7. What is the difference between computing tax expenditures on a cash-flow basis and on a present-value basis? Why is the distinction likely to be particularly important with respect to tax expenditures that take the form of deferrals?

8. The 1974 Congressional Budget Act, which mandated the tax expenditure budget, did not specify the "baseline" to which tax expenditures are to be compared. This omission is significant, because the baseline is probably the most important and most controversial aspect of the process. The officials charged with preparing the tax expenditure budgets thus have some leeway to change their approach over time, which may lead to charges of manipulating the process to serve political goals of the party controlling the Presidency (in the case of the OMB) or Congress (in the case of the Congressional Budget Committee).

9. The problem in selecting the baseline is dramatically demonstrated by the realization rule. As we have seen throughout this book, myriad problems, both conceptual and practical, arise from the failure to tax unrealized appreciation. Should failure to adhere to the Haig-Simons definition of income with regard to unrealized gain be regarded as a massive tax expenditure, or is the realization rule so basic that it is the "norm"? If so, should instances in which the law requires mark-to-market tax treatment be regarded as negative tax expenditures?

10. OMB compiles the tax expenditure budget using "reference law" and "normal tax" baselines. While the reference law baseline is an attempt to derive a supposed norm from present law, the normal tax baseline deviates from present law toward the Haig-Simons "ideal," at least in some respects. Because the concept of income is broader under Haig-Simons than under present law, OMB observes that "[tax expenditures] under the reference law baseline are generally tax expenditures under the normal tax baseline, but the reverse is not always true."

Some of the items classified as tax expenditures under the normal tax baseline, but not under the reference law baseline, are of significance. For example, accelerated depreciation (more rapid than economic depreciation) and corporate tax rates below the top rate (35 percent) are regarded as tax expenditures under the normal tax baseline, but not under the reference law baseline.

11. Note, however, that even the normal tax baseline embodies "several major departures from a pure comprehensive income tax." These include the failure to regard unrealized appreciation as income, failure to take account of inflation, and accepting a two-level tax on corporate income as part of the baseline.

12. The Appendix to the OMB tax expenditure budget for FY 2009, like most Bush-era tax expenditure budgets, undertakes an alternative computation of tax expenditures using a comprehensive, or Haig-Simons, baseline. Is such a baseline to be preferred to those traditionally used in the tax expenditure budget?

13. While tax expenditures, almost by definition, make the Internal Revenue Code longer and more complex, particular tax expenditures can actually simplify compliance with, and administration of, the law. Simplifying tax expenditures include provisions such as section 121 (effectively exempting from income most capital gains on sales of principal residences) and section 179 (allowing many taxpayers to immediately deduct purchases of equipment, rather than deducting the cost over time through capitalization and depreciation).

On the other hand, many tax expenditures clearly result in significant complication on all levels. An important example is the earned income tax credit, which brings millions of individuals who otherwise would not need to file returns into contact with the Internal Revenue Service. Whatever benefits the EITC may bring, simplifying life for either low-income taxpayers or the Service is not among them. (But, on the third hand, any program designed to deliver tens of billions of government dollars to low-income individuals would have to entail considerable complexity for the recipients and for *some* government agency.)

14. The Appendix of the FY 2009 (Bush) tax expenditure budget attempts to analyze tax expenditures under a comprehensive, Haig-Simons, definition of income. Difficulties, results some perhaps unexpected, immediately appear. Given the broader sweep of income under the Haig-Simons definition than under the norms of current law, one counterintuitive result is that some items presently classified as tax expenditures might not be regarded as tax expenditures under the comprehensive tax baseline. For example, deductions for home mortgage interest and property taxes on owner-occupied housing are regarded as tax expenditures under the traditional tax expenditure budget. But if the imputed value of living in the owner-occupied house should be regarded as Haig-Simons income, then associated expenses, such as interest and property taxes, would be appropriate deductions, and thus those deductions should not be regarded as tax expenditures.

15. Traditionally, little or no official attention has been given to deviations from the norm that increase taxes (such as various limitations on the deduction of losses). Do you find useful the concept of negative tax expenditures explored in the FY 2009 Appendix?

16. The double tax on corporate earnings can be viewed as a negative tax expenditure. The FY 2009 Appendix notes that Congress granted partial relief

21. How does a reduction in income tax rates affect tax expenditures?

22. Is the concept of tax expenditures merely a way of framing the issue as to what should be included in the income tax base?

23. If a credit against tax is allowed for purchase of a depreciable asset, should the tax basis of the asset thereafter be the full price paid for it or its cost reduced by the tax credit?

24. Professor Surrey argued that almost any tax expenditure could be duplicated, in substantive effect, by a direct expenditure program. Is this correct? What difference would it make? Would direct expenditures be more closely scrutinized? Would direct expenditures exclude as potential beneficiaries those with so little income that they paid no income tax, as tax expenditures routinely do?

25. Would charities be indifferent if Congress ended the tax deduction for charitable contributions and substituted, as Professor Surrey suggested, "a direct expenditure program under which the Government matched with its grants, on a no-questions-asked and no-second-thoughts basis, the gifts of private individuals to the charities they selected"?[j] Would such a direct expenditure be constitutional if the charity were a church?

26. Of course, even a tax expenditure in the form of a charitable contribution deduction could be constitutionally suspect. In a detailed review of this topic, Professor Linda Sugin concludes that, though the issue is not entirely free from doubt: "Indirect benefits do not imply government support and approval to the same extent as benefits that emanate straight from the government,"[k] and "it is clear that the economic equivalence of tax benefits and direct spending is not the most important factor to consider in establishment clause analysis."[l]

27. The structure of a tax expenditure can be important. Prior to the Tax Reform Act of 1986, taxpayers over the age of 65 and blind taxpayers were allowed an additional personal exemption, which had the effect of a deduction for all such taxpayers. The 1986 Act, in addition to reducing the amount of the benefit, changed its structure—rather than a personal exemption available to all aged and blind taxpayers, it was restructured as an increased standard deduction, which is of no value to those who itemize deductions.[m] What policy choices, or what views of the effects of age or blindness, justify one structure

j. Surrey, *supra* note a, at 133.

k. Linda Sugin, *Tax Expenditure Analysis and Constitutional Decisions*, 50 HASTINGS L.J. 407, 471 (1999).

l. *Id.* at 472.

m. Section 63(f).

as compared to the other? What different set of decisions would be reflected by converting the tax advantage to a "refundable" credit?

28. Why does Congress give a tax advantage to taxpayers who are elderly or blind, and not to taxpayers with other afflictions, such as quadriplegia? Can such distinctions be defended?

29. Tax expenditures arising from deferral of tax liability have attracted relatively little political opposition, perhaps because the advantages of deferral are better understood by the beneficiaries than by the general public. Moreover, such tax expenditures can be defended politically on the grounds that the tax is "merely" being postponed.

Tax expenditures arising from deferral are difficult to quantify because the cost to the government depends not only on the amount and length of deferment, but also on the interest rate assumed in computing the time value of money. In measuring these tax expenditures, the Office of Management and Budget uses as a discount rate "the interest rate on comparable maturity Treasury debt." Is this appropriate, or should we look to what the typical taxpayer would have to pay to borrow money?

30. Professor Zelinsky asserts that Surrey and his adherents have unfairly painted tax expenditures, in part due to a failure to "compare the messy realities of tax preferences with the equally unattractive realities of direct expenditure programs."

31. Zelinsky asserts that the choice between tax expenditures and direct expenditures may entail a tradeoff between expertise and "capture." Which way does a desire for knowledgeable decisionmakers point? What does Zelinsky mean by "capture," and why does he view capture as a serious concern?

32. Zelinsky uses agriculture to illustrate his argument. Given that all three officials are appointed by the President and serve at his pleasure, why is it more likely that the Secretary of Agriculture will be more responsive to a particular constituency (agricultural interests) than will the Secretary of the Treasury and the Commissioner of Internal Revenue?

33. Professor Zelinsky makes a telling point, in noting the broad Treasury proposals in 1984 ("Treasury I," which ultimately led to the Tax Reform Act of 1986), and observing that "[i]t is hard to conceive of the direct expenditure departments proposing such sweeping repeal of the programs they administer."

34. For reasons perhaps more obvious, members of the House and Senate agriculture committees are far more likely to be allied with agriculture

interests than are members of the Ways and Means and Finance Committees—or than the membership of the House and Senate as a whole. Who is likely to seek a seat on an agriculture committee—a representative of a rural or urban state or district? From what industry can a member of an agricultural committee look to receive a disproportionate share of her campaign contributions?

Professor Zelinsky's point is not that the tax committees are "inhabited exclusively by the pure of heart," but that they are more likely to serve disparate, competing constituencies.

35. After reading Professor Zelinsky's argument, are you, like he, "agnostic" concerning the choice between tax expenditures and direct expenditure programs, or do you generally prefer one approach or the other?

36. A relatively new statute, the Government Performance and Results Act of 1993 ("Results Act"), offers the possibility of more effective oversight of government programs, including those administered through tax expenditures. In response to that Act, each year's Tax Expenditure Budget includes an appendix that evaluates tax expenditures and compares them to direct expenditures and regulations, which are alternative means of pursuing governmental goals. (See Appendix of the 2011 Tax Expenditure Budget; similar appendices have been in each budget since 1993.)

Professor Mary Heen concludes that "[t]he Results Act framework, if comprehensively applied, provides a new opportunity to address the management and oversight problems posed by the use of tax expenditures as alternatives to direct expenditure programs."[n] While promising in theory, however, Professor Heen expresses concern, based on early experience with two employment tax credits (Welfare-to-Work Tax Credit and Work Opportunity Tax Credit), that the information generated by the executive review may not lead to effective legislative oversight:

> The lack of integrated review in these particular cases does not derive from a lack of transparency or a dearth of data; instead, it represents, depending upon your view of the legislative process, either "business as usual" or a structural failure to consider tax system and direct spending alternatives as part of a coordinated program review process.[o]

C. THE TAX EXPENDITURES CONCEPT CHALLENGED

Unless carefully confined, the premise of the tax expenditures concept might be ridiculed by *reductio ad absurdum*: any portion of a taxpayer's

n. Mary L. Heen, *Reinventing Tax Expenditure Reform: Improving Program Oversight Under the Government Performance and Results Act*, 35 WAKE FOREST L. REV. 751, 825 (2000).

o. *Id.* at 826.

income that the Government allows the taxpayer to keep would be a tax expenditure. In a slightly less extreme form, under a progressive income tax rate structure, any revenue lost by failure to tax everyone at the top bracket rate might be considered a tax expenditure.

The more limited view of tax expenditures requires the application of normative standards, but, as the excerpts in this subchapter demonstrate, these standards are open to challenge. Professors Kahn and Lehman argue that the definition of the "norm" in tax law cannot be divorced from broader societal judgments—that the tax laws "serve to reaffirm public values that are 'normative' in every sense of the word except the one used by advocates of tax expenditure budgets." Professor Bittker, perhaps the leading tax scholar of his generation, criticized the tax expenditure concept in 1969, when Stanley Surrey's idea was new and prior to the 1974 congressional mandate for an annual tax expenditure budget. Finally, the brief excerpt from Philip Oliver may cast doubt on the concept by suggesting that one deduction generally regarded as a classic tax expenditure—the deduction for home mortgage interest—may be helpful in equitably measuring income, rather than merely furthering the nontax goal of assisting taxpayers in purchasing homes.

