Ohio Northern University Law Review

Volume 38 | Issue 1 Article 1

And Then Cnut Told Reagan . . .Lessons from the Tax Reform Act of 1986*

Pamela F. Olson

Follow this and additional works at: https://digitalcommons.onu.edu/onu_law_review

Part of the Law Commons

Recommended Citation
Olson, Pamela F. () "And Then Cnut Told Reagan . . .Lessons from the Tax Reform Act of 1986*," *Ohio Northern University Law Review*: Vol. 38: Iss. 1, Article 1.
Available at: https://digitalcommons.onu.edu/onu_law_review/vol38/iss1/1

This Article is brought to you for free and open access by the ONU Journals and Publications at DigitalCommons@ONU. It has been accepted for inclusion in Ohio Northern University Law Review by an authorized editor of DigitalCommons@ONU. For more information, please contact digitalcommons@onu.edu.

Ohio Northern University
Law Review

Woodworth Memorial Lecture

And Then Cnut Told Reagan . . .
Lessons from the Tax Reform Act of 1986*

PAMELA F. OLSON

Let me begin by saying what an honor it is to deliver a lecture named for Dr. Laurence Woodworth. I never had the opportunity to work with Dr. Woodworth, but I understand the admiration and respect his colleagues had for him from the reverential tone in their voices when they wonder, more than thirty years after his passing, "what Larry would do" about a thorny tax issue. Given the sway he reportedly held with senators and congressmen in advising them on policy, we could certainly use his talent now.

In the first part of the 11th century, Cnut the Great, the second son of a Danish king, led the conquest of England, his native Denmark, Norway, and finally parts of Sweden. Like all Scandinavians, Cnut was a practical man. He modestly described himself as "king of all England and Denmark and the Norwegians and of some of the Swedes . . . ."[1] Reports suggest that he came to the control of this broad territory in like manner to his Viking forebears, which is to say, violently, but that once in power, he ruled wisely, ushering in a time of relative prosperity. Although he lost his Swedish subjects a few years prior to his death, had his sons not died shortly after Cnut's passing, perhaps today we would have an October holiday honoring Leif Ericsson instead of Christopher Columbus.[2]

---

* Laurence Neal Woodworth Memorial Lecture, May 6, 2010.

1. MICHAEL K. LAWSON, CNUT: ENGLAND'S VIKING KING 97 (Tempus 2004).

2. As is no doubt apparent from my last name, I am of Scandinavian descent. Three of my grandparents are of Norwegian extraction, or so I had always thought until a recent trip to Copenhagen. Over dinner conversation with our Danish hosts, I was informed that, because my Norwegian grandparents had emigrated during the period when Denmark controlled Norway, I was actually of Danish descent. In either event, I lay claim to the heritage of Cnut the Great.

Published by DigitalCommons@ONU,

Ohio Northern University Law Review, Vol. 38 [], Iss. 1, Art. 1

As the Shakespearian version of the story goes, Cnut's success went to his head, an occurrence not uncommon with rulers. King Cnut set his throne on the shore and commanded the tide not to wet his robes. When the tide came in, as tides do, Cnut discovered that his words had no power to stem its rise. Again, being a practical man, Cnut swiftly recognized his error. He proclaimed, "Let all men know how empty and worthless is the power of kings . . . ."[3] Of course, no politician would make the same mistake today. He—or she—would consult the tide charts, carefully plant the throne at high tide, duly command the tide to cease its rise, and wait for the adulation of the citizenry when its obedience was reported on Twitter.

Reagan and Tax Reform. Metaphorically speaking, Ronald Reagan understood the lesson of King Cnut—that there are events beyond politicians' ability to influence or alter, let alone control, that there are fundamental laws that can be harnessed, but not overridden. Nowhere is that more evident than in President Reagan's effort to reform the income tax laws. In particular, the Treasury Department effort he launched in 1984 reflected a keen appreciation of the laws of economics as applied to the design of the tax law.

The goal in the design of a tax system is a regime that fosters economic growth and maximizes national income. The ideal system would raise the revenues necessary to fund the operations of the government with the least adverse impact on the economy. Because all taxes distort decisions to work, to save, and to invest, a well-designed system should minimize the distortions that taxes cause. Minimizing distortion means a system that does not discourage work or saving and that does not skew investment decisions—a system that allows investment dollars to flow to the activities where they produce the highest pre-tax returns, which, in turn, maximizes national income.

It may be worth pausing here to note that the best way to encourage job creation is with policies that foster economic growth and maximize national income. While economic growth and job creation may not be synonymous, job creation does not exist in the absence of economic growth. So our objective should be to set our economic policies to support growth, and the jobs will follow. Without economic growth, tax policy devolves to zero-sum discussions of divvying up the pie.

As I was preparing to testify a few years ago at a Ways & Means Committee hearing on corporate inversions, the Treasury Legislative Affairs

3. MICHAEL J. MCHUGH & JOHN SOUTHWORTH, STORY OF THE MIDDLE AGES 43 (Christian Liberty Press 2002).

deputy who staffed tax policy expressed dismay that my oral statement contained no references to jobs. A debate ensued in my office with Tax Policy economists objecting to adding a jobs reference because the objective was to get the tax policy right and the jobs would naturally follow. That was not enough for Legislative Affairs. When it became clear that failing to add explicit references to jobs to my statement would result in a chorus of Legislative Affairs staffers behind me during the testimony chanting, "Jobs, jobs, jobs!" I added jobs four times to the final paragraph of the testimony and it went off without a hitch. In testimony before the Senate Finance Committee earlier this year, I made the mistake of including only a single jobs reference in my oral statement, which was promptly seized on by a Finance Committee member. It just goes to show that you cannot say "jobs" too many times. So to be perfectly clear, I want it understood that any references to economic growth are all about jobs because economic growth is the essential precondition to jobs.

The Treasury Department's 1984 tax reform analysis identified areas in which the tax laws created advantages and disadvantages among industries and investments and recommended reforms that would level the playing field.[4] The economic model employed by the Treasury Department indicated that leveling the playing field would have a more significant impact on economic growth than reducing the tax on capital.

