, or property, without due process of law.").

[9] *Welch v. Henry*, 305 U.S. 134, 147 (1938).

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Rather, "in each case it is necessary to consider the nature of the tax and the circumstances in which it is laid before it can be said that its retroactive application is so harsh and oppressive as to transgress the constitutional limitation."[10]

The Supreme Court has since laid out a framework by which courts should determine whether retroactive tax legislation is "so harsh and oppressive as to transgress the constitutional limitation." Most recently, in *Carlton*, the Court held that a retroactive change in the income tax laws must (1) be imposed for a legitimate legislative purpose, (2) be rationally connected to that legislative purpose, and (3) have a "modest period of retroactivity."[11]

Since *Carlton*, lower courts have also subjected retroactive changes to tax penalties to this framework. However, *Carlton* and its predecessors relied, at least in part, on the proposition that taxation is not "a penalty imposed on the taxpayer . . . but a way of apportioning the cost of government among those who in some measure are privileged to enjoy its benefits and must bear its burdens."[12] Therefore, retroactive tax penalties are arguably owed considerably more scrutiny in the courts than retroactive taxes.[13]

Legitimate Legislative Purpose

The Court said in *Carlton* that the "prohibition against arbitrary and irrational legislation" applies equally to tax legislation as to other "enactments in the sphere of economic policy."[14] Therefore, the constitutional "burden is met simply by showing that the retroactive application of the legislation is itself justified by a rational legislative purpose."[15]

In *Carlton*, the legislative purpose for the retroactive taxation at issue was to correct a "mistake in the original 1986 provision that would have created a significant and unanticipated revenue loss."[16] In correcting its mistake, Congress "decided to prevent the loss by denying the [broader-than-intended] deduction to those who had made purely tax-motivated" transactions.[17] The Court found Congress's purpose and its retroactive means of achieving it not to be unreasonable.[18]

The Court did, however, elucidate what might constitute an illegitimate purpose. Namely, it indicated that Congress cannot act "with an improper motive, as by targeting" taxpayers "after deliberately inducing them to engage" in transactions later subjected to adverse retroactive legislation.[19]

Courts of appeal have elaborated, accepting as legitimate legislative purposes: "the purpose of treating similarly situated taxpayers similarly;"[20] the purpose "to raise revenue, to address the Federal deficit, to improve tax equity, and to make the system more progressive;"[21] and the purpose to "prevent the revenue loss that would result if taxpayers, aware of a likely impending change in the law, were permitted to order their affairs freely to avoid the effect of the change."[22] The Tax Court has also said that "the raising of Government revenue is considered a sufficient and legitimate legislative purpose."[23]

Rational Connection

In addition to the requirement that retroactive tax legislation serve a proper purpose, its retroactivity must be rationally connected to that purpose. That is, there must be a "rational connection between the facts found [by Congress] and the [legislative] choice" to impose a tax retroactively.[24] Put another way, the legislative choice to serve a legitimate legislative purpose by

[10] *Id.*

[11] *United States v. Carlton*, 512 U.S. 26, 32 (1994).

[12] *Welch v. Henry*, 305 U.S. at 146-147; *Carlton*, 512 U.S. at 33.

[13] *See Licari v. Commissioner*, 946 F.2d 690, 694 (9th Cir. 1991).

[14] *Carlton*, 512 U.S. at 30, *citing Pension Benefit Guaranty Corporation v. R. A. Gray & Co.*, 467 U.S. 717, 733 (1984).

[15] *Id.* at 31, quoting *R.A. Gray*, 467 U.S. at 729-730.

[16] *Id.* at 32.

[17] *Id.*

[18] *Id.*

[19] *Id.*

[20] *NationsBank of Texas NA v. United States*, 269 F.3d 1332, 1337 (Fed. Cir. 2001).

[21] *Quarty v. United States*, 170 F.3d 961, 967 (9th Cir. 1999).

[22] *Furlong v. Commissioner*, 36 F.3d 25, 28 (7th Cir. 1994) (internal quotations omitted).

[23] *Venable v. Commissioner*, T.C. Memo. 2003-240, at *14.

[24] *Burlington Truck Lines Inc. v. United States*, 371 U.S. 156, 168 (1962).