EXPENDITURE BUDGETS: A CRITICAL VIEW

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54 Tax Notes 1661, 1661-63 (1992)

The various tax expenditure budgets prepared in the legislative and executive branches purport to carry out a straightforward task. They claim to identify those situations in which Congress has departed from the "normative," "normal," or "correct" tax rule in a way that is equivalent to the appropriation of public funds. Or, as it is sometimes put, they expose circumstances in which Congress has chosen to subsidize certain activities indirectly, through the Internal Revenue Code.

Yet, the very statement of the task exposes its Achilles heel. It assumes the existence of one true, "correct," "normative" rule of federal income taxation that should be applied to any given transaction. The collection of all such rules stands as a kind of Platonic Internal Revenue Code, an implicit reprimand to the flawed efforts of our mortal Congress.

We believe that questions of tax policy are more complicated than that. An ideal Internal Revenue Code makes no more sense than an ideal Environmental Protection Act or an ideal Penal Code. An income tax stands inside, not outside, the society that enacts it.

The particular contours of our federal income tax serve to reaffirm public values that are "normative" in every sense of the word except the one used by advocates of tax expenditure budgets. The disallowance of a deduction for illegal bribes confirms that we think they are naughty. Similarly, the limitation on losses from wagering transactions shows that we do not consider

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them to be an appropriate foundation for a career. Conversely, the exclusion from income of tort recoveries is an expression of public compassion. And our refusal to tax people when their neighbors help them move furniture, or (as some have suggested) when they enjoy a few moments of leisure, suggests a shared sense of a private domain in which even the tax collector will respect people's right to be left alone.

Experts can help to clarify the implications of one tax policy choice over another. They can show how one choice favors one particular set of moral, political, or economic commitments over another. They can argue for greater consistency in the way tensions among such commitments are resolved. They can estimate the differences in the amount and distribution of revenues that would be collected under different regimes. But, the ultimate choice must rest with the citizen and not the oracle.

The Choice Among Utopias

Let us describe a series of perspectives that are frequently presented concerning the ideal nature of an income tax:

(1) For some observers of the tax scene, any tax that alters citizen behavior is terribly unfortunate. Such observers decry any tax that alters individuals' economic incentives from what they would have been in a world with no taxes and a perfect marketplace. They would prefer that the government raise its revenues exclusively by taxing (a) activities that generate negative externalities, and (b) goods for which the demand is entirely inelastic. Since no income tax can pretend to be nondistortional, such observers view all income taxes as tainted by a kind of "original sin."

(2) Other, more practically minded observers, worry that the taxes that would satisfy perspective (1) would not generate enough revenues for the government to finance its current level of operations. They believe that Nicholas Kaldor had it right almost 40 years ago, when he argued that the proper income tax system is what we now call a consumption tax. Such observers are willing to accept the fact that a consumption tax biases taxpayers' choice between labor and leisure. They console themselves with the observation that at least a consumption tax avoids biasing the choice between savings and current consumption.

(3) Another set of commentators objects that a consumption tax that would satisfy perspective (2) ignores the new economic power reflected in congealed, unconsumed, newly acquired wealth. They contend that all such economic power should be reckoned in the tax base, perhaps as a proxy for an (ideal) wealth tax. For such observers, the touchstone of income taxation must be the sum of consumption and wealth accumulation—what is commonly known as Haig-Simons income.

(4) Still other commentators find fault with the pure Haig-Simons approach endorsed under perspective (3). It would offend such commentators' notions of privacy to tax citizens on unrealized asset appreciation and on imputed income from services or durable goods. Or, at least, it would require a preposterous expenditure of administrative resources in an ultimately futile quest. These observers would prefer that we tax Haig-Simons income to the

extent it is realized through market interactions.

(5) Yet another set of commentators finds fault with even the market-delimited, realization-qualified version of the Haig-Simons approach suggested by perspective (4). They believe that such an approach unacceptably distorts investor incentives, leading them to overconsume and undersave, to indulge in too much leisure and not enough work. While they are in sympathy with the political vision that would allocate the tax burden according to accumulating economic power, they favor qualifications to that vision whenever the cost to productive incentives appears to jeopardize economic growth.

(6) Finally, one finds the United States Congress. It apparently believes that even the approach dictated by perspective (5) would leave the American economy in the wrong place. Not enough research and development, not enough low-income housing, not enough money in the hands of working families with children, not enough money in the hands of churches and museums, too many renters and not enough homeowners, etc., etc., etc.

If one is prone to depression, one can view the foregoing list of perspectives from (1) to (6) as identifying a kind of linear decline. Each is one step further from the Garden of Eden of distortion-free taxation. We view them differently. We prefer to see each perspective as emphasizing different elements in a basket of normative values—efficiency (in the neoclassical economic sense), consumption/savings neutrality, privacy, equity, administrability, charity, pragmatism, etc.

What is disturbing about the language of tax expenditures is its tone of moral absolutism. The tax expenditure budget is said to distinguish "normal" tax practice from that which is deviant. Sometimes it is said to distinguish provisions that are "normative" (?) from those that are (presumably) nonnormative (?!). This language is doubly confusing. First, it suggests that provisions that fit *within* the implicit baseline of the tax expenditure budget are somehow pure, safe, and good. They should not be changed because "neutral" principles have blessed them. Conversely, the language suggests that provisions that fall *outside* the implicit baseline of the tax expenditure budget (tax expenditures) are somehow corrupt, dangerous, and evil. They should be changed as soon as possible to conform with the "neutral" position. To flirt with them is to call one's probity into question.

This is, of course, a bit of an overstatement. But, it captures the rhetorical direction of the tax expenditure budget. And that rhetorical direction is grossly misleading. The tax expenditure budget's conception of an appropriate tax base has no legitimate claim to establishing the terms of political debate. * * *

The Illusion of Value-Free Precision—An Example

The reference point for construction of the tax expenditure budget is a measure of taxable income that is close to position (4) above, with some variations. That may be some people's Platonic Internal Revenue Code, but it is obviously not everyone's. The choice among perspectives is a contestable, contingent, political decision. Thus, while the several existing tax expenditure

budgets give an appearance of being the products of a highly sophisticated, expert, neutral examination of the tax system, they could just as accurately be characterized as exercises in mystification. They create only an illusion of value-free scientific precision in a heavily politicized domain.

Consider two features of our tax system. First, it grants a form of accelerated depreciation. Second, it does not tax unrealized gains. The first feature appears in tax expenditure budgets. * * * Yet the second feature—the refusal to tax unrealized gains—does not appear in any tax expenditure budget.

The tax expenditure budget baseline, which distinguishes between these two features, is "normative" in the sense that it advances a particular moral or political claim. It reflects a particular balance among the ideals of efficiency, equity, neutrality, administrability, privacy, charity, and pragmatism. But, each of the six perspectives enumerated in the prior section is "normative" in precisely the same way. * * *

One can advance plausible arguments in favor of taxing unrealized gains. One can advance plausible arguments against granting accelerated depreciation deductions. One could also argue for the status quo with regard to each of these features. But, there is no *a priori* reason to classify one feature differently from the other, or to allocate a heavier burden of persuasion to those who attack realization or defend accelerated depreciation than one allocates to those who defend realization or attack accelerated depreciation.

* * *

ACCOUNTING FOR FEDERAL "TAX SUBSIDIES" IN THE NATIONAL BUDGET

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22 National Tax Journal 244, 246-57 (1969)

Although Mr. Surrey did not address himself to the mode of presentation, his proposal implied that "tax benefit provisions" would be reported in the Budget as hypothetical expenditures, to be "classified along customary budgetary lines: assistance to business, natural resources, agriculture, aid to the elderly, medical assistance, aid to charitable institutions, and so on."[5]

* * *

Fleshing out Mr. Surrey's proposal, the Treasury has estimated the revenue lost by virtue of "the major respects in which the current income tax bases deviate from widely accepted definitions of income and standards of business accounting and from the generally accepted structure of an income tax." These estimates were published, along with a discussion of the conceptual framework governing the items selected for inclusion, in an exhibit to Secretary Fowler's final report as Secretary of the Treasury, under the title "The Tax Expenditure Budget: A Conceptual Analysis." This study should be

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5. Surrey, Taxes and the Federal Budget (speech to Financial Executives Institute, Dallas Chapter, Feb. 13, 1968), p. 13.

regarded as only a first step in achieving the "full accounting" envisioned by Mr. Surrey. * * *

It has been a familiar exercise for many years to compute the "cost" of a proposed tax provision by estimating the amount of revenue that would be lost by its enactment; and at first blush, a "full accounting" seems to require nothing more than an aggregation of such estimates, based on existing tax concessions, rather than on proposed ones. If that were its only prerequisite, an expansion of the Treasury's estimating facilities and staff would bring us close to achieving the promise of a "full accounting." To be fully informative, of course, the estimates would have to take account of the fact that tax concessions influence behavior; since the revenue "lost" by virtue of any tax provision depends in part on its absence, its "cost" cannot be accurately measured by merely recomputing the tax liability on the return as filed. It might turn out that the revenue effects of tax incentive provisions, if they succeed in their objective of altering behavior, are especially difficult to estimate—although these are precisely the provisions that are most in need of cost effectiveness studies. * * *

Even if the Treasury's estimates could be refined to take into account tax-induced changes in behavior, however, a major obstacle in achieving a "full accounting" would remain, viz., the fact that a systematic compilation of revenue losses requires an agreed starting point, departures from which can be identified. What is needed is not an ad hoc list of tax provisions, but a generally acceptable model, or set of principles, enabling us to decide with reasonable assurance which income tax provisions are departures from the model, whose costs are to be reported as "tax expenditures." In this connection, it is important to note that the proposed "full accounting" is evidently intended to embrace every provision that serves as the substitute for an appropriation, including those that are solely or primarily distributive in function (e.g., the extra $600 exemption for the blind and the aged).[p]

In listing the exclusion of social security benefits as a "tax expenditure" that ought to be reflected in the Federal Budget as aid to the elderly, the Treasury analysts very likely had in mind the fact that these receipts constitute income under the Haig-Simons definition. Conversely, their study accepts the deduction of business expenses under §162 as necessary to the accurate determination of net income, with the result that the revenue "lost" by virtue of this provision is not reported as a "tax expenditure" to aid private enterprise. In making this distinction, no value judgment is intended: the deduction of business expenses and the exclusion of social security benefits are not treated differently because one provision is "good" and the other "bad," but because one is helpful or necessary in defining net income, while the other distorts the computation of income. Thus, in asking that the revenue losses resulting from "deliberate departures from accepted concepts of net income and through special exemptions, deductions and credits" be reported as

p. Present law no longer provides an additional personal exemption for aged and blind taxpayers; they are entitled, however, to an increased standard deduction. Section 63(f). (Ed.)