The Treasury Department's analysis was not perfect. Neither was it politically popular. As a consequence of the latter, the initial report,[5] released in 1984, was revised and a second, less politically-controversial report was released in 1985.[6] The bill ultimately signed into law by President Reagan as the Tax Reform Act of 1986[7] was further massaged by the House,[8] the Senate,[9] and a conference committee[10] prior to its passage.

Though it differed in significant respects from the Treasury Department's 1984 analysis, the 1986 Tax Reform Act represented a

---

4. *See generally* OFFICE OF THE SEC'Y, DEP'T OF THE TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH: THE TREASURY DEPARTMENT REPORT TO THE PRESIDENT (1984).

5. *Id*.

6. OFFICE OF THE SEC'Y, DEP'T OF THE TREASURY, THE PRESIDENT'S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH, AND SIMPLICITY (1985).

7. Pub. L. No. 99-514, 100 Stat. 2085 (codified as amended in scattered sections of 16 U.S.C., 19 U.S.C., 25 U.S.C., 26 U.S.C., 28 U.S.C., 29 U.S.C., 42 U.S.C., 46 U.S.C., and 49 U.S.C.) (1986).

8. H.R. REP. NO. 99-426 (1985).

9. S. REP. NO. 99-313 (1986).

10. H.R. REP. NO. 99-841 (1986) (Conf. Rep.), *reprinted in* 1986 U.S.C.C.A.N. 4075.

Ohio Northern University Law Review, Vol. 38 [], Iss. 1, Art. 1

remarkable political achievement.[11] It was also a remarkable economic achievement for the progress it made in leveling the playing field.

For all its attributes, however, the Tax Reform Act was fundamentally flawed in numerous respects. Some of the flaws may have been masked at the time by the dominance of the U.S. economy, the Act's dramatically reduced corporate tax rates relative to other countries' rates, or structural delays in implementation or effect. But some of the flaws were obvious–or should have been. And some flaws clearly stem from either denial or an unwillingness to make tough decisions.

Remember the Alamo! No, that's not it. Remember Santayana, or more precisely, with talk of tax reform everywhere, remember what Santayana said: "Those who cannot remember the past are condemned to repeat it."[12] With that in mind, let us look at some of the flaws of the 1986 Tax Reform Act.

On the business side, the Tax Reform Act was premised on the "classic" view that a corporation should be taxed separately from and in addition to the tax imposed on its owners. To that end, the Tax Reform Act perfected the system of double taxation for corporate income.[13] Curiously, it failed to block the exits.[14] The 1986 reform left the double tax system elective by preserving passthrough treatment for partnerships and for corporations sufficiently closely-held to qualify for S corporation status. Perfection of the double tax regime may have been the most serious error in the Tax Reform Act. It included a rate of tax on corporate income more than twenty percent higher than the tax on noncorporate income and a second tax on dividends and capital gains from the sale of corporate stock at ordinary income tax rates.[15] The differential caused a Treasury Department wag to observe that Congress might have to replace the collapsible corporation provision with a collapsible individual provision. The Act set off a furious

---

11. *See* Albert R. Hunt, *Introduction* to JEFFREY H. BIRNBAUM & ALAN S. MURRAY, SHOWDOWN AT GUCCI GULCH: LAWMAKERS, LOBBYISTS, AND THE UNLIKELY TRIUMPH OF TAX REFORM (1987).

12. 1 GEORGE SANTAYANA, THE LIFE OF REASON: OR THE PHASES OF HUMAN PROGRESS, 284 (Charles Scribner's Sons 1906).

13. H.R. REP. NO. 99-841. The Tax Reform Act of 1986 effectively repealed the codification of the *General Utilities* doctrine, which generally permitted corporations to distribute appreciated property without gain recognition.

14. *Id.* Once effective, the repeal of *General Utilities* increased the potential cost of leaving corporate solution.

15. Tax Reform Act § 601, 100 Stat. at 2249. As amended by the Tax Reform Act of 1986, section 11(b) of the Internal Revenue Code provided for a 34 percent top tax rate for corporations. *Id.* § 101, 100 Stat. at 2096; § 302, 100 Stat. at 2218 (Section 1 provided for a twenty-eight percent top tax rate on the income of individuals, including dividends and capital gains).

https://digitalcommons.onu.edu/onu_law_review/vol38/iss1/1

Olson: And Then Cnut Told Reagan . . .Lessons from the Tax Reform Act of

effort on the part of every well-advised business to escape the corporate form of business via S election or converting to partnership form.[16] Even publicly-traded companies got into the act. Master limited partnerships became so popular that Congress was compelled just one year later to "protect" the corporate tax base by enacting a provision preventing the adoption of partnership form by publicly-traded companies.[17]

The migration of businesses from corporate to passthrough form clearly affected corporate tax receipts, apparently in ways that were unanticipated judging from the prompt action the following year limiting publicly-traded partnerships. If indeed Congress failed to predict the migration, it illustrates another fundamental law—one that cannot be controlled, harnessed, or repealed—the law of unintended consequences.

Even after Congress blocked the exit for publicly-traded companies, it left in place means of reducing the double tax. The deductibility of interest payments, for example, encouraged the use of debt as a method of distributing corporate earnings with no more than a single level of tax. The full tax on dividends, which added over eighteen percentage points to the tax on corporate earnings,[18] discouraged the payment of dividends, more so once the top individual rate was increased in 1993 to 39.6%.[19] The subsequent reduction in the capital gains rates made stock buybacks a popular and much less costly alternative to the payment of dividends, especially relative to the increased individual rates.[20] It is my personal view that the tax preference for debt and tax deterrent to payment of dividends contributed significantly to the corporate instability and governance issues that plagued us, particularly in the 1990s.

