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Lawrence Zelenak
Duke University

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Giving Credits Where Credits Are (Arguably) Due: A Half Century's Evolution in the Design of Personal Tax Expenditures

by

*Lawrence Zelenak**

Abstract

In the late 1960s, when Stanley Surrey introduced the concept of tax expenditures and the federal government began producing tax expenditure budgets, personal tax expenditures in the form of deductions (for nonbusiness interest, charitable donations, state and local taxes, and medical expenses) equaled roughly 1.2% of gross domestic product, and personal tax expenditures in the form of credits were virtually nonexistent. Although Surrey was critical of all tax expenditures, he had particular scorn for tax expenditures in the form of deductions, which he characterized as upside-down subsidies. He explained that converting deduction tax expenditures to credits would make them less objectionable, by eliminating their upside-down character. Over the ensuing half century, Congress has shifted from deductions to credits—gradually for decades, with a dramatic acceleration of the shift in 2017. Today, in sharpest contrast with the Surrey era, major tax expenditures in the form of personal credits equal roughly 1.23% of GDP, while major deduction expenditures have fallen to about 0.61%. This Article describes this fundamental transformation of a significant fraction of the national economy, first from a big picture perspective and then with detailed

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accounts of the evolution of the major personal tax expenditures. The Article also offers a policy analysis of the transformation, with three major conclusions: (1) Congress has been overly influenced by Surrey's upside-down critique, in that it has wrongly viewed as upside-down subsidies deductions justified on income-defining (ability-to-pay) grounds; (2) in designing personal tax expenditures, Congress has legislated as if a number of design features automatically follow from the choice between deduction and credit, when in fact they do not; and (3) Congress has been right (at least mostly) to ignore Surrey's recommendation that all credits should be taxable.

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I. Introduction

Stanley Surrey, then Assistant Secretary of the Treasury of Tax Policy (and once and future Harvard Law School professor), first propounded the tax expenditure concept in a 1967 speech. According to Surrey, the federal income tax features:

> a system of tax expenditures under which governmental financial assistance programs are carried out through special tax provisions rather than through direct government expenditures. This second system bears no basic relation to the structure of the income tax and is not necessary to its operation; it is simply grafted on to that structure.[1]

As Surrey explained, a tax expenditure could take the form of a tax exemption for a particular type of income, a deduction for an expenditure that would not be deductible if the goal of the tax system were simply to measure a taxpayer's economic net income, or a credit reducing tax liability by the amount of the credit.[2]

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1. Stanley S. Surrey et al., Federal Income Taxation: Cases and Materials 232 (successor ed. 1986); *see also* Excerpts from Remarks by Assistant Secretary Surrey, November 15, 1967, Before the Money Marketeers, on the U.S. Income Tax System—The Need for a Full Accounting [hereinafter Surrey, Excerpts], *as reprinted in* U.S. Treas. Dep't, Annual Report of the Secretary of the Treasury on the State of the Finances for the Fiscal Year Ended June 30, 1968, at 322 (1969) [hereinafter 1968 Treas. Report].

2. Ever since Surrey introduced the tax expenditure concept, it has been subject to intense criticism on various grounds. For excellent descriptions and evaluations of all the major criticisms, see J. Clifton Fleming, Jr. & Robert J. Peroni, *Reinvigorating Tax Expenditure Analysis and Its International Dimension*, 27 Va. Tax Rev. 437 (2008). The most serious critique—expressed first and most forcefully by Boris Bittker—was that Surrey defined tax expenditures as provisions "grafted onto" the "structure of the income tax," but that there was not and never could be agreement on the "proper measurement of net income" and that without such agreement identification of tax expenditures was impossible. Boris I. Bittker, *Accounting for Federal "Tax Subsidies" in the National Budget*, 22 Nat'l Tax J. 244, 248 (1969) (quoting Surrey, Excerpts, *supra* note 1, at 324, as to the "proper measurement of net income"). While Bittker was right that disagreement about the "proper measurement of net income" meant that any tax expenditure budget would be controversial around the edges, Surrey was right that even a debatable-in-some-respects tax expenditure budget could "assist the legislators in developing the image of a proper tax structure and in analyzing the problems of structure and theory at the borderline." Stanley S. Surrey & William F. Hellmuth, *The Tax Expenditure Budget—Response to Professor Bittker*, 22 Nat'l Tax J. 528, 537 (1969).

The following year, responding to Surrey's plea that "[w]e need a much higher degree of accounting for the dollars that the tax expenditure programs which grew up in the past are now absorbing,"[3] the Treasury Department issued the first set of federal tax expenditure estimates, for fiscal year 1968.[4] In the personal category, the major expenditures identified by Treasury included the deductibility of interest on consumer credit (revenue cost $1.3 billion), the deductibility of interest on home mortgages ($1.9 billion), the deductibility of property taxes on owner-occupied housing ($1.8 billion), the deductibility of other non-business state and local taxes ($2.8 billion), the deductibility of charitable donations ($2.37 billion), the deductibility of medical expenses not covered by insurance ($1.5 billion), the exclusion of employer-provided health insurance (EPHI) ($1.1 billion), and the exclusion for employment-based retirement savings ($3.0 billion).[5] Personal credits were almost nonexistent; the only item in that category was the retirement income credit, at a revenue cost of only $200 million.[6]

Focusing for the moment on tax expenditures designed to subsidize cash outlays by taxpayers (and thus setting aside the exclusions for employment-based health insurance and retirement savings), a striking aspect of these estimates is the utter dominance of deductions over credits. The big-four personal deductions of 1968 (for interest, charitable donations, state and local taxes, and medical expenses) totaled $11.67 billion. By contrast, there was not a single dollar of tax expenditure in the form of a credit for some stated percentage of outlays for tax favored purchases.[7]

Surrey was tremendously successful in institutionalizing the concept of tax expenditures and the annual publication of official tax

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3. Surrey, Excerpts, *supra* note 1, at 326.

4. U.S. Treas. Dep't, The Tax Expenditure Budget: A Conceptual Analysis, *as reprinted in* 1968 Treas. Report, *supra* note 1, at 326, 339–40. The estimates covered both tax expenditures relating to the production of income (business and investment tax expenditures) and those relating to taxpayer activities engaged in for reasons other than the pursuit of profit (personal tax expenditures). The focus of this Article, however, is limited to personal tax expenditures.

5. *Id.* at 339–40.

6. *Id.* at 334.

7. The retirement income credit (former I.R.C. § 37 (1954)) equaled a percentage (tied to the first rate bracket) of a limited amount of retirement income, not a percentage of any taxpayer expenditures.

expenditure budgets (TEBs). Despite the absence of a legislative mandate for the preparation of TEBs in the early years, in 1970 Treasury produced a second TEB,[8] and in 1972 and 1973, Treasury and the Joint Committee on Taxation cooperated in the production of updated TEBs.[9] In 1974 Congress enacted legislation requiring the annual production of TEBs by both the executive branch and the legislative branch.[10] Pursuant to that legislation, for almost half a century (and counting) there have been two annual TEBs, one from the Joint Committee on Taxation and one from Treasury.[11]

In Surrey's view, to identify a provision as a tax expenditure was to stigmatize it. His hope was that focusing congressional attention on tax expenditures by means of mandated annual reports would lead Congress to conclude that many tax expenditures were indefensible and should either be repealed outright or replaced with better-designed direct spending programs. Despite Surrey's impressive success in institutionalizing the tax expenditure concept, the annual publication of TEBs has failed to produce the effects for which Surrey had hoped. Surrey also had, however, a fallback position—that, if Congress was unwilling to cleanse the Internal Revenue Code of a particular tax expenditure, it

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8. Statement by Assistant Secretary Weidenbaum, June 2, 1970, before the Subcommittee on Economy in Government of the Joint Economic Committee, *reprinted in* U.S. Treas. Dep't, Annual Report of the Secretary of the Treasury on the State of Finances for the Fiscal Year Ending June 30, 1970, at 296 (1971).

9. U.S. Treas. Dep't & Joint Comm. on Internal Rev. Tax'n, 92d Cong., JCS-28-72, Estimates of Federal Tax Expenditures (1972); U.S. Treas. Dep't & Joint Comm. on Internal Rev. Tax'n, 93d Cong., JCS-20-73, Estimates of Federal Tax Expenditures (1973).

10. Congressional Budget and Impoundment Control Act of 1974, Pub. L. No. 93-344, § 301(d)(6) (congressional TEB), § 601 (executive branch TEB), 88 Stat. 297, 308, 323.

11. For the most recent Treasury TEB, see U.S. Treas. Dep't, Off. of Tax Analysis, Tax Expenditures (2020) [hereinafter Treas. 2020 TEB]. For the two most recent JCT TEBs, see Joint Comm. on Tax'n, 116th Cong., JCX-23-20, Estimates of Federal Tax Expenditures for Fiscal Years 2020–2024 (2020); Joint Comm. on Tax'n, 116th Cong., JCX-55-19, Estimates of Federal Tax Expenditures for Fiscal Years 2019–2023 (2019) [hereinafter JCT 2019 TEB].

should at least reform the expenditure to eliminate the "upside-down effect" of tax subsidies structured as deductions and exclusions.[12]

The upside-down effect follows from the fact that, in a tax system with progressive marginal rates, the tax benefit of a dollar of deduction or exclusion is a function of a taxpayer's marginal tax rate. Deducting or excluding $100 produces a tax saving of $37 for an affluent taxpayer in the 37% bracket, but deducting or excluding the same amount is worth only $10 for a lower income taxpayer in the 10% bracket. As Surrey explained, "the higher the individual's income and thus the higher the individual's income tax rate, the larger is the tax benefit–the tax reduction—brought about by the deduction [or exclusion]."[13] Surrey contended that a credit equal to some specified percentage of credit-eligible taxpayer outlays—for example, a credit equal to 20% of the amount a taxpayer donated to charity—would be a policy improvement over a deduction, especially if the credit was refundable (that is, allowed as a transfer payment to the extent the credit amount exceeded the taxpayer's pre-credit tax liability) and if the credit amount was itself included in the taxpayer's taxable income.[14]

In the decades since Surrey's indictment of tax expenditures in the late 1960s, the contemporaneous production of the first TEBs, Surrey's 1973 publication of *Pathways to Tax Reform* expanding his indictment to book length,[15] and the 1974 congressional mandate of annual TEBs, there has been a dramatic shift in the relative significance of personal deductions and personal credits. Although all of the big-four personal deductions of 1968 (call them the legacy deductions) still exist today, they are greatly diminished—partly because of new direct statutory limitations on the deductions, and partly by the indirect effect on itemized deductions of a large increase in the standard deduction (resulting in more taxpayers forgoing itemized deductions in order to claim the standard deduction). Over the same decades, although Congress has never been sufficiently impressed by Surrey's upside-down critique of deductions to convert any of 1968's big-four deductions to credits, it has been sufficiently impressed to legislate as if it had adopted a new default

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12. Stanley S. Surrey, Pathways to Tax Reform 37 (1973) [hereinafter Surrey, Pathways].

13. *Id.* at 36.

14. *Id.* at 97–100.

15. *Id.*

rule, to the effect that any *new* personal tax expenditure should be enacted as a credit rather than as a deduction.

There has been a remarkable shift in the design of personal tax expenditures—from deductions dominating credits in the late 1960s to the dominance of credits over deductions today—in the half century since Surrey introduced the tax expenditure concept.[16] Exclusions, meanwhile, have been relatively unaffected; they continue to play a role similar to their role in the late 1960s. As noted earlier, in 1968 the tax expenditures for the big-four personal deductions ($11.67 billion) were almost 60 times greater than the tax expenditure for the lone personal credit ($200 million).[17] In sharpest contrast, in 2019 the tax expenditures for five major personal credits (none of which existed in 1968) totaled $269.4 billion,[18] while the sum of the tax expenditures for the four legacy deductions was only $97.2 billion.[19] Personal tax expenditures in the form of credits amounted to less than 2% of personal tax expenditures in the form of deductions in 1968; in 2019, credit tax expenditures are

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16. In this paragraph, and elsewhere throughout this Article, tax expenditure estimates for several provisions are summed to determine the relative significance of expenditures in the forms of deductions, credits, and exclusions. Although this approach works well for identifying major changes over time in legislative use of the three forms, the Joint Committee on Taxation cautions that it estimates each tax expenditure in isolation:

> Each tax expenditure is calculated separately, under the assumption that all other tax expenditures remain in the Code. If two or more tax expenditures were estimated simultaneously, the total change in tax liability could be smaller or larger than the sum of the amounts shown for each item separately, as a result of interactions among the tax expenditure provisions.

JCT 2019 TEB, *supra* note 11, at 14.

17. *Supra* text accompanying notes 4–6.

18. The five credits are the dependent care credit (I.R.C. § 21), the child tax credit (I.R.C. § 24), the higher education credits (I.R.C. § 25A), the earned income credit (I.R.C. § 32), and the premium assistance credit (I.R.C. § 36B). For details on the 2019 tax expenditures for those credits, see *infra* text accompanying note 41.

19. Congress has not created any major new personal deductions since 1968. For details on the 2019 tax expenditures for the four legacy deductions, see *infra* text accompanying note 39.

over 275% of deduction tax expenditures. Although there is a different story of the decline of each legacy deduction and of the introduction and growth of each new credit, there are striking similarities across the stories. Perhaps the most significant similarity is the pervasive influence of Surrey's upside-down critique of tax subsidies in the form of deductions. In fact, Surrey's critique has been as influential in areas where it would not apply if properly understood as it has been in areas where it does properly apply. Other themes common to many of the stories include: (1) that Surrey's argument for credits over deductions has been more influential than his argument that credits should be refundable and taxable; (2) that the upside-down critique has been much more influential with respect to the design of new tax subsidies than in the rethinking of the design of the legacy deductions; and (3) that the legacy deductions—still in existence, but greatly diminished relative to their heyday five decades ago——have been much more politically vulnerable than the major personal exclusions (for employer-provided health insurance (EPHI) and for employment-based retirement savings) of the late 1960s.

Part II of this Article provides an overview of the shift from deductions to credits in the past half century. Part III consists of case studies of a number of personal deductions, credits, and exclusions, including both legislative changes over the decades and significant unsuccessful reform proposals. The case studies in Part III cover all of the big-ticket personal tax expenditures (deductions, credits, and exclusions), as well as an illustrative selection of smaller tax expenditure items. In the order covered, the tax expenditures considered in Part III are: the home mortgage interest deduction, the charitable deduction, the state and local tax (SALT) deduction, the exclusion for EPHI (and the closely related medical expense deduction), the premium assistance credit, childcare expenses (originally a deduction, later a credit), adoption expenses (originally a deduction, later a credit), the earned income tax credit, the higher education credits (and a related deduction), the child tax credit, and the several tax benefits (exclusion, deduction, and credit) for retirement savings. In the case of a deduction or exclusion in existence in the late 1960s (at the dawn of the tax expenditure concept), the Part III focus is on the legislative decision between retaining the tax expenditure as a deduction or exclusion and converting the tax expenditure to a credit. In the case of tax expenditures created after the institutionalization of the tax expenditure concept, the Part III focus is on the initial legislative choice among deduction, exclusion, and credit as the form of the new tax expenditure.

Part IV steps back from the case studies to consider design issues beyond the basic choice among deduction, credit, and exclusion. There are six major design choices for any nonbusiness tax expenditure: (1) whether the value of the subsidy should depend on the taxpayer's marginal tax rate; (2) whether the subsidy should be refundable; (3) whether the subsidy should be phased out for higher-income taxpayers; (4) in the case of a subsidy based on the amount of a taxpayer's outlays for a particular purpose, whether there should be a dollar cap on subsidized expenditures; (5) also in the case of a subsidy based on a taxpayer's outlays for a particular purpose, whether the subsidy should apply from the first dollar of outlays, or whether there should be a floor (perhaps based on a percentage of adjusted gross income) on subsidized expenditures; and (6) whether a taxpayer must forgo the standard deduction in order to claim the subsidy, or whether a taxpayer should be permitted to claim both the subsidy and the standard deduction. The argument of Part IV is that, properly understood, the choice among deduction, credit, and exclusion is a choice only with respect to the first of the six design issues, but that Congress frequently legislates as if the deduction-credit-exclusion choice dictates the other design choices as well. Part V considers why Surrey's argument that credits should be taxable has had so little influence with Congress. It concludes that the lack of influence is explained partly by the counterintuitive character of taxable credits and partly by the fact that Surrey was mostly wrong on the merits of this issue. Part VI briefly concludes.

II. The Shift from Deductions to Credits: An Overview

Selected data points in the evolution of personal tax expenditures from 1968 to 2017, and from 2017 to 2019, are set forth in the accompanying table. This section analyzes and contextualizes the information in the table. Recall the 1968 tax expenditure estimates noted earlier, including $11.67 billion for the big-four personal deductions, a mere $200 million for the one lonely personal credit, $1.1 billion for the EPHI exclusion, and $3.0 billion for the exclusion of employer-sponsored pensions.[20] The gross domestic product (GDP) of the United States for 1968 was $940.7 billion.[21] Thus, the big-four deductions equaled roughly

20. *Supra* text accompanying notes 5–6.

21. GDP data (based on data from the U.S. Bureau of Econ. Analysis) from Louis Johnston & Samuel H. Williamson, *What Was the U.S. GDP*

1.2% of GDP, the tiny and lonely credit roughly 0.0%, and the two major exclusions roughly 0.4%.

Table: Selected Tax Expenditure Budget Items, 1968, 2017, and 2019, in Billions of Nominal Dollars and as a Percentage of Gross Domestic Product[22]

Item	1968	2017	2019
Deduction, Interest on Consumer Credit	$1.3/0.14%	N/A	N/A
Deduction, Home Mortgage Interest	$1.9/0.20%	$66.4/0.34%	$27.0/0.13%
Deduction, Nonbusiness State and Local Taxes	$4.6/0.49%	$100.9/0.52%	$21.2/0.10%
Deduction, Charitable Donations	$2.37/0.25%	$57.0/0.29%	$43.1/0.20%
Deduction, Medical Expenses	$1.5/0.16%	$13.8/0.07%	$7.1/0.03%
Total for Above-Listed Deductions	**$11.67/1.24%**	**$238.1/1.22%**	**$98.4/0.46%**
Deduction, Retirement Savings	$0.06/0.01%	$25.7/0.13%	$32.6/0.15%
Total for Above-Listed Deductions, Including Retirement Savings	**$11.73/1.25%**	**$263.8/1.35%**	**$131.0/0.61%**
Exclusion, Employment-Based Retirement Savings	$3.0/0.32%	$194.4/1.00%	$209.8/0.98%
Exclusion, Employer-Provided Health Insurance	$1.1/0.12%	$150.6/0.77%	$152.5/0.71%

Then?, MEASURINGWORTH (2020), www.measuringworth.org/usgdp/ [https://perma.cc/4LF6-XB2X].

22. U.S. TREAS. DEP'T, *supra* note 4, at 339–40 tbl.II (for 1968); JOINT COMM. ON TAX'N, 115TH CONG., JCX-34-18, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2017–2021, at 33–46 tbl.1 (2018) [hereinafter JCT 2017 TEB] (for 2017); JCT 2019 TEB, *supra* note 11, at 20–32 tbl.1 (for 2019). GDP percentages are author's calculations, based on GDPs of $940.7 billion (1968), $19.485 trillion (2017), and $21.43 trillion (2019).

Total for Listed Exclusions	**$4.1/0.44%**	**$345.0/1.77%**	**$362.3/1.69%**
Credit, Higher Education Expenses	N/A	$19.4/0.10%	$18.3/0.09%
Child Tax Credit	N/A	$64.1/0.28%	$117.7/0.55%
Credit, Dependent Care Expenses	N/A[23]	$4.6/0.02%	$4.6/0.02%
Premium Assistance Credit	N/A	$37.6/0.19%	$52.9/0.25%
Earned Income Credit	N/A	$70.6/0.36%	$70.0/0.33%
Total for Listed Credits	**N/A**	**$186.3/0.96%**	**$263.5/1.23%**

The expansion of personal credits occurred gradually over the decades. Major milestones included: the creation of the earned income credit (EIC) in 1975 and a major expansion of the credit in 1993;[24] the creation of the dependent care credit (converted from an earlier deduction) in 1976;[25] the introduction of the child tax credit in 1997 and a major expansion in 2017;[26] the introduction of the higher education credits, also in 1997;[27] and the creation of the premium assistance credit in 2010.[28]

Even with the dramatic increase in personal credits, personal deductions remained more significant than personal credits in TEBs until the enactment of the Tax Cuts and Jobs Act of 2017 (TCJA). In the decades from the 1960s until 2017 (pre-TCJA), Congress had imposed several new limitations on the big-four legacy deductions. The more

23. Although there was no dependent care credit in 1968, there was a limited deduction for dependent care expenses. The tax expenditure estimate for the 1968 deduction was a mere $25 million, which rounds to 0.00% of 1968 GDP. U.S. Treas. Dep't, *supra* note 4, at 340.

24. Tax Reduction Act of 1975, Pub. L. No. 94-12, § 204, 89 Stat. 26, 30–32; Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13131, 107 Stat. 312, 433–35.

25. Tax Reform Act of 1976, Pub. L. No. 94-455, § 504, 90 Stat. 1520, 1563–65.

26. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 101, 111 Stat. 788, 796–99; Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, § 11022, 131 Stat. 2054, 2073–74.

27. Taxpayer Relief Act of 1997 § 201, 111 Stat. at 799–806.

28. Patient Protection and Affordable Care Act, Pub. L. No. 111-148, § 1401, 124 Stat. 119, 213–20 (2010).

significant new limitations included: the 1986 repeal of the deduction for personal (nonbusiness) interest expense other than home mortgage interest;[29] the 1987 imposition of a ceiling of $1,000,000 on the principal amount of home acquisition indebtedness, the interest on which is deductible;[30] the 1986 repeal of the sales tax deduction;[31] and the increase (in stages) in the floor on the deductibility of medical expenses from 3% of adjusted gross income in the late 1960s to 10% today.[32] With the exception of the increased floor on the deductibility of medical expenses, none of the changes threatened the status of the legacy deductions as extremely large tax expenditures. For 2017 (the last year unaffected by TCJA), the Joint Committee on Taxation estimated the total tax expenditures for the legacy deductions at $238 billion, consisting of $66.4 billion for the home mortgage interest deduction, $57.0 billion for the charitable deduction, $13.8 billion for the medical expense deduction, and $100.9 billion for the SALT deduction.[33] Adding in $25.7 billion of tax expenditures for deductions (not exclusions) for retirement savings brings the total to $263.7 billion.[34] In the same 2017 TEB, the Joint Committee estimated the total tax expenditures for the five personal credits mentioned above at $186.3 billion, consisting of $19.4 billion for the higher education credits, $54.1 billion for the child tax credit, $4.6 billion for the dependent care credit, $37.6 billion for the premium assistance credit, and $70.6 billion for the EIC.[35] The above estimates do not reflect all personal deductions and credits, but they do

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29. Tax Reform Act of 1986, Pub. L. No. 99-514, § 511(b), 100 Stat. 2085, 2246–48.

30. Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, § 10102, 101 Stat. 1330, 1330-384 to 1330-386.

31. Tax Reform Act of 1986 § 134, 100 Stat. at 2116.

32. I.R.C. § 213(a).

33. JCT 2017 TEB, *supra* note 22, at 37–44. The $57.0 billion for the charitable deduction is the sum of the estimates for donations to educational organizations ($9.6 billion), health organizations ($4.5 billion), and all other charities ($42.9 billion).

34. *Id.* at 43–44 ($7.7 billion for deductions for contributions to self-employed retirement plans and $18.0 billion for deductions for contributions to individual retirement accounts).

35. *Id.* at 40–43. Some unspecified portion of the $4.6 billion of the expenditure for the dependent care credit is actually for the I.R.C. § 129 exclusion for dependent care assistance programs, which the Joint Committee lumps together with the dependent care credit.

include all 2017 big-ticket items in both categories. As for nonbusiness exclusions, the biggest tax expenditures in 2017, by far, were the EPHI exclusion (a tax expenditure of $150.6 billion) and the exclusions for employment-based contributions to defined benefit and defined contribution retirement plans (coming in at $194.4 billion, combined).[36]

The bottom line for 2017 was that, despite some new statutory restrictions on the legacy deductions, and despite the tremendous growth in personal credits since the 1960s—all of which growth was attributable to credits that did not exist when Surrey introduced the tax expenditure concept—personal deductions remained of greater economic significance than credits. Also, the exclusions of EPHI and employment-based retirement savings had increased tremendously in economic significance (from a 1968 tax expenditure about one-tenth the combined size of the tax expenditures for the big-four deductions, to a 2017 tax expenditure equal to about 145% of the combined expenditures for the legacy deductions), despite the fact that there have been no fundamental changes in the statutory rules governing the exclusions.[37] As with the 1968 data, it is helpful to consider the magnitude of the various tax expenditures not only in relation to the other expenditures but also in relation to GDP. The GDP of the United States for 2017 was $19.485 trillion.[38] Thus the combined 2017 tax expenditures for the four legacy deductions were about 1.2% of GDP—virtually unchanged since 1968. Also taking into account the deductions for retirement savings brings 2017 deductions up to about 1.35% of GDP. Personal credits in 2017 were about 0.95% of GDP, up from approximately 0% in 1968. And the two major exclusions, which had been about 0.4% of GDP in 1968, were up to roughly 1.77% in 2017.

As dramatic as the changes from 1968 to 2017 surely were, the Tax Cuts and Jobs Act of 2017 has produced comparably dramatic changes from 2017 to 2019—not over a half century, but almost overnight. According to the Joint Committee on Taxation, for 2019 (the first year for which the TCJA changes are fully reflected in the tax expenditure estimates), the tax expenditures for the four legacy

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36. *Id.* at 42–43.