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tax legislation retroactively must not be arbitrary.[25]

Courts have found that retroactive tax statutes were arbitrary when Congress sought to tax actions that taxpayers could not have predicted would be taxable. For example, in *Milliken*, the Supreme Court said, "This Court has held the taxation of gifts made, and completely vested beyond recall, before the passage of any statute taxing them, to be so palpably arbitrary and unreasonable as to infringe the due process clause."[26]

Modest Period of Retroactivity

A retroactive tax law must also be subject to a "modest period of retroactivity."[27] Unfortunately, the Supreme Court has not given any definitive pronouncement on what is modest; that is, how long is too long. That being said, the Court has found a two-year retroactive period to be modest,[28] and lower courts have found even longer periods do not violate due process.[29] Moreover, at least one circuit court has determined that a four-year period of retroactivity for a tax penalty rate increase was modest.[30]

Possible Due Process Issues

Given this framework for analyzing whether retroactive tax legislation violates due process protections, we turn to some possible arguments concerning the accelerated ERC claim filing deadline and the enhanced section 6701 penalty for so-called COVID-ERTC promoters, each of which would apply retroactively.

The Accelerated Filing Deadline

Taxpayers might argue that Congress acted with an improper legislative purpose in adopting a January 31 filing deadline. While that deadline was two weeks away when the legislation was first proposed, it will be retroactive by the time the legislation is enacted — if it is enacted.

In *Carlton*, the Supreme Court warned against offering tax benefits to induce taxpayers to a certain behavior and then retroactively taking those benefits away. Here, Congress took steps to induce American businesses to keep employees on payroll in 2020 and 2021, assuring taxpayers in successive legislative packages that they would have until April 15, 2024, or April 15, 2025, to file for the ERC. In the Taxpayer Certainty and Disaster Relief Act of 2020, Congress went as far as mandating a public awareness campaign, directing the Treasury secretary to coordinate with the Small Business Administration to "provide to all employers educational materials relating to the credit."[31]

Then, on January 16, the House Ways and Means Committee gave businesses 15 days' notice that their time to claim ERCs might unexpectedly be running out. The CBO predicts the ERC portions of the legislation will decrease outlays by $17.8 billion and increase revenues by $60.8 billion. How the CBO arrived at that amount is unclear, but, presumably, at least some of it consists of credits to which taxpayers would otherwise be entitled. In other words, the early, retroactive termination of the ERC will deny taxpayers tax benefits that Congress promised to them for doing what Congress wanted them to do — keeping employees employed.

Of course, some taxpayers had notice that Congress might change the deadline, and we suspect that many rushed to file claims by January 31. Yet some taxpayers were likely unable to file by that date, and others may have been oblivious to the potential for an accelerated deadline. Those taxpayers who have filed or will file after January 31 but before April 15, 2024, or April 15, 2025, might argue that they were induced to keep employees on the payroll with the promise of a credit that — at the time they claimed it — was timely filed. Imagine the taxpayer with an unquestionably legitimate claim that kept employees on the payroll at the promise of the

[25] *Carlton*, 512 U.S. at 32.

[26] *Milliken v. United States*, 283 U.S. 15, 21 (1931), *citing Nichols v. Coolidge*, 274 U.S. 531 (1927); *Untermyer v. Anderson*, 276 U.S. 440 (1928); *Coolidge v. Long*, 282 U.S. 582 (1931).

[27] *Carlton*, 512 U.S. at 32.

[28] *Id.* at 134.

[29] *See, e.g.*, *GPX International Tire Corp. v. United States*, 780 F.3d 1136 (Fed. Cir. 1991) (The court found a period of retroactivity a little over five years did not violate the due process clause.); *Temple University v. United States*, 769 F.2d 126 (3d Cir. 1985) (The court applied a period of six years' retroactivity to taxpayer's return.).

[30] *Licari*, 946 F.2d at 694.

[31] P.L. 116-260, division EE, Title II, section 207(n).

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ERC and filed its refund claims on February 1, only to find out months later that Congress retroactively enacted a January 31 deadline. That story is sympathetic and compelling. Taking away the ERC retroactively appears unfair and, perhaps more importantly, to be in some conflict with the Supreme Court's admonition in *Carlton*.[32]

Taxpayers might also argue that Congress has acted arbitrarily in accelerating the filing deadline to a time in the past. A purported purpose of this legislation is to protect taxpayers and stop the filing of fraudulent claims by purported bad-actor promoters.[33] At least since the *Loving* and *Ridgley* opinions in 2014, Congress has been aware of the IRS's desire for greater authority to regulate return preparers and impose restrictions on, for example, their ability to collect contingency fees.[34] Indeed, this legislative package includes separate provisions more specifically tailored to deterring and punishing COVID-ERTC promoters (provisions that have their own issues, as discussed below). Against that backdrop, taxpayers might argue that simply rejecting all claims after January 31, with no more than 15 days' notice of that deadline after Congress has had some 10 years to consider its position on the risks associated with return preparers is not rationally connected to the legislative purpose of protecting taxpayers from purported bad actors.