"expenditures," Mr. Surrey noted that these "tax benefit provisions" will have to be separated from provisions that serve to define income accurately: "We should not, of course, overlook the difficulties of interpretation or measurement involved here."[9] * * * In the same vein, the Treasury study seeks to identify the provisions of existing law that deviate "from widely accepted definitions of income and standards of business accounting and from the generally accepted structure of an income tax."

To effect a "full accounting," then, we must first construct an ideal or correct income tax structure, departures from which will be reflected as "tax expenditures" in the National Budget. Although Mr. Surrey is not explicit on the point, his proposal has much in common with the call for a comprehensive income tax base, which similarly presupposes an ideal tax structure—based on the Haig-Simons definition of income—any departure from which is to be regarded as a maverick that must shoulder a heavy burden of justification.

The call for a "full accounting" does not by itself imply that repeal of all of these provisions is feasible or desirable, but only that the revenue lost by sticking with existing law should be disclosed in the Budget. At the same time, it is not insignificant that Mr. Surrey doubts the "efficiency" of these provisions and their ability to withstand public scrutiny if viewed as expenditures; after all, the purpose of the "full accounting" is to stimulate a re-examination of "tax expenditures," rather than merely to record them for economic historians or antiquarian statisticians. Unless the "full accounting" is to be limited to those provisions that the incumbent Secretary of the Treasury wants Congress to repeal, however, it will require a formidable list of tax provisions to be reflected as "expenditures" if the Haig-Simons definition is to be the criterion for judging the extent of the current Internal Revenue Code's departure from "a proper measurement of net income."

Such a comprehensive list of "tax expenditures" would include a number of items that Congress has so far shown no interest in repealing, despite the magnitude of the revenue "lost" by their preservation. Thus, the cash receipts and disbursements method of accounting for income—which conflicts with the Haig-Simons definition because it does not currently reflect changes in the taxpayer's net worth—can be described as a "tax subsidy," granted for the double purpose of simplifying the income-reporting process for taxpayers with rudimentary records and of easing the payment problem for taxpayers who have rendered services or sold property, but have not yet collected from their customers and clients. Another example of a "tax expenditure" that has hitherto been considered sacrosanct is the exclusion of unrealized appreciation from income, a "preference" that is customarily accepted by even the most confirmed advocates of a comprehensive income tax base on the ground that difficulties in valuing the taxpayer's assets make it administratively impossible to apply the Haig-Simons definition in this area. * * *

A whole-hearted enemy of "backstairs" spending might, I suppose, argue

9. Surrey, The United Income Tax System—the Need for a Full Accounting (speech to Money Marketeers, Nov. 15, 1967), p. 5.

that a disclosure of the cost of the cash receipts and disbursements method of accounting or of the realization concept would be a first step to their elimination. * * *

Favorable legislative action on such proposals is so remote a possibility, however, that one may be inclined to argue for reporting in the National Budget only those "tax expenditures" that Congress is likely to repeal—once they have been brought into the open. But if the "full accounting" is to be limited in this fashion, some of the prime candidates for inclusion on the "expenditure" side might fall by the wayside. I am not at all sure, for example, that percentage depletion and the immunity of state and municipal bond interest are more vulnerable to Congressional hostility than the cash method of accounting. * * *

Assuming a consistent application of the Haig-Simons definition, however, there are many other areas that would generate "tax expenditures" for inclusion in the Budget, including the exclusion from taxable income of gifts, bequests, life insurance proceeds, and recoveries for personal injuries and wrongful death; * * * personal and dependency exemptions; imputed income from assets and housewives' services; the non-recognition provisions (e.g., exchanges of like-kind property, corporate reorganizations, etc.); depreciation deductions that exceed declines in market value * * *; current deductions for expenditures that have value beyond the current year (e.g., research and experimental expenses, institutional advertising, and outlays for industrial know-how); special accounting privileges (e.g., installment sale reporting); the foreign tax credit[15] and other items. The Treasury study—perhaps because it is offered as a "minimum" rather than comprehensive list—makes a number of compromises in applying the Haig-Simons definition in these areas. Thus, it estimates the cost of excluding employers' contributions to pension plans and the interest component of life insurance savings, but not the revenue cost of excluding increases in the taxpayer's net worth resulting from other transactions. Similarly debatable lines are drawn at other points, in that the study estimates the revenue cost of excluding or deducting: public assistance, but not gifts from charitable agencies, friends, and relatives; sick pay and workmen's compensation, but not recoveries and settlements in personal injury suits; child care expenses of employees, but not their moving expenses; accelerated depreciation on buildings, but not straight-line depreciation (even though it too may exceed the property's decline in market value); the

15. The foreign tax credit protects taxpayers with foreign operations against double income taxation; but of all possible ways of accomplishing this end, it is the most costly for the United States. If its cost were reflected as a "tax expenditure," Congress might decide that relief from double taxation could be procured more "efficiently" by hiring more persuasive ambassadors, speaking softly but carrying a big stick, or threatening to reduce our appropriations for foreign aid. In the alternative, Congress might decide that if a deduction is a sufficient recognition of the added burden of a state or local income tax, it is equally sufficient in the case of a foreign tax. The proper treatment of the foreign tax credit is discussed in the Treasury's Tax Expenditure Budget, Annual Report of the Secretary of the Treasury on the State of the Finances (fiscal year ended June 30, 1968) (1969), p. 331; but no estimate of its cost is made because of the complexity of the issues involved.

expensing of research and experimental expenditures, but not the rapid amortization of such outlays (even if their long-term value is substantial), nor the expensing of comparable outlays for good will, industrial know-how, etc.; nonbusiness state and local taxes, but not foreign taxes. * * *

The revenue cost of the omitted items may have been too difficult to estimate with the data at hand when the Tax Expenditure Budget was prepared; I mention them not to criticize an admittedly "minimum" list for conforming to its self-description, but to illustrate the scope of the Haig-Simons definition. Because I have recently discussed the ramifications of a consistent adherence to this definition, I will not undertake to list here the many other provisions of existing law that, in my opinion, depart from that definition. Suffice it to say that a "full accounting" for these departures would be a formidable undertaking, comparable to Prof. Charles O. Galvin's challenging proposal for a tax model based on the comprehensive income tax base concept. There is, however, a major difference between the two projects, stemming from the fact that the Haig-Simons definition provides no guidance to many structural issues that must be decided in any income tax law. As to these decisions, the unofficial research model proposed by Prof. Galvin can experiment with alternatives, while the Treasury's "full accounting" will have to select one "correct" model against which to measure existing law. Because I see no way to select such an "official" model for these structural provisions, I am not sanguine about the prospects for a "full accounting."

One such area is the rate structure. In 1964, income tax rates were substantially reduced, for the stated purpose of encouraging economic growth. Since an alternative method of accomplishing this objective was a federal subsidy, should the reduction have been reflected in the Treasury's "Tax Expenditure Budget?" The logic of the "full accounting" approach suggests an affirmative response, so that the cost of this effort to increase economic growth by a rate reduction would be constantly brought to public attention, thus encouraging an annual review of both the merits of its objective and its efficiency as compared with other devices and programs to accomplish the same end. * * *

Once it is decided that a rate reduction may be a form of "back door spending," however, we encounter a troublesome—perhaps an insoluble—problem of measurement. The cost of the 1964 experiment in encouraging economic growth by a rate reduction might, I suppose, be ascertained by computing the difference between (*a*) the revenue actually collected, and (*b*) the amount that would have been produced if the old rates had been perpetuated. (Ideally, of course, account should be taken of the effect of the reduced rate on the volume of taxable income; but if this is not done for other "tax expenditures," presumably it would not be done in this instance either.) The aggregate cost of the tax reduction would then be allocated among income classes, to reflect the cost of the tax cut for each such group. This process could be repeated for each tax cut in our history, so that the "tax expenditure" section of the National Budget would report, separately, the "cost" of every such change, classified as an aid to investment, a device to

encourage consumer spending, and so on, depending on its purpose. The aggregate to be reported for the current year would thus be the difference between the revenue produced by the rates actually in effect, and the amount that would have been produced if the highest rates in history had been preserved. The benchmark year would vary from one taxable income class to another, of course, since the peak rate applicable to each class would be the standard for determining the "cost" of encouraging that group of taxpayers to engage in investment, consumption, or other tax-favored activity.

* * *

Another problem—equally unsolved by the Haig-Simons definition, but equally troublesome to the "full accounting" approach—is the taxable unit to be used in computing the "tax expenditures" that are to be reflected in the National Budget. The problem can be illustrated by a question: should the difference between the tax liability of a married man (or a head of a household) and that of a single individual with the same taxable income be reflected on the expenditure side of the National Budget, as a subsidy to family life, in the interest of a "full accounting"? * * *

It would simplify the search for a "full accounting" to accept the Code's existing classification of taxpayers, disregarding the possibility that structural decisions in this area constitute "tax expenditures." If this were to be done, however, it would seem equally appropriate to me to treat taxpayers who are blind, over 65, or otherwise "different" as appropriate taxpaying units whose exemptions or other allowances are simply devices for imposing rates appropriate to their divergent taxpaying abilities; and the same could be said of taxpayers who have minor children, support aged parents, suffer from illness, or are victimized by fire or theft. * * *

A taxonomic problem that creates similar difficulties for a "full accounting" arises from the separate rate schedules that are applicable under current law to individuals and corporations. Does the fact that the individual rate is lower than the corporate rate at the $5,000 income level mean that the difference is a "tax expenditure" to aid low-bracket individuals? Conversely, since the corporate rate is lower than the individual rate at the $200,000 level, does *this* difference constitute a "tax expenditure" to aid corporate business? Or are the two rate schedules simply not to be compared, on the theory that we have two entirely separate income taxes, each levied on its own self-contained group of taxpayers? * * *

Of course, if the Haig-Simons definition were to be applied to individual taxpayers with rigor, there would be no need to compute the income of legal entities like corporations, since the natural person's net worth computation would have fully taken the corporate activities into account. On this theory, the "tax expenditure" to be reported in the interest of achieving a "full accounting" would take account of the taxes that would be collected from individual shareholders if unrealized appreciation and depreciation on their stock entered into the computation of income. The Treasury's "Tax Expenditure Budget," however, does not attempt such a rigorous application of the Haig-Simons definition, but instead contains estimates of the revenue

cost of existing provisions relating to Western Hemisphere Trade Corporations, the excess bad debt reserves of financial institutions, and the deferral of tax on shipping companies.

The study's working hypothesis, stated without independent discussion, is "[t]he assumption inherent in current law, that corporations are separate entities and subject to income taxation independently from their shareholders." * * * Yet the exemption from corporate tax that is granted to Subchapter S corporations and regulated investment companies is not treated as a "tax expenditure"; evidently it is appropriate to view these corporations as conduits rather than entities. * * * [D]ifficulties in deciding whether corporations are conduits or entities suggest that there simply are no "generally accepted" principles specifying the proper relationship between a corporation's income and its shareholders' tax liability—with the result that it is difficult, if not impossible, to apply the "tax expenditure" concept in this area.