37. For a partial explanation of the reasons for the tremendous increase in the EPHI tax expenditure in the absence of major changes in the governing tax law, see *infra* text accompanying notes 99–100.

38. GDP data (based on data from the U.S. Bureau of Economic Analysis) from Johnston & Williamson, *supra* note 21.

deductions total only $98.4 billion: $27.0 billion for the home mortgage interest deduction, $43.1 billion for the charitable deduction, $7.1 billion for the medical expense deduction, and $21.2 billion for the SALT deduction.[39] Adding in the deductions (not exclusions) for retirement savings, at $32.6 billion, brings the major deductions to $131.0 billion.[40] While the legacy deductions were greatly diminished compared to their pre- TCJA significance, the five personal credits had become more significant, with a combined tax expenditure of $263.5 billion: $18.3 billion for the higher education credits, $117.7 billion for the child tax credit, $52.9 billion for the premium assistance credit, $70.0 billion for the EIC, and $4.6 billion for the dependent care credit.[41] The tax expenditure for the EPHI exclusion had grown (very slightly) to $152.5 billion, and the expenditures for the employment-based pension exclusions to $209.8 billion.[42] With 2019 GDP of $21.43 trillion,[43] the legacy deductions were 0.46% of GDP—less than 40% of the GDP percentage for the same deductions in 2017. (The legacy deductions plus the retirement savings deductions were 0.61% of GDP.) The credits, however, were up from 0.95% of GDP in 2017 to 1.23% in 2019, while the health insurance and pension exclusions were down slightly, from 1.77% to 1.69%.

What TCJA changes in personal deductions and credits are responsible for this sudden triumph of credits over deductions? Two of the four legacy deductions took significant direct hits from TCJA. TCJA lowered the ceiling on home acquisition indebtedness, the interest on which is deductible, from $1,000,000 to $750,000, and repealed the deduction for interest on up to $100,000 of home equity indebtedness.[44] Of considerably greater significance, it also imposed a ceiling of $10,000

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39. JCT 2019 TEB, *supra* note 11, at 23–30.

40. *Id.* at 29–30.

41. *Id.* at 26–29. As with the 2017 estimates, the estimate for the dependent care credit includes the I.R.C. § 129 exclusion for dependent care assistance programs.

42. *Id.* at 28–29.

43. *Gross Domestic Product, Fourth Quarter and Year 2019 (Advance Estimate)*, U.S. Bureau Econ. Analysis (Jan. 30, 2020), https://www.bea.gov/news/2020/gross-domestic-product-fourth-quarter-and-year-2019-advance-estimate [https://perma.cc/C4KD-2626] [hereinafter *GDP 2019*].

44. Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, § 11043, 131 Stat. 2054, 2086.

on the deductibility of state and local taxes.[45] In addition to these direct hits, the near-doubling of the standard deduction—in the case of a joint return, from $12,700 in 2017 to $24,000 in 2018[46]—impacted all itemized deductions by greatly decreasing the number of taxpayers who would benefit by itemizing rather than claiming the standard deduction. For a sense of the relative impact of the direct hits and the indirect hits, compare the relatively modest 2017 to 2019 decrease in the charitable deduction tax expenditure from $57.0 billion to $43.1 billion, to the more dramatic decrease in the home mortgage interest deduction tax expenditure from $66.4 billion to $27.0 billion, and the huge decrease in the SALT deduction tax expenditure from $100.9 billion to $21.2 billion. In fact, the SALT deduction alone accounted for well over half ($79.4 billion out of $139.6 billion) of the 2017 to 2019 decrease in the sum of the tax expenditures for the legacy deductions.

Of the $77.2 billion increase in personal credit tax expenditures from 2017 to 2019, the vast majority—$63.6 billion—is in the child tax credit and is explained by the doubling of the per-child credit from $1,000 to $2,000 (and by accompanying increases in the partial refundability of the credit and of the availability of the credit to upper-income parents).[47] Of course, like the EIC but unlike the three other major credits and the legacy deductions, the child tax credit is not a subsidy based on a taxpayer's outlays for specified purposes and is thus a somewhat different creature from the outlay-based tax expenditures. Moreover, the massive increase from 2017 to 2019 in the child tax credit expenditure depends on a debatable choice by the Joint Committee in defining tax expenditures. Congress apparently intended the doubling of the child tax credit as rough compensation to parents for the repeal of the dependency exemption.[48] Despite the legislative notion that the credit and the exemption served sufficiently similar purposes that an increase in the former could replace the latter, the Joint Committee treats the credit as a tax expenditure but treated the exemption as part of "the normal structure of the individual income tax" (and thus not a tax expenditure).[49] The quoted language from the Joint Committee's TEB published in 2018 is carried over from earlier TEBs when the law provided

45. *Id.* § 11042, 131 Stat. at 2085–86.
46. *Id.* § 11021, 131 Stat. at 2072–73.
47. *Id.* § 11022, 131 Stat. at 2073–74.
48. *See* the discussion *infra* text accompanying notes 248–254.
49. JCT 2019 TEB, *supra* note 11, at 3.

for a substantial dependency exemption. The implication of that language in the 2018 TEB—when the law did not allow any exemption—might seem to be that denial of an exemption is a negative tax expenditure (overtaxing taxpayers relative to "the normal structure of the individual income tax"), but the 2018 TEB does not show the denial as a negative expenditure. Apparently, the Joint Committee's notion is that a dependency exemption, at whatever amount set by Congress (including zero), is part of the normal structure, with the result that no exemption amount (not even zero) can give rise to either a positive or negative tax expenditure.[50]

In any event, the 2017 to 2019 increase in the tax expenditure total for personal credits might be dismissed on the grounds that, if the Joint Committee is going to consider the dependency exemption part of the normal structure of the income tax, and if the increased child credit is a substitute for the exemption, then the Joint Committee should also have treated the increase in the credit as a part of the normal structure rather than as a tax expenditure. On the other hand, one could also argue that both dependency exemptions and the child credit should have been treated as tax expenditures all along. Under that view, the dependency exemption would have appeared in the 2017 TEB as a large deduction-type tax expenditure, which expenditure would have disappeared in the 2019 TEB. Arguably, then, by not having treated the dependency exemption as a tax expenditure in 2017, the Joint Committee has actually understated the shift from deduction-type tax expenditures to credit-type expenditures resulting from TCJA.

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50. The Joint Committee's TEB acknowledges the differing treatment of the credit and the exemption in its tax expenditure analysis and offers an explanation of sorts for the difference:

> While some features of the tax law, such as the child credit . . . , provide what may be considered adjustments for family size that have the objective of achieving a similar policy as personal exemptions, they do not do so in a way that defines a zero-rate bracket. . . . The Joint Committee staff considers these credits to be tax expenditures.

Id. at 4. In the spirit of Lord Byron, one wishes the Joint Committee would explain its explanation. *See* Lord Byron, Don Juan, at dedication l. 16 (1819–24).

III. The Evolution of Personal Tax Expenditures: Some Case Studies

A. The Home Mortgage Interest Deduction

In 1968 the home mortgage interest deduction was already of very long-standing, as part of the general deductibility of nonbusiness interest.[51] In 1968 there was no ceiling on the deductibility of home mortgage interest. In 1987 Congress limited the deduction to interest on $1,000,000 of acquisition indebtedness, and in 2017 Congress reduced the principal limitation to $750,000 (and repealed the deduction for interest on up to $100,000 of home equity indebtedness).[52] The focus, here, however, will not be on the rather modest legislative limitations on the deduction but on the fact that the deduction remains a deduction.

Congress has never seriously considered that acceptance of the validity of Surrey's upside-down critique of deductions might call for conversion of the deduction to a credit (equal to some stated percentage of interest paid), although the idea has certainly been proposed. Perhaps most notably, in 2005 President George W. Bush's Tax Reform Panel proposed replacing the deduction with a 15% credit, with the loan principal amount generating credit-eligible interest capped at the average price of housing in the taxpayer's area.[53] If adopted, the proposal would have been very costly to some homeowners, both because the 15% credit rate was far below the marginal tax rates of upper-income taxpayers and because in many parts of the country the loan principal cap for the credit was far below the cap for the deduction.[54] Although the entire Report of the President's Panel was widely and correctly viewed as politically dead

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51. For an excellent history and critique of the home mortgage interest deduction, see Dennis J. Ventry, Jr., *The Accidental Deduction: A History and Critique of the Tax Subsidy for Mortgage Interest*, 73 Law & Contemp. Probs. 233 (2010).

52. Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, § 10102, 101 Stat. 1330, 1330-384 to 1330-386; Tax Cuts and Jobs Act of 2017 § 11043, 131 Stat. at 2086.

53. President's Advisory Panel on Tax Reform, Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System 70–75 (2005).

54. Lawrence Zelenak, *The Theory and Practice of Tax Reform*, 105 Mich. L. Rev. 1133, 1145 (2007) (offering a fairly typical example in which the proposed credit would be worth less than half the tax savings from the deduction, and an example of a high-bracket taxpayer with a large

on arrival, the proposed replacement of the deduction with a limited credit was perhaps the most sincerely dead of all the Panel's proposals. "[T]he National Association of Realtors estimated that home prices would fall by 15 percent" if the proposal were enacted;[55] the Mortgage Bankers Association labeled the proposal "a tax increase for a lot of working Americans;"[56] and the National Association of Homebuilders released survey results indicating that 75% of likely voters opposed the proposal.[57] Neither President Bush nor Congress indicated any interest whatsoever in enactment of the proposal.

More recently, the Obama administration repeatedly proposed limiting the tax savings from all itemized deductions, including the home mortgage interest deduction, to 28% of the amount of the deductible expense.[58] Instead of realizing tax savings of $19,800 from the deduction of $50,000 of home mortgage interest, a taxpayer in the 39.6% bracket (the top bracket at the time) would have realized a tax savings of only $14,000 under the proposal. Congress never exhibited the slightest interest in enacting the Obama proposal.

Although the Obama administration described the proposal as retaining a limited version of the deduction, in substance the proposal was a deduction-credit hybrid. Taxpayers with marginal rates below 28% would have continued to claim the deduction without change; taxpayers with marginal rates above 28% would have claimed a 28% credit instead of a deduction; and taxpayers with a marginal rate of 28% could have been viewed as either continuing to claim the deduction or as claiming a 28% credit. Adoption of the proposal would have been a substantial move in the direction of converting a major legacy deduction to a credit. Moreover, it would have been a move of which Surrey would have heartily approved, because the mortgage interest deduction

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mortgage for whom the credit would be worth less than 10% of the tax savings from the deduction).

55. Eduardo Porter & David Leonhardt, *Goodbye, My Sweet Deduction*, N.Y. Times (Nov. 3, 2005), https://www.nytimes.com/2005/11/03/business/goodbye-my-sweet-deduction.html [https://perma.cc/J287-CNQB].

56. *Id.*

57. Sandra Fleishman, *Deduction Eruption: Tax Proposal May Not Float, but It Sure Is Making Waves*, Wash. Post (Nov. 12, 2005), https://www.washingtonpost.com/wp-dyn/content/article/2005/11/11/AR2005111100066_pf.html [https://perma.cc/FZ77-BQW3].

58. *See, e.g.*, U.S. Treas. Dep't, General Explanation of the Administration's Fiscal Year 2013 Revenue Proposals 73–74 (2012).

is vulnerable to Surrey's upside-down critique of deductions as tax expenditures. In fact, in his 1973 book on tax expenditures, Surrey used the mortgage interest deduction as the classic illustration of his critique, commenting, "One can assume that no HUD Secretary would ever have presented to Congress a direct housing program with this upside-down effect."[59]

On the other hand, there are two income-defining arguments supporting a mortgage interest deduction (rather than a credit). The first is the claim that an interest deduction is necessary to give owners of mortgaged homes a tax benefit equivalent to the exclusion of imputed rental income enjoyed by owner-occupiers of unmortgaged homes.[60] The second is that, because the income tax applies to interest income received by savers as compensation for deferring consumption, symmetry requires that the interest expense borne by borrowers as the cost of accelerating consumption be deductible.[61] There are serious counterarguments to both claims, but the two claims certainly weaken the force of Surrey's upside-down critique of the deduction.

It is striking that the mortgage interest deduction has easily resisted conversion to a credit (or even to a hybrid deduction-credit) despite having been squarely in the crosshairs of Surrey's critique, while (as detailed later) two former deductions also supported by plausible income-defining analyses—the childcare deduction and the dependency exemption—have been converted to credits.[62] A significant difference between the mortgage interest deduction and the two deductions that have been converted to credits is that the interest deduction is not (and never has been) subject to a high-income phaseout. Although Congress has limited the deduction by capping the amount of loan principal on which interest may be deducted, it has never used a phaseout to deny the benefit of the capped deduction to upper-income homeowners. In the absence of a phaseout, conversion of the deduction to a credit (with the credit percentage set at some level significantly below the top marginal tax rate) would be to the disadvantage of upper-income homeowners.

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59. Surrey, Pathways, *supra* note 12, at 37.

60. For a full exposition of this point, see Marvin A. Chirelstein & Lawrence Zelenak, Federal Income Taxation 217–21 (14th ed. 2018).

61. William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 Harv. L. Rev. 309, 376 & n.116 (1972).

62. *See infra* text accompanying notes 131–165 (childcare deduction), 227–256 (dependency exemption).

Given the political power of affluent homeowners, and of the residential real estate industry, it is not surprising that the deduction remains unconverted. As will become clearer after examination of the histories of other deductions, the record suggests that the existence of an upper-income phaseout may be a necessary condition for the deduction-to-credit conversion of a tax expenditure.

B. The Charitable Deduction

The charitable deduction can be understood as a matching grant program for taxpayer contributions to charity, with the generosity of the match depending on the taxpayer's marginal tax rate. For a taxpayer with a (hypothetical) marginal rate of 40% giving $100 to a charity, the $40 of tax savings from the deduction means that only $60 of the $100 received by the charity ultimately comes out of the taxpayer's pocket; the other $40 comes (indirectly, of course) from the federal government. Thus, for every $3 of after-tax cost to the taxpayer, the government contributes $2 of its own. The match is much less generous for a taxpayer in the 10% bracket; for every $9 of after-tax cost to the taxpayer, the government adds just $1. And there is no match at all for a charitable contribution by a taxpayer who claims the standard deduction. The above is, of course, an application of Surrey's critique of deduction-based tax expenditures as upside-down subsidies. In his 1973 book Surrey commented that "the task is to devise a direct subsidy [for charitable donations] that continues private designation of the charitable donee and freedom from federal control," and noted hopefully that "some researchers [are] exploring a system of direct matching grants."[63]

It is a bit surprising, then, that the charitable deduction has proven to be the sturdiest of all the legacy tax expenditure deductions. Congress has never subjected the charitable deduction to a percentage-of-income floor (unlike the medical expense deduction, with its floor of 10% of adjusted gross income (AGI)) nor to a dollar cap on the amount deductible comparable to the $10,000 ceiling on the SALT deduction or the $750,000 ceiling on home mortgage principal for purposes of the interest deduction.[64] Although it has been indirectly impacted—along

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63. Surrey, Pathways, *supra* note 12, at 204.

64. To be sure, I.R.C. § 170(b)(1) generally limits the charitable deduction to 50% of a taxpayer's adjusted gross income (with both higher and lower AGI-percentage limits applying in some cases, and with a five-year

with all other itemized deductions—by TCJA's near-doubling of the standard deduction, in other respects it has survived largely unscathed.

Congress has never come close to either imposing major limits on the deduction (such as a flat dollar cap or an AGI-based phaseout) or to converting the deduction to a credit or (as Surrey suggested) to a nontax matching grant. The lack of legislative interest has not been due to a failure of imagination. As noted earlier in connection with the mortgage interest deduction, the Obama administration repeatedly proposed capping the benefit of all itemized deductions—the charitable deduction among them—at 28%.[65] The effect would have been to convert the deduction into a hybrid deduction-credit, with the subsidy functioning simply as a 28% credit for those wealthy donors making the largest charitable donations. Congress was not remotely interested.

There have also been, over the years, a number of proposals from various sources to eliminate the upside-down matching grant effect of the deduction by converting it to a credit—including a flurry of such proposals in 2010.[66] Congress, however, has never seriously contemplated converting the deduction to a credit.

The stubborn refusal of Congress even to think about converting the deduction to a credit is not surprising in light of three contributing factors. First, as suggested by the earlier discussion of the mortgage interest deduction, Congress does not convert existing deductions to credits if a revenue-neutral conversion would be to the detriment of upper-income taxpayers and if a credit rate high enough to hold harmless top-bracket taxpayers would be very costly to the fisc. Because the charitable deduction has never been subject to either a flat dollar cap or

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carryforward for amounts not deductible by reason of the percentage limitation). Although this is a dollar cap of a sort, for wealthy donors it is higher by orders of magnitude than the dollar caps imposed on the SALT and mortgage interest deductions.

65. U.S. Treas. Dep't, *supra* note 58, at 73–74.

66. Debt Reduction Task Force, Bipartisan Pol'y Ctr., Restoring America's Future 17 (2010) (replacing the charitable deduction with a 15% refundable credit) (task force co-chaired by Pete Domenici & Alice Rivlin); Nat'l Comm'n on Fiscal Resp. and Reform, The Moment of Truth 31 fig.7 (2010) (committee known as Bowles-Simpson; replacing the deduction with a 12% refundable credit for donations in excess of 2% of AGI); Our Fiscal Sec., Investing in America's Economy: A Budget Blueprint for Economic Recovery and Fiscal Responsibility 32 (2010) (replacing the charitable deduction with a 25% refundable credit).

an AGI-based phaseout, top bracket taxpayers—and perhaps of even greater political significance, their favored charities—would lose greatly from the revenue-neutral conversion of the deduction to a credit at some flat rate well below the top marginal rate. And although setting the credit rate equal to the top marginal rate would solve that problem, that would greatly increase the cost to the fisc of an already very pricey tax expenditure.[67]

Second, there has long been an argument—not terribly compelling, but persistent—that the charitable deduction is not really a tax expenditure at all but rather a proper adjustment to the tax base reflective of ability to pay. The basic idea is that money one gives to charity is the equivalent—from an ability-to-pay perspective—of money one never had and that a deduction (not a credit) is the appropriate tool for removing that money from the base of the income tax. Although some may find the claim that money you give to charity is like money you never had to be almost self-refuting, the argument has never gone away. William Andrews in 1972 presented the strongest case for that view,[68] and the view remains influential to this day.[69]

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67. In addition to being to the detriment of upper-income donors, a revenue-neutral conversion of the deduction to a credit would be to the detriment of the charities favored by those donors. It has long been recognized that donors at different income levels favor different types of charities; donations from donors of modest incomes skew heavily toward churches and other religious organizations, whereas donations from upper-income donors skew toward higher education and cultural organizations. *See, e.g.*, Charles T. Clotfelter, *Charitable Giving and Tax Legislation in the Reagan Era*, 48 Law & Contemp. Probs. 197, 203 tbl.4 (1985). If necessary, colleges, universities, and cultural organizations would exert their considerable political influence to resist proposals to convert the deduction to a credit. For a detailed account of the successful efforts by universities and art museums in a closely related context (involving the repeal of the short-lived disallowance of the deduction for unrealized appreciation in donated property for purposes of the alternative minimum tax), see Lawrence Zelenak, Figuring Out the Tax: Congress, Treasury, and the Design of the Early Modern Income Tax 125–31 (2018).

68. Andrews, *supra* note 61, at 344–75.

69. *See, e.g.*, Roger Colinvaux et al., *Evaluating the Charitable Deduction and Proposed Reforms*, Urb. Inst. 6–7 (June 2012), https://www.urban.org/sites/default/files/publication/25491/412586-Evaluating-the-Charitable-Deduction-and-Proposed-Reforms.PDF [https://perma.cc/W5A4-K65D] (providing a clear and succinct statement of the argument, without

Third, the deduction fares quite well—decidedly better than a flat credit would fare—when analyzed in terms of "Treasury efficiency." Treasury efficiency is about bang-for-the-buck—in other words, the size of the increase in charitable contributions caused by the tax subsidy relative to the revenue loss from the subsidy.[70] The Treasury efficiency of a tax subsidy for charitable giving depends on the price elasticity of giving; if the existence of a charitable deduction increases giving by more than the revenue loss from the deduction, the deduction is Treasury efficient. And the greater the increase in giving relative to the revenue loss, the more spectacularly Treasury efficient the deduction.

Of course, the price elasticity of charitable giving is not uniform; it may vary with many attributes of both taxpayers and their donees, notably including taxpayers' income levels. Empirical studies of the price elasticity of charitable giving are something of a cottage industry among public finance economists. Although results differ from study to study, among the more robust results are that price elasticity (and thus Treasury efficiency) increases with income and that the current deduction regime is strikingly Treasury efficient for high-income donors.[71] For example, in 2011 economist C. Eugene Steuerle told the Senate Finance Committee that, although a "floor under charitable giving" (that is, allowing a deduction only to the extent a taxpayer's charitable donations exceeded, say, 2% of AGI) would produce "[v]ery limited loss of charitable giving per dollar of revenue pick up," by contrast, "[c]apping the deduction or converting the deduction to a credit likely creates a greater loss of charitable giving . . . because they affect taxpayers who are considered by some researchers to be more sensitive to tax incentives."[72]

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either endorsement or rejection); JOINT COMM. ON TAX'N, 113TH CONG., JCX-4-13, PRESENT LAW AND BACKGROUND RELATING TO THE FEDERAL TAX TREATMENT OF CHARITABLE CONTRIBUTIONS 50–51 (2013) (briefly setting forth the argument, also without endorsement or rejection).

70. Joseph J. Cordes, *Re-Thinking the Deduction for Charitable Contributions: Evaluating the Effect of Deficit-Reduction Proposals*, 64 NAT'L TAX J. 1001, 1012 (2011).

71. *Id.* at 1020 (citing studies).

72. *Tax Reform Options: Incentives for Charitable Giving: Hearing Before the S. Comm. on Fin.*, 112th Cong. 130 (2011) (Statement of C. Eugene Steuerle, Urban Inst. Richard B. Fisher Chair & Inst. Fellow) [hereinafter *Tax Reform Options*].

In short, because the price elasticity of charitable giving by upper-income taxpayers tends to be quite high, the current deduction is likely more Treasury efficient than a revenue-neutral credit replacement, with the result that economists tend to look favorably on the deduction. Two caveats are worth noting here. First (as the economists would readily acknowledge), there is more to the policy analysis of the charitable deduction than Treasury efficiency. Suppose the deduction results in Harvard University receiving $2 in donations for every dollar of revenue loss to the fisc. That is impressive Treasury efficiency, but it is a good policy result only if it is better (from the perspective of the federal government) that Harvard have $2 than that the federal government have $1—a proposition that is not exactly self-evident outside of Harvard Yard. Second, the reason Congress enacted a charitable deduction rather than a credit in 1917 had nothing to do with Treasury efficiency. Rather, the 1917 Congress opted for a deduction rather than a credit out of a failure of imagination. In 1917, and for decades thereafter, a tax benefit for a favored type of taxpayer expenditure always took the form of a deduction, for the simple reason that the credit alternative had never entered the legislative mind. A charitable deduction may be superior to a credit from a Treasury efficiency perspective, and that superiority may be among the reasons Congress has never seriously considered a deduction-to-credit conversion, but Treasury efficiency had nothing to do with the original choice of a deduction or the unexamined retention of the deduction for many decades.[73]

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73. This is not the only example of sophisticated economic analysis providing support for a tax policy enacted by Congress for completely unrelated reasons. Consider, for example, the high marginal tax rate "bubble" imposed on lower-income workers by the phaseout of the EIC. Congress enacted the EIC phaseout based on a misguided view that a phaseout was necessary to deny the credit to middle- and upper-income earners, without realizing that the EIC can be effectively taxed away for higher earners even without an explicit phaseout. Daniel Shaviro, *The Minimum Wage, the Earned Income Tax Credit, and Optimal Subsidy Policy*, 64 U. Chi. L. Rev. 405, 463 (1997). As it happens, however, optimal tax analysis strongly suggests that high marginal tax rates in the general range of the EIC phaseout are optimal (because high rates in that range produce tax revenue without causing deadweight loss, when applied to the many higher-income taxpayers for whom the rates in that range are inframarginal). Lawrence Zelenak, *Redesigning the Earned Income Tax Credit as a Family-Size Adjustment to the Minimum Wage*, 57 Tax L. Rev. 301, 328–32 (2004).

In recent years, some tax policy analysts have made an additional argument in defense of the charitable deduction, in response to the Surrey-inspired claim that the upside-down effect of the deduction makes it regressive. As Joseph Cordes explains:

> As a simple example, if the desired degree of progressivity can be achieved by taxing two people making $100,000 a total of $40,000, then the tax code can either require each to pay $20,000, with no charitable deduction, or grant charitable deductions and then adjust rates so that the individual making substantial charitable deductions pays $19,000 and the individual making no contributions pays $21,000. Either system has the same degree of overall progressivity. Thus, eliminating the charitable deduction or converting it to a credit need not make the overall tax system any more (or less) progressive, depending on how rates are adjusted.[74]

As explained below, essentially the same argument can be offered in defense of allowing dependency exemptions (which function as deductions) to upper-income taxpayers.[75] In fact, the argument can be used as a counter to a claim that structuring any tax expenditure as a deduction renders the subsidy regressive and therefore objectionable. There are, however, two important limitations to the force of the argument. First, the argument assumes that Congress will accompany the creation or retention of the deduction with appropriately progressive adjustments to the tax rate structure. If such adjustments are not part of the deal, the argument fails. Second, since achieving desired distributional results through a combination of an upside-down, deduction-based subsidy and adjustments to the rate structure is more complicated than using a credit and leaving the rate structure unchanged, there has to be some other reason to prefer a deduction to a credit. Such reasons arguably exist in the case of both dependency exemptions and the charitable deduction—the view that dependency exemptions are part of the

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74. Cordes, *supra* note 70, at 1010. For more elaborate statements of the same point, see Colinvaux et al., *supra* note 69, at 10, and *Tax Reform Options*, *supra* note 72, at 128–29 (statement of C. Eugene Steuerle).

