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# Reinvigorating Tax Expenditure Analysis and its International Dimension

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# REINVIGORATING TAX EXPENDITURE ANALYSIS AND ITS INTERNATIONAL DIMENSION\*

*J. Clifton Fleming, Jr.\*\* and Robert J. Peroni\*\*\**

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## I. INTRODUCTION

Federal tax expenditures (i.e., subsidies and incentives provided through the federal income tax system) are an important feature of the American fiscal system that has grown even more significant in recent years. For example, the U.S. Government Accountability Office estimated that tax expenditures in fiscal year 2004 were equivalent to \$896 billion of direct expenditures and concluded that, since 1988, tax expenditures have often exceeded direct, discretionary federal spending.<sup>1</sup> As a result, it is no surprise that debates regarding tax expenditures (including the magnitude and proper role of such expenditures) are a significant part of tax policy analysis.

For practical purposes, these debates began in earnest in the United States when the late Professor Stanley Surrey, then Assistant Secretary of the Treasury for Tax Policy, gave a November 1967 speech in which he famously argued that if a tax provision effectively delivers a subsidy or incentive for a discrete income source or taxpayer group, it is the equivalent of a direct government cash payment and, by implication, should be subjected to the same scrutiny as an explicit outlay of money.<sup>2</sup> Consistent with this approach, Surrey

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<sup>1</sup> See U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-05-690, TAX EXPENDITURES REPRESENT A SUBSTANTIAL FEDERAL COMMITMENT AND NEED TO BE REEXAMINED 8, 35 n.43, 36 (Sept. 2005) [hereinafter GAO, FEDERAL COMMITMENT], available at <http://www.gao.gov/new.items/d05690.pdf>. In addition, the U.S. Treasury Department has estimated that if all corporate tax expenditures were repealed, effective January 1, 2008, \$1.24 trillion of additional revenue would be raised over the 2008–2017 period. See U.S. TREAS. DEP'T, BACKGROUND PAPER, TREASURY CONFERENCE ON BUSINESS TAXATION AND GLOBAL COMPETITIVENESS 10–11 (July 23, 2007) [hereinafter U.S. TREAS. DEP'T, BACKGROUND PAPER], available at <http://www.ustreas.gov/press/releases/reports/07230%20r.pdf>. For a commentary that classifies and analyzes the growth of tax expenditures, see JOHN F. WITTE, THE POLITICS AND DEVELOPMENT OF THE FEDERAL INCOME TAX 288–98 (1985).

<sup>2</sup> Stanley S. Surrey, *The United States Income Tax System — The Need for Full Accounting*, in TAX POLICY AND TAX REFORM: SELECTED SPEECHES AND TESTIMONY OF STANLEY S. SURREY 575, 575–85 (William F. Hellmuth & Oliver Oldman eds., 1973) [hereinafter Surrey, *Full Accounting*]; see also STANLEY S. SURREY, PATHWAYS TO TAX REFORM 33 (1973) [hereinafter SURREY, PATHWAYS]; STANLEY S. SURREY & PAUL R. MCDANIEL, TAX EXPENDITURES 88 (1985) [hereinafter SURREY &

gave the name “tax expenditure” to features of the tax law that provide subsidies or incentives,<sup>3</sup> thus bringing tax expenditure analysis (TEA) into American tax policy consciousness.<sup>4</sup> During his remaining

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MCDANIEL, TAX EXPENDITURES]. For another commentator who supports the tax expenditure theory, see Michael J. McIntyre, *A Solution to the Problem of Defining a Tax Expenditure*, 14 U.C. DAVIS L. REV. 79, 89 (1980) (“Logic suggests that tax expenditures should be subjected to the same kinds of cost/benefit scrutiny and political tradeoffs applicable to functionally equivalent direct spending programs.”).

Although this analytical approach would seem to support a First Amendment Establishment Clause attack on both the federal income tax exemption for religious organizations and the income tax deduction for contributions to these organizations, see, e.g., SURREY & MCDANIEL, TAX EXPENDITURES, *supra*, at 132–37; Donna D. Adler, *The Internal Revenue Code, the Constitution, and the Courts: The Use of Tax Expenditure Analysis in Judicial Decision Making*, 28 WAKE FOREST L. REV. 855, 912–14 (1993), the relevant U.S. Supreme Court jurisprudence is generally understood to support the proposition that the exemption and deduction are not ordinarily vulnerable to a First Amendment challenge. See, e.g., Linda Sugin, *Tax Expenditure Analysis and Constitutional Decisions*, 50 HASTINGS L.J. 407, 460–72 (1999) (“[I]t is clear that the economic equivalence of tax benefits and direct spending is not the most important factor to consider in establishment clause analysis.”); Edward A. Zelinsky, *James Madison and Public Choice at Gucci Gulch: A Procedural Defense of Tax Expenditures and Tax Institutions*, 102 YALE L.J. 1165, 1192–93 (1993) [hereinafter Zelinsky, *A Procedural Defense of Tax Expenditures*] (arguing that the First Amendment distinction between tax and direct subsidies is “more compelling procedurally” than many commentators believe); see also Boris I. Bittker, *Churches, Taxes and the Constitution*, 78 YALE L.J. 1285 (1969); Edward A. Zelinsky, *Are Tax “Benefits” Constitutionally Equivalent to Direct Expenditures?*, 112 HARV. L. REV. 379 (1998).

<sup>3</sup> See Surrey, *Full Accounting*, *supra* note 2, at 576–78; see also STATE OF CALIFORNIA, LEGISLATIVE ANALYST’S OFFICE, TAX EXPENDITURE REVIEWS 1 (Nov. 2007), available at [http://www.lao.ca.gov/2007/tax\\_expenditures/tax\\_expenditures\\_1107.pdf](http://www.lao.ca.gov/2007/tax_expenditures/tax_expenditures_1107.pdf) (defining tax expenditures as “features of the tax code — including credits, deductions, exclusions, and exemptions — that enable a targeted set of taxpayers to reduce their taxes relative to what they would pay under what policymakers perceive to be a ‘basic’ or ‘normal’ tax-law structure”); C. EUGENE STEUERLE, CONTEMPORARY U.S. TAX POLICY 297 (2004) [hereinafter STEUERLE, CONTEMPORARY TAX POLICY] (defining tax expenditures as “[s]pending programs channeled through the tax system”); Martin A. Sullivan, *Economic Analysis: Tax Incentives and Economists*, 111 TAX NOTES 20 (Apr. 3, 2006) [hereinafter Sullivan, *Tax Incentives*] (defining tax expenditures as “deliberate departures from neutral taxation directed at a particular group of taxpayers”).

<sup>4</sup> Although Surrey scored a rhetorical coup with his popularization of the phrase “tax expenditure,” others had earlier called attention to the many subsidies delivered through the tax system and the issues they present, which was the essence of Surrey’s concern in promoting tax expenditure analysis (TEA). See, e.g., Walter J. Blum, *Tax Policy and Preferential Provisions in the Income Tax Base*, in 1 COMMITTEE ON WAYS AND MEANS, TAX REVISION COMPENDIUM 77, 83 (Comm. Print

fourteen months in government service, Surrey oversaw the creation of Treasury's first tax expenditure budget<sup>5</sup> and, following his return to the Harvard Law School faculty, he wrote or co-authored (mostly with Professor Paul McDaniel) a series of books and articles forcefully promoting TEA as a tool for formulating sound governmental policy, primarily federal income tax policy.<sup>6</sup> This work succeeded in making TEA a fixture in American income tax debates.

Surrey argued that tax expenditures suffered from certain inherent defects that almost always made them inferior to analogous cash outlays.<sup>7</sup> Indeed, for Surrey, the list of acceptable tax

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1959) [hereinafter Blum, *Preferential Provisions*] (“[S]ubsidies through the income tax are likely to be especially pernicious . . . . All in all, a less desirable form of administering a subsidy is not easily imagined.”); Bernard Wolfman, *Federal Tax Policy and the Support of Science*, 114 U. PA. L. REV. 171, 186 (1965) (“The sums federally allocated by tax preferences and special relief provisions should be reflected in the federal budget and accounts.”); see also WILLIAM VICKREY, AGENDA FOR PROGRESSIVE TAXATION 18 (1947) (describing the favorable federal income tax treatment of home ownership as an inefficient subsidy). For a discussion of the history of the tax expenditure concept, see Jonathan Barry Forman, *Origins of the Tax Expenditure Budget*, 30 TAX NOTES 537 (Feb. 10, 1986).

<sup>5</sup> See U.S. Treas. Dep't, *The Tax Expenditure Budget: A Conceptual Analysis*, in TAX POLICY AND TAX REFORM: SELECTED SPEECHES AND TESTIMONY OF STANLEY S. SURREY 587, 587–612 (William F. Hellmuth & Oliver Oldman eds., 1973) [hereinafter U.S. Treas. Dep't, *Conceptual Analysis*]; Forman, *supra* note 4, at 539–41.

<sup>6</sup> See, e.g., SURREY, PATHWAYS, *supra* note 2; SURREY & MCDANIEL, TAX EXPENDITURES, *supra* note 2; Paul R. McDaniel & Stanley S. Surrey, *Tax Expenditures: How to Identify Them; How to Control Them*, 15 TAX NOTES 595 (May 24, 1982); Stanley S. Surrey, *Federal Income Tax Reform: The Varied Approaches Necessary to Replace Tax Expenditures with Direct Governmental Assistance*, 84 HARV. L. REV. 352 (1970); Stanley S. Surrey, *Government Assistance: The Choice Between Direct Programs and Tax Expenditures*, 8 TAX NOTES 507 (Apr. 30, 1979); Stanley S. Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 HARV. L. REV. 705 (1970) [hereinafter Surrey, *Implementing Government Policy*]; Stanley S. Surrey, *Tax Subsidies as a Device for Implementing Government Policy*, 3 TAX ADVISER 196 (1972); Stanley S. Surrey & Paul R. McDaniel, *The Tax Expenditure Concept and the Budget Reform Act of 1974*, 17 B.C. INDUS. & COM. L. REV. 679 (1976); Stanley S. Surrey & Paul R. McDaniel, *The Tax Expenditure Concept and the Legislative Process*, in THE ECONOMICS OF TAXATION 123 (Henry J. Aaron & Michael J. Boskin eds., 1980) [hereinafter ECONOMICS OF TAXATION]; Stanley S. Surrey & Paul R. McDaniel, *The Tax Expenditure Concept: Current Developments and Emerging Issues*, 20 B.C. L. REV. 225 (1979) [hereinafter Surrey & McDaniel, *Current Developments*]. For a work by Professor Surrey on special interest tax legislation that pre-dated his TEA scholarship, see Stanley S. Surrey, *The Congress and the Tax Lobbyist — How Special Tax Provisions Get Enacted*, 70 HARV. L. REV. 1145 (1957).

<sup>7</sup> See Surrey, *Full Accounting*, *supra* note 2, at 579, 583; Surrey, *Implementing*

expenditures was so short that the practical effect of TEA was to reject almost any income tax provision characterized as a tax expenditure.<sup>8</sup> Automatic outcomes derived from formulas or definitions are rendered suspect, however, by the baroque complexity of the federal income tax system's structure and effects. For many analysts and commentators, this complexity dictates the need to "do tax policy" by identifying relevant criteria, applying the criteria to tax policy issues, and weighing answers resulting from the individual criteria against each other when the answers conflict.<sup>9</sup> Since the answers frequently do conflict, tax policy decisions taken under this

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*Government Policy*, *supra* note 6, at 726–32; Stanley S. Surrey & William F. Hellmuth, *The Tax Expenditure Budget—Response to Professor Bittker*, 22 NAT'L TAX J. 528 (1969).

<sup>8</sup> Surrey, however, insisted that classifying a tax provision as a tax expenditure should not cause its automatic rejection, *see* SURREY & MCDANIEL, TAX EXPENDITURES, *supra* note 2, at 5–6, and that the label "tax expenditure" did not carry an inherently negative connotation. *See* U.S. Treas. Dep't, *Conceptual Analysis*, *supra* note 5, at 588–89; Surrey, *Full Accounting*, *supra* note 2, at 578–79. However, his work was so broadly critical of tax expenditures, *see, e.g.*, SURREY, PATHWAYS, *supra* note 2, at 134–49; SURREY & MCDANIEL, TAX EXPENDITURES, *supra* note 2, at 71–97, that TEA is widely understood as attaching a pejorative label to tax expenditures and as generally arguing for their elimination. *See* Bruce Bartlett, *The End of Tax Expenditures As We Know Them?*, 92 TAX NOTES 413, 414 (July 16, 2001) [hereinafter Bartlett, *The End*]; Douglas A. Kahn & Jeffrey S. Lehman, *Tax Expenditure Budgets: A Critical View*, 54 TAX NOTES 1661, 1662–63 (Mar. 30, 1992); Julie Roin, *Truth in Government: Beyond the Tax Expenditure Budget*, 54 HASTINGS L.J. 603, 612 (2003); Daniel N. Shaviro, *Rethinking Tax Expenditures and Fiscal Language*, 57 TAX L. REV. 187, 201–02 (2004); Victor Thuronyi, *Tax Expenditures: A Reassessment*, 1988 DUKE L.J. 1155, 1165 (1988); David A. Weisbach & Jacob Nussim, *The Integration of Tax and Spending Programs*, 113 YALE L.J. 955, 976 (2004). Surrey was not alone, however, in regarding tax expenditures as usually objectionable. *See, e.g.*, Blum, *Preferential Provisions*, *supra* note 4, at 83 ("[A] less desirable form of administering a subsidy is not easily imagined."); Eric J. Toder, *Tax Cuts or Spending — Does It Make a Difference?*, 53 NAT'L TAX J. 361, 362 (2000) ("By the usual standards of tax policy analysis, tax expenditures make the tax system worse . . .").

<sup>9</sup> *See, e.g.*, U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-05-1009SP, UNDERSTANDING THE TAX REFORM DEBATE: BACKGROUND, CRITERIA, & QUESTIONS 24–52 (Sept. 2005), *available at* <http://www.gao.gov/new.items/d051009sp.pdf>; U.S. TREAS. DEP'T, 1 TAX REFORM FOR FAIRNESS, SIMPLICITY AND ECONOMIC GROWTH 13–19 (Nov. 1984) [hereinafter U.S. TREAS. DEP'T, TAX REFORM], *available at* <http://www.ustreas.gov/offices/tax-policy/library/tax-reform/>; JOSEPH M. DODGE, J. CLIFTON FLEMING, JR. & DEBORAH A. GEIER, FEDERAL INCOME TAX: DOCTRINE, STRUCTURE AND POLICY 119–35 (3d ed. 2004); JOEL SLEMROD & JON BAKIJA, TAXING OURSELVES 55–188, 231 (3d ed. 2004); *see also* JOSEPH A. PECHMAN, FEDERAL TAX POLICY (5th ed. 1987); Joseph T. Sneed, *The Criteria of Federal Income Tax Policy*, 17 STAN. L. REV. 567 (1965).

multi-factor approach typically involve a substantial degree of judgment. Controversies are frequent and automatic outcomes are few.

Consequently, there is considerable resistance to touchstones and formulas in the federal income tax world<sup>10</sup> and it is no surprise that TEA was rigorously criticized from its inception and continues to draw negative reviews.<sup>11</sup> Notwithstanding this criticism, the Congressional Budget and Impoundment Control Act of 1974 requires the President's annual budget submission to contain a list of tax expenditures,<sup>12</sup> and Congress's Joint Committee on Taxation has produced its own tax expenditure list each year since 1972.<sup>13</sup> Although TEA has not restrained or reversed the growth of tax expenditures as

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<sup>10</sup> As an example, Professor Charlotte Crane has stated,

[T]here is not — and probably cannot be — an ideal concept of an income tax that is worth using as a starting point. There are simply too many compromises that must be made in translating any concept into a workable tax base, and too much room for arguing about which are expedients necessary to make the tax administrable and which are the result of a perceived need to respond to political pressure to lower tax burdens.

Charlotte Crane, *The Income Tax and the Burden of Perfection*, 100 NW. U. L. REV. 171, 185 (2006); see also Weisbach & Nussim, *supra* note 8, at 976 (“There is no such thing as a normative tax base.”). *Contra* authorities cited *infra* note 56.

<sup>11</sup> See Bartlett, *The End*, *supra* note 8; Boris I. Bittker, *Accounting for Federal “Tax Subsidies” in the National Budget*, 22 NAT’L TAX J. 244 (1969) [hereinafter Bittker, *Accounting*]; Crane, *supra* note 10, at 184 (characterizing TEA as an academic obsession); Thomas D. Griffith, *Theories of Personal Deductions in the Income Tax*, 40 HASTINGS L.J. 343, 345–66 (1989) (arguing, in part, that Surrey’s tax expenditure model is not grounded on any principle of distributive justice); Kahn & Lehman, *supra* note 8; Bernard Wolfman, *Tax Expenditures: From Idea to Ideology*, 99 HARV. L. REV. 491 (1985) (reviewing SURREY & MCDANIEL, *TAX EXPENDITURES*, *supra* note 2); Edward A. Zelinsky, *Efficiency and Income Taxes: The Rehabilitation of Tax Incentives*, 64 TEX. L. REV. 973, 1026–33 (1986) [hereinafter Zelinsky, *The Rehabilitation of Tax Incentives*]; Zelinsky, *A Procedural Defense of Tax Expenditures*, *supra* note 2; Edward A. Zelinsky, *Qualified Plans and Identifying Tax Expenditures: A Rejoinder to Professor Stein*, 9 AM. J. TAX POL’Y 257 (1991); Edward A. Zelinsky, *Tax Policy v. Revenue Policy: Qualified Plans, Tax Expenditures, and the Flat, Plan Level Tax*, 13 VA. TAX REV. 591 (1994); Edward A. Zelinsky, *The Tax Reform Act of 1986: A Response to Professor Yorio and His Vision of the Future of the Internal Revenue Code*, 55 FORDHAM L. REV. 885, 889–94 (1987) [hereinafter Zelinsky, *Response*]; Edward A. Zelinsky, *The Tax Treatment of Qualified Plans: A Classic Defense of the Status Quo*, 66 N.C. L. REV. 315 (1988).

<sup>12</sup> See Pub. L. No. 93-344, § 601, 88 Stat. 297, 323 (1974).

<sup>13</sup> See, e.g., STAFF OF JOINT COMM. ON TAXATION, 110TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2007-2011, at 1 n.2 (Joint Comm. Print 2007) [hereinafter STAFF OF JOINT COMM. ON TAX’N, 2007 ESTIMATES].



Surrey had hoped it would,<sup>14</sup> TEA continues to play a major role in tax policy debates to the chagrin of its detractors.<sup>15</sup>

Even though TEA is familiar to most tax lawyers and scholars, we will provide a necessary illustration in Part II of this article. This discussion will set the stage for the analysis that follows and also provide a device for structuring that analysis.

The persistence of TEA in a hostile environment suggests that it has meaningful substance regardless of the criticism it receives. In Part III of this article, we will undertake to show that TEA is both a logical consequence of, and a device for implementing, the principle of ability-to-pay, the Schanz-Haig-Simons definition of income, and the tax policy principle of neutrality.

In Part IV, we will expand on Surrey's point that the tax expenditure characterization does not make an income tax provision bad per se. Instead, affixing the tax expenditure label triggers a

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<sup>14</sup> See GAO, FEDERAL COMMITMENT, *supra* note 1, at 19–42; U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-06-1028T, INDIVIDUAL INCOME TAX POLICY: STREAMLINING, SIMPLIFICATION, AND ADDITIONAL REFORMS ARE DESIRABLE 9–10 (Aug. 2006), available at <http://www.gao.gov/new.items/d061028t.pdf>; U.S. GEN. ACCOUNTING OFFICE, GAO/GGD/AIMD-94-122, TAX POLICY: TAX EXPENDITURES DESERVE MORE SCRUTINY 33–35, 50 (June 1994).

Although the total amount of tax expenditures has not been reduced, their composition in recent years has shifted away from benefits for businesses and towards benefits for individuals. See STEUERLE, CONTEMPORARY TAX POLICY, *supra* note 3, at 43–44; Toder, *supra* note 8, at 362.

<sup>15</sup> See, e.g., PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, SIMPLE, FAIR, & PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM 27, 53, 57 (2005) [hereinafter PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, PROPOSALS], available at <http://www.taxreformpanel.gov/final-report> (utilizing TEA in the development of tax reform proposals); Griffith, *supra* note 11, at 349 (stating that TEA “has had a significant impact on the formulation of tax policy”); Joann M. Weiner, *Tax Expenditures and the Federal Budget*, 118 TAX NOTES 586 (Feb. 4, 2008); see also WITTE, *supra* note 1, at 269 (discussing the influence of TEA on the tax policymaking process); Shaviro, *supra* note 8, at 187 (“At least 14 countries release tax expenditure data . . .”). One critic of TEA, Professor Edward Zelinsky, has described the influence of TEA in the following way:

Few academic doctrines can claim the intellectual and political success of tax expenditure analysis. In roughly a generation's time, Professor Surrey's procedural and substantive critique of tax subsidies has become entrenched in the law school curriculum and in legal scholarship. More impressively, the tax expenditure concept has been enshrined in federal law and become part of the daily discourse of the national budget process.

Zelinsky, *A Procedural Defense of Tax Expenditures*, *supra* note 2, at 1165 (footnotes omitted).

requirement that the provision in question must be recast and examined as a direct expenditure analogue and then must go through a cost/benefit analysis. Indeed, we regard TEA's principal purpose and justification to be its role as a triggering mechanism for mandatory recasting and cost/benefit analysis.<sup>16</sup> Under this form of scrutiny, tax policymakers first ask whether the tax expenditure in question would pass muster if it were proposed as an equivalent direct expenditure program.<sup>17</sup> For a tax expenditure that survives this inquiry, the next questions are whether it yields net benefits and, if so, whether the benefits could be better achieved through a direct expenditure program. A tax provision that successfully endures this analytical approach gets a passing grade even though it bears the tax expenditure label. Of course, many, perhaps most, tax expenditures will receive failing marks when scrutinized in this fashion — but this is due to their inherent weaknesses and not because TEA amounts to a rule of automatic disqualification.

One of Surrey's objectives in advocating TEA was to force recognition of both the revenue costs of individual tax expenditures and the aggregate revenue cost of all tax expenditures.<sup>18</sup> Critics have contended that flaws in the revenue estimation process make TEA useless for this purpose. In Part IV, we will argue that these criticisms are overbroad. Our central theme in this article, however, is that even if these and certain other objections are valid, TEA is an important tool for identifying tax provisions that should be subjected to recasting and to cost/benefit scrutiny. We will also address other criticisms of TEA in Part IV and argue that these objections are either misguided, deal with marginal matters, or are outside the realm of practical tax policy concerns.

In Part V, we will provide a brief explanation of the evaluative method that we believe should be applied to tax expenditures. In Part VI, we will examine several important features of the U.S. international income tax system — deferral, cross-crediting, and the export sales source rule. In our judgment, all of these features involve tax expenditures that receive failing marks under the recasting and cost/benefit analysis explained in Part V. Part VII will summarize our overall conclusions.

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<sup>16</sup> See SURREY & MCDANIEL, *TAX EXPENDITURES*, *supra* note 2, at 5–6.

<sup>17</sup> See SURREY, *PATHWAYS*, *supra* note 2, at 36–40.

<sup>18</sup> See SURREY & MCDANIEL, *TAX EXPENDITURES*, *supra* note 2, at 6, 25, 233.

## II. A SIMPLE, BUT NECESSARY, ILLUSTRATION

At its core, TEA is the essence of simplicity. We can illustrate the basic idea by considering a simplified version of a longstanding TEA target:<sup>19</sup> the section 103 exclusion for interest on public purpose state and municipal government bonds.<sup>20</sup>

Assume that the U.S. federal income tax has only one rate, 35%, bonds issued by corporations are paying 10% per annum taxable interest, and interest received on state and local government bonds is excluded from gross income. An investor who buys a corporate bond paying 10% interest before tax will have only 6.5% interest after paying a 35% income tax.<sup>21</sup> As a result, tax-free state and local government bonds that pay only 6.5% interest will be competitive with 10% corporate bonds of equal quality and governmental issuers of the tax-free bonds will be able to borrow at a cost that is 35% less<sup>22</sup> than the borrowing cost of corporations.

At this point, it is useful to note that the purchasers of the tax-exempt bonds in this example are said to pay a 35% *implicit tax*<sup>23</sup> because that is the percentage difference between the 6.5% exempt interest they will receive<sup>24</sup> and the 10% before-tax interest that they would have received if there had been no interest tax exemption and they had purchased bonds paying taxable interest.<sup>25</sup> This 35% implicit

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<sup>19</sup> See SURREY & MCDANIEL, *TAX EXPENDITURES*, *supra* note 2, at 83–84.

<sup>20</sup> See I.R.C. § 103.

<sup>21</sup>  $10\% \times (1 - 0.35) = 6.5\%$ .

<sup>22</sup>  $(0.10 - 0.065) \div 0.10 = 0.35$ .

<sup>23</sup>  $(10\% - 6.5\%) \div 10\% = 35\%$ . See, e.g., U.S. TREAS. DEP'T, *BLUEPRINTS FOR BASIC TAX REFORM 84* (Jan. 17, 1977) [hereinafter U.S. TREAS. DEP'T, *BLUEPRINTS*], available at <http://www.treas.gov/offices/tax-policy/library/blueprints>; SLEMROD & BAKIJA, *supra* note 9, at 75. For general explanations of the implicit tax concept, see MYRON S. SCHOLES, MARK A. WOLFSON, MERLE ERICKSON, EDWARD L. MAYDEW & TERRY SHEVLIN, *TAXES AND BUSINESS STRATEGY* 121–22, 125–27 (3d ed. 2005); Harry Watson, *Implicit Taxes*, in *THE ENCYCLOPEDIA OF TAXATION AND TAX POLICY* 185 (Joseph J. Cordes, Robert D. Ebel & Jane G. Gravelle eds., 2d ed. 2005) [hereinafter *ENCYCLOPEDIA*]. For an article that argues that consideration of the effects of implicit taxes should pay a greater role in federal income tax policy analysis and a response to that article, see Charlotte Crane, *Some Explicit Thinking About Implicit Taxes*, 52 *SMU L. REV.* 339 (1999); David A. Weisbach, *Implications of Implicit Taxes*, 52 *SMU L. REV.* 373 (1999) (responding to Professor Crane's article).

<sup>24</sup> See *supra* note 21.

<sup>25</sup>  $(0.10 - 0.065) \div 0.10 = 0.35$ . See U.S. TREAS. DEP'T, *BLUEPRINTS*, *supra* note 23, at 84; SLEMROD & BAKIJA, *supra* note 9, at 75, 230; Bartlett, *The End*, *supra* note 8, at 418.

tax is identical to both (1) the 35% interest savings garnered by the state and local governments as a result of being able to issue bonds that pay 6.5% exempt interest instead of 10% taxable interest, and (2) the federal government's loss of the 35% tax that would have been collected if there had been no tax exemption for the interest and the purchasers of the exempt state and local government bonds had instead invested in bonds paying 10% taxable interest. In other words, the state and local government bond issuers, the 35% bracket investors in the exempt-interest bonds, and the federal government are all in the same positions they would occupy if the investors had paid a 35% federal tax on receipts of 10% interest and the federal government had then sent checks to the state and local government issuers equal to 35% of their 10% interest cost.<sup>26</sup> Accordingly, the exemption can be viewed as equivalent to the government acting as a conduit by taking 35% of the 10% bond interest from the recipients and transferring it through the appropriations process to the state and local government issuers of the bonds.<sup>27</sup>

An exemption for interest paid on state and local government bonds, however, *unlike a deduction for business expenses*, is not a required feature of a normatively correct income tax base.<sup>28</sup>

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<sup>26</sup> See SHOLES, WOLFSON, ERICKSON, MAYDEW & SHEVLIN, *supra* note 23, at 126 ("To whom is the implicit tax paid? In our tax-exempt municipal bond example, it is paid to the issuers of the tax-exempt securities. The issuing municipalities receive an implicit subsidy by way of a lower cost of capital."); Calvin H. Johnson, *A Thermometer for the Tax System: The Overall Health of the Tax System as Measured by Implicit Tax*, 56 SMU L. REV. 13, 16 (2003) [hereinafter Johnson, *Thermometer*]. As stated by Professor Walter Blum: "There is thus a constructive receipt by the government. Lastly, this imputed [tax] revenue is assumed to be spent by the government . . . . Such a constructive expenditure is the other side of a constructive receipt." Walter J. Blum, *Book Review*, 1 J. CORP. TAX'N 486 (1975) [hereinafter Blum, *Book Review*].

<sup>27</sup> See SHOLES, WOLFSON, ERICKSON, MAYDEW & SHEVLIN, *supra* note 23, at 126 ("This taxing scheme, which uses implicit taxes to subsidize municipal spending programs, is similar to an alternative scheme in which all bonds (including municipal bonds) are fully taxable at the federal level and the federal government remits the tax collected on municipal bonds to each issuing authority."). Tax aficionados know that in the real world, the progressive rates of the federal income tax cause the benefit realized by the state and local government bond issuers to be substantially less than the federal government's loss of tax revenue. We have avoided that problem in this example by stipulating that the income tax has only one rate — 35%. In Part IV.A, this article discusses the effect of progressive rates on the exemption for interest paid on state and local government public purpose bonds.

<sup>28</sup> See PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, PROPOSALS, *supra* note 15, at 124; 1 U.S. TREAS. DEP'T, TAX REFORM, *supra* note 9, at 135; U.S.

Consequently, the only reason the federal government functions as a conduit here is because Congress *elected* to give up the 35% explicit tax on interest paid to investors in the state and local government bonds. For that reason, the constructive transfer to state and local governments in this example was not made by the investors; it was actually funded by the federal government with revenue forgone at the direction of Congress. As a result, TEA labels the interest exclusion in this example a tax expenditure,<sup>29</sup> i.e., a federal government outlay made through the income tax regime instead of through the federal government's cash expenditure system. TEA then requires that this exclusion/tax exemption be recast into the form of an equivalent direct expenditure as illustrated above.<sup>30</sup> If the equivalent direct expenditure is not unacceptable *per se*, it should next be subjected to cost/benefit analysis.<sup>31</sup>

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TREAS. DEP'T, BLUEPRINTS, *supra* note 23, at 84; Shaviro, *supra* note 8, at 209–10.

<sup>29</sup> See, e.g., STAFF OF JOINT COMM. ON TAX'N, 2007 ESTIMATES, *supra* note 13, at 5, 24–35; OFFICE OF MGMT. & BUDGET, EXECUTIVE OFFICE OF THE PRESIDENT, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2008, ANALYTICAL PERSPECTIVES 287 (2007) [hereinafter 2008 ANALYTICAL PERSPECTIVES]; OFFICE OF MGMT. & BUDGET, EXECUTIVE OFFICE OF THE PRESIDENT, BUDGET OF THE UNITED STATES, FISCAL YEAR 2007, ANALYTICAL PERSPECTIVES 287 (2006) [hereinafter 2007 ANALYTICAL PERSPECTIVES].

<sup>30</sup> Professors David Weisbach and Jacob Nussim have argued that for this purpose, a tax expenditure should be compared with the direct expenditure program that is most likely to be adopted to accomplish the tax expenditure's goals rather than with a direct expenditure program that precisely mimics the features of the tax expenditure. See Weisbach & Nussim, *supra* note 8, at 982. We disagree because it is important to know whether a direct expenditure program would be acceptable if it possessed all the significant features of a particular tax expenditure. If the direct expenditure program would not be acceptable on these terms, then it becomes critical to ask why the objections would be cured by implementing the program as a tax expenditure. This important question will go unanswered, and a fundamental benefit of TEA will be lost, unless tax expenditures are compared with direct expenditure programs having the same major characteristics as the respective tax expenditures.

<sup>31</sup> In hindsight, the entire exercise seems so obvious that when this article was presented in draft form at a faculty research colloquium, an audience member was amazed to learn that TEA was not common knowledge in the United States before Surrey's work. With respect to the earlier development of TEA in Germany, see Harry A. Shannon III, *The Tax Expenditure Concept in the United States and Germany: A Comparison*, 33 TAX NOTES 201 (Oct. 13, 1986). For a cataloguing of tax expenditures in five other countries, see PAUL R. MCDANIEL & STANLEY S. SURREY, INTERNATIONAL ASPECTS OF TAX EXPENDITURES: A COMPARATIVE STUDY (1985). For discussions of tax expenditures in countries that are members of the Organisation for Economic Co-operation and Development (OECD), see OECD, A REVIEW OF ISSUES AND COUNTRY PRACTICES (1984); OECD, TAX EXPENDITURES: RECENT

The Bush administration's Office of Management and Budget (OMB) recently criticized TEA for failing to accept the fact that tax expenditure programs and direct expenditure programs often function very differently. OMB's argument was stated as follows: "Although tax expenditures can often be thought of as tax subsidies, they are frequently unlike any of the subsidies found on the spending side of the budget. The differences can be so great that comparing the two types of subsidy is like comparing apples with oranges."<sup>32</sup>

We agree that tax expenditures and direct expenditure programs often look different with respect to the rigor of their eligibility criteria, application procedures, and administrative management. The likely explanation for these differences, however, is that the cash outlay feature of direct expenditure programs causes a demand for higher levels of justification, targeting, and management than apply to government spending hidden in the tax system.<sup>33</sup> It is difficult, however, to find a rational basis for applying lower standards of program design, management, and scrutiny to tax expenditures. By forcing recognition of the economic equivalence of tax expenditures and direct expenditures, TEA also forces an examination of whether the looser eligibility, application, and management/administrative approaches that often characterize tax expenditure programs are justifiable. Stated more broadly, TEA is an important tool for spotlighting hidden government spending and subjecting it to a more rigorous analysis than it would otherwise receive.

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EXPERIENCES (1996). For a paper discussing more recent work by the OECD on tax expenditures, see Dirk-Jan Kraan, *Off-budget and Tax Expenditures*, 4 OECD J. BUDGETING 121 (2004). For a discussion of the application of TEA to lesser developed countries' tax systems, see Lotfi Maktouf & Stanley S. Surrey, *Tax Expenditure Analysis and Tax and Budgetary Reform in Less Developed Countries*, 15 LAW & POL'Y INT'L BUS. 739 (1983).

<sup>32</sup> See Letter of James D. Foster, Associate Director of Economic Policy, Office of Management and Budget 2 (Sept. 2, 2005) [hereinafter Foster Letter], in GAO, FEDERAL COMMITMENT, *supra* note 1, at 83.

<sup>33</sup> For speculation as to why this is the case, see Poh Eng Hin, *Fiscal Misperceptions Associated with Tax Expenditure Spending: The Case of Pronatalist Tax Incentives in Singapore*, 5 EJOURNAL OF TAX RES. 5, 10 (2007), available at <http://www.atax.unsw.edu.au/ejtr/>; Calvin H. Johnson, *Tax Incentives Are Always the Wrong Way to Go*, 111 TAX NOTES 90, 92 (Apr. 3, 2006) [hereinafter Johnson, *Wrong Way*]; Shaviro, *supra* note 8, at 220; Weisbach & Nussim, *supra* note 8, at 970. *But see* Zelinsky, *A Procedural Defense of Tax Expenditures*, *supra* note 2, at 1179–80.

### III. IS TEA MORE THAN RHETORIC?

If tax policy tools, such as TEA, are to have normative force, they must possess a principled basis. Otherwise, their power depends entirely on their effectiveness as rhetoric in the world of raw politics.<sup>34</sup> This is an important point because TEA is sometimes discussed as if it were merely an unprincipled rhetorical device, cunningly created to serve the political agenda of those who oppose subsidies and incentives delivered through the tax system.<sup>35</sup> Closer examination, however, shows that this criticism is incorrect because TEA is actually grounded in three fundamental tax policy principles — ability-to-pay, the Schanz-Haig-Simons definition of income, and neutrality.

#### A. Ability-to-Pay and SHS

In Part II, we concluded that the state and local governmental bond interest exclusion is a federal government outlay made through the tax system. This conclusion is valid, however, only if the interest paid on state and local government bonds properly belongs in the income tax base — i.e., some norm requires all interest receipts to be treated as income — so that the interest exclusion is elective and deviant on the part of Congress. Surrey peremptorily declared that the proper baseline for this purpose is the Schanz-Haig-Simons definition of income,<sup>36</sup> modified to incorporate widely accepted business

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<sup>34</sup> As Professor Daniel Goldberg has observed regarding the tax system generally:

Without a theoretical standard based upon fundamental principles of taxation uniformly applied, the system will be cast loose from its moorings. No provisions would have a stronger claim based on principle than any other provision motivated by a specific identified perceived benefit. Under such a system, future tax legislation will become simply a test of political power.

Daniel S. Goldberg, *The U.S. Consumption Tax: Evolution, Not Revolution*, 57 TAX LAW. 1, 29 (2003).

<sup>35</sup> See Kahn & Lehman, *supra* note 8, at 1663 (asserting that tax expenditure budgets “create only an illusion of value-free scientific precision in a heavily politicized domain”); Shaviro, *supra* note 8, at 188 (characterizing TEA as “a mere fiscal language innovation”). *But see* Martin Feldstein, *A Contribution to the Theory of Tax Expenditures: The Case of Charitable Giving*, in *ECONOMICS OF TAXATION*, *supra* note 6, at 102 (critic of TEA making clear that “rejection of the presumption that all tax expenditures are bad implies no criticism of the valuable idea of the ‘tax expenditure budget’”).

<sup>36</sup> See SURREY & MCDANIEL, *TAX EXPENDITURES*, *supra* note 2, at 3–4.

accounting standards and the generally accepted structure of an income tax.<sup>37</sup> In our view, however, an understanding of TEA's normative baseline requires a brief explanation of a more fundamental concept — the principle of ability-to-pay.

The parameters of a normatively correct income tax base are usually determined by applying an array of widely accepted tax policy criteria,<sup>38</sup> one of the most important of which is the proposition that the income tax burden should be allocated among resident taxpayers in relation to their taxpaying capacities, often referred to as the principle of ability-to-pay.<sup>39</sup> Indeed, it is fair to regard this

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<sup>37</sup> See *id.* at 4; Thuronyi, *supra* note 8, at 1164–65.

<sup>38</sup> See DODGE, FLEMING & GEIER, *supra* note 9, at 117–50.

<sup>39</sup> See *Report on Double Taxation Submitted to the Financial Committee by Professors Bruins, Einaudi, Seligman and Sir Josiah Stamp*, League of Nations Doc. E.F.S. 73.F.19., at 18 (1923), reprinted in 4 STAFF OF JOINT COMM. ON TAXATION, LEGISLATIVE HISTORY OF UNITED STATES TAX CONVENTIONS 4003, 4022 (1962); U.S. TREAS. DEP'T, BLUEPRINTS, *supra* note 23, at 1, 24; MICHAEL J. GRAETZ & DEBORAH H. SCHENK, FEDERAL INCOME TAXATION 27, 37–38 (5th ed. 2005); WILLIAM A. KLEIN, JOSEPH BANKMAN & DANIEL N. SHAVIRO, FEDERAL INCOME TAXATION 6–7 (13th ed. 2003); RICHARD A. MUSGRAVE & PEGGY B. MUSGRAVE, PUBLIC FINANCE IN THEORY AND PRACTICE 232–40 (4th ed. 1984); STEPHEN G. UTZ, TAX POLICY 31–32, 41 (1993); Robert A. Green, *The Future of Source-Based Taxation of the Income of Multinational Enterprises*, 79 CORNELL L. REV. 18, 29 (1993); Martin J. McMahon, Jr. & Alice G. Abreu, *Winner-Take-All Markets: Easing the Case for Progressive Taxation*, 4 FLA. TAX REV. 1, 72–80 (1998); Robert L. Palmer, *Toward Unilateral Coherence in Determining Jurisdiction to Tax Income*, 30 HARV. INT'L L.J. 1, 9–10 (1989); Donald Phares, *Tax Equity Analysis*, in ENCYCLOPEDIA, *supra* note 23, at 399; Sneed, *supra* note 9, at 574–80; see also U.S. TREAS. DEP'T, DISTRIBUTIONAL ANALYSIS METHODOLOGY, OTA PAPER NO. 85, at 6 (1999) [hereinafter U.S. TREAS. DEP'T, DISTRIBUTIONAL ANALYSIS], available at <http://www.ustreas.gov/offices/tax-policy/library/ota85.pdf>. For a discussion of the use of fairness considerations in defining income, see Victor Thuronyi, *The Concept of Income*, 46 TAX L. REV. 45 (1990).

Countries rely on a benefits theory to tax income earned within their borders by foreign persons. See Stephen E. Shay, J. Clifton Fleming, Jr. & Robert J. Peroni, *The David R. Tillinghast Lecture — “What’s Source Got to Do With It?” Source Rules and U.S. International Taxation*, 56 TAX L. REV. 81, 90–106 (2002) [hereinafter Shay, Fleming & Peroni, *Source Rules*].

Ability-to-pay is a foundational principle in the income tax systems of many countries in addition to the United States. See Henry Ordower, *Horizontal and Vertical Equity in Taxation as Constitutional Principles: Germany and the United States Contrasted*, 7 FLA. TAX REV. 259, 304 (2006); Frans Vanistendael, *Legal Framework for Taxation*, in 1 TAX LAW DESIGN AND DRAFTING 15, 22–23 (Victor Thuronyi ed., 1996). The ability-to-pay principle has even been made a constitutional limitation on the power to tax in Italy, Spain, and Germany. See *id.*; see also Basic Facts About the United Nations, The United Nations: Organization,



longstanding concept<sup>40</sup> as the major fairness norm in the U.S. federal income tax system.<sup>41</sup>

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<http://www.un.org/aboutun/basicfacts/unorg.htm> (“The fundamental criterion on which the scale of assessments is based is the capacity of countries to pay.”).

<sup>40</sup> The ability-to-pay principle has a lengthy intellectual history. Adam Smith endorsed it as a foundational tax norm although, failing to understand that it differed from the benefit principle, he conflated the two. See Richard A. Musgrave, *Fairness in Taxation*, in *ENCYCLOPEDIA*, *supra* note 23, at 135. Smith’s statement was: “The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state.” ADAM SMITH, *AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS* 371 (4th ed. 1850). Kant also recognized the ability-to-pay principle as a norm of taxation. Like Smith, he conflated it with the benefit principle but he also clearly acknowledged the redistributive implications of ability-to-pay. Kant’s statement was:

The general will of the people has united itself into a society which is to maintain itself perpetually; and for this end it has submitted itself to the internal authority of the state in order to maintain those members of the society who are unable to maintain themselves. For reasons of state the government is therefore authorized to constrain the wealthy to provide the means of sustenance to those who are unable to provide for even their most necessary natural needs. The wealthy have acquired an obligation to the commonwealth, since they owe their existence to an act of submitting to its protection and care, which they need in order to live; on this obligation the state now bases its right to contribute what is theirs to maintaining their fellow citizens. This can be done either by imposing a tax on the property or commerce of citizens, or by establishing funds and using the interest from them, not for the needs of the state (for it is rich), but for the needs of the people. It will do this by way of coercion (since we are speaking here only of the *right* of the state against the people), by public taxation, not merely by *voluntary* contributions, some of which are made for gain (such as lotteries, which produce more poor people and more danger to public property than there would otherwise be, and which should therefore not be permitted).

IMMANUEL KANT, *THE METAPHYSICS OF MORALS* 101 (Mary Gregor ed., 1996) (emphasis in original). More recent commentators on taxation have recognized that the ability-to-pay and benefit principles are separate norms. See, e.g., LIAM MURPHY & THOMAS NAGEL, *THE MYTH OF OWNERSHIP* 16–30 (2002); Deborah A. Geier, *Time to Bring Back the Benefit Norm?*, 102 *TAX NOTES* 1155 (Mar. 1, 2004); Sagit Leviner, *From Deontology to Practical Application: The Vision of a Good Society and the Tax System*, 26 *VA. TAX REV.* 405, 423–30 (2006).