16. George A. Plesko, *The Role of Taxes in Organizational Choice: S Conversions After the Tax Reform Act of 1986*, 7 (1994), *available at* http://web.mit.edu/gplesko/www/Plesko%20Sconv.pdf (Whereas the annual growth in the number of S corporation returns was 9.5 percent during the 1959-1986 period, the number of S corporations grew by more than 36.5 percent between 1986 and 1987); *see* Susan Nelson & Tom Petska, *Partnerships, Passive Losses, and Tax Reform* (April 2011), *available at* http://www.irs.gov/pub/irs-soi/81-87papltxrf.pdf (The total number of partnerships actually declined between 1986 and 1987 due in part to changes to the passive activity loss rules, but the amount of income reported by partnerships with positive ordinary income increased by nine percent during that period).

17. *See* I.R.C. § 7704 (West 2011).

18. Tax Reform Act, §§ 101-104, 100 Stat. at 2096-2106; § 601, 100 Stat. at 2249. The eighteen percentage points are calculated by multiplying the highest individual tax rate at the time against the percentage of corporate profits available for distribution after tax (.28 X .66 = 18.48%).

19. Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13202, 107 Stat. 312, 461 (1993).

20. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 311, 111 Stat. 788, 831 (1997) (reduced the top capital gains rate from twenty-eight percent to twenty percent).

Published by DigitalCommons@ONU,

The double tax mistake was ameliorated somewhat by enactment of the fifteen percent rate on dividends and capital gains in 2003.[21] The 2003 change may have been the most significant improvement to the structure of the Internal Revenue Code ("Code") in recent decades. Like a number of other features of the Code, however, it was enacted in temporary form and is now subject to the vagaries of the annual tax extender process.[22]

The result of the two-tier tax in the Tax Reform Act is that non-corporate or passthrough entities continue to grow in popularity. That is reflected in the portion of business income—over fifty percent in recent years—that is earned by non-corporate entities and by the fact that even in the IRS's large business division over half of the returns filed for 2009 were of pass-through entities.[23]

Congress banked on a shift of tens of billions of dollars in tax liability from the individual to the corporate sector to help pay for the sharp reduction in individual income tax rates contained in the 1986 Act.[24] That shift was based again on the classic view that corporations are separate taxpayers from their owners and as such should pay their fair share of tax. President Reagan apparently also held that view as he expressed his disapproval of companies particularly effective in reducing their tax liabilities.

Despite the classic view, economists have long been uncertain about who bears the burden of the corporate tax.[25] Though not widely understood, corporations clearly pass on the burden to one or more of three possibilities—shareholders, employees, or customers. Given its incidence, many assume the burden of the tax falls on the corporate owners. In other words, it's Paris Hilton who picks up the tab for this levy. Economic

---

21. Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub L. No. 108-27, 117 Stat. 752 (2003).

22. Originally set to expire for tax years beginning after December 31, 2008, the sunset date for the preferential fifteen percent rate on dividends and capital gains was extended to December 31, 2010, by the Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, § 102, 120 Stat. 345, 346 (2006), and then to December 31, 2012, by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, § 102, 124 Stat. 3296, 3298 (2010).

23. According to calculations based on IRS Statistics of Income data from 2004 to 2008, individual owners of flow-through businesses earned fifty-four percent of all business net income. Robert Carroll & Gerald Prante, *The Flow-Through Business Sector and Tax Reform* 1, 6 (April 2011), *available at* http://www.s-corp.org/wp-content/uploads/2011/04/Flow-Through-Report-Final-2011-04-08.pdf.

24. The Joint Committee on Taxation estimated that the Tax Reform Act of 1986 would increase tax revenue from corporations by $120 billion and reduce tax revenue from individuals by $122 billion. *See* STAFF OF JOINT COMM. ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 1357 (1987) [hereinafter GENERAL EXPLANATION OF THE TAX REFORM ACT]; Chris Atkins, *Tax Reform and Revenue Neutrality: President's Panel Should Avoid the Redistribution of 1986*, TAX FOUNDATION (July 13, 2005), http://www.taxfoundation.org/news/show/777.html.

25. *See*, *e.g.*, Alan Auerbach, *Who Bears the Corporate Tax? A Review of What We Know* (Nat'l Bureau of Econ. Research, Working Paper No. 11686, 2005).

research over the last decade, however, supports a different conclusion. A substantial part of the burden of the corporate income tax in an open economy, in fact, falls on employees.[26] Because of the uncertainty over who bears the corporate tax burden, some tax distribution tables do not include the corporate tax. If it were included with the burden falling on employees, the tax system would appear more regressive, and a cut in corporate taxes would make the system more progressive.

All of this is above and beyond the comprehension of many voters, the media, and political leaders. I was reminded earlier this week of a House floor exchange between two Congressmen. The first said, "Corporations don't pay tax; people do." And the second retorted, "That's the problem!" If we are going to succeed in reforming the tax laws, we must have more thought-leadership grounded in sound economics from our politicians and the media.

Don't Tax Me.[27] Besides perfecting the double tax system, the Tax Reform Act targeted the international operations of U.S.-headquartered companies with a number of complicated changes that tightened the rules for including foreign income and claiming foreign tax credits.[28] Many of the changes had no policy rationale to commend them other than that they raised revenue from an unpopular source—big businesses' foreign operations. Although a few of the more arbitrary changes have been reversed by subsequent legislation with a corresponding reduction in complexity and economic irrationality, the legislative reversals had delayed effective dates—courtesy of budget rules.

One reversal has yet to take effect—the interest allocation rules for computing foreign tax credits.[29] The Tax Reform Act required the allocation of interest expense on a water's edge basis, allocating all U.S. interest expense on a global basis without regard to the leverage in the

---

26. William C. Randolph, *International Burdens of the Corporate Income Tax* 4, 25 (Cong. Budget Office, Working Paper No. 2006-09, 2006); Mihir Desai, C. Fritz Foley, & James Hines, Labor and Capital Shares of the Corporate Tax Burden: International Evidence 18 (December 2007), *available at* http://www.people.hbs.edu/mdesai/PDFs/Labor%20and%20Capital.pdf.