75. *Infra* text accompanying note 232.

non-subsidy normative structure of the income tax,[76] and the Treasury efficiency case for the charitable deduction—but may not exist in other contexts.

C. The State and Local Tax (SALT) Deduction

If interest in replacing other legacy deductions with credits has been rather limited, interest in replacing the SALT deduction with a credit has been almost nonexistent. The Obama administration's proposal to cap the tax benefit of all itemized deductions at 28% would have converted the SALT deduction to a credit-deduction hybrid,[77] and a 2016 Report of the Tax Policy Center analyzed the economic effects of replacing the SALT deduction with a 15% credit,[78] but there is little more.

Instead, the would-be reformers of the SALT deduction have focused on either complete repeal or on a dollar cap on the deduction (retaining the deduction form, but sharply reducing the size of the SALT deduction tax expenditure). The two tax reform proposals of President Reagan's Treasury Department—commonly known as Treasury I and Treasury II—both called simply for the repeal (without replacement) of the deduction. According to Treasury I:

> Expenditures by State and local governments provide benefits primarily for residents of the taxing jurisdiction. To the extent that State and local taxes merely reflect the benefits of services provided to taxpayers, there is no more reason for a Federal subsidy for spending by State and local governments than for private spending.[79]

Similarly, Treasury II explained that the SALT deduction should be repealed because "State and local taxpayers receive important personal

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76. *Supra* text accompanying notes 49–50.

77. U.S. Treas. Dep't, *supra* note 58, at 73–74.

78. Frank Sammartino & Kim Rueben, *Revisiting the State and Local Deduction*, Tax Pol'y Ctr. 21 (Mar. 31, 2016), https://www.taxpolicycenter.org/sites/default/files/alfresco/publication-pdfs/2000693-Revisiting-the-State-and-Local-Tax-Deduction.pdf [https://perma.cc/4BTL-U9J5].

79. U.S. Treas. Dep't, Tax Reform for Fairness, Simplicity, and Economic Growth 78 (1984).

benefits in return for their taxes, such as public education, water and sewer services and municipal garbage removal."[80] Notably, neither Treasury I nor Treasury II proposed repeal of any of the other legacy personal deductions.

Although the SALT deduction survived the Tax Reform Act of 1986 with the loss of only the sales tax deduction,[81] Treasury I and II suggested that the SALT deduction was more politically vulnerable to repeal without replacement than any of the other legacy deductions. This was suggested again in 2005, when President George W. Bush's Tax Reform Panel recommended retention of the charitable and medical expense deductions and the conversion to a credit of the mortgage interest deduction, but repeal without replacement for the SALT deduction.[82] According to the Panel: "This deduction provides a federal subsidy for public services provided by state and local governments. Taxpayers who claim the state and local tax deduction pay for these services with tax-free dollars. . . . [T]hese expenditures should be treated like any other nondeductible personal expense, such as food or clothing. . . ."[83] Although the SALT deduction easily survived any threat posed to it by President Bush's Panel, the Panel's Report again suggested the deduction was uniquely vulnerable to outright repeal.

The Ways and Means Committee's version of what became the Tax Cuts and Jobs Act of 2017 would have repealed the deduction for nonbusiness state and local taxes, with the exception of up to $10,000 of real property taxes.[84] After Republican members of Congress from high-tax states (especially California, New York, and New Jersey) complained that the complete repeal of the deduction for state and local income tax would not sit well with their constituents,[85] the final version

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80. The President's Tax Proposals to Congress for Fairness, Growth, and Simplicity 63 (1985).

81. Tax Reform Act of 1986, Pub. L. No. 99-514, § 134, 100 Stat. 2085, 2116.

82. President's Advisory Panel on Tax Reform, *supra* note 53, at 61, 70–84.

83. *Id.* at 83.

84. H.R. Rep. No. 115-409, at 165–66 (2017).

85. Alan Rappeport & Thomas Kaplan, *Republicans Consider More Generous State and Local Tax Break*, N.Y. Times (Dec. 5, 2017), https://nyti.ms/2AXEabb [https://perma.cc/6KL4-AK8H].

of the legislation retained the state and local income tax deduction, subject to a $10,000 ceiling on the deduction of state and local taxes of all types.[86]

Although the SALT deduction has survived as a deduction (in greatly diminished form) and in that sense resembles the other surviving legacy deductions, its story is very different from those of the mortgage interest deduction and the charitable deduction. With the other two deductions, there was widespread agreement that significant income tax benefits were politically necessary, and the question was whether Congress should retain the deductions or convert them to credits (or to a credit-deduction hybrid). Congress has chosen not to convert those deductions, because conversions to credits would involve either incurring the wrath of high-income taxpayers or significantly increasing the magnitude of the tax expenditures.

With the SALT deduction, in sharp contrast, repeal without replacement has been a real possibility; there is no consensus either that a tax expenditure is justified on the merits or that the deduction is one of the third rails of American tax politics. Part of the explanation for the greater political vulnerability of the SALT deduction is the widespread perception (an oversimplification, to be sure) that the taxpayers most fervent in their support of the SALT deduction live in high-tax blue states, so that a Republican-controlled Congress (as in 2017) can severely limit the deduction without offending the constituents of the legislators in control of the congressional agenda. By contrast, the mortgage interest and charitable deduction are seen as enjoying much more bipartisan taxpayer support, with the result that legislators of both parties are reluctant to impose major new limitations on those tax benefits.

An alternative explanation for the political vulnerability of the SALT deduction in 2017 might focus on the long-standing denial of the SALT deduction for purposes of the alternative minimum tax (AMT). The AMT disallowance originated in 1982.[87] When enacted, the AMT disallowance generated little controversy, for the simple reason that the AMT affected few taxpayers and raised little revenue (in

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86. Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, § 11042, 131 Stat. 2054, 2085–86.

87. Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 201(a), 96 Stat. 324, 414.

1983, 0.3 million individual tax returns and $2.5 billion revenue).[88] However, over the years between 1982 and 2017, the AMT grew tremendously in both the number of affected taxpayers and revenue produced; by 2017 the AMT raised almost $38 billion of revenue from over 5 million taxpayers.[89] At first glance, this suggests a "boiled frog" explanation for the 2017 SALT ceiling. The deduction-denial water was cold in 1982, but by 2017 the water had been heated to boiling by the gradual increase in the impact of AMT, at which point there might have been little resistance to Congress's finishing the job—or nearly so—by imposing the $10,000 ceiling for purposes of the regular tax.

The boiled frog explanation does not, however, hold up under scrutiny. According to Joint Committee on Taxation estimates for 2017, SALT deductions claimed on 42.3 million individual returns reduced tax liabilities by $109.4 billion (despite the AMT disallowance of the SALT deduction); for 2018 (the first year to which the ceiling applied) the newly limited SALT deduction reduced tax liabilities by only $20.3 billion on only 16.6 million returns.[90] Whether measured by head count or dollars, the 2018 numbers are radically lower than the 2017 numbers; they are not merely a continuation—or even an acceleration—of pre-2017 trends.[91]

In addition to the preceding data-based rejection of the boiled frog hypothesis, rejection of the hypothesis is supported by the overwhelming outcry from blue-state taxpayers and politicians in response to the $10,000 ceiling. Not only did the ceiling inspire various clever-but-unsuccessful attempts by blue state legislators to help their affluent residents maneuver around the SALT ceiling,[92] voter antipathy to the

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88. *Aggregate AMT Projections and Recent History, 1970–2027*, Tax Pol'y Ctr. (Apr. 28, 2017), https://www.taxpolicycenter.org/model-estimates/baseline-alternative-minimum-tax-amt-tables-april-2017/t17-0146-aggregate-amt [https://perma.cc/A6YC-QBK9].

89. *Id.* If AMT revenue had merely kept pace with inflation from 1983 to 2017, the 2017 revenue would have been about $6.2 billion.

90. Joint Comm. on Tax'n, 115th Cong., JCX-32R-18, Tables Related to the Federal Tax System as in Effect 2017 through 2026, at 8 tbl.7 (2018).

91. The dramatic declines of 2017 are not due solely to the $10,000 SALT ceiling; rather, they reflect the combined effect of the ceiling and the near doubling of the standard deduction.

92. *See generally* Lawrence Zelenak, *SALT Ceiling Workarounds and Tax Shelters*, 160 Tax Notes 521 (July 23, 2018); *see also* T.D. 9864,

ceiling appears to have played a significant role in the defeat in the 2018 midterms of more than a few Republican House members representing affluent districts in high-tax states.[93]

In short, the primary explanation for the enactment of the SALT ceiling appears to have been the perception of Republican members of Congress that the deduction was a blue-state tax benefit—not that political support for an uncapped deduction had been fatally eroded by the AMT.

While repeal of the deduction—or, as with TCJA in 2017, limitations so severe as to verge on repeal—has been very much in play, conversion of the deduction to a credit has not. In part, this has been because standard policy analyses of the deduction provide little support for its conversion to a credit. To the extent taxpayers receive consumption benefits in return for state and local taxes paid, there is no compelling policy rationale for any federal tax subsidy, whether deduction or credit; and to the extent state and local taxes are redistributive—that is, to the extent taxpayers do not receive government benefits in return for their taxes—the taxes are the equivalent of money the taxpayers never had and so are properly deductible for federal income tax purposes under an ability-to-pay rationale.[94] In short: taxes-for-benefits call for neither a deduction nor a credit, and taxes-for-redistribution call for a deduction. What is missing, of course, is any variety of state and local tax calling for a federal tax credit. From this perspective, the TCJA approach of treating state and local taxes as partly deductible and partly nondeductible (and not at all creditable) makes sense, although there are surely better tools than a $10,000 ceiling for distinguishing between taxes-for-benefits and taxes-for-redistribution.[95]

2019–27 I.R.B. 6 (preamble to and final regulations aimed at attempts to avoid the SALT ceiling by converting state and local taxes to charitable contributions).

93. Jim Tankersly & Ben Casselman, *Did a Tax Increase Tucked into Trump's Tax Cut Come Back to Bite Republicans?*, N.Y. Times (Nov. 19, 2018), https://nyti.ms/2zcyWGj [https://perma.cc/JU3P-R77D].

94. *See generally* Gladriel Shobe, *Disaggregating the State and Local Tax Deduction*, 35 Va. Tax Rev. 327 (2016).

95. At least at first glance, and ironically enough, the $10,000 ceiling would seem to disallow a deduction for precisely those state and local taxes most likely to serve a redistributive function.

The SALT deduction is now a mere shadow of its recent former self, and its long-term survival—even in mere shadow form—is far from assured. In striking contrast, however, with the mortgage interest and charitable deductions, there has never been and likely never will be any serious consideration of conversion to a credit; all the action will be around the questions of how sharply limited the deduction should be and whether it should be put out of its misery by complete repeal.

D. The Exclusion for Employer-Provided Health Insurance (and the Medical Expense Deduction)

Although the rules of Code section 106, excluding from gross income the value of employer-provided health insurance (EPHI), have not undergone any radical changes between the 1968 publication of the first TEB and today, the size of the EPHI exclusion tax expenditure has grown tremendously over the past half century. For 1968, Treasury estimated the tax expenditure at $1.1 billion, or about 0.12% of 1968 GDP.[96] For 2019, the Joint Committee on Taxation puts the same tax expenditure at $152.5 billion, or about 0.71% of GDP.[97] The nearly six-fold increase in the size of the tax expenditure as a fraction of GDP is attributable not to any major legislative changes in the exclusion (there have been none) but rather to the increase in the cost of medical care (and thus, indirectly, the cost of health insurance) as a percentage of the GDP and by growth in the share of health expenditures covered by health insurance rather than by out-of-pocket payments by individuals.

Total national health expenditures as a share of GDP have grown from about 7% in 1970 to about 18% in recent years.[98] And private insurance's share of total national health expenditures has grown from 21% in 1970 to 33.9% in 2017, while the out-of-pocket share has fallen from 33% in 1970 to 10.5% in 2017.[99] These two factors are sufficient to explain about two-thirds of the increase in the size of the EPHI

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96. U.S. Treas. Dep't, *supra* note 4, at 340.

97. JCT 2019 TEB, *supra* note 11, at 28.

98. Rabah Kamal et al., *How Has U.S. Spending on Healthcare Changed over Time?*, Health Sys. Tracker (Dec. 20, 2019), https://www.healthsystemtracker.org/chart-collection/u-s-spending-healthcare-changed-time/#item-start [https://perma.cc/DL8B-W6U4].

99. *Id.* Over the same time frame, public insurance's share has grown from 22% to 40.7%, and the "other" share has fallen from 24% to 15%. *Id.*

exclusion tax expenditure as a percentage of GDP; the explanation for the remainder of the increase is not readily apparent.[100]

Over the last half century, there has been a remarkable reversal in the relative revenue significance of the EPHI exclusion and the medical expense deduction (Code section 213). For 1968, Treasury put the deduction tax expenditure at $1.5 billion, significantly above the $1.1 billion estimate for the exclusion.[101] For 2019, the Joint Committee on Taxation estimates the deduction at $7.1 billion—less than 5% of the $152.5 billion estimate for the exclusion.[102] The diminished significance of the deduction is explained partly by out-of-pocket expenditures' dwindling share of national health care spending, partly by legislated increases over time in the percentage-of-AGI floor on deductible medical expenses (from 3% at the time of the first TEB, to 10% today[103]), and (very recently) partly by TCJA's near-doubling of the standard deduction. Of course, the raising of the floor on the deduction may have contributed to the decrease in out-of-pocket spending's share of overall healthcare expenditures. In any event, the dwindling significance of the deduction—from about 0.16% of GDP in 1968 to about 0.03% in 2019—resembles, but is even more dramatic than, the decline of the other legacy deductions. Although Congress has never converted the deduction to a credit (or even seriously considered doing so), both changes in the tax laws and nontax changes in the economy have greatly diminished the deduction.

The EPHI exclusion, of course, has not shared the fate of the medical expense deduction and the other legacy deductions. The greatly increased economic significance of the exclusion is a result of changing economic conditions rather than changes in the tax rules, but the very absence of changes in the EPHI tax rules is in striking contrast with the $10,000 SALT ceiling, the $750,000 ceiling on home mortgage principal, and the effect of the near-doubling of the standard deduction on all itemized deductions.[104]

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100. A significant underestimation by Treasury of the 1968 tax expenditure is one possible explanation.

101. U.S. Treas. Dep't, *supra* note 4, at 340.

102. JCT 2019 TEB, *supra* note 11, at 28–29.

103. I.R.C. § 213(a).

104. The excise tax (former I.R.C. § 4980I (2010)) on so-called "Cadillac" EPHI, created in 2010 by the Affordable Care Act and later repealed without ever having come into effect, could have been viewed as an indirect

To a considerable extent, the exclusion's success in avoiding the new legislative restrictions that have plagued the legacy deductions has depended on the simple fact that it is an exclusion rather than a deduction. There is no deep theoretical distinction between an exclusion and a deduction. The tax benefit of each is the amount deducted or excluded, multiplied by the taxpayer's marginal tax rate; without any change of substance, any exclusion could be recast as an inclusion accompanied by an offsetting deduction. The legislative choice of an exclusion rather than an inclusion-and-offsetting-deduction is explained by the fact that a no-step process (exclusion) is simpler than a two-step process (inclusion-deduction). Thus, whenever Congress desires a tax expenditure and an exclusion is feasible—that is, whenever the tax subsidy is based on the source of benefits received by a taxpayer rather than by the way a taxpayer spends her money—Congress chooses an exclusion over an inclusion-followed-by-deduction. For no very good reason, however, neither the EPHI exclusion nor any other exclusion is at the mercy of the standard deduction as are itemized deductions. Taxpayers do not have to choose between exclusions and the standard deduction, with the result that increases in the standard deduction have no effect on exclusions, even as they may severely limit itemized deductions.

That the EPHI exclusion, and exclusions generally, do not interact with the standard deduction is attributable more to a legislative failure of imagination than to any considered policy decision. As discussed in Part IV below,[105] it would certainly be technically feasible for Congress to enact a rule that taxpayers can exclude EPHI from income only if they do not claim the standard deduction.[106] But Congress has never evinced the slightest interest in that approach—in part, perhaps, because the approach would require placing a dollar value on EPHI for purposes of the income tax, and avoiding the need to value non-cash benefits is one of the attractions of exclusions.

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limitation on the exclusion. The Cadillac tax is discussed *infra* text accompanying notes 116–118.

105. *Infra* text accompanying notes 303–327.

106. Such a rule should be accompanied by an increase in the standard deduction amount. A standard deduction serving as an alternative to the claiming of both itemized deductions and the EPHI exclusion (and perhaps other exclusions as well) should be larger than a standard deduction serving as an alternative only to itemized deductions.

By being an exclusion rather than a deduction (or credit), the EPHI exclusion also avoids other restrictions. It is not subject to an AGI-based phaseout (unlike the child tax credit) or an AGI-based floor (unlike the medical expense deduction) or a dollar cap on the amount eligible for favorable treatment (unlike the SALT deduction and the dependent care credit). Any such restrictions would mar the elegant simplicity of the exclusion approach and would involve valuation problems in the case of health insurance and other non-cash benefits.[107] It seems fair to conclude that the reason EPHI has avoided the kinds of limitations to which the legacy deductions have been subject is not that health insurance is a more sacred cow than home ownership or charities but simply that tax expenditures in the form of exclusions have a certain under-the-radar quality—even, amazingly enough, in the case of a $152.5 billion-a-year tax expenditure larger than any other single item in the tax expenditure budget. The under-the-radar quality of exclusions also explains why there has been less discussion of the possibility of replacing the exclusion with a credit—that is, repealing the exclusion and using the revenue from repeal to finance a new health insurance tax credit—than of the possibility of converting various existing deductions into credits.

To be fair, the imagination deficit—the failure to recognize that the exclusion could be converted to an inclusion-deduction, could be subject to deduction-style restrictions even without conversion, or could be converted to an inclusion-credit—has not been total. In 1989 the conservative Heritage Foundation proposed eliminating the EPHI exclusion and using the revenue gained from the repeal to finance a system of refundable credits for health insurance premiums.[108] The

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107. Both dollar caps on exclusions and AGI-based phaseouts of exclusions appear in the Internal Revenue Code. *See, e.g.*, I.R.C. § 127 ($5,250 maximum exclusion for benefits under employment-based educational assistance programs) and § 86 (modified AGI-based phasedown of the exclusion of Social Security benefits). But such caps and phaseouts generally apply only to cash benefits and in-kind benefits that the taxpayer's employer purchases for cash, as to which there are no valuation difficulties. Of course, employers pay cash to insurers for employees' group health insurance coverage, but that does not solve the problem of allocating the total amount paid by an employer among all covered employees.

108. Edmund F. Haislmaier, *Health Care for Workers and Their Families*, *in* Heritage Found., A National Health System for America 55, 58–59 (Stuart M. Butler & Edmund F. Haislmaier eds., 1989); Stuart M. Butler,

Heritage proposal was an important intellectual predecessor of both Romneycare in Massachusetts and federal Obamacare (although, of course, Obamacare did not involve the elimination of the EPHI exclusion).[109] Nor was the idea of eliminating the exclusion new even in 1989; the Heritage paper cited several earlier proposals to similar effect, dating back to 1981.[110]

In its Budget for Fiscal Year 2008, the Bush administration proposed including the value of EPHI in an employee's gross income while creating a new standard deduction (separate from the existing standard deduction) for all taxpayers covered by qualifying insurance, with the amount of the deduction sufficient to offset most or all of the inclusion for most insured taxpayers.[111]

In 2008, MIT economist Jonathan Gruber, who later became one of the principal architects of Obamacare, described a national plan

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Assuring Affordable Health Care for All Americans, Heritage Found.: Lectures (Oct. 1, 1989), https://www.heritage.org/social-security/report/assuring-affordable-health-care-all-americans [https://perma.cc/XT7F-7LJY].

109. Steven Brill, America's Bitter Pill: Money, Politics, Backroom Deals, and the Fight to Fix Our Broken Healthcare System 30–31 (2015).

110. Haislmaier, *supra* note 108, at 58 n.46.

111. Budget of the United States Government: Fiscal Year 2008, at 69 (2007). The 2008 Budget proposal resembled the 2005 proposal of President Bush's Tax Reform Panel, to allow an above-the-line deduction (not subject to a percentage-of-AGI floor) for health insurance purchased in the individual market, with the amount of the deduction limited to the average cost of health insurance, and to correspondingly cap the EPHI exclusion at the average cost of insurance. President's Advisory Panel on Tax Reform, *supra* note 53, at 80–82. For a detailed description and critique of the Bush Budget proposal, see Len Burman et al., *The President's Proposed Standard Deduction for Health Insurance: An Evaluation*, Tax Pol'y Ctr. (Feb. 14, 2007), https://www.urban.org/sites/default/files/publication/46371/411423-The-President-s-Proposed-Standard-Deduction-for-Health-Insurance.pdf [https://perma.cc/ND5J-DG25]. *See also* Leonard E. Burman & Jonathan Gruber, *Tax Credits for Health Insurance* 22 (Urban–Brookings Tax Pol'y Ctr., Discussion Paper No. 19, 2005), https://www.urban.org/sites/default/files/publication/51831/411176-Tax-Credits-for-Health-Insurance.PDF [https://perma.cc/Y6FW-U4VG] (noting that Congress could "pay for health insurance tax credits by scaling back or eliminating the existing exclusion for employment-based health insurance," but adding that it is doubtful "whether such options would have any political feasibility in the foreseeable future").

for universal health insurance coverage, involving mandated purchases of health insurance by individuals, federal subsidies to cover premium costs, and the financing of the "new $131 billion-a-year federal expenditure" by repeal of the EPHI exclusion.[112] As it turned out, although Congress enacted a major new tax credit for health insurance premiums as a cornerstone of its 2010 Obamacare legislation,[113] the 2010 legislation did not repeal, or even limit, the exclusion.

In his stump speech during the 2008 presidential campaign, Barack Obama promised voters that his proposed health care reforms would not affect existing EPHI.[114] Following the Obama victory in the November election, however, there was serious interest among leading congressional Democrats in imposing some limitations on the EPHI exclusion. Just eight days after the election, Senate Finance Committee Chair Max Baucus released a white paper on health reform, which included a call for premium subsidies (closely resembling the subsidies later enacted as part of Obamacare), and a comment that, although repeal of the EPHI exclusion "goes too far because it could cause widespread disruption," it might be appropriate "to cap the amount of health care premiums that can be excluded from employee wages. . . . by limiting or capping the tax exclusion based on the value of health benefits or, as an alternative, based on a person's income—or both."[115] With Baucus (along with some other Senate Democrats) urging some restrictions on the exclusion, and the Obama White House strenuously disagreeing (out of concern that restrictions would violate Obama's campaign pledge and would infuriate labor unions), Baucus and the Finance Committee eventually settled on the idea—possibly first suggested by John Kerry—of a "Cadillac tax" imposed on overly generous EPHI, but with the tax

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112. Jonathan Gruber, *Taking Massachusetts National: An Incremental Approach to Universal Health Insurance* 18 (Brookings Inst., Hamilton Project, Discussion Paper 2008-4, 2008), https://www.hamiltonproject.org/assets/legacy/files/downloads_and_links/Taking_Massachusetts_National-_An_Incremental_Approach_to_Universal_Health_Insurance.pdf [https://perma.cc/BE2T-5NAT]; *see also* Jonathan Gruber, *Covering the Uninsured in the United States*, 46 J. Econ. Literature 571, 602–03 (2008).

113. I.R.C. § 36B, discussed in detail *infra* text accompanying notes 124–130.

114. Brill, *supra* note 109, at 62.

115. Max Baucus, Call to Action: Health Reform 2009, at 81–82 (2008), https://www.finance.senate.gov/imo/media/doc/finalwhitepaper1.pdf [https://perma.cc/XHS8-5V8W].

imposed as an excise tax on insurers rather than as an income tax on insured employees.[116] The excise tax was enacted as part of Obamacare, but with its effective date delayed until 2018.[117] After further delaying the effective date of the tax (until 2022), Congress finally put the tax out of its misery in 2019.[118] Although the Cadillac tax could have been understood as an indirect limitation on the EPHI exclusion, it was obviously not a direct limitation. In any event, it has now been interred, without ever having come into effect.

Having strenuously defended the EPHI exclusion in 2010, the Obama administration later suggested limiting the exclusion by applying its proposed 28% cap not only to itemized deductions but also to the EPHI exclusion.[119] Apparently the idea was that a taxpayer in the 36% bracket (for example) would be taxed on EPHI at the rate of 8%, or (equivalently) would calculate tax at the rate of 36% on the entire value of the EPHI but could offset most of that tax with a credit equal to 28% of the value of the insurance. As with the companion Obama proposal to convert itemized deductions to deduction-credit hybrids, the proposal to convert the EPHI exclusion to an exclusion-credit hybrid went nowhere in Congress.

One final point about the EPHI exclusion is worth noting here. To this point the discussion has assumed that the exclusion is non-controversially categorized as a tax expenditure. There is a very plausible argument, however, that the value of health insurance should be excluded from the base of a normative income tax. There is general agreement among income tax theorists that tax should be imposed only on "clear income," defined as income in excess of subsistence needs. The costs of subsistence include not only food, clothing, and shelter, but also necessary medical care. The standard deduction serves to remove most subsistence level income from the tax base. It is not well suited, however, to removing the cost of basic medical care from the tax base because

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116. Brill, supra note 109, at 168–69; Chairman's Mark on America's Healthy Future Act of 2009, S. Comm. on Fin. 199 (2009).

117. Patient Protection and Affordable Care Act, Pub. L. No. 111-148, § 9001, 124 Stat. 119, 847–53 (2010); Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1401(b), 124 Stat. 1029, 1059–60. The tax was codified at I.R.C. § 4980I (2010).