The proper classification of tax-exempt organizations presents another problem for the "full accounting" approach. Should the tax exemptions accorded to educational institutions, churches, charitable organizations, social clubs, and other non-profit institutions be reflected as "tax expenditures" to benefit education, religion, charity, and social intercourse? Or is it more appropriate to view the federal income tax as a device by which the government shares in the profits of activities that are carried on for the personal benefit of individual taxpayers, so that the activities of nonprofit institutions are not a proper subject for income taxation? So regarded, the tax exemption accorded to these institutions is an acknowledgment of, rather than a departure from, the "true nature" of the federal income tax; and hence it is not a "tax expenditure" required for a "full accounting" in the National Budget. * * *

The same question—is tax-exemption an "expenditure" or not?—must be answered with respect to state and municipal governmental agencies, which are not taxed by the federal government on their income, whether derived from taxation, the sale of property or services, investments, or other sources. One might, of course, assert that the immunity from federal taxation that is enjoyed by state and local governments constitutes an "expenditure" because it accomplishes the same result as federal grants to these agencies; and that a failure to acknowledge this infusion of federal assistance understates the federal contribution to their well-being. On the other hand, one is tempted to argue that governmental agencies (even if engaged in activities that compete with private business) do not realize "income" in the Haig-Simons sense, or that, if they do, the federal income tax properly exempts them because it is concerned only with activities carried on for private profit. If this view is accepted, their exemption would not be recorded as a "tax expenditure."

If we conclude that the tax exemption accorded to non-profit organizations and governmental agencies is not a tax expenditure, however, a doubt arises about the proper way to reflect the deductions allowed to individuals for charitable contributions and state and local taxes, as well as the exclusion

from taxable income of state and municipal bond interest. To the extent that these tax provisions inure to the benefit of the individual taxpayer, they might be properly classified as tax expenditures. To the extent of the benefit inuring to the non-profit or governmental agency, however, should these exemptions be bracketed with the agency's *own* exemption, and excluded from the list of "tax expenditures"? If the purpose of a "full accounting" is to disclose the cost of all "government expenditures made through the tax system," it would seem desirable to fish or cut bait: either record the tax-exempt organization's tax benefits as "expenditures" whether they derive from its own exemption or from concessions allowed to others that are passed on to it; or disregard these benefits entirely. To pick and choose among these tax provisions, recording some but not others as "tax expenditures," is a way of compromising on a middle ground, but it falls short of a "full accounting."

* * *

SECTION 265(2): A COUNTERPRODUCTIVE SOLUTION TO A NONEXISTENT PROBLEM

Philip D. Oliver*

40 Tax Law Review 351, 394-96 (1986)

The taxpayer with ready cash can purchase a house outright. Instead of investing his cash to earn a taxable stream of income and then paying nondeductible rent from after-tax dollars, in effect, he can receive a tax-free flow of imputed income from the personal residence. The interest deduction places the taxpayer purchasing his house with borrowed funds in a similar position. For example, suppose each of three taxpayers, *A, B,* and *C,* desires to purchase a personal residence costing $50,000. *A* and *B* each has $50,000 of ready cash; thus, they can purchase their residences for cash, or invest the cash and purchase the residences with borrowed funds. *C* has no available assets and therefore must borrow in order to purchase his residence. Assume further, and somewhat artificially, that the taxpayers can lend or borrow money at 10% interest. Ignoring the transactions described below, the three taxpayers have equal taxable income and will itemize deductions.

A uses his $50,000 cash to purchase his house. He receives neither taxable income nor a deduction as a result of the transaction. The imputed income of the rental value of the house, of course, is not included in income.

Unlike *A, B* chooses to invest his $50,000 cash at 10% interest. He borrows $50,000, also at 10%, to purchase his house. *B* receives taxable income of $5,000 from his investment, but the deduction for the $5,000 interest paid by *B* will offset the interest income. *B*'s taxable income therefore is equal to *A*'s.[184] Because these taxpayers have engaged in transactions that are

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184. *A* and *B* may not have identical taxable incomes since *B*'s offsetting income and deduction may affect other computations. * * *

Of more importance is the assumption that all three taxpayers would itemize deductions even

substantially equivalent in economic terms, their taxable income should be affected in the same way.

C, having no choice, also borrows to purchase his residence. Like *B*, he receives a $5,000 interest deduction. Since *C* has no offsetting income item, *C* has $5,000 less taxable income then either *A* or *B*. This result, however, is precisely what we should expect. *A* and *B* each has $50,000 of assets that, given a 10% interest rate of return, will produce $5,000 annually.

* * *

The denial of an interest deduction thus would favor those with liquid excess cash and the ability to divert it to investments producing only untaxed imputed income. It would disfavor those who borrow to purchase assets that produce imputed income. The interest deduction thus effectively allows those not having sufficient wealth and liquidity to purchase personal assets without borrowing to enjoy the benefits of untaxed imputed personal income.

* * *

Notes and Questions

37. In criticizing the tax expenditures concept, Professors Kahn and Lehman did not mean that every provision in the Internal Revenue Code is normal because it exists, thus depriving us of any standard for judgment. They are saying, in effect, that "normal" is not a useful standard. Virtually every tax provision has political or social implications. In their view, all provisions should be reviewed on their merits, without trying for an automatic rule that will distinguish tax expenditures from normal provisions.

38. Should failure to adopt the Haig-Simons definition of income be regarded as a tax expenditure?

39. Many items generally regarded as tax expenditures are also identified as items of tax preference under the alternative minimum tax provisions (sections 55-59). The AMT provisions demonstrate congressional ambivalence about these items. Does the existence of the AMT provisions support either the proponents or the detractors of the tax expenditures concept?

40. Professor Bittker argues persuasively that a "full accounting" of tax expenditures is likely to be unattainable. Yet not all the distinctions are as nebulous as he suggests. For example, consider his comparison of the exclusion from gross income of Social Security benefits (classified in the official tax expenditure budgets as a tax expenditure favoring the elderly) with the

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without the interest deduction. If this were not the case, *A* would be in a favored position since a portion of the interest deduction of *B* and *C* would be absorbed by the zero bracket amount, and only the excess would be deductible. *See* I.R.C. § 63.

These refinements, however, do not alter the basic point. The interest deduction, even in the case of interest arising from a purely personal expenditure, assures substantial equity among these three typical taxpayers.

section 162 deduction of business expenses (*not* classified as a tax expenditure favoring business). Do you agree with the classifications of the official tax expenditure budgets, or agree with Bittker' suggestion that either of these provisions might logically be included as part of a "full accounting"?

41. In evaluating critiques such as those put forward by Kahn and Lehman, and by Bittker, remember that the fair question is not whether the tax expenditure technique is perfect. No analytic tool will ever meet that test. The question should be whether, even with its considerable imperfections, the tax expenditure concept, on balance, is helpful to Congress and the public in understanding what is going on in the large and complex federal budget.

42. Does Oliver's argument suggest that the home mortgage interest deduction is justified? That it does not constitute a tax expenditure?

43. Note that defense of the present-law home mortgage interest deduction is necessary only because present law fails to reach the imputed income generated by owner-occupied homes. A more ideal system might tax all owners on the imputed income from housing, in which case the interest deduction, as an expense associated with the generation of taxable income, clearly would be appropriate. In that case, the three taxpayers in Oliver's example would have appropriate differences in taxable income as a matter of course.

44. Are we left with a hopeless standoff between the proponents of the tax expenditures approach and its opponents?

D. WHAT FORM SHOULD TAX EXPENDITURES TAKE?

This subchapter opens with a brief excerpt from an article written by William Bradley and Philip Oliver in 1983, not long before the investment tax credit ("ITC") was virtually repealed in the Tax Reform Act of 1986. While the authors focused on the ambiguity in the ITC statute and the Service's administration of it, the broader point made by the excerpt is the importance of clarity in any tax expenditure.

The primary excerpt in this subchapter is from Professor Goldberg's article on "periodic" tax expenditures. Tax expenditures can take many forms. Some, like the former ITC, are one-time exemptions. Under the ITC immediately prior to the Tax Reform Act of 1986, taxpayers who made qualifying expenditures could reduce their taxes by ten percent of the amount expended. No further subsidy from the ITC was to be expected from that year's expenditures (though taxpayers might expect that the program would continue to be available for the next year's expenditures).

Many tax expenditures, however, give rise to ongoing tax preferences. Professor Goldberg terms these preferences "periodic." Examples include the

exclusion of interest on most bonds issued by states and their subdivisions (section 103) and the deduction of interest on home mortgages (section 163(h)(3)). Purchasers of state-issued bonds and homes expect to derive a tax advantage not just in the year of purchase, but in the future as well. And they expect to be able to sell these assets to others, who can themselves benefit from the same favorable tax treatment.

Professor Goldberg discusses the problems that arise when Congress changes its mind and removes a periodic tax expenditure.

INVESTMENT TAX CREDIT: THE ILLUSORY INCENTIVE

William H. Bradley* & Philip D. Oliver**

2 Virginia Tax Review 267, 269-70 (1983)

If ITC is to provide its intended salutary effect, it is apparent that clarity in application of the provisions is important. In fact, while always desirable, clarity is of significantly greater importance here than in most areas of tax law, because a "tax expenditure" such as ITC can be justified only as a stimulus, as a means of encouraging taxpayers to do things which otherwise have nothing to do with taxation or tax policy (in the case of ITC, making investments in certain capital assets).[11]

* * *

The major thesis of this article is that the failure by Congress and the Internal Revenue Service to provide clear guidance to taxpayers with respect to the question of whether particular items of property qualify for the credit has frustrated, to a significant extent, the incentive to invest intended by Congress when it enacted the ITC provisions. In prescribing property which qualifies for the credit, inconsistent and vacillating interpretations by the Internal Revenue Service have compounded the ambiguity of the statute and the regulations. To the extent that the availability of ITC, where the primary governmental goal is unrelated to the raising of revenue, is governed by an unclear legal framework, the likely result is that taxpayers will tend to make the same investment they otherwise would have made, then seek the maximum ITC available. This phenomenon entirely frustrates the governmental policy of encouraging investment and converts a stimulus into a windfall.[16]

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11. Most tax provisions are directed only at the raising of revenue, and while complexity and ambiguity are never desirable, at least in these instances the complexity and ambiguity are likely to be associated with traditional tax goals, such as the accurate determination of the amount, timing, and character of the income.

16. Even where the law is unclear, the possible availability of ITC will still provide taxpayers some motivation to make a given investment, despite possible challenge from the Service. This would appear to be an inefficient "tax expenditure," however, since it can reasonably be assumed that a taxpayer will not substantially alter its investment policy when it knows that it may be "buying a lawsuit."

TAX SUBSIDIES: ONE-TIME VS. PERIODIC— AN ECONOMIC ANALYSIS OF THE TAX POLICY ALTERNATIVES

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49 Tax Law Review 305, 305-27, 329, 331-47 (1994)

Introduction

The current tax system integrates structural revenue raising provisions with policy-driven tax incentive, or subsidy, provisions designed to induce taxpayers to engage in activities favored by Congress for extrinsic political or social reasons. The wisdom of this dual mission has been the subject of extensive analysis and criticism. Indeed, the Tax Reform Act of 1986 marked a distinct shift away from the use of tax incentives.