Ultimately, the decision to use ability-to-pay as a foundational principle of a tax system is based on a societal decision that other approaches are inferior. See generally Reuven S. Avi-Yonah, *The Three Goals of Taxation*, 60 *TAX L. REV.* 1, 14–15 (2006) [hereinafter Avi-Yonah, *Three Goals*].

<sup>41</sup> See U.S. TREAS. DEP’T, *BLUEPRINTS*, *supra* note 23, at 1; STEUERLE,

Nevertheless, the ability-to-pay concept has drawn sharp criticism because its meaning can be controversial at the margins. For example, commentators often refine the ability-to-pay fairness concept by subdividing it into a horizontal equity component (taxpayers with equal incomes should pay equal amounts of tax) and a vertical equity component (taxpayers with unequal incomes should pay amounts of tax which are sufficiently unequal to fairly reflect the differences in their incomes).<sup>42</sup> Other commentators, however, have criticized these refinements by asserting that horizontal equity has no significance as a tax policy norm separate from vertical equity or that neither horizontal nor vertical equity has any content that is independent of more general notions regarding fundamental fairness.<sup>43</sup> There has also been disagreement regarding certain nuances of the ability-to-pay concept, such as the proper handling of psychic income, leisure, underachievement, and various personal characteristics of taxpayers.<sup>44</sup> Finally, ability-to-pay analysis has been criticized for focusing on

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CONTEMPORARY TAX POLICY, *supra* note 3, at 10. Regarding the history of the rise of the ability-to-pay concept as a foundational principle in U.S. tax policy, see RICHARD J. JOSEPH, *THE ORIGINS OF THE AMERICAN INCOME TAX: THE REVENUE ACT OF 1894 AND ITS AFTERMATH* 89–90, 95–96 (2004); Ajay K. Mehrota, *Envisioning the Modern American Fiscal State: Progressive Era Economists and the Intellectual Foundations of the U.S. Income Tax*, 52 UCLA L. REV. 1793 (2005); Dennis J. Ventry, Jr., *Equity versus Efficiency and the U.S. Tax System in Historical Perspective*, in *TAX JUSTICE: THE ONGOING DEBATE* 25 (Joseph J. Thorndike & Dennis J. Ventry, Jr. eds., 2002).

<sup>42</sup> See DAVID F. BRADFORD, *UNTANGLING THE INCOME TAX* 150–53 (1986); JOSEPH M. DODGE, *THE LOGIC OF TAX* 88 (1989); GRAETZ & SCHENK, *supra* note 39, at 27–28; WILLIAM A. KLEIN, *POLICY ANALYSIS OF THE FEDERAL INCOME TAX* 7 (1976); Eric M. Zolt, *The Uneasy Case for Uniform Taxation*, 16 VA. TAX REV. 39, 86–98 (1996).

<sup>43</sup> See generally Louis Kaplow, *A Note on Horizontal Equity*, 1 FLA. TAX REV. 191 (1992); Louis Kaplow, *Horizontal Equity: Measures in Search of a Principle*, 42 NAT'L TAX J. 139 (1989); Paul R. McDaniel & James R. Repetti, *Horizontal and Vertical Equity: The Musgrave/Kaplow Exchange*, 1 FLA. TAX REV. 607 (1993); Richard A. Musgrave, *Horizontal Equity: A Further Note*, 1 FLA. TAX REV. 354 (1993); Richard A. Musgrave, *Horizontal Equity, Once More*, 43 NAT'L TAX J. 113 (1990). *But see* Joseph M. Dodge, *Theories of Tax Justice: Ruminations on the Benefit, Partnership, and Ability-to-Pay Principles*, 58 TAX L. REV. 399, 458–59 (2005) [hereinafter Dodge, *Theories*].

<sup>44</sup> See STAFF OF JOINT COMM. ON TAXATION, 105TH CONG., *REPORT RELATING TO THE IMPACT ON INDIVIDUALS AND FAMILIES OF REPLACING THE FEDERAL INCOME TAX* 107–17 (Joint Comm. Print 1997); Anthony C. Infanti, *Tax Equity*, 55 BUFF. L. REV. 1191 (2008) [hereinafter Infanti, *Tax Equity*]; Zolt, *supra* note 42, at 89–101; *see also* Barbara H. Fried, *The Puzzling Case for Proportionate Taxation*, 2 CHAPMAN L. REV. 157, 182–83 (1999) [hereinafter Fried, *Puzzling Case*]. These strike us as peripheral matters.

taxation without considering the distributional effects of government expenditures<sup>45</sup> and for using the prevailing distribution of income as the measure of taxpaying capacity without inquiring into whether that income distribution is itself fair.<sup>46</sup> As noted, these points have caused some commentators to dismiss ability-to-pay as unhelpful.<sup>47</sup>

In our view, these attacks greatly undervalue the importance of the ability-to-pay principle in establishing the general structure and content of the tax base. This utility plus the intuitive appeal<sup>48</sup> of the

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<sup>45</sup> See MURPHY & NAGEL, *supra* note 40, at 24–25, 30, 184; Fried, *Puzzling Case*, *supra* note 44, at 182. In our view, an unfairly distributed tax burden is problematic even in the unlikely case in which tax inequity is completely corrected by redistributive spending. See also Dodge, *Theories*, *supra* note 43, at 451–52, 456–57.

<sup>46</sup> See MURPHY & NAGEL, *supra* note 40, at 28–30; Fried, *Puzzling Case*, *supra* note 44, at 182. This criticism overlooks the fact that the ability-to-pay concept is a tax burden distribution norm, not an income distribution norm. To demand that the ability-to-pay concept provide a normative basis for both tax burden distribution and income distribution is to demand too much. A separate income distribution norm is required. See also Dodge, *Theories*, *supra* note 43, at 454 (“[T]he point of the ability-to-pay principle is precisely that a tax base keyed to market outcomes is the only rational foundation for a system of redistribution that would alter such outcomes. Existing distributions . . . have no normative status whatsoever under the objective ability-to-pay tax justice norm.”).

<sup>47</sup> See, e.g., LOUIS EISENSTEIN, *THE IDEOLOGIES OF TAXATION* 56 (1961) (“To speak forcefully of ability to pay is merely to indulge in evasive rhetoric.”); MURPHY & NAGEL, *supra* note 40, at 30 (“[T]he vague idea of ‘ability to pay’ will not help us when we move to the different question of what distributive [aims] a just government should have.”); SLEMRD & BAKIJA, *supra* note 9, at 64 (“On the compelling questions of the day, however — such as whether millionaires ought to pay 70 percent, 50 percent, or 30 percent of their income in tax or whether poor families should pay anything at all — the ability-to-pay principle has nothing concrete to offer.”); Alvin Warren, *Would a Consumption Tax Be Fairer Than an Income Tax?*, 89 *YALE L.J.* 1081, 1092–93 (1980) (“Such definitions reduce to statements that society should appropriately tax what it should appropriately tax.”).

<sup>48</sup> Regarding the intuitive appeal of the ability-to-pay principle, Professor Joseph Dodge has observed:

[T]he ability-to-pay principle can be constructed from a [preference-neutral] Rawls-type contractarian method: A person in ignorance of his or her material station in life (and moderately risk-averse) would opt to be forced to contribute to government according to the ability-to-pay principle (so long, of course, as everybody else is subject to the same taxing principle).

Dodge, *Theories*, *supra* note 43, at 460. Consistent with this view, William Safire, the conservative New York Times political editor, said: “Most of us accept as ‘fair’ this principle: the poor should pay nothing, the middlers something, the rich the highest percentage.” William Safire, *The 25% Solution*, *N.Y. TIMES*, Apr. 20, 1995, at A23,

ability-to-pay principle has caused it to persist as a major parameter of tax policy.<sup>49</sup> Thus, a prominent tax economist has recently referred to the horizontal equity component of ability-to-pay as “perhaps the queen of all principles affecting government policy.”<sup>50</sup>

More importantly, the preceding controversies and criticisms have been made effectively irrelevant by the development of a U.S. tax policy consensus under which ability-to-pay means that taxpayers with larger net incomes in a given year should generally pay more tax (calculated with progressive rates) than those who have smaller net incomes in the same year,<sup>51</sup> and that when comparing net incomes for

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quoted in MICHAEL J. GRAETZ, *THE U.S. INCOME TAX: WHAT IT IS, HOW IT GOT THAT WAY, AND WHERE WE GO FROM HERE* 11 (1999). Professor Richard Schmalbeck reached the same conclusion as Safire. Richard L. Schmalbeck, *Race and the Federal Income Tax: Has a Disparate Impact Case Been Made?*, 76 N.C.L. REV. 1817, 1820 (1998).

<sup>49</sup> See U.S. TREAS. DEP'T, *BLUEPRINTS*, *supra* note 23, at 1; STEUERLE, *CONTEMPORARY TAX POLICY*, *supra* note 3, at 10.

<sup>50</sup> See STEUERLE, *CONTEMPORARY TAX POLICY*, *supra* note 3, at 10 (“[H]orizontal equity . . . asserts that those with equal ability to pay should pay equal taxes. . . . Horizontal equity is perhaps the queen of all principles affecting government policy . . . .”); see also Gene Steuerle, *A Consensus Base for Tax Reform*, 113 TAX NOTES 371 (Oct. 23, 2006) [hereinafter Steuerle, *Consensus*].

<sup>51</sup> See, e.g., *Testimony of Robert J. Carroll, Deputy Assistant Secretary (Tax Analysis), United States Department of the Treasury, Before the S. Finance Comm.*, 109th Cong. 3 (Sept. 20, 2006) [hereinafter *Carroll Testimony*], available at <http://www.ustreas.gov/press/releases/reports/carrolltestimony%209.20.06.pdf> (“[T]he tax system should be appropriately progressive.”); PRESIDENT’S ADVISORY PANEL ON FEDERAL TAX REFORM, *PROPOSALS*, *supra* note 15, at 49 (“All members of the Panel endorsed the goal of a progressive tax structure.”); Thomas L. Hungerford, *Tax Expenditures: Good, Bad or Ugly?*, 113 TAX NOTES 325, 329 (Oct. 23, 2006) (“[A]bout two-thirds of Americans ‘believe that people with high incomes should pay a larger share of their income in taxes than those with lower income.’”); Theodore P. Seto & Sandi L. Buhai, *Tax and Disability: Ability-to-Pay and the Taxation of Difference*, 154 U. PA. L. REV. 1053, 1057 (2006) (“[S]tandard tax theory largely ignores differences — other than differences in ‘income’ — in the ability of taxpayers to pay taxes.”). On a related point, the Pew Research Center for the People and the Press has conducted a series of national polls of adult Americans showing that from 1994 to 2007, agreement with the statement that it is the government’s responsibility “to take care of people who can’t take care of themselves” has increased from 57% to 69% and agreement that the government should assist the needy even if doing so causes an increase in government debt has risen from 41% to 54%. See PEW RESEARCH CENTER FOR THE PEOPLE & THE PRESS, *TRENDS IN POLITICAL VALUES AND CORE ATTITUDES: 1987-2007* (Mar. 22, 2007), available at <http://people-press.org/reports/pdf/312.pdf>. For an article that analyzes the moral, economic, and administrative effects of a progressive rate structure, see Joseph Bankman & Thomas Griffith, *Social Welfare and the Rate Structure: A New Look at Progressive Taxation*, 75 CAL. L. REV. 1905

this purpose, the realization principle is applied,<sup>52</sup> an objective, market-based standard is used,<sup>53</sup> and items that cannot be feasibly measured (e.g., leisure, psychic income, and forgone opportunities) are omitted.<sup>54</sup> The emergence of this consensus has made the ability-to-pay principle a workable concept despite uncertainties and controversies at the margins.<sup>55</sup>

Integrally related to ability-to-pay is the widely accepted Schanz-Haig-Simons (SHS) definition of income which provides that an individual's income is the sum of his or her consumption and change in wealth during the taxable period, usually a year.<sup>56</sup> Under this definition, both amounts that are consumed and amounts that are

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(1987).

<sup>52</sup> See U.S. TREAS. DEP'T, BLUEPRINTS, *supra* note 23, at 46–47; William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113, 1141–48 (1974) [hereinafter Andrews, *Cash Flow Personal Income Tax*]; Christopher H. Hanna, *Tax Theories and Tax Reform*, 59 SMU L. REV. 435, 437–38 (2006); Ronald A. Pearlman, *A Tax Reform Caveat: In the Real World, There Is No Perfect Tax System*, in TOWARD FUNDAMENTAL TAX REFORM 106, 108–09 (Alan J. Auerbach & Kevin A. Hassett eds., 2005) [hereinafter Pearlman, *No Perfect Tax System*]; Deborah H. Schenk, *A Positive Account of the Realization Principle*, 57 TAX L. REV. 355, 396 (2004).

<sup>53</sup> See HENRY C. SIMONS, PERSONAL INCOME TAXATION 51 (1938); Dodge, *Theories*, *supra* note 43, at 449; see also KLEIN, *supra* note 42, at 7 (“On balance, the case for objectivity . . . has carried the day with respect to the tax system. But, again, it is useful to keep in mind . . . that by opting for objectivity, we have simultaneously decided to settle for a less-than-perfect measure of ability.”).

<sup>54</sup> See U.S. TREAS. DEP'T, BLUEPRINTS, *supra* note 23, at 3, 159–62; 1 U.S. TREAS. DEP'T, TAX REFORM, *supra* note 9, at 14–15, 37–42; WALTER J. BLUM & HARRY KALVEN, JR., THE UNEASY CASE FOR PROGRESSIVE TAXATION 64 (1953); BRADFORD, *supra* note 42, at 16–19, 155–56; KLEIN, BANKMAN & SHAVIRO, *supra* note 39, at 6–7; Dodge, *Theories*, *supra* note 43, at 449–50; Vada Waters Lindsey, *The Widening Gap Under the Internal Revenue Code: The Need for Renewed Progressivity*, 5 FLA. TAX REV. 1, 3, 7–8, 39–40 (2001); Herbert A. Stein, *What's Wrong with the Federal Tax System*, in COMMITTEE ON WAYS AND MEANS, TAX REVISION COMPENDIUM 107, 110–14 (Comm. Print 1959); see also PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, PROPOSALS, *supra* note 15, at 30 (Treasury Department calculates ability-to-pay in terms of “wages and salaries, business or farm net income, taxable and tax-exempt interest, dividends, rental income, realized capital gains, cash transfers from the government, and retirement benefits”).

<sup>55</sup> For recent vigorous defenses of the ability-to-pay principle, see Dodge, *Theories*, *supra* note 43, at 449–61; Seto & Buhai, *supra* note 51.

<sup>56</sup> See SLEMROD & BAKIJA, *supra* note 9, at 28; Hanna, *supra* note 52, at 436 (“The Haig-Simons definition of income is generally considered by most tax scholars to be the ideal definition of income.”).

saved are included in the tax base.<sup>57</sup> Obviously, this is a way of describing an individual's taxpaying ability.<sup>58</sup> Thus, SHS is generally understood to be based on the ability-to-pay principle and as a formula for implementing that principle.<sup>59</sup>

Not surprisingly, the theoretical criticisms leveled at the ability-to-pay principle with regard to the lack of clarity at the margins or the failure to include certain items<sup>60</sup> have also been directed at SHS. Because the U.S. tax policy consensus accepts ability-to-pay as a workable concept despite these objections, that same consensus has also embraced SHS as a practical policy guide.<sup>61</sup>

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<sup>57</sup> The most famous statement of the Schanz-Haig-Simons (SHS) formula is:

Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question. In other words, it is merely the result obtained by adding consumption during the period to "wealth" at the end of the period and then subtracting "wealth" at the beginning. . . . Moreover, this gain may be measured and defined most easily by positing a dual objective or purpose, consumption and accumulation, each of which may be estimated in a common unit by appeal to market prices.

SIMONS, *supra* note 53, at 50.

<sup>58</sup> Indeed, Simons characterized the SHS definition as a "measure of the individual's prosperity." SIMONS, *supra* note 53, at 206; *see also* Warren, *supra* note 47, at 1085–86 ("The arithmetical process of the Haig-Simons definition should not, however, obscure the nature of the aggregate tax base, which is the product of the society's private capital and labor for the accounting period. The Haig-Simons calculation simply identifies how much of that product has ended up in each taxable unit.").

<sup>59</sup> SHS is principally based on the ability-to-pay concept. *See* U.S. TREAS. DEP'T, BLUEPRINTS, *supra* note 23, at 31; U.S. TREAS. DEP'T, DISTRIBUTIONAL ANALYSIS, *supra* note 39, at 7; William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309, 326–29 (1972) [hereinafter Andrews, *Personal Deductions*]; Dodge, *Theories*, *supra* note 43, at 450; *see also* Joseph M. Dodge, *What's Wrong with Carryover Basis Under H.R. 8*, 91 TAX NOTES 961, 971 (May 7, 2001) (suggesting that the assignment-of-income doctrine, a core principle of the U.S. federal income tax, may be based on the ability-to-pay concept). Consistent with the principle of ability-to-pay, the consumption element of SHS is measured in objective, market-based terms. *See* Daniel Shaviro, *The Man Who Lost Too Much: Zarin v. Commissioner and the Measurement of Taxable Consumption*, 45 TAX L. REV. 215, 223–24 (1990).

<sup>60</sup> *See supra* text accompanying notes 42–46; *see also* Infanti, *Tax Equity*, *supra* note 44.

<sup>61</sup> *See* SLEMROD & BAKIJA, *supra* note 9, at 30 ("[A]s long as we are operating an income tax, it is important to understand how the tax system's definition of income compares to the 'true' measure of income."); Hanna, *supra* note 52, at 448–49; Stanley A. Koppelman, *Personal Deductions Under an Ideal Income Tax*, 43 TAX L. REV. 679,

To be sure, the SHS concept has not prevented the income tax from acquiring a mass of incoherent special pleading provisions.<sup>62</sup> Moreover, SHS is not the exclusive criterion of good tax policy. It must be weighed against other considerations such as enforceability, administrability, economic efficiency, simplification, revenue yield, and governmental effectiveness. Nevertheless, the SHS definition does provide a principled structure that is useful for testing the efficacy of tax provisions and opposing bad tax policy.

The interesting point to be made here, however, is that because SHS derives from the ability-to-pay principle and because Surrey explicitly used SHS as the first step in constructing his TEA income baseline,<sup>63</sup> TEA must also be rooted in the ability-to-pay concept. Consequently, it is puzzling to find that Surrey rejected ability-to-pay as a justification for TEA.<sup>64</sup> The apparent explanation is that Surrey wanted the deductions for medical expenses and charitable contributions to be classified as tax expenditures<sup>65</sup> and he saw this objective as threatened by the fact that some commentators regard these items as reflecting decreased ability-to-pay and, therefore, properly removed from the SHS baseline.<sup>66</sup> Surrey's concern has diminished in practical importance with respect to medical expense deductions because the applicable 7.5% of adjusted gross income

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683 (1988) (“[The SHS] definition has become the generally accepted foundation for modern day, normative analysis of the meaning of income as a base for personal taxation.”). *But see* Boris I. Bittker, *A “Comprehensive Tax Base” as a Goal of Income Tax Reform*, 80 HARV. L. REV. 925 (1967); Douglas A. Kahn, *Accelerated Depreciation — Tax Expenditure or Proper Allowance for Measuring Net Income?*, 78 MICH. L. REV. 1, 3–10 (1979).

<sup>62</sup> See SLEMROD & BAKIJA, *supra* note 9, at 31–53; Steuerle, *Consensus*, *supra* note 50, at 372 (“What has essentially happened to the tax policy process in recent decades is that it has increasingly adopted many of the bad habits of the expenditure policy process.”).

<sup>63</sup> See SURREY & MCDANIEL, *TAX EXPENDITURES*, *supra* note 2, at 3–4, 186–87; *see also* Goldberg, *supra* note 34, at 26 (“The basic premise of this view rests on the current tax system being an income tax and income for these purposes being defined, consistent with the generally accepted Haig-Simons definition, as personal consumption plus increase in wealth . . .”). The Surrey baseline did, however, include modifications of and supplements to the SHS definition. *See* SURREY & MCDANIEL, *TAX EXPENDITURES*, *supra* note 2, at 186–92.

<sup>64</sup> *See* SURREY & MCDANIEL, *TAX EXPENDITURES*, *supra* note 2, at 188, 284–85 n.12.

<sup>65</sup> *Id.* at 205–06.

<sup>66</sup> *See* SURREY, *PATHWAYS*, *supra* note 2, at 21; SURREY & MCDANIEL, *TAX EXPENDITURES*, *supra* note 2, at 188, 205, 284–85 n.12.

floor<sup>67</sup> and the narrowing of the statutory definition of qualifying medical expenses have made them available only to a small group of taxpayers.<sup>68</sup>

More fundamentally, regardless of Surrey's reason for resisting a linkage between ability-to-pay and TEA, his position is not well-founded because income is the generally recognized measure of ability-to-pay<sup>69</sup> and SHS, which Surrey saw as the first step in defining the TEA baseline, is generally recognized as the theoretically correct definition of income.<sup>70</sup> Consequently, TEA should be regarded as a necessary extension of the ability-to-pay principle in spite of Surrey's objection.

The linkage between ability-to-pay and TEA can be illustrated by again considering the example in Part II regarding tax-exempt interest. Interest paid on bonds issued by state and local governments confers ability-to-pay on the interest recipients just as effectively as taxable interest paid on corporate bonds. Thus, the ability-to-pay principle dictates that interest on state and local government bonds belongs in the tax base and that Congress's exclusion of that interest is an elective deviation from the ability-to-pay standard.<sup>71</sup> Once that

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<sup>67</sup> See I.R.C. § 213(a).

<sup>68</sup> Of the individuals who filed income tax returns for 2004, only 7.2% claimed medical expense deductions. See Michael Parisi & Scott Hollenbeck, *Individual Income Tax Returns, 2004*, in INTERNAL REVENUE SERVICE, SOI BULL., FALL 2006, at 8, 11 (2006), available at <http://www.irs.gov/pub/irs-soi/04indtr.pdf>.

<sup>69</sup> See U.S. TREAS. DEP'T, BLUEPRINTS, *supra* note 23, at 31; U.S. TREAS. DEP'T, DISTRIBUTIONAL ANALYSIS, *supra* note 39, at 6–7; Richard A. Musgrave, *Fairness in Taxation*, in ENCYCLOPEDIA, *supra* note 23, at 136.

<sup>70</sup> See U.S. TREAS. DEP'T, BLUEPRINTS, *supra* note 23, at 31; U.S. TREAS. DEP'T, DISTRIBUTIONAL ANALYSIS, *supra* note 39, at 7; SLEMROD & BAKIJA, *supra* note 9, at 28; Andrews, *Personal Deductions*, *supra* note 59, at 326–29; Hanna, *supra* note 52, at 436. Professor Thomas Griffith has criticized Surrey's TEA model on the grounds that it lacks any normative foundation because it adopts the SHS definition of income as the baseline without providing sufficient justification for doing so. See Griffith, *supra* note 11, at 363–66. As indicated in the text above, we believe that the ability-to-pay principle provides that justification.

<sup>71</sup> See PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, PROPOSALS, *supra* note 15, at 124 (stating that the exemption for state and local bond interest is “an incentive for investment in public infrastructure . . . [s]imilar to preferences for home ownership, charitable giving, and health coverage . . .”); 1 U.S. TREAS. DEP'T, TAX REFORM, *supra* note 9, at 135 (“The exemption of this interest is inconsistent with a comprehensive income tax.”); U.S. TREAS. DEP'T, BLUEPRINTS, *supra* note 23, at 84 (“The annual receipt or accrual of interest on State and local obligations unquestionably increases the taxpayer's opportunity to consume, add to wealth, or make gifts. It is, therefore, properly regarded as a source of income.”); Andrews,



analytical bridge is crossed, the conclusion that the interest exclusion results in forgone revenue is inescapable.<sup>72</sup> This conclusion requires an analytical tool to account for and evaluate the consequences of the forgone revenue in terms reflecting the interest savings of the bond issuers. The application of TEA to the example in Part II shows that the forgone revenue is effectively transferred by the federal government to the bond issuers with the same impact as a cash grant. More generally, the Part II example illustrates that TEA functions as a necessary consequence of, and adjunct to, the ability-to-pay principle with respect to all provisions that deliver subsidies or incentives by carving out (through deductions, exclusions, credits, or deferral provisions) items that properly belong in the base of an ability-to-pay-grounded income tax.

### B. Neutrality

A second major tax policy principle is that, to the greatest extent possible, tax provisions should achieve neutrality — i.e., taxpayer behavior should be altered as little as possible from what it would be in the absence of a particular tax provision.<sup>73</sup> Incentives and subsidies, including tax expenditures, enhance the after-tax economic returns from affected activities and cause taxpayers to engage in those activities to a greater extent than would otherwise be the case, interfering with the free market's allocation of resources.<sup>74</sup> The late Professor Walter Blum stated this point as follows:

A more classical line of attack on special dispensations under the income tax is that they cause a misallocation of economic resources. By taxing (and thus penalizing) certain

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*Personal Deductions*, *supra* note 59, at 376–77; Shaviro, *supra* note 8, at 210 (“[T]he contrast between the tax treatment of municipal bond interest and other interest makes no sense in purely distributional terms.”).

<sup>72</sup> See PRESIDENT’S ADVISORY PANEL ON FEDERAL TAX REFORM, PROPOSALS, *supra* note 15, at 13 (“A tax expenditure is a tax incentive . . . . Many of these tax incentives could have been structured as a direct government spending program. Either way, it costs the government money to provide benefits, which must be financed with higher taxes elsewhere.”).

<sup>73</sup> See U.S. TREAS. DEP’T, TAX REFORM, *supra* note 9, at 13; SLEMROD & BAKIJA, *supra* note 9, at 131–35.

<sup>74</sup> See *Carroll Testimony*, *supra* note 51, at 3; GAO, FEDERAL COMMITMENT, *supra* note 1, at 49–50; PRESIDENT’S ADVISORY PANEL ON FEDERAL TAX REFORM, PROPOSALS, *supra* note 15, at 70–72; SLEMROD & BAKIJA, *supra* note 9, at 218; Toder, *supra* note 8, at 362.

activities less than others the preferential provisions — so the argument goes — cause more resources to flow into these endeavors than would be attracted if the tax system were perfectly neutral, and as a result scarce resources are utilized in less productive combinations. I concur in the soundness of this reasoning.<sup>75</sup>

Accordingly, the interest exclusion in the example in Part II distorted free market choices by causing more capital to flow into state and municipal bonds than would otherwise have been the case.

Before aspects of the tax system that are not neutral can be evaluated and addressed, however, they must first be identified; a focused analytical tool is highly useful for that purpose. TEA serves this end with respect to incentives and subsidies delivered through income tax provisions. Stated differently, TEA is a device for identifying features of the tax system which cause taxpayers to pursue certain activities more extensively than they otherwise would.<sup>76</sup> Thus, a legitimate concern for neutrality in the tax system drives the use of TEA as a tool of sound tax policy.

#### IV. OTHER CRITICISMS OF TEA

##### A. *Do Implicit Taxes Nullify Concerns Regarding Tax Expenditures?*

To the extent that a tax expenditure causes investors to move more capital into an activity or economic sector than would otherwise be the case, the before-tax rate of return in the respective activity or sector will fall from what it would have been in the absence of the tax expenditure. As explained in Part II, this decline is characterized as an implicit tax borne by investors who chase the tax expenditure benefit.<sup>77</sup> TEA opponents sometimes make the suggestion that implicit taxes substantially mitigate objections to tax expenditures.<sup>78</sup>

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<sup>75</sup> Blum, *Preferential Provisions*, *supra* note 4, at 82; see also *Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee, Dividend Taxation of Individuals in the Internal Market*, at 18, COM (2003) 810 final (Dec. 19, 2003); Sullivan, *Tax Incentives*, *supra* note 3, at 23.

<sup>76</sup> See Shaviro, *supra* note 8, at 204.

<sup>77</sup> See SLEMROD & BAKIJA, *supra* note 9, at 75, 230; Boris I. Bittker, *Tax Shelters and Tax Capitalization, or Does the Early Bird Get A Free Lunch?*, 28 NAT'L TAX J. 416 (1975); see also Susan Ackerman & David Ott, *An Analysis of the Revenue Effects of Proposed Substitutes for Tax Exemption of State and Local Bonds*, 23 NAT'L TAX J. 397 (1970); Boris I. Bittker, *Equity, Efficiency, and Income Tax Theory: Do*

To examine the implicit tax concept and its possible impact on TEA, it will be helpful to revisit the example in Part II where corporate bonds pay 10% interest before tax, the federal income tax rate is a flat 35%, and interest on state and municipal government bonds is tax exempt. On these facts, investors are willing to buy state and municipal government bonds that bear only 6.5% interest because they see those bonds as equivalent to corporate bonds of equal quality that pay 10% interest but that require the interest recipients to incur a 35% tax. According to the implicit tax argument, the market-induced reduction of investors' interest receipts from 10% to 6.5% reflects a 35% implicit tax<sup>79</sup> — the same rate of tax explicitly borne by investors in corporate bonds that generate taxable interest.

### 1. Distortion

At this point, a small modification of the example in Part II will be helpful. Assume that the hypothetical 35% flat rate U.S. income tax has been operating without an exemption for interest on state and municipal government bonds, that these governments have been unable to borrow because they cannot afford the 10% market rate interest cost, that Congress decides to assist these governments by subsidizing their borrowing costs, and that the federal income tax is amended to create an exemption for interest on state and municipal government bonds. The new tax exemption will result in increased state and municipal government borrowing at 6.5%, and investors in state and municipal government bonds will bear the 35% implicit tax illustrated in Part II, but only to the extent that state and municipal governments respond to the exemption with debt offerings and investors switch to those debt offerings from taxable bonds and other taxable investment media. In other words, the implicit tax will occur with respect to an exemption for interest paid on state and local government bonds, and with respect to any other form of investment favored by a tax expenditure, only to the extent that tax expenditures distort choices by causing more capital to flow to the favored activities or investments than would be the case without a tax expenditure.<sup>80</sup>

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*Misallocations Drive Out Inequities?*, 16 SAN DIEGO L. REV. 735 (1979) [hereinafter Bittker, *Do Misallocations Drive Out Inequities?*].

<sup>78</sup> See Bartlett, *The End*, *supra* note 8, at 418.

<sup>79</sup>  $(0.10 - 0.065) \div 0.10 = 0.35$ . See also SLEMROD & BAKIJA, *supra* note 9, at 75.

<sup>80</sup> See Johnson, *Thermometer*, *supra* note 26, at 17; see also U.S. TREAS. DEP'T, BACKGROUND PAPER, *supra* note 1, at 7 (stating that the expansion of economic activities favored by tax incentives "may occur at the expense of other economic

As a result, implicit tax reasoning does not negate, and indeed confirms, the validity of the neutrality objection to tax expenditures. Of course, this objection can be overcome by, for example, demonstrating that a particular tax expenditure counterbalances some other distortion caused by the tax system or corrects a market failure.<sup>81</sup> Thus, contrary to the assertion of some TEA critics, characterization of an Internal Revenue Code (Code) provision as a tax expenditure does not end the inquiry concerning whether the provision can be justified on efficiency grounds. Nevertheless, implicit tax analysis shows that tax expenditures enter into the cost/benefit scrutiny described below with one strike against them because they are facially distortive elements in the tax system.

## 2. Capture

Tax expenditure theory opponents, however, are willing to live with this challenge because they see the implicit tax concept as helpful in overcoming a TEA-based fairness objection to tax expenditures. In the context of the Part II tax-exempt bond hypothetical that we have been analyzing, the fairness objection begins by pointing out that purchasers of tax-exempt bonds will pay no *explicit tax* on their interest income while others who earn their income in the form of wages will incur a 35% explicit tax. This difference, so the fairness argument goes, is a horizontal inequity that violates the principle of ability-to-pay.<sup>82</sup>

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activities, and the value of what is lost can exceed the value of what is gained, reducing the overall value of society's output of goods and services").

<sup>81</sup> See STAFF OF JOINT COMM. ON TAXATION, 109TH CONG., PRESENT LAW AND BACKGROUND RELATING TO TAX EXEMPTIONS AND INCENTIVES FOR HIGHER EDUCATION 29–30 (Joint Comm. Print 2006) (arguing that federal education subsidies, including tax expenditures, may be necessary to offset market failure regarding positive externalities of education and to achieve egalitarian goals); U.S. TREAS. DEP'T, BACKGROUND PAPER, *supra* note 1, at 8 (suggesting that tax incentives may be justified if the additional economic activity encouraged by the tax incentives is warranted by spillover effects or externality considerations); Sullivan, *Tax Incentives*, *supra* note 3, at 23–24; Zelinsky, *The Rehabilitation of Tax Incentives*, *supra* note 11 (positing an economic efficiency defense of tax expenditures in many cases); see also Peter J. Wiedenbeck, *Paternalism and Income Tax Reform*, 33 U. KAN. L. REV. 675, 683–87 (1985) (discussing three economic efficiency reasons for using tax expenditures).

<sup>82</sup> See U.S. TREAS. DEP'T, BLUEPRINTS, *supra* note 23, at 84. A deceptively attractive response is that because anyone can buy a tax-exempt bond and receive tax-exempt interest, the interest exemption does not violate the horizontal equity component of the ability-to-pay principle. This argument, however, has at least two

The conventional response to this argument is that, as illustrated in Part II, the bond purchasers are paying a 35% implicit tax<sup>83</sup> equal to the 35% explicit tax on the wage earners. This is the case despite the fact that the implicit tax borne by the interest recipients is effectively earmarked for a particular federal government purpose — assisting state and municipal governments by reducing their borrowing costs. As a result, the interest exemption might represent a poor policy decision for various practical reasons,<sup>84</sup> but not because it creates inequity between tax-exempt bondholders and taxpayers who earn

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flaws. First, investors can purchase tax-exempt bonds only to the extent that they have savings and savings are heavily concentrated among the wealthy and relatively scarce among other Americans. See Martin A. Sullivan, *Economic Analysis: Inequality, Populism, and Democratic Tax Policy*, 114 TAX NOTES 16, 17–18 (Jan. 8, 2007) (“[In 2004,] [t]he least wealthy 50 percent of households held only 2.5 percent of the nation’s wealth. Meanwhile, the wealthiest 10 percent held nearly 70 percent.”); see also Thomas L. Hungerford, *Income Inequality and the U.S. Tax System*, 117 TAX NOTES 465, 467 (Oct. 29, 2007) (reporting that in 2004, household income at the 90th percentile was 11.2 times household income at the 10th percentile); Barry W. Johnson & Brian G. Raub, *Personal Wealth, 2001*, in INTERNAL REVENUE SERVICE, SOI BULL., WINTER 2005-06, at 120 (2006), available at <http://www.irs.gov/pub/irs-soi/01pwart.pdf> (in 2001, the wealthiest 3.5% of the U.S. population held 32.7% of the total U.S. net worth). Thus, the opportunity to buy section 103 bonds is not equally available. See Gerald Prante, *Comparing Popular Tax Deductions to the Bush Tax Cuts*, TAX FOUNDATION (July 21, 2007), available at <http://www.taxfoundation.org/publications/show/22447.html> (70.5% of the benefit of the section 103 exemption is received by the top 10% of the individual income earners). Second, the exemption is worth more to upper-income taxpayers with a high marginal rate than to lower-bracket taxpayers. See U.S. TREAS. DEP’T, BLUEPRINTS, *supra* note 23, at 84. This bias of the section 103 exemption and numerous other tax expenditure provisions in favor of high-income taxpayers causes these provisions to be sometimes referred to as “upside-down subsidies.” See, e.g., Gerard M. Brannon, *Tax Expenditures and Income Distribution: A Theoretical Analysis of the Upside-Down Subsidy Argument*, in ECONOMICS OF TAXATION, *supra* note 6, at 87. For a defense of the “upside-down effect” of tax subsidies in certain cases on both efficiency and equity grounds, see Zelinsky, *The Rehabilitation of Tax Incentives*, *supra* note 11, at 1025–26, 1031–32. For a critique of the argument that tax expenditures undermine progressivity, see Griffith, *supra* note 11, at 352–60.

In a recent article, three proponents of using the tax system to achieve nonrevenue raising social objectives have proposed ameliorating the upside-down effect of tax incentive provisions by converting exclusions or deductions for such social objectives into uniform refundable tax credits. See Lily L. Batchelder, Fred T. Goldberg, Jr. & Peter R. Orszag, *Efficiency and Tax Incentives: The Case for Refundable Tax Credits*, 59 STAN. L. REV. 23 (2006).

<sup>83</sup> See SLEMROD & BAKIJA, *supra* note 9, at 75.

<sup>84</sup> See generally SLEMROD & BAKIJA, *supra* note 9, at 228–30; Johnson, *Thermometer*, *supra* note 26, at 17.

their income in taxable forms. On the facts of the example in Part II, the implicit tax borne by the bond purchasers fully eliminates any inequity between wage earners and recipients of exempt interest.<sup>85</sup>

TEA opponents would then be inclined to argue that, like the exemption for interest paid on state and municipal government bonds, all tax expenditures that function as a subsidy or incentive with respect to an income producing activity cause investors to move more capital into the favored activities than would otherwise be the case. This shift in turn causes a decline in the before-tax rate of return for those activities and, as the argument goes, imposes an implicit tax that mitigates, or perhaps eliminates, the horizontal equity objection with respect to all such tax expenditures. Although this line of analysis would not apply to tax expenditures that lack a connection to income producing activities or investments, such as the extra standard deduction for the aged and the blind,<sup>86</sup> it would reach the many tax expenditures that are designed to favor particular forms of income production.

The preceding argument is seriously impaired, however, if the tax expenditure benefit does not move primarily to its target, i.e., if the tax expenditure is captured to a significant extent by nontargets. Such capture does occur and can be illustrated by slightly but critically modifying the example in Part II. Assume that the federal income tax has two rates — 35% and 10% — and that state and municipal governments cannot meet their financing needs by selling tax-exempt bonds exclusively to taxpayers whose marginal rate is 35% (the high-bracket investors). Indeed, assume that one quarter of the bonds must be sold to taxpayers whose marginal rate is 10% (the low-bracket investors). Those taxpayers will not regard the tax-exempt bonds as equivalent to taxable corporate bonds paying 10% interest unless the exempt bonds pay at least 9% interest.<sup>87</sup> This is 2.5 percentage points higher than the 6.5% interest rate necessary to attract the high-bracket investors<sup>88</sup> but there is no practical way to segment a tax-exempt bond offering by selling 6.5% interest bonds to the high-

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<sup>85</sup> See GRAETZ & SCHENK, *supra* note 39, at 215–16; see also Martin J. Bailey, *Progressivity and Investment Yields under U.S. Income Taxation*, 82 J. POL. ECON. 1157, 1174 (1974) (“Apparent horizontal inequities as a rule shake out in competitive resource allocation and translate into misuse of resources.”); Bittker, *Do Misallocations Drive Out Inequities?*, *supra* note 77, at 739–42.

<sup>86</sup> See Bittker, *Do Misallocations Drive Out Inequities?*, *supra* note 77, at 746.

<sup>87</sup> A low-bracket investor who buys a corporate bond paying 10% taxable interest will have 9% interest after paying the applicable 10% tax.

<sup>88</sup> See *supra* text accompanying notes 21–22.

bracket investors and 9% interest bonds to the low-bracket investors. Thus, all the bonds issued by state and local governments in this scenario must pay 9% interest and all the buyers will bear an implicit tax limited to the 10% difference between the 10% taxable interest available on corporate bonds and the 9% tax-exempt interest available on state and municipal government bonds. Most importantly, the borrowing cost of the tax-exempt bond issuers, presumably the intended beneficiaries of this tax subsidy/tax expenditure, will be reduced only from 10% to 9%.

These facts are unobjectionable on equity grounds with respect to the low-bracket investors because their 10% implicit tax equals the 10% explicit tax paid by low-bracket wage earners.<sup>89</sup> Moreover, the situation in the case of the low-bracket investors is, in fact, the same as if the exempt bonds had paid 10% taxable interest and the federal government had received a 10% tax (equal to the 10% implicit tax) on that interest and used it to fund subsidy payments that reduced the tax-exempt bond issuers' net borrowing cost by 10% (from 10% to 9%). In other words, the tax expenditure with respect to the low-bracket investors inures fully to the intended beneficiaries — the exempt bond issuers.

As shown in Part II, however, the high-bracket investors would have been willing to buy the tax-exempt bonds even if they had paid only 6.5% interest. Stated differently, the high-bracket investors were willing to bear an implicit tax of 35%, which would have exactly equaled the 35% explicit tax that the government lost with respect to those investors because of the exemption. Because the income tax in this hypothetical has two rates and there is a shortage of high-bracket investors, those investors are able to buy tax-exempt bonds paying the 9% rate of interest necessary to attract the low-bracket investors. Consequently, the high-bracket investors suffer only a 10% implicit tax burden and are able to avoid twenty-five percentage points of implicit tax. Thus, there is inequity to the extent that high-bracket investors, who bear an implicit tax of only 10%, and high-bracket wage earners, who pay a 35% tax on their compensation income, comprise different groups for reasons other than personal choice. Moreover, there is also inequity between low-bracket and high-bracket investors in that the 10% explicit tax avoided by the low-bracket investors is exactly offset by the 10% implicit tax that they bear while the high-bracket investors avoid a 35% explicit tax but bear only the same 10% offsetting implicit tax suffered by the low-

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<sup>89</sup> See Bittker, *Do Misallocations Drive Out Inequities?*, *supra* note 77, at 743–44.

bracket investors. Most importantly, this analysis shows that there is a substantial element of waste with respect to the high-bracket investors because the twenty-five percentage points of implicit tax that they avoid has no effect on reducing the interest cost of the tax-exempt bond issuers from 10% to 9%. Thus, the twenty-five percentage points of implicit tax avoided by the high-bracket investors are simply a windfall that the high-bracket investors have successfully captured.<sup>90</sup>

Enough is known about the tax-exempt bond market for us to be certain that the preceding example reflects reality. That is, state and municipal bond offerings are in fact too large to be absorbed by the highest-bracket investors and some must be sold to investors in lower brackets.<sup>91</sup> Thus, these bonds, as in the preceding example, bear interest rates set to attract lower-bracket investors with the result that a substantial portion of the related federal tax expenditure is diverted from the target beneficiaries and captured by high-bracket investors.<sup>92</sup> There is less precise information available about tax expenditures related to other income producing activities, but what is known suggests that the capture phenomenon is widespread among these tax expenditures.<sup>93</sup> At the end of the day, the implicit tax concept does not

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<sup>90</sup> See *id.* at 742–44 (characterizing this capture as the “trickle-up phenomenon”). See generally U.S. TREAS. DEP’T, BLUEPRINTS, *supra* note 23, at 84; SLEMROD & BAKIJA, *supra* note 9, at 230.

<sup>91</sup> See GRAETZ & SCHENK, *supra* note 39, at 216; SLEMROD & BAKIJA, *supra* note 9, at 230.

<sup>92</sup> See SLEMROD & BAKIJA, *supra* note 9, at 230.