27. Explaining Congress' reluctance to target particular revenue sources for tax increases, Senator Russell Long, a member of the Senate Finance Committee during its deliberations over the Tax Reform Act of 1986, quipped "Don't tax you, don't tax me, tax that fellow behind the tree!" 132 CONG. REC. 7348 (1986) (statement of Sen. Russell Long). Another variant of Senator Long's maxim ends in "tax the corporation across the sea!"

28. Gregory May, *Tax Reform Act of 1986: Summary of Selected Foreign Tax Provisions*, (William & Mary Annual Tax Conference, Paper No, 565, 1986), *available at* http://scholarship.law.wm.edu/tax/565.

29. Section 864(f), which permits corporations to elect to allocate interest expense on a worldwide basis, is effective for taxable years beginning after December 31, 2020. I.R.C. § 864(f)(6) (West 2011).

Ohio Northern University Law Review, Vol. 38 [], Iss. 1, Art. 1

foreign operations or whether the indebtedness funded the foreign operations—because, after all, money is fungible. It is a particularly egregious example of bad tax policy because it is both bad economics and can create a disincentive for debt-financed investment in the United States. The right answer is to allocate interest expense on a worldwide basis, which was the change enacted in 2004. The original delayed effective date has been further delayed multiple times as a source of revenue for popular tax extenders.[30] That worldwide allocation is widely recognized as the correct answer has been insufficient to deter the continued delays in its effective date.

The Tax Reform Act preserved the basic structure of the international provisions—a worldwide system with tax on profits of the active business of foreign subsidiaries when those profits are repatriated. A worldwide system of taxation with tax on repatriation can create a disincentive to reinvest at home, though the disincentive is lessened when the foreign tax on the income equals or exceeds the U.S. tax so that credits offset the U.S. tax liability incurred on repatriation.[31] The Tax Reform Act significantly reduced the corporate tax rate, particularly relative to other countries, which may have minimized the anticompetitive effect of some of the international changes for the first few years following its passage. Even so, a system with a built-in disincentive for U.S.-based companies to reinvest in the United States surely violates the principle that the tax system should not skew investment decisions. As other governments, including our major trade partners, have seen our bid and raised it with even lower corporate tax rates and now territorial tax systems, the distortion caused by the worldwide system is clearly evident.[32]

The U.S. corporate tax regime, mired in policies first adopted nearly fifty years ago and maintained in the 1986 overhaul, is increasingly out of step with policies adopted by other countries to the disadvantage of our economy and the jobs that might otherwise be created here. Political rhetoric indicates recognition of the issue but a failure to grasp the

---

30. The American Jobs Creation Act of 2004 originally provided that section 864(f) would be effective for taxable years beginning after December 31, 2008. Pub. L. No. 108-357, § 401, 118 Stat. 1418, 1488, 1491 (2004). That date was extended to December 31, 2010 in the Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, § 2203, 122 Stat. 2654, 2849-850 (2008), to December 31, 2017 in the Worker, Homeownership, and Business Assistance Act of 2009, Pub. L. No. 111-92, 15, 123 Stat. 2984, 2996 (2009), and to December 31, 2020 in the 2010 Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147, § 551, 124 Stat. 71, 117 (2010).

31. *See* ECONOMIC REPORT OF THE PRESIDENT 208-11 (2003), *available at* http://www.gpoaccess.gov/usbudget/fy04/pdf/2003_erp.pdf.

32. *See Hearing on Tax Reform: A Necessary Component for Restoring Fiscal Responsibility: Before the S. Comm. on the Budget*, 112th Cong. 8-9 (2011) (testimony of Roseann Altshuler), *available at* http://budget.senate.gov/republican/hearingarchive/testimonies/2011/2011-02-02Altshuler.pdf.

economics. The tax system is often described as rewarding U.S. companies' foreign operations because the foreign earnings are only taxed when repatriated. That is one way of looking at it. But it would be the wrong way to look at it. The foreign advantage exists because other countries offer lower rates and investment incentives. We can only offset the foreign advantage by reducing our own tax rate. We will not make the United States a more attractive location for investment by maintaining our higher corporate rate. Neither can we make U.S. companies more competitive by subjecting all of their earnings to a thirty-five percent tax. That will only make U.S. companies' foreign operations more valuable in the hands of their foreign competitors. The right answer is to retake the position we held after the Tax Reform Act as a leader in reducing corporate tax rates. We should also reconsider our worldwide tax system to eliminate the disincentive to U.S. companies reinvesting their foreign earnings in the United States.

Complexity Costs. Every tax system that uses income as a base features certain irreducible complexity because measuring income is difficult. The Tax Reform Act carried the complexity of the tax law to new heights, treating compliance as a given and the administrative burden associated with it as a free good.

On the business side, Congress continued legislative changes begun in 1984, adding provisions that deviated explicitly from financial accounting principles in the belief that the provisions would more clearly reflect income or curtail some improper tax benefit.[33] For financial accounting purposes, businesses must measure their income according to detailed rules prescribed by the Financial Accounting Standards Board or the International Accounting Standards Board. For tax purposes, businesses must re-measure their income according to rules devised by Congress.

Regardless of Congressional wisdom or that of the tax lawyers, accountants, and economists who assist it in devising the rules in the Code, the benefit of the multiple deviations from financial accounting is questionable. While it is undoubtedly true that the Code's measurement of income must differ in certain particulars from the rules of financial accounting because their purposes are not entirely aligned, there is no compelling reason for the many disparities between the Code and the financial accounting rules. During testimony before a House Committee a

33. *See*, *e.g.*, I.R.C. § 263A (Lexis 2011) (capitalization and inclusion in inventory costs of certain expenses), added by the Tax Reform Act, § 803(a), 1001 Stat. at 2350-55, and I.RC. § 461(h) (economic performance), added by the Deficit Reduction Act of 1984, Pub. L. No.. 98-369, § 91(a), 92 Stat. 494, 598-609 (1984).