It now has become apparent that this country is likely to reverse much of the 1986 tax reform and to resume using the tax system to provide incentives for business and other socially desirable activities. * * *

At this stage in tax evolution, one either could warn again of the dangers of using the tax system to advance social and economic goals, or accept the inevitable and attempt to insure that tax incentives are structured in the best possible way. Adopting the latter course, this Article offers a new and useful framework for structuring tax policy in the 1990's in order to minimize harmful economic and social side effects of tax incentives. The Article identifies the most pernicious type of tax incentives as periodic subsidies, that is, subsidies that are available to taxpayers over a period of years, rather than on a one-time basis. Periodic subsidies are inefficient and are likely to decrease the horizontal equity of the tax system. Drawing on the jurisprudence of just compensation law and on economic theory, the Article concludes that Congress should refuse to succumb to the temptation to use periodic tax incentives as an instrument of tax and economic policy but, instead, should employ only one-time subsidies. In reaching this conclusion, the Article takes issue with the recent scholarship of Professors Michael Graetz[7] and Louis Kaplow[8] whose advice to eschew transition relief for tax changes apparently has gained substantial currency among tax policymakers.

* * *

A New Tax Policy Framework for Tax Incentives

The Traditional Approach: Tax Expenditures

All tax incentive provisions have one thing in common, regardless of their form. They are designed to generate a movement of capital or labor into a particular activity by reducing the effective tax on income from that activity. A tax incentive provision works only when it has the effect of reducing a participant's tax. The resultant reduction in the federal government's revenue collection attributable to the tax incentive provision can be viewed as a subsidy

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7. Michael J. Graetz, Legal Transitions: The Case of Retroactivity in Income Tax Revision, 126 U. Pa. L. Rev. 47 (1977-1978) [hereinafter Tax Revision].

8. Louis Kaplow, An Economic Analysis of Legal Transitions, 99 Harv. L. Rev. 509 (1986).

to the tax-favored activity. Stanley Surrey referred to the lost revenue attributable to a tax incentive provision as a "tax expenditure."

Commentators sometimes disagree about which tax provisions represent subsidies and which represent integral parts of the income tax structure because they involve measurement of income. Structural components are the so-called normative elements of a revenue raising system. They include the definition of income, the specification of accounting periods, the determination of entities subject to tax, and the specification of tax rate schedules and exemption levels. Thus, a change in tax rates, for example, does not constitute a subsidy. Rather, tax rates represent a cooperative agreement on burden sharing once the tax base has been established.

In contrast, a tax subsidy is a special preference that represents a departure from the normal tax structure, designed to favor a particular industry, activity or class of people. In that sense, tax subsidies represent an alternative to direct government financing of the recipients of those preferences and should be analyzed as such. Examples of tax subsidies include cost recovery deductions exceeding economic depreciation and various targeted tax benefits ranging from the deduction for research and development expenses to the exclusion for scholarships.

Although tax rates are not tax subsidies, the economic benefit of any tax subsidy through deduction or exemption is influenced significantly by the tax rates. The greater the tax rate, the greater will be the subsidy impact of a special deduction or exclusion.

Long before the 1980's, Stanley Surrey and his adherents argued that activities should be encouraged, if at all, through direct government subsidies instead of tax incentives. They contended that using the tax system to subsidize activities was undesirable, and that if the social policy objectives were desired, direct government grants would be preferable to tax incentive provisions.

Under what now has become accepted as traditional tax policy analysis, based upon Surrey's insight, tax incentive provisions are categorized according to the manner in which they operate: by exclusion, deduction or credit. Traditional analysis focuses on the upside down nature of tax subsidies that operate through exclusions or deductions by comparing them to direct expenditures. Thus, tax policy analysis under the traditional approach would ask whether the tax system is a more efficient means for providing the subsidy than a direct grant and, if so, whether the subsidy should take the form of an exclusion, deduction or credit, bearing in mind the equity of each mechanism.

A New Framework: One-Time vs. Periodic Subsidies

A comparison of tax incentive provisions with direct grants and the trichotomy of alternative forms of subsidy, while important, is typically where analysis of tax incentive provisions ends. Tax policy analysis should take the further, and I believe essential, step of dividing tax incentive provisions into two categories: (1) those that provide one-time subsidies in the year of acquisition of the property or commencement of the activity and (2) those that

operate each year the property is owned or the activity is conducted by artificially increasing the after-tax yield from the property or activity. This additional step is even more important than the steps under the traditional approach. Such a distinction becomes particularly important whenever a decision is made to discontinue a tax subsidy.

The investment tax credit and the deduction for research and development expenses represent examples of the first category of incentives. Once received by the taxpayer, the subsidy cannot be removed or altered. The decision to purchase the property or engage in the activity is affected by the one-time payment, which would be considered together with the current and long-term financial projections for the activity. This type of tax incentive can be turned on and off by the government without concern for ignoring the taxpayer's reliance because the taxpayer's subsidy cannot be affected by later government policy. To be sure, the following year Congress could increase the subsidy so that taxpayers who waited a year could obtain a greater benefit than those taxpayers who acted earlier. A taxpayer's reliance argument, however, would be no greater than the consumer who purchased an item of clothing at full price when he could have waited for the item to go on sale. The taxpayer may feel unhappy, but has not suffered a direct subsidy reduction; he has received exactly what he bargained for notwithstanding the post-acquisition price reduction.

The second type of tax incentive operates through subsidies made in periodic (generally annual) installments. Examples include accelerated depreciation and tax-exempt interest on municipal bonds. In enacting the tax incentive provision, the government has promised the taxpayer that if she acquires the property, the federal government each year will subsidize the economic yield. For example, accelerated depreciation promises the owner an annual subsidy in the amount of the reduced tax liability resulting from the accelerated portion of the depreciation (reduced by the present value of the anticipated tax on the extra gain at time of sale).[24] Similarly, municipal bonds promise the owner an annual subsidy in the amount of the forgone federal tax on the interest received from the issuer. Thus, in deciding whether to acquire property or engage in the desired activity, the taxpayer makes a present value calculation of an annuity of tax subsidies beginning in the year of acquisition and ending with the year of expected disposition (or full depreciation of the property or maturity of the tax-exempt bond). Thus, the taxpayer has a legitimate reliance interest in expecting the subsidy to continue for the life of the activity, unless the duration of the subsidy otherwise was limited initially.

The economic consequences of periodic subsidies are more variable and unpredictable than those of one-time subsidies. The financial impact of a one-

24. Periodic deductions, such as nonaccelerated depreciation, do not necessarily represent subsidies. For example, depreciation represents a mechanical means of allocating the cost of property over the property's life: in that sense, it attempts to mirror, as much as practicable, the property's decline in value. As such, this deduction and other periodic deductions do not represent subsidies, but rather are structural as an inherent part of the measurement of income.

time tax subsidy can be computed in a fairly straightforward manner. A taxpayer can value the subsidy because tax rates will be known for the year of the subsidy. Therefore, policymakers can set the subsidy at the appropriate level to elicit the desired activity.

Periodic subsidies, on the other hand, involve economic benefits extending beyond the year of the taxpayer's expenditure. Accordingly, a subsequent event such as a change in the tax rates affects the subsidy. For example, a reduction in tax rates in subsequent years effectively reduces the amount of a periodic deduction or exemption subsidy. If the after-tax yield to a taxpayer in a tax-subsidized activity declines, property customized for or dedicated on a long-term basis to that activity suffers a reduction in value as well. Thus, although changes in tax rates are not themselves subsidies, changes in tax rates from a long-standing norm will affect the level of a subsidy. Periodic subsidies, therefore, represent something of an unguided missile in tax policy.

Whether a subsidy takes the form of an exclusion, deduction or credit, however, often is not the most relevant feature in analyzing the effect of the subsidy. The most significant feature of a subsidy from an economic viewpoint in many cases is whether it is periodic and, therefore, whether taxpayers act currently with the expectation of obtaining benefits in future years.

This feature may have practical political ramifications as well. A one-time subsidy requires an immediate outlay by the government to fund the subsidy. Accordingly, it would have to be accounted for entirely in the year it is availed of by the taxpayer, through purchase or expenditure, in the form of lower tax collections, thereby creating a greater budget deficit in that year. In contrast, a periodic subsidy of equivalent value could be accounted for over its entire life. Therefore, although a one-time subsidy may be a theoretical substitute for a periodic subsidy, it may not be a politically viable one.

A government's choice of a periodic subsidy instead of a one-time subsidy masks its real cost. In effect, it allows the government easy tax subsidy payment terms because it is accounted for through reduced tax collections in years subsequent to the year in which the subsidized taxpayer engaged in the desired activity or made the desired expenditure. It therefore creates the illusion that subsidy payments are to be made in the future, whereas the government has committed itself in the initial year to make those payments. In essence, the government has borrowed money in the initial year to make a subsidy payment in the amount of the present value of the series of periodic tax benefits, and will repay that borrowing, plus interest, in installments. The ability to obfuscate the real cost of the tax subsidy through the use of a periodic subsidy, however, should not dictate its use.

The Fundamental Problems in Removing Periodic Subsidies

Equity

Periodic Subsidies Contrasted with One-Time Subsidies

Repeal of a periodic tax subsidy on which the taxpayer has acted in reliance is inequitable and can have a serious destabilizing effect on the

economy. As a result, Congress should not remove a periodic subsidy without either transition relief for or compensation of the recipient.

The inequity created by repeal of a periodic tax subsidy can be understood best by observing the dynamics of a periodic subsidy. Introduction of a subsidy may result in some degree of extraordinary profits for recipients. If a lengthy adjustment period is needed for taxpayers to respond to the subsidy, the subsidy could result in windfalls to those recipients who already engage in, or otherwise would have engaged in, the desired activity, or to those who respond to the subsidy quickly. Those windfall benefits would continue until a sufficient amount of the encouraged activity develops to allow market forces to bid down profits from those activities. Excess profits are created during the adjustment period to encourage the desired behavior. The government cannot attempt to recoup the windfalls because to do so would blunt the incentive effect of the subsidy.

'Moreover, during the adjustment period, property particularly suitable for the subsidized activity, if in limited supply, would increase in value because the return that it generates, including the subsidy, would increase. The property's increase in value largely would reflect the present value of the excess profits during the adjustment period.

The removal of the subsidy is precisely the reverse side of the coin. When a periodic tax subsidy is reduced or eliminated before the activity is terminated (or prior to an announced termination date), an owner who already has made the expenditure cannot undo that decision. The owner's profit from the activity reflects and is dependent on the subsidy. The owner's reduced profit (or losses) resulting from elimination of the subsidy will continue until aggregate market output in the activity adjusts and is reduced sufficiently to raise prices. During the adjustment period, the owner will suffer reduced income or operating losses. The longer the adjustment period, the greater the overall economic impact of the subsidy's repeal on the owner. Likewise, the value of the activity or property dedicated to the activity will be reduced, reflecting its reduced return, which then would not include the subsidy that has been removed. That economic loss would not merely offset the previous windfall because those who suffer the loss may or may not have been recipients of the previous windfall.[27]

A periodic subsidy represents a government promise of future benefits or subsidy payments that are intended to cause taxpayers to make current expenditures and changes in their investments. A taxpayer's decision to make that expenditure is based upon the estimated present value of the stream of subsidy payments.[28] Removing the subsidy for those who already have

27. For example, a taxpayer who purchased property for its then fair market value, which already reflected the value of the subsidy, will have paid a premium for the subsidy benefits. Removal of the subsidy will cause a loss to that taxpayer equal to that premium, that is, the portion of that taxpayer's purchase price attributable to the subsidy.