<sup>93</sup> See PRESIDENT’S ADVISORY PANEL ON FEDERAL TAX REFORM, PROPOSALS, *supra* note 15, at 8 (suggesting that the HOPE credit “may encourage colleges and universities to increase tuition, thereby capturing some of the benefit of the credit”), 70–72 (suggesting that the housing industry captures some of the benefits of income tax provisions designed to help individuals acquire homes); John E. Anderson, Jeffrey P. Clemens & Andrew R. Hanson, *Tax Reform and Incentives to Encourage Owner-Occupied Housing: Analysis of the President’s Tax Reform Panel Recommendation to Convert the Mortgage Interest Deduction to a Tax Credit* 23 (Sept. 19, 2006), <http://ssrn.com/abstract=943062> (concluding that the benefit of the mortgage interest deduction is significantly captured by taxpayers other than those on the margin between renting and purchasing and those who are low and moderate income households seeking to become first-time homeowners); Jane G. Gravelle, *Do Tax Incentives Work?*, 111 TAX NOTES 88 (Apr. 3, 2006) (suggesting that various tax subsidies are subject to the capture problem); Johnson, *Thermometer*, *supra* note 26, at 31 (arguing that because all investments compete for a common pool of capital, the rate of implicit tax on tax-exempt state and municipal bonds sets the limit on the implicit tax borne by investors in all tax expenditure-subsidized activities, thus making all such activities subject to the capture phenomenon); see also Larry D. Singell, Jr. & Joe A. Stone, *For Whom The Pell Tolls: The Response of University Tuition to Federal*



eliminate the horizontal inequities of tax expenditures and its failure to do so results in substantial waste.

*B. Is TEA Relevant to the Formation of Government Policy?*

1. The Relevance, or Not, of a Normative Tax Base

As noted above, TEA depends on identifying a normative tax base<sup>94</sup> and, for this purpose, Surrey used the SHS definition of income with various adjustments and supplements.<sup>95</sup> This aspect of TEA has spawned sharp controversies over whether particular income tax provisions are (1) elements of SHS and, therefore, not tax expenditures, or (2) departures from SHS and, consequently, tax expenditures.<sup>96</sup> Recently, Professors David Weisbach and Jacob Nussim, expanding on earlier work by Professor Michael McIntyre,<sup>97</sup> have argued that the question of whether a particular tax provision deviates from a correctly defined income tax base is an unnecessary inquiry and a distraction from what should be the controlling issue regarding tax expenditures.<sup>98</sup> According to Weisbach and Nussim, the controlling question is whether particular subsidies and incentives are best operated through the tax system or through some other means

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*Grants-in-Aid* 16 (2005), [http://darkwing.uoregon.edu/~lsingell/Pell\\_Bennett.pdf](http://darkwing.uoregon.edu/~lsingell/Pell_Bennett.pdf) (concluding that based on a survey of 1554 colleges and universities from 1989 to 1996, there is little evidence that Pell grants are captured by in-state tuition increases at public universities but that “increases in Pell grants appear to be matched nearly one for one by increases in tuition” at private universities).

<sup>94</sup> See *supra* text accompanying notes 36–72.

<sup>95</sup> See SURREY & MCDANIEL, *TAX EXPENDITURES*, *supra* note 2, at 186–94.

<sup>96</sup> See generally Bartlett, *The End*, *supra* note 8; Bittker, *Accounting*, *supra* note 11; Boris I. Bittker, *Income Tax Deductions, Credits, and Subsidies for Personal Expenditures*, 16 J.L. & ECON. 193 (1973) [hereinafter Bittker, *Personal Expenditures*]; Kahn & Lehman, *supra* note 8.

<sup>97</sup> Professor Michael McIntyre has argued that instead of attempting to determine which tax provisions are parts of the normative income tax base and which are subsidies or incentives that deviate from the norm, policymakers should listen to the defenders of various tax provisions and apply TEA only to the extent of claims that the tax provisions in question will produce spending-like benefits. See McIntyre, *supra* note 2, at 94–99. This approach will be useful in many cases but it can probably be circumvented by substituting rhetoric couched in terms of removing tax barriers, deterrents, and discrimination in place of rhetoric phrased in the language of subsidies and incentives. See generally EISENSTEIN, *supra* note 47, at 57–88.

<sup>98</sup> See Weisbach & Nussim, *supra* note 8, at 977 (“[T]his focus on definitions distracts from the underlying substantive arguments surrounding tax expenditures.”).

such as a direct expenditure program administered by a nontax agency.<sup>99</sup> The kernel of their argument is as follows:

The central question . . . is how to determine the best way to implement a government program . . . . It can be implemented through a direct spending program or through a tax program. The question is how to make this choice.<sup>100</sup>

. . . .

. . . [I]t is hard to see how . . . [this] should depend on a definition of income. For example, if we are going to subsidize medical expenses, whether it is desirable to do so through the tax system should not depend on whether a medical expense deduction meets the definition of income. Debates about the matter seem completely beside the point.<sup>101</sup>

A significant problem with this argument is that to determine whether a particular government subsidy, such as a deduction for medical expenses, is best delivered as a direct expenditure or as a subsidy through the tax system, we need to know the tax system's content and structure so that we can evaluate the effectiveness of the tax expenditure alternative and the costs it imposes on the tax system.<sup>102</sup> The results of this evaluation must then be taken into account along with the costs and benefits of the direct expenditure alternative. One way to do this analysis is to assume that the contemplated tax expenditure would occur in an income tax regime identical to the present system with its irrational and inefficient load of tax expenditures. This would distort the analysis, however, because the systemic costs (in terms of complexity, enforceability, and possible unfairness) of a proposed tax expenditure would likely appear much smaller if the tax expenditure were evaluated as just one item among

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<sup>99</sup> *Id.* at 973–76. These commentators frankly admit that this is a difficult and complex question to answer. *See id.* at 992–1023.

<sup>100</sup> *Id.* at 961.

<sup>101</sup> *Id.* at 975; *see also* Shaviro, *supra* note 8, at 199 (“Where the tax expenditure debate went off the rails, . . . was not in its aim of identifying ‘special’ provisions . . . but in its means of doing so, through the identification of a supposedly canonical, yet in practice under-theorized and rightly controversial, official definition of the ‘normative income tax base.’”).

<sup>102</sup> For example, the windfall enjoyed by high-bracket taxpayers who purchase tax-exempt bonds, *see supra* notes 89–93 and accompanying text, cannot be observed and evaluated unless the progressive rate structure of the income tax is taken into account.

many others that were also dubious but that were assumed to be constant. The analysis called for by Weisbach and Nussim should at least include an alternative cost/benefit calculation in which the contemplated subsidy is assumed to be cobbled onto a normatively correct tax base. From this standpoint, Weisbach's and Nussim's approach requires that tax expenditures be evaluated in relation to a normative income definition regardless of their argument to the contrary.<sup>103</sup> In the present tax policy world, the primacy of the ability-to-pay principle means that the baseline definition will be SHS.<sup>104</sup>

Perhaps Weisbach and Nussim agree that a normative income definition, such as SHS, is indeed necessary for purposes of *designing* a basic income tax system. They may be arguing that the income definition is *irrelevant only with respect to subsidies and incentives* delivered through that basic system. If this is their contention, we believe that it misinterprets and undervalues TEA's use of a baseline definition of income. TEA's focus on determining whether particular provisions are or are not necessary ingredients in defining an SHS income tax base is not about fidelity to an academic abstraction.<sup>105</sup> On

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<sup>103</sup> If a tax system had no normative baseline, there would be no debates over whether particular tax provisions do or do not fit within an SHS tax and, thus, no arguments over whether various features are or are not tax expenditures. Instead, we would look solely to the political process to legitimate or reject tax provisions. Anything that could pass both houses of Congress and obtain the President's approval would be acceptable.

There are compelling reasons not to go down this road. As observed by two leading commentators, "the political system is incapable of distinguishing legitimate arguments from illegitimate ones and often succumbs to the political clout of powerful pleaders." SLEMROD & BAKIJA, *supra* note 9, at 218. Thus, without a normative baseline, tax legislation would "become simply a test of political power," Goldberg, *supra* note 34, at 29, and the tax law would be "simply a hodgepodge of excises that are not based on any structural tax components." Sugin, *supra* note 2, at 427. The resulting inequities and inefficiencies would make for an ugly picture and within that ugly picture, various tax expenditures would look more acceptable than if they were examined against a normatively correct system. Conversely, "the notion that taxes should be apportioned among the population according to an intelligible, reasonable, and acceptable principle . . . can constrain unbridled rent-seeking tax politics." Dodge, *Theories*, *supra* note 43, at 460. Thus, identifying a normative baseline does seem to be an important component of TEA.

<sup>104</sup> See *supra* notes 56–70 and accompanying text.

<sup>105</sup> In this respect, we agree with the following statement by one TEA critic: "[F]idelity to a definition is not the sole test of a good tax system. Its revenue yield, simplicity, and other characteristics are also important . . ." Bittker, *Personal Expenditures*, *supra* note 96, at 213. It is our position that TEA is only one test, albeit an important test, for evaluating the soundness of provisions within a tax system.

the contrary, it is about first identifying tax provisions that are subsidies or incentives, because they are not features that define the contents of an ability-to-pay tax base (i.e., TEA is concerned with the transparency of government programs) and then subjecting those subsidies and incentives to rigorous scrutiny. Stated differently, TEA's principal function is to serve as the triggering mechanism for mandatory recasting and cost/benefit analysis that we will now explore in greater detail.<sup>106</sup>

## 2. Recasting Tax Expenditures as Direct Expenditures

Weisbach and Nussim might reply that they fully agree with the need for cost/benefit analysis of tax expenditures but that their focus on whether a government program should be operated through the tax system or through the direct expenditure system is, indeed, a form of cost/benefit analysis and that their approach has the advantage of bringing us directly to the cost/benefit inquiry without getting involved in the controversies regarding the normative income definition that can arise under TEA.<sup>107</sup> The first problem we see with this argument is that it ignores the usefulness of TEA in deciding whether a particular tax expenditure is even a credible programmatic option that merits serious consideration. The importance of this point can be illustrated by returning to the example of the section 103 exclusion for interest paid on public purpose bonds issued by state and local governments.

In Part IV.A.2 of this article, we explained that because taxpayers in the highest marginal income tax rate bracket purchase less than substantially all of the tax-exempt bonds offered by state and local governments, these bonds must pay interest at a rate sufficiently high to attract meaningful numbers of lower-bracket investors. This rate, however, is higher than necessary to make state and local government bonds attractive to high-bracket taxpayers. In other words, a significant part of the tax savings garnered by investors in state and

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<sup>106</sup> Professors Weisbach and Nusim recognize that TEA triggers heightened scrutiny. See Weisbach & Nussim, *supra* note 8, at 974 n.49 (“[T]he principal consequence of categorizing a program as a tax expenditure is the application of regular government budgetary analysis and scrutiny.”). They seem, however, to regard this point as unrelated to their concerns.

<sup>107</sup> *Id.* at 1028 (“[T]he purpose of the framework presented in this Article is to prompt us to question — to reconsider the costs and benefits of our present institutions and to evaluate whether our present allocations of tasks and functions across government agencies make sense.”).

local government bonds plays no part in lowering the interest rate on those bonds, which is the intended purpose for this tax exemption/subsidy. As a result, a substantial component of the federal revenue loss from the section 103 exemption is effectively diverted from the state and local government bond issuers and captured by the high-bracket investors. Specifically, one study shows that in recent years only between 10% and 30% of the federal revenue loss with respect to top-bracket investors inured to the benefit of state and local governments. The remainder was a windfall reaped by the wealthiest Americans.<sup>108</sup>

Weisbach and Nussim would apparently agree that given these facts, the tax expenditure in section 103 is wasteful and inequitable.<sup>109</sup> Nevertheless, they seem to regard this as irrelevant because it sheds no light on what for them is a substantially more important question: assuming that the government has decided to adopt a wasteful and inequitable subsidy for state and local government borrowers, is the subsidy best delivered through a tax expenditure or a direct expenditure? Moreover, their approach to answering this question seems to depend entirely on weighing the benefits of overall governmental simplification and coordination that arise from integrating government programs into the tax system against the benefits of specialization that result from focusing the tax system on revenue collection and assigning other government programs to expert nontax bureaucracies. Weisbach and Nussim apparently regard TEA as substantially unilluminating for this purpose. Specifically, they state that:

In contrast to . . . [the comprehensive tax base and tax expenditure theories], which focus on taxation, our theory focuses on institutional design — the question of how the government chooses to compartmentalize its functions. *It is entirely irrelevant whether some piece of government policy complies with independent tax norms.* If the underlying policy is held constant, there are no effects of putting a program into or taking a program out of the tax system even if doing so hurts or enhances traditional notions of tax policy. Welfare is the same regardless of whether the program is formally part of the tax system or is located somewhere else in the

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<sup>108</sup> See Johnson, *Thermometer*, *supra* note 26, at 30; see also U.S. TREAS. DEP'T, BLUEPRINTS, *supra* note 23, at 84.

<sup>109</sup> See Weisbach & Nussim, *supra* note 8, at 967–68.

government. If we mistakenly look only at the tax system instead of overall government policy, we will draw the wrong conclusions. Putting a program into the tax system makes the tax system look more complicated, but there is unseen simplification elsewhere. The tax system will seem less efficient, but the efficiency of government policy is unchanged.

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... The Department of Defense needs highly specialized operatives, and thus benefits little from coordination with the revenue collection function. Welfare programs, on the other hand, may gain much from coordination with tax collection, and there may be low costs to losing the utility of separate units that can specialize in each function. The question is one of tradeoffs between the benefits of specialization on the one hand and the benefits of coordination on the other.<sup>110</sup>

....

... The key is to assume that a program of some sort will be implemented so that *it is not an option to say that these are bad ideas and we should do nothing*. They may very well be bad ideas . . . . The government will, sometimes for the better and sometimes for the worse, subsidize, penalize, or regulate various activities, and we must decide how this should be done.<sup>111</sup>

....

... Tax expenditure theory fails to account for the inherent benefits of integration . . . .<sup>112</sup>

As suggested above, however, this focus overlooks TEA's key implication that in considering whether to operate a spending regime

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<sup>110</sup> *Id.* at 958–59 (emphasis added). They also say that “the differences that matter most between tax and direct expenditures [are] the simplification that the tax system provides on the one hand, and the tailoring and accuracy that direct spending programs provide on the other.” *Id.* at 982. Professor Weisbach has published a subsequent article that extends his and Professor Nussim’s “specialization/coordination analysis by adding two additional, related factors: principal/agent problems and redundancy.” David A. Weisbach, *Tax Expenditures, Principal-Agent Problems, and Redundancy*, 84 WASH. U. L. REV. 1823, 1824 (2006).

<sup>111</sup> Weisbach & Nussim, *supra* note 8, at 963–64 (emphasis added).

<sup>112</sup> *Id.* at 982.

through the tax system, we should first recast the tax expenditure as an analogous direct expenditure program and then ask whether this direct expenditure is acceptable.<sup>113</sup> If the answer is negative, then an equivalent tax expenditure program should be viewed with skepticism. For example, the direct expenditure analogue of the section 103 exemption for interest on state and local government bonds would be a program of cash payments divided between governmental borrowers and wealthy individual investors with the portion received by the investors being windfalls that cause no reduction in the interest costs of the governmental borrowers.<sup>114</sup> Not only would this be wasteful, it would also be objectionable from a distributional standpoint because the windfall payments would go overwhelmingly to high-income taxpayers. A direct expenditure program displaying these characteristics of waste and inequity would have little (hopefully no) chance of being enacted. With these flaws exposed by TEA's mandatory recasting of the section 103 exemption into a direct expenditure program, the next question would be whether the simplification and coordination gains that might result from putting the program into the tax system — and this is the focus of Weisbach's and Nussim's analysis — would be large enough to transform an appalling direct expenditure program into an acceptable tax provision. The answer is likely no<sup>115</sup> but Weisbach and Nussim seem to regard the inquiry as unimportant.<sup>116</sup> Instead, they apparently view the issue of simplification and coordination gains as determinative when we believe that it should be only one factor in a broader analysis.

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<sup>113</sup> See SURREY, *PATHWAYS*, *supra* note 2, at 35–39 (“[B]efore we analyze the tax expenditure program, we must first translate the tax language into expenditure results.”); SURREY & MCDANIEL, *TAX EXPENDITURES*, *supra* note 2, at 80–82; Goldberg, *supra* note 34, at 26 (“Tax expenditure analysis converts special tax provisions and tax incentive provisions, whether in the form of exclusions, deductions or credits, into their economically equivalent spending provisions. In that manner, those provisions can be analyzed and evaluated more clearly than if buried in the tax code.”).

<sup>114</sup> See *supra* notes 87–92 and accompanying text.

<sup>115</sup> See SURREY, *PATHWAYS*, *supra* note 2, at 37 (“[A]lmost any of these tax expenditures is seen as woefully unfair or inefficient when cast as a direct expenditure program.”). If a tax expenditure is unfair, inefficient, or both as a direct expenditure program, it is difficult to see how transforming it into a tax expenditure makes it a worthy government program.

<sup>116</sup> See Weisbach & Nussim, *supra* note 8, at 957 (“[T]he decision to implement a ‘nontax’ program through the ‘tax system’ has little or nothing to do with tax policy. Instead, the tax expenditure decision, . . . or the decision to combine tax and spending programs, is solely a matter of institutional design.”).

### 3. The Suspect Status of Tax Expenditures and the Need for Compulsory Identification

We see a second difficulty with Weisbach's and Nussim's contention that they can skip over the question of whether a tax provision is or is not an element of a normatively correct income definition and move directly to deciding if a contemplated subsidy or incentive can best be delivered as a tax expenditure or as a direct expenditure. This difficulty can be explored by considering an example in their argument involving a tax expenditure for education.

Weisbach and Nussim point out that an education subsidy or incentive could be provided through either a direct expenditure, a tax expenditure, or a combination of both and they argue that the only important question is which of these three approaches provides the best delivery mechanism.<sup>117</sup> The principal elements of their argument are as follows:

[S]uppose that the government wants to provide an education incentive. . . .

Such a program can be implemented through an expenditure program that distributes money to individuals meeting the criteria. The department implementing the program, say the Department of Education, would have to create an application process, a certification or audit process (both for students and schools), a process for handing out money, and, if appropriate, a process for collecting payments. Setting up such a program would be complex and would take significant resources. Alternatively, a similar program could be implemented through the tax system by allowing individuals to subtract or add the same amounts to their taxes (or if their taxes are not sufficient, by requiring the Department of the Treasury to write a check to the individual based on a claim made on his tax form). Similar application, certification, and auditing requirements could be imposed. The additional requirements imposed on the tax system would also be significant, making the tax system much more complex. As a final alternative, the program could be split between the tax system and another agency, with each agency providing services related to its expertise and some

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<sup>117</sup> *Id.* at 963–64.



coordination between the operations.

....

The question is how we should decide which is the better method of implementing these programs in each of their circumstances.<sup>118</sup>

It is important to note that this approach requires the education tax expenditure alternative to undergo a certain degree of scrutiny. That is, it will not be chosen as the subsidy delivery method unless it appears to work better than either the direct expenditure alternative or the tax system/nontax agency hybrid. Although this testing seems to be less rigorous than what is required under TEA, it does mean that the hypothetical education tax expenditure is exposed to the risk of being unsuccessfully compared to the alternatives.

Weisbach and Nussim, however, state that in framing their analysis "we generally will discuss only comparisons between direct grants and tax subsidies."<sup>119</sup> We take this to mean that they respect the distinction between income-defining provisions and provisions that deliver subsidies or incentives. As a result, they would not require an education expense deduction to compete against a direct expenditure alternative or a mixed expenditure/deduction alternative if the education expense deduction were an element of a normatively correct income definition. The quintessential example would be a deduction for the cost of education that keeps the taxpayer up-to-date in her line of work without causing her to satisfy the minimum educational requirements for that work and without leading her to qualify for a new trade or business.<sup>120</sup> Although such a deduction subsidizes the acquisition of education in the sense that it lowers the after-tax cost of the education, the deduction has long been regarded as income-defining<sup>121</sup> and, therefore, not a subsidy or incentive.<sup>122</sup>

The broader significance of this point is that base-defining tax deductions and exclusions are not subsidies or incentives to any extent and are therefore privileged under Weisbach's and Nussim's form of

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<sup>118</sup> *Id.* at 961-63.

<sup>119</sup> *Id.* at 964.

<sup>120</sup> See Treas. Reg. § 1.162-5 (1967).

<sup>121</sup> See, e.g., *Coughlin v. Commissioner*, 203 F.2d 307 (2d Cir. 1953).

<sup>122</sup> Expenses of earning income are neither consumption nor additions to saving and, therefore, should be deducted when computing SHS income. See Andrews, *Personal Deductions*, *supra* note 59, at 313; Bittker, *Personal Expenditures*, *supra* note 96, at 202-03.

analysis because base-defining provisions do not have to compete against direct expenditure alternatives. Likewise, base-defining deductions and exclusions are excused from the high level of scrutiny that TEA imposes on subsidies and incentives and are also privileged to that extent.

With respect to TEA, this status of privilege has troubled two other commentators who are critics of TEA, Professors Douglas Kahn and Jeffrey Lehman, because it means that under TEA, Code provisions are subject to radically different burdens of justification depending on whether they are components of the normative tax base or deviations and, therefore, tax expenditures. As indicated above, the normative base-defining provisions (the section 162 business expense deduction is an example) are accepted without the need for justification while TEA forces tax expenditure provisions to pass through recasting and cost/benefit analysis (and Weisbach and Nussim would require such provisions to compete against direct expenditure alternatives). Kahn and Lehman object to this disparate treatment and seem to suggest that all Code provisions should face the same level of scrutiny. They state that “[t]he tax expenditure budget’s conception of an appropriate tax base has no legitimate claim to establishing the terms of political debate. It should not immunize provisions of the code from political discussion, nor should it change the burden of justification for others.”<sup>123</sup> Presumably, they would make the same argument with respect to the more limited scrutiny advocated by Weisbach and Nussim, although their work preceded Weisbach’s and Nussim’s by many years and consequently did not discuss it.

One way to respond to this objection would be to put tax expenditures and normative base-defining provisions on the same footing by entirely relieving tax expenditures from any burden of justification, including the burden advocated by Weisbach and Nussim. The test of a tax expenditure’s legitimacy would then be whether it could garner sufficient votes to pass both houses of Congress and get signed into law by the President. No responsible tax analyst would advocate such an abandonment of principle in favor of special interest politics<sup>124</sup> and Kahn and Lehman are not in favor of

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<sup>123</sup> Kahn & Lehman, *supra* note 8, at 1663.

<sup>124</sup> See SLEMROD & BAKIJA, *supra* note 9, at 218 (“[T]he political system is incapable of distinguishing legitimate arguments from illegitimate ones and often succumbs to the political clout of powerful pleaders.”); Nancy Staudt, *Redundant Tax and Spending Programs*, 100 NW. U. L. REV. 1197, 1212 (2006) (opining that the tax law writing committees are “notorious for pandering to special interests to the

doing so. Instead, they seem to suggest that normative base-defining provisions should be scrutinized in the same way as tax expenditures. Specifically, they state that:

We think democratic debate would be promoted if we knew how much additional revenue could be gained by repealing each of the code provisions shown in the various tax expenditure budgets, as well as who would bear the incidence of that additional revenue. We think democratic debate would also be promoted in precisely the same way, however, if we knew how much additional revenue could be gained through a host of changes to provisions that are not shown on the tax expenditure budgets. Most tax provisions, like most policy judgments, are good only as long as their price tags are not exorbitant. Here again, the tax expenditure budget hides that fact by suggesting that certain features of the tax system are different in kind from others.<sup>125</sup>

It would be possible to adopt this suggestion and, for example, require the section 162 and section 212(1) and (2) deductions to pass a TEA-style recasting and cost/benefit test or the Weisbach and Nussim test even though they are costs of earning income.<sup>126</sup> While this is a useful exercise for students, there would be no point in requiring

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detriment of unorganized and diffuse groups”); *id.* at 1212 n.64 (“There is no reason to believe that the tax-writing committees are less political than all other congressional committees and the evidence suggests just the opposite — the tax-writing committees are the most political of all.”); *see also* STEUERLE, CONTEMPORARY TAX POLICY, *supra* note 3, at 249–51; Daniel J. Mitchell, *Tax Incentives Work — and That’s a Big Argument for the Flat Tax*, 111 TAX NOTES 93 (Apr. 3, 2006) (“The tax code is correctly viewed as one of the leading sources of political corruption in Washington . . . .”); Gene Steuerle, *Summers on Social Tax Expenditures: Where He’s Wrong . . . or at Least Incomplete*, 89 TAX NOTES 1639 (Dec. 18, 2000) [hereinafter Steuerle, *Summers on Social Tax Expenditures II*]; Stanley S. Surrey, *The Congress and the Tax Lobbyists — How Special Tax Provisions Get Enacted*, 70 HARV. L. REV. 1145 (1957). For a contrary view by a TEA critic that tax institutions are less susceptible to capture by interest groups because of their more competitive nature and greater visibility, see Zelinsky, *A Procedural Defense of Tax Expenditures*, *supra* note 2.

<sup>125</sup> Kahn & Lehman, *supra* note 8, at 1664–65; *see also* Weisbach & Nussim, *supra* note 8, at 976–77.

<sup>126</sup> Expenses of earning income are neither consumption nor additions to saving and, therefore, should be deducted when computing SHS income. *See* Bittker, *Personal Expenditures*, *supra* note 96, at 202–03; Andrews, *Personal Deductions*, *supra* note 59, at 313.

others to join in because the answer almost always would be that denying deductions for income producing costs (i.e., operating the income tax as a tax on gross income) would yield unacceptable inequities and distortions<sup>127</sup> unless the government refunded all tax collected with respect to income producing costs. That approach would, however, involve a circular flow of money that seems pointless when compared to a net income tax that allows deductions for the costs of earning income. In our view, deductions for these and the other normative base-defining costs of a net income tax will almost always pass TEA-style recasting and cost/benefit scrutiny as well as Weisbach's and Nussim's analysis and there is no point in putting them through either test.<sup>128</sup>

More importantly, there seems to be little practical interest in eliminating the burden of proof difference between normative base-

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<sup>127</sup> See U.S. GEN. ACCOUNTING OFFICE, ECONOMIC ADMINISTRATIVE, AND TAXPAYER COMPLIANCE ASPECTS OF A GROSS INCOME TAX (1989). One exception to this conclusion might be provisions such as section 67, which do limit the deduction for certain costs of producing income (e.g., unreimbursed employee business expenses that are deductible under section 162), on the grounds of reducing compliance and administrative burdens. Such provisions might be viewed as appropriate tax penalty or negative tax expenditure provisions because their benefits (e.g., reduced compliance and administrative costs for both the taxpayers and the government) exceed the costs of the inequities and distortions caused by disallowing otherwise legitimate income producing expenses that do not exceed the deduction floor. Some commentators (including one of the authors of this article), however, have argued that such provisions are not appropriate elements of a properly designed income tax system. See, e.g., Jeffrey H. Kahn, *Beyond the Little Dutch Boy: An Argument for Structural Change in Tax Deduction Classification*, 80 WASH. L. REV. 1 (2005); Robert J. Peroni, *Reform in the Use of Phase-Outs and Floors in the Individual Income Tax System*, 91 TAX NOTES 1415 (May 28, 2001).

<sup>128</sup> It is true that the progressive rate structure gives the deduction for these costs an upside-down effect because the resulting tax savings of high-bracket taxpayers are a greater percentage of deducted costs than is the case for deductions by low-bracket taxpayers. The denial of deductions for income producing costs, however, would amount to imposing a tax penalty, see SURREY & MCDANIEL, TAX EXPENDITURES, *supra* note 2, at 80, thereby causing an economic distortion. See Bittker, *Personal Expenditures*, *supra* note 96, at 199. On the other hand, replacing the deductions for income producing costs with credits would be problematic because setting the credit rate at the highest marginal rate would give lower-bracket taxpayers a windfall (indeed, they would be tax expenditure beneficiaries) and setting the credit rate at any level below the highest marginal rate would effectively penalize top-bracket taxpayers. See *generally id.* at 209. Moreover, the upside-down effect of allowing deductions for income producing costs "merely confirms [the fact] that the rate structure is progressive." *Id.* at 208. On balance, the allowance of deductions for income producing costs is the best approach.

defining provisions and tax expenditures by subjecting the former to the same degree of scrutiny as the latter. This likely reflects an intuitive judgment that if a Code provision effectively transfers federal money to private beneficiaries, it requires a higher level of justification than a provision that is a necessary element of a normatively correct tax base.<sup>129</sup>

For all these reasons, it remains and it is likely to remain the case that normative base-defining provisions occupy a comparatively privileged position under TEA because they are self-justifying and that this would also be true if the Weisbach and Nussim approach were adopted. By contrast, tax subsidies and incentives that are not elements in defining the normative tax base are “presumptively suspect”<sup>130</sup> and required to endure heightened scrutiny under both TEA<sup>131</sup> and, to a lesser extent, the Weisbach and Nussim approach.

This conclusion leads us back to Professors Weisbach and Nussim and their suggestion that the question of whether a tax subsidy or incentive is a deviation from the normative tax base is irrelevant. Advocates of tax incentives and subsidies know that the rigorous scrutiny required by TEA is often toxic to their interests and they would immediately recognize that even the lower bar imposed by the Weisbach and Nussim approach presents a risk that their pet provisions might go down. Thus, in the present world of TEA, taxpayers have resisted having tax subsidies that benefit them identified as departures from the normative baseline<sup>132</sup> and they would surely continue to do so if the Weisbach and Nussim approach were adopted.

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<sup>129</sup> See Leonard E. Burman, *Is the Tax Expenditure Concept Still Relevant?*, 56 NAT'L TAX J. 613, 614 (2003) (“The purpose of the tax expenditure estimates is to subject spending programs administered through the tax code to the same Congressional scrutiny and control as direct expenditures.”); Sullivan, *Tax Incentives*, *supra* note 3, at 26 (“If, however, lobbyist-legislator-advocates claim that tax breaks provide a tax incentive, the tax break must be held to a higher standard: Does the tax incentive help the economy? . . . [It does] if its economic benefits outweigh its economic costs.”).

<sup>130</sup> See Goldberg, *supra* note 34, at 26. As aptly stated by one leading tax economist: “The burden of proof, in effect, always remains with the advocates for discrimination.” Steuerle, *Consensus*, *supra* note 50, at 371.

<sup>131</sup> See Weisbach & Nussim, *supra* note 8, at 974 n.49 (“Following the goal of Surrey’s work, the principal consequence of categorizing a program as a tax expenditure is the application of regular government budgetary analysis and scrutiny.”).

<sup>132</sup> See Sugin, *supra* note 2, at 417–18.

For example, U.S. tax on foreign active business income is generally deferred until the income is repatriated to the United States<sup>133</sup> whereas all other business income earned by U.S. residents bears a current U.S. tax. Accordingly, Surrey characterized this type of deferral as a tax expenditure<sup>134</sup> and we will expand on that point in Part VI. Nevertheless, defenders of tax deferral for foreign business income have argued that because it is based on the separateness of corporations and shareholders, it is a component of a normatively correct income tax base and, therefore, not exposed to the scrutiny that goes with tax expenditure characterization.<sup>135</sup> This illustrates how the privileged status of base-defining provisions produces conflicts over whether particular features of the tax system are elements of a normatively correct tax base or are tax expenditures. The same dynamic would be present under the Weisbach and Nussim approach.

Promoters and defenders of tax subsidies and incentives also resist tax expenditure classification for at least two process-related

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<sup>133</sup> See AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT: INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION — PROPOSALS ON UNITED STATES TAXATION OF FOREIGN PERSONS AND OF THE FOREIGN INCOME OF UNITED STATES PERSONS 171–72 (1987) [hereinafter ALI, INTERNATIONAL TAX STUDY]; CHARLES H. GUSTAFSON, ROBERT J. PERONI & RICHARD CRAWFORD PUGH, TAXATION OF INTERNATIONAL TRANSACTIONS 34–35, 443–44 (3d ed. 2006); 1 JOSEPH ISENBERGH, INTERNATIONAL TAXATION: U.S. TAXATION OF FOREIGN PERSONS AND FOREIGN INCOME ¶ 1.12 (3d ed. 2004); 1 JOEL D. KUNTZ & ROBERT J. PERONI, U.S. INTERNATIONAL TAXATION ¶ B3.01 (1992); SLEMROD & BAKIJA, *supra* note 9, at 50; Hugh J. Ault & David F. Bradford, *Taxing International Income: An Analysis of the U.S. System and Its Economic Premises*, in TAXATION IN THE GLOBAL ECONOMY 11, 12, 27–28 (Assaf Razin & Joel Slemrod eds., 1990); Robert J. Peroni, *Back to the Future: A Path to Progressive Reform of the U.S. International Income Tax Rules*, 51 U. MIAMI L. REV. 975, 986–87 (1997) [hereinafter Peroni, *Back to the Future*]; Robert J. Peroni, J. Clifton Fleming, Jr. & Stephen E. Shay, *Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income*, 52 SMU L. REV. 455, 457 (1999) [hereinafter Peroni, Fleming & Shay, *Getting Serious About Curtailing Deferral*].

<sup>134</sup> See SURREY & MCDANIEL, TAX EXPENDITURES, *supra* note 2, at 159.

<sup>135</sup> See 1 NATIONAL FOREIGN TRADE COUNCIL, THE NFTC FOREIGN INCOME PROJECT: INTERNATIONAL TAX POLICY FOR THE 21ST CENTURY — REPORT AND ANALYSIS 3 n.3 (2001) [hereinafter NFTC, REPORT AND ANALYSIS], available at <http://www.nftc.org/default/tax/fip/FIP%20Part%201.pdf>; see also HUGH J. AULT & BRIAN J. ARNOLD, COMPARATIVE INCOME TAXATION: A STRUCTURAL ANALYSIS 377 (2d ed. 2004); 1 ISENBERGH, *supra* note 133, ¶ 1.12; Ault & Bradford, *supra* note 133, at 35; Michael S. Kirsch, *The Congressional Response to Corporate Expatriations: The Tension Between Symbols and Substance in the Taxation of Multinational Corporations*, 24 VA. TAX REV. 475, 486–87 (2005); Stanley S. Surrey, *Current Issues in the Taxation of Corporate Foreign Investment*, 56 COLUM. L. REV. 815, 826–27 (1956).

reasons. First, although it is theoretically possible to use sunset provisions that require tax expenditures to be scrutinized annually, like most direct expenditures, this is not the usual practice.<sup>136</sup> Tax expenditures typically endure much longer than direct expenditures before having to be reviewed and justified anew.<sup>137</sup> Thus, tax expenditure beneficiaries are usually more secure in their largesse than are direct expenditure recipients. For example, Part IV.A.2 of this article illustrated the wasteful benefit capture consequence of the section 103 exemption for interest paid on state and municipal government debt. This problem could be eliminated by abolishing section 103 and instituting a direct expenditure program under which the Treasury sends subsidy checks to governmental debt issuers.<sup>138</sup> State and local governments, however, strenuously resist this alternative and it is generally understood that they do so because they believe that the direct expenditure approach, even if enacted as an entitlement program like Social Security or Medicare, would be more vulnerable to budget cutting than the present tax expenditure in section 103 of the Code.<sup>139</sup>

A second process-related reason for resisting having tax subsidies labeled as tax expenditures is that outlays successfully hidden in the tax system allow politicians to have it both ways. By avoiding direct expenditures while using tax expenditures that do not appear in media accounts as “government spending,” politicians can simultaneously

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<sup>136</sup> See generally SURREY & MCDANIEL, *TAX EXPENDITURES*, *supra* note 2, at 54–65; Hin, *supra* note 33, at 8 n.7. *But see* WITTE, *supra* note 1, at 311–35 (concluding that many of the most controversial tax expenditures undergo frequent and serious review).

<sup>137</sup> See GAO, *FEDERAL COMMITMENT*, *supra* note 1, at 17–18, 68–69; Michael Brostek, *Tax Expenditures Need to Be Reexamined*, 111 *TAX NOTES* 86, 87 (Apr. 3, 2006); Jane G. Gravelle, *Tax Expenditures*, in *ENCYCLOPEDIA*, *supra* note 23, at 407. *But cf.* WITTE, *supra* note 1, at 312–17 (maintaining that the presumption that tax expenditures are rarely modified is “overstated”); Zelinsky, *A Procedural Defense of Tax Expenditures*, *supra* note 2, at 1191. Indeed, none of the forty largest tax expenditures listed in the tax expenditure discussion portion of the Bush Administration’s fiscal 2007 budget is subject to sunset provisions. See 2007 *ANALYTICAL PERSPECTIVES*, *supra* note 29, at 296–97.

<sup>138</sup> See U.S. TREAS. DEP’T, *BLUEPRINTS*, *supra* note 23, at 85.

<sup>139</sup> See SLEMRD & BAKIJA, *supra* note 9, at 230; *see also* Johnson, *Wrong Way*, *supra* note 33, at 92 (speculating that if the section 103 exemption were converted into a direct expenditure program, it would be eliminated “in a budget cycle or two”). State and municipal governments have been generally successful in preventing substantial reform of section 103 from becoming part of a major tax revision plan. *See, e.g.*, PRESIDENT’S ADVISORY PANEL ON FEDERAL TAX REFORM, *PROPOSALS*, *supra* note 15, at 124; U.S. TREAS. DEP’T, *TAX REFORM*, *supra* note 9, at 147.

argue that they are limiting government spending and size but also providing valuable benefits to constituents and interest groups.<sup>140</sup> Thus, the fact that tax expenditure programs lack transparency and accountability makes them appealing to politicians who are concerned about being re-elected and need to raise large amounts of campaign contributions from private interests to do so. This stealth characteristic of tax expenditure programs is inconsistent with democratic ideals, and TEA is one tool for helping achieve a more open and accountable process for enacting governmental programs.

For all of these reasons, under both TEA and the Weisbach and Nussim approach, interested parties will fight against having their tax incentives and subsidies classified as such (so as to avoid scrutiny and frequent review). Consequently, something is needed to compel identification of deviations from the normative tax base and force them to undergo examination. Both our and Surrey's version of TEA provides the necessary device through the principle that departures from the normative income baseline are tax expenditures. The Weisbach and Nussim approach, by contrast, disavows the use of any such device and provides no guidance for situations in which

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<sup>140</sup> See STEUERLE, CONTEMPORARY TAX POLICY, *supra* note 3, at 181, 184, 194, 240–41; Hin, *supra* note 33, at 10–11; Shaviro, *supra* note 8, at 189, 191, 197; Steuerle, *Summers on Social Tax Expenditures II*, *supra* note 124, at 1639; Toder, *supra* note 8, at 361, 370. Professors Weisbach and Nussim make a contrary argument with respect to this second point. According to them, “if a congressman can fight for either tax reductions or direct spending, and if constituents perceive direct spending dollars to be greater than equivalent amounts of tax reductions [that function as tax expenditures], then the congressman may prefer direct spending.” Weisbach & Nussim, *supra* note 8, at 971. We concede that this calculation may work with respect to some constituents. Sophisticated constituents, particularly large corporations, however, will understand that a dollar of benefit through a tax expenditure is as helpful as a dollar of direct expenditure benefit. Thus, these important and powerful constituents will be perfectly happy with the decision to use tax expenditures instead of direct expenditures and indeed will prefer tax expenditures because of the comparative lack of transparency and freedom from review that is mentioned in the text of this article. See Hin, *supra* note 33, at 35–36 (reporting that a survey of individual Singapore taxpayers showed that “beneficiaries (particularly, high-income beneficiaries who stand to gain the most) are more perceptive than non-beneficiaries of the overall distribution of the tax subsidies”). Moreover, among the unsophisticated constituents who perceive direct spending dollars to be more valuable than tax expenditure dollars, there will be many who are favorably impressed by the reduction in federal expenditures and government size that appear to accompany substituting tax expenditures for direct expenditures. Thus, it would seem on balance that there will be a strong preference for using the tax expenditure approach to hide transfers of government largesse from the voting public and press.



taxpayers argue that particular provisions that look like tax subsidies and incentives are actually elements of the normative tax base.<sup>141</sup>

#### 4. Narrow Versus Broad Cost/Benefit Analysis

We have previously suggested that the Weisbach and Nussim approach to cost/benefit analysis has an additional problem — although it is rigorously reasoned, it is also very narrow. To be specific, it is limited to analyzing the tradeoffs between the benefits of overall governmental simplification and coordination that come from integrating government programs into the tax system versus the benefits of specialization that come from devoting the tax system to revenue collection while locating other government programs in nontax agencies.<sup>142</sup> Although that dichotomy is an important piece of the puzzle, the Weisbach and Nussim approach to cost/benefit analysis seems to overlook the facts that the primary purpose of the federal income tax is to raise revenue for federal government purposes,<sup>143</sup> that a high degree of voluntary compliance is required for the income tax to perform this function,<sup>144</sup> and that the application of cost/benefit analysis to any tax expenditure must seriously consider the effects of its complexities and inequities (if any) on Internal Revenue Service (Service) treatment of taxpayers and on voluntary taxpayer

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<sup>141</sup> This same criticism applies to Victor Thuronyi's proposal to replace TEA with a concept of "substitutable tax provisions." See Thuronyi, *supra* note 8.

Weisbach and Nussim stipulate that recognizing "the functional equivalence of putting a program in the tax system or somewhere else" is a "key insight." Weisbach & Nussim, *supra* note 8, at 958. They do not, however, seem to see a need for demanding recognition of this equivalence when a select group of taxpayers, Treasury, and/or Congress would prefer to ignore it.

<sup>142</sup> See Weisbach & Nussim, *supra* note 8, at 979–82. In a subsequent article, Professor Weisbach expanded the Weisbach and Nussim analysis to include consideration of principal-agent problems and redundancy. See Weisbach, *supra* note 110. He continued, however, to hold to the view that tax policy is irrelevant to this analysis. *Id.* at 1824–25.

<sup>143</sup> See STEUERLE, CONTEMPORARY TAX POLICY, *supra* note 3, at 15; Douglas Holtz-Eakin, *The Case for a Consumption Tax*, 113 TAX NOTES 373, 375 (Oct. 23, 2006); Sullivan, *Tax Incentives*, *supra* note 3, at 22. A different statement of the same principle is: "[T]he primary . . . effect of the [income] tax . . . is to reduce private consumption and accumulation in order to free resources for public use." Andrews, *Personal Deductions*, *supra* note 59, at 313.

<sup>144</sup> The overall Internal Revenue Service (Service) audit coverage rate for returns of individuals has been below 1% for the fiscal years 1997–2006 inclusive. See INTERNAL REVENUE SERVICE, FISCAL YEAR 2006 ENFORCEMENT AND SERVICE RESULTS 3, [http://www.irs.gov/pub/newsroom/11-06\\_enforcement\\_stats.pdf](http://www.irs.gov/pub/newsroom/11-06_enforcement_stats.pdf).

compliance and the ability of the Service to effectively perform its examination function.<sup>145</sup> Stated differently, Weisbach's and Nussim's insistence on ignoring tax policy norms apparently would require policymakers to disregard the effects on voluntary compliance arising from any complexities and inequities engendered by tax expenditures.<sup>146</sup> By contrast, TEA provides a cost/benefit framework within which to answer the question on which Professors Weisbach and Nussim are focused (simplification and coordination versus specialization)<sup>147</sup> but that also requires a broader inquiry that includes critical issues, such as distributional fairness, distortive effects, and general effectiveness,<sup>148</sup> in addition to coordination, governmental simplification, and specialization.

##### 5. When Only a Tax Expenditure Can Be Enacted

At this point, we digress from our critique of Weisbach's and Nussim's work to examine an argument that they did not make but that can be viewed as distantly related to their analysis. To be specific, it is well known that following the 1994 Republican takeover of

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<sup>145</sup> See U.S. TREAS. DEP'T, TAX REFORM, *supra* note 9, at 9; MICHAEL J. GRAETZ, THE U.S. INCOME TAX: WHAT IT IS, HOW IT GOT THAT WAY, AND WHERE WE GO FROM HERE 105–07 (1999); SURREY & MCDANIEL, TAX EXPENDITURES, *supra* note 2, at 26–27; Charles E. McLure, Jr., *Economics and Tax Reform: 1986 and Now*, 113 TAX NOTES 362, 363 (Apr. 4, 2006); Sullivan, *Tax Incentives*, *supra* note 3, at 22; see also Edward Yorio, *Equity, Efficiency, and the Tax Reform Act of 1986*, 55 FORDHAM L. REV. 395, 425–26 (1987) [hereinafter Yorio, *Tax Reform Act of 1986*]; Edward Yorio, *The Future of Tax Reform: A Rejoinder to Professor Zelinsky*, 55 FORDHAM L. REV. 899, 904–05 (1987).