118. Further Consolidated Appropriations Act of 2020, Pub. L. No. 116-94, Div. N., § 503(a), 133 Stat. 2534, 3119 (2019).

119. U.S. Treas. Dep't, *supra* note 58, at 73–74.

the cost of basic medical care (and thus the cost of basic health insurance) varies greatly among persons according to age, sex, and health condition. Rather than attempting to build the cost of basic health care into a one-size-fits-all standard deduction, it makes sense to vary the amount of the basic health care exclusion as the cost of basic health care varies from taxpayer to taxpayer. The EPHI exclusion makes good sense—and is not a tax subsidy—under this analysis. The only criticism of the exclusion, from this perspective, is that it does not attempt to limit the exclusion to the cost of basic insurance.[120]

But the EPHI exclusion is far from the only tax expenditure for which there is a plausible argument that it should not be so categorized, because the deduction or exclusion in question serves a non-tax-expenditure income-defining function. As noted elsewhere in this Article, similar arguments can be made concerning (among other things) the charitable and SALT deductions,[121] and the former deduction for child-care expenses.[122] These arguments have proven insufficient, however, to protect some of those other tax benefits from rather severe statutory limitations on their availability.[123] The best explanation of why the EPHI exclusion is not subject to comparable limitations is not that the case for the exclusion as income-defining is uniquely compelling but rather the under-the-radar quality of even the largest tax expenditure exclusions.

E. The Premium Assistance Credit

In 2010 the Affordable Care Act introduced the refundable Premium Assistance Credit (PAC), which provides subsidies for low- and moderate-income individuals and families purchasing health insurance through state or federal health insurance exchanges.[124] To be eligible for the PAC, a taxpayer must have household income of at least 100% but

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120. This paragraph is adapted from Richard Schmalbeck et al., Federal Income Taxation 130 (5th ed. 2018).

121. *Supra* text accompanying notes 68–69 (charitable deduction) and 94–95 (SALT deduction).

122. *Infra* text accompanying notes 131–133.

123. Even the charitable deduction, which is the least restricted of the major itemized deductions, is available only to the small percentage of taxpayers forgoing the standard deduction.

124. Patient Protection and Affordable Care Act, Pub. L. No. 111-148, § 1401, 124 Stat. 119, 213–20 (2010) (codified at I.R.C. § 36B).

not more than 400% of the federal poverty level (FPL), and must not be covered by Medicaid or be eligible for affordable employer-sponsored health insurance. Within the range of PAC-eligible household incomes, the generosity of the credit decreases as household income increases. The amount of the credit is designed so that the after-credit cost of basic health insurance shall not exceed a specified percentage of the taxpayer's household income, with the specified percentage increasing as the household income (expressed as a percentage of the FPL) increases.

Most refundable credits, including the earned income credit (EIC) and the partially refundable child tax credit (CTC), are paid out only after the year to which they relate. A taxpayer eligible for a refundable EIC for 2019, for example, would receive the refund only after filing a 2019 tax return in 2020. Congress realized, however, that cash flow problems would make it difficult or impossible for many PAC-eligible taxpayers to take advantage of the PAC if they could do so only by initially paying their entire health insurance premiums with their own money, with receipt of the credit delayed until the following year. To solve this cash flow problem, the PAC rules innovatively provided for advance monthly payments of the credit from the government to the taxpayer's insurer during the year to which the credit relates.[125]

There is a companion subsidy, also targeted at individuals and families with incomes between 100% and 400% of the FPL purchasing insurance through a state or federal exchange.[126] The subsidy, which is a direct expenditure program instead of a refundable tax credit, is for out-of-pocket costs (for deductibles and co-payments) incurred by persons covered by qualifying insurance.

It is unclear why the Democrats in control of Congress in 2010 decided that of two such closely related subsidies, aimed at the same target population and enacted in adjacent sections of the same legislation, one should be designed as a tax credit and the other as a direct spending program.[127] As events have unfolded, by far the most significant difference between tax and nontax subsidy design in this instance has

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125. *Id.* § 1412, 124 Stat. at 231–33 (codified at 42 U.S.C. § 18082).

126. *Id.* § 1402, 124 Stat. at 220–24 (codified at 42 U.S.C. § 18071).

127. *See* Lawrence Zelenak, *Choosing Between Tax and Nontax Delivery Mechanisms for Health Insurance Subsidies*, 65 Tax L. Rev. 723 (2012) (considering whether there was any justification for the legislative choice of different methods of administration for the two subsidies and concluding that there was not).

been something the architects of the 2010 legislation never contemplated. Taking the position that the nontax cost-sharing subsidies required legislative appropriation of funds (and that the mere existence of the subsidy provision in the United States Code did not constitute an appropriation), in 2017 the Trump administration announced that henceforth "CSR [cost-sharing reduction] payments are prohibited unless and until a valid appropriation exists."[128] By contrast, refundable tax credits clearly do not require appropriations; the mere inclusion of the credit provision in the Internal Revenue Code suffices. Thus, the PAC continued even as the CSR payments were suspended.

As important as the distinction between the tax-based PAC and the nontax CSR program has become, for purposes of this Article the most significant point is that Congress in 2010 never even considered a tax deduction as a design alternative to the PAC. The reason is clear. As is evident from the earlier description of the rules for determining the amount of the PAC, the idea was that the government should pay (through the PAC) just enough of the cost of a taxpayer's premium to ensure that the taxpayer's net-of-credit premium cost did not exceed a statutorily specified percentage of household income (with the percentage increasing as household income rose relative to the FPL).[129] With the subsidy conceived of—and administered as—the government paying a portion of an insured's premium, a credit rather than a deduction was obviously in order (assuming the subsidy was to be a tax provision of any kind). A nontax delivery method would also have been viable, as evidenced by the companion CSR subsidy. A tax deduction, however, could not have produced subsidies in the desired amounts. As a result, Congress gave no consideration whatsoever to the possibility of a premium subsidy in the form of a deduction.

In some of the other histories recounted here of the post-Surrey era, Congress considered both deductions and credits before deciding (rightly or wrongly) that a particular subsidy should be structured as a credit. The PAC story is different, however, in that there was no

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128. Memorandum from Eric Hargan, Acting Sec'y of Health & Hum. Servs., to Seema Verma, Administrator, Ctrs. for Medicare & Medicaid Servs. (Oct. 12, 2017), https://www.hhs.gov/sites/default/files/csr-payment-memo.pdf [https://perma.cc/3S8A-6KUV].

129. Joint Comm. on Tax'n, JCS-2-11, General Explanation of Tax Legislation Enacted in the 11th Congress 262–64 (2011).

legislative pondering. Given the congressional intent underlying the subsidy, Congress realized from the outset that a deduction was unsuitable.[130]

F. Tax Benefits for Childcare Expenses

Amounts paid for childcare while both parents are gainfully employed are jointly caused expenses, in the sense that both the existence of the child and the existence of the parents' jobs are necessary causes of the childcare expense, but neither child nor employment is a sufficient cause of the expense. The theoretically correct income tax treatment of expenses of this sort—jointly caused by the intersection of the taxpayer's personal life and the taxpayer's profit-seeking activities—is debatable. Such expenses could be viewed as personal—under the reasoning that a childless taxpayer with the same job would not incur the expense—and so nondeductible like other "personal, living, or family expenses."[131] Alternatively, the tax system could take the existence of the child as a given, in which case childcare expenses should be fully deductible as "ordinary and necessary" costs of earning a living.[132] Just as business expense deductions in general are not viewed as tax expenditures—because the base of a normative income tax is net income, and a deduction for business expenses is needed to reduce gross income to net[133]—so too childcare expenses in particular should not be viewed as tax expenditures under an income tax system taking the existence of children as a given. Moreover, under such a system there would be no reason to criticize a deduction for childcare expenses as an upside-down subsidy. In fact, it would not be a subsidy at all because a deduction (not a credit)

130. Whether a new credit for the purchase of health insurance might have served as a replacement for the EPHI exclusion, rather than coexisting with the exclusion, is a different question. As described above in the discussion of the EPHI exclusion (*supra* text accompanying notes 96–113), some advocates of a tax credit for health insurance premiums did indeed favor financing a new credit with the repeal of the exclusion.

131. I.R.C. § 262(a).

132. I.R.C. § 162(a).

133. JCT 2019 TEB, *supra* note 11, at 3 (noting that deductions for employee business expenses are part of "the normal structure of the income tax" and thus not tax expenditures).

for business expenses is necessary to reduce gross income to the desired tax base of net income.

Before 1954, nothing in the Internal Revenue Code specifically addressed the income tax treatment of employment-related childcare expenses. The Treasury and the IRS, however, consistently took the position that childcare was a nondeductible personal expense, and the courts agreed.[134] In 1954 Congress enacted a new provision allowing an itemized deduction for expenses incurred by "a woman or a widower" for childcare "but only if such care is for the purpose of enabling the taxpayer to be gainfully employed."[135] The amount of the deduction was limited in two ways. The deduction could not in any event exceed $600 (regardless of the number of children) and, in the case of a working wife, the maximum amount of the deduction was reduced dollar-for-dollar as the combined AGI of the spouses exceeded $4,500 (thus denying any deduction to a couple with AGI of $5,100 or more). As is clear from the structure of the phaseout, Congress did not support a married woman being in the paid labor force if her family could live comfortably on her husband's income.

The structure of the 1954 deduction suggested some confusion on the part of Congress as to whether the tax allowance was intended as a refinement of the concept of net income or whether it was intended as a subsidy. Both the fact that the allowance was a deduction rather than a credit, and the fact that the deduction was available only for costs incurred "for the purpose of enabling the taxpayer to be gainfully employed," suggested Congress had come around to the view that childcare was a legitimate business expense. On the other hand, the $600 ceiling, the classification of the allowance as an itemized deduction (making it unavailable to any taxpayer claiming the standard deduction), and the phaseout of the deduction for higher-income parents, were all inconsistent with the general tax treatment of business expenses and thus suggestive of a subsidy rationale. Perhaps the best explanation for the structure of the deduction is that the 1954 Congress was thinking more in terms of subsidy than in terms of recognition of childcare as a business expense but nevertheless designed the allowance as a deduction (rather than as a credit) because of a failure of imagination. In that era, the federal income tax included no credit subsidies for personal expenses

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134. The leading case was Smith v. Comm'r, 40 B.T.A. 1038 (1939).

135. Internal Revenue Code of 1954, Pub. L. No. 83-591, § 214, 68A Stat. 3, 70–71.

of any kind; the idea of structuring the new childcare allowance as a credit seems not to have occurred to the drafters of the 1954 Code.[136]

Congress retained the basic structure of the 1954 childcare deduction until 1976, although by then Congress had increased the deduction ceiling to $4,800 (derived from a monthly ceiling of $400); Congress had also liberalized the phaseout rules, so that the ceiling was reduced by half of the excess of AGI over $35,000.[137] In 1976, however, Congress repealed the deduction and replaced it with a credit.[138] The new credit equaled 20% of employment-related childcare expenses, up to a ceiling on credit-eligible expenses of $2,000 (one child) or $4,000 (two or more children).[139] The credit was nonrefundable. However, unlike the deduction it replaced, it was not reduced or eliminated for higher-income taxpayers.

In the history of the federal income tax, this was the first instance of Congress converting an existing deduction to a credit. Even today, it remains the only clean instance of such a conversion in the history of the income tax.[140] What explains this unique event? To be sure, credits were in the air in 1976. Just three years earlier, Surrey had published *Pathways to Tax Reform*, analyzing tax expenditures at book length and expounding on the superiority of credit tax expenditures to deduction tax expenditures.[141] And with the enactment of the EIC (initially as a

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136. The 100% foreign tax credit (FTC) was included in the 1954 Code, but it served as a tool for allocating tax revenue between the United States and other countries rather than as a means of subsidizing particular types of taxpayer consumption expenditures. *Id.* §§ 33, 901, 68A Stat. at 13, 285–86. Thus, the FTC had no influence on Congress's unexamined assumption that a deduction, rather than a credit, was the proper vehicle for a tax subsidy for childcare expenses.

137. Former I.R.C. § 214 (1954) (as amended prior to its 1976 repeal).

138. Tax Reform Act of 1976, Pub. L. No. 94-455, § 504, 90 Stat. 1520, 1563–66 (formerly codified at I.R.C. § 44A).

139. *Id.*

140. As described later (*infra* text accompanying notes 171–179), a decade passed between the repeal of the adoption deduction in 1986 and the enactment of the adoption credit in 1996. And as also described later (*infra* text accompanying notes 235–246), the replacement of the dependency exemption by the child tax credit took two full decades, beginning with the introduction of the credit in 1997, and ending only with the zeroing-out of the exemption and expansion of the credit in 2017.

141. SURREY, PATHWAYS, *supra* note 12.

temporary measure) in 1975,[142] Congress had provided itself with a prominent and recent precedent for a nonbusiness tax expenditure structured as a credit rather than a deduction (albeit not a credit designed as a percentage of credit-eligible expenditures). Still, these influences did not lead to the conversion to credits of the charitable deduction, the SALT deduction, the deduction for home mortgage and consumer interest, or the medical expense deduction—or even to mere legislative consideration of the conversion of any of those deductions. So, again, what was special about the costs of childcare?

A reader looking for enlightenment in the official "reasons for change" provided by the reports of the tax-writing committees would come away disappointed. According to both the Report of the House Ways and Means Committee and that of the Senate Finance Committee, the childcare deduction was "unduly restricted by its classification as an itemized deduction."[143] The Reports do not mention, however, the obvious point that retaining the deduction but changing its status to above-the-line (so that taxpayers could claim the deduction even if they claimed the standard deduction rather than itemizing) would also have solved this problem. The Reports continued, the "committee believes that such expenses should be viewed as a cost of earning income for which all working taxpayers may make a claim"[144]—but without noting that a deduction, not a credit, is the proper tool for treating childcare costs as business expenses. The Reports also echoed Surrey's upside-down critique of deductions as tax expenditures: "While deductions favor taxpayers in the higher marginal tax brackets, a tax credit provides more help for taxpayers in the lower brackets."[145] The Reports did not note, however, that Surrey's critique is inapplicable to deductions serving a net-income-defining purpose rather than a tax expenditure purpose and that the Reports had just asserted (earlier in the same paragraph) that childcare expenses "should be viewed as a cost of earning income"—in other words, as deductible business expenses.

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142. For the history of the EIC, see *infra* text accompanying notes 184–199.

143. H.R. Rep. No. 94-658, at 147 (1975); S. Rep. No. 94-938, at 132 (1976).

144. H.R. Rep. No. 94-658, *supra* note 143, at 147; S. Rep. No. 94-938, *supra* note 143, at 132.

145. H.R. Rep. No. 94-658, *supra* note 143, at 147; S. Rep. No. 94-938, *supra* note 143, at 132.

The real explanation for the conversion of the childcare tax allowance from a deduction to a credit is not to be found in the "reasons for change" offered by the tax-writing committees. Rather, the explanation has to do with winners and losers in tax reform and the revenue cost of reform. In general, the conversion of a deduction to a credit requires Congress to choose between two unattractive options. If the conversion is to make no taxpayers worse off than under prior law, the conversion will involve a large revenue loss. Suppose, for example, Congress were to convert the charitable deduction to a credit. If taxpayers in the 37% top bracket are not to lose from this change, the credit rate must be no lower than 37%. But a 37% credit would be more generous—in many cases, much more generous—than current law for all other taxpayers, with the result that the credit would be a more expensive tax expenditure than the deduction it would replace. Alternatively, Congress could replace the deduction with a lower-percentage credit estimated to produce the same revenue loss as the deduction. But if the revenue-neutral credit rate turned out to be, say, 25%, top bracket donors and their favored charities would be unhappy—and not quietly so.

The above considerations explain why the 1976 Congress did not even think about converting any of the major legacy personal deductions to credits. The childcare deduction was different, however, for two reasons. First, unlike the big-four deductions, the childcare deduction was subject to an AGI-based phaseout so that upper-income taxpayers could not claim it. Most taxpayers subject to marginal tax rates significantly above 20% (the rate of the new credit) had been ineligible for any childcare deduction because of the phaseout and so could only have benefitted by the replacement of a deduction for which they did not qualify with a credit for which they did qualify. No matter how much higher than 20% their marginal tax rates, they would gain from the deduction-to-credit conversion. Second, because the existing deduction was a relatively small tax expenditure, Congress could significantly increase the overall generosity of the childcare tax allowance at an affordable revenue cost.

In early 1977, when it assumed the childcare tax allowance would continue as a deduction, the Joint Committee on Taxation estimated the 1977 tax expenditure for the deduction at $420 million.[146] Even by the standards of the time, this was a small tax expenditure. For

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146. Joint Comm. on Tax'n, 94th Cong., JCS-5-76, Estimates of Federal Tax Expenditures 8 (1976).

comparison, the same TEB put the charitable deduction tax expenditure at $4.4 billion, the home mortgage and consumer credit interest deduction at $5.8 billion, the SALT deduction at $10.5 billion, and the medical expense deduction at $2.1 billion.[147] The smallest of these other tax expenditures was five times the size of the childcare deduction—a difference largely explained by the absence of dollar caps and AGI-based phaseouts for the other deductions.

According to the Joint Committee on Taxation, the 1977 tax expenditure for the new childcare credit was $840 million—as it happened, exactly twice the Committee's earlier estimate for the childcare deduction for the same year (made under the assumption that the deduction would continue).[148] With the doubling of the childcare tax expenditure (primarily a result of the elimination of the AGI-based ceiling), it is not surprising that Congress was able to minimize the number of losers from the conversion and the size of their losses. Yet, because the childcare tax expenditure was relatively small to begin with, the revenue loss from the doubling was a mere $420 million—almost a rounding error compared with (for example) the roughly $5.4 billion it would have cost Congress to convert the charitable deduction to a credit producing twice the revenue loss of the deduction.[149]

Writing a few years later, John R. Nelson, Jr., and Wendy Warring used IRS data to estimate who benefitted, and how much, from the conversion of the deduction to a credit.[150] Lower-income households (with incomes below $5,000) did indeed gain from the elimination of the need to itemize in order to claim the tax benefit; those households claimed the credit at three times the rate they had claimed the deduction, and their aggregate tax savings rose from $1 million to $3 million (comparing 1975 and 1976). For middle-income taxpayers ($5,000 to $20,000), the credit produced results very similar to the deduction. But for upper-income taxpayers (above $20,000), the number of households

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147. *Id.* at 7–9.

148. Joint Comm. on Tax'n, 95th Cong., JCS-10-77, Estimates of Federal Tax Expenditures 8 (1977).

149. *Id.* at 8–9 (the sum of separate tax expenditure items for charitable deductions to educational organizations, to health organizations, and to all other charities).

150. John R. Nelson, Jr. & Wendy E. Warring, *The Child Care Tax Deduction/Credit*, *in* Making Policies for Children: A Study of the Federal Process 206, 252 (Cheryl D. Hayes ed., 1982).

claiming the tax benefit increased sevenfold, and the aggregate tax savings increased eightfold. In all, Nelson and Warring estimated that "83 percent of the increase in households claiming the benefit and 94 percent of the additional tax savings were accounted for by families earning over $20,000 per year."[151]

The lesson for other potential deduction-to-credit conversions? The political prospects for the conversion of an existing deduction to a credit will be best if the conversion involves neither taking away significant benefits from a significant number of taxpayers nor a major increase (by federal budget standards) in the size of the tax expenditure. Put slightly differently, the outlook for a deduction-to-credit conversion is most promising when the conversion is actually to the benefit of the upper-income taxpayers who would normally be harmed by such a conversion.

As a small tax expenditure subject to an impactful AGI-based phaseout, the childcare deduction was the ideal candidate for conversion to a credit, and so Congress converted it. By contrast, all four of the major legacy deductions are poor conversion candidates by these criteria, and Congress has converted none of them. With the imposition of the $10,000 ceiling in 2017,[152] however, the SALT deduction now bears watching in this respect; the ceiling moves the SALT deduction closer to the condition of the childcare deduction just before its conversion.

Congress's reliance on the upside-down subsidy critique of deductions to justify replacing a deduction with a credit more favorable than the deduction to upper-income taxpayers was a perversion of Surrey's prescription. There was a second respect in which the new credit deviated from Surrey's advice—the new credit was nonrefundable. That the credit was nonrefundable cannot be explained as a simple congressional failure of imagination. Congress had enacted the refundable EIC just one year earlier.[153] During the consideration of the 1976 legislation, Senator Edward Kennedy urged the Senate Finance Committee to make the new dependent care credit refundable, and when that effort failed he tried again with a floor amendment.[154] Kennedy described his proposal as building on the refundable EIC, which he described as the "brainchild" of Finance Committee Chairman Russell Long, and Long offered his support for

151. *Id.*

152. I.R.C. § 164(b)(6).

153. For a detailed consideration of the EIC, including its original enactment in 1975, see *infra* text accompanying notes 184–199.

154. Nelson & Warring, *supra* note 150, at 250–51.

Kennedy's proposal.[155] Although Senator James Allen complained that a refundable credit amounted to "putting an expensive social program in the tax laws . . . [which] would more properly be the subject of some added social program,"[156] Kennedy's amendment passed by a vote of 71 to 21.[157] The refundability provision died in conference, however, with the House conferees agreeing with Treasury's view that the provision had "nothing to do with the determination of tax liability; it is simply an addition to the tax system which more properly serves a welfare function."[158]

Although the focus of this discussion has been on the 1976 conversion of the childcare deduction to a credit, there is also an important post-1976 chapter to the story of the income tax treatment of childcare expenses. In 1981 Congress added section 129 to the Code, providing an exclusion for employer-provided childcare benefits, applicable to both in-kind benefits and employer reimbursements of childcare expenses incurred by employees.[159] The provision originated with a Senate floor amendment introduced by Senator Howard Metzenbaum as an exclusion limited to in-kind employer-provided childcare.[160] The explanation of the bill noted that it would provide a statutory basis for existing practice, because "the IRS does not currently litigate this issue [of the taxability of in-kind childcare benefits] because of a temporary congressional ban on IRS activity to expand the concept of in-kind compensation."[161] After discussion with the managers of the pending tax bill, a revised version of Metzenbaum's proposal passed as a Senate floor amendment, with the support of the Senate leadership and the Treasury Department, and eventually became law.[162] The revised version provided an exclusion not only for in-kind benefits but also for payment by employers of employees' childcare costs.[163]

As enacted in 1981, section 129 imposed no ceiling on the value of excludable benefits. Congress rectified that situation in 1986, imposing

155. 122 Cong. Rec. 23,114–15 (July 21, 1976).

156. *Id.* at 23,115.

157. *Id.* at 23,117.

158. Nelson & Warring, *supra* note 150, at 251 (quoting Off. of Mgmt. & Budget, Legis. Reference File G3-14/75.5 (1976)).

159. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 124(e)(1), 95 Stat. 172, 198–200.

160. 127 Cong. Rec. 15,619–20 (July 14, 1981).

161. *Id.* at 15,625.

162. *Id.* at 17,387–94 (July 24, 1981).

163. *Id.* at 17,389–90.

a $5,000 ceiling (regardless of the number of children).[164] The statute did not provide for inflation adjustments to the ceiling, and the ceiling remains $5,000 to this day. According to the estimates of the Treasury Department's Office of Tax Analysis for 2019, the childcare credit is a much larger tax expenditure than the section 129 exclusion for benefits received pursuant to dependent care assistance programs—$4.26 billion for the credit, compared with only $570 million for the exclusion.[165]

Because an exclusion is the equivalent of an inclusion and an offsetting deduction, one might take the story of the two childcare tax benefits (credit and exclusion) as an instance of Congress deciding to make everyone a winner—lower-bracket taxpayers got their credit while higher-bracket taxpayers got a deduction equivalent. Although there is some truth to that interpretation, it is subject to three significant caveats. First, the politics of the 1976 deduction-to-credit conversion were unrelated to the introduction of the exclusion five years later. Second, the main impetus for the 1981 exclusion was the legislative desire not to tax in-kind childcare, driven by the usual considerations favoring exclusion of in-kind benefits (including the simplicity of exclusions and the avoidance of the need to value the benefits); the exclusion of employer reimbursements was something of an afterthought. Finally, although the original uncapped exclusion was hugely to the benefit of affluent taxpayers, the current exclusion capped at $5,000 obviously is not—a point brought home by the relative tax expenditure estimates for the two provisions.

G. Tax Benefits for Adoption Expenses

In 1981 Congress introduced an itemized deduction for up to $1,500 of expenses incurred by adoptive parents in connection with a special needs adoption.[166] According to the Joint Committee on Taxation:

> The Congress was concerned with obstacles to the adoption of children who have special needs which make them hard to place, even without regard to the

164. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1163, 100 Stat. 2085, 2510–11.

165. Treas. 2020 TEB, *supra* note 11, tbl.2b ll. 111 & 116.

166. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 125, 95 Stat. 172, 201 (codified as former I.R.C. § 222 (1981)).

> high cost of adoption. Accordingly, the Act provides a limited deduction intended to encourage, and reduce the financial burdens in connection with, the adoption of children who have special needs.[167]

This was a tiny tax expenditure as tax expenditures go; the Joint Committee estimated the expenditure at $10 million per year for 1982 through 1986.[168] Nevertheless, the adoption deduction, and the later adoption credit (described below), are instructive in understanding changes over time in the legislative choice between deductions and credits.

As an itemized deduction, the special needs adoption deduction was available only to the minority of taxpayers (35% in 1982, for example[169]) forgoing the standard deduction. Even among itemizers, the same $1,500 deduction would be worth $750 to taxpayers in the 50% bracket but only $300 to taxpayers in the 20% bracket. Moreover, this was unmistakably a tax expenditure; there was no plausible argument that a deduction (rather than a credit) was appropriate in refining the concept of net income to reflect ability to pay. And nothing in the legislative rationale for the deduction (as stated by the Joint Committee) offered any insight into why Congress thought an adoption tax expenditure should be structured as a deduction rather than a credit.