28. Professor Graetz, however, would argue, in effect, that such a present value calculation would have been irrational because the taxpayer would have been unreasonable to expect the subsidy payments to continue for the duration of the defined term—for example, years to maturity of a tax-

responded represents a breach of promise.

The injury resulting from this breach of promise should be analyzed by reference to two distinct interests that the recipient has in the subsidy and for which the recipient may be entitled to protection: first, the interest in continuing to receive the subsidy itself for the agreed-upon term, and second, the right to retain a capitalized value of the subsidy for disposition. From the perspective of both equity and long-term economic efficiency, the recipient of a subsidy should be entitled to continue receiving the periodic subsidy promised, even if the subsidy results in large gains to the recipient. Moreover, in some cases a transferee of the subsidized property or activity also should be entitled to the continuing benefits of the subsidy. If a periodic subsidy is to be removed, however, the recipient should be compensated by the government for the value of the removed subsidy that has been capitalized into the price of the subsidized property or activity.

One-time subsidies, in contrast, generally can be removed without inequity to its recipients. When a tax incentive elicits oversupply and therefore production of an unneeded item, the government should be able to eliminate it prospectively. Otherwise, the economy would be saddled forever with any artificially induced market inefficiency.

Repeal of a one-time subsidy is always prospective. To be sure, even one-time subsidies can elicit changes in behavior that reverberate throughout the economy and can have far-reaching effects. That is true regardless of whether the subsidies are made through the tax system or directly. For example, a one-year investment tax credit, if effective, will cause manufacturers to increase their purchases of productive equipment and machinery because of the reduced cost of the machinery. Those purchases should allow expanded production and reduce end product production costs, as well as end product prices, because of the increased supply of the end product. Thus, purchasers of the end product share the reduction in the cost of machinery resulting from the one-time subsidy. * * *

Users of that product may come to depend upon lower prices of the product and adjust their behavior and choices accordingly. For example, they may come to depend upon an adequate supply of the product at its prevailing price, even though that price prevails only because of a government subsidy. If the one-time subsidy is eliminated, the cost structure of new producers increases, thereby reducing the supply of that product and pushing up the price. The product user again shares the cost increase. Does that user now have any argument that he reasonably relied upon the subsidy for the product and is entitled to continue buying that product at the subsidized price?

This example illustrates the destabilizing effect on the economy of all subsidies, whether made through the tax system or otherwise, and whether one-time or periodic. Turning the spigot on and off can significantly impact

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exempt bond, or the entire recovery period of a depreciable asset. Rather, "[i]n the market context, only behavior that takes into account probabilities of change is treated as reasonable." Graetz, Tax Revision, note 7, at 66. Treasury, at least in 1977, took a contrary view. See Treasury Dep't, Blueprints for Basic Tax Reform 187, 200-01 (1977) (favoring grandfathering and phase-ins).

the economics of the subsidized property or activity. Subsidies, therefore, should be used sparingly and then only when overriding policy justifications dictate.

One-time subsidies, however, do not create an interest to recipients on which they can rely for similar subsidies in the future. The immediate recipient of the one-time subsidy (in the illustration, the producer) makes its economic decisions based upon that knowledge, but should be precluded from claiming reliance on any implied promise or expectation that the subsidy will be repeated in future years.

For the user of the product manufactured by the subsidy recipient and others further down the chain, the introduction and later removal of the subsidy are similar to all other changes in cost or demand structure affecting their products. Although the subsidies can be destabilizing, they do not create reliance interests. The user should not be able to rely on the government's continuation of the subsidy.

* * * [T]he harm resulting from destabilizing effects of one-time subsidies is very different in degree from the harm resulting from the removal of periodic subsidies, on which recipients have relied directly in making long-term business decisions. The first elicits objections from businesses that it is difficult to plan purchases and production and that government subsidization policy has made it more difficult. The second, however, elicits objections rising to the level of breach of promise against the government. That objection in the private law context is the type that gives a remedy of damages to the injured party. Although these differences may seem a matter of degree, they are so large that they become differences in kind.

The Right to Continuation of the Periodic Subsidy for the Duration of the Activity

The clearest example of a periodic subsidy for which recipients should be protected by continuation of the subsidy is the exclusion from gross income of interest from state and local bonds. Because a tax-exempt bondholder is not taxable on the interest from the bond, market forces cause the yield or interest rate on a tax-exempt bond to be significantly lower than an equivalent taxable bond. The relevant financial comparison of the two bonds should be their respective after-tax yields rather than pretax yields. The issue price of these bonds, by virtue of market forces, reflects the value of the tax exemption so that the after-tax yield from such bonds approximately equals the after-tax yield of taxable bonds of equivalent credit quality and term. Viewed another way, a prospective purchaser of a tax-exempt bond pays a premium for the bond compared to the price that would be paid for a taxable bond of equivalent pretax yield. The premium reflects the value of the exemption from income tax of the stream of interest payments to be earned on the bond.

The exclusion from income of the interest appears to be a subsidy to bondholders. In reality, however, a large part of the subsidy is transferred to the issuing state or municipality because the exemption permits the state or municipality to borrow money by issuing the bonds at a lower-than-market interest rate. The allocation of the subsidy between the issuer and the private

investor depends on the supply and demand of tax-exempt obligations which, in turn, depends on the investors' marginal income tax rates.

If the tax exemption for existing state and municipal debt obligations were eliminated, the owners of those bonds would have a justifiable complaint that they relied on the government's promise of interest income exclusion in making their investment decisions for the term of the bond. These bonds should be entitled to continued exclusion, regardless of whether new bonds issued by states or municipalities are eligible for similar tax-exempt status. Indeed, those investors paid for the promise of tax exemption by paying a premium for the bond relative to an equivalent taxable bond.

Arguably, the risk of reduction or loss of the subsidy, for example, the removal of the tax exclusion for the interest, is discounted by the market and, therefore, also is capitalized in the bonds' value. If that is the case, the government's subsidy is more of an expectation of likely government action or inaction, for which there is no commitment, than it is a promise. Therefore, the tax exclusion would not be fully capitalized, causing the interest rate on the bonds to include a risk premium reflecting the possibility of the change in the law. But it appears certain, given the longstanding existence of the exclusion, that the tax exemption is regarded by investors as a promise. Accordingly, virtually all of the exclusion is reflected in the bond's value.

Thus, it is no more justifiable for the government to terminate unilaterally a periodic subsidy that has already elicited the desired behavior by recipients, without transition relief (that is, grandfathering or compensation) than it is for the government to coerce repayment of a one-time subsidy. This equivalence leads one to conclude that a periodic subsidy should not be removed for current recipients unless transition relief is provided. To restate the proposition, a periodic subsidy should be continued for the current recipient who reasonably anticipated that the subsidy would continue and acted in reliance on it.

* * *

The Right to Receive or Be Compensated for the Capitalized Value of the Periodic Subsidy Upon its Removal

A second problem with periodic subsidies involves the protection of the recipient's interest in a somewhat more debatable manner: the protection of the capitalization of the subsidy in the value of the subsidized property or activity. * * *

Returning to the illustration involving tax-exempt bonds, it is clear that the periodic subsidy now accorded tax-exempt bonds by means of the exclusion of interest from gross income is capitalized in the value of the bonds. The issue price of the bonds at original issue and the subsequent market price of those bonds reflect the value of the subsidy. If that subsidy were eliminated for future holders of the bonds that already have been issued, the bonds would suffer a significant reduction in value, even if the interest income exclusion remained available to the original holders. Such a policy change would render the bonds illiquid, at least at their pre-policy change value, thereby destroying an important attribute of the financial asset, its ready marketability. In that

event, only financially distressed holders or those whose tax rates somehow were reduced to zero would seek to dispose of those bonds at the resale price, which would be substantially below the original issue price (regardless of what happened to market interest rates). Holders with continuing financial stability or taxable income also would experience detriment. Interestingly, loss of liquidity experienced by those holders would not be offset against any government savings because the continued exclusion would permit the interest to escape taxation. The described inequity results because the market value of the bonds at any time, and therefore any holder's purchase price, incorporates the tax exemption. In substance, the periodic subsidy in the form of an income exclusion has attached to the bonds themselves rather than being personal to the holders of those bonds. The bonds should continue to be viewed in that light to reflect the reasonable expectations of the bond purchasers who, in reliance upon the promise of present and future tax exemption of the interest from those bonds, purchased those bonds at the original issue price (or, in the after-market, at a price reflecting the tax exemption for the term of the bond).

To the extent that the subsidized property (such as the equipment in the first illustration) is a depreciating asset with a relatively short limited life or liquidity of the property is not an important attribute because, for example, it has a dedicated use that is not easily changed, the problem, as a practical, although not as a theoretical matter, becomes less significant. As long as the owner can and likely will continue to realize the value of the subsidy through continued use of the property, wealth reduction due to loss in resale value may be sufficiently small relative to the cost of determining and administering compensation to the owner that, arguably, it may be ignored. Where, however, the owner is unable to continue to realize the value of the subsidy through continued use of the property or liquidity of the property is an important component of its value, which will be the case, generally, if the subsidized property is of a long or unlimited economic life (such as the tax-exempt bond), the problem becomes much more significant. The market value of the property and, therefore, its purchase price is tied inextricably to its expected future market value upon resale. Accordingly, even retroactive relief by continuation of the benefits of the periodic subsidy to the original owner will not correct the problem, because the resale value of the property is dependent upon the availability of the subsidy to future owners. A prospective purchaser, to whom the subsidy will not be available, would be unwilling to pay a price equivalent to the fair market value of the property when the subsidy existed. * * * [39]

Even if desirable, it may be impossible to compensate the owner for her loss. Determining the magnitude of the owner's loss would be very difficult if

39. For example, suppose Congress proposed elimination of the home mortgage interest deduction available to owners of owner occupied residential real estate. See IRC § 163(h). Elimination of the deduction would increase the after-tax cost of the mortgage payment and therefore the after-tax cost of owning the residence, a property generally purchased with mortgage financing. One would expect a reduction in home prices to follow.

compensation were in the form of an outright payment because the amount of loss is dependent upon secondary and tertiary market consequences. Indeed, Professor Graetz has noted that elimination of the tax benefit could cause a reduction in the supply of formerly subsidized property, resulting in an increase in the economic return from the existing property by virtue of its relative scarcity. Professor Graetz concludes that full compensation would have to take these market adjustments into account.