<sup>146</sup> Regarding such complexities and inequities, see PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, PROPOSALS, *supra* note 15, at 5; STAFF OF JOINT ECON. COMM., 109TH CONG., INDIVIDUALS AND THE COMPLIANCE COSTS OF TAXATION 6 (Joint Comm. Print 2005); SURREY & MCDANIEL, TAX EXPENDITURES, *supra* note 2, at 107; Blum, *Preferential Provisions*, *supra* note 4, at 83; Toder, *supra* note 8, at 370.

<sup>147</sup> Professors Weisbach and Nussim provide a thoughtful demonstration of how cost/benefit analysis applies to their focus issue by discussing the possibility of integrating the food stamp program into the income tax system. See Weisbach & Nussim, *supra* note 8, at 997–1023; see also Toder, *supra* note 8, at 368–69.

<sup>148</sup> See PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, PROPOSALS, *supra* note 15, at 83 (“[T]he Panel believes that . . . tax preferences should be treated like any direct spending program, and should be evaluated by policymakers based on objective criteria, such as their cost, the distribution of their benefits, overall effectiveness, and the appropriateness of administering them through the tax system.”).

Congress, the Clinton administration and Congress collaborated in using tax expenditures to adopt governmental programs that could not be enacted via the direct expenditure approach in the then-prevailing political environment.<sup>149</sup> Among these tax expenditures were higher education tax credits and a child tax credit.<sup>150</sup> This history suggests that in certain circumstances, tax expenditures can be used to accomplish worthy governmental objectives that could not otherwise be done through the legislative system.<sup>151</sup> The implication is that TEA is badly flawed in this setting because it is an obstacle to the accomplishment of desirable goals when a tax expenditure is the only feasible alternative for enacting the governmental program.<sup>152</sup>

It strikes us that using this argument to protect a particular tax expenditure from TEA amounts to an admission that the tax expenditure is a direct expenditure equivalent and also amounts to a waiver of any claim that the tax expenditure in question is part of the normative tax base. More importantly, this argument is not grounds for excusing the tax expenditure from rigorous cost/benefit analysis; the “slippery slope” consequence of exempting “good” tax expenditures from TEA scrutiny is obvious.<sup>153</sup> Instead, if the cost/benefit analysis described later in Part V of this article shows that the program truly is desirable, then the fact that a tax expenditure is

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<sup>149</sup> See STEUERLE, CONTEMPORARY TAX POLICY, *supra* note 3, at 181–82, 190–96, 206; Christopher Bergin, *Civics 2000*, 89 TAX NOTES 1501 (Dec. 18, 2000); Martin A. Sullivan, *Tax Expenditure Budget, Now More Than Ever*, 86 TAX NOTES 1187 (Feb. 28, 2000) [hereinafter Sullivan, *Tax Expenditure Budget*].

<sup>150</sup> See STEUERLE, CONTEMPORARY TAX POLICY, *supra* note 3, at 181, 191–93.

<sup>151</sup> See generally Steuerle, *Summers on Social Tax Expenditures II*, *supra* note 124; Sullivan, *Tax Expenditure Budget*, *supra* note 149, at 1188.

<sup>152</sup> At the Tax Foundation’s November 16, 2000 national conference, then Treasury Secretary Lawrence H. Summers praised the Clinton administration’s education tax credits and stated that the tax policy community is “‘a tad theological in resisting bringing tax expenditures into the system.’” Christopher Bergin, *Summers Says It’s Important to Promote “Values” Through the Code*, 89 TAX NOTES 994, 994 (Nov. 20, 2000); see also Wiedenbeck, *supra* note 81, at 688–99 (defending tax expenditures on the ground that they accomplish worthy governmental objectives that could not be accomplished through explicit direct expenditure programs due to public perceptions/political concerns).

<sup>153</sup> As stated by one leading commentator, Gene Steuerle: “Over the long run, politicians who think they are achieving good by hiding what they are doing may end up with just the opposite result. They breed cynicism among the public, who then approach government from the standpoint of self-interest (‘at least I’ll get mine’), abandon support for government altogether, or become disinterested and fail to engage in the building up of a better civil society.” Steuerle, *Summers on Social Tax Expenditures II*, *supra* note 124, at 1639.

the only politically acceptable possibility is a relevant consideration in determining whether to house the program in the tax system or the direct expenditure system. This consideration, however, should not be conclusive. Where the Service would be an unacceptably poor manager of the program or the program would place unacceptable costs on the tax system, the program should not be adopted as a tax expenditure even though political considerations make the direct expenditure alternative unavailable. Sometimes the lesser evil is to have no program at all.

## 6. Conclusion

According to Professors Weisbach and Nussim, TEA is faulty because “the theory ultimately falls back on tax policy for recommendations.”<sup>154</sup> In our view, this is only partially correct as a description and it is not well-founded as a criticism. TEA does, indeed, rely on tax policy to determine whether recasting and cost/benefit analysis should be invoked but we conclude that tax policy is appropriate for this purpose. Moreover, the cost/benefit analysis envisioned by TEA is not a pure tax policy exercise. It involves the integration/specialization tradeoffs that concern Weisbach and Nussim and other nontax-system issues (such as whether to have a program at all) as well as tax system concerns (such as fairness and complexity within the tax system).<sup>155</sup> In other words, TEA makes tax policy concerns only one element, but an appropriate and important element, in this mix.

### *C. Is TEA a Rule of Automatic Disqualification or Acceptance?*

Some critics of TEA have argued that it functions as a rule of automatic, or nearly automatic, disqualification for all Code provisions labeled as tax expenditures.<sup>156</sup> This supposed feature of TEA is said to give undue weight to the definition of tax expenditure, particularly in cases where experts disagree over whether provisions are or are not deviations from the normative baseline. Perhaps the

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<sup>154</sup> Weisbach & Nussim, *supra* note 8, at 958.

<sup>155</sup> See SURREY & MCDANIEL, *TAX EXPENDITURES*, *supra* note 2, at 5–6.

<sup>156</sup> See Bartlett, *The End*, *supra* note 8, at 414; Boris I. Bittker, *Income Tax “Loopholes” and Political Rhetoric*, 71 MICH. L. REV. 1099, 1113 (1973); Blum, *Book Review*, *supra* note 26, at 490; Kahn & Lehman, *supra* note 8, at 1662–63; Shaviro, *supra* note 8, at 201–02; Thuronyi, *supra* note 8, at 1165; Weisbach & Nussim, *supra* note 8, at 976.

strongest version of this criticism comes from Professors Kahn and Lehman who said:

What is disturbing about the language of tax expenditures is its tone of moral absolutism. . . . [T]he 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.<sup>157</sup>

This is not, however, what Surrey said, or what we advocate. Surrey and his frequent co-author, Professor McDaniel, explained TEA’s desired effect as follows:

*The classification of an item as a tax expenditure does not in itself make that item either a desirable or an undesirable provision; nor does it indicate whether the inclusion of the item in the tax system is good or bad fiscal policy. The classification of an item as a tax expenditure is purely informative, just as the presence of an item in the direct budget of a government is informative; it is simply a way of announcing that the item is not part of the normative tax structure. This being so, it is appropriate to ask whether the presence of those items in the tax system is desirable or undesirable, given the existing budget policy, tax policy, and other relevant criteria.*<sup>158</sup>

Similarly, the preceding part of this article explains our view that TEA does not automatically disqualify a tax expenditure program but, instead, triggers appropriately heightened scrutiny and a serious cost/benefit analysis of the program.<sup>159</sup>

Admittedly a large number of tax expenditures are shown to be unjustified when subjected to the rigorous examination advocated by

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<sup>157</sup> Kahn & Lehman, *supra* note 8, at 1662–63.

<sup>158</sup> SURREY & MCDANIEL, TAX EXPENDITURES, *supra* note 2, at 5–6 (emphasis added); *see also* SURREY & MCDANIEL, TAX EXPENDITURES, *supra* note 2, at 25–27; Burman, *supra* note 129, at 614; Sullivan, *Tax Incentives*, *supra* note 3, at 26.

<sup>159</sup> *See* Sugin, *supra* note 2, at 416–26.

Surrey and us and that fact has surely caused critics to label TEA as a rule of automatic, or near automatic, disqualification. That label, however, is a mischaracterization of Surrey's and our position. The failure of many tax expenditures to pass muster under the analysis that we advocate is due to their inherent weakness and not to an automatic effect of TEA.

Professor Blum argued that the close scrutiny of tax expenditures that we advocate would have the effect of limiting debate over the wisdom of various tax law provisions.<sup>160</sup> We respectfully disagree. If anything, closer scrutiny will produce more open, robust, and informed debates about the efficacy of these tax subsidies; that, in fact, is one of the major benefits of TEA. We fail to see how a lack of transparency concerning tax subsidy provisions promotes effective tax policy debate and analysis.

Finally, it should also be noted that a provision that escapes the tax expenditure label because it fits within the SHS definition of income is not automatically acceptable. Such a provision must still be examined in the light of other tax policy criteria, including enforceability, administrability, economic efficiency, simplification, and revenue yield.

#### D. Hidden Agenda?

Some have suggested that Surrey's advocacy of TEA was a pretext to advance his agenda of a broad-based progressive income tax.<sup>161</sup> The validity of this suggestion is uncertain with respect to progression because Surrey, although concerned about progressive rates being undermined<sup>162</sup> by tax expenditures that disproportionately benefit upper-income taxpayers,<sup>163</sup> did not consider the tax expenditure concept as applying to the personal exemptions or to those rate brackets that are below the highest rate in the individual rate tables.<sup>164</sup> Moreover, if the point concerning a broad base is meant

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<sup>160</sup> See Blum, *Book Review*, *supra* note 26, at 490–91.

<sup>161</sup> See Bartlett, *The End*, *supra* note 8, at 414; Shaviro, *supra* note 8, at 189, 201–02, 204–05 (“[TEA] seems to be viewed in many circles as logically dubious special pleading in support of a particular policy agenda.”).

<sup>162</sup> See SURREY, *PATHWAYS*, *supra* note 2, at 68–72; SURREY & MCDANIEL, *TAX EXPENDITURES*, *supra* note 2, at 103, 108–11.

<sup>163</sup> *I.e.*, tax expenditures structured as deductions, exclusions, exemptions, and deferral of income recognition. See Toder, *supra* note 8, at 366.

<sup>164</sup> See SURREY, *PATHWAYS*, *supra* note 2, at 13; SURREY & MCDANIEL, *TAX EXPENDITURES*, *supra* note 2, at 185–86, 191–92, 220. For a discussion of this point,

as criticism, it is a curious reproach in view of the widespread agreement that the base broadening produced by eliminating tax expenditures is desirable because it mitigates the distortive effects of an income tax, particularly if at least some of the revenue produced by an enlarged tax base is used to finance tax rate reduction.<sup>165</sup> From this standpoint, if TEA is a clandestine device for promoting base broadening, then it is a salutary tool for pursuing a widely shared tax policy goal.

### E. Does TEA Overreach?

TEA has been criticized on a number of grounds for overreaching. We now examine that critique of TEA.

#### 1. Does TEA Imply That the Government Owns All of Your Income?

TEA has been the target of a rhetorical flourish created more for

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see *infra* text accompanying notes 178–186. Surrey did, however, regard the rate brackets below the top corporate rate as tax expenditures. See SURREY & MCDANIEL, TAX EXPENDITURES, *supra* note 2, at 220–22.

<sup>165</sup> See STAFF OF JOINT COMM. ON TAXATION, 109TH CONG., MACROECONOMIC ANALYSIS OF A PROPOSAL TO BROADEN THE INDIVIDUAL INCOME TAX BASE AND LOWER INDIVIDUAL INCOME TAX RATES 16 (Joint Comm. Print 2006); U.S. TREAS. DEP'T, BACKGROUND PAPER, *supra* note 1, at 7–11, 25; U.S. TREAS. DEP'T, BLUEPRINTS, *supra* note 23, at 2; 1 U.S. TREAS. DEP'T, TAX REFORM, *supra* note 9, at 13–14; U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-06-1028T, INDIVIDUAL INCOME TAX POLICY: STREAMLINING SIMPLIFICATION AND ADDITIONAL REFORMS ARE DESIRABLE 21–22 (Aug. 2006); Carroll Testimony, *supra* note 51, at 3; Alan J. Auerbach & Kevin A. Hassett, *Introduction*, in TOWARD FUNDAMENTAL TAX REFORM 1, 2 (Alan J. Auerbach & Kevin J. Hassett eds., 2005); Bruce Bartlett, *Agenda for Tax Reform*, 105 TAX NOTES 1531, 1532–33 (Dec. 13, 2004) [hereinafter Bartlett, *Agenda*]; Heidi Glenn, *Business Leaders Would Give Up Tax Breaks for Lower Rates*, 116 TAX NOTES 324 (July 30, 2007); Holtz-Eakin, *supra* note 143, at 375; Pearlman, *No Perfect Tax System*, *supra* note 52, at 113; Joseph A. Pechman, *Erosion of the Individual Income Tax*, 10 NAT'L TAX J. 1, 2 (1957); Joel Slemrod, *My Beautiful Tax Reform*, in TOWARD FUNDAMENTAL TAX REFORM 135, 144 (Alan J. Auerbach & Kevin Hassett eds., 2005) [hereinafter Slemrod, *Beautiful Reform*]; Martin A. Sullivan, *Economic Analysis: Beyond the Conventional Wisdom: Rate Cuts Beat Expensing*, 118 TAX NOTES 456 (Jan. 28, 2008); Sullivan, *Tax Incentives*, *supra* note 3, at 23; Toder, *supra* note 8, at 362; Weisbach & Nussim, *supra* note 8, at 967–68; see also Cordia Scott, *U.S. Must Broaden Tax Base, OECD Survey Says*, 103 TAX NOTES 295 (Apr. 19, 2004) (stating that base broadening is desirable to produce additional revenue for federal deficit reduction).

political speeches and writings than for thoughtful policy analysis.<sup>166</sup> According to this rhetoric, when TEA proponents characterize narrowly drawn tax reductions<sup>167</sup> as the equivalent of direct government expenditures, the proponents are implicitly arguing that the government's taxing power gives it a normative claim to all income earned by U.S. residents and, therefore, that all exclusions, deductions, credits, and tax rates that reduce income taxation below 100% are transfers of largesse from the Treasury to the tax reduction beneficiaries.<sup>168</sup> A typical example of this forensic strategy is the statement that "lurking behind the concept of the tax expenditure is a more sinister premise . . . . It is the subtle disposition to think of all income as virtual state property, and forbearance to tax away every last penny of it as itself a tax expenditure."<sup>169</sup> Although the rhetoric usually goes no further than this, the intended argument seems to be that TEA is fatally flawed because it is based on the ridiculous view that the government's taxing power makes it the *a priori* owner of all privately generated income.

This argument, however, cannot withstand scrutiny. First, the

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<sup>166</sup> See Thuronyi, *supra* note 8, at 1178 ("Politicians commonly attack the tax expenditure concept for assuming that our money belongs to the government and that the government is doing us a favor by not taxing it.").

<sup>167</sup> These are tax reductions that are limited to particular activities, income sources, or taxpayers. See authorities cited *supra* note 3.

<sup>168</sup> See, e.g., STAFF OF JOINT ECON. COMM., 106TH CONG., TAX EXPENDITURES: A REVIEW AND ANALYSIS 9 (Comm. Print 1999) [hereinafter STAFF OF JOINT ECON. COMM., REVIEW]; Bartlett, *The End*, *supra* note 8, at 419; Thuronyi, *supra* note 8, at 1178; *The \$91 Billion Loophole*, WALL ST. J., Mar. 20, 1975, at 22; see also Heidi Glenn, *Bush Administration Questions Value of Tax Expenditures List*, 91 TAX NOTES 535 (Apr. 23, 2001) [hereinafter Glenn, *Questions*]; Anthony C. Infanti, *A Tax Crit Identity Crisis? Or Tax Expenditure Analysis, Deconstruction, and the Rethinking of a Collective Identity*, 26 WHITTIER L. REV. 707, 740-41 (2005); Zelinsky, *The Rehabilitation of Tax Incentives*, *supra* note 11, at 979. One commentator has characterized this argument against TEA as "peculiar." See Burman, *supra* note 129, at 620.

<sup>169</sup> Charles Fried, *Whose Money Is It?*, WASH. POST, Jan. 1, 1995, at C7; see also Marjorie E. Kornhauser, *Legitimacy and the Right of Revolution: The Role of Tax Protests and Anti-Tax Rhetoric in America*, 50 BUFF. L. REV. 819, 896-97 (2002) ("[S]ome people believe that the Bush Administration's wording in the [2002 fiscal year] budget [referring to 'so-called' tax expenditures 'of questionable analytical value'] has an ideological basis reflecting a concern that 'the rhetoric [of the tax expenditure concept] suggests it's the government's money and not the people's money.'") (quoting Heidi Glenn, *Bush Administration Questions Value of Tax Expenditure List*, 91 TAX NOTES 535 (Apr. 23, 2001) (quoting statement of Joel Friedman, senior fellow at the Center on Budget and Policy Priorities)).



federal government could never acquire actual ownership, through the tax system, of all income earned by U.S. residents unless Congress used its taxing powers to impose a generally applicable federal income tax with a single rate of 100%.<sup>170</sup> The extremely attenuated possibility of such legislation<sup>171</sup> derives from Article I of the United States Constitution, which confers on Congress the general power to “lay and collect Taxes,”<sup>172</sup> and from the Sixteenth Amendment thereto, which specifically allows Congress to impose “taxes on incomes, from whatever source derived, without apportionment among the several States.”<sup>173</sup> Neither of these delegations of authority is explicitly capped, although in some cases such authority may be limited by other provisions in the Constitution. TEA, however, cannot be interpreted as implying that this taxing power makes the federal government the owner of all income earned by U.S. residents unless TEA can be fairly understood as asserting that Congress has a normative obligation to adopt a generally applicable income tax and that 100% is the normatively correct rate for such a tax.<sup>174</sup> TEA does not, however, require the enactment of an income tax<sup>175</sup> and it does not, in fact, prescribe any particular level of generally applicable income taxation as normatively correct.<sup>176</sup> Moreover, TEA does not

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<sup>170</sup> See SURREY & MCDANIEL, *TAX EXPENDITURES*, *supra* note 2, at 61.

<sup>171</sup> There is a very close to zero probability of such an outcome ever occurring given that, for many years, the total U.S. tax burden imposed by all levels of government has been confined within a range between 25% and 30% of GDP, *see* Jeffrey Owens, *Fundamental Tax Reform, An International Perspective*, 59 NAT'L TAX J. 131, 134 (2006), and total federal revenues have averaged less than 20% of GDP. *See* CONG. BUDGET OFFICE, *THE BUDGET AND ECONOMIC OUTLOOK: AN UPDATE* xi (Aug. 2006). Enactment of a 100%-rate income tax would be tantamount to political suicide for the members of Congress who voted for it and would be economically disastrous because it would effectively destroy any incentive for work effort and wealth accumulation. *See, e.g.*, Reuven S. Avi-Yonah, *Corporations, Society, and the State: A Defense of the Corporate Tax*, 90 VA. L. REV. 1193, 1246–47 (2004) [hereinafter *Avi-Yonah, Corporations, Society, and the State*]. Professor Reuven Avi-Yonah also has suggested that a federal income tax imposed at a 100% rate could be treated as an unconstitutional “taking.” *Id.* To date, however, the Supreme Court has generally rejected Takings Clause challenges to tax provisions. *See* Eduardo Moises Penalver, *Regulatory Taxings*, 104 COLUM. L. REV. 2182, 2198–2204 (2004).

<sup>172</sup> U.S. CONST. art. I, § 8, cl. 1.

<sup>173</sup> U.S. CONST. amend. XVI.

<sup>174</sup> *See* Shaviro, *supra* note 8, at 204.

<sup>175</sup> There is a strong normative case in favor of an income tax, but it rests on the ability-to-pay concept, coupled with the valuation difficulties associated with wealth taxes, and not on TEA.

<sup>176</sup> *See* SURREY & MCDANIEL, *TAX EXPENDITURES*, *supra* note 2, at 61, 191–92.

dictate that revenue gained by eliminating tax expenditures must be spent by the federal government. Indeed, TEA has nothing to say about whether such revenue should be used for direct expenditure purposes or to pay for tax rate reductions.<sup>177</sup>

Indeed, some critics have charged that TEA is logically flawed because it does not take a normative position with respect to the generally applicable rate or rates under an income tax on individuals. For example, Professors Kahn and Lehman have asked, “Why isn’t the existence of marginal rates below the highest marginal rate a tax expenditure?”<sup>178</sup>

A useful way to respond to this is to hypothesize a generally applicable progressive rate table, say 10%, 20%, and 30%. We can then ask two alternative versions of Kahn’s and Lehman’s question: (1) Why is the existence of the two marginal rates above the 10% marginal rate not a tax penalty or negative tax expenditure (as often charged by critics of progression) and (2) Why is the rate below the 20% middle rate not a tax expenditure and why is the rate above the middle rate not a tax penalty?

There is no objective or normative basis for arguing that Kahn’s and Lehman’s question, or either of our alternative versions, is the correct inquiry because there is no objective or normative basis for arguing that the 10% rate, the 20% rate, or the 30% rate establishes the baseline from which the other two hypothetical rates are departures. For this reason, TEA is largely agnostic with respect to generally applicable rates.

This is not to say that there are no normative guides with respect to income tax rates. For example, low tax rates that are *targeted* at a particular activity, investment, or taxpayer group are not part of the normative baseline for TEA purposes.<sup>179</sup> Moreover, regressive rates would violate the ability-to-pay principle<sup>180</sup> unless there were offsetting features in the overall tax system or the governmental expenditure system.<sup>181</sup> Thus, regressive rates would not ordinarily be a

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<sup>177</sup> See Burman, *supra* note 129, at 621 (pointing out that revenue gained from eliminating or reducing tax expenditures was used to pay for the dramatic, but revenue neutral, income tax rate reductions adopted in the Tax Reform Act of 1986); Hungerford, *supra* note 51, at 327 (same).

<sup>178</sup> Kahn & Lehman, *supra* note 8, at 1664.

<sup>179</sup> For further discussion of this point, see *infra* Part IV.E.2.

<sup>180</sup> See, e.g., SLEMRD & BAKIJA, *supra* note 9, at 62.

<sup>181</sup> As stated by one commentator: “An apparently regressive tax system may be mitigated by increased spending benefits for lower-income households.” Donald Phares, *Tax Equity Analysis*, in *ENCYCLOPEDIA*, *supra* note 23, at 401; see also Fried,

feature of the normative baseline for TEA purposes. Conversely, the broad societal consensus in favor of progressive rates makes some degree of progression an element of the normative baseline.<sup>182</sup>

Finally, it has been argued that income tax rates should be high enough to provide “adequate” funding for government<sup>183</sup> — a normative position that gives extremely broad leeway to policymakers. Within these rather loose parameters, however, TEA regards the adoption of taxes and the setting of generally applicable rates of tax as policy matters properly controlled by Congress and TEA functions within the boundaries set by Congress’s choices on those points, whatever they might be.<sup>184</sup> In other words, once a decision is made to have a tax on income, the ability-to-pay concept and other principles set normative parameters for the tax base, but the choice of a general rate, or table of general rates, applied to the tax base is largely free of normative constraints.<sup>185</sup> Thus, if Congress selected a generally applicable U.S. federal income tax rate of only 1%, TEA would have nothing to say about that rate choice but, in that setting, TEA would apply the tax expenditure label to provisions of the tax statute that imposed a less than 1% rate on discrete classes of income.<sup>186</sup> The larger point, however, is that because TEA does not advocate the adoption of any particular form or general level of taxation, it cannot fairly be characterized as implying that the

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*Puzzling Case*, *supra* note 44, at 182–83; Sullivan, *Tax Incentives*, *supra* note 3, at 23–24.

<sup>182</sup> See PRESIDENT’S ADVISORY PANEL ON FEDERAL TAX REFORM, PROPOSALS, *supra* note 15, at 49; *Carroll Testimony*, *supra* note 51; Hungerford, *supra* note 51, at 329.

<sup>183</sup> See MURPHY & NAGEL, *supra* note 40, at 184 (“[T]ax policy should be dictated . . . by the joint aims of financing public goods at the right level and securing social justice . . . .”); Susan Pace Hamill, *An Evaluation of Federal Tax Policy Based on Judeo-Christian Ethics*, 25 VA. TAX REV. 671, 680–93 (2006) (arguing that Judeo-Christian ethics require a tax system that raises sufficient revenue to guarantee access to minimum subsistence and adequate education, healthcare, and housing); Hungerford, *supra* note 51, at 329 (“[A] tax system should raise adequate revenue to run the government and meet the needs of the governed.”).

<sup>184</sup> See SURREY, PATHWAYS, *supra* note 2, at 17; SURREY & MCDANIEL, TAX EXPENDITURES, *supra* note 2, at 191–92.

<sup>185</sup> As stated by one commentator: “Only the political process can ultimately decide such issues when there is a range of ‘reasonable’ compromises, as when basic principles by themselves do not really tell us how stimulative, progressive, or revenue-raising a tax system should be.” Steuerle, *Consensus*, *supra* note 50, at 372.

<sup>186</sup> See Shaviro, *supra* note 8, at 204.

congressional taxing power makes the federal government the owner of all income generated by U.S. residents.<sup>187</sup>

In addition, Congress's constitutionally authorized income taxing powers are not self-executing. Legislative action on the part of a Congress and President elected by "we the people" is required before the federal government has any specific claim to any part of the income earned by U.S. residents. In that sense, the federal tax burden is imposed by the voters upon themselves and a high-marginal-rate income tax would be a self-inflicted wound that could not be attributed to TEA.

Finally, let us again consider the example in Part II regarding the exclusion for interest received on bonds issued by state and local governments. Although that interest is exempt from tax, it confers ability-to-pay on recipients to the same extent as taxable interest paid by private debtors such as corporations and banks. This requires the conclusion that the interest exclusion in the example in Part II is a stark deviation from the kind of tax that Congress has chosen to impose — a tax on income defined principally in terms of ability-to-pay. Only at this point does TEA become relevant and its effect is limited to (1) demonstrating that Congress has used the tax system to make an elective<sup>188</sup> transfer of forgone revenue that is denominated a tax expenditure, (2) recasting the tax expenditure as an analogous direct expenditure and then evaluating the analogue, and (3) applying cost/benefit analysis to the tax expenditure. This approach has no implications regarding the existence, or nonexistence, of a normative governmental right to privately generated income.

In short, the political allegation that TEA implies federal government ownership of all income earned by U.S. residents is simply unsupported.

## 2. Are Tax Expenditures Indistinguishable from Tax Cuts?

A second possible version of the charge that TEA overreaches is the assertion that TEA has no meaningful analytical power because there is no mathematical difference between a tax incentive or subsidy that lowers *X*'s tax bill by one dollar and tax relief for *X* in the form of a one dollar tax cut. Thus, so the argument goes, it is as logical to call

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<sup>187</sup> See *id.* at 187 (referring to the government-owns-all-your-income allegation as a canard).

<sup>188</sup> There is no significant constitutional barrier to nondiscriminatory federal income taxation of interest paid on state and local government bonds. See *South Carolina v. Baker*, 485 U.S. 505 (1988).

tax expenditures tax cuts (good) as it is to call them tax expenditures (bad) and TEA advocates overreach when they insist on favoring the tax expenditure characterization over the tax cut label.<sup>189</sup>

A response to this second argument requires a brief extension of the analysis that disposed of the government-owns-all-your-income canard. To be specific, the preceding tax cut/tax expenditure equivalency argument glosses over the fact that not all tax reductions are the same. For example, assume that the U.S. income tax has a single rate of 35% and *no exclusion for interest paid on state and local government bonds*. A reduction in the general rate from 35% to 30% would not be a tax expenditure because the reduction would not create preferential treatment for any particular activity or income source.<sup>190</sup> Thus, it would simply be a tax cut. The creation of an exclusion for state and local government bond interest, however, would be a tax expenditure, not a mere tax cut, because it would preferentially carve out a class of income that is normatively includable in the base of an income tax. Stated differently, the mathematical equivalence between (1) taxing a particular activity or income source while providing a direct government payment to the participating taxpayers and (2) simply enacting an equivalent tax reduction limited to the particular activity or income source does not establish that either (1) or (2) is the same as (3) a reduction in the general tax rate for *all taxpayers*. Instead, the mathematical equivalency of (1) and (2) shows that (2) is the same as a government subvention paid to discrete, privileged beneficiaries and that is the whole point of TEA.<sup>191</sup> As stated by President George W. Bush's Advisory Panel on Federal Tax Reform, "[a] tax expenditure is a tax incentive that provides special tax treatment to a *particular type of activity*."<sup>192</sup>

The late Professor Boris Bittker objected to the preceding distinction between a general rate reduction and a targeted preferential rate reduction. He posited a situation where a tax cut is enacted with respect to only the highest rate bracket because Congress believes that investment will be stimulated by the greater propensity of high-income taxpayers to save additional after-tax

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<sup>189</sup> See generally STAFF OF JOINT ECON. COMM., REVIEW, *supra* note 168, at 9; Shaviro, *supra* note 8, at 191; Thuronyi, *supra* note 8, at 1178–79.

<sup>190</sup> See SURREY & MCDANIEL, TAX EXPENDITURES, *supra* note 2, at 191–92.

<sup>191</sup> See Sugin, *supra* note 2, at 410, 416; authorities cited *supra* note 3.

<sup>192</sup> PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, PROPOSALS, *supra* note 15, at 13 (emphasis added).

income. He assumed that because this hypothetical rate reduction applies to all high-income taxpayers, it might be considered “general” and, therefore, not a tax expenditure.<sup>193</sup>

His assumption strikes us as reasonable. Of course, a dissenter could sensibly insist that Bittker’s top-bracket rate cut is not “general” because it is limited to the top bracket and that a rate cut is general only when it hits all, or most, brackets. Clever fox that he was, Bittker would then likely force this critic to deal with, say, a 50% rate cut in the top bracket and a 1% reduction in each of the lower rates. The critic might reasonably respond by arguing that the 1% cuts should be ignored as *de minimis* and, accordingly, that the 50% rate cut should be classified as a tax expenditure. Bittker, however, would then likely force the critic to agonize over where, in the 1% to 50% range, the lower-bracket tax cuts would be sufficiently large to make the top-bracket rate reduction part of a “general” tax cut and, therefore, not a tax expenditure. It is tempting to avoid this pain by conceding that the 50% rate cut in the top bracket is “general,” and not a tax expenditure, even if there is no meaningful reduction in the lower rates.

But treating Bittker’s hypothetical top-bracket rate cut as general, and not a tax expenditure, creates a new problem. It gives a preferred position in legislative contests to an investment stimulus measure (the top-bracket rate cut) that is overbroad since it will also free up more income for luxury consumption, while an investment credit is treated as a suspect tax expenditure<sup>194</sup> even though it can be structured as a more effective, targeted investment stimulus than the top-bracket rate cut.

A dissenter might suggest dodging this problem by treating the top-bracket rate reduction as a tax expenditure, even though it is a “general” rate cut, because Congress’s motive was a tax expenditure-type motive — to stimulate investment.<sup>195</sup> Under this approach, however, the same rate reduction would not be a tax expenditure if Congress’s action was based on a belief that the top rate was unnecessarily high<sup>196</sup> or unfairly skewed so that America was grinding

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<sup>193</sup> See Bittker, *Accounting*, *supra* note 11, at 252.

<sup>194</sup> Surrey considered an investment tax credit to be a tax expenditure. See SURREY, *PATHWAYS*, *supra* note 2, at 32, 34.

<sup>195</sup> See Shaviro, *supra* note 8, at 218.

<sup>196</sup> Granted, it would be difficult to hold this belief in the face of present and projected federal budget challenges. See CONG. BUDGET OFFICE, *THE BUDGET AND ECONOMIC OUTLOOK: AN UPDATE 1–3* (Aug. 2006); CONG. BUDGET OFFICE, *THE BUDGET AND ECONOMIC OUTLOOK: FISCAL YEARS 2007 TO 2016*, at 1–25 (Jan. 2006).

the faces of the rich.<sup>197</sup> This distinction did not impress Bittker; he suggested that it would likely do nothing more than influence Congress's choice of rhetoric without changing the substance of the matter.<sup>198</sup> In short, Bittker thought that the problem of deciding which rate cuts are, and are not, tax expenditures is unsolvable.<sup>199</sup>

Bittker's argument is a reasonable objection with respect to the aspect of TEA on which he was focused. To be specific, Bittker's analysis of general and targeted tax cuts was addressed to Surrey's hope that tax expenditures could be summed up and reflected in an accounting of total federal government outlays.<sup>200</sup> Bittker's point was that an acceptably accurate total of tax expenditures is impossible if we cannot decide whether a tax cut is a tax expenditure or not.<sup>201</sup> In our view, Bittker's argument, though logically correct, is overstated. We are, after all, operating in an environment where total annual direct federal expenditures exceed \$2.7 trillion<sup>202</sup> and total annual federal tax expenditures exceed \$700 billion.<sup>203</sup> Given numbers of that magnitude, decisions on classifying particular items as tax expenditures or not have a substantial margin for error in terms of absolute dollars. In that context, it is our sense that we can get close enough to a usable tax expenditure total by treating tax cuts as tax expenditures when they are clearly targeted at particular income sources or activities (as distinguished from being targeted at particular economic classes) and as "not tax expenditures" in other cases, including Bittker's hypothetical top-bracket rate cut that is enacted because Congress believes that the wealthy beneficiaries will stimulate investment by saving their tax reduction. In other words, we would

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<sup>197</sup> Likewise, it would be hard to hold this belief given the generally increasing concentration of income and wealth in the hands of the most affluent Americans. *See* DODGE, FLEMING & GEIER, *supra* note 9, at 143–47; SLEMROD & BAKIJA, *supra* note 9, at 65–68; John W. Lee, III, *Class Warfare 1988–2005 over Top Individual Tax Rates: Teeter-Totter from Soak-the-Rich to Robin Hood-in-Reverse*, 2 HASTINGS BUS. L.J. 47 (2006).

<sup>198</sup> *See* Bittker, *Accounting*, *supra* note 11, at 252.

<sup>199</sup> *Id.*

<sup>200</sup> *See* SURREY & MCDANIEL, TAX EXPENDITURES, *supra* note 2, at 6, 25, 226; Surrey, *Full Accounting*, *supra* note 2, at 578; Weisbach & Nussim, *supra* note 8, at 973.

<sup>201</sup> *See* Bittker, *Accounting*, *supra* note 11, at 252.

<sup>202</sup> The President's budget proposed outlays of \$2.77 trillion for fiscal 2007, *see* 2007 ANALYTICAL PERSPECTIVES, *supra* note 29, at 340, and \$2.9 trillion for fiscal 2008, *see* 2008 ANALYTICAL PERSPECTIVES, *supra* note 29, at 340.

<sup>203</sup> The estimated revenue loss from tax expenditures in fiscal 2004 was approximately \$728 billion. *See* GAO, FEDERAL COMMITMENT, *supra* note 1, at 8, 26.

not treat Bittker's top-bracket rate cut as a tax expenditure, regardless of the congressional motive behind it, because we regard attempts to be more precise on this point as a game that is not worth the candle.

The preceding point carries more force with respect to the aspect of TEA on which we are focused. Our primary concern is TEA's role in triggering a substantially higher level of scrutiny than applies to provisions that are elements of the SHS baseline.<sup>204</sup> For that purpose, an accurate dollar total of tax expenditures is not important. Instead, the critical objective is to ensure that tax provisions with a subsidy or incentive element are carefully examined to see if they are justifiable. Thus, an investment credit and a rate cut that the context shows is targeted to particular *activities* or income *sources* (as distinguished from particular income *classes*) should be subjected to TEA scrutiny, and we ought not to abandon that aspect of TEA even if we have difficulty in deciding whether Bittker's hypothetical rate cut that is directed at an economic class is actually a tax expenditure.

The problem of distinguishing tax cuts from tax expenditures was raised by the enactment of section 199 as part of the American Jobs Creation Act of 2004.<sup>205</sup> Congress's declared objective for this provision was to assist domestic manufacturers, and no other class of taxpayers, to compete in worldwide markets.<sup>206</sup> This is clearly a tax expenditure-type purpose. However, section 199 operates by lowering a taxpayer's effective tax rate through a deduction generally equal to 9% (when fully phased in) of qualified production activities income,<sup>207</sup> a term that is defined much more broadly than the ordinary understanding of manufacturing income.<sup>208</sup> For that reason, President

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<sup>204</sup> In other words, we agree with Professor Shaviro's view that TEA is an important tax policy tool as well as a budget management tool. See Shaviro, *supra* note 8, at 218–19.

<sup>205</sup> American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418 (2004).

<sup>206</sup> See STAFF OF JOINT COMM. ON TAXATION, 109TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 108TH CONGRESS 170 (Joint Comm. Print 2005) [hereinafter STAFF OF JOINT COMM. ON TAX'N, 2005 GENERAL EXPLANATION].

<sup>207</sup> See I.R.C. § 199(a)(1); STAFF OF JOINT COMM. ON TAX'N, 2005 GENERAL EXPLANATION, *supra* note 206, at 170–76; Carol Conjura, Timothy A. Zuber & Katherine M. Breaks, *Practical Considerations in Implementing the Section 199 Regulations*, 105 J. TAX'N 68 (2006); Deloitte Tax LLP, *Producing Results: An Analysis of the New Production Activities Deduction*, 106 TAX NOTES 961, 962 (Feb. 21, 2005).

<sup>208</sup> For example, the term includes revenue from domestic movie making (section 199(c)(4)(A)(i)(II)), domestic electricity generation (section 199(c)(4)(A)(i)(III)),



Bush's fiscal 2008 budget document argues that section 199 might be a general tax cut instead of a tax expenditure. The relevant statement in the budget document is as follows:

[T]he deduction may prove to be so broad that it is available to most U.S. businesses, in which case it might not be seen as a tax expenditure. Rather, it would then represent a feature of the baseline tax rate system because the deduction is equivalent to a lower tax rate.<sup>209</sup>

We disagree with this characterization of the section 199 deduction. The type of income that qualifies for the deduction is, indeed, defined very broadly to include counter-intuitive items. Nevertheless, the service, retail, and financial sectors of the economy are largely excluded from section 199. In our judgment, this means that the scope of section 199 is too narrow to allow it to qualify as a general tax cut; it should be regarded as a tax expenditure and subjected to recasting and appropriately rigorous cost/benefit analysis.

### 3. Should There Be a Special Dispensation for C Corporations?

Critics sometimes suggest that even if TEA is valid, its advocates overreach when they apply it to tax subsidies and incentives enjoyed with respect to the income of C corporations. This view rests on the fact that the earnings of sole proprietors, S corporations, and Subchapter K entities bear only one level of tax (at the level of the owners) while C corporation profits are subject to an entity-level tax in addition to the tax paid by shareholders on dividend income. This double tax regime is said to create penalty-like excess taxation of C corporation earnings that amounts to a negative tax expenditure or tax penalty for conducting business in the C corporation form of business enterprise. Thus, so the argument goes, tax subsidies and incentives granted to C corporations, or to shareholders with respect to C corporation dividends, merely mitigate a negative tax expenditure (the double tax regime) and do not result in a net transfer

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and engineering and architectural services performed in the United States with respect to domestic construction projects (section 199(c)(4)(A)(iii)).

<sup>209</sup> 2008 ANALYTICAL PERSPECTIVES, *supra* note 29, at 315. *But see* U.S. TREAS. DEP'T, BACKGROUND PAPER, *supra* note 1, at 8–9 (treating the section 199 deduction as a targeted tax incentive, rather than a tax rate cut, which adds to the complexity of the tax system and will result in more disputes between taxpayers and the Service).

to the corporate beneficiaries.<sup>210</sup>

Surrey responded to this point by arguing that once Congress has made a policy determination to impose a double tax regime on C corporations, double taxation is the normative baseline and tax subsidies and incentives in the form of preferential reductions in either the corporate income tax or the shareholder tax are deviations from that baseline and, therefore, tax expenditures.<sup>211</sup> This response is a variation of the argument used above to rebut the government-owns-all-your-income canard and it strikes us as correct.

This point can be buttressed, however, by considering a major purpose of the corporate income tax. As previously noted, the income of a domestic C corporation is typically subjected to both a corporate-level tax as it is earned by the corporation and also to a shareholder-level tax at the, perhaps distant, time when the shareholders receive the income from the corporation or sell their shares.<sup>212</sup> This taxation scheme initially seems difficult to explain on ability-to-pay grounds because liability under the corporate-level tax is calibrated to the taxable income of the corporation and bears no necessary relationship to the respective abilities to pay of any individuals.<sup>213</sup> Thus, several

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<sup>210</sup> See 2008 ANALYTICAL PERSPECTIVES, *supra* note 29, at 314, which stated:

[T]he reduction or elimination of individual level tax on income from investment in corporate equities might not be a tax expenditure relative to a comprehensive income baseline because the income is taxed first at the corporate level. A similar line of reasoning suggests that in the case of corporations, expensing of R&E or accelerated depreciation are not tax expenditures because they offset the corporate tax penalty.

See also Bartlett, *The End*, *supra* note 8, at 417, 419; Sullivan, *Tax Incentives*, *supra* note 3, at 24.

<sup>211</sup> See SURREY & MCDANIEL, TAX EXPENDITURES, *supra* note 2, at 4, 215.

<sup>212</sup> See I.R.C. §§ 11, 61(a)(3), (7). The shareholder-level tax is not reduced by credits reflecting corporate-level tax. Thus, the corporate-level and shareholder-level income taxes function as independent, cumulative levies. Double taxation is avoided in the cases of S corporations and domestic C corporations reporting their income with a parent corporation on a consolidated return. See I.R.C. §§ 1361(b)(3), 1501.

This article assumes that classical double taxation of C corporation income will continue as the general pattern under the Code for the foreseeable future even though we believe that a properly designed integration of the corporate and shareholder income taxes would be a desirable tax policy move.

<sup>213</sup> See I.R.C. § 11(a), (b)(1); M. Slade Kendrick, *Corporate Income Tax Rate Structure*, in 3 COMMITTEE ON WAYS AND MEANS, TAX REVISION COMPENDIUM 2289, 2297 (Comm. Print 1959); Slemrod, *Beautiful Reform*, *supra* note 165, at 142; George K. Yin, *The Future Taxation of Private Business Firms*, 4 FLA. TAX REV. 141, 152 (1999) [hereinafter Yin, *Future Taxation*]. Because the corporate-level tax is generally

rationales other than ability-to-pay have been proposed as justifications for the corporate-level tax and there is disagreement regarding which of these is the “best” and, indeed, whether the basic concept of a separate, unintegrated corporate income tax is defensible at all.<sup>214</sup> The merits of this controversy are outside the scope of this article.

More importantly, in spite of this dispute over the theoretical justification for a separate, unintegrated tax on corporate income, there is broad agreement that because pass-through treatment probably cannot be practically imposed on corporations with large numbers of shareholders,<sup>215</sup> and because Congress is quite unlikely, in

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regarded as borne by living individual taxpayers and not the entity itself, *see* 2007 ANALYTICAL PERSPECTIVES, *supra* note 29, at 286; PRESIDENT’S ADVISORY PANEL ON FEDERAL TAX REFORM, PROPOSALS, *supra* note 15, at 34; U.S. TREAS. DEP’T, BLUEPRINTS, *supra* note 23, at 4, the question of a C corporation’s ability-to-pay is commonly viewed as irrelevant. *See* PETER ANDREW HARRIS, CORPORATE/SHAREHOLDER INCOME TAXATION AND ALLOCATING TAXING RIGHTS BETWEEN COUNTRIES 104 (1996); Michael J. Graetz, *David R. Tillinghast Lecture: Taxing International Income: Inadequate Principles, Outdated Concepts and Unsatisfactory Policies*, 54 TAX L. REV. 261, 301–02 (2001) [hereinafter Graetz, *Taxing International Income*]; *see also* Katherine Pratt, *The Debt-Equity Distinction in a Second-Best World*, 53 VAND. L. REV. 1055, 1113–14 (2000).