The 1981 adoption expense deduction thus runs counter to this Article's claim that, in the post-Surrey era, Congress chose deductions over credits when designing new nonbusiness tax expenditures.[170] The adoption expense deduction is evidence that Congress's conversion to a preference for credits over deductions was gradual and partial, not

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167. Joint Comm. on Tax'n, 97th Cong., JCS-71-81, General Explanation of the Economic Recovery Tax Act of 1981, at 57 (1981).

168. Joint Comm. on Tax'n, 97th Cong., JCS-4-82, Estimates of Federal Tax Expenditure for Fiscal Years 1982–1987, at 15 (1982).

169. Author's calculations, based on *Selected Historical Data*, Stat. Income Bull., Spring 1990, at 135, 160 tbl.7.

170. In that respect it resembles the Clinton administration's original preference, a decade-and-a-half later, for a deduction rather than a credit as the vehicle for a new tax benefit for college tuition expenses. In the case of the tuition tax benefit, however, Congress in 1997 enacted a credit—not a deduction—as the original form of the tax subsidy for tuition. For the development of tax subsidies for college tuition expenses, see *infra* text accompanying notes 201–226.

instantaneous and total. Most likely the 1981 proponents of a tax break for special needs adoption expenses gave little or no thought to whether the tax break should be a deduction or a credit. They made the new tax preference a deduction simply because in 1981 deductions, not credits, were still the norm for tax breaks for nonbusiness cash outlays.

As a very minor part of the base broadening of the Tax Reform Act of 1986, Congress repealed the adoption deduction.[171] In explaining the reason for the repeal, the Joint Committee made the obvious point (which had somehow escaped the attention of Congress in 1981) that "[t]he deduction provided relatively greater benefits to higher-income taxpayers, who presumably have relatively less need for Federal assistance, and no benefits to nonitemizers or to individuals whose income is so low that they had no tax liability."[172] Although converting the deduction to a refundable credit would have been a natural response to the enumerated shortcomings of the deduction, Congress instead opted for a nontax direct subsidy for special needs adoptions.[173] Conversion of a tax expenditure to a nontax direct spending program was even better, from Surrey's perspective, than conversion to a credit.

Adoption expenses were not destined, however, to be without their own tax expenditure for long. In 1994 and 1995 House Republicans, as part of their Contract with America, proposed a refundable tax credit for adoption expenses—not limited to special needs adoptions.[174] The proposed credit was remarkably generous: a 100% (dollar-for-dollar) credit for up to $5,000 of adoption expenses, with the credit phased out between AGI of $60,000 and $100,000.[175] Although the choice of a credit over a deduction might be explained by House Republicans' agreement with Surrey's upside-down critique, it is also likely that the House Republicans realized that a 100% credit would be far more valuable than a 100% deduction, even for top-bracket taxpayers.

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171. Tax Reform Act of 1986, Pub. L. No. 99-514, § 135, 100 Stat. 2085, 2116 (1986).

172. Joint Comm. on Tax'n, 99th Cong., JCS-10-87, General Explanation of the Tax Reform Act of 1986, at 52 (1987).

173. Tax Reform Act of 1986 § 1711, 100 Stat. at 2783–84 (amending Social Security Act).

174. *See* Staff of H. Comm. on Ways & Means, 104th Cong., Description of Provisions in the Contract with America Within the Jurisdiction of the Committee on Ways and Means 8 (1995).

175. *Id.*

Somewhat modified from the Contract with America proposal, the adoption credit became law in 1996.[176] As enacted, the new nonrefundable credit equaled 100% of adoption expenses up to $5,000 (or up to $6,000 in the case of a special needs adoption); the phaseout range was increased to $75,000 to $115,000 of AGI.[177] The new credit dwarfed the existing nontax adoption subsidy, which was limited to special needs adoptions and capped at $1,000 per child.[178] In full triangulation mode, in his signing statement President Clinton announced he was "particularly gratified" by the inclusion of the adoption credit in the tax legislation.[179] And so, after a few bumps in the road, the tax subsidy for adoption expenses assumed the credit form typical of subsidies enacted in the decades following Surrey's upside-down critique and the institutionalization of the tax expenditure concept.

The most notable post-1996 development has been the expansion of the credit in 2001. The 2001 legislation made the credit permanent, increased the AGI level at which the phaseout began, indexed the dollar parameters for inflation, and—most remarkably—provided a $10,000 credit for a special needs adoption even if the taxpayer's actual expenses were less than $10,000.[180]

Apart from the foreign tax credit,[181] dollar-for-dollar tax credits for taxpayer expenditures are exceedingly rare; such a 100% credit means the government bears the entire burden of the taxpayer's expenditure, up to any dollar cap on creditable expenses.[182] A 100% credit for

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176. Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1807, 110 Stat. 1755, 1899–1901 (codified at I.R.C. § 23).

177. *Id.*

178. *See* Joint Comm. on Tax'n, JCS-12-96, General Explanation of Tax Legislation Enacted in the 104th Congress 200 (1996).

179. William J. Clinton, *Statement on Signing the Small Business Job Protection Act of 1996*, Am. Presidency Project (Aug. 20, 1996), www.presidency.ucsb.edu/documents/statement-signing-the-small-business-job-protection-act-1996 [https://perma.cc/KS64-A5ZC].

180. *See* Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 202, 115 Stat. 38, 47–49 (currently codified at I.R.C. § 23(a)(3)).

181. I.R.C. § 27.

182. The 100% American Opportunity Tax Credit (AOTC) for the first $2,000 of college tuition payments is another example of a dollar-for-dollar credit, but because the $2,000 ceiling on the 100% credit is so low relative to typical college tuition (even at public colleges) presumably the AOTC does not

adoption expenditures of up to $14,440 (in 2021)[183] is remarkable enough. Even more remarkable is the allowance of a special needs adoption credit in excess of actual expenditures—potentially as much as $14,440 in excess, if a taxpayer somehow accomplished a special needs adoption without incurring any expenses. In effect, the government pays a taxpayer for a special needs adoption (rather than merely covering the taxpayer's expenses), with the amount of the payment equal to the excess of $14,440 over the taxpayer's actual expenses.

H. The Earned Income Credit

With its original enactment in 1975 as a temporary measure (made permanent three years later),[184] the earned income credit (EIC) became the prototype of a nonbusiness personal credit in the federal income tax. Not only was it the first major personal credit to be enacted; for decades it remained the largest such credit until very recently, when the child tax credit (CTC) surpassed the EIC by reason of the CTC's 2017 doubling by TCJA. In addition to serving as a precedent for the enactment of other personal credits (including the conversion of existing deductions to credits), it has served more particularly as a precedent for other *refundable* credits.

The choice of a credit, rather than a deduction, as the tool for delivering federal cash subsidies to low-income families was not inevitable. In fact, accounts of the developments leading up to the 1975 enactment of the EIC commonly begin with Milton Friedman's advocacy of a negative income tax in a brief passage in his 1962 book, *Capitalism and Freedom*. Friedman explained that, as a result of the personal exemption—then a deduction of $600 per person—a person with zero income could be thought of as having income of *negative* $600 after taking the exemption into account.[185] Although a taxpayer could not, under the income tax law of the time, use the personal exemption (or, for that

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feel much like a 100% credit to most taxpayers who claim it. For more on the AOTC, see *infra* text accompanying notes 206–207.

183. Rev. Proc. 2020–45, 2020–46 I.R.B. 1016.

184. Tax Reduction Act of 1975, Pub. L. No. 94-12, § 204, 89 Stat. 26, 30–32; Revenue Act of 1978, Pub. L. No. 95-600, § 104, 92 Stat. 2763, 2772–73 (1978).

185. Milton Friedman, Capitalism and Freedom 230 (reprint ed. 2020) (1962).

matter, any other personal deductions) to reduce his taxable income below zero, Friedman argued that a person with no income should be permitted to use his $600 exemption to reduce his income to negative $600 and that a "tax" rate—Friedman suggested 50%, although he noted that rate could be higher or lower, and that different rates could apply to different levels of negative income—should apply to that negative income.[186] Applying the suggested 50% rate to $600 of negative income, the "taxpayer" would be entitled to a $300 cash payment—a negative tax—from the government. A taxpayer with, say, $400 of income before taking the exemption into account would have taxable income of negative $200 and would be entitled to $100 from the government. According to Friedman, this approach had several attractive features—including its laser-like focus on poverty relief, its delivery of benefits in the form of cash, the fact that it did not eliminate work incentives ("[a]n extra dollar earned always means more money available for expenditure"), and ease of administration (the plan "would fit directly into our current income tax system and could be administered along with it").[187]

Although, as Dennis Ventry has detailed,[188] the negative income tax goes back further than Friedman's 1962 book—for example, the economist George Stigler wrote in 1946 that there was "great attractiveness in the proposal that we extend the personal income tax to the lowest income brackets with negative rates"[189]—Friedman's influence as a negative income tax proponent far surpassed that of all predecessors.

When Congress thinks of refundable tax benefits today, it thinks exclusively of refundable credits. But, as Friedman and other negative income tax advocates recognized decades ago, any deduction can also be the foundation of a refundable tax benefit, as long as (1) the deduction is permitted to reduce taxable income below zero, and (2) there is a tax rate schedule applicable to negative income. Moreover, as Friedman also recognized, this is true both for formula-based deductions not

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186. *Id.* Friedman also noted that other deductible personal expenses, such as medical expenses, could make income even more negative; for example, a taxpayer with no income, a $600 personal exemption, and $400 of medical expenses, would have $1,000 of negative income.

187. *Id.* at 231.

188. Dennis J. Ventry, Jr., *The Negative Income Tax: An Intellectual History*, 77 Tax Notes Today 491 (Oct. 27, 1997).

189. George J. Stigler, *The Economics of Minimum Wage Legislation*, 36 Am. Econ. Rev. 358, 365 (1946).

tied to taxpayer expenditures (such as the personal exemption) and for expenditure-based deductions (such as the medical expense deduction).

For a time, in the late 1960s and early 1970s, it seemed as if Congress might enact a negative income tax resembling Friedman's proposal. The political highwater mark for the negative income tax may have been President Nixon's 1969 Family Assistance Plan (FAP) proposal.[190] As Nixon explained in an address to the nation, under the FAP a family of four would receive an annual cash benefit of $1,600 (the equivalent of about $11,000 today) if the family had no income.[191] Parents could earn up to $720 per year without reduction of the $1,600 benefit, but after that the benefit was reduced by 50% of earned income; for a family of four with $1,720 income, for example, the FAP benefit would be $1,100.[192]

In its basic structure, the FAP would have been consistent with Friedman's 1962 proposal—a maximum benefit for a recipient with no income, with the benefit reduced by a percentage (as it happened, 50% in both cases) of a recipient's income. There were, however, two notable differences between the FAP and Friedman's negative income tax. First, in contrast to Friedman's proposal (and also in contrast to the EIC Congress later enacted), the FAP was to be administered not by the Internal Revenue Service as part of the income tax, but by the Department of Health, Education, and Welfare as a welfare program.[193] Second, and relatedly, the FAP's presentation was not that of a negative income tax. In Friedman's negative income tax proposal, the maximum benefit was *calculated* by using a deduction mechanism: subtracting a $600 exemption from zero income resulted in income of negative $600 and applying a 50% rate to negative $600 produced a $300 transfer payment. The FAP *could* have been expressed the same way. Instead of simply stating (as it did) that the maximum benefit was $500 per person for each of the first two members of a family and $300 for each

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190. *See Transcript of Nixon's Address to Nation Outlining Proposals for Welfare Reform*, N.Y. Times (Aug. 9, 1969), https://timesmachine.nytimes.com/timesmachine/1969/08/09/78389673.html?pageNumber=10 [https://perma.cc/P593-E6BB].

191. *Id.* This was subject to the requirement that anyone accepting FAP benefits must also accept work (or work training) if available, with an exception for those unable to work and for mothers of young children.

192. *Id.* $1,600 reduced by 50% of the excess of $1,720 over $720.

193. *See* H.R. Rep. No. 91-904, at 57 (1970).

additional member,[194] the FAP could have provided for a $1,000 exemption for each of the first two family members, a $600 exemption for each additional member, and a negative income tax rate of 50%. An eligible family of four with no income would then have been entitled to a benefit of $1,600—that is, 50% of the family's income of negative $3,200. But instead of requiring *derivation* of FAP benefits from exemptions and a rate structure applicable to negative income, Nixon's FAP proposal simply stated the maximum benefit amount and provided an income-based phaseout. What Friedman had conceived of as a deduction, leading to negative income and refundable tax losses, the Nixon administration repackaged as an income-sensitive, nontax transfer payment. If the administration had retained its method of calculating FAP benefits but opted for tax-based administration, in form the FAP would have been a proposal for a refundable credit. Whereas Friedman had been led to the deduction approach by the aesthetic appeal of a tax system applying symmetrically to both positive and negative income, the Nixon administration preferred the simplicity of a maximum benefit defined as $500 per person to the presentational complexity of a maximum benefit defined as 50% of $1,000 of below-zero income.

Certainly, the substance of the FAP could have been expressed as a deduction, as Friedman had done in *Capitalism and Freedom*.[195] But Congress never enacted the FAP, or anything closely resembling it. Instead, in 1975 Congress introduced the EIC, providing a refundable credit equal to 10% of the first $4,000 of earned income (resulting in a maximum credit of $400), with the credit phased out at the rate of 10% as income increased above $4,000 (with the phaseout complete at $8,000).[196]

The enacted EIC of 1975 was very different in substance from the proposed FAP of 1969. Whereas the FAP conferred its largest benefit on a family with no income (assuming the family qualified for one of the exceptions to the work requirement), the EIC gave no benefit to a family with no income and conferred increasing benefits as earned income rose from zero to $4,000.[197] The EIC structure was largely the

194. *Id.* at 12.

195. See discussion *supra* accompanying notes 185–187.

196. Tax Reduction Act of 1975, Pub. L. No. 94-12, § 204, 89 Stat. 26, 30–32 (current version at I.R.C. § 32).

197. Dennis Ventry has written perhaps the definitive account of how the FAP evolved into the EIC. Dennis J. Ventry, Jr., *The Collision of Tax*

creation of Senator Russell Long. After Congress had rejected the FAP—with the decisive objections being that a guaranteed income would reward the idle, and that the high phaseout rate would penalize and discourage work effort[198]—in 1972 Long proposed what became (with a few revisions) the EIC in 1975.[199] The most striking difference between the EIC and the FAP was that the FAP was available only to the "deserving poor," with desert established by the existence and amount of earned income.[200]

Unlike the FAP, which could have been readily repackaged as refundable tax *losses* created by *deductions* (rather than as nontax transfer payments or refundable credits), the substance of the EIC did not lend itself to being implemented by deductions. True, designing the EIC as a deduction would not have been strictly impossible. Congress might have provided, for example, that every dollar of the first $4,000 of a taxpayer's earned income gave rise to a deduction of two dollars, so that a taxpayer with earned income of $4,000 would have taxable income of negative $4,000, and Congress could then have applied a 10% rate to that negative income to produce a transfer payment of $400. But that would have been ludicrously convoluted, and Congress never considered anything of the sort.

To sum up: As Friedman's negative income tax proposal demonstrates, a low-income transfer program embedded in the federal income tax *could* be implemented through deductions instead of refundable credits. However, the history of the FAP and the EIC demonstrates two points: (1) that even when a deduction format would have been practical (in the case of the FAP), negative income tax proponents chose not to package their proposal in deduction terms; and (2) that whatever chance there might have been for packaging low-income, tax-based transfer payments as deductions rather than credits was lost in the substantive move from a guaranteed income to a wage subsidy.

Of course, neither Friedman's negative income tax, nor Nixon's FAP, nor Long's EIC, was a tax allowance for tax-favored expenditures. Thus, the congressional choice of credits over deductions in the context of anti-poverty tax program design did not lead inexorably to a

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and Welfare Policies: The Political History of the Earned Income Tax Credit, 1969–99, 53 Nat. Tax J. 983 (2000).

198. *Id.* at 988–92.

199. *Id.* at 992–96.

200. *Id.* at 992 & n.30.

legislative preference for credits over deductions in the case of tax subsidies for specified types of taxpayer spending. And yet, it is quite plausible that the legislative choice of an earned income credit over Friedman's proposed deduction influenced later legislative choices in the design of tax subsidies for taxpayer expenditures in three ways: (1) making it more likely that Congress would design new subsidies as credits instead of as deductions; (2) making it possible that, under ideal conditions, Congress would convert existing deductions to credits; and (3) ensuring that Congress would look to refundable credits (rather than a "tax" rate schedule applicable to negative income) as the sole device for effectuating transfer payments through the income tax.

I. Tax Benefits for College Tuition

Although the income tax exclusion for scholarships (Code section 117) dates back to the Internal Revenue Code of 1954,[201] before 1997 there was no income tax subsidy—neither deduction nor credit—for higher-education expenses not covered by scholarships. At the urging of President Clinton, in 1997 Congress enacted not one, but two, tax credits for college tuition and related expenses.[202] Five years later, during the George W. Bush presidency, Congress added a limited above-the-line deduction for qualified tuition and related expenses.[203] The first credit created by the 1997 legislation, the Hope Scholarship Credit (HSC, later revised and renamed the American Opportunity Tax Credit (AOTC)), applied to expenses of only the first two years of college; it equaled 100% of the first $1,000 of a student's qualifying expenses, plus half of the next $1,000, for a per-student maximum credit of $1,500. The second credit, the Lifetime Learning Credit (LLC), applied on a per-taxpayer (rather than per-student) basis, was not limited to the first two years of college, and equaled 20% of up to $10,000 of qualifying expenses paid by a taxpayer (for a per-taxpayer maximum credit of $2,000). Both credits were nonrefundable, and both were subject to rather aggressive income-based phaseout rules (with both phaseouts beginning at $40,000, or $80,000 in the case of a joint return). The deduction added in 2001

201. I.R.C. § 117 (1954).

202. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 201, 111 Stat. 788, 799–806 (codified at I.R.C. § 25A).

203. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 431(a), 115 Stat. 38, 66–68 (codified at I.R.C. § 222).

(as a four-year temporary provision) was limited to $3,000 per taxpayer (increased to $4,000 for 2004 and 2005). The deduction was subject to a cliff effect instead of a phaseout; under the 2002 and 2003 version of the cliff effect, no deduction whatsoever was allowed to a taxpayer with AGI of more than $65,000 ($130,000 for a joint return).[204] Coordination rules provided that no deduction was allowed for expenses of a student if any taxpayer claimed the HSC or LLC with respect to that student for the same year.

As may be apparent from the above descriptions, most taxpayers faced with a choice between claiming one of the credits and the deduction would have realized a substantially larger tax benefit by claiming the credit. Accordingly, the Joint Committee's 2002 tax expenditure estimate for the credits was $4.3 billion, compared with $1.5 billion for the deduction.[205]

Over the years since 2001, Congress has significantly increased the generosity of the credit regime. The AOTC (replacing the HSC) now equals 100% of the first $2,000 of qualified expenses plus 25% of the next $2,000 (for a maximum credit of $2,500 per student) and is available for a student's first four years of college.[206] The credit is now partially refundable,[207] and the income-based phaseout does not begin until $80,000 ($160,000 for a joint return). In contrast, although Congress extended the life of the temporary deduction beyond its original four years, it has never increased the generosity of the deduction (relative to the rules applicable in 2004 and 2005). For 2017, the Joint Committee estimated the tax expenditure for the credits at $19.4 billion, compared with a mere $0.4 billion for the deduction.[208]

In broad outline, the story of the tuition credits supports the view that, in the post-Surrey era, Surrey's upside-down critique of tax

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204. Under the later-years' version of the deduction, the maximum deduction was $4,000 for a taxpayer with AGI of $65,000 or less ($130,000 or less in the case of a joint return), $2,000 for a taxpayer with AGI above $65,000 ($130,000) but not above $80,000 ($160,000), and zero for a taxpayer with AGI above $80,000 ($160,000). I.R.C. § 222.

205. Joint Comm. on Tax'n, 107th Cong., JCS-1-02, Estimates of Federal Tax Expenditures for Fiscal Years 2002–2006, at 24 (2002).

206. I.R.C. § 25A(b).

207. I.R.C. § 25A(i) (providing that 40% of the credit is refundable).

208. JCT 2017 TEB, *supra* note 22, at 40.

expenditures in the form of deductions has been sufficiently influential with Congress that new tax subsidies based on taxpayer spending have taken the form of credits rather than deductions. There are, however, two details that complicate the story—the fact that President Clinton originally proposed a deduction rather than a credit and the enactment of the tuition deduction in 2001.

In early 1995, in his Budget Message for Fiscal Year 1996, Clinton proposed an above-the-line deduction for post-secondary tuition and fees, up to a maximum deduction of $10,000, and subject to a phaseout operating between AGI of $70,000 and $90,000 ($100,000 and $120,000 for a joint return).[209] By commenting that "this deduction could provide tax savings of $1,500 to $2,800 for middle-income families,"[210] Clinton implicitly noted that the same $10,000 deduction would be worth almost twice as much for taxpayers in the 28% bracket as it would be worth for lower-income taxpayers in the 15% bracket. He made no attempt, however, to explain why this upside-down effect was appropriate. Clinton also made no attempt to explain why the new subsidy should be denied to both low-income families (with no income to be offset by the deduction) and to upper-income families (with incomes above the phaseout range). The only thing in the Budget Message that even hinted at an explanation for the choice of a deduction over a credit was the statement that a tuition deduction "will help level the playing field between investments for physical capital and those for human capital" by giving human capital a deduction analogous to "deductions for depreciation."[211] All in all, however, the 1995 deduction proposal reads as if no one in the Clinton administration had ever heard of Stanley Surrey and his critique of deductions-as-tax-expenditures.

Seemingly more sophisticated in tax expenditure policy analysis than the administration, representatives of the nation's colleges "criticized the tuition deduction because it would give bigger subsidies to people with higher incomes than to those in lower brackets."[212] By

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209. The Budget Message of the President: The Budget for Fiscal Year 1996, at 14–15 (1995), https://fraser.stlouisfed.org/files/docs/publications/usbudget/BUDGET-1996-BUD.pdf [hereinafter 1996 Clinton Budget Message].

210. *Id.* at 15.

211. *Id.*

212. Douglas Lederman, *The Politicking and Policy Making Behind a $40-Billion Windfall*, Chron. Higher Educ. (Nov. 28, 1997),

November 1995, in response to the upside-down subsidy critique from the colleges, administration officials were trading internal memos favoring a $1,600-a-year tax credit for the first two years of college.[213] Clinton unveiled a credit proposal (reduced from $1,600 to $1,500) in his Princeton University commencement address in June 1996.[214] Rather than advocating the credit as a substitute for his earlier $10,000 deduction proposal, Clinton urged Congress to enact both the credit and the deduction.[215]

In early February 1997, following Clinton's reelection, the administration's budget called on Congress to enact both the $1,500 credit (labeled the Hope Scholarship Credit, after a popular Georgia program it vaguely resembled) and the $10,000 deduction.[216] There was virtually no support in Congress for the deduction proposal. The deduction was omitted from both the bill produced by the House Ways and Means Committee and from the bill later produced by the Senate Finance Committee.[217] Although both committees were Republican-controlled, the lack of interest in the deduction was bipartisan; the Finance Committee Democrats put together their own package of education tax proposals, which also omitted the deduction.[218] In the end, the White House

https://www.chronicle.com/article/the-politicking-and-policy-making-behind-a-40-billion-windfall/ [https://perma.cc/458D-FXMP].

213. *Id.*

214. *Excerpts from Address to Princeton Graduates*, N.Y. Times (June 5, 1996), https://timesmachine.nytimes.com/timesmachine/1996/06/05/096695.html?pageNumber=28.

215. *Id.*

216. Budget of the United States Government: Fiscal Year 1998, at 17, 57–58 (1997).

217. The House version of the bill included a deduction of a peculiar and limited sort; if a taxpayer received a distribution of earnings from a prepaid tuition program, included the distribution in gross income, and used the distribution to pay tuition, the taxpayer could deduct up to $10,000 of tuition. H.R. Rep. No. 105-148, at 319–28 (1997). Ordinarily, a rule of this sort would be expressed as an exclusion, rather than as an inclusion and an offsetting deduction, and the Finance Committee's version of the bill adopted the usual exclusion approach. S. Rep. No. 105-33, at 12–20 (1997). The Act itself also adopted the usual exclusion approach. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 213, 111 Stat. 788, 813–17 (exclusion codified at I.R.C. § 530(d)(2)(A)).

218. Lederman, *supra* note 212.

gave up its pursuit of the deduction in favor of a proposal by Representative Charles B. Rangel for a "Lifetime Learning Credit" equal to 20% of up to $10,000 of college costs.[219] On the credit-versus-deduction question, Congress—both Republicans and Democrats—was more attuned to Surrey's critique than was the Clinton administration.

Of course, a Congress more fully attuned to Surrey would have made the HSC and the LLC refundable, which the actual Congress did not. Higher education lobbyists worked hard to persuade the Senate to make the HSC refundable and claimed to have sold the idea to as many as 50 senators, but in the end refundability failed in the Senate because of its $6 billion price tag.[220] It did not help that the administration did not favor refundability, perhaps out of a belief that refundability was politically impossible with Republicans in control of both the House and Senate. More than a decade later in 2009, with Democrats in control of both the House and the Senate and a Democrat in the White House, Congress made the AOTC (the successor to the HSC) 40% refundable.[221] According to the Joint Committee, the 2009 Congress believed—indisputably correctly—"that making a portion of the credit refundable will deliver an incentive to attend college to those who do not benefit from the present-law credit."[222]

The enactment in 2001 of a deduction for higher education expenses is somewhat puzzling given that the higher education credits already existed and were retained.[223] The coexistence of the higher

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219. *See id.*

220. *See id.*

221. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 1004, 123 Stat. 115, 313–14 (2009) (codified at I.R.C. § 25A(i)).