The size and speed of the adjustment resulting from the elimination of a tax benefit and the impact of the elimination on the owner of property receiving the benefit depend upon many factors. * * * These market adjustments and fluctuations, which are inherent when subsidies are introduced as a fiscal policy tool, likely make it impossible to quantify the loss accurately. That impossibility, however, should not suggest that no compensation is warranted when a periodic subsidy is removed. Rather, it suggests that determining the compensation amount would require simplifying assumptions and likely would result in some degree of over- or undercompensation.

If transition relief took the form of the continued periodic subsidy attaching to the property, great complexity could result. Not all competing properties on the market would offer the same tax attributes. Administering such a system could be very difficult.

* * *

In sum, these inequities that would arise on repeal of a periodic subsidy and the complexity of any possible relief raise serious questions regarding the wisdom of their use.

The Need for Transition Relief

The government should have the option to remove uneconomic subsidies, even if they are the periodic type with long-term responses, and even if the subsidy has been capitalized into the value of the property. Forcing the government to continue all subsidies for future purchases would doom the economy to permanent inefficiency by resulting in subsidizing activities that already produce adequate supply of product or oversupply. If the subsidy is removed, however, transition rules should be enacted to prevent inequities, and in some cases, current owners should be entitled to compensation for their resultant wealth reduction. To state the proposition advanced in this Section, (1) a periodic subsidy should not be removed, even prospectively for transferees, if the current recipient of the subsidy reasonably anticipated that the property would be transferable, or, alternatively, (2) if the subsidy is removed, the current recipients should be compensated for the present value of the lost subsidy over an appropriate adjustment period. In many cases, only the second of these alternatives is feasible.

Initially, this proposition may seem objectionable or, at the very least, politically impossible to implement. Indeed, the right of a tax subsidy recipient to enjoy continued benefits from a tax provision, either through grandfathering or compensation, has been the subject of significant scholarship. Professor Graetz contends that policymakers should be free to make at least "nominally prospective" changes in the tax law without

grandfathering or compensating those adversely affected by the change. "Nominally prospective" changes are changes that alter the rules only for post-enactment periods, but affect the tax treatment and value of assets acquired before enactment and, therefore, have retroactive impact.[46]

Professor Graetz's view essentially is premised on the proposition that a taxpayer whose tax liability is reduced by a tax subsidy is getting away with something, or, in his parlance, is the beneficiary of horizontal inequity. As the goal of tax change is to reduce that horizontal inequity, a change in the law with that objective should not necessitate either compensating the adversely affected taxpayer or grandfathering the tax subsidy as it affects the taxpayer.

This Article takes a different view. The legislative choices regarding burden sharing are found in the structural components of the tax law (for example, tax rates). Burdens are and should be shared as provided by those structural components. Tax incentive provisions, in contrast, are equivalent to direct subsidy payments outside the tax system. As tax savings to a recipient are only the medium for such payment, they should be ignored when evaluating burden sharing. Just as one does not take into account direct subsidies in determining whether the tax system is equitable, one should similarly ignore subsidies made indirectly through the tax system.

Removing a periodic subsidy after a taxpayer has acted upon it imposes an additional burden on that taxpayer unrelated to her income level or ability to pay. Accordingly, it results in a deviation from the burden sharing norm inherent in the structural components and lacks appeal to the distributional fairness on which the tax system as a whole relies.

Viewing tax incentive provisions as part of the burden sharing scheme, as Professor Graetz does, incorrectly leads one to view the elimination of periodic tax subsidies as a means of improving horizontal equity. On the contrary, periodic tax benefits which, in static terms, appear to create horizontal inequity, in dynamic terms, represent simply a collection of an amount promised and due from the government. When the subsidy terminated is a periodic subsidy enacted to encourage taxpayer behavior, it should be viewed analytically as a one-time subsidy, payment of which is made on the installment basis. The recipient of a periodic tax subsidy in the form of reduced tax liability, in reality, enjoys merely a deferred payment of a previous period's subsidy. The recipient already has paid for the subsidy by making what Congress determined to be a socially desirable expenditure in a previous year. The wisdom of the legislative policy choice should be addressed with respect to the year in which taxpayers respond to it, not in subsequent years.

This view does not depend upon whether the periodic tax subsidy represents a wise or even a sensible policy choice from an economic viewpoint, or whether it adds to overall equity in the economic system. Indeed, I would suggest that over the years, most periodic tax subsidies have proven to be mistakes. * * *

Professor Graetz's analysis and justifications for nominally prospective

46. Graetz, Tax Revision, note 7, at 49.

tax changes with retroactive effect underscore the uncertainty and danger of periodic subsidies because, once in place, they can be so easily reinterpreted as causing unjustified horizontal inequity. His analysis, therefore, represents another persuasive argument that periodic subsidies should be avoided.

* * *

One-Time Subsidies, in Contrast

Problems of unfairness, compensation and transition relief that arise upon removal of periodic tax subsidies do not afflict one-time subsidies. After a one-time subsidy has been received, a taxpayer's return on investment is determined solely by market forces, unaugmented by further subsidy. * * * Accordingly, one-time subsidies could be removed equitably, without compensable harm to one who previously has been the recipient of the subsidy. Moreover, one-time subsidies would seem to avoid the perceived problem that some taxpayers are looting the treasury and continue to do so after the incentive is no longer necessary or desirable.

* * *

Economic Efficiency and the Predictability of Tax Laws

One-time subsidies also are superior to periodic subsidies in terms of economic efficiency. First, economic efficiency is served by predictable tax subsidies (assuming there are to be subsidies at all) so that those affected by subsidies can rely on that predictability. Making periodic subsidies uncertain in duration and subject to removal by legislative whim, is economically inefficient because it requires the government to include a risk premium in the subsidy. A risk premium overpays for desired activities unless the subsidy is removed before its expected term has expired.

In contrast, a one-time subsidy is completely predictable because there is 100% certainty that it will be obtained. A periodic subsidy can never attain that level of predictability so long as there is a risk of an uncompensated termination. Moreover, even if the duration of the periodic subsidy were assured, its value could not be assured 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.

* * *

In sum, periodic subsidies, even if not subject to removal, are less efficient than one-time subsidies. When risk of repeal is factored in, however, they become substantially less efficient.

Illustration: Commercial Real Estate

Periodic subsidies have represented a major component of the government's fiscal policy, and the Code is replete with them. The economic impact of the creation and removal of a periodic tax subsidy is illustrated most graphically by the accelerated depreciation deductions accorded to owners of real estate in the early 1980's and their effective removal through enactment of the passive activity loss rules in 1986. This Section illustrates shortcomings in the periodic tax subsidies accorded real estate during this period and the

devastating consequences of their removal without adequate transition relief.

Periodic Subsidy for Real Estate During the Early 1980's

In 1981 Congress created significant tax incentives for real estate by means of accelerated depreciation. In substance, owners of real estate were able to recover the cost of their depreciable real estate (buildings and other improvements, but not land) over a 15-year period. Thus, for income tax purposes, a building would be regarded as having been used up and valueless after only 15 years even though, in virtually all likely situations, the building would have retained substantial value and in many cases increased in value during that same period. The recovery period was lengthened by subsequent legislation to 18 years and later to 19 years. But, even after these changes, the tax depreciation in most cases greatly exceeded the actual reduction, if any, in value of those buildings.

The legislative judgment to grant special deductions and, therefore, impose a lighter tax burden on real estate and real estate activities was motivated by a desire to increase the production of depreciable real estate for the good of the entire economy. The supply of commercial buildings increased from 1981 to 1986 as a result of new construction, although it is impossible to prove that the 1981 legislation caused the building boom because of the inherent limitations on statistical analysis in a dynamic economy.

Congress did not limit the special tax relief for real estate to new construction. It extended the provision to any depreciable real estate acquired by a taxpayer after the effective date of the legislation, so long as the new owner did not own a significant interest in it beforehand. The accelerated depreciation allowed new owners to purchase old buildings and write off the cost of the buildings over the generously short recovery period of 15 years. The extension of the tax subsidy to existing property appears to have been pure governmental largesse, significantly increasing the purchases and sales of existing depreciable real estate. * * *

Taxpayers fortunate enough to own income producing real property received windfalls. The tax legislation actually increased the demand for and value of their property by allowing a prospective purchaser to obtain a tax benefit from acquiring the existing property. * * *

After 1981, substantial capital flowed into real estate production and resulted in a building boom. Prospective owners no longer needed to be assured of the same tenant demand, low interest financing and relatively low vacancy rate to project a profit from operating a newly constructed building or purchasing an existing building. Production soared and rental space, particularly office space, increased in supply. Net income from operating property tended to decline as a result. Some economists predicted that this phenomenon would continue until real estate activities earned no more on a net after-tax basis than had been the case prior to 1981. However, during the 1980's, it appears that real estate operating yields may have declined even below the level predictable by the subsidy alone, because an expectation of appreciation may have influenced people to accept less in current yield in

anticipation of large gains upon sale.

After 1981, capital flowed into real estate activities from sources other than real estate professionals. One might characterize a real estate investor as participating in or acquiring a "tax shelter." * * *

Congress' Response: The Passive Activity Loss Rules

Public antipathy toward tax shelters may explain why Congress enacted a new set of anti-tax shelter provisions, the passive activity loss rules. * * *

The effect of the passive loss rules has been to preclude taxpayers from offsetting earned income and portfolio income (such as investment income from stocks, bonds and bank and money market accounts) with real estate and other tax shelter losses. By precluding the use of those losses, Congress effectively removed the tax subsidy 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 antishelter rules not only removed the subsidy but, in many cases, also imposed a penalty on the activity.

Yet, Congress made no attempt to compensate property owners for either the loss of the subsidy or the loss in value of the property, which would not enjoy tax-preferred treatment in the hands of a prospective purchaser. In passing the 1986 Act, Congress appeared to recognize the importance of transition rules in preventing inequity, but failed to provide adequate protection. The passive loss provision 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.[82] These phase-in rules, however, interacted with two other important changes contained in the 1986 Act: (1) the alternative minimum tax (AMT) and (2) the investment interest expense limitation. Most importantly, passive losses allowable under the phase-in rules constituted tax preference items for AMT purposes. Under appropriate circumstances, the passive losses were rendered without tax benefit and, therefore, unusable to an investor. Moreover, by eliminating the subsidy entirely for prospective purchasers of the property, the 1986 Act did nothing to protect the value of the property that had become dependent on the subsidy.

* * *

The Decline of Real Estate Prices and The Savings and Loan Crisis

The crisis in the savings and loan (S&L) industry had many causes, ranging from unpredictable economic changes to bad business judgment to

82. Generally, the passive activity loss rules were effective for years beginning after 1986. Reg. § 1.469-11. However, the rules were phased in for certain post-effective date losses. Passive losses from a "pre-enactment interest" (an interest held on October 22, 1986, the date of enactment, or acquired thereafter 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, 60% in 1988, 80% in 1989 and 90% in 1990. IRC § 469(m).

thievery. One of its most significant causes was the decline in real estate prices that resulted from Congress' shift in tax policy toward real estate.