<sup>214</sup> *See* AMERICAN LAW INSTITUTE, TAXATION OF PRIVATE BUSINESS ENTERPRISES 51–55, 59–63 (1999); AMERICAN LAW INSTITUTE, INTEGRATION OF THE INDIVIDUAL AND CORPORATE INCOME TAXES 44–46 (1993) [hereinafter AMERICAN LAW INSTITUTE, INTEGRATION]; BRADFORD, *supra* note 42, at 103; Robert Cassanos, *Single Taxation of Publicly Traded Entities*, 99 TAX NOTES 1663, 1665–69 (June 16, 2003); Jeffrey A. Maine, *Linking Limited Liability and Entity Taxation: A Critique of the ALI Reporters’ Study on the Taxation of Private Business Enterprises*, 62 U. PITT. L. REV. 223, 241–44, 253–57 (2000); Pratt, *supra* note 213, at 1100–03, 1109–10. With respect to the historical origins of the corporate-level tax, *see* Steven A. Bank, *Entity Theory as Myth in the Origins of the Corporate Income Tax*, 43 WM. & MARY L. REV. 447 (2001); Marjorie E. Kornhauser, *Corporate Regulation and the Origins of the Corporate Income Tax*, 66 IND. L.J. 53 (1990).

<sup>215</sup> *See* Graeme S. Cooper & Richard K. Gordon, *Taxation of Enterprises and Their Owners*, in 2 TAX LAW DESIGN AND DRAFTING 811, 817 (Victor Thuronyi ed., 1998); Pratt, *supra* note 213, at 1112–13; George K. Yin, *Corporate Tax Integration and the Search for the Pragmatic Ideal*, 47 TAX L. REV. 431, 434 (1992); *see also* U.S. TREAS. DEP’T, INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS: TAXING BUSINESS INCOME ONCE 27–35 (1992) [hereinafter U.S. TREAS. DEP’T, INTEGRATION]. Among other things, large numbers of shareholders imply frequent trading in a corporation’s stock which creates difficulties in allocating income and losses to the shareholders. For contrary views asserting that a pass-through system can be constructed for publicly traded corporations with large numbers of shareholders, *see* U.S. TREAS. DEP’T, BLUEPRINTS, *supra* note 23, at 69–74; Joseph M. Dodge, *A Combined Mark-to-Market and Pass-Through Corporate Shareholder Integration*

the near term, to adopt other means of currently taxing shareholders on corporate income through integration of the corporate and individual income taxes, the present corporate-level tax must be maintained as a crude, second-best anti-deferral device.<sup>216</sup> Otherwise, shareholders of domestic C corporations would be able to completely defer taxation until they withdrew the corporation's earnings (or sold their shares), thus achieving a deferral of U.S. tax that is not available

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*Proposal*, 50 TAX L. REV. 265 (1995) [hereinafter Dodge, *Integration Proposal*]; Yin, *Future Taxation*, *supra* note 213, at 195–96.

<sup>216</sup> See U.S. TREAS. DEP'T, INTEGRATION, *supra* note 215, at 189 & n.1; 1 U.S. TREAS. DEP'T, TAX REFORM, *supra* note 9, at 118–21; J.D.R. ADAMS & J. WHALLEY, THE INTERNATIONAL TAXATION OF MULTINATIONAL ENTERPRISES IN DEVELOPED COUNTRIES 8 (1997); AMERICAN LAW INSTITUTE, INTEGRATION, *supra* note 214, at 94; BRADFORD, *supra* note 42, at 55; RICHARD L. DOERNBERG & HOWARD E. ABRAMS, FEDERAL INCOME TAXATION OF CORPORATIONS AND PARTNERSHIPS 4–5 (3d ed. 2000); JANE G. GRAVELLE & THOMAS L. HUNGERFORD, CRS REPORT FOR CONGRESS, CORPORATE TAX REFORM: ISSUES FOR CONGRESS 4 (Cong. Res. Service, Oct. 31, 2007); HARRIS, *supra* note 213, at 102–04; RICHARD A. MUSGRAVE & PEGGY B. MUSGRAVE, PUBLIC FINANCE IN THEORY AND PRACTICE 372 (5th ed. 1989); PECHMAN, *supra* note 9, at 136; SLEMROD & BAKIJA, *supra* note 9, at 235–36; JOSEPH E. STIGLITZ, ECONOMICS OF THE PUBLIC SECTOR 586–87 (2d ed. 1988); Avi-Yonah, *Corporations, Society, and the State*, *supra* note 171, at 1201; Cooper & Gordon, *supra* note 215, at 812–13; Malcolm Gammie, *The Taxation of Inward Direct Investment in North America Following the Free Trade Agreement*, 49 TAX L. REV. 615, 628–29 (1994); Graetz, *Taxing International Income*, *supra* note 213, at 302; Green, *supra* note 39, at 28; Jeffrey L. Kwall, *The Uncertain Case Against the Double Taxation of Corporate Income*, 68 N.C. L. REV. 613, 629–30 (1990); David A. Weisbach, *The Irreducible Complexity of Firm-Level Income Taxes: Theory and Doctrine in the Corporate Tax*, 60 TAX L. REV. 215, 217 (2007); see also U.S. TREAS. DEP'T, THE DEFERRAL OF INCOME EARNED THROUGH U.S. CONTROLLED FOREIGN CORPORATIONS 4 (2000) [hereinafter U.S. TREAS. DEP'T, DEFERRAL STUDY], available at <http://www.ustreas.gov/offices/tax-policy/library/subpartf.pdf>; JEFFREY L. KWALL, THE FEDERAL INCOME TAXATION OF CORPORATIONS, PARTNERSHIPS, LIMITED LIABILITY COMPANIES, AND THEIR OWNERS 5–8 (3d ed. 2005); UTZ, *supra* note 39, at 177–78; Pratt, *supra* note 213, at 1115; Rebecca S. Rudnick, *Who Should Pay the Corporate Tax in a Flat Tax World*, 39 CASE W. RES. L. REV. 965, 1066–69 (1988–89); Joseph A. Snoe, *The Entity Tax and Corporate Integration: An Agency Cost Analysis and a Call for a Deferred Distributions Tax*, 48 U. MIAMI L. REV. 1, 43 (1993).

Of course, if the corporate-level tax were integrated with the shareholder-level tax, the corporate-level tax could continue to serve its anti-deferral function without imposing the double tax result that characterizes the present approach to taxing C corporations. There is, however, no near-term likelihood of such an integration scheme being adopted and this article assumes continuation of the current regime of C corporation taxation, no matter how ill-advised that may be from a tax policy standpoint.

to the owners of closely held businesses taxed under the Subchapter K or S pass-through regimes.<sup>217</sup> Indeed, we believe that the anti-deferral effect of the present U.S. corporate income tax is the only persuasive reason for a large, unintegrated levy on domestic C corporation earnings.<sup>218</sup>

This analysis brings us back to ability-to-pay, because undistributed C corporation income represents a resource that confers ability-to-pay but that is being accumulated for the shareholders in the corporation. If no tax were paid on this income until distributions occurred, the shareholders' ability-to-pay would be currently mismeasured. For this reason, the anti-deferral corporate income tax is an important backstop to an ability-to-pay-based income tax system.

For the corporate income tax to be a perfect anti-deferral device, two conditions would have to be satisfied. First, the tax would apply only to C corporation income that is allocable to shareholders who would bear a shareholder-level tax if the income were distributed to them when earned. Second, the corporate income tax base and rate would be calibrated to precisely offset any advantage gained at the shareholder level from deferring the shareholder tax on dividend distributions and stock sale gains.<sup>219</sup> The current law's corporate

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<sup>217</sup> Deferral is already available to the U.S. shareholders of foreign corporations, with some notable exceptions, as explained below, *see infra* Part VI.A. However, the absence of both an integration scheme and a corporate-level tax would extend deferral of U.S. tax to the far larger universe of U.S. shareholders of domestic corporations.

Generally speaking, only closely held businesses can qualify for the Subchapter K or S regimes. *See* I.R.C. §§ 1361(b)(1)(A) (regarding Subchapter S), 7704 (regarding Subchapter K). Indeed, the current structure of the income tax creates an incentive for new closely held business enterprises to operate under the Subchapter K or S pass-through taxation regimes. *See* U.S. TREAS. DEP'T, TAXES AND CORPORATE CHOICE OF ORGANIZATIONAL FORM, OTA PAPER NO. 73 (1997), available at <http://www.ustreas.gov/offices/tax-policy/library/ota73.pdf>. *But see* John W. Lee, *A Populist Political Perspective of the Business Tax Entities Universe: "Hey the Stars Might Lie but the Numbers Never Do,"* 78 TEX. L. REV. 885 (2000) (pointing out that despite the conventional wisdom that the preferable entity for new, closely held business ventures is an LLC, new formations of corporations (either C corporations or S corporations) outnumbered new LLC formations in all but one state, usually by a 2-to-1 or greater margin, in the 1995–1998 period).

<sup>218</sup> *See generally* Steven A. Bank, *A Capital Lock-In Theory of the Corporate Income Tax*, 94 GEO. L.J. 889, 894, 944, 947 (2006); Kim Brooks, *Learning to Live with an Imperfect Tax: A Defence of the Corporate Tax*, 36 U. BRIT. COLUM. L. REV. 621, 638–39 (2003).

<sup>219</sup> *See generally* Daniel Halperin & Ethan Yale, *Deferred Compensation Revisited*, 114 TAX NOTES 939, 943 (Mar. 5, 2007).

income tax does not satisfy either of these conditions<sup>220</sup> and its failure to do so results in well-known distortions, such as the incentive to capitalize C corporations with debt capital that generates deductible interest payments, instead of using equity capital that yields nondeductible dividends, and the incentive for C corporations to accumulate income rather than distribute it to shareholders.<sup>221</sup> For

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<sup>220</sup> In addition, the corporate income tax is overbroad to the extent that it reaches foreign stockholders' shares of foreign-source income earned by U.S. corporations. See J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income*, 5 FLA. TAX REV. 299, 321–23 (2001) [hereinafter Fleming, Peroni & Shay, *Fairness in International Taxation*].

Regarding the incidence of the corporate income tax, the Treasury Department and the Congressional Budget Office assume that the tax is borne by all owners of capital, see PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, PROPOSALS, *supra* note 15, at 34; CONG. BUDGET OFFICE, EFFECTIVE FEDERAL TAX RATES UNDER CURRENT LAW, 2001 TO 2014, at 3 (Aug. 2004), but the Joint Committee on Taxation generally assumes that the tax is borne only by owners of corporate capital, see STAFF OF JOINT COMM. ON TAXATION, 103D CONG., METHODOLOGY AND ISSUES IN MEASURING CHANGES IN THE DISTRIBUTION OF TAX BURDENS 8 (Joint Comm. Print 1993). Some economists, however, argue that the tax is partially borne by labor and consumers. See PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, PROPOSALS, *supra* note 15, at 34; SLEMROD & BAKIJA, *supra* note 9, at 77–78; Phares, *Tax Equity Analysis*, in ENCYCLOPEDIA, *supra* note 23, at 400. With respect to differences between the corporate and individual tax bases, see STAFF OF JOINT COMM. ON TAXATION, PRESENT LAW AND BACKGROUND RELATING TO SELECTED BUSINESS TAX ISSUES 26–28 (Joint Comm. Print 2006).

<sup>221</sup> See PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, PROPOSALS, *supra* note 15, at 99–102; SLEMROD & BAKIJA, *supra* note 9, at 48–49. The amount of double taxation that actually occurs in practice as a result of the two levels of tax that apply to C corporation income may not be large. See William G. Gale, *Tax Reform Options in the Real World*, in TOWARD FUNDAMENTAL TAX REFORM 34, 41 (Alan J. Auerbach & Kevin A. Hassett eds., 2005) (“[Because of various tax strategies,] [o]nly about a quarter of corporate income appears to be taxed at both the individual and corporate level, and all of that is now taxed at a maximum rate of 15 percent at the personal level. . . . About one quarter of corporate income is taxed at the individual level, but not the corporate level; one quarter is taxed at the corporate level, but not the individual level; and one quarter appears never to be taxed.”); Samuel C. Thompson, Jr., *President's Dividends Plan Undertaxes High-Income Taxpayers*, 98 TAX NOTES 389, 391–92 (Jan. 20, 2003) (double taxation of C corporation earnings is “not a common occurrence”); George K. Yin, *How Much Tax Do Large Public Corporations Pay?: Estimating the Effective Tax Rates of the S&P 500*, 89 VA. L. REV. 1793, 1798 (2003) (stating that, over the period 1995–2000, when the top statutory corporate income tax rate was 35%, the effective tax rate of the group of corporations comprising the S&P 500 fell from 30.11% to 27.98%); see also CONG. BUDGET OFFICE, TAXING CAPITAL INCOME: EFFECTIVE RATES AND APPROACHES TO REFORM 7–8 (Oct. 2005) [hereinafter CONG. BUDGET OFFICE, TAXING CAPITAL INCOME]

those reasons, we have characterized the corporate income tax above as a crude, second-best anti-deferral device and we recommend integration of the corporate and individual income taxes through a regime that would produce only one tax on C corporation business income, imposed primarily when the income is earned.<sup>222</sup>

Nevertheless, the considerably imperfect corporate income tax is all that prevents the C corporation business form from being utilized as a massive tax deferral machine<sup>223</sup> and the corporate income tax can fill its anti-deferral role effectively only if its base is substantially inclusive of all items that should be income if earned directly by individual shareholders. When viewed from that vantage point, corporate income tax deviations from a normatively correct individual income tax base are subsidies or incentives to the corporate activities that benefit therefrom and the deviations should be regarded as tax expenditures for this reason as well as the reason suggested above by Surrey. Consequently, such corporate tax expenditures should be subject to recasting and rigorous cost/benefit analysis just the same as other tax expenditures.

#### F. Tax Norms Versus Social Values

Professors Kahn and Lehman have pointed out that although certain Code provisions deviate from the normative income tax base (their principal examples are the denial of deductions for illegal bribes,<sup>224</sup> the gambling loss deduction limitation,<sup>225</sup> and the exclusion of

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(describing the effective tax rate for corporations as 26.3%). Nevertheless, the strategies utilized to mitigate or avoid double taxation of C corporation income are distortions of taxpayer behavior that have negative economic efficiency consequences.

<sup>222</sup> For examples of extensively developed integration proposals, see U.S. TREAS. DEP'T, INTEGRATION, *supra* note 215; AMERICAN LAW INSTITUTE, INTEGRATION, *supra* note 214; Dodge, *Integration Proposal*, *supra* note 215. We recognize, however, that a principled and coherent corporate integration system is not likely to be enacted within the reasonably foreseeable future. Given that reality, the present double tax system is the lesser evil in comparison to the extensive deferral of tax on domestic income that would occur if the income of U.S. corporations were not taxed until dividends were distributed or shareholders sold their stock.

<sup>223</sup> See SLEMROD & BAKIJA, *supra* note 9, at 275. Of course, foreign C corporations are already tax deferral machines as explained *infra* Part VI.A. However, if the corporate-level income tax were eliminated without enacting an integration system, all domestic C corporations would be tax deferral machines as well.

<sup>224</sup> See I.R.C. § 162(c).

<sup>225</sup> See I.R.C. § 165(d). Actually, the limitation on the deduction of gambling

certain personal injury recoveries<sup>226</sup>), these departures reflect nontax societal norms. They have then argued that it is unacceptable to use TEA as a vehicle through which tax norms trump these and other value judgments of the American public.<sup>227</sup> As they put it, “the ultimate choice must rest with the citizen and not the oracle.”<sup>228</sup>

We believe that this view misconstrues the role of TEA, which does not prohibit value-based departures from the normative definition of income. Instead, TEA requires that the costs and benefits of such departures be forthrightly acknowledged and weighed so that society will make informed decisions about the degree to which it wishes nontax norms to trump tax norms and vice versa. It is difficult to see how TEA, which involves identifying the existence of government programs effected through the tax system and subjecting those programs to a cost/benefit analysis, does anything but enhance the ability of citizens (through their elected representatives) to exercise value-based choices concerning those programs.

In any event, this criticism of TEA is largely irrelevant with respect to the international tax provisions that we examine below in Part VI of this article because those provisions are not manifestations of any value judgments by the American public. They are largely manifestations of successful lobbying efforts by a relatively small but powerful group of multinational corporate taxpayers and their sophisticated tax advisers.

### *G. Zero Taxation as a Possible Norm*

One could argue that the proper policy baseline is a world with no taxation so that subsidies and incentives in the form of reduced taxation or outright exemptions effectively bring us towards, or back to, the baseline and should not be characterized as tax expenditures. A no-tax world is, however, a world of no government, or virtually no government. This condition amounts to a Hobbesian nightmare filled with such poverty and insecurity that people would rapidly abandon it by organizing governments which, even when of the small Lockean

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losses is not an indisputable example of a departure from the SHS definition of income because many, perhaps most, of those losses are entertainment expenditures and, therefore, should properly be viewed as personal consumption costs that should not be deducted for tax purposes under either an income or consumption tax base. See DODGE, FLEMING & GEIER, *supra* note 9, at 586–88.

<sup>226</sup> See I.R.C. § 104(a).

<sup>227</sup> See Kahn & Lehman, *supra* note 8, at 1662.

<sup>228</sup> *Id.*



sort, imply taxation.<sup>229</sup> Thus, zero taxation is not a realistic policy choice in our complex and dangerous world. For these reasons, a no-tax baseline is not a meaningful alternative and it should play no part in any serious critique of TEA.

#### H. Consumption Taxation as the Norm

A substantial number of leading commentators has expressed the belief that a normatively correct tax regime would exclude savings from the tax base or, alternatively, would include saved amounts in the tax base but exempt all returns thereon.<sup>230</sup> Either way, only consumption would be taxed; savings and investment would be exempt.<sup>231</sup>

Surrey's muscular version of TEA rejected consumption as the normative tax base and took as its baseline the SHS definition of income,<sup>232</sup> which treats all amounts that are saved as income inclusions along with amounts which are consumed.<sup>233</sup> Thus, if consumption alone were accepted as the correct tax base, the number of tax provisions carrying the tax expenditure label would be reduced because provisions that have the effect of eliminating savings from the

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<sup>229</sup> See generally MURPHY & NAGEL, *supra* note 40, at 31–33.

<sup>230</sup> See, e.g., Joseph Bankman & David A. Weisbach, *The Superiority of an Ideal Consumption Tax over an Ideal Income Tax*, 58 STAN. L. REV. 1413 (2006); Edward J. McCaffery, *A New Understanding of Tax*, 103 MICH. L. REV. 807 (2005) [hereinafter McCaffery, *New Understanding*]; Daniel N. Shaviro, *Replacing the Income Tax with a Progressive Consumption Tax*, 103 TAX NOTES 91 (Apr. 5, 2004). Regarding the views of the economics profession on this question, compare Bartlett, *Agenda, supra* note 165, at 1532 (“[M]ost economists now favor a consumption-based tax system.”), with Robert Whaples, *Do Economists Agree on Anything? Yes!*, 3 ECONOMISTS’ VOICE 9 (2006), available at <http://www.bepress.com/ev/vol3/iss9/art1> (reporting on a 2005 survey of randomly selected members of the American Economics Association in which the mean average response to the question of whether the United States should replace the income tax with an equivalent consumption tax was in the range of “neutral” to “disagree”).

<sup>231</sup> If tax and interest rates remain constant, the exclusion of saved amounts coupled with taxation at the time of consumption of all returns to saving (including recovery of principal) will provide the same economic treatment of the riskless return to capital as the up-front taxation of saved amounts coupled with the exclusion of all returns thereon (including recovery of principal). See DODGE, FLEMING & GEIER, *supra* note 9, at 72–73; SLEMROD & BAKIJA, *supra* note 9, at 199–205.

<sup>232</sup> See SURREY & MCDANIEL, TAX EXPENDITURES, *supra* note 2, at 3–4; see also Goldberg, *supra* note 34, at 26.

<sup>233</sup> See SIMONS, *supra* note 53, at 50.

tax base,<sup>234</sup> or reducing the tax on investments,<sup>235</sup> would no longer be tax expenditures.<sup>236</sup>

The extent of the reduction would, however, be less than is commonly supposed because a number of tax expenditures would probably persist under a consumption tax regime. For example, the President's fiscal 2007 budget document lists the following features of existing federal income tax law as tax expenditures, or probably tax expenditures, under a consumption-based tax system, and favorable treatment of these popular items would likely be preserved in some form in a consumption tax regime:

*Tax Expenditure Under a Consumption Base*

Exclusion of workers' compensation benefits

*Probably a Tax Expenditure Under a Consumption Base*

Deductibility of mortgage interest on owner-occupied homes

Child credit

Deductibility of nonbusiness state and local taxes other than on owner-occupied homes

Exclusion of Social Security benefits for retired workers

Deductibility of State and local property tax on owner-occupied homes

Earned income tax credit

Exclusion of Social Security benefits of dependents and survivors<sup>237</sup>

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<sup>234</sup> *E.g.*, the IRA regime and section 401(k) plans.

<sup>235</sup> *E.g.*, Roth IRAs and the section 103 exclusion for interest received on public purpose debt issued by state and local governments.

<sup>236</sup> *See* 2007 ANALYTICAL PERSPECTIVES, *supra* note 29, at 322–25, 328. Moreover, there would be no separate corporate income tax in a theoretically correct consumption tax regime. *See* PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, PROPOSALS, *supra* note 15, at 37–40; U.S. TREAS. DEP'T, BLUEPRINTS, *supra* note 23, at 133–34; SLEMROD & BAKIJA, *supra* note 9, at 234–42. Thus, the tax subsidies and incentives in the present corporate income tax would not be tax expenditures if consumption taxation were the norm.

One of the complaints made against TEA by some consumption tax advocates is that the inclusion of consumption tax features in the tax expenditure lists highlights the revenue cost of replacing the federal income tax with a consumption tax regime and makes such replacement more difficult to achieve. *See* STAFF OF JOINT ECON. COMM., REVIEW, *supra* note 168, at 5–6; Bartlett, *The End*, *supra* note 8, at 420.

<sup>237</sup> 2007 ANALYTICAL PERSPECTIVES, *supra* note 29, at 328 app. tbl.2.

More importantly, any politically acceptable federal consumption tax would almost surely be adorned with additional tax expenditures designed to direct the flow of capital into many of the investments and activities that are the beneficiaries of tax expenditures under the existing federal income tax.<sup>238</sup> To be specific, it seems virtually certain that in some way the existing tax expenditures in favor of such things as investments in state and local government bonds, investments in business and industrial equipment, and investments in owner-occupied residences would be substantially preserved.<sup>239</sup> Undoubtedly, Congress would be under pressure to enact other departures from a theoretically pure consumption base as well; it is naïve to think that shifting the tax base from income to consumption would eliminate the efforts by various interest groups to obtain narrowly based tax preferences of their liking. For these reasons, TEA would have an important role to play even if the federal income tax were replaced by a consumption tax. Nevertheless, if consumption taxation were to replace the SHS definition of income as the normative baseline of the federal income tax, the number of tax expenditures would be reduced,<sup>240</sup> the international tax provisions that are discussed below in Part VI of this article either would be unnecessary (because all forms of savings would be excluded from the tax base) or would no longer carry the tax expenditure label, and TEA would change somewhat.

The vigorous debate regarding the SHS income tax base versus the consumption tax base has generated a vast literature without coming even close to resolving the dispute.<sup>241</sup> Any attempt on our part

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<sup>238</sup> See J. Clifton Fleming, Jr., *Scoping Out the Uncertain Simplification (Complication?) Effects of VATs, BATs and Consumed Income Taxes*, 2 FLA. TAX REV. 390, 398–99, 421–39 (1995) [hereinafter Fleming, *Scoping Out*]; see also Robert J. Peroni, *Tax Reform Interrupted: The Chaotic State of Tax Policy in 2003*, 35 MCGEORGE L. REV. 277, 317 n.165 (2004) [hereinafter Peroni, *Chaotic State of Tax Policy*] (“[T]he pressure on Congress to enact tax preferences that treat expenses incurred in favored personal consumption activities as non-consumption expenses for tax purposes would be as intense, if not more intense, under a cash-flow consumption tax system as under our existing system.”).

<sup>239</sup> See Fleming, *Scoping Out*, *supra* note 238.

<sup>240</sup> See Goldberg, *supra* note 34, at 28; Hungerford, *supra* note 51, at 326 n.3.

<sup>241</sup> See, e.g., SLEMRÖD & BAKJUA, *supra* note 9, at 233–71; Andrews, *Cash Flow Personal Income Tax*, *supra* note 52; William D. Andrews, *Fairness and the Personal Income Tax: A Reply to Professor Warren*, 88 HARV. L. REV. 947 (1975); J. Clifton Fleming, Jr., *Replacing the Federal Income Tax with a Postpaid Consumption Tax: Preliminary Thoughts Regarding a Government Matching Program for Wealthy Investors and a New Tax Policy Lens*, 59 SMU L. REV. 617 (2006) [hereinafter Fleming, *Postpaid Consumption Tax*]; Barbara H. Fried, *Fairness and the*

to achieve closure would involve abandoning this TEA article in favor of a lengthy piece (perhaps a book) on the income versus consumption base controversy. Although we have strong views regarding this important issue, we choose to remain focused on TEA and to defer the other project to a later piece. For purposes of this article, we simply note that consumption *with a general exclusion for savings* has not been adopted as the baseline for the federal income tax and is unlikely to be adopted within the foreseeable future.<sup>242</sup> Consequently, we will proceed to discuss TEA in the light of the SHS baseline.

*I. Not So Fast! Hasn't Our Hybrid Income/Consumption Tax Evolved into Primarily a Consumption Tax?*

Tax academics in both the economics and law disciplines tend to dislike disputes over definitions because these controversies often obscure more fundamental issues. We generally share that distaste for definitional debates. Nevertheless, we now venture into the debate over whether the federal income tax is properly defined as an SHS tax with tax expenditures or as a hybrid income/consumption tax.<sup>243</sup> We do so because some commentators advocate the latter definition as a ground for limiting or discarding TEA. To be specific, TEA critics contend that although the federal income tax is not a full-bore consumption tax, it has so many important consumption tax features that it is at least a hybrid income/consumption tax.<sup>244</sup> Accordingly, so

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*Consumption Tax*, 44 STAN. L. REV. 961 (1992); McCaffery, *New Understanding*, *supra* note 230; Alvin C. Warren, Jr., *Fairness and a Consumption-Type or Cash Flow Personal Income Tax*, 88 HARV. L. REV. 931 (1975); Warren, *supra* note 47.

<sup>242</sup> Replacing the federal income tax with a full-blown consumption tax would involve either a large downward distribution of the tax burden or structural refinements to the consumption tax that would diminish its simplification and efficiency aspects. See SLEMROD & BAKIJA, *supra* note 9, at 256–64; authorities cited *supra* note 238. These are probably insuperable political barriers. See SLEMROD & BAKIJA, *supra* note 9, at 271; *Report of the Task Force on International Tax Reform*, 59 TAX LAW. 649, 653 (2006) [hereinafter *International Task Force Report*]; see also PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, PROPOSALS, *supra* note 15, at 49 (“[T]he Panel decided to design reform options that would remain relatively close to the current distribution of tax burdens.”); STEUERLE, CONTEMPORARY TAX POLICY, *supra* note 3, at 241–42; Bartlett, *Agenda*, *supra* note 165, at 1533; Hungerford, *supra* note 51, at 326 n.3; Shaviro, *supra* note 8, at 215.

<sup>243</sup> See generally Edward J. McCaffery, *Tax Policy Under a Hybrid Income-Consumption Tax*, 70 TEX. L. REV. 1145 (1992) [hereinafter McCaffery, *Hybrid-Income Consumption Tax*].

<sup>244</sup> See 2007 ANALYTICAL PERSPECTIVES, *supra* note 29, at 315; PRESIDENT'S

the argument goes, it is unrealistic to use income tax concepts as the baseline for identifying deviations and classifying them as tax expenditures.<sup>245</sup> The implication of this contention is either that there is no feasible baseline<sup>246</sup> with the result that TEA must be discarded or that the proper baseline is consumption taxation so that all existing tax expenditures that create consumption tax results are no longer tax expenditures.<sup>247</sup>

The consumption tax features of our current income tax system, however, are more constrained than the preceding argument suggests. For example, in spite of the Code's consumption tax treatment of various retirement savings plans and its better-than-consumption-tax treatment of owner-occupied housing,<sup>248</sup> about two-thirds of household savings are taxed as they would be under SHS.<sup>249</sup> Moreover, most of the income tax system's currently existing consumption tax features were adopted to effectuate discrete federal objectives such as aid to state and local governments through the

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ADVISORY PANEL ON FEDERAL TAX REFORM, PROPOSALS, *supra* note 15, at 21; SLEMROD & BAKIJA, *supra* note 9, at 215; Andrews, *Cash Flow Personal Income Tax*, *supra* note 52, at 1120; Bartlett, *Agenda*, *supra* note 165, at 1533; Glenn, *Questions*, *supra* note 168, at 535–36; McCaffery, *Hybrid-Income Consumption Tax*, *supra* note 243, at 1152.

<sup>245</sup> See Goldberg, *supra* note 34, at 28; Shaviro, *supra* note 8, at 215–16; Sugin, *supra* note 2, at 427, 429.

<sup>246</sup> See STAFF OF JOINT ECON. COMM., REVIEW, *supra* note 168, at 9; Kahn & Lehman, *supra* note 8, at 1661; Sugin, *supra* note 2, at 427.

<sup>247</sup> See Bartlett, *The End*, *supra* note 8, at 420–22. As noted at *supra* note 236, this argument has an interesting sub-argument: TEA is inadvisable because the revenue loss figures it generates interfere with accomplishing the full replacement of the federal income tax with a consumption tax regime. See STAFF OF JOINT ECON. COMM., REVIEW, *supra* note 168, at 9; Bartlett, *The End*, *supra* note 8, at 420.

<sup>248</sup> See PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, PROPOSALS, *supra* note 15, at 70–71 (concluding that the set of tax expenditures related to personal residences results in an “economy-wide [income] tax rate on housing investment [that] is close to zero”); CONG. BUDGET OFFICE, TAXING CAPITAL INCOME, *supra* note 221, at 8 (finding an effective tax rate of minus 5.1% on owner-occupied housing). Under a theoretically pure consumption tax, the net imputed income from owner-occupied housing would bear the generally applicable rate of tax. See 2007 ANALYTICAL PERSPECTIVES, *supra* note 29, at 325–26; U.S. TREAS. DEP'T, BLUEPRINTS, *supra* note 23, at 121–22; SLEMROD & BAKIJA, *supra* note 9, at 220–22. There is no reason to believe that tax policy advocates would be any more successful in ridding a U.S. consumption tax system of this tax expenditure than they have been in eliminating it from the current U.S. income tax system. See Peroni, *Chaotic State of Tax Policy*, *supra* note 238, at 304–05.

<sup>249</sup> See 2008 ANALYTICAL PERSPECTIVES, *supra* note 29, at 285; PRESIDENT'S ADVISORY PANEL, PROPOSALS ON FEDERAL TAX REFORM, *supra* note 15, at 21–22.

section 103 exemption<sup>250</sup> and encouragement of private savings for retirement, education, and healthcare by means of various tax-preferred savings plans.<sup>251</sup> In addition, the preferential tax treatment of long-term capital gains<sup>252</sup> was adopted for the multiple but limited purposes of ameliorating the effect of several years of asset appreciation being realized in a single year (the “bunching” problem), counteracting the effects of inflation, alleviating the “lock-in” effect that results from the disparate income tax treatment of realized and unrealized gains, encouraging risk taking, and stimulating saving.<sup>253</sup> As these examples indicate, the consumption tax features of the Code, although often overbroad, inefficient, and incoherent, are generally targeted to achieve narrow policy goals<sup>254</sup> and many are subject to significant limitations.<sup>255</sup> These features do not represent a policy

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<sup>250</sup> PRESIDENT’S ADVISORY PANEL ON FEDERAL TAX REFORM, PROPOSALS, *supra* note 15, at 124 (characterizing section 103 as “an incentive for investment in public infrastructure”); SLEMMOD & BAKIJA, *supra* note 9, at 229–30 (stating that the effect of section 103 “is to subsidize debt-financed expenditures in the states and municipalities”).

<sup>251</sup> See U.S. TREAS. DEP’T, GENERAL EXPLANATIONS OF THE ADMINISTRATION’S FISCAL YEAR 2007 REVENUE PROPOSALS 5–8 (2006) [hereinafter U.S. TREAS. DEP’T, 2007 PROPOSALS].

<sup>252</sup> See I.R.C. § 1(h).

<sup>253</sup> See STAFF OF JOINT COMM. ON TAX’N, 2005 GENERAL EXPLANATION, *supra* note 206, at 22–23; MARVIN A. CHIRELSTEIN, FEDERAL INCOME TAXATION 364 (10th ed. 2005); PAUL R. MCDANIEL, MARTIN J. MCMAHON, JR., DANIEL L. SIMMONS & ALICE ABREU, FEDERAL INCOME TAXATION 1118–19 (5th ed. 2004).

<sup>254</sup> See U.S. TREAS. DEP’T, 2007 PROPOSALS, *supra* note 251, at 5–8; PRESIDENT’S ADVISORY PANEL ON FEDERAL TAX REFORM, PROPOSALS, *supra* note 15, at 72 (stating that the set of tax expenditures that subsidizes owner-occupied housing “is often justified on the grounds that it is necessary for promoting home ownership”); Christopher Howard, *Tax Reform: The Sam Gerard Problem*, 113 TAX NOTES 365, 366 (Oct. 23, 2006). Closely related is Professor Deborah Geier’s argument that the current income tax system’s departures from pure SHS are driven by the goal of only taxing income that is available for discretionary use and not by the goal of achieving consumption-based taxation. See Deborah A. Geier, *The Taxation of Income Available for Discretionary Use*, 25 VA. TAX REV. 765 (2006); see also Seto & Buhai, *supra* note 51, at 1127–35. For a discussion of the discretionary use concept under German income tax law, see also Ordower, *supra* note 39, at 302–08.

<sup>255</sup> For examples, see the limitations imposed by sections 402(g), 404, 404A, 408, and 408A on the use of certain retirement savings plans. See generally JONATHAN BARRY FORMAN, MAKING AMERICA WORK 218–19 (2006). In addition, note that the preferential tax treatment of long-term capital gains is generally limited to gains (in excess of losses) from sales or exchanges of properties that qualify as capital assets or so-called “quasi-capital assets” and that are held for more than one year. See I.R.C. §§ 1(h), 1221, 1222, 1231.

decision to embrace the consumption tax approach by generally removing savings from the tax base.<sup>256</sup>

Furthermore, one of the largest consumption tax features of the current income tax system, the realization doctrine,<sup>257</sup> was conceded by Henry Simons, a chief proponent of SHS, as an administrative necessity in any feasible SHS tax.<sup>258</sup> Thus, the realization doctrine is arguably as much an income tax feature as a consumption tax feature and its inclusion in the income tax does not necessarily support the argument that the income tax is a hybrid levy.<sup>259</sup> In addition, even though consumption taxes exclude imputed income, the exclusion is based on practical concerns rather than doctrinal principles.<sup>260</sup> The failure to include imputed income in the income tax base, then, is not a partial adoption of a consumption tax norm.

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<sup>256</sup> This is not to say that tax expenditures cannot be used to achieve an incremental conversion of the income tax into a consumption tax or a near-consumption tax. For a description of a plan to do so, see William G. Gale & Peter R. Orszag, *An Economic Assessment of Tax Policy in the Bush Administration, 2001–2004*, 45 B.C. L. REV. 1157, 1227–30 (2004). Instead, we argue that the existing consumption tax elements in the federal income tax are better characterized as rifle shots directed at particular issues within a tax regime that primarily taxes income.

<sup>257</sup> The realization doctrine excludes unrealized asset appreciation from the current income tax base. This is the mathematical equivalent of deducting unrealized gains that the taxpayer effectively adds to savings by electing to defer realization. A deduction for an addition to savings achieves a consumption tax result. See DODGE, FLEMING & GEIER, *supra* note 9, at 70–73.

<sup>258</sup> See SIMONS, *supra* note 53, at 100, 207–08. For proposals to eliminate the realization requirement in the income tax system, see Noel B. Cunningham & Deborah H. Schenk, *Taxation Without Realization: A “Revolutionary” Approach to Ownership*, 47 TAX L. REV. 725 (1992); Mary Louise Fellows, *A Comprehensive Attack on Tax Deferral*, 88 MICH. L. REV. 722 (1990); Mark L. Louie, Note, *Realizing Appreciation Without Sale: Accrual Taxation of Capital Gains on Marketable Securities*, 34 STAN. L. REV. 857 (1982); David J. Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 U. PA. L. REV. 1111 (1986).

<sup>259</sup> See Goldberg, *supra* note 34, at 26; Shaviro, *supra* note 8, at 213. One TEA critic, Professor Zelinsky, argues that the departures from the SHS base based on considerations of enforceability/practicality and taxpayer morale make it “difficult see why an ideal [SHS] cannot be breached for other equally compelling concerns such as efficiency,” thus suggesting that these departures undercut TEA arguments against tax incentives. See Zelinsky, *The Rehabilitation of Tax Incentives*, *supra* note 11, at 1029. In our view, this is substantially the same as asserting that tax expenditures are acceptable if they pass cost/benefit analysis, an assertion with which we agree.

<sup>260</sup> See generally Michael J. Graetz, *Implementing a Progressive Consumption Tax*, 92 HARV. L. REV. 1575, 1614 (1979) [hereinafter Graetz, *Progressive Consumption Tax*].

As these examples have illustrated, the consumption tax features of the Code were not, generally speaking, adopted for the purpose of moving the income tax system closer to a consumption tax ideal. Instead, these features were adopted in pursuance of other policies and their consumption tax effects are secondary consequences of those other objectives.

For these reasons, there is a strong case for characterizing the current federal income tax as an SHS tax levy with targeted tax expenditures and concessions to administrative necessity, rather than as a hybrid income/consumption tax. This treatment becomes compelling when we consider that tax expenditures structured on the basis of consumption tax principles will “work” only if the baseline income tax is an SHS levy. This point can be illustrated by returning to the example in Part II of this article regarding the exemption for interest paid on state and local government public purpose debt. If a theoretically correct consumption tax were substituted for the federal income tax, all income from capital, including all interest, would be effectively exempt<sup>261</sup> and issuers of state and municipal government bonds would have to pay the same interest rates as all other borrowers, including business corporations.<sup>262</sup>

State and local government bond issuers might be indifferent to losing the benefit of the section 103 exemption if the consequence of replacing the federal income tax with a consumption tax were a dramatic decline in interest rates generally. It is not certain, however, that this would happen, and indeed there is credible evidence that general interest rates would increase substantially.<sup>263</sup> Faced with this uncertainty, the risk averse approach is to assume that if the federal income tax were fully replaced by a levy on consumption, there would not be a general interest rate reduction sufficiently large to effectively neutralize the states’ and local governments’ loss of the section 103 benefit enjoyed under the income tax. This drives us to conclude that section 103 “works” only because it is part of an SHS system under which interest is generally taxed.

Moreover, it is reasonable to regard section 103’s purpose as not only reducing the interest costs of state and municipal governments, but also conferring a comparative borrowing advantage on those

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<sup>261</sup> See SLEMROD & BAKIJA, *supra* note 9, at 214, 222. See generally Fleming, *Postpaid Consumption Tax*, *supra* note 241.

<sup>262</sup> See Harry Watson, *Implicit Taxes*, in ENCYCLOPEDIA, *supra* note 23, at 185.

<sup>263</sup> See CONG. BUDGET OFFICE, *THE ECONOMIC EFFECTS OF COMPREHENSIVE TAX REFORM 33–34* (July 1997); SLEMROD & BAKIJA, *supra* note 9, at 223.



governments. Indeed, in the most detailed consumption tax proposal yet developed in the United States, the Unlimited Savings Allowance (USA) System,<sup>264</sup> the section 103 exemption was continued with respect to interest received by individuals on state and municipal government debt.<sup>265</sup> This continuation went beyond consumption tax principles because the deduction granted under the USA System to individuals for the cost of state and municipal government bonds was, by itself, sufficient to create a consumption tax exemption for the interest paid to individuals with respect to those bonds.<sup>266</sup> Thus, the section 103 exemption in the USA System effectively imposed a negative tax rate with respect to interest received by individuals on state and local government debt. The USA System authors took this step because they believed that the rationale of section 103 in the present income tax is to confer a comparative advantage on state and municipal governments vis-à-vis other borrowers (a view certain to be shared by virtually all state and local politicians) and that this advantage should be preserved under their proposed system.<sup>267</sup>

From this standpoint, the effective elimination of the present section 103 by replacing the current income tax with a consumption tax having only theoretically correct elements (i.e., no section 103 exemption) would deprive state and municipal governments of a comparative advantage that they currently enjoy. A similar analysis arguably applies to all other currently existing Code tax expenditures that create a consumption tax result by eliminating the tax on particular types of capital income (e.g., tax-favored retirement savings vehicles) or that move particular types of capital income in the direction of consumption tax treatment by lowering the applicable rate of tax.

For these reasons, it seems correct to conclude that the section 103 exemption in its present form, and other consumption-type tax expenditures, work only because they are components of an SHS tax system instead of a consumption tax regime. Because these tax expenditures are meant to work and because they do so only if there is a substantial amount of capital income that is taxed pursuant to SHS

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<sup>264</sup> See Paul H. O'Neill & Robert A. Lutz, *Unlimited Savings Allowance (USA) Tax System*, 66 TAX NOTES 1485 (Mar. 10, 1995) [hereinafter *USA System*].

<sup>265</sup> See *id.* at 1564.

<sup>266</sup> See Fleming, *Postpaid Consumption Tax*, *supra* note 241, at 620–28; *USA System*, *supra* note 264, at 1564.

<sup>267</sup> See *USA System*, *supra* note 264, at 1564.

principles,<sup>268</sup> we should resist the inference that consumption-type tax expenditures in the federal income tax have swamped the SHS baseline and moved the system to the uncertain baseline, if any, that underlies a hybrid income/consumption tax.<sup>269</sup> The better conclusion is that the federal income tax is an SHS tax with targeted tax expenditures (subject to the understanding that a practical SHS tax operates with a realization principle).<sup>270</sup> Most importantly, this conclusion supports using an SHS baseline for TEA purposes and legitimizes inquiries into whether the consumption tax features of the present income tax are tax expenditures and, if so, whether they can survive recasting and cost/benefit scrutiny.

### J. Indeterminacy

Other critics have argued that uncertainties regarding both the SHS baseline and the items that should be included in the tax expenditure list give TEA a degree of conceptual indeterminacy that substantially limits its usefulness as a policy tool.<sup>271</sup> With respect to the SHS baseline, these critics point out that there is a debate among experts regarding the scope of the consumption component of the SHS definition of income. The usual examples of this are the disagreements over whether personal casualty losses, personal medical expenses, and charitable contributions are nonconsumption costs that should be subtracted when computing SHS income or, instead, are consumption items that should remain in the tax base.<sup>272</sup> These critics also argue that the conceptual validity of TEA is thrown into question by the practice of omitting certain items from the tax

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<sup>268</sup> See CONG. BUDGET OFFICE, TAXING CAPITAL INCOME, *supra* note 221, at 7 (calculating a 24.2% effective tax rate on business capital income and a 13.8% overall tax rate on capital income).