Ohio Northern University Law Review, Vol. 38 [], Iss. 1, Art. 1

few years ago, I was questioned by a member who was dismayed to learn that corporations reported a different income number to their shareholders than to the IRS. The Congressman's question is illustrative of the fact that the disparities Congress has created between financial and tax accounting have contributed to a black box view of the tax system and added to political cynicism. The disparities make the job of complying more difficult and deprive the system of the potential benefit of leveraging competing interests against each other.

Laws of Politics—Avoid Voter Wrath. On the individual side, the Tax Reform Act included a beefed up alternative minimum tax ("AMT")[34] as a substitute for repealing or limiting a number of popular individual tax preferences. Though intended when originally enacted to ensure that wealthy individuals paid at least some amount of income tax, the AMT's design never carried out that purpose. As revised by the 1986 Act, the AMT is inordinately complicated and has the effect of reversing many of the benefits Congress determined to retain. Because it is unlike other provisions in the tax law that are indexed for inflation, it has the effect of ensnaring more taxpayers with each passing year. If the 2001 tax cuts continue to be extended, it will eventually cost more to repeal the AMT than to repeal the regular income tax.

Congressional staff involved in the drafting of the Act have stated that the lack of indexing was intended to bring more taxpayers into the AMT and eventually replace the regular income tax base with the AMT base. Whether the Congressional champions of the Tax Reform Act were aware of this clandestine reform plan is unclear. Suffice it to say that no Congress nor any President since when faced with the AMT's immediate impact on voters has embraced the stealth elimination of tax benefits. Nonetheless, the projected cost of repeal under the budget rules has prevented outright repeal and permanent indexation. Instead, Congress has enacted annual patches that increase the AMT's exemptions to limit the number of voters it hits.[35]

34. Tax Reform Act § 701, 100 Stat. at 2320-45.

35. *See* Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 § 201(a)(1)-(2), 124 Stat. at 3299; American Recovery and Reinvestment Tax Act of 2009, Pub. L. No. 111-5, §1012(a)(1)-(2), 123 Stat. 115, 319 (2009); Tax Extenders and Alternative Minimum Tax Relief Act of 2008, Division C, Pub. L. No. 110-343, § 102(a)(1)-(2), 122 Stat. 3765, 3863 (2008); Tax Increase Prevention Act of 2007, Pub. L. No. 110-166, § 2(a)(1)–(2), 121 Stat. 2461, (2007); Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, § 301(a)(1)-(2), 120 Stat. 345, 353 (2006); Working Families Tax Relief Act of 2004, Pub. L. No. 108-311, § 103(a), 118 Stat. 1166, 1168 (2004); Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, § 106(a)(1)-(2), 117 Stat. 752, 755 (2003); Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 701(A)-(B), 115 Stat. 38, 148 (2001); Omnibus Budget Reconciliation Act, § 13203(b)(1)-(3), (c)(1), 107 Stat. 312 at 461-62.

https://digitalcommons.onu.edu/onu_law_review/vol38/iss1/1

For the federal budget, Congress's unwillingness either to embrace the AMT or permanently fix it yields a false source of revenue. The country's budget situation is actually worse than the continuing temporary patches would lead one to believe. For the individual taxpayers potentially subject to it, the temporary patches produce instability and uncertainty.

While expanding the AMT and preserving individual tax preferences may have pleased voters, the fundamental law of economics has prevailed. The result of maintaining the preferences has had predictable economic effects—increased demand for the preferred items. The largest individual tax preference today is the exclusion for employer-provided health care,[36] and it will continue to grow because legislators have been unwilling to limit it and there is little credible analysis suggesting that last year's health care reform will bend the cost curve down. As Gene Steuerle has observed, the current system depends on individuals bargaining with their doctors over what someone else will pay for their health care.[37] If you doubt that is a recipe for cost restraint, you have company. The problem is that the ultimate consumers of health care remain oblivious of its cost. They will continue to be oblivious until Congress finds the courage to rein in the health care exclusion. Doing so would be a step towards disciplining rising health care costs. It would also address a provision that is regressive and unfair.

Revenue Neutrality. The Tax Reform Act was designed to be revenue neutral.[38] In other words, it was intended to produce the same amount of income tax revenue for the U.S. Treasury as the law it replaced. While revenue neutral reform may have taken issues off the table, it resulted in the inclusion of a number of provisions, not because they were good policy, but because they added the revenue necessary to hit the assigned target.[39] While the tax system must produce enough in revenues to cover what government spends, the first question should always be whether the individual provisions are sound economic policy, not whether their inclusion will produce a revenue neutral result. Otherwise, like the flight

---

36. STAFF OF JOINT COMM. ON TAXATION, BACKGROUND INFORMATION ON TAX EXPENDITURE ANALYSIS AND HISTORICAL SURVEY OF TAX EXPENDITURE ESTIMATES, at 25 (2011).

37. C. Eugene Steuerle, *Dealing with the Original Sin Driving Health Costs*, THE URBAN INSTITUTE (July 7, 2008), http://www.urban.org/url.cfm?ID=901183.

38. GENERAL EXPLANATION OF THE TAX REFORM ACT, *supra* note 24, at 1358; *see*, *e.g.*, Linda A. Schwartzstein, *Smoke and Mirrors: Tax Legislation, Uncertainty and Entrepreneurship*, 6 CORNELL J.L. & PUB. POL'Y 61, 77 (1996) ("tax acts such as the Tax Reform Act of 1986 were formed under political agreements that the bill would be revenue neutral" (citation omitted)).

39. The water's edge interest allocation provision of section 864 is one such example. I.R.C. § 864 (Lexis 2011).

Ohio Northern University Law Review, Vol. 38 [], Iss. 1, Art. 1

from corporate solution that followed the Tax Reform Act in 1986, the law of unintended consequences will prevail. On a static basis, the double tax system may have worked well. In the dynamic real economy, it failed to deliver. With today's mobility of capital and skilled workforces around the globe, we ignore fundamental laws of economics at our peril.