A further purported purpose of this legislation is to reduce the "burden" to "taxpayers with valid claims."[35] Yet, this legislation retroactively leaves out in the cold any taxpayer with a valid claim that timely filed its claim after January 31, 2024. The sympathetic hypothetical taxpayer that filed a legitimate claim on February 1 might have a strong argument that Congress has done the opposite of easing its "burden" by eliminating the program on which the taxpayer relied for help in meeting payroll.

Penalty Increases

COVID-ERTC promoters facing penalties under section 6701 would also likely challenge the retroactive penalty increases as being in furtherance of an improper legislative purpose. It is important to note, at the outset, that the bill would not modify the knowledge requirement of section 6701 unless the COVID-ERTC promoter did not comply with the new due diligence requirement (but that requirement is prospective). Thus, in those cases in which the due diligence requirement does not apply, the government will have to prove, either by a preponderance of the evidence or clear and convincing evidence (depending on the circuit),[36] that the COVID-ERTC promoter knew that a particular ERC claim would result in an understatement for a taxpayer. That will be a high hurdle for the government in all but the most egregious cases. That being said, concerns about retroactivity will remain.

In *Carlton*, the Supreme Court emphasized that taxation is neither a penalty nor a liability but "a way of apportioning the cost of government among those who . . . enjoy its benefits."[37] This is not the case in the present legislation. The House Ways and Means Committee has proposed legislation to target a specific, small class — the so-called COVID-ERTC promoters — with up to an almost 20,000 percent (or greater) increase in penalties.[38] The penalty is not apportioned among the masses who enjoy the fruits of government, nor even among those who received the benefits of the ERC. Indeed, the newly defined class of COVID-ERTC promoters might argue this penalty has little or nothing to do with the cost of government. Rather, they might argue, it is an enormous, purely retrospective penalty applied against a specific, disfavored industry and is a

[32] Obviously, eliminating the ERC any earlier than the originally enacted deadlines may be unfair to any business that relies on those original deadlines, but our focus here is on retroactivity.

[33] H.R. Rep. No. 118-353, at 94 (2024).

[34] *Ridgely v. Lew*, 554 F. Supp. 3d 89 (D.D.C. 2014); *Loving v. IRS*, 742 F.3d 1013 (D.C. Cir. 2014).

[35] H.R. Rep. No. 118-353, at 94.

[36] *See Barr v. United States*, 67 F.3d 469, 470 (2d Cir. 1995) (preponderance); *Mattingly v. United States*, 924 F.2d 785, 788 (8th Cir. 1991) (preponderance); *Carlson v. United States*, 754 F.3d 1223, 1228 (11th Cir. 2014) (clear and convincing).

[37] *Carlton*, 512 U.S. at 33, *citing Welch v. Henry*, 305 U.S. at 147.

[38] Under current law, a COVID-ERTC promoter would be subject to a $1,000 penalty under section 6701 for a client that is a business entity other than a corporation, like a partnership. Under the proposed legislation, that penalty would become at least $200,000 (or, if more, 75 percent of the gross income derived or to be derived from that client).

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"harsh and oppressive" targeted attack that "transgresses the constitutional limitation."[39]

There is also the notion that many COVID-ERTC promoters served Congress's early interest by raising awareness of the ERC and assisting eligible businesses with obtaining the refunds to which they were rightfully entitled. And, although the section 6701 penalty regime would not apply to most refund claims because of the high standard, the retroactively increased penalties will be cause for concern for even those who tried to get it right, especially since COVID-ERTC promoters worked without guidance from the IRS in those early days in which they helped raise awareness.

COVID-ERTC promoters might also argue that the penalty increase's four-year period of retroactivity is immodest. That argument might be strengthened by the fact that the penalty reaches back to a time when the IRS had not yet issued any guidance. Multiplying the penalty for COVID-ERTC promoters who acted under undeniably unclear law might appear "harsh and oppressive." Of course, the lack of guidance will make it even more difficult for the government to prove the knowledge element of section 6701, which should provide some protection.

[39] *Welch v. Henry*, 305 U.S. at 147.

Further, a COVID-ERTC promoter might reference precedent like *Milliken*, noting that the Supreme Court has generally found periods of retroactivity to be excessive when the "tax burden imposed could not have been understood and foreseen by the taxpayer at the time of the particular voluntary act which was made the occasion of the tax."[40] COVID-ERTC promoters might argue that, while they could have foreseen some penalty for the voluntary act that was the occasion of their being penalized, they could not have foreseen the total burden imposed by the greatly enhanced penalties proposed in the legislation.

Conclusion

This article is admittedly one-sided, presenting arguments that taxpayers and the newly defined class of COVID-ERTC promoters might make as to why retroactive pieces of the legislation violate due process. The government would undoubtedly respond to those arguments if and when presented. As noted, we believe Congress could avoid those issues simply by making the legislation prospective. ■

[40] *Milliken*, 283 U.S. at 21.

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