<sup>269</sup> See Sugin, *supra* note 2, at 427 (“A hybrid base defies the ideal of a ‘normal’ tax.”).

<sup>270</sup> See Hanna, *supra* note 52, at 449 (“The United States tax system is primarily an income tax system but has elements of a consumption tax system.”). See generally Avi-Yonah, *Three Goals*, *supra* note 40, at 24–25 (arguing that targeted savings and investment incentives that operate by conferring consumption tax treatment are effective only within an income tax system).

<sup>271</sup> See generally Bartlett, *The End*, *supra* note 8; Kahn & Lehman, *supra* note 8.

<sup>272</sup> See Bartlett, *The End*, *supra* note 8, at 416–17; Bittker, *Personal Expenditures*, *supra* note 96. It is worth noting that there are also uncertainties regarding the scope of the tax base in a consumption tax regime. See 2007 ANALYTICAL PERSPECTIVES, *supra* note 29, at 321–24; Graetz, *Progressive Consumption Tax*, *supra* note 260, at 1591–95.

expenditure list even though they represent departures from the SHS baseline.<sup>273</sup> For example, Surrey left the exclusion of the imputed rental value of owner-occupied homes and the exclusion of unrealized appreciation out of his initial tax expenditure list,<sup>274</sup> even though the excluded items are arguably SHS income inclusions, and the Treasury Department and the Joint Committee on Taxation have continued to omit these items from their annual tax expenditure lists.<sup>275</sup>

Professor Daniel Shaviro has argued that controversies regarding the TEA baseline would lessen if the baseline were restructured to draw a distinction between tax rules that distribute the tax burden in accordance with equitable principles, such as ability-to-pay, and tax rules that have no substantial burden-distributing purpose but, instead, serve to provide benefits to particular groups or activities. Only the latter, he argues, are tax expenditures.<sup>276</sup> Arguably, Surrey's version of TEA does this by defining tax expenditures with reference to the SHS definition of income, which is based principally on the concept of ability-to-pay. Moreover, Shaviro seems to concede that his proposed dichotomy has no more precision than the Surrey approach.<sup>277</sup>

The most important point to be made here, however, is that regardless of the debates over the precise scope of the SHS income

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<sup>273</sup> See Bartlett, *The End*, *supra* note 8, at 415–16; Bittker, *Accounting*, *supra* note 11, at 250. For a list of such items, see 2007 ANALYTICAL PERSPECTIVES, *supra* note 29, at 320.

<sup>274</sup> See SURREY, PATHWAYS, *supra* note 2, at 18–19; see also U.S. Treas. Dep't, *Conceptual Analysis*, *supra* note 5, at 593. Surrey viewed the realization doctrine as a deviation from the SHS definition but he nevertheless treated it as consistent with the baseline that he employed for TEA purposes because he considered the doctrine to be part of the generally accepted structure of an income tax. See SURREY & MCDANIEL, TAX EXPENDITURES, *supra* note 2, at 4, 198–99. If Surrey is regarded as unprincipled on this point, it should be noted, as discussed earlier in this article, that Simons himself viewed the realization doctrine as an inherent feature of a workable income tax. See SIMONS, *supra* note 53, at 100, 207–08. From this standpoint, the realization doctrine is not a deviation from the SHS baseline. In addition, even if the realization doctrine is a tax expenditure, it seems justifiable under cost/benefit analysis because of the administrative problems associated with taxing unrealized gains and allowing deductions for unrealized losses.

<sup>275</sup> See 2008 ANALYTICAL PERSPECTIVES, *supra* note 29, at 295; 2007 ANALYTICAL PERSPECTIVES, *supra* note 29, at 295; STAFF OF JOINT COMM. ON TAXATION, 109TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2006–2010, at 5 (Joint Comm. Print 2006) [hereinafter STAFF OF JOINT COMM. ON TAX'N, 2006 ESTIMATES]; Bartlett, *The End*, *supra* note 8, at 415–16.

<sup>276</sup> See Shaviro, *supra* note 8, at 188–89, 207–13.

<sup>277</sup> See *id.* at 213.

definition and the inclusion, or not, of certain items in the catalogue of tax expenditures, the government agencies that annually create tax expenditure lists have achieved a remarkable degree of consensus. For example, in the President's fiscal 2007 budget presentation, the Treasury Department listed 177 income tax expenditures,<sup>278</sup> and the corresponding presentation by the Staff of the Joint Committee on Taxation identified 192 such expenditures.<sup>279</sup> The two lists were the same except for no more than forty-three items.<sup>280</sup> This forty-three-item difference was only 24.3% of the Treasury's list and 22.4% of the Joint Committee Staff's list, meaning that the two lists had a greater than 75% overlap. Moreover, only one of the 100 largest items on the Treasury list was excluded from tax expenditure classification by the Joint Committee Staff.<sup>281</sup> This large area of common ground demonstrates that such definitional disputes are largely at the margins and that TEA has a settled core that makes it a useful analytical tool,<sup>282</sup> notwithstanding the intense criticism that it has endured.

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<sup>278</sup> See 2007 ANALYTICAL PERSPECTIVES, *supra* note 29, at 287–90. The Treasury Department prepares the annual list of tax expenditures that is included in the President's annual budget proposal. See GAO, FEDERAL COMMITMENT, *supra* note 1, at 7–8.

<sup>279</sup> See STAFF OF JOINT COMM. ON TAX'N, 2006 ESTIMATES, *supra* note 275, at 22–25, 30–42.

<sup>280</sup> We use the phrase “no more than” because certain items that are identified as tax expenditures by the Joint Committee Staff but are excluded from the Treasury list may have been excluded only because they fell below the \$5 million de minimis ceiling employed by the Treasury. Unfortunately, the Treasury's presentation does not identify items that it regards as tax expenditures but excludes from its list under this de minimis convention. See 2007 ANALYTICAL PERSPECTIVES, *supra* note 29, at 290 & tbl.19-1.

<sup>281</sup> See *id.* at 285–90, 296–97 & tbl.19-3; STAFF OF JOINT COMM. ON TAX'N, 2006 ESTIMATES, *supra* note 275, at 24–25. The one exception is the passive loss rules exception for up to \$25,000 of rental real estate losses. See I.R.C. § 469(i).

<sup>282</sup> See Burman, *supra* note 129, at 618, 626; Roin, *supra* note 8, at 605–08, 610–14; Sugin, *supra* note 2, at 416–19; Linda Sugin, *What Is Happening to the Tax Expenditure Budget?*, 104 TAX NOTES 763 (July 5, 2004). Surprising support came from the Bush administration's OMB, which stated:

The information in the tax expenditure tables can be useful to policymakers and the public. Potentially, it indicates how the current tax code deviates from an ideal tax system. . . . Despite the conceptual limitations, the tables of tax expenditures have provided tax reformers with information about where the tax code deviates from a defined baseline and about tax preferences that ought to be limited or even eliminated to improve the tax code.

Foster Letter, *supra* note 32, at 3, in GAO, FEDERAL COMMITMENT, *supra* note 1, at

*K. Inaccuracy*

One of Surrey's reasons for promoting TEA was to facilitate disclosure of the full cost of the federal government by producing estimates of revenue losses from tax expenditures that could be added to the totals of direct congressional appropriations.<sup>283</sup> Critics have argued that TEA cannot fulfill this role because the repeal of one or more tax expenditures would produce both positive and negative secondary revenue effects that are hard to quantify and make estimates of tax expenditure revenue losses inherently uncertain. The Treasury Department has explained this problem as follows with respect to its annual tax expenditure estimates:

The estimates shown for individual tax expenditures . . . do not necessarily equal the increase in Federal revenues (or the change in the budget balance) that would result from repealing these special provisions, for the following reasons:

First, eliminating a tax expenditure may have incentive effects that alter economic behavior. These incentives can affect the resulting magnitudes of the activity or of other tax provisions or Government programs. For example, if capital gains were taxed at ordinary rates, capital gain realizations would be expected to decline, potentially resulting in a decline in tax receipts. Such behavioral effects are not reflected in the estimates.

Second, tax expenditures are interdependent even without incentive effects. Repeal of a tax expenditure provision can increase or decrease the tax revenues associated with other provisions. For example, even if behavior does not change, repeal of an itemized deduction could increase the revenue costs from other deductions because some taxpayers would be moved into higher tax brackets. Alternatively, repeal of an itemized deduction could lower the revenue cost from other

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84; see also Charles Davenport, *Tax Expenditure Analysis as a Tool for Policymakers*, 11 TAX NOTES 1051, 1052 (Oct. 6, 1980) ("The only people who think there is a serious definitional problem are academics."); McIntyre, *supra* note 2, at 94-101 (arguing that the difficulties of defining tax expenditures can be obviated by treating as tax expenditures all tax provisions that are justified on subsidy or incentive grounds); Surrey & McDaniel, *Current Developments*, *supra* note 6, at 228 (arguing on similar grounds).

<sup>283</sup> See SURREY & MCDANIEL, TAX EXPENDITURES, *supra* note 2, at 6, 25, 226.

deductions if taxpayers are led to claim the standard deduction instead of itemizing. Similarly, if two provisions were repealed simultaneously, the increase in tax liability could be greater or less than the sum of the two separate tax expenditures, because each is estimated assuming that the other remains in force.<sup>284</sup>

From this point of view, the estimated revenue losses, and therefore the estimated costs, of tax expenditures are substantially uncertain and not helpful in measuring the full cost of the federal government.<sup>285</sup>

Such criticism may not be a good faith objection, however, because these same imperfections affect the procedures that are regularly used, without serious dissent, to produce revenue estimates for budgetary purposes and to evaluate proposed legislative changes.<sup>286</sup> More importantly, our principal point is that TEA is a highly useful tool for implementing the principles of ability-to-pay and neutrality and for imposing recasting and cost/benefit analysis. We are not concerned with calculating precise revenue loss amounts. The numbers yielded by TEA show rough magnitudes that are sufficient

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<sup>284</sup> 2008 ANALYTICAL PERSPECTIVES, *supra* note 29, at 286; *see also* THOMAS L. HUNGERFORD, CRS REPORT FOR CONGRESS, TAX EXPENDITURES: TRENDS AND CRITIQUES 7 (Cong. Res. Service, Sept. 13, 2006); Forman, *supra* note 4, at 541 (describing the early Nixon Administration's concerns about the reliability of TEA revenue estimates); Griffith, *supra* note 11, at 349; Joseph E. Stiglitz & Michael J. Boskin, *Impact of Recent Developments in Public Finance Theory on Public Policy Decisions: Some Lessons from the New Public Finance*, 67 AM. ECON. REV. 295, 296–97 (1977). *But see* Davenport, *supra* note 282, at 1054 (arguing that in a progressive income tax system the revenue gain resulting from eliminating several tax expenditure provisions would be larger than the total revenue gain determined by adding up the revenue estimates for each tax expenditure provision under the assumption that each such provision was the only one being repealed). For a model that attempts to determine the revenue gain from eliminating different combinations of tax expenditure provisions, *see* Daniel H. Weinberg, *The Distributional Implications of Tax Expenditures and Comprehensive Income Taxation*, 40 NAT'L TAX J. 237 (1987).

<sup>285</sup> *See* Bartlett, *The End*, *supra* note 8, at 415–18; Burman, *supra* note 129, at 614–15; Adam Carasso & Gene Steuerle, *Tax Expenditures: Revenue Loss Outlay Equivalents*, 101 TAX NOTES 287 (Oct. 6, 2003); Foster Letter, *supra* note 32, at 3–4, in GAO, FEDERAL COMMITMENT, *supra* note 1, at 84–85; Roin, *supra* note 8, at 613–14; *see also* SURREY & MCDANIEL, TAX EXPENDITURES, *supra* note 2, at 226–31; Shaviro, *supra* note 8, at 221–30.

<sup>286</sup> *See* PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, PROPOSALS, *supra* note 15, at 44–49; SLEMRD & BAKIJA, *supra* note 9, at 152–55; SURREY & MCDANIEL, TAX EXPENDITURES, *supra* note 2, at 6, 226–31; Roin, *supra* note 8, at 614–22; *see also* Davenport, *supra* note 282, at 1054.

for separating de minimis cases from significant cases and for making useful comparisons between tax expenditures and analogous direct expenditures.<sup>287</sup> Moreover, even if the TEA revenue loss estimates lack precision, they are more illuminating than the alternative — an estimate of zero (i.e., no estimate at all) — because such estimates show that tax expenditures are not without cost and that these costs are often material. In addition, the TEA cost estimates tell us something about the degree of distortion caused by particular tax expenditures, an important consideration in applying cost/benefit analysis.<sup>288</sup> Thus, in our view, the imprecision in TEA cost estimates does not significantly undercut the effectiveness of TEA as an analytical tool of tax policy.

#### *L. What Professor Bittker Actually Concluded*

Professor Boris Bittker was one of the earliest and most thoughtful skeptics regarding TEA<sup>289</sup> and more recent critics have relied on his work.<sup>290</sup> Consequently, it is interesting to recall that his bottom-line verdict on TEA was the following:

Would it be useful, then, to have a more limited accounting, one that confined itself to estimating the cost of departures from the Haig-Simons definition, without attempting to account for the “cost” of such structural provisions as the joint return, rate schedules, taxable periods, tax exemptions, and other aspects of existing law for which that definition provides no normative model? Yes, in my opinion: like the revenue estimates that usually accompany the Treasury’s recommendations for statutory changes, such calculations could provide information that would be helpful in applying our political, economic, and ethical criteria in making policy judgments about the income tax system. Assuming a consistent use of the Haig-Simons definition,

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<sup>287</sup> See GAO, FEDERAL COMMITMENT, *supra* note 1, at 19–21; PRESIDENT’S ADVISORY PANEL ON FEDERAL TAX REFORM, PROPOSALS, *supra* note 15, at 52–54; Sugin, *supra* note 2, at 416–17.

<sup>288</sup> See Burman, *supra* note 129, at 620.

<sup>289</sup> See, e.g., Bittker, *Accounting*, *supra* note 11; Bittker, *Personal Expenditures*, *supra* note 96.

<sup>290</sup> See STAFF OF JOINT ECON. COMM., REVIEW, *supra* note 168, at 6; Bartlett, *The End*, *supra* note 8, at 414–15; Kahn & Lehman, *supra* note 8, at 1663 n.8; see also Shaviro, *supra* note 8, at 205.

moreover, these estimates would help to *show whether the departures of existing law are skewed in a particular direction, and whether some departures counterbalance rather than reinforce the others* — matters of much importance for the person who acknowledges that some departures are unavoidable, but who wants nevertheless to approach as closely as possible to the Haig-Simons ideal. Finally, such a set of estimates would *permit statutory provisions that depart from the Haig-Simons definition to be judged on their merits*, free of the criticism that the non-disclosure of their cost automatically makes them inferior to subsidies as devices for achieving their objectives, since these instances of “back-door spending,” if disclosed, would be no more surreptitious than “front door spending.”<sup>291</sup>

These comments are consistent with our view that TEA’s most important function is to trigger rigorous scrutiny of tax provisions that depart from the SHS baseline and that its imperfections do not justify abandoning its benefits. The defects of TEA are real, but TEA can nevertheless continue to serve an important function in tax policy analysis. If anything, the growth of tax expenditure programs during the past three decades<sup>292</sup> makes TEA even more important in today’s policy world.

### M. The Limited Success of TEA

Although the President’s annual budget and the annual report of tax expenditures by the Joint Committee on Taxation provide comprehensive lists of tax expenditures, there is, regrettably, no institutionalized structure for regularly and comprehensively

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<sup>291</sup> Bittker, *Accounting*, *supra* note 11, at 260–61 (emphasis added); *see also* Shaviro, *supra* note 8, at 203. Another TEA critic, Professor Zelinsky, has also acknowledged the positive influence of TEA on the tax policymaking process: “Despite my reservations about the classification of items as normative or subsidizing, I believe that on balance, the tax expenditure budget has improved the quality of tax discussion and policymaking, forcing greater scrutiny of the Code and proposals to change it.” Zelinsky, *A Procedural Defense of Tax Expenditures*, *supra* note 2, at 1168 n.14; *see also* Zelinsky, *Response*, *supra* note 11, at 893–94 (“Professor Surrey and his followers have performed a service of inestimable value by demonstrating the equivalence between direct and tax expenditures, exposing the fallacy that tax expenditures are costless, establishing annual accounting of tax expenditures, and highlighting the possible inequities and inefficiencies of such expenditures.”).

<sup>292</sup> *See* GAO, FEDERAL COMMITMENT, *supra* note 1, at 19–23.



submitting tax incentives and subsidies to recasting and cost/benefit analysis.<sup>293</sup> Instead, TEA is usually employed *ad hoc* in response to proposals for new tax expenditures (both to review the new proposals and to determine if existing tax expenditures should be repealed to pay for the new ones) and in response to broader tax reform programs.<sup>294</sup> Various commentators have suggested governmental arrangements and methods that would ensure more regular cost/benefit review of tax expenditures<sup>295</sup> and we hope that those suggestions will be fully explored and will bear fruit. Such suggestions are not, however, within the scope of this article. Rather, our principal point is that even with the limitations resulting from its present *ad hoc* application, TEA is a valuable tax policy tool that has had a positive influence on the tax legislative process.<sup>296</sup>

Nevertheless, TEA has met with less than complete success. Tax expenditures, whether defective or well-conceived, have continued to grow in number<sup>297</sup> and Professor Surrey's hope "that tax expenditures once identified [would] be converted into direct expenditures or repealed altogether, has made little if any headway."<sup>298</sup> However, the complaints lodged against TEA by advocates of tax incentives and subsidies<sup>299</sup> suggest that TEA has had a restraining effect and that without its presence tax expenditure growth would have been even more robust. Moreover, TEA continues to provide both a tool for

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<sup>293</sup> See *id.* at 58–71; Burman, *supra* note 129, at 622–26; Foster Letter, *supra* note 32, at 4, in GAO, FEDERAL COMMITMENT, *supra* note 1, at 85; Hungerford, *supra* note 51, at 328.

<sup>294</sup> See Foster Letter, *supra* note 32, at 4, in GAO, FEDERAL COMMITMENT, *supra* note 1, at 85.

<sup>295</sup> See, e.g., GAO, FEDERAL COMMITMENT, *supra* note 1, at 73–74; Mary L. Heen, *Reinventing Tax Expenditure Reform: Improving Government Program Oversight Under the Government Performance and Results Act*, 35 WAKE FOREST L. REV. 751 (2000).

<sup>296</sup> See Burman, *supra* note 129, at 626; Roin, *supra* note 8, at 605–08, 610–13; Sugin, *supra* note 2, at 416–17.

<sup>297</sup> See GAO, FEDERAL COMMITMENT, *supra* note 1, at 19–23.

<sup>298</sup> Shaviro, *supra* note 8, at 187 (citations omitted). One TEA critic, Professor Zelinsky, has suggested that one reason that TEA has been unsuccessful in eliminating tax expenditures is a framing effect phenomenon, under which support for a government program varies depending on whether it is framed as a direct program or tax subsidy. See Edward A. Zelinsky, *Do Tax Expenditures Create Framing Effects? Volunteer Firefighters, Property Tax Exemptions, and the Paradox of Tax Expenditure Analysis*, 24 VA. TAX REV. 797 (2005).

<sup>299</sup> See STAFF OF JOINT ECON. COMM., REVIEW, *supra* note 168, at 6; Bartlett, *The End*, *supra* note 8, at 420; Fried, *supra* note 169.

asking the right questions about tax incentives and subsidies and a goad to the Treasury Department and Congress to do so. TEA helps promote transparency and accountability in the process of enacting government programs through the tax system and makes it more difficult for politicians to hide what they are really doing in terms of government spending. In short, given the continuing pressures on the Executive Branch and Congress to use tax expenditures in lieu of direct expenditure programs as a way to lessen political accountability for such actions, TEA or something very much like it is as important as it ever was.<sup>300</sup>

## V. COST/BENEFIT ANALYSIS

As has been noted many times in this article, the appropriate labeling of a tax provision as a tax expenditure (i.e., properly classifying a statutory provision as a tax expenditure) does not call for automatic rejection of the provision. Instead, it calls for a cost/benefit analysis.<sup>301</sup> Because tax expenditures are so varied, this cost/benefit analysis will usually have to be done on a case-by-case basis; a mandatory template seems inadvisable. Nevertheless, the following questions will be relevant in most cases:<sup>302</sup>

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<sup>300</sup> See also Peroni, *Chaotic State of Tax Policy*, *supra* note 238, at 317.

<sup>301</sup> SURREY, *PATHWAYS*, *supra* note 2, at viii; SURREY & MCDANIEL, *TAX EXPENDITURES*, *supra* note 2, at 25–27; Shaviro, *supra* note 8, at 209, 221. Professor Surrey argued that tax expenditures had certain characteristics that usually made them inferior to direct expenditures as a method for implementing government programs. See SURREY, *PATHWAYS*, *supra* note 2, at 134–54; SURREY & MCDANIEL, *TAX EXPENDITURES*, *supra* note 2, at 102–17. These characteristics are not automatic disqualifiers. Instead, they should be woven into questions 2 and 3 of the cost/benefit analysis listed *infra* text accompanying notes 302–04. For critiques contending that some of Surrey’s points regarding the general inferiority of tax expenditures are overstated, see Roin, *supra* note 8, at 612; Toder, *supra* note 8, at 366–68; Weisbach & Nussim, *supra* note 8, at 978–79; Zelinsky, *The Rehabilitation of Tax Incentives*, *supra* note 11, at 1026–33; Zelinsky, *A Procedural Defense of Tax Expenditures*, *supra* note 2, at 1194–1207.

<sup>302</sup> These questions, however, may need to be modified in appropriate cases. For example, question 1 would have to be modified in a case where an argument can be made in favor of having a government program but interpretation of the relevant constitutional case law would allow an indirect tax subsidy to be used but not a direct expenditure program (e.g., the charitable deduction under section 170 for gifts to religious organizations). In such a case, question 1 would be modified to ask whether the direct program analogue would be acceptable, assuming that such a program was constitutionally permissible. For more detailed approaches to structuring the cost/benefit analysis of a tax expenditure provision, see PRESIDENT’S ADVISORY

1. Is the tax expenditure an acceptable governmental program when recast as an analogous direct expenditure program?
2. If the answer to the preceding question is yes, do the benefits of the tax expenditure outweigh its costs, including its undesirable effects and its costs of administration?<sup>303</sup>
3. If the answers to both of the preceding questions are yes, can the tax expenditure's benefits, nevertheless, be better achieved through a direct expenditure program?<sup>304</sup>

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PANEL ON FEDERAL TAX REFORM, PROPOSALS, *supra* note 15, at 83; THE CENTURY FOUNDATION WORKING GROUP ON TAX EXPENDITURES, BAD BREAKS ALL AROUND (2002); SURREY & MCDANIEL, TAX EXPENDITURES, *supra* note 2, at 112–17; Gene Steuerle, *Summers on Social Tax Expenditures: Where He's Right*, 89 TAX NOTES 1481 (Dec. 11, 2000); Steuerle, *Summers on Social Tax Expenditures II*, *supra* note 124, at 1639; Sullivan, *Tax Incentives*, *supra* note 3, at 21–26. For discussions of the reasons why most tax expenditures fail under cost/benefit scrutiny, see Shaviro, *supra* note 8, at 202; Weisbach & Nussim, *supra* note 8, at 973, 978.

<sup>303</sup> The costs of a tax expenditure should include the costs of administering the program through the tax system but there is no specific information available regarding the administrative costs of tax expenditures. See GAO, FEDERAL COMMITMENT, *supra* note 1, at 54; Toder, *supra* note 8, at 365. This information failure could make the costs of a tax expenditure program erroneously appear to be lower than the costs of an analogous direct expenditure program when, in fact, they are not lower. This problem obviously is most serious when the tax expenditure program being evaluated is particularly complex (as is true of most international tax provisions) so that the government is forced to incur substantial administrative costs to implement/enforce it.

<sup>304</sup> Professor Anne Alstott has noted that tax system-based governmental programs have certain inherent institutional limitations that need to be taken into account in answering this question: “less accurate targeting, less responsiveness to changing needs, and vulnerability to noncompliance.” Anne L. Alstott, *The Earned Income Tax Credit and the Limitations of Tax-Based Welfare Reform*, 108 HARV. L. REV. 533, 589 (1995) (analyzing the earned income tax credit in section 32 as a mechanism for effecting welfare reform). By contrast, one TEA critic, Professor Zelinsky, takes the position that in many cases tax subsidies are preferable to their direct expenditure program analogues because “the committees and agencies that design and administer tax subsidies are less prone to capture by clientele groups, conform more closely to pluralist norms, and are better positioned to make decisions informed by expertise than their direct expenditure counterparts.” Zelinsky, *A Procedural Defense of Tax Expenditures*, *supra* note 2, at 1194. *Contra* authorities cited *supra* note 124. Professor Zelinsky also defends many tax subsidies on economic efficiency grounds. See Zelinsky, *The Rehabilitation of Tax Incentives*, *supra* note 11.

If the answer to the third question is that a direct expenditure program is a better delivery mechanism for achieving the benefits of the program, then the tax provision in question should be retained only if other tax policy criteria support its retention. If the answer to the third question is negative (i.e., a direct expenditure provision would not be a superior method for achieving the benefits of the program), then the provision withstands scrutiny under TEA and is a good candidate for retention in the federal income tax system.

Different policy analysts may reach different conclusions based on this analysis. To take one example, a number of commentators have argued that the charitable contribution deduction in section 170 is an example of a tax expenditure provision that is an acceptable governmental program, the benefits of which exceed its costs (including, most particularly, its effects on tax administration and tax compliance), and which is superior to its direct governmental program analogue.<sup>305</sup> Yet, other commentators have taken the position that the charitable contribution deduction is an inefficient tax expenditure and that a program of direct grants for charities (at least, nonreligious charities) would be more effective.<sup>306</sup> This latter point of view has

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<sup>305</sup> See, e.g., RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 529 (7th ed. 2007) (concluding that the charitable contribution deduction may be more efficient in promoting charitable giving than a direct governmental program of charitable grants); Feldstein, *supra* note 35, at 99 (same; making use of extension of Ramsey theory of optimal commodity taxation in assessing the efficiency of the charitable contribution deduction); see also Zelinsky, *A Procedural Defense of Tax Expenditures*, *supra* note 2, at 1192–94 (arguing that in the charitable area, “there is less danger of religious interests’ capturing tax institutions than direct expenditure agencies”). For an analysis of nonprofit tax policies as a tax expenditure program of providing foreign aid, see David E. Pozen, Comment, *Tax Expenditures as Foreign Aid*, 116 *YALE L.J.* 869 (2007).

Some commentators have argued that the charitable contribution deduction is a base-defining provision rather than a subsidy. See Andrews, *Personal Deductions*, *supra* note 59, at 344–46. Under this view, the charitable contribution deduction would not even be subject to TEA. For a spirited critique of the Andrews theory for not treating the charitable contribution deduction as a subsidy, see Mark P. Gergen, *The Case for a Charitable Contributions Deduction*, 74 *VA. L. REV.* 1393, 1414–26 (1988).

<sup>306</sup> See, e.g., E.C. Lashbrooke, Jr., *An Economic and Constitutional Case for Repeal of the I.R.C. Section 170 Deduction for Charitable Contributions to Religious Organizations*, 27 *DUQ. L. REV.* 695 (1989); Paul R. McDaniel, *Federal Matching Grants for Charitable Contributions: A Substitute for the Income Tax Deduction*, 27 *TAX L. REV.* 377 (1972); Yorio, *Tax Reform Act of 1986*, *supra* note 145, at 422–23. The Service is reportedly undertaking a study to determine whether it would make sense to replace the charitable contribution deduction in the Code with a direct

generally prevailed among the tax policy commentators but not with the U.S. Congress, which to date has been unwilling to repeal (or even substantially reduce) the charitable contribution tax subsidy. Although tax reform proponents are not pleased with this outcome, the debate has at least focused on the right questions and TEA has been a major factor in achieving that focus.

## VI. TEA AND THE U.S. INTERNATIONAL INCOME TAX REGIME

In our judgment, Parts I through IV of this article have shown that regardless of its imperfections, TEA is a useful and powerful tool of tax policy analysis and that TEA is as important today as it was when it first achieved prominence in the United States in the 1960s. TEA, however, has been under-utilized in international taxation, which has grown in significance as cross-border transactions have become a more important part of the U.S. and world economies.<sup>307</sup> As is true of the domestic tax area discussed earlier in this article, TEA can help focus tax policy analysts on the right questions in evaluating the efficacy of the international tax provisions in the Code and it is unfortunate that TEA has played such a small role in the international tax reform debates to date. One major objective of this article is to help remedy this deficiency. Accordingly, in this Part of the article, we apply TEA to three important elements of the U.S. system for taxing income derived by U.S. persons from business or investment activities conducted abroad — deferral of U.S. tax on income earned through a foreign corporation, cross-crediting, and the export sales source rule.

### *A. Deferral of U.S. Tax on Income Earned Through a Foreign Corporation*

Under the current U.S. international tax rules, foreign-source

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government program in the form of a government match of charitable contributions. See Dustin Stamper, *IRS Studying Bold Policy Replacement for Charitable Deduction*, 2007 TNT 115-7 (June 14, 2007).

<sup>307</sup> See, e.g., U.S. TREAS. DEP'T., APPROACHES TO IMPROVE THE COMPETITIVENESS OF THE U.S. BUSINESS TAX SYSTEM FOR THE 21<sup>ST</sup> CENTURY 2 (Dec. 2007) [hereinafter U.S. TREAS. DEP'T., COMPETITIVENESS REPORT]; U.S. Commerce Dep't, Bureau of Econ. Analysis, *Transactional Tables: U.S. International Transactions in Goods and Services and U.S. International Transactions*, 85 SURVEY OF CURRENT BUSINESS D-64, D-65 (May 2005); U.S. Commerce Dep't, Bureau of Econ. Analysis, *Transactional Tables: U.S. International Transactions in Goods and Services and U.S. International Transactions*, 84 SURVEY OF CURRENT BUSINESS D-62, D-63 (Oct. 2004).

income earned by a U.S. person directly, through an unincorporated branch, or through an entity taxed on a pass-through basis (i.e., a partnership or limited liability company that is treated as a partnership for U.S. tax purposes under the U.S. entity classification rules)<sup>308</sup> pays current U.S. tax on that income, subject to a direct foreign tax credit for creditable foreign taxes imposed on such income.<sup>309</sup> By contrast, foreign-source income earned by a U.S. person through a foreign subsidiary corporation generally is not subject to U.S. tax until the income is repatriated through a distribution to the U.S. person or upon sale by the U.S. person of the foreign subsidiary's stock (i.e., the tax is "deferred"),<sup>310</sup> unless one of the anti-deferral regimes in the Code applies.<sup>311</sup> Thus, the U.S. person obtains the benefit of deferral of the U.S. tax, which substantially reduces the effective rate of that tax. In fact, if the period of deferral is long enough, the present value of the future U.S. tax approaches zero and

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<sup>308</sup> See Treas. Reg. §§ 301.7701-2 (2007), -3 (2006). The entity classification rules of current law are often referred to as the "check-the-box" rules. For a discussion of these rules, see ROBERT J. PERONI, STEVEN A. BANK & GLENN E. COVEN, *CASES AND MATERIALS ON TAXATION OF BUSINESS ENTERPRISES* 40–48, 817–21 (3d ed. 2006).

<sup>309</sup> See, e.g., GUSTAFSON, PERONI & PUGH, *supra* note 133, at 34, 276, 443–44; 1 KUNTZ & PERONI, *supra* note 133, ¶ B3.01; SCHOLES, WOLFSON, ERICKSON, MAYDEW & SHEVLIN, *supra* note 23, at 288–90. For a detailed policy study by the Treasury Department on the deferral issue, see U.S. TREAS. DEP'T, *DEFERRAL STUDY*, *supra* note 216. For an earlier Treasury study on international tax reform, which included a significant discussion of the deferral issue, see U.S. TREAS. DEP'T, *INTERNATIONAL TAX REFORM: AN INTERIM REPORT* 7–17, 41–53 (Jan. 1993) [hereinafter U.S. TREAS. DEP'T, *INTERIM REPORT*].

<sup>310</sup> See, e.g., ALI, *INTERNATIONAL TAX STUDY*, *supra* note 133, at 171–72; GUSTAFSON, PERONI & PUGH, *supra* note 133, at 34, 276, 443–44; 1 ISENBERGH, *supra* note 133, ¶ 1.12; 1 KUNTZ & PERONI, *supra* note 133, ¶ B3.01; SCHOLES, WOLFSON, ERICKSON, MAYDEW & SHEVLIN, *supra* note 23, at 288–90; see also Ault & Bradford, *supra* note 133, at 12, 27–28.

<sup>311</sup> The two most important anti-deferral regimes are the Subpart F provisions that apply to a "controlled foreign corporation" (CFC), I.R.C. §§ 951–964, and the rules that apply to a "passive foreign investment company," I.R.C. §§ 1291–1298. See 3 BORIS I. BITTKER & LAWRENCE LOKKEN, *FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS* chs. 69, 70 (rev. 3d ed. 2005); 3 ISENBERGH, *supra* note 133, chs. 70–77, 80; 1 KUNTZ & PERONI, *supra* note 133, chs. B2, B3. In our view, these anti-deferral regimes do not do enough to curtail the deferral subsidy, particularly in the light of the legislative changes made to them since 1996 that further reduce their effectiveness. See, e.g., Robert J. Peroni, *Deferral of U.S. Tax on International Income: End It, Don't Mend It — Why Should We Be Stuck in the Middle with Subpart F?*, 79 *TEX. L. REV.* 1609, 1612 (2001) [hereinafter Peroni, *End It, Don't Mend It*]; Peroni, Fleming, & Shay, *Getting Serious About Curtailing Deferral*, *supra* note 133, at 488–92.

deferral becomes equivalent to exemption of tax on the foreign corporation's income.<sup>312</sup> Consequently, deferral has many of the same distortive effects on taxpayer behavior as would outright exemption of the foreign-source income from U.S. tax.<sup>313</sup>

This deferral subsidy encourages U.S. persons to shift their operations and investments abroad to low-tax foreign countries,<sup>314</sup> even if their pre-tax returns on the investments in such foreign countries are below those on comparable investments in the United States.<sup>315</sup> This deferral subsidy also serves as a barrier to repatriation

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<sup>312</sup> See, e.g., REUVEN S. AVI-YONAH, INTERNATIONAL TAX AS INTERNATIONAL LAW 124 (2007) [hereinafter AVI-YONAH, INTERNATIONAL TAX AS INTERNATIONAL LAW]; VITO TANZI, TAXATION IN AN INTEGRATING WORLD 78 (1995); Reuven S. Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 HARV. L. REV. 1573, 1593 n.70 (2000); Fleming, Peroni & Shay, *Fairness in International Taxation*, *supra* note 220, at 339–40; Daniel J. Frisch, *The Economics of International Taxation: Some Old and New Approaches*, 47 TAX NOTES 581, 584 (Apr. 30, 1990); Michael J. Graetz & Michael M. O'Hear, *The "Original Intent" of U.S. International Taxation*, 46 DUKE L.J. 1021, 1065 (1997). For a recent article discussing U.S. companies that use deferral and other tax preferences to reduce their taxes to very low effective rates, see Nanette Byrnes, *The Taxman Barely Cometh*, BUS. WK., Dec. 3, 2007, at 56.

<sup>313</sup> See, e.g., GUSTAFSON, PERONI & PUGH, *supra* note 133, at 443–44.

<sup>314</sup> See *id.*; Martin A. Sullivan, *Economic Analysis: U.S. Multinationals Move More Profits to Tax Havens*, 102 TAX NOTES 690 (Feb. 9, 2004); see also Rosanne Altshuler & Harry Grubert, *Governments and Multinational Corporations in the Race to the Bottom*, 110 TAX NOTES 979 (Feb. 27, 2006) (concluding that empirical analysis shows that aggressive tax planning strategies, which take advantage of deferral and the check-the-box entity classification regulations, played a greater role in the decline in the effective tax rates on the foreign income of U.S. multinationals during the period after 1996); David Harris, Randall Morck, Joel Slemrod & Bernard Yeung, *Income Shifting in U.S. Multinational Corporations*, in STUDIES IN INTERNATIONAL TAXATION 277, 278 (Alberto Giovannini, R. Glenn Hubbard & Joel Slemrod eds., 1993) (empirical study reporting "cross-firm regression results that are consistent with the notion that multinational firms shift income from high-tax locations to the United States and from the United States to low tax locations").

<sup>315</sup> See, e.g., U.S. TREAS. DEP'T, INTERIM REPORT, *supra* note 309, at 7 ("[T]he combined benefits of the deferral of U.S. tax and the lower foreign corporate-level tax could cause a U.S. multinational corporation to prefer foreign investments with pre-tax returns substantially below those of otherwise comparable domestic investments."); GUSTAFSON, PERONI & PUGH, *supra* note 133, at 444; Peroni, *Back to the Future*, *supra* note 133, at 987; Peroni, *End It, Don't Mend It*, *supra* note 311, at 1613–14; Robert J. Peroni, *The Proper Approach for Taxing the Income of Foreign Controlled Corporations*, 26 BROOK. J. INT'L L. 1579, 1583–84 (2001) [hereinafter Peroni, *The Proper Approach*]; see also J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Deferral: Consider Ending It, Instead of Expanding It*, 86 TAX NOTES 837, 837–38 (Feb. 7, 2000) [hereinafter Fleming, Peroni & Shay, *Consider*

of the U.S. person's share of the foreign corporation's foreign-source income because it encourages U.S. persons to favor retention of the earnings by the foreign corporation.<sup>316</sup> The empirical studies, however, are inconclusive on the extent of the effect of repatriation taxes on location decisions of U.S. corporations.<sup>317</sup>

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*Ending It*]; Peroni, Fleming & Shay, *Getting Serious About Curtailing Deferral*, *supra* note 133, at 468–69. *But see* Charles I. Kingson, *The Coherence of International Taxation*, 81 COLUM. L. REV. 1151, 1269–70 (1981) [hereinafter Kingson, *Coherence*] (suggesting that deferral as a substantive tax policy issue has become less important as the problem of exporting jobs in the manufacturing sector has allegedly peaked and the supposedly less mobile trade and service industries become increasingly responsible for job creation in the United States).

<sup>316</sup> J. Clifton Fleming, Jr. & Robert J. Peroni, *Eviscerating the Foreign Tax Credit Limitations and Cutting the Repatriation Tax — What's ETI Repeal Got To Do With It?*, 104 TAX NOTES 1393, 1406 (Sept. 20, 2004) [hereinafter Fleming & Peroni, *ETI Repeal*]. Thus, the U.S. tax is viewed as a barrier to repatriations and leads to what many commentators call the “lockout phenomenon,” i.e., foreign-source earnings that would otherwise be repatriated to the United States are locked out of the United States by the prospect of a U.S. income tax upon repatriation. *See id.* In 2004, Congress enacted a temporary relief measure in the form of a dividends-received deduction in section 965, which was intended to encourage repatriations of deferred earnings. *See* American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 422, 118 Stat. 1418, 1514–19 (2004). For a tax policy critique of the section 965 deduction on fairness and economic efficiency grounds, see Fleming & Peroni, *ETI Repeal*, *supra*. For a critique of the section 965 deduction as a tax amnesty program, see Craig M. Boise, *Breaking Open Offshore Piggybanks: Deferral and the Utility of Amnesty*, 14 GEO. MASON L. REV. 667 (2007).

<sup>317</sup> *See* DAVID L. BRUMBAUGH, TAX EXEMPTION FOR REPATRIATED FOREIGN EARNINGS: PROPOSALS AND ANALYSIS 7 (Cong. Res. Service, Oct. 22, 2003); HARRY GRUBERT & JOHN MUTTI, TAXING INTERNATIONAL BUSINESS INCOME: DIVIDEND EXEMPTION VERSUS THE CURRENT SYSTEM (2001) [hereinafter GRUBERT & MUTTI, TAXING INTERNATIONAL BUSINESS INCOME]; Rosanne Altshuler & Harry Grubert, *Repatriation Taxes, Repatriation Strategies and Multinational Financial Policy*, 87 J. PUB. ECON. 73 (2003) [hereinafter Altshuler & Grubert, *Repatriation Taxes*]; Rosanne Altshuler & Harry Grubert, *Where Will They Go if We Go Territorial? Dividend Exemption and the Foreign Location Decisions of U.S. Multinational Corporations*, 54 NAT'L TAX J. 787 (2001); Mihir A. Desai, C. Fritz Foley & James R. Hines, Jr., *Repatriation Taxes and Dividend Distortions*, 54 NAT'L TAX J. 829 (2001); Fleming & Peroni, *ETI Repeal*, *supra* note 316, at 1410. Moreover, a 2007 Treasury background paper stated that “comparisons of the behavior of corporations with and without excess foreign tax credits suggest that the repatriation tax must not be imposing a significant burden.” U.S. TREAS. DEP'T, BACKGROUND PAPER, *supra* note 1, at 51. One major reason for this is the various techniques that U.S. corporations can use to avoid the repatriation tax on dividends while still having cash flow to the U.S. parent corporation. *Id.*; *see, e.g.*, Altshuler & Grubert, *Repatriation Taxes*, *supra*, at 74; Fleming & Peroni, *ETI Repeal*, *supra* note 316, at 1410.



To determine whether the deferral subsidy represents a departure from a normative baseline and, therefore, is a tax expenditure provision, we must first identify a baseline. In this context, we can articulate the baseline in three alternative ways.

*The general principle of ability-to-pay.* As developed more fully in Part III.A above,<sup>318</sup> the principle that the income tax burden should be allocated among taxpayers in relation to their taxpaying abilities — the ability-to-pay principle — is the fundamental fairness norm underlying the U.S. federal income tax system. U.S. persons' foreign-source income confers ability-to-pay<sup>319</sup> but deferral allows U.S. persons to avoid current U.S. taxation with respect to foreign-source income earned through a foreign corporation. Thus, even though the U.S. income tax system has incorporated some significant features of a consumption tax base by exempting certain types of savings from current taxation, the deferral subsidy is a departure from the general ability-to-pay baseline.<sup>320</sup>

*The anti-deferral tax concept supporting the imposition of the corporate income tax.* As explained earlier in this article,<sup>321</sup> the corporate income tax serves a critical anti-deferral function, although it is admittedly a crude, second-best anti-deferral mechanism. Without the corporate income tax, C corporation shareholders would be able to completely defer taxation of business income earned through the corporation until they withdrew the earnings from the corporation (or sold their stock); the corporate income tax attempts to prevent that from happening by imposing a current income tax on a C corporation's net earnings. Because deferral of U.S. tax on foreign-source income earned through a foreign C corporation owned by U.S. persons allows avoidance of current imposition of the corporate income tax, deferral undercuts the anti-deferral function of the corporate tax system and, thus, is a departure from the corporate income tax baseline.

*The general current business taxation regime.* The general approach of the U.S. income tax system is to impose current tax on

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<sup>318</sup> See *supra* text accompanying notes 36–55.

<sup>319</sup> See, e.g., Ault & Bradford, *supra* note 133, at 27 (U.S. system of taxing the worldwide income of its citizens and residents “reflects the conception of income as a measure of ability to pay”).

<sup>320</sup> See Fleming, Peroni & Shay, *Fairness in International Taxation*, *supra* note 220, at 353–54; Peroni, *Back to the Future*, *supra* note 133, at 981–82; see also TANZI, *supra* note 312, at 77–78 (stating that residence-based taxation of international income is superior to source-based taxation on both allocative and equity grounds).