Many S&Ls invested in mortgages on new real estate projects that promised high yields during the 1980's due to generous depreciation recovery rates. * * * As long as real estate values increased during the early 1980's, those loans that had been made prudently were well-secured and safe. Many S&Ls lent money on outrageous projects with little economic feasibility to obtain front-end fees and what appeared to be high, but risky yields. However, even more conservatively managed institutions lent money on real estate projects at prudent loan-to-value ratios (ratios of the amount of the loan to the fair market value of the project securing the loan). Those loans were well-secured as long as real estate values were maintained or increased, which occurred during the transition period of the early 1980's.

The values of those properties depended on the generous tax benefits accorded real estate. The availability of those tax benefits to prospective owners supported the market prices of the property even though the rental income may not have been sufficient to make them economic.

When the government withdrew the subsidies in 1986 by enacting the passive activity loss rules and lengthening depreciation recovery periods for property acquired after 1986, real estate had to be operated or sold without benefit of the tax subsidies. Investors, who could no longer use losses from real estate to offset other income, were less likely to provide the equity funds for new projects or to purchase existing projects. As a result, a major source of equity for real estate acquisitions evaporated. Moreover, by the time Congress passed the 1986 Act, vacancy rates in many buildings had increased with the added supply of rentable space brought about by the tax subsidies.

An insufficient number of buyers existed for real estate projects that were put on the market for sale. Prices for real estate stopped increasing and in many cases began to fall. Consequently, the S&Ls as well as other banking institutions that had been well-secured when real estate values were high became undersecured. That situation was particularly dangerous for institutions that had made nonrecourse loans. Defaults became more common, prices declined further and the market became flooded with available real estate.

Even falling prices failed to attract new buyers. First, without tax subsidies, the projects were not worth as much as they had been previously. Second, the banking industry's reaction to the falling prices was precisely the opposite of what would be necessary to stop those declines. * * *

Prudent policy for any individual S&L on the brink of insolvency dictated that it collect as much as possible of its outstanding real estate loans and refuse to loan additional amounts in a falling real estate market. What represented prudent policy for any individual institution, however, became an unfortunate overall banking policy for sellers of real estate when all financial institutions adopted it. Thus, the surplus of owners needing to sell and the dearth of buyers with ready funding sources transformed predictable price declines into free falls.

* * * [I]t should be recognized that the real estate boom was spurred by

the federal government's creation of significant periodic tax subsidies for the industry in 1981. Congress removed them in 1986, and replaced them with what amounted to tax penalties. * * *

[M]any S&Ls and other banking institutions were locked in. Their loan portfolios were created when the real estate securing the loans had value supported by the government subsidies. Only after the loans were made was the collateral devalued. The existence of federal deposit insurance will, of course, leave the federal taxpayers bearing the ultimate economic cost of many of these losses.

* * *

Illustration of Future Tax Policy Choice: Owner-Occupied Real Estate

The experience of real estate owners during the 1980's could be repeated if the periodic tax subsidies accorded other subsidized activities such as tax-exempt bonds and retirement savings were eliminated, even prospectively. Owner-occupied residential property appears to be a potential candidate in Congress' search for base broadening tactics. Economic destabilization could result if these periodic subsidies were eliminated, even if the elimination were prospective only and limited to future owners, because the value of the subsidies has been capitalized in the price of the properties.

Subsidies for owner-occupied housing include the deduction for home mortgage interest and the deduction for real property taxes. * * *

These deductions, if viewed as an encouragement to purchase a home, could be viewed as periodic subsidies. Elimination of these deductions would increase the after-tax cost of home ownership. * * *

Transition problems created by the elimination of the subsidies would not be solved merely by making the changes prospective and grandfathering current homeowners because the subsidies no longer would be reflected in the market prices that prospective purchasers of homes would be willing to pay. Even the prospective elimination of the subsidies would be likely to produce a reduction in single-family home prices and, in some cases, the elimination of the homeowner's built-up equity (the value of the home less the mortgage on it). Thus, regardless of how desirable in theoretical policy terms, the elimination of the "middle class" subsidies to home ownership may be, even the prospective elimination would cause considerable economic dislocation and financial hardship to current homeowners, absent compensation for the loss by the government. Such compensation, as a practical matter, would be unlikely because the elimination of the subsidies would have derived from the desire to eliminate the governmental expenditure through the tax system rather than out of some sense of theoretical tidiness, however laudable that latter goal may be.

* * *

Conclusion

* * * [E]nactment of periodic tax subsidies should be rejected unless Congress is willing to define, specifically limit and guarantee their duration. In the absence of such assurances, Congress should be prepared to live with

periodic subsidies permanently or to compensate recipients if the subsidies are later removed. Use of certain periodic subsidies that involve the creation of transferable long-term benefits could require that the subsidy become a permanent part of the tax law if compensation is not politically viable.

As a practical matter, however, it is unlikely that Congress will be willing to retain every periodic subsidy enacted. Therefore, Congress should overcome the temptation to enact periodic tax subsidies.

Notes and Questions

45. Obviously, clarity is to be desired in any provision of law, including any provision of tax law. Do you agree with Bradley and Oliver that clarity is particularly important for incentive tax expenditures?

46. Professor Goldberg asserts a sharp dichotomy between one-time incentives and periodic incentives. Can a taxpayer never legitimately rely on the continuation of one-time incentives? Should a taxpayer always be entitled to rely on the continuation of periodic incentives?

47. As Goldberg recognizes, even if the incentive statute remains unaltered, changes in tax rates can materially affect the value of incentives. For example, it is likely that some presently-outstanding state bonds were issued before 1981, when the maximum rate on unearned income was 70 percent; clearly, the value of the tax exemption is worth much less today, with a maximum rate under 40 percent.

48. Would the logic of Professor Goldberg's argument lead one to conclude that Congress could not materially alter its basic form of taxation—for example, by instituting a consumption tax as a replacement for, or significant addition to, the income tax—without compensating all who entered the tax-preferred investment on the assumption that the income tax would continue as the dominant federal tax? (Here, many of the transition problems resemble those discussed in Chapter Seven, particularly in Notes #77-85.)

49. As one example of a periodic tax preference, which perhaps never should have been enacted but cannot be ended without working an injustice, Goldberg highlights the home mortgage interest deduction. Importantly, present owners may have profited little from the deduction, because their purchase price was inflated by the existence of the tax preference. As Kay and King argued (see Chapter Three, Note #2), this problem "demonstrates why tax capitalization is such a dangerous trap; although we believe it would be better if the system had never incorporated these concessions, it does not seem that it would now be either equitable or desirable to withdraw them."

50. Most observers would give high marks to the Tax Reform Act of 1986 as an example of true tax reform. The 1986 Act, however, not only removed

periodic preferences, but substituted tax penalties (or "negative tax preferences") in the form of passive loss limitation rules. Professor Goldberg argues that this combination of actions, undertaken for the perhaps laudable purpose of curtailing tax shelters, thereby contributed to the savings and loan crisis of the late 1980s. That crisis ultimately cost taxpayers and investors hundreds of billions of dollars.

51. Professor Goldberg puts forward full compensation to present beneficiaries of preferences as an acceptable alternative to keeping the tax preferences on the books, but he acknowledges that such compensation would be difficult to compute, and highly unlikely as a political matter. His primary message is that Congress should not start down the periodic preference route.

52. But what are we to do once Congress places an unwise periodic preference in the law? Given that full compensation of present beneficiaries is not realistically in the cards, does Professor Goldberg's logic doom us to keep an inefficient and unwise preference forever?

53. While Professor Goldberg argues that generous transition rules (at a minimum) are required for fairness, Professor Sheldon Pollack sees a somewhat different value in grandfathering and similar transition relief. While such relief may look like (and, indeed, may be) politically-inspired relief for special interests, it may make possible better law over the long term:

> Tax reformists sneer at the "corrupt" use of transition rules to benefit special interests located in the districts of committee members. However, the granting of favors by transition rules was one of [House Ways and Means Chairman] Rostenkowski's most skillful tactics in gaining passage of a purer reform package [in the Tax Reform Act of 1986] than what would otherwise have been possible. On the whole, aggregating support for a tax bill by offering generous transition rules (to permit certain industries or even individuals to retain more favorable treatment under prior law) should be viewed as preferable to offering special tax provisions or expenditures that become a permanent fixture in the Code. The old maxim that politics is the art of the possible is lost upon those who seek the radical implementation of their ideal tax policies.[q]

54. Observe that while periodic incentives may be worse policy than one-time subsidies, as Professor Goldberg argues, they may be attractive to Congress. They allow Congress to reward preferred constituencies today, while pushing most of the revenue cost of doing so into the future.

55. Professor Michael Graetz, whose work is frequently referred to (and disputed by) Professor Goldberg, argues that the risk of legal change is simply

q. Sheldon D. Pollack, *A New Dynamics of Tax Policy*, 12 AM. J. TAX POL. 61, 80 (1995).

one more risk for investors to take into account, and should not deter Congress from changing the law: "The tax law must remain a flexible instrument of public policy. When a provision has outlived its usefulness, it should be eliminated without the delay and windfall gains inherent in grandfathering prior transactions. People should make investments with the expectation that political policies may change."[r]

56. Goldberg differs with Graetz concerning whether principles of tax equity support removal of tax incentives. Graetz would favor ending an incentive that should never have been enacted; the recipient was the beneficiary of "horizontal inequity," and the tax system should attempt to reduce such inequity. Goldberg, by contrast, views tax incentives as the equivalent of direct subsidy payments from government. Therefore, he argues, tax incentives should be ignored in an analysis of the tax system's equity, just as direct subsidies effected through appropriations would be ignored. (Here, it might be noted, Goldberg effectively adopts Surrey's insistence that tax expenditures are the functional equivalent of direct government spending.) Again, Goldberg emphasizes that the primary lesson to be drawn is that Congress should not employ periodic tax incentives in the first place.

57. Is there anything special about tax provisions? Governments frequently change the law, upsetting expectations. What if a state where gambling was legal changed its law after investors had spent billions of dollars building casinos in the reasonable expectation that the state would continue to allow gambling? What of producers and sellers of alcoholic beverages, many in business for decades, when Prohibition was instituted in 1919? What of the holders of billions of dollars worth of slaves when the Thirteenth Amendment[s] freed all slaves without compensation of their owners?

It is easy to understand a moral imperative to end slavery, and less weighty moral and practical arguments can be advanced against gambling and alcoholic beverages. It is less obvious that society should advance its moral and other policy judgments without any compensation to those who lawfully relied on the earlier societal view. Yet, the lesson of history, which Professor Goldberg does not dispute in the tax context, is that compensation will rarely be forthcoming from the political system. Barring compensation, should society implement its current views of policy, or refrain from doing so on the basis that such a change would be unfair to those who relied on earlier law?

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r. Michael J. Graetz, *Legal Transitions: The Case of Retroactivity in Income Tax Revision*, 126 U. PA. L. REV. 47, 87 (1977).

s. President Lincoln's Emancipation Proclamation of 1862 (effective January 1, 1863) clearly did not free all slaves. Leaving aside questions of Presidential authority and the practical problem of enforcement at a time when the United States Government was not in control of the states where most slaves lived, the proclamation was wholly inapplicable to the northern tier of slave states, from Delaware to Missouri, which had not seceded. Only with the post-war Thirteenth Amendment were all slaves freed.