The Intervening Years. The flaws of the Tax Reform Act have been exacerbated—and occasionally mitigated—by the thousands of changes to the Internal Revenue Code Congress has enacted in the twenty-five years since passage of the Tax Reform Act.[40] The pace of legislative change outstrips the capacity of the taxpaying public and the Internal Revenue Service to absorb it, but of greater concern is the reversal of the progress made in the Tax Reform Act in eliminating the distortions tilting the playing field. This became a serious problem in the 1990s when our political parties realized tax cuts and spending increases were not mutually exclusive if they just combined them in targeted tax provisions. In the late 1990s, a witty Treasury economist tried to end the legislative hyperactivity by drafting "The Tax Credit for the Taxpayer Who Didn't Get a Tax Credit."[41] The problem has grown worse over time as Congress uses the Code to dispense all manner of benefits, many of them bearing no rational relationship to the collection of the revenue necessary to fund the operations of government. As a gag, Office of Tax Policy staff prepared a draft proposal for a "celebrations" tax credit—to offset the horrendous costs of graduations, weddings, baptisms, and bar mitzvahs. So accustomed to the dreck crossing the Assistant Secretary's desk, the Assistant Secretary, who will remain nameless, began marking up the draft!

Why either party has thought it desirable to put the tax collector in charge of determining eligibility for and distributing benefits is a mystery. The IRS's enforcement methods with respect to social welfare benefits have produced complaints from the left. One would expect provisions that encourage affection for April 15th to concern the right.

The continual enactment of targeted tax provisions leaves the IRS with responsibility for the administration of policies aimed at the environment,[42] conservation,[43] green energy,[44] manufacturing,[45] innovation,[46] education,[47]

---

40. *Hearing Statement of Senator Max Baucus Regarding Changes to the Tax Code since the 1986 Tax Reform Act,* U.S. SENATE COMMITTEE ON FINANCE (March 1, 2010), http://finance.senate.gov/newsroom/chairman/release/?id=8d485c02-c17f-4b5c-af9c-b66141354322.

41. *The U.S. Tax Code's Impact on Revenue Projections and the Federal Budget: Hearing Before the H. Comm. On the Budget*, 108th Cong. 37 (2004) (statement of Pamela F. Olson), *available at* www.gpo.gov/fdsys/pkg/CHRG-108hhrg95053/pdf/CHRG-108hhrg95053.pdf.

42. *See*, *e.g.*, I.R.C. §§ 45Q, 198, 4064, 9507 (Lexis 2011).

43. *See*, *e.g.*, *id.* §§ 170(b)(1)(E), 2031(c).

saving,[48] retirement,[49] health care,[50] child care,[51] welfare,[52] corporate governance,[53] export promotion,[54] charitable giving,[55] governance of tax exempt organizations,[56] and economic development,[57] to name a few. Regardless of the merits of the policies and whatever the IRS's capabilities, it is unreasonable to charge it with oversight of such a diverse range of activities.

The result of running such policies through the Code is spending that is largely uncapped, unverified, and unverifiable. In the best of circumstances, we have limited means of assessing the efficacy of many government spending programs. In this case, Congress has effectively signed a blank check, meaning there is no possibility of assessing efficacy in even the most rudimentary fashion. Moreover, because many of these provisions duplicate direct spending by other agencies of government, it is impossible to assess whether a provision has been effective in attaining the intended objective.

Another hazard of the targeted tax provisions is that their complexity undermines respect for the tax law. There are too many restrictions, too many qualifications, too many exceptions, and too many phaseouts for the taxpaying public to comprehend.[58] The result is a sense of unfairness that

---

44. *See*, *e.g.*, *id.* § 45.
45. *See*, *e.g.*, *id.* § 199.
46. *See*, *e.g.*, *id.* §§ 41, 174.
47. *See*, *e.g.*, I.R.C. § 25A.
48. *See*, *e.g.*, *id.* § 25B.
49. *See*, *e.g.*, *id.* §§ 401(k), 403(b).
50. *See*, *e.g.*, *id.* § 106(a).
51. *See*, *e.g.*, *id.* § 21.
52. *See*, *e.g.*, I.R.C. §§ 32, 24.
53. *See*, *e.g.*, *id.* §§162(m), 280G, 6707A(e).
54. *See*, *e.g.*, *id.* §§ 921-27 (*repealed by* FSC Repeal and Extraterritorial Income Act of 2000, 106 Pub. L. No. 519, § 2, 114 Stat. 2423 (2000)), *replaced by* I.R.C. § 114 (*repealed by* American Jobs Creation Act § 102, 118 Stat. at 1423), I.R.C § 864(b).
55. *See*, *e.g.*, I.R.C. § 170.
56. *See*, *e.g.*, *id.* § 501.
57. *See*, *e.g.*, *id.* § 45D.
58. The Earned Income Tax Credit ("EITC") provides a maximum benefit of $5,660.00 for individuals with three or more qualifying children, but phases out for individuals making more than $43,350. *Id.* at § 32(b), adjusted for inflation per Rev. Proc. 09-50, 2009-45 I.R.B. 617, § 3.06(1). Households making $110,000 or less receive the full child tax credit. The credit begins to phase out after $110,000, up to $150,000. Those making above $150,000 do not receive the credit. *Id.* at § 24(a)-(b). Individuals making up to $105,000 ($169,000 for married filing jointly) can make contributions to a Roth IRA up to $5,000 per year (or $6,000 if over 50 years old). After $105,000 and up to $120,000 ($169,000-$170,000 for married filing jointly), the $5,000 begins to phaseout. Those with income over $120,000 ($179,000 for married filing jointly) do not qualify to make a Roth IRA contribution. I.R.C. § 408A(c)(3), adjusted for inflation per I.R.S. Notice 94, 2009-50 I.R.B. 848. Some individuals may deduct qualified student loan interest. Individuals making under $60,000 ($120,000 for married filing jointly) may claim up to $2500. Individuals making between $60,000 and $75,000 ($120,000 and

Ohio Northern University Law Review, Vol. 38 [], Iss. 1, Art. 1

the taxpayer may have been arbitrarily deprived of a benefit and a sense of uneasiness that available benefits may have been overlooked. Besides that, the Code often contains multiple overlapping and mutually exclusive provisions aimed at the same goal among which the taxpayer must choose. The electivity may increase the potential benefit but it multiplies the complexity. Determining which of the various education benefits is most advantageous, for example, may require an advanced degree.[59]

That said, many taxpayers prefer targeted tax provisions to other forms of government spending, probably because they are easier to access than other forms of government spending. Imagine thinking it easier to get something from the IRS! Their political popularity is not a reason for continuing to dispense benefit programs through the tax code. It is a reason to fix the operations of other government departments and agencies so they can assume responsibility for the spending programs logically within their purview.