222. Joint Comm. on Tax'n, JCS-2-11, *supra* note 129, at 26.

223. One might also be puzzled by the enactment of two Code provisions excluding from gross income distributions from two types of savings programs—"qualified tuition programs" (I.R.C. § 529) and "Coverdell education savings accounts" (I.R.C. § 530)—to the extent the distributions are used to pay for qualified education expenses of a designated beneficiary. The basic structure of the two exclusions is analogous to that of the Roth IRA—no deductions for amounts contributed to the savings account but permanent exclusion of the resulting investment income. Congress enacted section 529 in 1996 but only as a deferral provision; Congress converted it to a permanent exclusion in 2001. Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1806, 110 Stat. 1755, 1895–99; Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 402, 115 Stat. 38, 60–63.

education credits and the deduction resembles the coexistence, for nearly two decades, of the child tax credit and the dependency exemption[224]—with the significant difference that taxpayers could claim both child tax benefits whereas they were required to choose between the two tuition tax benefits. The 2001 tuition deduction originated with the Finance Committee, which explained: "The Committee recognizes that in some cases a deduction for education expenses may provide greater tax relief than the present-law credits. The Committee wishes to maximize tax benefits for education, and provide greater choice for taxpayers in determining which tax benefit is most appropriate for them."[225]

The explanation is unsatisfactory; it does not follow from the mere fact that a deduction might provide greater tax relief than a credit that giving taxpayers a choice between a deduction and a credit is called for. A deduction would be appropriate on ability-to-pay grounds if it served an income-defining function, but that view of a tuition deduction is implausible, and the Committee did not assert it. Moreover, if the Committee had been of that view, it should have made the deduction available to taxpayers at all income levels instead of subjecting the deduction to an AGI-based phaseout. Strangely, the upper-bracket taxpayers who would have benefitted most from claiming a deduction at 35% rather than, say, claiming the LLC at a credit rate of 20%, were

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Congress enacted section 530 in 1997, at the same time as the higher education credits. Taxpayer Relief Act of 1997 § 213, 111 Stat. 788 at 813. Annual contributions under section 530 are capped at $2,000, with the ability to make even that modest contribution phased out for higher-income taxpayers. I.R.C. § 530(b)(1)(A)(iii). By contrast, section 529 imposes no cap on contributions and is available to contributors at all income levels. I.R.C. § 529. The introduction of the section 529 and section 530 exclusions, around the same time as the enactment of the higher education credits, might be interpreted as Congress making everyone a winner: lower-bracket taxpayers got a credit, while higher-bracket taxpayers gained a deduction-equivalent. The problem with that interpretation, however, is that the exclusions serve as deduction equivalents only for taxpayers who have investment income to exclude—that is, those taxpayers with the wherewithal and foresight to contribute to higher-education savings programs. That this is a major limitation is confirmed by the 2019 tax expenditure estimates of $1.3 billion for section 529 and a mere $0.1 billion for section 530, compared with $18.3 billion for the higher education credits. JCT 2019 TEB, *supra* note 11, at 26–27.

224. Described *infra* text accompanying notes 242–245.

225. S. Prt. No. 107-30, at 41 (2001).

ineligible for the new deduction because of the income-based cliff effect. The only two explanations for the new deduction would seem to have been (1) a belief that a deduction for college tuition is income-defining, or (2) an unprincipled desire to benefit upper-bracket taxpayers. Both explanations were undermined, however, by rules denying the deduction to precisely those taxpayers for whom a deduction would have been most valuable.

In any event, the deduction has proven to be little more than a blip in the saga of tax benefits for college tuition. The credits have become preferable to the deduction for almost all taxpayers, because of the failure of Congress to increase the generosity of the deduction to match the increased generosity of the AOTC. As noted earlier, for 2017 the Joint Committee on Taxation estimated the tax expenditure for the deduction at $0.4 billion, compared with $19.4 billion for the credits.[226]

J. The Dependency Exemption Becomes the Child Tax Credit

So-called dependency exemptions—"so-called" because they are actually *deductions* of a statutorily-fixed dollar amount—are almost as old as the federal income tax. Congress enacted the first dependency exemption, of $200 per child, in 1917, just three years after the introduction of the modern federal income tax.[227]

From the beginning of tax expenditure budget analysis in the late 1960s, estimators did not treat dependency exemptions as tax expenditures. In its first tax expenditure budget publication, in 1969, Treasury explained that it excluded from the definition of tax expenditures "features of our income tax system . . . considered not as variations from the generally accepted measure of net income or a tax preference but as part of the structure of an income tax system based on ability to pay," and offered "personal exemptions" (meaning both exemptions for taxpayers themselves and exemptions for their dependents) as the first example of such a feature.[228] In his 1973 book elaborating on the tax expenditure concept, Surrey expressly approved of this treatment of dependency exemptions.[229] The Joint Committee has also concurred,

226. *See* JCT 2017 TEB, *supra* note 22, at 40.

227. War Revenue Act, Pub. L. No. 65-50, § 1203(1), 40 Stat. 300, 331 (1917).

228. U.S. Treas. Dep't, *supra* note 4, at 329.

229. Surrey, Pathways, *supra* note 12, at 13.

explaining that it did not treat dependency exemptions as tax expenditures "because Congress believes these amounts approximate the level of income below which it would be difficult for . . . a family to obtain minimal amounts of food, clothing and shelter."[230]

Surrey's critique of tax expenditures in the form of deductions as upside-down subsidies applies only to tax provisions properly understood as subsidies; it has no application to provisions serving (as Treasury put it) "as part of the structure of an income tax system based on ability to pay."[231] Dependency exemptions are—or, rather, were, when they existed—part of that structure. The idea was that people have ability to pay tax only out of their "clear income"—that is, income above the amount needed to cover basic subsistence needs. If the cost of subsistence increases by, say, $4,000 for every additional dependent in a family, then a per-dependent exemption of $4,000 would serve to equalize the taxable incomes of a childless taxpayer with gross income of $100,000 and a two-child taxpayer with gross income of $108,000.

It is true, of course, that the tax saving produced by a dependency exemption is a function of a taxpayer's marginal tax rate, with the result that a $4,000 deduction would reduce the tax liability of an affluent taxpayer with a marginal rate of (say) 40% by $1,600, while the same deduction would be worth only $600 to a taxpayer of modest means in the 15% bracket.[232] But it does not follow that the dependency exemption is an upside-down subsidy for the simple reason (as explained above) that it is not a subsidy at all. Any upside-down critique of dependency exemptions—a critique Surrey himself emphatically did not make—would be based on a misconception that exemptions are about vertical equity (fairness between rich and poor taxpayers), when in fact exemptions are about horizontal equity (fairness between taxpayers at the same income level but with different family sizes). Assume $4,000 is an accurate measure of the per-child increase in a family's cost of subsistence living. Consider the four couples in the table below:

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230. Joint Comm. on Tax'n, 100th Cong., JCS-3-87, Estimates of Federal Tax Expenditures for Fiscal Years 1988–1992, at 3–4 (1987).

231. U.S. Treas. Dep't, *supra* note 4, at 329.

232. This paragraph is a revised version of a paragraph in Richard Schmalbeck & Lawrence Zelenak, Federal Income Taxation 728–29 (1st ed. 2004).

Couple	Income (before exemptions)	Number of children
The As	$40,000	0
The Bs	$52,000	3
The Cs	$150,000	0
The Ds	$162,000	3

Couples *A* and *B* have the same amount of clear income and thus should have equal taxable incomes. Similarly, couples *C* and *D* have the same clear income and should have equal taxable incomes. Horizontal equity between the *A*s and the *B*s, and between the *C*s and the *D*s, would be achieved by giving each three-child couple a dependency deduction $12,000 larger than the deduction allowed to the childless couples. In a tax system with progressive marginal rates, the *D*s' $12,000 deduction will decrease their tax liability by more than the *B*s' $12,000 deduction will reduce their tax liability, but that result is unobjectionable. If there is a legitimate vertical equity objection to the distribution of tax burdens among the four couples, it must be that the upper-middle-class taxpayers (the *C*s and *D*s) do not pay enough tax relative to the lower-middle class taxpayers (the *A*s and *B*s). But if that is the objection, the solution is to redesign the tax rate schedule—lowering marginal rates at the bottom and raising them at the top—not to phase out exemptions for high-income taxpayers or to replace or supplement them with child tax credits.

Despite the strong case—outlined above—for allowing dependency exemptions to taxpayers at all income levels, in 1986 Congress added a provision phasing out the benefit of dependency exemptions (and of taxpayers' exemptions for themselves, as well) for upper-income taxpayers.[233] For a taxpayer in the phaseout range, the provision functioned as a semi-hidden marginal tax rate increase (of five percentage points); for taxpayers with incomes above the high-end of the phaseout range, the provision meant that there were no differences in tax liabilities based on differences in family size. As the Joint Committee has noted, denial of dependency exemptions to some taxpayers, in a system in which exemptions are generally allowed and serve a structural (non-subsidy) purpose, is actually a "negative tax expenditure" resulting in

233. Tax Reform Act of 1986, Pub. L. No. 99-514, § 101(a), 100 Stat. 2085, 2096–98 (1986) (formerly codified at I.R.C. § 1(g) (1986)).

the over taxation of high-income taxpayers with children relative to "an identifiable general rule of the present tax law."[234]

If a follower of Stanley Surrey had examined the dependency exemption in the late 1980s or early 1990s, the likely conclusion would *not* have been that it was an upside-down subsidy that Congress should replace with a credit. To the contrary, the likely conclusion would have been that the phaseout of the exemption was an unjustified negative tax expenditure and that Congress should restore the exemption to its pre-1986 glory. What actually happened, however, was very different.

In its 1991 Final Report, the National Commission on Children (established by Congress in 1987 "to serve as a forum on behalf of the children of the Nation"[235]) called on Congress to enact a new child tax credit.[236] Ignoring the fact that the dependency exemption was not a tax expenditure, the Report applied to it the classic upside-down subsidy critique: "Since it reduces the portion of a family's income that is taxable, its value is greater for taxpayers in higher brackets. It is of lesser or no value to families whose incomes are so low that they have little or no tax liability."[237] Consistent with its (misguided) critique of the exemption, the Report advocated "the creation of a $1,000 refundable tax credit for all children through age 18 and elimination of the personal exemption for dependent children to partially offset the costs."[238]

Nothing came of the Report's recommendation in the short term, but in early 1995, pursuant to their Contract with America, House Republicans introduced a bill providing for a $500-per-child tax credit—in addition to the existing dependency exemption rather than as a replacement for it.[239] The credit was to be phased out for taxpayers with AGIs between $200,000 and $250,000.

Following his triangulation strategy, President Clinton in his Budget for Fiscal Year 1996 proposed a more limited version of a $500

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234. Joint Comm. on Tax'n, 110th Cong., JCS-2-08, Estimates of Federal Tax Expenditures for Fiscal Years 2008–2012, at 5, 7 (2008).

235. Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, § 9136, 101 Stat. 1330, 1330-316.

236. Nat'l Comm'n on Child., Beyond Rhetoric: A New American Agenda for Children and Families 94–95 (1991).

237. *Id.* at 86–87.

238. *Id.* at 94.

239. H.R. 6, 104th Cong. (1st Sess. 1995) (bill was supported by Rep. Crane and more than 100 co-sponsors).

per child tax credit; the proposed credit was allowed only for children under the age of 13, was phased out for taxpayers with AGIs between $60,000 and $75,000, and was nonrefundable.[240] Like the House Republicans' proposal, Clinton's was in addition to the continuation of dependency exemptions.

With the President and congressional Republicans largely in agreement, it was only a matter of time before they compromised their differences. In 1997 Congress passed, and the President signed, legislation creating a $500 credit for each qualifying child under the age of 17, subject to phaseout as AGI increased above $75,000 (or above $110,000 for joint returns), and generally nonrefundable (but with limited refundability for taxpayers with three or more qualifying children).[241] The new child tax credit (CTC) was in addition to the existing dependency exemption. In identical language, the Reports of both the Ways and Means Committee and the Finance Committee explained that the CTC was called for because "the individual income tax structure does not reduce tax liability by enough to reflect a family's reduced ability to pay taxes as family size increases."[242] Neither Report, however, explained why the coexistence of the CTC and the dependency exemption was preferable to either (1) an increase in the exemption amount without a new credit or (2) the Commission's 1991 suggested repeal of the exemption to finance a larger credit.

With some legislative tinkering—including, notably, liberalization of the partial refundability of the CTC and the suspension of the phaseout of dependency exemptions in the jubilee years of 2010 through 2012—the coexistence of the credit and the exemption continued for two decades. In 2005, President Bush's Advisory Panel on Federal Tax Reform echoed the 1991 Report of the National Commission on Children by calling for the repeal of the dependency exemption and an increase in the CTC amount to $1,500 per child.[243] For reasons having little to do with its merits, the Panel's Report was widely viewed as

240. 1996 Clinton Budget Message, *supra* note 209, at 14.

241. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 101(a), 111 Stat. 788, 796–98 (codified at I.R.C. § 24).

242. H.R. Rep. No. 105-148, at 310 (1997); S. Rep. No. 105-33, at 3 (1997).

243. *See* President's Advisory Panel on Tax Reform, *supra* note 53, at 65.

dead on arrival[244] and did not result in any legislation. But then, to the surprise of many, as part of the Tax Cuts and Jobs Acts of 2017 Congress eliminated dependency exemptions for 2018 through 2025[245] and increased the CTC from $1,000 to $2,000 per child for those years.[246] The 2017 legislation also made the CTC more available to parents at both ends of the income distribution—by increasing (to $1,400) the partial refundability of the credit at the low end and by greatly increasing the AGI level at which the phaseout begins (from $75,000 to $200,000, or from $110,000 to $400,000 for joint returns) at the high end.

So, at least for now, Congress has gone from only dependency exemptions, to the coexistence of exemptions and the CTC, to only the CTC. With the two decades of coexistence as a midway point, Congress has gradually converted the exemption to a credit. What drove the 2017 legislative decision to convert the dependency exemption into a $1,000 increase in the CTC? The official explanations in the Report of the Ways and Means Committee shed little light. According to the Report, the Committee believed that consolidating the standard deduction and exemptions into a larger standard deduction "simplifies the tax code."[247] So, according to the Committee, the increase in the standard deduction—not the increase in the CTC—is the replacement for dependency exemptions. That is difficult to take seriously, however, because a replacement for dependency exemptions should obviously be sensitive to family size—as the CTC is, but the standard deduction is not. The Committee's explanation of the increase in the CTC also fails to connect the increase with the demise of exemptions. Instead, the Committee claims that the CTC increase is "to ensure that all members of a household are accounted for in determining families' ability to pay income tax."[248] The Committee does not explain why it believes that an increased credit, rather than a continuation of the exemption, is the

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244. *See* Steven Pearlstein, *Tax Reform That's Bold and Beautiful*, Wash. Post, (Nov. 4, 2005), https://www.washingtonpost.com/wp-dyn/content/article/2005/11/04/AR2005110400058.html [https://perma.cc/K4V3-ULN8].

245. *See* I.R.C. § 151(d)(5). Oddly enough, the legislation retained the concept of dependency exemptions but provided that the amount of the exemption is zero in 2018 through 2025.

246. *See* I.R.C. § 24(h)(2).

247. H.R. Rep. No. 115-409, at 125 (2017).

248. *Id.* at 136.

appropriate device for reflecting the effect of family size on ability to pay.

Given the inadequacy of the official explanations, one searches for other legislative motivations. It seems likely that several factors went into the decision. First, Congress probably believed (quite reasonably) that a larger CTC was simpler than the combination of an exemption and a smaller CTC—especially considering that far fewer taxpayers would be subject to phaseout rules under the new regime than under the old. Second, Congress may have been influenced by Surrey's upside-down critique of deductions as tax expenditures. The irony, of course, is that Surrey would not have been pleased, since the conversion would have been based on the misapplication of Surrey's upside-down critique to a non-subsidy structural tax provision.[249]

Finally, and crucially, consider the upper-income taxpayers who would ordinarily be disadvantaged by the conversion of a deduction to a credit and who could thus constitute a formidable political obstacle to the conversion. They were not disadvantaged in this instance, because they were already denied dependency exemptions (at least in part, and often entirely) by the phaseout provisions. Take, for example, a married couple with two children and AGI of $400,000. In the absence of the 2017 legislation, in 2018 they would have been entitled to no child tax credit[250] and two dependency exemptions of only $1,494 each.[251] Their marginal tax rate would have been dependent on taxable income, not AGI, but would probably have been 33%. If so, the combined tax

249. Although the upside-down critique does not appear in the official "reasons for change" in the Ways and Means Committee's report, recall (as described *supra* text accompanying notes 235–242) that the critique played an essential role in Congress's decision in 1997 to create the CTC instead of enlarging the exemption. Nothing suggests that the Congress of 2017 was any more enlightened on this point than the Congress of 1997.

250. Under the earlier rules, the phaseout of their two $1,000 credits would have been complete at AGI of $149,001. *See* I.R.C. § 24(b).

251. Rev. Proc. 2017–58, 2017–45 I.R.B. 489 (dependency exemption inflation adjustments that would have applied for 2018 in the absence of the 2017 tax legislation; the exemption amount would have been $4,150 and the joint return phaseout threshold $320,000). At $400,000 AGI, exemptions would have been reduced by 64%: [($400,000— $320,000)/$2,500] × 2% = 64%. The allowed 36% of each exemption would have been $4,150 × 36% = $1,494.

savings from the two dependency exemptions would have been $986.[252] Under the 2017 legislation, in sharp contrast, they are entitled to two CTCs of $2,000 each.[253] They come out more than $3,000 ahead by reason of the legislative deduction-to-credit conversion. All else being equal, upper-income taxpayers may fare better with deductions than with credits, but all else is not equal when repealed deductions were subject to phaseout and their replacement credits are not.

The story of the full conversion of the dependency exemption to the CTC (at least until 2026) has two striking similarities to the earlier story of the conversion of the childcare deduction to the childcare credit.[254] First, neither deduction provision was an obvious candidate, on the merits, for conversion. In each case there was a good argument that a deduction was theoretically correct and thus was not an upside-down subsidy. Second, in each case the fact that the deduction provision was subject to a phaseout was crucial to the political feasibility of the conversion. Because the credit replacing the deduction was either not subject to phaseout (dependent care expenses) or was subject to a phaseout only at a higher income threshold than the repealed deduction (CTC), the high-income taxpayers who would normally lose from the conversion of a deduction to a credit instead benefitted from the change.

Of course, this raises the question of why the dependency exemptions were subject to phaseout, a complete analysis of which would require a substantial article of its own.[255] For present purposes, two observations will suffice. The first is that there is no reason to think that the Congress of 1986 introduced the phaseout to set the stage for the conversion of the exemption to a credit more than three decades later. The second is that the introduction of the phaseout in 1986 was not based on any principled belief that adjustments to tax liabilities based on family size were inappropriate for upper-income taxpayers but instead were based on a legislative desire to make marginal tax rates appear lower than they really were.[256]

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252. $\$1.494 \times 2 \times .33 = \$986$.

253. Their AGI of $400,000 exactly equals the phaseout threshold, so their credits are not reduced by the phaseout.

254. *Supra* text accompanying notes 140–159.

255. For a brief discussion of why the childcare deduction was subject to phaseout, see *supra* text following note 135.

256. Alan Murray & Jeffrey Birnbaum, Showdown at Gucci Gulch: Lawmakers, Lobbyists, and the Unlikely Triumph of Tax Reform

K. Exclusions, Deductions, and Credits for Retirement Savings

The dominant form of tax favored retirement savings today—featuring immediate deductibility by employers of contributions to employee pensions, deferral of employees' tax on employers' contributions until receipt of pension distributions by retirees, and similar deferral of employees' tax on the investment return on employer's contributions—traces back to the Revenue Act of 1921.[257] Thus the earliest favorable income tax treatment of employer-provided pensions took the form of neither a deduction nor a credit but of an exclusion of the employer's contributions from the tax base of the employee. There is no mystery to the legislative choice of an exclusion. As explained earlier (in the discussion of the tax treatment of employer-provided health insurance[258]), whenever Congress opts for favorable tax treatment and an exclusion is feasible—that is, whenever the favorable tax treatment depends on the source from which a taxpayer receives a particular type of benefit rather than on how a taxpayer spends her money—Congress chooses an exclusion because it is simpler than the alternative of an inclusion and an offsetting deduction.

The cash-flow taxation of employer-provided pensions legislated in the 1920s was consistent with cash-flow style consumption taxation and so would not have been a tax preference if analyzed relative to consumption tax norms rather than income tax norms. Although the Congress of the 1920s never explained or defended its tax treatment of pensions on consumption tax grounds, tax theorists—most notably, the

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219 (1987) (describing the phaseout of exemptions as a "tax-writing trick" which "made the top individual tax rate seem lower than it really was").

257. Revenue Act of 1921, Pub. L. No. 67-98, § 219(f), 42 Stat. 227, 247 (1921). The Act provided that a "trust created by an employer as a part of a stock bonus or profit-sharing plan" was not taxable on its investment income, but that "the amount actually distributed or made available to any distributee shall be taxable to him in the year in which so distributed or made available." *Id.* The crucial favorable tax treatment for the employee—the exclusion from the employee's tax base of the employer's contribution to the trust—was implied rather than stated, but the implication was unmistakable. Five years later, the Revenue Act of 1926 revised the law to extend the deferral treatment to "pension" plans (in addition to stock bonus and profit-sharing plans). Revenue Act of 1926, Pub. L. No. 69-20, § 219(f), 44 Stat. 9, 33 (1926).

258. *See supra* text accompanying notes 96–123.

great Yale economist Irving Fisher[259]—had made the theoretical case for a consumption tax years before. At some less-than-fully conscious level, the Congress of the 1920s may have decided that the ideal tax base was an income-consumption hybrid, with consumption tax treatment applying to employer-provided retirement savings.[260]

The next major development in the income taxation of retirement savings was the introduction in 1962 of a deduction for the contributions of a self-employed person to a so-called "Keogh" retirement plan.[261] As explained by the deduction's leading proponent, Representative Eugene James Keogh, the primary purpose of the deduction was "to give self-employed persons access to retirement plans on a reasonably similar basis to that accorded corporate stockholder employees."[262] Because a self-employed person had to actually contribute a portion of his income to a retirement plan rather than merely benefitting from his employer's contribution on his behalf, the new favorable treatment necessarily took the form of a deduction. The deduction offset the inclusion of the contributed amount in gross income, thus producing a tax result consistent with that produced for employees by an exclusion.

In its first tax expenditure budget, for the 1968 fiscal year, Treasury estimated the tax expenditure for the "treatment of pension plans" for employees at $3.00 billion, and for self-employed persons at $0.06 billion.[263] Those were the only two income tax preferences for retirement savings at the time. Deductions for contributions to individual retirement accounts (IRAs) were still in the future, as was the saver's credit of Code section 25B.

Congress turned to deductions again in the following decade, when it included in the Employee Retirement Income Security Act of 1974 (ERISA) a deduction for contributions to IRAs by employees not

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259. Irving Fisher, The Nature of Capital and Income 101–18 (1906).

260. The normative case for a hybrid income-consumption tax is further discussed *infra* text accompanying notes 300–302.

261. *See* Self-Employed Individuals Tax Retirement Act of 1962, Pub. L. No. 87-792, § 2, 76 Stat. 809, 809–12.

262. H.R. Rep. No. 87-378, at 2 (1961). For detailed background on and analysis of the 1962 legislation, see Teresa C. Campbell, *Self-Employed Individuals Tax Retirement Act of 1962*, 32 Fordham L. Rev. 279 (1963).

263. U.S. Treas. Dep't, *supra* note 4, at 340.

covered by employers-sponsored retirement plans.[264] The new retirement tax savings benefit for employees took the form of a deduction for the same reason the 1962 benefit for the self-employed had taken that form; a deduction produces equivalent results to an exclusion, and the simpler exclusion approach is not available when the favorable tax treatment is based on what the taxpayer does with her money, rather than on the nature of the benefit the taxpayer receives from her employer.[265]

In 1997 Congress introduced the so-called Roth IRA (named after Senator William Roth, one of its leading proponents) as an alternative to the existing deductible IRA.[266] Contributions to Roth IRAs are not deductible, but all distributions from Roth IRAs (whether representing a return of the taxpayer's original investment or investment earnings) are excluded from income. If a taxpayer's marginal tax rate is the same in the year she makes an IRA contribution and the year she receives a distribution from the IRA, a deductible ("traditional") IRA and a Roth IRA produce equivalent results.[267]

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264. Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, § 2002, 88 Stat. 829, 958–59 (enacting I.R.C. § 219, providing a deduction for contributions to IRAs by employees who are not active participants in employer-sponsored plans, with the maximum deduction equal to the lesser of $1,500 or 15% of taxable compensation). The Ways and Means Committee explained that the new IRA deduction was intended "to make the tax laws relating to qualified retirement plans fairer by providing greater equality of treatment under such plans" for employees without employer pensions. H.R. Rep. No. 93-779, at 8 (1974).

265. Congress has made numerous changes to the IRA provisions since 1974—most notably, extending eligibility to make deductible contributions to all employees (including active participants in employer plans) in 1981, and in 1986 introducing income-based limits on the ability of active participants in employer plans to make deductible contributions. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 311(a), 95 Stat. 172, 274–78 (1981); Tax Reform Act of 1986, Pub. L. No. 99-514, § 1101(a), 100 Stat. 2085, 2411–13 (1986). Of course, these adjustments to the IRA eligibility rules had no effect on the character of the IRA tax benefit as a deduction.

266. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 302(a), 111 Stat. 788, 825–28 (1997) (codified at I.R.C. § 408A).