<sup>321</sup> See *supra* text accompanying notes 215–18.

business income earned by a U.S. person, whether that income is earned through an unincorporated branch, a sole proprietorship, a flow-through entity (i.e., a partnership, a limited liability company taxed as a partnership for federal income tax purposes, or an S corporation), or an entity taxed as a C corporation for federal income tax purposes.<sup>322</sup> Deferral with respect to foreign-source income earned by U.S. persons through a foreign corporation is a deviation from this general approach. Thus, the deferral privilege is a significant departure from the current taxation of business income that generally prevails within the present income tax system.<sup>323</sup> This departure creates a preference for foreign-source income and encourages taxpayers to shift business and investment activities from the United States to low-tax foreign countries.<sup>324</sup>

Stated differently, deferral is the equivalent of imposing postpaid consumption tax treatment (i.e., allowing a deduction at time of investment and imposing taxation on liquidation of the investment) with respect to the income of a controlled foreign corporation (CFC) invested in the CFC's business operations.<sup>325</sup> Thus, deferral effectively

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<sup>322</sup> See I.R.C. §§ 1, 11, 61(a)(1), (a)(2), 63, 702, 1366; ELISABETH A. OWENS, THE FOREIGN TAX CREDIT 3 (1961) (“[T]he source or nature of income, whether it is from one type of business or another, earned or unearned, from a foreign or domestic source, is largely immaterial in the basic tax structure.”).

<sup>323</sup> See, e.g., ALI, INTERNATIONAL TAX STUDY, *supra* note 133, at 171–72.

<sup>324</sup> See, e.g., Jane G. Gravelle, *Foreign Tax Provisions of the American Jobs Act of 1996*, 72 TAX NOTES 1165, 1166–67 (Aug. 26, 1996); Donald J. Rousslang, *Deferral and the Optimal Taxation of International Investment Income*, 53 NAT'L TAX J. 589 (2000); see also Martin A. Sullivan, *Economic Analysis: A Challenge to Conventional International Tax Wisdom*, 113 TAX NOTES 951, 959–60 (Dec. 6, 2006) [hereinafter Sullivan, *A Challenge*] (deferral helps contribute to the phenomenon of “runaway plants,” but the magnitude of the problem is relatively small). Regarding the responsiveness of host country taxes on location of U.S. multinational investment, see Harry Grubert & John Mutti, *Do Taxes Influence Where U.S. Corporations Invest?*, 53 NAT'L TAX J. 825 (2000) (empirical study of the international operations of more than 500 U.S. companies in sixty potential foreign locations showing that average effective tax rates of host countries “have a significant effect on the amount of capital that U.S. MNCs [U.S. multinational corporations] have in a given location” and suggesting that almost one out of every five dollars invested abroad by U.S. corporations is drawn to its investment location because of low host country taxes); Rosanne Altshuler, Harry Grubert & T. Scott Newlon, *Has U.S. Investment Become More Sensitive to Tax Rates?* (Nat'l Bureau of Econ. Research, Working Paper No. 6383, 1998) (providing further empirical support for proposition that foreign investment by U.S. multinational corporations is sensitive to host country tax rates).

<sup>325</sup> See Fleming, Peroni & Shay, *Consider Ending It*, *supra* note 315, at 844–45; Peroni, Fleming, & Shay, *Getting Serious About Curtailing Deferral*, *supra* note 133, at

provides an *exemption* from U.S. tax with respect to earnings on CFC income invested in the CFC's business operations.<sup>326</sup> This effective exemption via deferral is a subsidy delivered through the tax system<sup>327</sup> and, therefore, is properly characterized as a tax expenditure. The Staff of the Joint Committee on Taxation and the Office of Management and Budget/Treasury have both consistently treated deferral as a tax expenditure and have attempted to quantify the cost of this tax subsidy.<sup>328</sup>

Some proponents of deferral argue that deferral is not a tax expenditure.<sup>329</sup> As noted earlier in this article, they base this argument in part on the proposition that deferral follows from a decision to treat corporations and shareholders as separate taxpayers and, therefore, is not a deviation from the normative baseline for properly measuring net income.<sup>330</sup> As explained above, however, this view is inconsistent with (1) the principle of ability-to-pay, (2) the anti-deferral tax concept supporting the imposition of the corporate income tax, and (3) the general current business taxation regime.<sup>331</sup>

Other proponents of deferral argue that even if deferral is a tax subsidy, it survives a cost/benefit analysis because it remedies a competitiveness problem that U.S. multinationals experience when they engage in international business transactions in low-tax foreign

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466–68. This point is illustrated in the example *infra* Part VI.C.

<sup>326</sup> See Fleming, Peroni & Shay, *Consider Ending It*, *supra* note 315, at 845; Peroni, Fleming & Shay, *Getting Serious About Curtailing Deferral*, *supra* note 133, at 467–68; see also U.S. TREAS. DEP'T, BACKGROUND PAPER, *supra* note 1, at 45 (stating that deferral “substantially lowers the effective rate of tax” on active business income earned through a foreign subsidiary “and moves the U.S. tax system towards a territorial system”); Graetz & O’Hear, *supra* note 312, at 1064–65.

<sup>327</sup> With respect to measuring the amount of the subsidy, see SURREY & MCDANIEL, TAX EXPENDITURES, *supra* note 2, at 228–30.

<sup>328</sup> See, e.g., STAFF OF JOINT COMM. ON TAX’N, 2007 ESTIMATES, *supra* note 13, at 24 (estimating the total revenue cost for fiscal years 2007–2011 from the deferral of U.S. income tax on the active income of CFCs as \$34.6 billion and from the deferral of active financing income as \$5.7 billion); 2008 ANALYTICAL PERSPECTIVES, *supra* note 29, at 287 (estimating the total revenue cost for fiscal years 2008–2012 from the deferral of U.S. income tax on the income of CFCs as \$73.35 billion and from the deferred taxes for financial firms from certain income earned abroad as \$3.55 billion).

<sup>329</sup> See Bartlett, *The End*, *supra* note 8, at 416–17 (arguing that deferral is not a tax expenditure); see also NORMAN TURE, TAXING FOREIGN SOURCE INCOME: THE ECONOMIC AND EQUITY ISSUES 8–12 (Tax Foundation 1976) (arguing that deferral is not a tax subsidy).

<sup>330</sup> See *supra* text accompanying note 135.

<sup>331</sup> See *supra* text accompanying notes 215–18 and 318–24.

countries.<sup>332</sup> This claim, however, is typically made with little or no empirical support for the existence of a competitiveness problem<sup>333</sup>

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<sup>332</sup> See, e.g., ERNST & YOUNG, *THE COMPETITIVE BURDEN: TAX TREATMENT OF U.S. MULTINATIONALS 2* (Tax Foundation 1991) (focusing on the tax systems of Germany, Japan, the Netherlands, and the United States and concluding that “the United States subjects the foreign operations of its multinationals to the severest tax constraints and the heaviest tax burden of any of the four countries studied”); GARY CLYDE HUFBAUER, *U.S. TAXATION OF INTERNATIONAL INCOME: BLUEPRINT FOR REFORM 49–55* (1992); 1 NFTC, *REPORT AND ANALYSIS*, *supra* note 135, at 3, 5; SOL PICCIOTTO, *INTERNATIONAL BUSINESS TAXATION 114* (1992); William P. McClure & Herman B. Bouma, *The Taxation of Foreign Income from 1909 to 1989: How a Tilted Playing Field Developed*, 43 *TAX NOTES* 1379 (June 12, 1989); Peter Merrill & Carol Dunahoo, *‘Runaway Plant’ Legislation: Rhetoric and Reality*, 72 *TAX NOTES* 221, 226 (July 8, 1996); see also H.R. REP. NO. 108-548, pt. 1, at 209 (2004) (discussing competitiveness concerns as a rationale for repealing in 2004 the anti-deferral rules in section 954 relating to foreign base company shipping income); U.S. TREAS. DEP’T, *INTERIM REPORT*, *supra* note 309, at 3 (discussing how deferral and exemption both support the objective of competitiveness, but conflict with the objective of neutrality using traditional economic analysis); U.S. TREAS. DEP’T, *COMPETITIVENESS REPORT*, *supra* note 307, at 85–86 (discussing competitiveness concerns as a rationale for weakening the Subpart F anti-deferral rules); HERBERT STEIN, *TAX POLICY IN THE TWENTY-FIRST CENTURY 82–83* (Herbert Stein ed., 1988); Rosanne Altshuler, *Recent Developments in the Debate on Deferral*, 87 *TAX NOTES* 255, 258–60 (Apr. 10, 2000) (summarizing the arguments in favor of capital import neutrality and deferral); Graetz & O’Hear, *supra* note 312, at 1109 (“[The compromises between conflicting principles in the international tax area] have made the tax law governing international transactions subject to routine complaints of competitive disadvantage by U.S. companies depending on where they are competing and against whom.”). For an international tax economist who argues that deferral enhances the economic efficiency of the home country under certain circumstances, see James R. Hines, Jr., *The Case Against Deferral: A Deferral Reconsideration*, 52 *NAT’L TAX J.* 385 (1999).

<sup>333</sup> See U.S. TREAS. DEP’T, *DEFERRAL STUDY*, *supra* note 216, at 56 (“[T]he United States, as a general matter, is agreed by almost any measure to be one of the most competitive countries in the world.”), 57 (“[T]he available data simply do not provide a reliable basis for evaluating whether subpart F has affected multinational competitiveness to any significant extent.”); Sullivan, *Incentives*, *supra* note 3, at 23–25; Timothy Aepfel, *Overseas Profits Help U.S. Firms Through Tumult*, *WALL ST. J.*, Aug. 9, 2007, at 1 (discussing that U.S. corporations continue to experience growth in foreign-source profits); Marc Champion, *U.S. Ranked Most Competitive; Oil-Rich Nations Show Promise*, *WALL. ST. J.*, Nov. 1, 2007, at A4 (2007 World Economic Forum report characterized the U.S. economy as the most competitive in the world); see also Mitchell A. Kane, *Ownership Neutrality, Ownership Distortions, and International Tax Welfare Benchmarks*, 26 *VA. TAX REV.* 53, 64–65 (2006); Richard C. Pugh, *The Deferral Principle and U.S. Investment in Developing Countries*, in *UNITED STATES TAXATION AND DEVELOPING COUNTRIES 267, 280* (Robert Hellawell ed., 1980) (stating that “one faces a relative scarcity of detailed empirical analysis” in

and largely on the basis of limited anecdotal support or unsupported assertions.<sup>334</sup> Therefore, this competitiveness claim appears to be overstated at best.<sup>335</sup> Moreover, there is little factual support for the

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assessing the claims of advocates and opponents of deferral). *But cf.* STAFF OF JOINT COMM. ON TAXATION, 109TH CONG., OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES 189 (Joint Comm. Print 2005) [hereinafter STAFF OF JOINT COMM. ON TAX'N, OPTIONS], available at <http://house.gov/jct/s-2-05.pdf> (opining that the current U.S. international tax system “arguably” impairs the competitiveness of U.S. multinationals “in some cases”); U.S. TREAS. DEP'T, BACKGROUND PAPER, *supra* note 1, at 43 (“[T]he United States likely experiences some reduction of both foreign direct investment and its corporate tax base due to its above-average CIT [corporate income tax] rate.”). For a skeptical economic efficiency critique of the competitiveness arguments for the deferral subsidy, see Gravelle, *supra* note 324, at 1168.

<sup>334</sup> For an example of a report that, though well-written, provides only limited anecdotal support for its claims, see 1 NATIONAL FOREIGN TRADE COUNCIL, THE NFTC FOREIGN INCOME PROJECT: INTERNATIONAL TAX POLICY FOR THE 21ST CENTURY — PART ONE: A RECONSIDERATION OF SUBPART F 102–10 (2001), available at <http://www.nftc.org/default.asp?Mode=DirectoryDisplay&id=162>. For critiques of this report, see Reuven S. Avi-Yonah, *Competition and Competitiveness: Review of the NFTC Subpart F Report*, 83 TAX NOTES 582 (Apr. 26, 1999); Fleming, Peroni & Shay, *Consider Ending It*, *supra* note 315. For a defense of this report by one of its authors and a leading proponent of the competitiveness-based arguments for allowing deferral, see Peter R. Merrill, *A Response to Professor Avi-Yonah on Subpart F*, 83 TAX NOTES 1802 (June 14, 1999).

<sup>335</sup> See, e.g., TIMO VIHHERKENTTA, TAX INCENTIVES IN DEVELOPING COUNTRIES AND INTERNATIONAL TAXATION 64 (1991); Gravelle, *supra* note 324, at 1168; see also Paul R. McDaniel, *Herman Goldman Lecture: Territorial vs. Worldwide International Tax Systems: Which is Better for the U.S.?*, 62 THE RECORD 70, 71 n.4 (2007) [hereinafter McDaniel, *Herman Goldman Lecture*] (rejecting competitiveness as a tax policy criterion “(1) because it has no substantive tax policy content (it seems largely to be a rhetorical slogan for U.S. multinationals that want tax cuts) and (2) [the author has] . . . found no empirical studies that show U.S. companies are at a competitive disadvantage vis-à-vis their foreign competitors”); Paul R. McDaniel, *Territorial vs Worldwide International Tax Systems: Which is Better for the U.S.?*, 8 FLA. TAX REV. 283, 285 n.3 (2007) [hereinafter McDaniel, *Territorial vs Worldwide*] (same); Michael J. McIntyre, *Guidelines for Taxing International Capital Flows; The Legal Perspective*, 46 NAT'L TAX J. 315, 321 (1993) (opining that capital import neutrality is “a spending principle, not a tax principle”); Joel Slemrod, *Competitive Advantage and the Optimal Tax Treatment of the Foreign-Source Income of Multinationals: The Case of the United States and Japan*, 9 AM. J. TAX POL'Y 113 (1991); cf. Michael S. Kirsch, *Taxing Citizens in a Global Economy*, 82 N.Y.U. L. REV. 443, 517–19 (2007) (maintaining that changes in the global economy weaken, rather than strengthen, competitiveness arguments for the foreign earned income exclusion in section 911).

idea that deferral is actually effective in enhancing the competitiveness of U.S. multinationals.<sup>336</sup>

At the end of the day, deferral is a distortive governmental subsidy yielding dubious benefits. Consequently, deferral fails under cost/benefit analysis as a program for providing U.S. corporations with government assistance to make them competitive in the global economy. This conclusion is bolstered by the fact that certain anomalies in the U.S. deferral subsidy cause its claimed benefits to be only loosely coordinated with the supposed justifications for providing this tax subsidy.<sup>337</sup>

First, the benefit of the deferral subsidy increases to the degree that repatriation of CFC foreign earnings is delayed. This means that U.S. taxpayers who can afford to postpone repatriation indefinitely receive a much larger governmental subsidy than those who must repatriate foreign earnings at an earlier time. Stated differently, the size of the subsidy is determined significantly by the length of the deferral period instead of the degree of foreign competition. The policy reasons advanced in favor of deferral do not support this result.<sup>338</sup>

Second, the deferral subsidy encourages retention and reinvestment of foreign earnings by the CFC even though the CFC's U.S. shareholders might be able to invest its earnings at higher before-tax rates of return than are obtainable by the CFC. The tax subsidy for deferral, thus, encourages economically inefficient behavior by the

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<sup>336</sup> With regard to the effectiveness of deferral in enhancing competitiveness, see 2007 ANALYTICAL PERSPECTIVES, *supra* note 29, at 301 (“Measuring the effectiveness of these provisions raises challenging issues.”); *International Task Force Report*, *supra* note 242, at 680 (“There is little or no empirical evidence supporting the benefits of deferral as a justification for the competitiveness concerns raised by the availability of deferral for foreign but not domestic income.”). *But see* HUFBAUER, *supra* note 332.

There is empirical support for the proposition that investment by U.S. multinational corporations in low-tax foreign countries is less beneficial to U.S. competitiveness than investment by U.S. multinational corporations in high-tax foreign countries. See Sullivan, *A Challenge*, *supra* note 324, at 956–57. Because deferral encourages U.S. persons to shift business and investment activities to low-tax foreign countries, deferral may in fact harm, rather than benefit, U.S. competitiveness.

<sup>337</sup> See Fleming, Peroni & Shay, *Consider Ending It*, *supra* note 315, at 845; Peroni, Fleming & Shay, *Getting Serious About Curtailing Deferral*, *supra* note 133, at 469.

<sup>338</sup> See Fleming, Peroni & Shay, *Consider Ending It*, *supra* note 315, at 845; Peroni, Fleming & Shay, *Getting Serious About Curtailing Deferral*, *supra* note 133, at 469.

CFC and its U.S. shareholders.<sup>339</sup> It is highly doubtful that Congress would purposely enact a government program that has this negative behavioral effect.

Third, the deferral subsidy is fully available without regard to whether the U.S. shareholder investing in the CFC has little competition in the country in which the foreign income is earned or faces intense competition in that country.<sup>340</sup> The deferral subsidy is available even if the U.S. shareholder investing in the CFC faces competition primarily from individuals and corporations resident in foreign countries that impose heavier tax burdens than does the United States. Moreover, the deferral subsidy is fully forthcoming even if the U.S. taxpayer's principal competitors in a particular foreign country are other U.S. taxpayers. In other words, the deferral subsidy is available without regard to whether, or the degree to which, the U.S. taxpayer receiving the subsidy is actually facing a competitiveness problem.<sup>341</sup> Thus, the deferral subsidy is not tailored in any significant way to remedy the alleged competitiveness problems that have been advanced as justification for the subsidy. This failure to properly target the deferral subsidy is a problem shared by many other domestic and international tax expenditure provisions.

Fourth, the deferral subsidy is available even with respect to foreign subsidiaries of U.S. multinationals that produce goods for sale in the United States (sometimes referred to as the "runaway plant" problem).<sup>342</sup> In this case, the deferral subsidy creates a competitive advantage for such foreign subsidiaries over purely domestic competitors that sell the same goods in the United States. This feature is even less defensible than other aspects of the subsidy<sup>343</sup> and fails to serve either fairness or efficiency concerns. Any sensible reform of the U.S. international tax rules should at a minimum eliminate this element of the deferral subsidy.

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<sup>339</sup> See Fleming, Peroni & Shay, *Consider Ending It*, *supra* note 315, at 845; Peroni, Fleming & Shay, *Getting Serious About Curtailing Deferral*, *supra* note 133, at 469.

<sup>340</sup> See Fleming, Peroni & Shay, *Consider Ending It*, *supra* note 315, at 845; Peroni, Fleming & Shay, *Getting Serious About Curtailing Deferral*, *supra* note 133, at 469.

<sup>341</sup> See Fleming, Peroni & Shay, *Consider Ending It*, *supra* note 315, at 845; Peroni, Fleming & Shay, *Getting Serious About Curtailing Deferral*, *supra* note 133, at 469.

<sup>342</sup> See, e.g., Frisch, *supra* note 312, at 585.

<sup>343</sup> See *id.* at 585. Attempts to fix this defect in the U.S. international tax rules have been unsuccessful over the years.

Fifth, the deferral subsidy is fully available regardless of the extent to which it actually ameliorates other alleged defects in the U.S. international tax rules, such as the supposed over-restrictiveness of the foreign tax credit limitation and the interest expense allocation rules, which are said by deferral advocates to help create a competitiveness problem for U.S. multinational corporations.<sup>344</sup> This argument in favor of deferral was difficult to sustain even before the American Jobs Creation Act of 2004 eviscerated the foreign tax credit limitations in section 904(d) and changed the interest allocation rules in a way favorable to U.S. multinational corporations (the latter change effective for tax years ending after 2008).<sup>345</sup> Whatever strength this argument in favor of the deferral subsidy ever had has been dissipated by this 2004 legislation. In fact, in many cases, the effective U.S. tax rate on foreign-source business income is quite low or even negative,<sup>346</sup> so no competitiveness problem can be shown to exist.

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<sup>344</sup> See Fleming, Peroni & Shay, *Consider Ending It*, *supra* note 315, at 846; Peroni, Fleming & Shay, *Getting Serious About Curtailing Deferral*, *supra* note 133, at 469–70.

<sup>345</sup> See Fleming & Peroni, *ETI Repeal*, *supra* note 316. For another spirited critique of the international tax provisions in the 2004 legislation, see Charles I. Kingson, *The Great American Jobs Act Caper*, 58 TAX L. REV. 327 (2005). For a contrary view that characterizes the international tax component of the 2004 legislation as consisting of “mostly justified simplification measures,” see Reuven S. Avi-Yonah, *The Silver Lining: The International Tax Provisions of the American Jobs Creation Act — A Reconsideration*, 59 BULL. FOR INT’L FISCAL DOCUMENTATION 27 (2005); Reuven S. Avi-Yonah, *All of a Piece Throughout: The Four Ages of U.S. International Taxation*, 25 VA. TAX REV. 313, 334 (2005).

<sup>346</sup> See, e.g., Rosanne Altshuler & T. Scott Newlon, *The Effects of U.S. Tax Policy on the Income Repatriation Patterns of U.S. Multinational Corporations*, in STUDIES IN INTERNATIONAL TAXATION 77, 90–92 (Alberto Giovannini, R. Glenn Hubbard & Joel Slemrod eds., 1993) (finding that the average U.S. tax rate on the foreign-source income of a large sample of U.S. multinational corporations was only 3.4% in 1986); Harry Grubert & John Mutti, *Taxing Multinationals in a World with Portfolio Flows and R&D: Is Capital Export Neutrality Obsolete?*, 2 INT’L TAX & PUB. FIN. 439, 451–52 (1995) [hereinafter Grubert & Mutti, *Taxing Multinationals*] (using 1990 tax return data, the authors calculated a residual effective U.S. tax rate of about 2.7% on active foreign-source income and an effective tax rate of only about 1.9% if the deferred income of foreign subsidiaries is taken into account; the authors calculated a *negative* effective tax rate of about 2.6% if certain misclassifications of U.S.-source income as foreign-source income under current law are taken into account); Stephen E. Shay, *Exploring Alternatives to Subpart F*, 82 TAXES 29, 38 (Mar. 2004); Martin A. Sullivan, *Economic Analysis: Data Shows Dramatic Shift of Profits to Tax Havens*, 104 TAX NOTES 1190 (Sept. 13, 2004) (“The profits of foreign subsidiaries of U.S. corporations in 18 tax havens soared from \$88 billion in 1999 to \$149 billion in 2002.”); see also PRESIDENT’S ADVISORY PANEL ON FEDERAL TAX REFORM, PROPOSALS, *supra* note



Thus, as is true of most tax expenditure provisions in the federal income tax system, the deferral subsidy provides more governmental relief than is necessary to achieve its claimed objectives and, therefore, is quite wasteful. Congress would not likely enact a direct governmental program having this effect.

Sixth, the availability of, and amount of benefit received from, the deferral subsidy is unrelated to whether the subsidy furthers a specific foreign policy or economic assistance objective of the United States by encouraging the taxpayer to operate in the low-tax foreign country.<sup>347</sup> Thus, deferral is a poorly targeted tax incentive program, which may work at cross-purposes with other tax and nontax U.S. governmental policies.

In sum, TEA demonstrates that deferral is a costly and ineffective tax subsidy — namely, a tax expenditure which cannot pass muster under any serious cost/benefit scrutiny. Accordingly, as we and another co-author have argued in a series of articles, the deferral subsidy should be eliminated by taxing U.S. shareholders currently on their pro rata shares of a CFC's net income, whether or not distributed, and allowing them a foreign tax credit for any foreign income taxes imposed on such income (subject to a properly designed foreign tax credit limitation).<sup>348</sup> Repealing deferral in the way we

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15, at 104 (noting that under the current U.S. international tax system, some U.S. multinationals are taxed at a lower rate on their foreign-source income than they would be under an explicit exemption system and that some other multinationals are taxed at a negative rate on their foreign-source income); *International Task Force Report*, *supra* note 242, at 655–56 (“The effective rate of U.S. and foreign income taxation of foreign income is understood to be materially lower than the effective rate on domestic income.”).

<sup>347</sup> See Fleming, Peroni & Shay, *Consider Ending It*, *supra* note 315, at 846; Peroni, Fleming & Shay, *Getting Serious About Curtailing Deferral*, *supra* note 133, at 469.

<sup>348</sup> See Fleming, Peroni & Shay, *Consider Ending It*, *supra* note 315, at 850; Peroni, *Back to the Future*, *supra* note 133, at 989–92; Peroni, Fleming & Shay, *Getting Serious About Curtailing Deferral*, *supra* note 133, at 523–24. For Treasury Department discussions of various alternatives to the current Subpart F regime, see U.S. TREAS. DEP'T, *DEFERRAL STUDY*, *supra* note 216, at 86–95; U.S. TREAS. DEP'T, *INTERIM REPORT*, *supra* note 309, at 41–53. For other commentary recommending termination of the deferral privilege, see Reuven S. Avi-Yonah, *To End Deferral As We Know It: Simplification Potential of Check-the-Box*, 74 TAX NOTES 219 (Jan. 13, 1997); Asim Bhansali, Note, *Globalizing Consolidated Taxation of United States Multinationals*, 74 TEX. L. REV. 1401 (1996); Green, *supra* note 39, at 74–80; Joseph Isenbergh, *Perspectives on the Deferral of U.S. Taxation of the Earnings of Foreign Corporations*, 66 TAXES 1062 (1988); Stephen E. Shay, *Revisiting U.S. Anti-Deferral Rules*, 74 TAXES 1042 (1996). For a critique of proposals to end deferral, see Reuven

propose in these articles would enhance the competitiveness of U.S. multinationals by removing the distortions of economic behavior occasioned by the current deferral subsidy, combined with the incoherent Subpart F and passive foreign investment company anti-deferral regimes. U.S. multinationals would then be free to make locational decisions and earnings repatriation decisions based on the highest and best use of the funds involved.<sup>349</sup> If, despite this change, the effect of U.S. taxation on the competitiveness of U.S. multinational corporations in the global economy is demonstrated to be an actual and serious problem, the first remedy that should be tried is an across-the-board reduction in the corporate tax rates in section 11, not a distortive regime that effectively exempts only one type of income (foreign-source business income) from U.S. income tax.<sup>350</sup>

### B. Cross-Crediting

To mitigate international double taxation and attempt to prevent such double taxation from discouraging economically efficient cross-border transactions,<sup>351</sup> the United States grants U.S. citizens, resident

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S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 TEX. L. REV. 1301, 1329 (1996) [hereinafter Avi-Yonah, *Structure of International Taxation*].

<sup>349</sup> See also Edward D. Kleinbard, *Throw Territorial Taxation from the Train*, 114 TAX NOTES 547 (Feb. 5, 2007) [hereinafter Kleinbard, *Territorial Taxation*] (making a similar claim with respect to his full-inclusion “business enterprise income tax” proposal). Kleinbard’s business enterprise income tax proposal first appeared in print in bare-bones outline form in 2005. See Edward D. Kleinbard, *The Business Enterprise Income Tax: A Prospectus*, 106 TAX NOTES 97 (Jan. 3, 2005).

<sup>350</sup> See STAFF OF JOINT COMM. ON TAXATION, 106TH CONG., OVERVIEW OF PRESENT-LAW RULES AND ECONOMIC ISSUES IN INTERNATIONAL TAXATION 57 (Joint Comm. Print 1999) (“A policy that reduces all tax rates (applied to domestic and foreign source income equally) is superior to a policy of equal revenue cost that reduces tax rates only on foreign source income. With a broad reduction in rates, there is a comparable increase in the rate of saving with no distortion of the allocation of capital.”); MICHAEL J. GRAETZ, 100 MILLION UNNECESSARY RETURNS: A SIMPLE, FAIR, AND COMPETITIVE TAX PLAN FOR THE UNITED STATES 123 (2008) (“In my view, the most important corporate tax change Congress could enact — both to stimulate our domestic economy and to increase the competitiveness of U.S. companies throughout the world — would be to lower our corporate tax rate substantially.”); Sullivan, *A Challenge*, *supra* note 324, at 959; see also Peroni, *End It, Don’t Mend It*, *supra* note 311, at 1619; Peroni, *The Proper Approach*, *supra* note 315, at 1592. For the reasons discussed earlier in this article, see *supra* text accompanying notes 189–209, such an across-the-board tax cut would not constitute a tax expenditure program and would not have to undergo TEA.

<sup>351</sup> See, e.g., GUSTAFSON, PERONI & PUGH, *supra* note 133, at 277; OWENS, *supra*

aliens, and domestic corporations a foreign tax credit.<sup>352</sup> The foreign tax credit is in the form of a dollar-for-dollar offset of qualifying foreign taxes against the taxpayer's pre-credit U.S. tax liability, but has long been subject to limitations of various types. Under the overall limitation in section 904(a), the taxpayer's foreign tax credit for the year is limited to the taxpayer's pre-foreign tax credit U.S. tax liability on the taxpayer's foreign-source taxable income (i.e., foreign source gross income minus the allowable deductions that are allocable and apportionable to such income).<sup>353</sup> The purpose of the overall limitation is to prevent the foreign tax credit from offsetting U.S. tax liability on U.S.-source taxable income.<sup>354</sup> Under current law, section 904(d) breaks down this overall limitation into two categories, or "baskets," which prevent the excess foreign tax credits from one basket of foreign-source taxable income from being offset (cross credited) against the U.S. residual tax liability on low-taxed foreign-source taxable income in the other basket.<sup>355</sup> Note, however, that a taxpayer may freely cross credit the foreign tax credits generated on high-taxed foreign income against the U.S. residual tax on low-taxed foreign income within the same limitation category or basket.<sup>356</sup>

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note 322, at 2–3.

<sup>352</sup> See I.R.C. §§ 901–903.

<sup>353</sup> I.R.C. § 904(a).

<sup>354</sup> See, e.g., U.S. TREAS. DEP'T, INTERIM REPORT, *supra* note 309, at 3–4, 18; U.S. TREAS. DEP'T, BACKGROUND PAPER, *supra* note 1, at 45; GUSTAFSON, PERONI & PUGH, *supra* note 133, at 372; OWENS, *supra* note 322, at 198. The foreign tax credit limitations in section 904, including the overall limitation, conflict with a strict application of efficiency objectives because these limitations may discourage U.S. persons from investing in high-tax foreign countries. See, e.g., U.S. TREAS. DEP'T, INTERIM REPORT, *supra* note 309, at 18; Ault & Bradford, *supra* note 133, at 40. However, concern with preservation of the U.S. tax base from inappropriate erosion overrides these efficiency objectives and, accordingly, Congress has imposed some form of limitation on the foreign tax credit since 1921. See *id.* Stated differently, allowing an unlimited foreign tax credit would amount to a U.S. tax subsidy of high-tax foreign countries and "would encourage foreign countries to impose discriminatorily higher taxes on U.S. persons." Peroni, *Back to the Future*, *supra* note 133, at 978; see Frisch, *supra* note 312, at 583; Charles I. Kingson, *The Foreign Tax Credit and Its Critics*, 9 AM. J. TAX POL'Y 1, 56 (1991) [hereinafter Kingson, *Foreign Tax Credit*]. Moreover, the fundamental purpose of the foreign tax credit is to mitigate international double taxation and this is accomplished if a foreign tax credit is allowed to the extent of the pre-credit U.S. tax on the U.S. taxpayer's foreign-source income. See, e.g., AULT & ARNOLD, *supra* note 135, at 362.

<sup>355</sup> See GUSTAFSON, PERONI & PUGH, *supra* note 133, at 34, 377–87; 2 ISENBERGH, *supra* note 133, ch. 57; 1 KUNTZ & PERONI, *supra* note 133, ¶ B4.16.

<sup>356</sup> See U.S. TREAS. DEP'T, INTERIM REPORT, *supra* note 309, at 18; GUSTAFSON,

Proponents of cross-crediting typically argue that the U.S. tax system should allow liberal cross-crediting because such cross-crediting enhances the competitiveness of U.S. multinational corporations in the global economy.<sup>357</sup> These claims, however, suffer from many of the same defects as do the competitiveness arguments in support of the deferral subsidy discussed above, including, most importantly, a paucity of empirical support for such claims.<sup>358</sup>

To determine whether cross-crediting represents a departure from a normative baseline and, therefore, a tax expenditure provision, we must first identify a baseline. In this context, we can articulate the baseline in two alternative ways — a per-item (i.e., per-transaction) foreign tax credit limitation or a per-country foreign tax credit limitation.

*Per-item foreign tax credit limitation.* Because the income tax system is based on transactions and the fundamental purpose of the foreign tax credit is to mitigate international double taxation, a theoretically pure foreign tax credit limitation would be applied on an item-by-item (i.e., transaction-by-transaction) basis.<sup>359</sup> An item-by-item foreign tax credit limitation would ensure that a taxpayer's foreign tax credit is limited to the actual amount of foreign income tax imposed on the taxpayer's foreign-source income and would greatly minimize, if not completely eliminate, the subsidy aspects of the

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PERONI & PUGH, *supra* note 133, at 373–75, 383–85; SCHOLES, WOLFSON, ERICKSON, MAYDEW & SHEVLIN, *supra* note 23, at 318–22; Ault & Bradford, *supra* note 133, at 18.

<sup>357</sup> See U.S. TREAS. DEP'T, INTERIM REPORT, *supra* note 309, at 22; GUSTAFSON, PERONI & PUGH, *supra* note 133, at 375–76; 1 NATIONAL FOREIGN TRADE COUNCIL, THE NFTC FOREIGN INCOME TAX PROJECT: INTERNATIONAL TAX POLICY FOR THE 21ST CENTURY — PART TWO: RELIEF OF INTERNATIONAL DOUBLE TAXATION 301–09 (2001) [hereinafter NFTC, RELIEF OF INTERNATIONAL DOUBLE TAXATION], available at [http://www.nftc.org/default/tax/fip/NFTC1a%Part%20Volume1\\_part2Chap1-5.pdf](http://www.nftc.org/default/tax/fip/NFTC1a%Part%20Volume1_part2Chap1-5.pdf).

<sup>358</sup> See *supra* text accompanying notes 332–47.

<sup>359</sup> See, e.g., U.S. TREAS. DEP'T, THE PRESIDENT'S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH, AND SIMPLICITY 386 (1985) [hereinafter U.S. TREAS. DEP'T, PRESIDENT'S 1985 TAX PROPOSALS], available at <http://www.ustreas.gov/offices/tax-policy/library/tax-reform/pres85index.shtml> (“Double taxation would be fully relieved if income derived from each separate transaction were treated separately for credit purposes and the U.S. tax were offset by a credit for the foreign tax paid with respect to that income.”); ALI, INTERNATIONAL TAX STUDY, *supra* note 133, at 318–21 (“[I]t is believed that an item-by-item approach provides the correct theoretical starting point for considering the credit limitation . . . .”); Peroni, *Back to the Future*, *supra* note 133, at 996; see also AULT & ARNOLD, *supra* note 135, at 362; Kingson, *Foreign Tax Credit*, *supra* note 354, at 17. *But see* McClure & Bouma, *supra* note 332, at 1403 n.192.

foreign tax credit.<sup>360</sup> Any foreign tax credit limitation other than the per-item approach allows some degree of cross-crediting, which in effect subsidizes a U.S. taxpayer's business and investment activities in low-tax foreign countries.<sup>361</sup> A per-item approach has not been adopted, however, because it would impose substantial administrative costs on both taxpayers and the government that would exceed its benefits.<sup>362</sup> Nevertheless, because such an approach represents the limitation that most fully implements the mitigation of double taxation purpose underlying the foreign tax credit, it is appropriate to use the per-item limitation as a benchmark for determining whether cross-crediting is a tax expenditure.

*Per-country foreign tax credit limitation.* A per-country limitation allows a U.S. taxpayer to credit foreign taxes only to the extent of the pre-foreign tax credit U.S. tax liability on the taxpayer's income from sources within a particular foreign country.<sup>363</sup> This approach, therefore, does not allow the taxpayer to cross credit or average high foreign taxes above the top U.S. tax rate on foreign-source income earned in one foreign country against the taxpayer's residual U.S. tax liability on foreign-source income earned in a different low-tax or no-

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<sup>360</sup> See, e.g., U.S. TREAS. DEP'T, PRESIDENT'S 1985 TAX PROPOSALS, *supra* note 359, at 386–88; ALI, INTERNATIONAL TAX STUDY, *supra* note 133, at 318–19.

<sup>361</sup> See, e.g., U.S. TREAS. DEP'T, PRESIDENT'S 1985 TAX PROPOSALS, *supra* note 359, at 386–87 (“Any departure from a transactional approach to crediting foreign tax will permit some averaging of foreign taxes and will therefore involve some surrender of the residual tax imposed by the United States on foreign income that is taxed by foreign countries at rates below the U.S. rate.”); ALI, INTERNATIONAL TAX STUDY, *supra* note 133, at 318–19.

<sup>362</sup> See U.S. TREAS. DEP'T, PRESIDENT'S 1985 TAX PROPOSALS, *supra* note 359, at 388 (“[T]he technical complexity of such a system would make it unworkable.”); ALI, INTERNATIONAL TAX STUDY, *supra* note 133, at 319–20; Yariv Brauner, *An International Tax Regime in Crystallization*, 56 TAX L. REV. 259, 286 (2003).

<sup>363</sup> See 2 U.S. TREAS. DEP'T, TAX REFORM, *supra* note 9, at 360–63; U.S. TREAS. DEP'T, PRESIDENT'S 1985 TAX PROPOSALS, *supra* note 359, at 385–96; Peroni, *Back to the Future*, *supra* note 133, at 995–96; Robert J. Peroni, J. Clifton Fleming, Jr. & Stephen E. Shay, *Reform and Simplification of the U.S. Foreign Tax Credit Rules*, 101 TAX NOTES 103, 121 (Oct. 6, 2003) [hereinafter Peroni, Fleming & Shay, *Reform of Foreign Tax Credit Rules*]; see also ALI, INTERNATIONAL TAX STUDY, *supra* note 133, at 321, 323–26; GUSTAFSON, PERONI & PUGH, *supra* note 133, at 376–77. For critiques of the per-country foreign tax credit limitation, see Alan W. Granwell, *Calculating the Foreign Tax Credit Limitation on a Per Country Basis*, 28 TAX NOTES 567 (July 29, 1985); John P. Steines, Jr., *Foreign Tax Credit Reform: A Response to Peroni*, et al., 101 TAX NOTES 134 (Oct. 6, 2003); David R. Tillinghast, *International Tax Simplification*, 8 AM. J. TAX POL'Y 187, 216–17 (1990).

tax foreign country.<sup>364</sup> Instead, the per-country limitation restricts a U.S. taxpayer's cross-crediting opportunities to high-taxed and low-taxed foreign-source income within the same foreign country. As a practical matter, this approximates the theoretically correct per-item result because tax haven countries will rarely impose tax in excess of the U.S. rate on any significant amount of income and, consequently, cross-crediting opportunities will be minimal. Accordingly, unlike the overall limitation or even a multi-basket foreign tax credit limitation, the per-country limitation eliminates double taxation without creating a significant incentive for U.S. taxpayers to shift investments from the United States to low-tax countries.<sup>365</sup> Thus, the per-country limitation promotes economic efficiency.<sup>366</sup>

The cross-crediting allowed by the current two-basket system in revised section 904(d) (which was enacted in 2004 and became effective in 2007) is a clear departure from either the per-item or per-country baseline.<sup>367</sup> Thus, cross-crediting operates as a subsidy for foreign investment by allowing a U.S. person to credit foreign taxes higher than the U.S. rate on some types of foreign-source income against the U.S. residual tax on other types of low- or zero-taxed foreign-source income, which is the equivalent of the U.S. government giving the U.S. person a grant in the amount of the U.S. residual tax eliminated.<sup>368</sup> Moreover, cross-crediting enhances the benefit of the

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<sup>364</sup> See, e.g., OWENS, *supra* note 322, at 198–200.

<sup>365</sup> See 2 U.S. TREAS. DEP'T, TAX REFORM, *supra* note 9, at 360–61, 363; U.S. TREAS. DEP'T, PRESIDENT'S 1985 TAX PROPOSALS, *supra* note 359, at 386–88, 394–95; Peroni, *Back to the Future*, *supra* note 133, at 995–96; Peroni, Fleming & Shay, *Reform of Foreign Tax Credit Rules*, *supra* note 363, at 121; Shay, Fleming & Peroni, *Source Rules*, *supra* note 39, at 153.

<sup>366</sup> ALI, INTERNATIONAL TAX STUDY, *supra* note 133, at 323; Fleming & Peroni, *ETI Repeal*, *supra* note 316, at 1405. *But see* 1 NFTC, RELIEF OF INTERNATIONAL DOUBLE TAXATION, *supra* note 357, at 296–97.

<sup>367</sup> Even the nine-basket system enacted as part of the Tax Reform Act of 1986 allowed a good deal of cross-crediting and therefore was a clear departure from either baseline because one of the baskets in that system, the general or residual basket, contained a significant majority of the foreign-source income earned by U.S. persons. See, e.g., U.S. TREAS. DEP'T, INTERIM REPORT, *supra* note 309, at 20 (stating that “approximately 75 percent of all foreign source income falls within the general limitation category” of former section 904(d)(1)(I), before its amendment in 2004). For the authors' critique of the foreign tax credit limitation changes made by the American Jobs Creation Act of 2004, see generally Fleming & Peroni, *ETI Repeal*, *supra* note 316.

<sup>368</sup> As we have discussed in an earlier article, cross-crediting remains a serious problem notwithstanding the nominal worldwide decline in corporate tax rates. See Fleming & Peroni, *ETI Repeal*, *supra* note 316, at 1403–04; see also Simeon Djankov,

deferral subsidy by eliminating or reducing the U.S. residual tax on a CFC's foreign-source income when the income is eventually repatriated.<sup>369</sup> To the extent that the U.S. residual tax is eliminated, the U.S. system of worldwide taxation with deferral is converted into a "self-help" elective exemption system, which is more generous to taxpayers than a properly designed, nonelective exemption system for taxing foreign business income<sup>370</sup> and which is inconsistent with the ability-to-pay and SHS principles underlying an income tax system.

The cross-crediting subsidy does not survive a cost/benefit analysis because it has the inefficient effect of encouraging U.S. persons with high-taxed foreign-source income to shift some of their business and investment activities to low-tax foreign countries even if the pre-tax return in those countries is lower than in the United States.<sup>371</sup> Congress would not likely enact an equivalent direct

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Tim Ganser, Caralee McLeish, Rita Ramalho & Andrei Shleifer, *The Effect of Corporate Taxes on Investment and Entrepreneurship* (2007), available at <http://www.nber.org/confer/2007/pef07/shleifer.pdf> (graph entitled "Effective Corporate Tax Rate on Business Density," which identifies approximately twenty countries with effective corporate tax rates higher than that of the United States). For a contrary view arguing that probably cross-crediting or averaging should be ignored by U.S. tax policymakers and an overall foreign tax credit limitation should be adopted, see AVI-YONAH, *INTERNATIONAL TAX AS INTERNATIONAL LAW*, *supra* note 312, at 158–62.

<sup>369</sup> See, e.g., STAFF OF JOINT COMM. ON TAXATION, 108TH CONG., *THE IMPACT OF INTERNATIONAL TAX REFORM: BACKGROUND AND SELECTED ISSUES RELATING TO U.S. INTERNATIONAL TAX RULES AND THE COMPETITIVENESS OF U.S. BUSINESSES* 64 (Joint Comm. Print 2006) ("[B]ecause excess foreign tax credits cannot be carried forward indefinitely, deferral expands the opportunity for cross-crediting (if effective foreign tax rates vary across years or across jurisdictions) by not deeming high foreign taxes to be paid until a year when the U.S. taxpayer chooses also to repatriate low-taxed foreign source income."); James R. Hines, Jr. & R. Glenn Hubbard, *Coming Home to America: Dividend Repatriations by U.S. Multinationals*, in *TAXATION IN THE GLOBAL ECONOMY* 161, 178 (Assaf Razin & Joel Slemrod eds., 1990) ("[T]he combination of the credit system and deferral can diminish substantially the revenue raised by the United States from the taxation of overseas operations of U.S. multinationals."); see also Kingson, *Coherence*, *supra* note 315, at 1270 ("[E]nding deferral without changing the overall foreign tax credit limitation might have only limited revenue impact . . .").