The Limits of Politics. The system of distortions that is current law has naturally led to widespread interest in reforming it. Yet many calls for reform reflect the planting of thrones on the shore and futile commands for halting the tide. The proposals would repeat, or even aggravate, the flaws of current law. With debate unmoored from economic reality, there is a real danger that tax reform will both perpetuate existing harms and create new ones.

There is another version of the story of King Cnut. In the alternative version, King Cnut, a seafaring Viking and a religious man, recognized that he had no power to control the tide, and placed his throne on the shore to demonstrate to his loyal subjects the limits of kingly power.[60] Like King Cnut, politicians have no power to compel the tides to stop their rise. Neither can they repeal fundamental laws of economics or their effect on

---

$150,000 for married filing jointly) begin to phase out of the credit, and those individuals making above $75,000 ($150,000 for married filing jointly) are not eligible for the credit. *Id.* at § 221(b), adjusted for inflation per Rev. Proc. 09-50, 2009-45 I.R.B. 617, § 3.23.

59. There are two mutually exclusive education credits, Lifetime Learning credit and the American Opportunity credit, with different restrictions and income limits. The American Opportunity credit is $2,500 per student, is only for undergraduate study, is limited to four years, cannot be claimed if the student has a felony conviction, and has an income eligibility limit of $90,000 ($180,000 married filing jointly). By contrast, the Lifetime Learning credit is $2,000 per return, is for undergraduate, graduate and any other kind of post-secondary study, is not limited to a certain number of years, does not consider the student's criminal record, and has an income eligibility limit of $60,000 ($120,000 for married filing jointly). Neither credit can be claimed if the student's filing status is married filing separately. IRS, *Appendix B. Highlights of Education Tax Benefits for Tax Year 2010*, INTERNAL REVENUE SERVICE, *http*://www.irs.gov/publications/p970/ar02.html#en_US_2010_publink1000255787 (last visited Oct. 16, 2011).

60. MCHUGH & SOUTHWORTH, *supra* note 3, at 43.

https://digitalcommons.onu.edu/onu_law_review/vol38/iss1/1

Olson: And Then Cnut Told Reagan . . .Lessons from the Tax Reform Act of

human behavior. But who will tell their constituents? And will they tell them before we have surrendered our position of global leadership?

The Law of Arithmetic. There is a growing disconnect in our system between paying for government and receipt of government benefits. That may account for the recent assertion that the one law voters have directed Congress to repeal is the law of arithmetic. It may also account for voters' apparent belief that the government can cut their taxes without cutting any government programs. The government still has the printing presses, doesn't it? The recent ads asserting that Social Security has not contributed to the deficit or that government should keep its hands off Medicare would be comical if they didn't display such frightening misunderstandings.

How do we help our fellow citizens understand that the "bonds" in the Social Security Trust Fund represent (1) money spent and (2) a promise that our children and grandchildren will repay them through higher taxes in the future?[61] That the government taking its hands off Medicare means that the program will not be there for those who need it because its price is unsustainable unless we bend the health care cost curve down?

If you are a fan of Dave Barry, you may recall his tax reform proposal of a few years ago to send Congress to a desert island and refuse to let them off until they had reformed the tax code. He went on to note that it really didn't matter whether they succeeded. The point was not to let them off the island![62]

Before we run out to adopt Barry's plan, we ought to consider the California experience. It demonstrates there is actually something worse than leaving the tax law in the hands of the legislature, and that is putting it in the hands of the voters. Via ballot initiatives, Californians have, since 1978, voted themselves tax cuts and spending increases. As *The Economist* recently observed, the problem in California is too much democracy. To fund its budget needs, the state has increasingly relied on income taxes from the wealthiest taxpayers. The problem is that the incomes of the wealthiest taxpayers on which the state now relies for eighty percent of its revenue are the most volatile. The income is largely attributable to capital gains, stock option exercises, and bonuses. All of those go up and down with the economy. The result is a boom and bust cycle of epic proportion. Receipts plummet when the economy turns down and the state is most in need of

---

61. *See* Gene Steuerle, *The Pointless Debate Over the Social Security Trust Fund*, THE GOVERNMENT WE DESERVE/THE URBAN INSTITUTE, (March 24, 2011), http://www.urban.org/publications/901417.html.

62. *Dave Barry on Taxes*, A VIEW FROM THE RIGHT (Feb. 14, 2011), http://aviewfromtheright.com/2011/02/14/dave-barry-on-taxes/.

Published by DigitalCommons@ONU,

Ohio Northern University Law Review, Vol. 38 [], Iss. 1, Art. 1

revenue. When the economy turns up again, the legislature resets its budget as though there will never be another downturn.[63]

There may be a lesson in the laboratory of our federal system, if we can learn from the mistakes of the states as well as their successes. California, with its enormous budget woes, provides a clear picture of what happens when government spending is divorced from government funding. The cure may be found in a series of ballot initiatives being readied for future elections intended to discipline some of the democracy and restore responsibility. Doing so will require a huge amount of voter education, but if they can pull it off in California, it bodes well for the nation at large.

Political Leadership. In his 2007 Woodworth Lecture, John Buckley astutely observed that "[l]aws enacted without regard to politics seldom last long."[64] Political leadership is far more difficult in an era dominated by soundbites. It belongs to the politician who can tell the voter in six seconds what he wants to hear as opposed to help the voter understand what he needs to know to participate responsibly in a democratic society. It is also difficult in an era of hyper-partisanship where one party's support guarantees the other's vociferous opposition without regard to merit.