267. Suppose, for example, a taxpayer with a marginal tax rate of 20% in both years contributes $5,000 to a traditional IRA in Year 1 and receives a distribution of $12,000 (representing the original $5,000 plus $7,000 of investment gain) in Year 10. After the 20% tax in Year 10, the taxpayer will be left with $9,600. With the Roth IRA alternative, the taxpayer

The policy explanation for the Roth IRA innovation offered by the Joint Committee of Taxation in its 1997 Bluebook leaves something to be desired; the Bluebook merely states that "some individuals would be more likely to save if funds set aside in a tax-favored account could be withdrawn without tax," and that "[s]ome taxpayers might find such a vehicle more suitable for their savings needs."[268] Unmentioned by the Bluebook, a major attraction for Congress of Roth IRA wage-tax type treatment of retirement savings is that it moves the revenue loss out of the year of the IRA contribution and into the year of the distribution, thereby moving most of the revenue loss outside of the "budget window" used in making official revenue estimates for tax legislation.[269]

Although the introduction of Roth IRAs—with a back-end tax exclusion in place of a front-end deduction—was a significant innovation in tax policy toward retirement savings, it was consistent with the prior legislative practice of using exclusions as the primary vehicles for the delivery of retirement tax benefits, with supplementation by deductions where exclusions do not work. Credits had still not made an appearance in the retirement savings context, despite the fact that by the 1990s Congress had become enthusiastic about using credits to subsidize various sorts of personal expenditures.

The first—and still the only—tax credit for retirement savings finally appeared in 2001, with the enactment of the saver's credit of Code section 25B (initially as a temporary provision).[270] As originally enacted, the nonrefundable credit equaled a statutorily specified percentage of an eligible individual's "qualified retirement savings," with qualified savings generally defined as IRA contributions and elective deferrals under employer-sponsored plans. The maximum credit-eligible contribution was $2,000. The maximum "applicable percentage" of 50% was available to a married couple with adjusted gross income (AGI) of

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will use $1,000 of the $5,000 to pay the tax due in Year 1 as a result of the unavailability of a Year 1 deduction. The $4,000 invested in the Roth IRA will grow to $9,600 (2.4 times the original investment, as with the traditional IRA) by Year 10, all of which can be distributed to the taxpayer free of tax.

268. Joint Comm. on Tax'n, 105th Cong., JCS-23-97, General Explanation of Tax Legislation Enacted in 1997, at 43 (1997).

269. For a criticism of this reason for preferring wage-tax treatment of retirement savings, see Zelenak, *supra* note 54, at 1135–38.

270. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 618, 115 Stat. 38, 106–08.

$30,000 or less, a head of household with AGI of $22,500 or less, and any other unmarried person with AGI of $15,000 or less. As AGI increased, the applicable percentage decreased by a series of cliff effects, first to 20%, then to 10%, and finally to 0% (with the 0% rate applying to taxpayers with AGIs in excess of $50,000, $37,500, or $25,000, depending on filing status). Thus, the largest possible credit was only $1,000 (50% of $2,000). Moreover, the availability of a credit that substantial was largely illusory because a taxpayer with AGI low enough to qualify for the 50% credit would not ordinarily have enough pre-credit tax liability to be able to use a nonrefundable $1,000 credit.

In 2006 Congress made the saver's credit a permanent provision and indexed the AGI parameters for inflation.[271] As adjusted for inflation, in 2019 the 50% credit is available for joint returns with AGIs of $38,500 or less, and no credit is available for joint returns with AGIs in excess of $64,000; the AGI parameters for heads of households, and for other unmarried taxpayers, are similarly adjusted.[272]

The Joint Committee on Taxation (JCT) has estimated the 2019 tax expenditure for the saver's credit at $1.2 billion.[273] The JCT offers vastly higher 2019 estimates for the deduction and exclusion retirement savings tax expenditures: $32.6 billion for self-employed and IRA deductions,[274] a massive $209.8 billion for the exclusion of contributions to employer-sponsored plans,[275] and $7.7 billion for the exclusion of Roth IRA investment income.[276]

Compared with the situation in the late 1960s, at the time of the first tax expenditure budget, the most striking development over the past half century has not been a change in the relative significance of exclusions, deductions, and credits. True, deductions have increased from 2% of exclusions in 1968 to around 15% of exclusions today, and credits have gone from nonexistent in 1968 to a tiny ($1.2 billion) tax expenditure

271. Pension Protection Act of 2006, Pub. L. No. 109-280, §§ 812 & 833(a), 120 Stat. 780, 997, 1003–04 (2006).

272. Notice 2018–83, 2018–47 I.R.B. 774.

273. JCT 2019 TEB, *supra* note 11, at 29.

274. *Id.* at 30 ($14.4 billion for the net cost of the deduction for retirement contributions by self-employed individuals and $18.2 billion for the net cost of deductible IRA contributions).

275. *Id.* at 29 (84.8 billion relating to defined benefit plans, and $125.0 billion relating to defined contribution plans).

276. *Id.*

today. However, in 2019 just as in 1968, exclusions dwarf deductions, and credits are of no revenue significance. Rather, the dramatic change has been in the size of the exclusion and deduction tax expenditures relative to GDP. In 1968, the $3.06 billion of tax expenditures (for exclusions and deductions combined) was roughly one-third of one percent of GDP. In 2019, the $250.1 billion of tax expenditures (again, for exclusions and deductions combined) was nearly 1.2% of GDP; tax expenditures for retirement savings, as a percentage of GDP, have more than tripled over the past fifty years.[277] There have been no changes in the tax treatment of retirement savings over that time span capable of explaining that dramatic increase. Rather, the explanation is increased use of the same basic tax rules by an increasingly wealthy nation to produce favorable tax treatment for greater and greater amounts of retirement savings—greater not only in terms of real value, but also relative to GDP.

In one respect, this story closely resembles the story of the federal income tax treatment of employer-provided health insurance over the same decades.[278] In both cases, the foundational exclusion has survived as an exclusion (without having faced any serious threats to its survival) and has grown greatly in economic significance not because of changes in the tax rules but because of nontax economic developments. As discussed in more detail earlier, in connection with the analysis of employer-provided health insurance, the simplicity and intuitive appeal of exclusions have made exclusions largely immune to large-scale Surrey-inspired conversion to credits.[279]

In another respect, however, the retirement savings story diverges from the health insurance story. As a result of Obamacare's introduction of the premium assistance credit (PAC), credits now play an important role in federal tax policy toward health insurance.[280] By contrast, the saver's credit, although now a permanent provision facing no threat of repeal, is of minimal economic significance. Over the past five decades, deductions for retirement savings have increased in

277. The GDP of the United States for 1968 was $940.7 billion. GDP for 2019 was $21.43 trillion. GDP data for 1968 (based on data from the U.S. Bureau of Economic Analysis) from Johnston & Williamson, *supra* note 21. GDP data for 2019 from *GDP 2019*, *supra* note 43.

278. For the details, see *supra* text accompanying notes 96–123.

279. See *supra* text accompanying notes 96–123.

280. For the details, see *supra* text accompanying notes 124–130.

economic significance relative to credits in sharp contrast to the triumph of credits over deductions in many other areas.[281]

Including tax expenditures for retirement savings in the overall story of the evolution of tax expenditure design over the last 50 years does not change the basic story. Taking retirement savings provisions into account, the overall story (as explained in the introduction) is still: (1) that deductions were overwhelmingly more significant than credits in 1968, (2) that in 2019 credits are decidedly more significant than deductions, and (3) that exclusions—despite their close resemblance to deductions—have been largely immune to the forces that have driven the movement from deductions to credits. Nevertheless, it is striking that credits have made no significant inroads in the retirement savings context despite their triumphs in other contexts. What might explain the difference?

A good starting point in the search for an explanation is the history of the saver's credit. In 1999 President Clinton proposed using a portion of the federal budget surplus to subsidize "universal savings accounts" (USAs); workers of low and moderate income would receive refundable tax credits deposited directly into their USAs.[282] The proposal included both a flat credit of $300 per person per year for workers with incomes below $40,000 and an additional credit matching a taxpayer's own USA contribution (with the generosity of the match declining as income increased).[283] Widely criticized as "far too complicated,"[284] the proposal did not come close to enactment in 1999.

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281. Because credits for retirement savings did not exist in 1968 and do exist today, credits today are infinitely greater than credits in 1968. But because the Keogh deduction existed in 1968, deductions for retirement savings today are only finitely greater than in 1968. By using that measure, one could argue that deductions have not increased in significance, relative to credits, since 1968. However, by the more reasonable percentage-of-GDP measure, deductions (for self-employed individuals and for IRAs) have increased much more than credits (from 0.01% to 0.16% of GDP in the case of deductions, but only from 0.00% to 0.01% of GDP in the case of credits).

282. William J. Clinton, Remarks of the President on Universal Savings Accounts (Apr. 14, 1999), https://clintonwhitehouse4.archives.gov/WH/New/html/19990414-3020.html.

283. Michael J. Graetz et al., *Universal Savings Accounts: The Clinton IRA*, 83 Tax Notes 1487, 1488 (June 7, 1999).

284. *Id.* at 1499.

The Clinton USA proposal did, however, prove influential with Congress. For the first time in the retirement savings context, Congress became interested in the classic Surrey critique of exclusions and deductions as upside-down subsidies and in the prescription of credits as the cure for upside-down subsidies.[285] The result was the enactment of the saver's credit in 2001, with bipartisan support. In order to meet revenue targets for the 2001 legislation, Congress opted for a saver's credit much less generous than the 1999 USA proposal—most notably, by making the credit nonrefundable.[286]

Following enactment, commentators praised the credit for "provid[ing] an incentive structure that is the reverse of other present-law retirement savings tax subsidies: taxpayers with the lowest income receive the greatest subsidy."[287] One article accurately described the credit as "an historic accomplishment" for being "the first and only major federal legislation that is directly targeted to promoting tax-qualified retirement saving for moderate- and lower-income workers."[288] Commentators also noted, however, that the nonrefundability feature interfered with the credit's targeting of lower-income workers. A study of the utilization of the credit in its first year of availability (2002) found that 43% of taxpayers who received the credit at the highest statutory rate of 50% had their credit amounts limited by nonrefundability and that 89% of those taxpayers would have had their credit amounts limited by nonrefundability if they had made the maximum credit-eligible contribution.[289]

Not surprisingly, there were calls to expand the credit in various ways—by increasing credit rates and income limits and, most importantly, by making the credit refundable.[290] Refundability would not have come cheaply. A 2004 study estimated that making the credit refundable, without making any other changes, would have more than doubled the revenue cost of the credit.[291]

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285. *See* William G. Gale et al., *The Saver's Credit: Issues and Options*, 103 Tax Notes 597 (May 3, 2004).

286. *Id.* at 602.

287. Gary Koenig & Robert Harvey, *Utilization of the Saver's Credit: An Analysis of the First Year*, 58 Nat'l Tax J. 787, 790 (2005).

288. Gale, et al., *supra* note 285, at 598.

289. Koenig & Harvey, supra note 287, at 788.

290. *See, e.g.*, Gale, et al., supra note 285, at 606–10.

291. *Id.* at 607 tbl.7.

Even as some tax reformers focused on incremental expansions of the saver's credit, other reformers had vastly more ambitious goals. In 2005 Gene Sperling (then a Senior Fellow at the Center for American Progress, and formerly President Clinton's National Economic Advisor) called for "replac[ing] our entire upside-down system of tax deductions for retirement savings. . . . with [a] flat tax credit of 30 percent for all savings done by all workers regardless of income."[292] Sperling acknowledged that taxpayers with marginal tax rates higher than the 30% credit rate "would receive a credit less generous than their current deduction" but argued this was appropriate because "tax incentives are least effective in generating new savings among this highest bracket."[293] A year later, William Gale, Jonathan Gruber, and Peter Orszag published a paper under the auspices of the Hamilton Project of the Brookings Institution, featuring a more detailed version of Sperling's proposal:

> Our plan would replace the existing tax deductions for contributions to retirement savings accounts with a government matching contribution into the account. Unlike the current system, workers' contributions to employer-based 401(k) accounts would no longer be excluded from income subject to taxation, and contributions to IRAs would no longer be tax deductible. Furthermore, any employer contributions to a 401(k) plan would be treated as taxable income to the employee (just as current wages are). However, all qualified employer and employee contributions would be eligible for the government matching contribution. . . . The qualifying government matching contribution would be 30 percent for all contributions up to the minimum of either: a) 10 percent of adjusted gross income . . . or b) $20,000 for 401(k) accounts and $5,000 for IRAs.[294]

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292. Gene Sperling, *A Progressive Framework for Social Security Reform*, Ctr. for Am. Progress 6 (Jan. 10, 2005), https://cdn.americanprogress.org/wp-content/uploads/kf/SOCIAL%20SECURITY%20-%20Sperling%20WEB%20FINAL.pdf?_ga=2.93128920.454007301.1607563588-466092666.1607563588.

293. *Id.*

294. William G. Gale et al., *Improving Opportunities and Incentives for Saving by Middle- and Low-Income Households* 12 (Brookings Inst.,

Like Sperling, the three co-authors acknowledged that high-bracket taxpayers would fare worse under their proposal than under existing law, but they argued (also like Sperling) that redirecting some retirement tax subsidies to lower-income households would make the subsidies more effective in encouraging new savings.[295] The Center for American Progress has continued to propose variations on the theme of a large-scale shift of tax subsidies for retirement savings from exclusions and deductions to credits.[296]

Congress, however, has never evinced any interest whatsoever in a broad conversion of retirement tax incentives from exclusions and deductions to refundable credits. For that matter, nearly two decades after the enactment of the saver's credit, reformers have not been able to achieve even the much more modest goal of refundability of the existing credit.[297] If the proponents of the saver's credit in 2001 hoped that its enactment would serve as a wedge for an eventual large-scale shift away from upside-down subsidies for retirement savings, those hopes could scarcely have been more thoroughly dashed. The saver's credit has survived but as little more than an answer to a trivia question. There are three major explanations for the failure of tax credits to make significant inroads in the retirement savings context even as they were routing deductions in other contexts.

The first explanation is based on the earliest tax preferences for retirement savings having been exclusions rather than deductions and on exclusions having continued to dominate even after the introduction

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Hamilton Project, Discussion Paper 2006-2, 2006) https://www.brookings.edu/wp-content/uploads/2016/06/200604hamilton_2.pdf [https://perma.cc/X9UG-9NQ6].

295. *Id.*

296. Michael Ettlinger et al., *Budgeting for Growth and Prosperity: A Long-Term Plan to Balance the Budget, Grow the Economy, and Strengthen the Middle Class*, Ctr. For Am. Progress 48 (May 2011), https://www.americanprogress.org/issues/economy/reports/2011/05/25/9572/budgeting-for-growth-and-prosperity/ [https://perma.cc/NHF3-VM3G] (calling for the replacement of the current exclusions and deductions with a 33% refundable credit and explaining that the proposal "ameliorates the upside-down problem with retirement tax incentives").

297. The Obama administration supported refundability, but with no success in Congress. The White House, Fact Sheet: Supporting Middle Class Families, *reprinted in* Doc. 2010-1771, Tax Analysts Document Serv. (Jan. 25, 2010).

of deductions. For the same reasons exclusions have resisted conversion to credits in other contexts—reasons relating to the simplicity, intuitive appeal, and under-the-radar quality of exclusions—they have resisted conversion in this context.

The second explanation relates to taxpayers who would be harmed by a revenue-neutral shift from exclusions and deductions to credits and who would forcefully oppose such a shift. As described earlier,[298] the circumstances of the former childcare deduction were nearly ideal for the conversion of the deduction to a credit. Because the childcare deduction was subject to an income-based phaseout, most taxpayers with marginal tax rates significantly higher than the credit rate were ineligible to claim the deduction and so could not be harmed by a deduction-to-credit conversion. Moreover, the revenue significance of the childcare tax preference was sufficiently modest that Congress could afford to minimize taxpayer losses from the conversion by making the tax expenditure associated with the new credit significantly larger than the revenue cost of the former deduction.

By contrast, neither circumstance has ever applied in the case of tax preferences for retirement savings. Because the exclusion has never been phased out for higher-income taxpayers, a revenue-neutral exclusion-to-credit conversion would inevitably be to the detriment of a large number of highly-compensated employees with marginal rates higher than the credit rate. Of course, those high-earners would be held harmless in the conversion if the credit rate—for them and for all other taxpayers—were set equal to the top marginal tax rate. But that approach would mean greatly increasing the revenue cost of what is already the largest item in the tax expenditure budget (if the exclusions for defined benefit and defined contribution plans are treated as a single item).[299] Making everyone a winner (or at least a non-loser) in an exclusion-to-credit conversion of tax subsidies for retirement savings would be prohibitively expensive—in striking contrast to the affordability of that approach in the childcare context.

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298. *Supra* text accompanying notes 131–158.

299. JCT 2019 TEB, *supra* note 11, at 29, 31 (showing, for 2019, combined tax expenditure items for defined benefit plans and defined contribution plans totaling $211.0 billion, compared with the next highest tax expenditure of $164.1 billion for the exclusion of employer-provided health insurance).

Finally, there has always been a strong case to be made that the cash-flow taxation of retirement savings produced by the exclusion and deduction provisions of current law is not a tax expenditure at all but rather represents the application of consumption tax norms to reasonable levels of retirement savings. The existing so-called income tax can be understood as a hybrid income-consumption tax under which life-cycle (retirement) savings are taxed under a consumption tax framework even as other savings are generally taxed under income tax principles.[300] According to this view, the exclusion and deduction provisions producing consumption tax treatment for retirement savings are not tax subsidies; rather, they are appropriate design elements of a hybrid tax. To put the point a bit differently, if the reference tax against which tax expenditures are measured is defined as a hybrid income-consumption tax, then existing exclusions and deductions for retirement savings should not be considered tax expenditures. And if those provisions are not subsidies at all, they cannot be objectionable as upside-down subsidies.

In the Budget of the United States Government for Fiscal Year 2004, the Bush Treasury Department raised precisely this point:

> The hybrid character of the existing tax system leads to many provisions that might make good sense in the context of a consumption tax, but that generate inefficiencies . . . when evaluated within the context of the existing tax rules. It is not clear how these [provisions] should be classified [for purposes of the tax expenditure budget].[301]

The Bush Treasury included in its "Analytical Perspectives" a list of items that are treated as tax expenditures relative to a comprehensive income tax base but that would not be tax expenditures relative to a comprehensive consumption tax base; not surprisingly, the two

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300. *See generally* Edward J. McCaffery, *Tax Policy Under a Hybrid Income-Consumption Tax*, 70 Tex. L. Rev. 1145 (1992); Lawrence Zelenak, *The Reification of Metaphor: Income Taxes, Consumption Taxes and Human Capital*, 51 Tax L. Rev. 1, 11–15 (1995).

301. Budget of the United States Government: Fiscal Year 2004: Analytical Perspectives 135 (2003).

biggest-dollar items on the list related to employment-based retirement savings.[302]

It is very difficult—perhaps impossible—to determine how much effect, if any, intellectual developments of this sort have on the tax policy views of members of Congress. It is not implausible, however, that the view that exclusions and deductions for retirement savings are not really tax expenditures has some currency in Congress. If so, part of the explanation for the almost complete failure of credits in this context is that legislators who think the current tax regime is the normatively correct non-subsidy treatment of retirement savings will not be interested in replacing that regime with the combination of income taxation of retirement savings and a tax credit for those same savings. Such legislators would view both aspects of the replacement regime—tax and credit—as departures from the existing theoretically correct treatment.

IV. Deduction, Exclusion, or Credit?

In fashioning a nonbusiness personal tax expenditure, Congress is faced with six major design decisions (apart from choice of particular numerical parameters):

1. Should the value of the subsidy depend on the taxpayer's marginal tax rate?

2. Should the subsidy be nonrefundable or refundable? (In other words, should the amount of the subsidy be limited to the taxpayer's pre-subsidy tax liability?)

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302. *Id.* at 140 tbl.2. For other thoughtful discussions, see Leonard E. Burman, *Is the Tax Expenditure Concept Still Relevant?*, 56 Nat. Tax J. 613, 619 (2003) ("Those who would prefer heavier reliance on consumption taxes would favor defining the normal tax as a broad-based consumption tax. Given that the actual income tax is a hybrid system containing many elements of income and consumption taxation, there is no objective way to resolve this dispute."); Joint Comm. on Tax'n, 110th Cong., JCX-37-08, A Reconsideration of Tax Expenditure Analysis 36 (2008) ("[I]n contrast to the prevailing view 40 years ago, there no longer is a near-universal consensus view as to the ideal tax system. Much academic work since the time Surrey first published his proposal for tax expenditure analysis has been devoted to arguing for the superiority of a consumption tax system over an income tax.").

3. Should the subsidy be phased out for higher-income taxpayers?

4. If the subsidy is based on tax-favored taxpayer expenditures, should the subsidy apply from the first dollar of expenditures or should there be a floor (for example, a specified percentage of AGI) on subsidy-generating expenditures?

5. If the subsidy is based on tax-favored taxpayer expenditures, should there be a statutory cap on the dollar amount of subsidy-generating expenditures?

6. Must the taxpayer forgo the benefit of the standard deduction in order to claim the subsidy, or should a taxpayer be able to claim both the subsidy and the standard deduction?

The legislative choice among a deduction, a credit, and an exclusion as the vehicle for the subsidy necessarily resolves only the first of the six issues. By their nature, deductions and exclusions produce tax benefits dependent on taxpayers' marginal tax rates; the same is not true of credits.[303]

It may seem that Congress is compelled to opt for an exclusion—and the resulting dependence on marginal tax rates—if the policy

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303. It would be possible, of course, to design a credit the amount of which equaled the product of credit-eligible expenses and the taxpayer's marginal tax rate. In fact, at least one such credit actually exists—in I.R.C. § 1341(a)(5). Under that provision, if a taxpayer in a later year repays funds she had received in an earlier year under a claim of right and had included in her income in that earlier year, she may claim a credit in the later year equal to the amount by which her earlier year tax liability would have been reduced if the funds had not been included in her income of the earlier year. *Id.* However, unlike deductions and exclusions, credits do not inherently produce tax benefits based on taxpayers' marginal tax rates. Except in very unusual circumstances (such as I.R.C. § 1341, where the credit-determining marginal tax rate is the taxpayer's rate for a prior year, rather than the current year), if Congress wants a tax benefit to be rate-based it should choose a deduction or exclusion rather than a credit specially designed to mimic a deduction or exclusion. And so it does.

justifying the tax break relates to taxpayers receiving a particular sort of benefit from a particular sort of source. Certainly, exclusions are both the simplest and the most common legislative choice in such circumstances. However, there is no technical impediment to requiring a taxpayer to include such receipts in income and then allowing the taxpayer a credit equal to some percentage (not based on marginal tax rates) of those receipts. As noted earlier, that approach has been suggested as a reform of the tax treatment of EPHI.[304] Thus, although the choice of an exclusion compels rate-based benefits, a legislative desire to enact source-based tax benefits does not compel the use of an exclusion rather than a credit.

For design choices two through six, all options remain open to Congress regardless of whether it structures the tax benefit as a deduction, an exclusion, or a credit. The following discussion elaborates on the compatibility of all three types of tax benefits with all possible answers to questions two through six.

Refundability. Under current law, several major credits (EIC, CTC, AOTC) are fully or partly refundable. By contrast, a deduction is of no benefit to a taxpayer who would have had no tax liability even without the deduction; the same is true of an exclusion. This is merely a difference in practice, however, rather than an inherent difference. As Milton Friedman emphasized in his advocacy of a negative income tax, a deduction can result in refundability (that is, a net transfer from government to taxpayer, instead of the reverse) if (1) the deduction results in the taxpayer having below-zero income, and (2) there is a "tax" rate schedule applicable to negative income.[305] And although an exclusion (unlike a deduction) will not in itself result in a taxpayer having negative income, an exclusion may be crucial in preserving negative income for a taxpayer who would have had negative income (produced by deductions) with the exclusion but positive (or zero) income in the absence of the exclusion.

Phaseouts. For all three types of tax benefits (deduction, exclusion, and credit), income-based phaseouts (generally keyed to AGI or a modified version of AGI) are both theoretically possible and reflected in current law. Phaseouts are the norm for credits; major examples include the EIC, CTC, AOTC, and the adoption credit. Phaseouts of exclusions, by contrast, are uncommon; part of the

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304. *Supra* text accompanying notes 108–113.

305. Friedman, *supra* note 185, at 192.

explanation for their scarcity is that, if an exclusion is based in part on the difficulty of valuing non-cash benefits, a phaseout of the exclusion reintroduces valuation problems for higher-income taxpayers. In any event, the partial phaseout of the exclusion of Social Security benefits demonstrates that Congress realizes that phasing out an exclusion is a policy option.[306] Phaseouts of deductions are less common than phaseouts of credits but more common than phaseouts of exclusions. Examples include the phaseout of dependency exemptions (applicable before 2018 and after 2025),[307] the phaseout of the former childcare deduction,[308] and the phaseout of the deduction for college tuition expenses.[309]

To be sure, phaseouts of both deductions and exclusions produce very odd—and difficult or impossible to justify—subsidization patterns. The tax benefit per dollar of deduction-generating expenditures increases with income until income reaches the phaseout threshold. Variations in tax benefit per dollar of expenditure may be quite complex in the phaseout range, as the phaseout works to decrease the per-expenditure-dollar tax benefit while the marginal tax rate structure works in the opposite direction. And, of course, once income is high enough that the phaseout is complete, otherwise deductible expenses produce no tax benefit.[310] One of Surrey's major critiques of tax expenditures generally—that no one would propose a direct spending program with the same distributional impact as many existing tax expenditures[311]—seems particularly apt for phased out deductions and exclusions. Nevertheless, there is no technical impediment to phasing out deductions and exclusions, and Congress has done so in a number of instances—although, to Congress's credit (so to speak), it seems to be growing less fond of that technique.[312]

306. I.R.C. § 86(a).

307. I.R.C. § 151(d)(3).

308. Former I.R.C. § 214 (1954) (as amended prior to its 1976 repeal), discussed *supra* text accompanying notes 135–137.