<sup>370</sup> See GRUBERT & MUTTI, *TAXING INTERNATIONAL BUSINESS INCOME*, *supra* note 317, at 12–13, 27–28, 42; Peroni, *The Proper Approach*, *supra* note 315, at 1586; Shay, Fleming & Peroni, *Source Rules*, *supra* note 39, at 153; see also U.S. TREAS. DEP'T, *COMPETITIVENESS REPORT*, *supra* note 307, at 57 (describing how the current U.S. international tax system allows U.S. multinational corporations to engage in "self-help territoriality").

<sup>371</sup> See, e.g., Ault & Bradford, *supra* note 133, at 40–41; James Kvaal, *Removing Tax Subsidies for Foreign Investment*, 111 *TAX NOTES* 1299 (June 12, 2006). *But see* 1

expenditure program that provided government grants to encourage U.S. taxpayers to shift their business and investment activities in this way.

*C. Example Illustrating the Effects of Deferral and Cross-Crediting*

These points concerning the effects of deferral and cross-crediting as tax subsidy programs can be illustrated with the following example. USCo is a U.S. domestic corporation that is about to build a new manufacturing plant and is debating whether to locate this facility in the United States or in Country X, a tax haven with no business profits tax, no withholding tax regime, and no branch profits tax.<sup>372</sup> USCo pays U.S. federal income tax at a 35% rate. Regardless of where USCo's new plant is situated, it will produce a \$1 million before-tax profit in Year 1 that will be reinvested at a 10% rate of return in the new manufacturing operation and then extracted and repatriated to USCo at the end of Year 2. The interest and discount rates are 10% per annum.

The following columns show the results of four different scenarios. To be specific, in column (1), the new factory is located in the United States and current law applies.<sup>373</sup> In column (2), the new factory is Country X property of USCo's wholly owned Country X subsidiary and the United States employs a worldwide income tax system with deferral but with effective barriers to cross-crediting. In column (3), the facts are the same as for column (2) except that USCo is allowed to eliminate U.S. tax on repatriated Country X income by cross crediting high foreign taxes on manufacturing income earned in Countries Y and Z, two developed foreign countries with income tax systems that have applicable tax rates above the top U.S. rate. In column (4), the new factory is located in Country X and the United States employs an exemption (territorial) tax system for foreign-source active business income.<sup>374</sup>

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NFTC, RELIEF OF INTERNATIONAL DOUBLE TAXATION, *supra* note 357.

<sup>372</sup> The example expressly assumes that Country X is a tax haven. Accordingly, if these taxes were imposed by Country X, they would have a very low rate and would be fully eliminated through foreign tax credits against USCo's U.S. income tax liability. Thus, all these taxes would likely be inconsequential and, to simplify this example, we assume that Country X does not impose them.

<sup>373</sup> Column (1) also shows the results if USCo located the factory in Country X and made the investment through a Country X subsidiary, but U.S. tax law were changed to (i) end deferral completely and (ii) effectively prevent cross-crediting.

<sup>374</sup> For the authors' tax policy critique of two similar proposed U.S. exemption



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systems, see J. Clifton Fleming, Jr. & Robert J. Peroni, *Exploring the Contours of a Proposed U.S. Exemption (Territorial) Tax System*, 109 TAX NOTES 1557 (Dec. 19, 2005) [hereinafter Fleming & Peroni, *Exploring the Contours of a Proposed U.S. Exemption System*] (critiquing proposals by the Staff of the Joint Committee on Taxation, STAFF OF JOINT COMM. ON TAX'N, OPTIONS, *supra* note 333, at 186–97, and by President Bush's Advisory Panel on Federal Tax Reform, PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, PROPOSALS, *supra* note 15, at 105, 132–35). For other commentary on these two exemption proposals, see Lawrence Lokken, *Territorial Taxation: Why Some U.S. Multinationals May Be Less Than Enthusiastic About the Idea (And Some Ideas They Really Dislike)*, 59 SMU L. REV. 751 (2006); McDaniel, *Herman Goldman Lecture*, *supra* note 335; McDaniel, *Territorial vs Worldwide*, *supra* note 335; Peter Merrill, Oren Penn, Hans-Martin Eckstein, David Grosman & Martijn van Kessel, *Restructuring Foreign-Source-Income Taxation: U.S. Territorial Tax Proposals and the International Experience*, 111 TAX NOTES 799 (May 15, 2006); James R. Repetti, *Will U.S. Investment Go Abroad in a Territorial Tax: A Critique of the President's Advisory Panel on Tax Reform*, 8 FLA. TAX REV. 303 (2007); George K. Yin, *Reforming the Taxation of Foreign Direct Investment by U.S. Taxpayers*, 118 TAX NOTES 173 (Jan. 7, 2008). For other critiques of exemption proposals for taxing foreign-source income, see U.S. TREAS. DEP'T, PRESIDENT'S 1985 TAX PROPOSALS, *supra* note 359, at 383; Hugh J. Ault, *Commentary*, 9 AM. J. TAX POL'Y 61 (1991); Kingson, *Foreign Tax Credit*, *supra* note 354, at 52–55; Kleinbard, *Territorial Taxation*, *supra* note 349. For commentary generally supporting one form or another of an exemption system for taxing international income, see GRUBERT & MUTTI, TAXING INTERNATIONAL BUSINESS INCOME, *supra* note 317; Terrence R. Chorvat, *Ending the Taxation of Foreign Business Income*, 42 ARIZ. L. REV. 835 (2000); Michael J. Graetz & Paul W. Oosterhuis, *Structuring an Exemption System for Foreign Income of U.S. Corporations*, 54 NAT'L TAX J. 771 (2001) (taking the position that enactment of an exemption system would provide significant opportunities for simplification of U.S. international income tax law); Kvaal, *supra* note 371 (arguing for a partial exemption system); H. David Rosenbloom, *From the Bottom Up: Taxing the Income of Foreign Controlled Corporations*, 26 BROOK. J. INT'L L. 1525, 1544 (2001); Klaus Vogel, *World-wide vs. Source Taxation of Income — A Review and Reevaluation of Arguments*, in INFLUENCE OF TAX DIFFERENTIALS ON INTERNATIONAL COMPETITIVENESS 117 (1990). For an earlier Treasury report that compares a modified exemption system with a current inclusion regime as alternative tax reform proposals, see U.S. TREAS. DEP'T, INTERIM REPORT, *supra* note 309, at 41–53.

	<u>Column (1)</u> U.S. Location, Current Law	<u>Column (2)</u> Country X CFC, Worldwide Taxation with Deferral, But No Cross-Crediting	<u>Column (3)</u> Same as Column (2), But with Cross- Crediting	<u>Column (4)</u> Country X Location, U.S. Exemption System
Year 1 Net Profit	\$1,000,000	\$1,000,000	\$1,000,000	\$1,000,000
Year 1 U.S. Tax @ 35%	<u>- 350,000</u>	<u>- 0 -</u> <sup>376</sup>	<u>- 0 -</u>	<u>- 0 -</u>
Invested in Year 2 @ 10%	\$ 650,000	\$1,000,000	\$1,000,000	\$1,000,000
Year 2 Return	+ 65,000	+ 100,000	+ 100,000	+ 100,000
Year 2 35% U.S. Tax on Year 2 Return	<u>- 22,750</u>	<u>- 0 -</u>	<u>- 0 -</u>	<u>- 0 -</u>
Distribution to USCo Headquarters	\$ 692,250	\$1,100,000	\$1,100,000	\$1,100,000
Dividend Tax @ 35%	<u>- 0 -</u> <sup>375</sup>	<u>- 385,000</u>	<u>- 0 -</u> <sup>377</sup>	<u>- 0 -</u> <sup>378</sup>
After-Tax Net to USCo	\$ 692,250	\$ 715,000	\$1,100,000	\$1,100,000

<sup>375</sup> There is no U.S. dividend tax in this column because the distribution to U.S. headquarters is either an intracorporate payment from a U.S. branch or a distribution by a wholly owned U.S. subsidiary that is not taxable under either the consolidated return rules or section 243(a)(3). Alternatively, if USCo located the factory in Country X and used a Country X subsidiary to make the investment, but deferral were ended completely and cross-crediting were prevented, the distribution by the Country X subsidiary to USCo would be exempt from U.S. tax because the earnings of the Country X subsidiary out of which the distribution was made would have already been subject to U.S. tax in the hands of its U.S. shareholder, USCo, in Years 1 and 2. See I.R.C. § 959.

<sup>376</sup> The Country X income is income from manufacturing within Country X and, therefore, Subpart F does not apply a Year 1 U.S. tax, regardless of whether or how much foreign tax is imposed on such income and regardless of whether the manufactured products are sold to related parties or to customers in other countries. See I.R.C. § 954(d). Thus, Subpart F does nothing to prevent deferral in this example; consequently, the \$350,000 tax in column (1) is deferred in columns (2) and (3), and eliminated by exemption in column (4) and the investments in those columns are scaled up from \$650,000 to \$1,000,000.

<sup>377</sup> Cross-crediting effectively eliminates the U.S. dividend tax.

<sup>378</sup> Under a U.S. exemption system, both dividend distributions from a foreign subsidiary's foreign-source active income and repatriations from a foreign branch's foreign-source active income likely would be exempt from U.S. tax. See generally Fleming & Peroni, *Exploring the Contours of a Proposed U.S. Exemption System*, *supra* note 374.

Note that the difference in after-tax net between columns (1) and (2) is \$22,750,<sup>379</sup> which equals USCo's tax incurred in column (1) on the Year 2 investment return when the factory is built in the United States. In other words, the consequence of deferral in column (2) is to eliminate a \$22,750 Year 2 U.S. tax that USCo would have paid if it had built the factory in the United States. Thus, USCo effectively receives a Year 2 \$22,750 subsidy from the U.S. tax system for locating the new factory in Country X instead of in the United States. This subsidy can be enjoyed annually in different amounts depending on USCo's profits and reinvestment decisions for Year 3 and beyond.

In addition, note that because cross-crediting eliminated the dividend tax in column (3), columns (3) and (4) produce identical bottom-line results. Stated differently, as mentioned earlier, loosely restrained cross-crediting, as is commonly allowed under the present U.S. system of worldwide taxation with deferral and an unrestrictive foreign tax credit limitation, effectively converts the U.S. international tax system into a poorly designed<sup>380</sup> and elective exemption regime that is more generous than a traditional exemption system.<sup>381</sup>

Finally, note that the difference between USCo's after-tax net income in column (1) and in columns (3) and (4) is not merely the \$22,750 difference between columns (1) and (2). Instead, it is a dramatically larger amount — namely, \$407,750.<sup>382</sup> The explanation is quite simple. In order to make the \$350,000 Year 1 U.S. tax in column

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<sup>379</sup> \$715,000 – \$692,250 = \$22,750.

<sup>380</sup> Among the reasons it is poorly designed is that unlike the exemption systems of countries that are international trade competitors of the United States, the U.S. system allows foreign-source losses to be deducted against U.S.-source income and effectively allows exemption treatment for foreign-source royalties.

<sup>381</sup> See authorities cited *supra* note 370. In fact, some leading U.S. multinational lobbying groups have come to understand that a properly designed exemption or territorial system would be less generous than our existing incoherent international tax system. See National Foreign Trade Council, Inc., *The NFTC's Report on Territorial Taxation*, 27 TAX NOTES INT'L 687, 707 (Aug. 5, 2002) (arguing that Congress should “reform” the U.S. international tax system by revising the Subpart F and foreign tax credit rules rather than by enacting a territorial system). This fact helps explain why many U.S. multinational corporations and their lobbying groups were opposed to the Staff of the Joint Committee on Taxation's and the Presidential Advisory Panel on Federal Tax Reform's 2005 exemption proposals, cited *supra* note 374. Moreover, because a combination of certain defective features of the current U.S. international tax rules can result in a negative effective tax rate on some types of foreign-source income, see, e.g., Grubert & Mutti, *Taxing Multinationals*, *supra* note 346, at 451–52, the current system, in some respects, may be more generous to taxpayers than would a properly designed cash flow consumption tax system.

<sup>382</sup> \$1,100,000 – \$692,250 = \$407,750.

(1) comparable to Year 2 amounts in columns (3) and (4), the \$350,000 Year 1 tax must be “grown” for one year at 10% (we are using a 10% interest assumption) so that it becomes \$385,000<sup>383</sup> at the end of Year 2. When we add this \$385,000 amount to the \$22,750 Year 2 tax in column (1), the sum is \$407,750, which equals the difference between USCo’s after-tax net in column (1) and in columns (3) and (4). In other words, the effect of the U.S. taxing regimes in columns (3) and (4) is to relieve USCo’s foreign-source income from *both* the Year 1 tax and the Year 2 tax that USCo would have incurred if it had built the factory in the United States.

Stated differently, the U.S. regimes of deferral with very loosely restrained cross-crediting (column (3)) and exemption (column (4)) provide USCo with a \$407,750 tax subsidy over Years 1 and 2 for building the new factory in Country X instead of in the United States. This subsidy can be enjoyed in future years in different amounts depending on USCo’s profits and reinvestment decisions for Year 3 and beyond. For the reasons discussed above, this tax subsidy would not survive the rigorous cost/benefit analysis under which all tax expenditure provisions should be analyzed. Consequently, TEA lends significant support to reform proposals to end or significantly curtail deferral and tighten the foreign tax credit limitation to bring the credit provision in line with its fundamental purpose of mitigating international double taxation.<sup>384</sup>

#### D. The Export Sales Source Rule

Under the current statute, income from the sale of purchased inventory is treated as arising in (i.e., sourced to) the place of sale<sup>385</sup> and, under the regulations<sup>386</sup> and case law,<sup>387</sup> the place of sale is treated

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<sup>383</sup>  $\$350,000 + (\$350,000 \times 0.10) = \$385,000$ .

<sup>384</sup> For examples of proposals to substantially curtail deferral, see Fleming, Peroni & Shay, *Consider Ending It*, *supra* note 315; Kleinbard, *Territorial Taxation*, *supra* note 349; Peroni, *Back to the Future*, *supra* note 133, at 989–92; Peroni, Fleming & Shay, *Getting Serious About Curtailing Deferral*, *supra* note 133; *see also International Task Force Report*, *supra* note 242, at 731–35. For examples of proposals to substantially reform the foreign tax credit limitation rules to restrict cross-crediting, see Peroni, *Back to the Future*, *supra* note 133, at 994–1002; Peroni, Fleming & Shay, *Reform of Foreign Tax Credit Rules*, *supra* note 363, at 113–23; *see also International Task Force Report*, *supra* note 242, at 772–76.

<sup>385</sup> *See* I.R.C. §§ 861(a)(6), 862(a)(6), 865(b).

<sup>386</sup> *See* Treas. Reg. § 1.861-7(c) (1960). The regulations, however, provide that the place where the substance of the sale occurred, instead of the place where title passed, will be treated as the place of sale if the “sales transaction is arranged in a particular

as the place where the rights, title, and interest of the seller of the inventory passes to the buyer (often referred to as the “title-passage test”). In situations where the U.S. seller is also the manufacturer of the inventory, the income is treated as partially production/manufacturing income and partially sales income,<sup>388</sup> with the production component sourced to the location of the seller’s production assets<sup>389</sup> and the sales component generally sourced under the title passage test.<sup>390</sup> The current regulations allocate the income between the production and sales functions by applying an arbitrary formula that treats 50% of the income from an export sale as sales income, which generally will be characterized as having a foreign source if title to the inventory is passed to the purchaser outside the United States.<sup>391</sup>

The result is that 50% of the U.S. seller/exporter’s income from the export sale of inventory manufactured in the United States can be treated as foreign-source income without regard to whether the U.S. seller/exporter has a sales office or sales employees abroad, without regard to whether the purchaser of the inventory is a CFC in which the U.S. exporter/seller owns a significant interest, and without regard

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manner for the primary purpose of tax avoidance.” *Id.*; see also *United States v. Balanovski*, 236 F.2d 298, 306 (2d Cir. 1956), *cert. denied*, 352 U.S. 968 (1957). The government has been generally unsuccessful when litigating the application of this tax-avoidance exception. See 3 BITTKER & LOKKEN, *supra* note 311, at 73-42, -43; GUSTAFSON, PERONI & PUGH, *supra* note 133, at 90; PHILIP F. POSTLEWAITE & SAMUEL A. DONALDSON, *INTERNATIONAL TAXATION: CORPORATE AND INDIVIDUAL* 46 (4th ed. 2003). Accordingly, the title passage test essentially determines the place of sale for inventory property, with few exceptions. See, e.g., I.R.C. § 865(e)(2).

<sup>387</sup> See, e.g., *A.P. Green Exp. Co. v. United States*, 284 F.2d 383 (Ct. Cl. 1960); *Liggett Group, Inc. v. Commissioner*, T.C. Memo. 1990-18 (1990).

<sup>388</sup> See I.R.C. §§ 863(b), 865(b); Treas. Reg. § 1.863-3(a), (b) (2006). See generally 3 BITTKER & LOKKEN, *supra* note 311, ch. 73; 1 ISENBERGH, *supra* note 133, ¶¶ 19.9–19.26; 1 KUNTZ & PERONI, *supra* note 133, ¶ A2.03[9][d].

<sup>389</sup> See Treas. Reg. § 1.863-3(c)(1) (2006).

<sup>390</sup> See I.R.C. §§ 861(a)(6), 862(a)(6), 863(b), 865(b); Treas. Reg. §§ 1.863-3(c)(2) (2006), 1.861-7(c) (1960).

<sup>391</sup> See Treas. Reg. § 1.863-3(b)(1) (2006). A taxpayer may instead elect to determine the amount of production income by using the so-called “independent factory or production price” if the taxpayer can establish that such an independent factory or production price exists. See Treas. Reg. § 1.863-3(b)(2) (2006). A third, rarely used alternative allows a taxpayer to allocate the income from export sales between the production and sales function based on the taxpayer’s books of account, but only if the taxpayer has received advanced permission from the Service district director and if certain other requirements in the regulations are met. See Treas. Reg. § 1.863-3(b)(3) (2006).

to whether any foreign country is likely to impose any tax on the sales income.<sup>392</sup> In fact, income from export sales of inventory by a U.S. seller/exporter usually bears little or no foreign income tax, unless the U.S. seller/exporter has a sales office or other fixed place of business or sales employees in the foreign country of sale.<sup>393</sup> This means that if a U.S. seller/exporter manufactures inventory and sells it to a foreign customer, which may be the seller's CFC, and passes title to the goods sold abroad, the result is zero-foreign-taxed income, half of which is characterized as foreign-source sales income for foreign tax credit limitation purposes.<sup>394</sup> This result occurs even though most of the income producing activity occurred in the United States. If the U.S. seller/exporter also has high-taxed foreign-source income from other transactions (i.e., income taxed at foreign tax rates in excess of the top U.S. rate), the excess credits on the high-taxed income can be offset (cross credited) against the U.S. residual tax on the zero-taxed export sales income and thereby reduce or eliminate the U.S. income tax on the export sales income.<sup>395</sup> Consequently, export sales activity is subsidized by effectively reducing the U.S. income tax on the export sales income.<sup>396</sup>

*Export sales source rule is a tax expenditure.* Rules for determining the geographic source of a taxpayer's income and deductions are essentially legal concepts that have no independent economic significance.<sup>397</sup> Instead, they work with other rules in the tax code to define the scope of the U.S. taxing jurisdiction over foreign persons with respect to their activities within the United States and over U.S. persons with respect to their activities outside the United States.<sup>398</sup> In

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<sup>392</sup> See Treas. Reg. § 1.863-3(b)(1) (2006).

<sup>393</sup> See, e.g., U.S. TREASURY DEP'T, REPORT TO THE CONGRESS ON THE SALES SOURCE RULES 1 (1993) [hereinafter U.S. TREAS. DEP'T, SALES SOURCE RULES REPORT].

<sup>394</sup> See, e.g., Donald J. Rousslang, *The Sales Source Rules for U.S. Exports: How Much Do They Cost?*, 62 TAX NOTES 1047 (Feb. 21, 1994) [hereinafter Rousslang, *Sales Source Rules*].

<sup>395</sup> See, e.g., *International Task Force Report*, *supra* note 242, at 703–05; Kingson, *Foreign Tax Credit*, *supra* note 354, at 20–22; Peroni, Fleming & Shay, *Reform of Foreign Tax Credit Rules*, *supra* note 363, at 118. The effect of cross-crediting in reducing U.S. income tax is illustrated with the example *supra* Part VI.C.

<sup>396</sup> See U.S. TREAS. DEP'T, SALES SOURCE RULES REPORT, *supra* note 393, at 13; Rousslang, *Sales Source Rules*, *supra* note 394, at 1047.

<sup>397</sup> See Ault & Bradford, *supra* note 133, at 12, 30–31; see also Graetz, *Taxing International Income*, *supra* note 213, at 317.

<sup>398</sup> See, e.g., 2 U.S. TREAS. DEP'T, TAX REFORM, *supra* note 9, 364; U.S. TREAS. DEP'T, PRESIDENT'S 1985 TAX PROPOSALS, *supra* note 359, at 399.

the context of U.S. taxation of the foreign business and investment activities of a U.S. person, including a U.S. multinational corporation, the source rules serve the function of defining (through the foreign tax credit mechanism) the circumstances under which the United States is willing to give its residents a foreign tax credit and thereby cede primary taxing jurisdiction to a foreign country because the income in question is determined to have its source in that country.<sup>399</sup> As a first principle, source rules “should allocate income to the place where the economic activity generating that income occurs.”<sup>400</sup> In addition, in the context of the foreign tax credit limitation, it makes sense that the source rules be designed to prevent erosion of the legitimate U.S. tax base through taxpayer manipulation of the source rules and the foreign tax credit limitation.<sup>401</sup> To achieve these objectives of appropriate U.S. tax base preservation and accurate determination of a U.S. person’s foreign tax credit limitation, the source rules should generally treat an item of income as having a U.S. source when that income item has a “reasonable economic nexus” with the United States.<sup>402</sup> In addition, because the primary purpose of the foreign tax credit is to mitigate international double taxation, the source rules that apply for foreign tax credit purposes should treat items of income as having a U.S. source if they are not generally subject to foreign taxation.<sup>403</sup>

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<sup>399</sup> See, e.g., 2 U.S. TREAS. DEP’T, TAX REFORM, *supra* note 9, 364; U.S. TREAS. DEP’T, PRESIDENT’S 1985 TAX PROPOSALS, *supra* note 359, at 399.

<sup>400</sup> 2 U.S. TREAS. DEP’T, TAX REFORM, *supra* note 9, at 365; U.S. TREAS. DEP’T, PRESIDENT’S 1985 TAX PROPOSALS, *supra* note 359, at 399; see also U.S. TREAS. DEP’T, INTERIM REPORT, *supra* note 309, at 1–2 (“[S]ourcing rules for both income and expense must permit accurate measurement of the taxable income generated by economic activity in the United States and by the foreign activities of U.S. investors.”), 30; Graetz, *Taxing International Income*, *supra* note 213, at 317 (“[The source rules] should be overhauled to be better linked to the location of real economic activity, the location of customers, workers, or assets.”); see also ALI, INTERNATIONAL TAX STUDY, *supra* note 133, at 19.

<sup>401</sup> 2 U.S. TREAS. DEP’T, TAX REFORM, *supra* note 9, at 365; U.S. TREAS. DEP’T, PRESIDENT’S 1985 TAX PROPOSALS, *supra* note 359, at 399; U.S. TREAS. DEP’T, INTERIM REPORT, *supra* note 309, at 1–2 (stating that properly designed source rules should help safeguard the U.S. tax base from inappropriate erosion), 4, 30 (noting the relationship between properly designed source rules and the appropriate scope of a taxpayer’s foreign tax credit limitation).

<sup>402</sup> See U.S. TREAS. DEP’T, INTERIM REPORT, *supra* note 309, at 30; see also ALI, INTERNATIONAL TAX STUDY, *supra* note 133, at 348.

<sup>403</sup> See U.S. TREAS. DEP’T, INTERIM REPORT, *supra* note 309, at 4, 30.

The export sales source rule does not attempt to actually associate the income source with the economic activity giving rise to the income.<sup>404</sup> Nor does it treat income from an export sale as having a U.S. source if that income is free of foreign tax. Instead, this rule arbitrarily allows 50% of the U.S. manufacturer's income from the export sale to be treated as foreign-source income even it bears no foreign tax and even though the bulk of the taxpayer's economic activity giving rise to the income (the production and sale of goods) may take place within the United States.<sup>405</sup> This rule arbitrarily treats 50% of the export income as sales income, regardless of the actual relative contributions of the U.S. exporter's production and sales activities to the earning of the income, and then allows the exporter to use the title passage test to source the artificially characterized sales component of the income as foreign-source income. The place where title passes typically will have little or no economic connection with the earning of the income from the export sale and is subject to great manipulation by taxpayers for tax-avoidance purposes.<sup>406</sup> Moreover, most foreign countries would not tax inventory sales income merely because title to the inventory property sold passes within the country.<sup>407</sup> Instead, an office or fixed place of business to which the inventory sale is attributable is a prerequisite to taxation of such income in most foreign countries.<sup>408</sup> Thus, the title passage test for determining the source of the sales portion of the income from the export sale effectively allows a U.S. taxpayer to artificially create low- or zero-taxed foreign-source sales income that expands the taxpayer's

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<sup>404</sup> See *id.* at 31 (concluding that the export sales source rule of current law "can reach results that depart significantly from the 'economic nexus' principle"), 32 (stating that the export sales source rule of current law "can source income in a manner that departs significantly from the 'economic nexus' principle"); 1 ISENBERGH, *supra* note 133, ¶¶ 19:46–19:47.

<sup>405</sup> 2 U.S. TREAS. DEP'T, TAX REFORM, *supra* note 9, at 365–67; U.S. TREAS. DEP'T, PRESIDENT'S 1985 TAX PROPOSALS, *supra* note 359, at 399.

<sup>406</sup> See 2 U.S. TREAS. DEP'T, TAX REFORM, *supra* note 9, at 365–67; U.S. TREAS. DEP'T, PRESIDENT'S 1985 TAX PROPOSALS, *supra* note 359, at 399–400; U.S. TREAS. DEP'T, INTERIM REPORT, *supra* note 309, at 32; cf. ALI, INTERNATIONAL TAX STUDY, *supra* note 133, at 21–22; 1 ISENBERGH, *supra* note 133, ¶¶ 16:9–16:10; OWENS, *supra* note 322, at 220.

<sup>407</sup> U.S. TREAS. DEP'T, PRESIDENT'S 1985 TAX PROPOSALS, *supra* note 359, at 399; U.S. TREAS. DEP'T, INTERIM REPORT, *supra* note 309, at 32; ALI, INTERNATIONAL TAX STUDY, *supra* note 133, at 354.

<sup>408</sup> See 2 U.S. TREAS. DEP'T, TAX REFORM, *supra* note 9, at 365–67; see also U.S. TREAS. DEP'T, PRESIDENT'S 1985 TAX PROPOSALS, *supra* note 359, at 399.



foreign tax credit limitation and increases the opportunities for cross-crediting.<sup>409</sup>

This rule is designed to promote a particular type of economic activity — namely, the manufacture of goods for export abroad.<sup>410</sup> The export sales source rule is a subsidy because it enhances the deferral and cross-crediting subsidies by artificially creating foreign-source income, much of it low- or zero-taxed.<sup>411</sup> This increases the utility of foreign tax credits by increasing the numerator of the foreign tax credit limitation fraction and often permits the U.S. exporter to credit the high foreign taxes on other foreign business income against the U.S. residual tax on the low- or zero-taxed export sales income and thereby reduce or eliminate the U.S. residual tax.<sup>412</sup> In analyzing whether the export sales source rule is a subsidy, an appropriate baseline needs to be used to determine how much of the income from

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<sup>409</sup> See 2 U.S. TREAS. DEP'T, TAX REFORM, *supra* note 9, at 365; U.S. TREAS. DEP'T, PRESIDENT'S 1985 TAX PROPOSALS, *supra* note 359, at 350–51, 399–400; ALI, INTERNATIONAL TAX STUDY, *supra* note 133, at 354. Concerns with the manipulability of the sales source rules for business income are longstanding. For example, Thomas Sewell Adams, an early 20th Century economist and consultant to the Treasury Department, whose work was influential in creating the U.S. rules for taxing international income, objected to an early version of the export sales source rule on the grounds that “such a rule denied the United States authority to tax much income that was, in essence, produced domestically and that such a rule was open to taxpayer manipulation.” Graetz & O’Hear, *supra* note 312, at 1057.

<sup>410</sup> See, e.g., U.S. TREAS. DEP'T, SALES SOURCE RULES REPORT, *supra* note 393, at 1; 1 ISENBERGH, *supra* note 133, ¶ 19:47 (noting that the purpose of the export sales source rule “is to confer a tax benefit on the export of manufactured goods from the United States”); Graetz, *Taxing International Income*, *supra* note 213, at 317; see also U.S. TREAS. DEP'T, INTERIM REPORT, *supra* note 309, at 32 (concluding that the export sales source rule of current law “can create a tax preference for exports over domestic sales”). One leading commentator has argued that the export sales source rule is a “more potent” tax subsidy than the dedicated export subsidies such as the now-repealed FSC provisions and extraterritorial income exclusion provisions. 1 ISENBERGH, *supra* note 133, ¶ 19:47.

<sup>411</sup> See U.S. TREAS. DEP'T, INTERIM REPORT, *supra* note 309, at 32; ALI, INTERNATIONAL TAX STUDY, *supra* note 133, at 32.

<sup>412</sup> See, e.g., U.S. TREAS. DEP'T, INTERIM REPORT, *supra* note 309, at 32; Peroni, *Back to the Future*, *supra* note 133, at 1007; see also U.S. TREAS. DEP'T, BACKGROUND PAPER, *supra* note 1, at 48 (“[T]he shielding of export income is an export incentive for corporations with excess foreign tax credits.”). In fact, the export sales source rule, when combined with the cross-crediting opportunities in the general category limitation basket, may create a negative effective U.S. tax rate on the foreign-source income from an export sale of inventory property under certain circumstances. See Rousslang, *Sales Source Rules*, *supra* note 394; see also U.S. TREAS. DEP'T, DEFERRAL STUDY, *supra* note 216, at 46.

the export sale should properly be treated as foreign-source income.

One appropriate baseline would be arm's length apportionment of the type used in the independent factory or production price method in the current regulations.<sup>413</sup> Under this approach, the production portion of the export sales income would be determined by using the price at which the manufactured product would exchange hands between an unrelated manufacturer and unrelated distributor applying the principles of the transfer pricing regulations under section 482.<sup>414</sup> This production portion of the income would then be sourced in accordance with the location of the exporter's production activities, which means that this portion of the income will be entirely or predominantly U.S.-source income in the usual case. The remainder of the income would be treated as sales income and usually foreign-source income if the title passage test is used to determine the source of the sales income.

A second appropriate baseline for determining the U.S.-source portion of the export sales income would be the amount of sales income that is determined under a formulary apportionment method using an appropriate multi-factor test.<sup>415</sup> This baseline approach avoids the administrative difficulties of using an arm's length approach and recognizes that there are a significant number of situations in which an arm's length price is unavailable or not obtainable at a reasonable

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<sup>413</sup> See Treas. Reg. § 1.863-3(b)(2) (2006). For a sampling of critiques of the use of the arm's length standard as the method for allocating the taxable income of multinational enterprises among different countries, see Reuven S. Avi-Yonah, *The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation*, 15 VA. TAX REV. 89 (1995); Avi-Yonah, *Structure of International Taxation*, *supra* note 348, at 1339–52; Stanley I. Langbein, *The Unitary Method and the Myth of Arm's Length*, 30 TAX NOTES 625, 669–70 (Feb. 17, 1986); Dale W. Wickham & Charles J. Kerester, *New Directions Needed for Solution of the International Transfer Pricing Tax Puzzle: Internationally Agreed Rules or Tax Warfare?*, 56 TAX NOTES 339, 344–55 (July 20, 1992).

<sup>414</sup> See, e.g., U.S. TREAS. DEP'T, INTERIM REPORT, *supra* note 309, at 32; ALI, INTERNATIONAL TAX STUDY, *supra* note 133, at 33, 353–54; 1 ISENBERGH, *supra* note 133, ¶ 19:46; see also OWENS, *supra* note 322, at 221 (“The independent factory price establishes a constructive selling price for the purpose of determining the manufacturing income from sources in the United States and a constructive cost of goods sold for determining the sales income from sources in the foreign country.”). This baseline would be generally consistent with the rules of the trading partners of the United States for the taxation of export income and with the rules for taxing export sales income in U.S. tax treaties. See U.S. TREAS. DEP'T, INTERIM REPORT, *supra* note 309, at 33.

<sup>415</sup> See, e.g., Peroni, *Back to the Future*, *supra* note 133, at 1008.

cost.<sup>416</sup>

A third appropriate baseline would be to treat the export sales income as entirely U.S.-source income under a residence of the seller approach, unless the U.S. exporter could show that the export sales income had some significant foreign nexus — namely that the income was attributable to a foreign office of the exporter that materially participated in the sale and/or was subject to a minimum amount of foreign income tax (e.g., a 10% foreign income tax).<sup>417</sup> Under this third baseline, only the portion of the export sales income shown to have the requisite foreign nexus would be foreign-source income; the remainder of the income would be treated as having a U.S. source.<sup>418</sup>

Regardless of which of these three baselines is used, the arbitrary 50% allocation approach in the export sales source rule of current law departs from the baseline in a significant way and does so for the purpose of promoting export sales activity by expanding cross-crediting opportunities. Thus, the export sales source rule of current law is an export subsidy effected through the tax system and is properly classified as a tax expenditure. Consistent with this analysis, the Staff of the Joint Committee on Taxation and the Office of Management and Budget/Treasury have both consistently treated the rule as a tax expenditure provision and attempted to quantify the cost of the tax subsidy.<sup>419</sup>

*Cost/benefit analysis of export sales source rule subsidy.* This tax subsidy would not survive a cost/benefit analysis. The costs of the subsidy in terms of revenue loss and domestic welfare loss outweigh any benefits that the subsidy provides in terms of increased domestic investment and U.S. exports. To be specific, this tax subsidy distorts some U.S. taxpayers' economic behavior by creating a tax incentive

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<sup>416</sup> Cf. U.S. TREAS. DEP'T, INTERIM REPORT, *supra* note 309, at 33.

<sup>417</sup> See *id.*; Peroni, *Back to the Future*, *supra* note 133, at 1007; Robert J. Peroni, *A Hitchhiker's Guide to Reform of the Foreign Tax Credit Limitation*, 56 SMU L. REV. 391, 396 (2003); Peroni, Fleming & Shay, *Reform of Foreign Tax Credit Rules*, *supra* note 363, at 118, 132; Shay, Fleming & Peroni, *Source Rules*, *supra* note 39, at 150–52; see also Lokken, *supra* note 374, at 769. This baseline would more closely reflect the approach of the trading partners of the United States and the taxation of export sales income under U.S. tax treaties than does the export sales source rule of current law. See U.S. TREAS. DEP'T, INTERIM REPORT, *supra* note 309, at 33.

<sup>418</sup> See U.S. TREAS. DEP'T, INTERIM REPORT, *supra* note 309, at 33.

<sup>419</sup> STAFF OF JOINT COMM. ON TAX'N, 2007 ESTIMATES, *supra* note 13, at 24 (estimating the total revenue cost for fiscal years 2007–2011 from the inventory property export sales source rule as \$34.0 billion); 2008 ANALYTICAL PERSPECTIVES, *supra* note 29, at 287 (estimating the total revenue cost for fiscal years 2008–2012 from the inventory property export sales source rule as \$12.577 billion).

for taxpayers in an excess foreign tax credit position to shift investment from other domestic business activities to domestic export activities, even if the domestic export activities have a lower pre-tax economic return.<sup>420</sup> This rule also has an adverse effect on the U.S. terms of trade, resulting in an overall negative effect on domestic economic welfare.<sup>421</sup> In addition, the rule seems to do little to increase U.S. exports and the revenue gain from replacing the rule with an economic activity-based rule may raise at least slightly more revenue than the reduction in exports that would result from such change.<sup>422</sup> It seems reasonably clear that the effect on exports from repeal of the rule would likely be minimal.<sup>423</sup>

In any event, the export sales source rule is a strangely designed program for subsidizing U.S. export activity. This rule generally benefits U.S. exporters/sellers who have excess foreign tax credits in the general limitation income category (i.e., more foreign tax credits in the category than available limitation) so that the exporter bears no net U.S. residual tax on its high-taxed active foreign business income in the general limitation category and must generate additional low-taxed foreign income to absorb the excess credits.<sup>424</sup> By contrast, this rule does not benefit U.S. exporters/sellers who are in an excess foreign tax credit limitation position (i.e., the foreign tax credit limitation exceeds the U.S. exporter/seller's creditable foreign taxes or, stated differently, the exporter's U.S. tax on its active foreign income is greater than its foreign tax payments so that it cannot obtain a U.S. tax benefit from the creation of additional low-taxed foreign

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<sup>420</sup> See Rousslang, *Sales Source Rules*, *supra* note 394, at 1051–53; see also STAFF OF JOINT COMM. ON TAXATION, 102D CONG., *FACTORS AFFECTING THE INTERNATIONAL COMPETITIVENESS OF THE UNITED STATES* 256–57 (Joint Comm. Print 1991); Donald J. Rousslang, *Comments on Hufbauer and DeRosa, Costs and Benefits of the Export Source Rule*, 76 *TAX NOTES* 541, 543–45 (July 28, 1997). *But see* Gary C. Hufbauer & Dean A. DeRosa, *Costs and Benefits of the Export Source Rule*, 75 *TAX NOTES* 1401, 1412 (June 9, 1997) [hereinafter Hufbauer & DeRosa, *Costs and Benefits*]; Gary C. Hufbauer & Dean A. DeRosa, *The Costs and Benefits of the U.S. Export Source Rule: A Rejoinder*, 77 *TAX NOTES* 103 (Oct. 6, 1997).

<sup>421</sup> See GRUBERT & MUTTI, *TAXING INTERNATIONAL BUSINESS INCOME*, *supra* note 317, at 46–47 (using a general equilibrium model and estimating that this export sales source rule results in a total tax benefit of about \$315 million and a welfare loss to the United States of about \$115 million).

<sup>422</sup> See U.S. TREAS. DEP'T, *SALES SOURCE RULES REPORT*, *supra* note 393, at 2, 23–25. *But see* Hufbauer & DeRosa, *Costs and Benefits*, *supra* note 420.

<sup>423</sup> See U.S. TREAS. DEP'T, *SALES SOURCE RULES REPORT*, *supra* note 393, at 2, 23–25.

<sup>424</sup> See U.S. TREAS. DEP'T, *INTERIM REPORT*, *supra* note 309, at 32–33.

income).<sup>425</sup> Thus, the amount of the subsidy provided varies with the amount of a U.S. exporter's excess foreign tax credits and with the taxpayer's ability to use them in a foreign tax credit carryover year.<sup>426</sup> Moreover, this rule does not benefit U.S. exporters/sellers who are in an excess credit position in a number of situations by reason of other complex and specific aspects of the U.S. exporter's foreign tax credit limitation position.<sup>427</sup> It is not immediately apparent why Congress would want to enact an export subsidy program that applies so arbitrarily because it is tied to the U.S. exporter's foreign tax credit limitation position.<sup>428</sup>

Finally, this rule creates an incentive for U.S. exporters to shift investment to high-tax foreign countries because the resulting high foreign tax can be cross credited against the U.S. residual tax on the low-taxed foreign-source income created through application of the export sales source rule.<sup>429</sup> This causes the U.S. Treasury to relieve high-tax foreign countries of some of the negative tax competition consequences that would otherwise result from their fiscal policies. Such an incentive effect bears no relationship to a rationally designed export subsidy program. If the export sales source rule were recast as a direct expenditure program with these characteristics, it would have little or no chance of being enacted into law.

One last point bears mention here. Given the obligations of the United States under the General Agreement on Tariffs and Trade, it probably could not replace this tax subsidy with a direct government grant to encourage exports.<sup>430</sup> In applying TEA to the export sales source rule, this consideration arguably would be a factor in favor of using the tax system to deliver an export subsidy if one could conclude that such a governmental program should be enacted in the first place.

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<sup>425</sup> *See id.*

<sup>426</sup> *See id.* Under section 904(c) of current law, a taxpayer may carry back excess foreign tax credits to the immediate prior tax year and carry them forward to the succeeding ten tax years.

<sup>427</sup> First, the U.S. exporter/seller will not receive a benefit if the U.S. exporter/seller would have an overall U.S.-source loss under an activity-based source rule. *See* U.S. TREAS. DEP'T, SALES SOURCE RULES REPORT, *supra* note 393, at 13–14. Second, the U.S. exporter/seller will not receive a benefit if the U.S. exporter/seller would have an overall foreign loss under an activity-based source rule. *See id.* at 14.

<sup>428</sup> *See id.* at 16.

<sup>429</sup> *See id.* at 14.

<sup>430</sup> *See also* Michael J. McIntyre, *Collecting Current Tax From U.S.-Resident Individuals and U.S.-Based MNEs on Income Earned Through Foreign Entities*, 11 TAX NOTES INT'L 440 (Aug. 14, 1995); *cf.* Peroni, *Back to the Future*, *supra* note 133, at 1006.

This is a dubious proposition under traditional economic theory, however, because such a program would be protectionist in approach and run counter to the economic theories supporting free trade. As a general matter, export subsidies distort resource allocation and are economically inefficient.<sup>431</sup> Thus, export subsidies generally are not sensible government programs.

In sum, TEA helps demonstrate that the export sales source rule is an inappropriate and ineffective subsidy for U.S. export sales activities. Accordingly, this element of the U.S. international tax system should be repealed and the source rules in the Code amended to provide that the source of the income from export sales will be determined using one of the baseline approaches discussed above, all of which more clearly reflect the location of the economic activities giving rise to the income than does the export sales source rule of current law.

## VII. CONCLUSIONS

The analysis in this article supports the propositions that TEA is grounded in the ability-to-pay and neutrality concepts, is unaffected by the implicit tax concept, and has a settled core that makes it an important and useful analytical tool of tax policy, despite the many criticisms that have been leveled at it over the years. In our view, the principal purpose and justification of TEA is to serve as a triggering mechanism for mandatory recasting and cost/benefit analysis of governmental programs accomplished through the federal income tax system. Stated differently, TEA's central focus is on transparency and accountability concerning governmental programs delivered through the tax system. It is meant to have a salutary restraining effect on the strong impulse by many members of Congress to engage in obfuscation by enacting governmental programs in the form of tax incentives that they would never advocate as direct expenditure programs. This potential restraining effect of TEA is even more important in today's policy climate where it is difficult for Congress to spend money openly by enacting new direct expenditure programs.

In the context of the U.S. international taxation rules, TEA helps expose serious defects in the existing framework for taxing income derived by U.S. persons from foreign activities. To be specific, when

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<sup>431</sup> See, e.g., Andrew Green & Michael Trebilcock, *Enforcing WTO Obligations: What Can We Learn From Export Subsidies?*, 10 J. ECON. L. 653, 660–64 (2007). Some commentators, however, have argued that export subsidies can promote economic efficiency under certain circumstances. See *id.* at 62–64.

three important features of the U.S. international tax rules — deferral, cross-crediting, and the export sales source rule — are recast and analyzed as direct governmental programs, TEA shows that these rules are inefficient subsidies that do not survive a cost/benefit analysis, are inappropriate from a tax policy standpoint, and should be significantly modified or repealed. Thus, TEA should play an increasingly important role in the analysis of legislative proposals in the international tax area.