We need some political courage today—and not just from those who have decided to hang up their political spikes. If King Cnut took his throne to the shore to provide his subjects a lesson, it was a display of remarkable political courage. President Reagan, Senator Packwood, and Congressman Rostenkowski displayed that kind of courage in forging ahead with the 1986 Act. President Obama displayed political courage with his decisions last week on the dispatch of Public Enemy Number One.

The sources of our current tax system's shortcomings have been identified and can be addressed in any overhaul. But doing so will require a greater measure of political courage and willingness to challenge the conventional wisdom than was evident in 1986. We must correct the policy mistakes made in 1986. We must also address the looming fiscal crisis.

There is an ad for a recruiting firm that opens to a scene of chimpanzees around a conference room table cheering wildly over a chart with an arrow pointing up. Sales are going through the roof. Enter the human—the recruiting firm's target audience. He walks to the chart and turns it right side up. Sales are taking a nose-dive, not going through the roof. The crowd of chimpanzees instantly turns to boos. Then the human leaves, one

---

63. *The People's Will*, THE ECONOMIST (Apr. 20, 2011), *available at* http://www.economist.com/node/18563638/print.

64. John L. Buckley, *Woodworth Memorial Lecture: Tax Changes Since Woodworth's Time: Implications for Future Tax Reform*, 34 Ohio N.U. L. Rev. 1, 15 (2008).

Olson: And Then Cnut Told Reagan . . .Lessons from the Tax Reform Act of

of the chimps turns the chart back upside down, and wild cheering resumes. In our political discussion, we need more honest humans and fewer cheering chimps.

Addressing our budget deficit will require more than the elimination of waste, fraud, and abuse on the spending side. Not that we should ignore waste, fraud, and abuse, but it is a drop in the bucket relative to the budget shortfall.[65] To regain our financial footing, we must reduce spending more broadly and reformulate entitlements like Social Security and Medicare.

Addressing the deficit will also require more than a tax hike on the top two percent or on the foreign operations of U.S. companies. Without regard to the merits of the tax increases that have been proposed to the top two percent of taxpayers or to foreign operations, the point is that they would raise insufficient revenue to remedy the deficit.[66] To the extent of ability, we must link a seat at the dinner table with a share of the tab.

There are limits to our ability to generate additional revenue through our existing tax bases. It seems unlikely that our primary tax bases—most notably, the corporate and individual income taxes and the Social Security and Medicare payroll taxes—can efficiently generate adequate revenue to meet future spending obligations even if those obligations are radically reduced. Economists have long observed that the economic burden of taxation increases with the square of the tax rate—that is, the cost of generating each dollar of tax revenue increases as the tax rate increases. Consequently, rather than increasing the income or payroll tax, we should consider the addition of an alternative tax base, coupled with lower rates on existing tax bases, as part of tax reform. The alternative source could be a carbon tax or a consumption tax. Either would meet with resistance, but so will the elimination of the individual income tax expenditures necessary to broaden the base sufficiently. Importantly, the addition of a consumption

---

65. *See*, *e.g*., HOUSE COMMITTEE ON THE BUDGET, PATH TO PROSPERITY: RESTORING AMERICA'S PROMISE, FISCAL YEAR 2012 BUDGET RESOLUTION (2011), *available at* http://budget.house.gov/UploadedFiles/PathToProsperityFY2012.pdf (discussing elimination of waste, abuse, and fraud); *Hearing Statement of Senator Max Baucus*, *supra* note 40 (discussing elimination of waste, abuse, and fraud).

66. *See*, *e.g*., TAX REDUCTION AND REFORM ACT OF 2007, H.R. 3970 (Oct. 29, 2007), *available at* http://waysandmeans.house.gov/media/pdf/110/Summary%20for%20Distribution.pdf (proposed to repeal the AMT and proposed a replacement tax for taxpayers at incomes over $200,000, which was projected to raise $831.70 billion over ten years); THE OBAMA FY 2012 BUDGET 184-85, *available at* http://www.whitehouse.gov/sites/default/files/omb/budget/fy2012/assets/tables.pdf (proposed the following international tax proposals: taxing currently excess returns associated with transfers of intangibles offshore, limit shifting of income through intangible property transfers, limit stripping on expatriated entities, which together were projected by OMB to raise a total $1.4 billion); WYDEN-COATS BIPARTISAN TAX FAIRNESS AND SIMPLIFICATION ACT OF 2011, 112 Cong. S. 727 (Apr. 5, 2011), *available at* http://www.gpo.gov/fdsys/pkg/BILLS-112s727is/pdf/BILLS-112s727is.pdf, pp. 80-81 (also proposed repeal of deferral of active income for controlled foreign corporations).

Published by DigitalCommons@ONU,

Ohio Northern University Law Review, Vol. 38 [], Iss. 1, Art. 1

tax would align our tax system with the tax system of every other developed country.

The Other Cnut. There is another Knute more closely associated with President Reagan because of Reagan's role in the biographical film about the other Knute's life—Notre Dame football coach Knute Rockne.[67] Reagan played George Gipp, also known as the Gipper, in the film. From the film comes the famous quote, "sometime when the team is up against it and the breaks are beating the boys, tell them to go out there with all they've got and win just one for the Gipper."[68]

The fiscal challenge ahead will require education and a willingness to look beyond the next election. None of this will be popular with voters, to be sure, but our nation's fiscal situation is such that partisan politics must be put aside for the sake of the greater good and of future generations. It's time to go out there with all we've got and win one for the Gipper!

67. For background on Knute Rockne and the origins of the quote, see *Biography*, THE OFFICIAL SITE OF KNUTE ROCKNE, http://www.knuterockne.com/biography.htm (last visited Nov. 8, 2011).

68. KNUTE ROCKNE, ALL AMERICAN (Warner Bros. 1940).

https://digitalcommons.onu.edu/onu_law_review/vol38/iss1/1