309. I.R.C. § 222(b).

310. Although the text is phrased in terms of deductions for taxpayer expenditures, the same analysis applies to both exclusions and deductions not based on expenditures.

311. Surrey, Pathways, *supra* note 12, at 37 (with respect to the home mortgage interest deduction).

312. As noted earlier, *supra* note 245, the phaseout of exemptions is not currently in effect because the exemption amount is zero.

Floors. Percentage-of-AGI floors on deductions are familiar.[313] The most prominent current example is the 10%-of-AGI floor on the medical expense deduction.[314] Also well-known is the two-percent-of-AGI floor on miscellaneous itemized deductions, applicable in years (before 2018 and after 2025) in which miscellaneous itemized deductions are deductible at all.[315] There are not any current tax credits allowable only with respect to taxpayer expenditures in excess of some percentage of AGI, but such a design is obviously technically feasible and has been urged—especially in connection with proposals to convert the charitable deduction to a credit.[316] There are also no percentage-of-AGI floors on exclusions in the current Internal Revenue Code. Reasons for their absence may include legislative reluctance to impose limitations on exclusions enacted largely to avoid valuation difficulties and legislative determinations that the "buying-the-base" concern commonly invoked to justify percentage-of-AGI floors on deductions may not often apply to exclusions.[317] Despite the lack of current-law floors

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313. As Daniel Hemel has explained, if a phaseout is broadly defined as "a feature of a tax provision that places limits on the benefits that can be claimed by taxpayers with incomes above a certain threshold," then a rule subjecting a tax benefit to a percentage-of-income floor can be understood as a special case of a phaseout–that is, a phaseout for which the income threshold is zero. Daniel Hemel, Phaseouts, at 4–5 (unpublished manuscript on file with the author). In other words, floors can be understood as a subset of phaseouts. Nevertheless, floors are discussed separately here, for two reasons. First, there are few indications, if any, that Congress thinks of a floor as merely a type of phaseout. Second, floors differ from other phaseouts in using an income threshold of zero, rather than a threshold in the five- or six-figure range, and in preserving the possibility of tax benefits for even the highest-income taxpayers (as long as the amount of the tax-favored expenditure exceeds the specified percentage of the taxpayer's income).

314. I.R.C. § 213(a).

315. I.R.C. § 67(a) & (g).

316. *See, e.g.*, *Tax Reform Options*, *supra* note 72, at 7–8 (Statement of Frank J. Sammartino, Assistant Dir. Tax Analysis, Cong. Budget Office) (noting, without recommendation, that one policy option would be replacing the charitable deduction with a flat percentage credit, with or without a percentage-of-AGI floor on creditable donations).

317. Stated differently, the "buying-the-base" concern is that a tax subsidy should not be awarded to a taxpayer for behavior he would have engaged in even without the subsidy, such as (perhaps) giving some small percentage of his income to charity.

on exclusions, there is no technical bar to (for example) a rule that a taxpayer can exclude EPHI from income only to the extent the value of the EPHI exceeds two percent of the taxpayer's AGI.

Dollar caps. Under current law, dollar caps on all three types of tax benefits are common. For deductions, by far the highest-profile dollar cap is the recently enacted $10,000 ceiling on the SALT deduction.[318] The $750,000 cap on home mortgage principal generating deductible interest is not a direct cap on the home mortgage interest deduction, but its effect is very similar to that of a direct cap.[319] A number of exclusions for employer-provided fringe benefits include dollar caps on excludable benefits; examples include qualified transportation fringes, educational assistance programs, and dependent care assistance programs.[320] As with phaseouts of exclusions and deductions, dollar caps on exclusions and deductions can produce strange distributional results. The tax benefit of the SALT deduction, for example, increases with the taxpayer's income until the taxpayer's income results in the taxpayer paying more than $10,000 in state and local taxes, at which point there is no federal tax benefit for additional SALT payments. These dubious distributional effects have not, however, dissuaded Congress from imposing dollar caps on a number of exclusions and deductions.

Dollar caps on credits are universal, or nearly so. The childcare credit, for example, takes into account no more than $6,000 of childcare expenses ($3,000 if there is only one qualifying child),[321] and the AOTC is based on no more than $4,000 of tuition and fees per student.[322] Credits not based on a percentage of taxpayer expenditures also have dollar caps. The CTC, for example, is $2,000 per qualifying child,[323] and the amount of earned income on which the EIC is calculated is subject to a dollar cap.[324]

Interaction with the Standard Deduction. As a quick glance at the current Internal Revenue Code will confirm, Congress is well aware

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318. I.R.C. § 164(b)(6).
319. I.R.C. § 163(h)(3)(F)(i)(II).
320. I.R.C. §§ 132(f), 127, &129, respectively
321. I.R.C. § 21(c).
322. I.R.C. § 25A(b)(1).
323. I.R.C. § 24(h)(2).
324. I.R.C. § 32(b)(2). The dollar caps are adjusted annually for inflation and are sensitive to the number of qualifying children.

that it has the policy option, in the case of any deduction, either of requiring a taxpayer to choose between that deduction and the standard deduction or of allowing a taxpayer to claim both that deduction and the standard deduction.[325] Although the major legacy deductions—for home mortgage interest, state and local taxes, charitable contributions, and medical expenses—are all itemized deductions available only to taxpayers not claiming the standard deduction, a number of other deductions—including deductions for reimbursed employee business expenses and for contributions to individual retirement accounts—are allowed to taxpayers claiming the standard deduction.[326] There is nothing in the current Code, however, to suggest that Congress realizes it could take the same approach with respect to credits and exclusions. Instead, current and long-standing legislative practice has been that otherwise allowable credits and exclusions are always available even if a taxpayer claims the standard deduction.

This state of affairs seems to be due to nothing more than a failure of imagination on the part of Congress. Assume, for the sake of argument, that there can be good reasons to put taxpayers to a choice between the standard deduction and tax benefits based on a taxpayer's actual tax-favored expenditures. For example, by reducing the number of taxpayers claiming expenditure-based tax benefits, the standard deduction reduces the need for taxpayers to keep records of expenditures and for the IRS to audit claimed expenditures, and it reduces taxpayers' opportunity and incentive to cheat by overstating expenditures.

Nothing in the above justifications suggests that taxpayers should be put to such a choice only if the expenditure-based tax benefit is a function of the taxpayer's marginal tax rate rather than (say) a flat percentage of qualifying expenditures. There could be a "standard credit" of some specified dollar amount (in addition to the standard deduction), with taxpayers required to choose between the standard credit and specified "below-the-line" credits (with the childcare credit and the higher education credits among the likely candidates for below-the-line status) just as they now choose between the standard deduction

325. I.R.C. § 62(a) (enumerating "above-the-line" deductions allowed even to taxpayers claiming the standard deduction) & § 63(b) (not allowing "below-the-line" itemized deductions to taxpayers claiming the standard deduction).

326. I.R.C. § 62(a)(2)(A) (reimbursed employee business expenses) & (a)(7) (individual retirement account contributions).

and itemized deductions. Or, better yet, there could be a unified "standard allowance" serving as a combined standard-deduction-standard-credit, with taxpayers required to choose between the standard allowance and the combination of below-the-line deductions and credits. Because the standard allowance would be an alternative to a wider range of tax benefits than the current standard deduction, it should be somewhat larger than the current standard deduction.

The process of choosing between the standard allowance and itemized-deductions-plus-itemized-credits would be more complicated than the present situation. Currently, a taxpayer need only compare the sum of her itemized deductions with her standard deduction amount and claim whichever amount is larger. With the introduction of itemized credits into the calculation, a taxpayer would need to convert credits into deduction equivalents in order to make an informed choice between itemizing and the standard allowance. Suppose, for example, the standard allowance (expressed as a deduction) is $30,000. A taxpayer has $12,000 of potential itemized deductions and $5,000 of potential itemized credits. If the taxpayer's marginal tax rate is 25%, the credits are the equivalent of a $20,000 deduction. Since the taxpayer's $32,000 of itemized-deductions-plus-credits exceeds the standard allowance, the taxpayer should itemize. If all facts remain the same except the taxpayer's marginal tax rate is 40%, the credits are the equivalent of a deduction of only $12,500, and the taxpayer should claim the standard allowance.[327] Although the increase in computational complexity would be significant—especially if a taxpayer had more than one relevant marginal tax rate—this approach should present no major difficulties for taxpayers using return preparation software.

The above analysis applies to exclusions as well as credits. Rather than automatically (and implicitly) designating all exclusions as above-the-line, Congress could consider whether each exclusion should be above- or below-the-line. If, for example, Congress decided the exclusion for employer-provided free parking should be below-the-line, then such parking would be excluded from income only for those taxpayers who declined the standard allowance in favor of itemizing their deductions, credits, *and exclusions*. Taxpayers claiming the standard allowance would be taxed on the value of their employer-provided parking.

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327. It would also be possible to express the standard allowance as a credit, in which case a taxpayer would need to convert deductions into credit equivalents in order to decide whether to itemize.

As with credits, any addition of exclusions to the standard allowance regime should be accompanied by an increase in the amount of the standard allowance.

Summing Up. The crucial takeaway from the above discussion is that there is only one inherent design difference between exclusions and deductions, on the one hand, and credits on the other; the tax benefit of an exclusion or deduction is a function of a taxpayer's marginal tax rate, and the tax benefit of a credit is not. Aside from that one difference, the choice among deduction, exclusion, and credit dictates none of the other design choices (relating to refundability, phaseouts, caps, floors, and the standard deduction). And yet, in long-established legislative practice, Congress acts as if many of the other design choices follow, more or less automatically, from its choice of deduction, exclusion, or credit. Credits may be refundable; deductions and exclusions never are. Credits are almost always phased out, exclusions almost never, and deductions somewhere in between. Deductions may be subject to floors, but exclusions and credits never are. Most nonbusiness deductions are allowed only to taxpayers not claiming the standard deduction, but credits and exclusions are never so limited. Only in the case of dollar caps does Congress appear to recognize that the choice (of whether to impose a dollar cap and, if so, at what level) is independent of the basic form of the tax benefit in question.

Legislating as if the other design choices were dictated by the initial choice of deduction, exclusion, or credit might not be problematic if Congress enacted a tax benefit in the form of an exclusion (for example) precisely because it liked the package of design elements associated with exclusions. That does not appear, however, to be what Congress is doing. Rather, Congress chooses a credit because it has internalized Surrey's upside-down critique of deductions (including in situations in which the critique definitely or arguably does not apply) and so never even considers (for example) whether taxpayers should be required to choose between the new credit and the standard deduction. Or Congress chooses an exclusion because an exclusion is simpler than an inclusion followed by a deduction or credit (in the case of a tax subsidy based on the source of a benefit received by a taxpayer). Having chosen an exclusion for no reason beyond simplicity, Congress scarcely realizes it has also chosen (among other things) an upside-down subsidy, a nonrefundable subsidy, a subsidy not subject to an income-based phaseout, and a subsidy available to both itemizers and non-itemizers. Except for the upside-down subsidy, these choices do not necessarily follow from the choice of an exclusion, but Congress acts as if they do.

V. Taxable Credits

In his 1973 *Pathways to Tax Reform*, Surrey argued that a properly designed tax credit would not only be refundable, it would also be taxable:

> While some of the proposals for credits against tax would make the credits refundable, none would include the credit itself in income. Government assistance in the form of credits against tax thus has a dual tax expenditure quality. First, . . . [the credit itself] is a tax expenditure. Second, since that Government aid is not included in income, the exclusion of the credit is also a tax expenditure. This latter aspect, like any exclusion from income, of course is more beneficial to those recipients in the higher brackets.[328]

In his 1985 follow-up book, *Tax Expenditures* (co-authored with Paul McDaniel, and published the year after Surrey's death), Surrey insisted on this point:

> If this inclusion of the credit in income is not required under the program design for the tax expenditure credit, then an additional tax expenditure arises, which is in effect an increase in the amount of the basic tax expenditure, the credit itself. In other words, the credit itself must be taxable. If it is not taxable, the credit will have the same upside-down effect as a deduction or exclusion.[329]

Surrey and McDaniel complained that taxable credits were rare as of 1995, although they noted that the credit for alcohol fuel was includible in income and that the reduction of the business expense deduction for wages paid by the amount of the jobs tax credit was "the mathematical equivalent of taxability" of the jobs tax credit.[330]

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328. Surrey, Pathways, *supra* note 12, at 99.

329. Stanley S. Surrey & Paul R. McDaniel, Tax Expenditures 110 (1985).

330. *Id.* at 111.

Taxable credits of both types—expressly taxable and effectively taxable—remain rare today. In fact, not a single one of the major nonbusiness credits examined in this article is taxable (in either sense). The few tax credits that are taxable (either directly or indirectly via deduction denial) are all business or investment credits. Several Code provisions create credits designed to increase the effective interest rates earned by holders of qualifying bonds.[331] Just as explicit interest on these bonds is taxable, so too a taxpayer receiving an interest-subsidy credit must include the amount of the credit in gross income as additional interest.[332] The Tax Cuts and Jobs Act of 2017 repealed the interest subsidy credits for bonds issued after 2017,[333] but the taxable credits continue to apply with respect to qualifying bonds issued before 2018. In addition, the Code disallows a business expense deduction for the portion of wages paid by a business equal to the employment credits received by the business, with similar rules applying to credit-generating drug testing expenses and research expenses and to a miscellany of other credit-generating business expenses.[334]

Despite these several rules expressly or effectively taxing certain business and investment credits, there are no Code provisions imposing tax on any of the nonbusiness credits considered in this Article. Surrey's failure to persuade Congress of the wisdom of taxing nonbusiness credits is in striking contrast with his notable success in persuading Congress to prefer nonbusiness credits to deductions. What explains this failure?

No doubt part of the explanation is that the giving-with-one-hand-while-taking-away-with-the-other character of taxable credits is counterintuitive to members of Congress and would be to their constituents as well. The idea is so counterintuitive, in fact, that Congress did

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331. From a policy perspective, the interest-subsidy credits are an alternative to the traditional exclusion of municipal bond interest under I.R.C. § 103.

332. I.R.C. § 54A(d)(1) & (f) (2016) (applying to interest subsidy credits for qualified academy bonds, clean renewable energy bonds, qualified forestry conservation bonds, build America and recovery zone bonds, and qualified school construction bonds).

333. Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, § 13404. 131 Stat. 2054, 2138 (2017).

334. I.R.C. § 280C (the original version of which Congress enacted in 1977 (Tax Reduction and Simplification Act of 1977, Pub. L. No. 95-30, § 202(c), 91 Stat. 126, 147).

not consider but ultimately reject the possibilities of taxing (for example) the EIC, CTC, or PAC; rather, the idea never entered the legislative mind. Another part of the explanation may be that Congress is attracted to nontaxable credits precisely because they make possible subsidies independent of a taxpayer's marginal tax rate (unlike deductions and exclusions), but if all credits must be taxable then all subsidies must be tax-rate dependent after all—a notion that Congress may understandably reject.[335]

Another possibility is that, rather than creating credits and then taxing away a significant part of their benefits, Congress prefers to build into the design of the credit itself whatever income-based adjustments in the credit amount Congress deems appropriate. Such adjustments could produce results equivalent to credit taxability only if the adjustments were based on taxable income and were designed always to operate at a taxpayer's marginal tax rate. There is no existing credit featuring either adjustments based on taxable income or adjustments operating at a taxpayer's marginal tax rate. However, credit adjustments based on other income measures are common,[336] and every phaseout operates as the equivalent of some marginal tax rate; the use of phaseouts helps explain the lack of legislative interest in explicitly taxing nonbusiness credits.

Even if Congress were to squarely consider Surrey's argument for taxing credits, it might conclude that there was an inherent conflict between the policy underlying the credit—for example, giving families $2,000 per year per child or paying enough of a family's health insurance premium to ensure that the family need spend no more than *x* percent of its income on health insurance—and the income tax policy of including credits in income so that taxable income might better reflect ability to pay. Faced with that conflict, Congress might opt for

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335. A taxable credit's relationship to a taxpayer's marginal tax rate is the inverse of that of a deduction. While a taxpayer in the 30% bracket, for example, enjoys a $30 tax saving from a $100 deduction, she will enjoy a net tax saving of $70 from a $100 taxable credit. The deduction and the taxable credit meet in the middle, so to speak, for a 50% bracket taxpayer ($50 tax savings in either case), and (oddly enough) a deduction would be more valuable than an equal-dollar taxable credit for a taxpayer in a bracket higher than 50%.

336. For example, earned income and AGI in the case of the EIC (I.R.C. § 32), and household income as a percentage of the FPL in the case of the PAC (I.R.C. § 36B).

nontaxability on the grounds that the nontax policy is simply more important, in context, than the tax policy. Or Congress might realize that it could nominally reconcile the policies by "grossing up" the credits to reflect their taxability—for example, by designing the PAC rules so that each taxpayer's credit amount was high enough that the after-tax amount of the credit was sufficient to accomplish the purpose of the PAC. But Congress might also decide that the complexity (and popular incomprehensibility) of such a Duke of York[337] approach was inferior to current law.

Finally, although it is not clear that the news has reached many members of Congress, Lily Batchelder, Fred Goldberg, and Peter Orszag (hereinafter BGO) have argued convincingly that taxing credits is wrong, even in theory, in the case of most nonbusiness credits.[338] Using the example of a credit equal to a specified percentage of a consumer purchase or other expenditure (and assuming that the optimally efficient subsidy is uniform and that the subsidy serves no distributional objectives), they conclude that the credit "should not be taxed if it is calculated based on an after-tax purchase, contribution, or return."[339] The underlying intuition is that the credit-generating purchase or expenditure is made with after-tax dollars so that taxing the credit would be double taxation.

Consider an example (not offered by BGO) involving a hypothetical 20% tax credit for charitable donations, enacted along with the repeal of the charitable deduction. Taxpayer *A* has a marginal tax rate of 20%, while taxpayer *B*'s marginal tax rate is 33.33%. For *A*, $125 of pre-tax income leaves $100 after tax; for *B*, $150 of pre-tax income leaves $100 after tax. Each donates $100 to charity for which each receives a $20 credit. If the credit itself is not taxable, the results nevertheless appropriately reflect the different marginal tax rates of the two taxpayers. *A* receives a $20 credit for a donation of $125 of pre-tax income, while *B*'s receipt of a $20 credit requires a donation of $150 of

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337. "Oh the grand old Duke of York / He had ten thousand men / He marched them up to the top of the hill / And he marched them down again." *The Grand Old Duke of York*, BBC Teach, https://www.bbc.co.uk/teach/school-radio/nursery-rhymes-the-grand-old-duke-of-york/zrymd6f [https://perma.cc/F2EZ-2W3M] (last visited Dec. 10, 2020).

338. Lily L. Batchelder et al., *Efficiency and Tax Incentives: The Case for Refundable Tax Credits*, 59 Stan. L. Rev. 23, 50–51 (2006).

339. *Id.* at 50.

pre-tax income. Taxing the credits would disturb this appropriate result.[340] It is unlikely that Congress fully grasped the BGO analysis of why a credit based on an after-tax purchase or contribution should not be taxed, but legislative practice is nevertheless consistent with that analysis.

BGO also explain that a credit should be taxable "if it is calculated based on a pre-tax purchase, contribution, or return."[341] The example they offer is a credit designed to serve as additional interest to investors in state and local bonds paying taxable interest. As noted earlier, when Congress has provided for such credits it has specified that the credits are taxable—again getting it right according to the BGO analysis.[342]

Credits properly not taxed under the BGO analysis include the adoption credit, the PAC, the AOTC, the childcare credit, and a hypothetical charitable contribution credit enacted as a replacement for the current deduction. The analysis does not apply, however, to a credit not based on any sort of purchase, contribution, or return, such as the CTC. At least at the moment, with the disallowance of dependency exemptions from 2018 through 2025, the best technical reason for not taxing the CTC is that a dependency exemption is called for by ability-to-pay principles and that the nontaxation of the credit serves as a hidden de facto exemption. If there were an explicit and adequate dependency exemption, the intellectual heirs of Surrey would have a strong

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340. *A*'s ratio of credit to pre-tax income is $20/$125, or 16%; *B*'s ratio is $20/$150, or 13.33%. The ratio of *A*'s ratio to *B*'s ratio is 16/13.33, or 120%. As it should, the 120% ratio equals the ratio of *A*'s after-tax income to *B*'s after-tax income, for the same amount of pre-tax income, in the absence of a charitable donation. (For example, if each had $100 of pre-tax income, *A* would have after-tax income of $80, and *B* would have after-tax income of $66.67. *A*'s $80 would be 120% of *B*'s $66.67.) If the credits were taxable, however, *A*'s net credit would be $16 (the $20 credit reduced by a $4 tax on the credit), while *B*'s net credit would be only $13.33 (the $20 credit reduced by a $6.67 tax). *A*'s ratio of credit to pre-tax income would be $16/$125, or 12.8%, *B*'s would be $13.33/$150, or 8.89%, and the ratio of *A*'s ratio to *B*'s would be 12.8/8.89, or 144%. The greater relative disadvantage to *B* under the taxable credit is attributable to the double taxation harming *B* more than *A* because of *B*'s higher tax rate.

341. Batchelder et al., *supra* note 338, at 50.

342. I.R.C. § 54A(f) (2016), discussed *supra* text accompanying notes 332–333.

argument for taxing the CTC, on the grounds that not taxing the CTC is the equivalent of allowing two dependency exemptions.[343]

Finally, the EIC—calculated as a percentage of a taxpayer's pre-tax earned income—would seem to be properly taxable under the BGO analysis.[344] Yet Congress has never even considered inclusion of the EIC in the base of the income tax, and it is almost inconceivable that it would ever do so. Politics aside, the best justification for the nontaxability of the EIC is one of those offered earlier—that Congress has built into the design of the EIC what it considers appropriate income-based adjustments instead of making income-based adjustments indirectly by taxing the credit.

VI. Conclusion

The goals of this Article have been largely descriptive—to explain how dramatically Congress has moved from deductions to credits in the half century since Stanley Surrey derided personal deductions as upside-down subsidies. Examining in detail the histories of the more significant personal tax expenditures, several themes emerge:

> –In the post-Surrey era, Congress has strongly preferred credits to deductions in designing new tax expenditures.
>
> –Although Congress has not converted any of the big-four legacy deductions (home mortgage interest, state and local taxes, charitable contributions, and medical expenses) to credits, it has severely reduced the economic significance of those deductions, both by enacting new limitations on the deductions themselves and by greatly increasing the standard deduction.

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343. Two qualifications to the statement in the text are worth noting, however. First, if the appropriate dependency exemption was (for example) $6,000 per child, Congress might accomplish that result by way of an explicit dependency exemption of $4,000 per child, along with a nontaxable CTC of $2,000 per child. Second, although the current-law phaseout of the CTC can be viewed as a sort of taxation, the distributional effects of the phaseout are very different from those of a taxed credit available at all income levels.

344. In their article, BGO do not consider how their credit taxability analysis should apply to the EIC.

–A striking development is that, whereas half a century ago all four of the legacy deductions were uncapped, now a taxpayer can deduct no more than $10,000 of state and local taxes, and no more than about $30,000 to $40,000 of home mortgage interest.[345] Although the medical expense deduction remains uncapped, only rarely will a high-income taxpayer have very large medical expenses not covered by insurance.[346] The charitable deduction is now the only major source of uncapped itemized deductions.

–In the few instances in which Congress has converted a deduction to a credit—childcare expenses, adoption expenses, and (by far most significantly) the transformation of the dependency exemption to the CTC—the crucial circumstance has been the existence of an income-based phaseout of the deduction, because of which upper-income taxpayers were generally not harmed by the deduction-to-credit conversion.

–Although exclusions are vulnerable to the upside-down subsidy critique (like deductions and unlike credits), exclusions in general—and the EPHI and retirement savings exclusions in particular—have fared much better than deductions in the post-Surrey era; the explanation for the difference relates to the somewhat under-the-radar character of even the largest exclusions.

The Article has also made several normative points, including the following:

–Congress has been overly influenced by Surrey's critique in that it has wrongly viewed as upside-down subsidies deductions justified on income-defining (ability-to-pay) grounds.

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345. I.R.C. § 164(b)(6) (capping the SALT deduction at $10,000); I.R.C. § 163(h)(3)(F)(i)(II) (not capping interest directly, but capping loan principal at $750,000).

346. The nondeductibility of cosmetic surgery eliminates what might otherwise be a significant source of very large medical expense deductions. I.R.C. § 213(d)(9). The most likely cause of very high medical expense deductions for high-income taxpayers may be unproven cancer treatments not covered by insurance.

–In designing tax expenditures, Congress has legislated as if a number of design features automatically follow from the choice among deduction, exclusion, and credit, when in fact they do not. It has not occurred to Congress, for example, that it would be feasible to require taxpayers to choose between credits and a standard allowance, and between exclusions and a standard allowance, rather than applying that approach only to itemized deductions.

–Congress has been right (at least mostly so) to ignore Surrey's recommendation that all credits should be taxable.

There is no reason, of course, to suppose that the Tax Cuts and Jobs Act of 2017 represents the end of history in the story of deductions versus credits. Although the tide of history strongly favors credits at the moment, there is a distinct possibility that deductions may stage a comeback. In fact, in the absence of new legislation there will be a dramatic resurgence of deductions relative to credits in 2026, when the CTC declines from $2,000 to $1,000 per child; dependency exemptions reappear; the $10,000 SALT ceiling disappears; and a large drop in the amount of the standard deduction increases the availability of itemized deductions. A sequel to this Article may be in order in about a decade.