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ARTICLES

TAX DEREGULATION

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Deregulation has played both the hero and the villain in recent years. This Article evaluates the impact of deregulation on what may be the single most economically important regulatory regime: the income tax. In order to accomplish this goal, it applies the concepts of fiscal arbitrage and compliance spirals to three deregulatory tax reforms. Compliance spirals describe an enforcement dynamic in which the regulator encourages compliance through a system of rewards for cooperation and punishment for noncooperation. Fiscal arbitrage describes policy measures that exploit cognitive biases and other anomalies to deliver political benefits by using minimal political capital. The combination of these two concepts creates a tool for tax authorities to evaluate deregulatory tax provisions for likely costs and benefits. On balance, this Article finds that tax deregulation is likely to be harmful.

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Introduction

The financial crisis has breathed new life into debates about the value of deregulation.[1] Some commentators have blamed the transformation of a rigid command-and-control financial regulatory regime into one that grants private actors broad discretion for the credit dis-

[1] The crisis has prompted greater skepticism of deregulation even among longtime advocates like Richard Posner. *Compare* Richard A. Posner, A Failure of Capitalism xii (2009) [hereinafter Posner, A Failure of Capitalism] ("We are learning from [the depression] that we need a more active and intelligent government to keep our model of capitalist economy from running off the rails. The movement to deregulate the financial industry went too far by exaggerating the resilience—the self-healing powers—of laissez-faire capitalism."), *with* Richard A. Posner, *A Financier Comments on* A Failure of Capitalism, Atlantic (June 17, 2009, 12:36 AM), http://correspondents.theatlantic.com/richard_posner/2009/06/a_financier_comments_on_a_failure_of_capitalism_the_book.php ("[O]ne important theme that failed to get appropriate consideration in [Posner's] book . . . is that markets are adaptive, as market players work hard to understand and integrate recent events into their business strategies, whereas governments have much more difficulty adjusting their approaches to changing conditions." (quoting E-mail from Lawrence Hillibrand to Richard A. Posner (May 22, 2009)). Growing doubt about the wisdom of deregulation is evinced by shifting attitudes toward the deregulation of the banking industry, including the elimination of the Depression-era Glass-Steagall banking restrictions. *Compare* William M. Isaac & Melanie L. Fein, *Facing the Future—Life Without Glass-Steagall*, 37 Cath. U. L. Rev. 281, 296 (1988) ("As a matter of sound regulatory philosophy, Congress should allow the banking industry to respond to the natural competitive forces that are shaping the markets unencumbered by regulatory constraints . . . . Glass-Steagall threatens the long-term health and survival of banks as the fulcrum of our financial system."), *with* Posner, A Failure of Capitalism, *supra*, at 326 ("[T]he economists who pushed deregulation . . . were not macroeconomists sensitive to the role of banking regulation in preventing risk-taking that could bring on a depression . . . .").

ruptions at the root of the financial crisis.[2] Tax deregulation produces a similar shift toward private autonomy at the expense of public control.[3] This Article first defines tax deregulation and then examines the profound—and, until now, wholly unexamined—influence that deregulation has had on the U.S. tax regime. At the most basic level, tax deregulation undermines sources of fiscal constraint and decreases public revenues at a time when deficits loom large and spending shows no signs of waning.

Over the past few decades, policymakers have replaced a presumption in favor of prescriptions and prohibitions with a preference for private choice.[4] Although deregulation is often associated with the airline and banking industries, few regulatory regimes have remained unchanged. Indeed, the same impulse that resulted in the dismantling of the Civil Aeronautics Board has transformed the way in which

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[2] Posner and others place significant blame for the current financial crisis on the misguided deregulation of the financial system. *See* POSNER, A FAILURE OF CAPITALISM, *supra* note 1, at 317–18 ("The deregulation movement that began in the 1970s was aimed at the regulated industries in general, and encompassed banking only because it was highly regulated. The economists and eventually the politicians who pressed for deregulation were not sensitive to the fact that deregulating banking has a macroeconomic significance that deregulating railroads or trucking or airlines or telecommunications or oil pipelines does not."); John C. Coffee, Jr. & Hillary A. Sale, *Redesigning the SEC: Does the Treasury Have a Better Idea?*, 95 VA. L. REV. 707, 711 (2009) ("Not only is deregulation no longer the presumptive policy prescription, the sense is growing that deregulation may have deepened the current crisis . . . . Unless constrained by prudential financial regulation, market forces appear to push financial institutions towards excessive use of leverage and inadequate diversification.").

[3] At the risk of overextending the analogy, it is worth noting that links have been drawn between the financial crisis and the long-running fiscal crisis. *See, e.g.*, Reuven S. Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 HARV. L. REV. 1573 (2000) (discussing international tax competition's role in reducing state revenue capabilities). Leaders of the so-called Group of 20 (G20) saw connections between the financial crisis and the fiscal crisis. At their April 2009 summit in London, the G20 announced that, as part of their response to the financial crisis, they "st[ood] ready to deploy sanctions to protect our public finances and financial systems." G20, THE GLOBAL PLAN FOR RECOVERY AND REFORM ¶ 15 (Apr. 2, 2009), *available at* http://www.g20.org/Documents/final-communique.pdf. *But cf.* Allison Christians, *Taxation in a Time of Crisis: Policy Leadership from the OECD to the G20*, 5 NW. J.L. & SOC. POL'Y 20, 39–40 (2010) (arguing that G20 lacks institutional capacity to influence tax policy to prevent financial crises).

[4] The check-the-box regulations offer an excellent illustration of this phenomenon. Under prior law, taxpayers were forced to comply with a burdensome four-factor test which classified entities according to their legal characteristics. *See* Treas. Reg. § 301.7701-2(a) (1961) (repealed 1997) (describing six criteria—of which four were deemed most salient—that identified de facto corporations for tax purposes). Under current law, taxpayers are explicitly invited to choose their classification. Treas. Reg. § 301.7701-3(a) (2010) (providing that eligible entities can elect to be classified as corporations or partnerships).

authorities combat pollution.[5] The tax laws have not been immune from this broad deregulatory dynamic.

Under the misleading banner of simplification, the deregulation of the tax laws has offered taxpayers greater freedom to manage the tax consequences of their activities. At the same time, it has provided policymakers with opportunities to exploit cognitive biases and flaws in the budgetary and legislative processes. That exploitation is possible even when the rationales for promoting taxpayer autonomy do not withstand the gentlest scrutiny. Unfortunately, our experience with tax deregulation has proven costly. This Article calls for a reconsideration of the deregulatory bias in our tax policymaking process.

The check-the-box entity classification regulations provide the clearest illustration of the appeal and the hazards of tax deregulation.[6] These regulations offer taxpayers freedom to choose or change a classification (and therefore tax treatment) by merely checking a box on a tax form.[7] While quite different from the changes that deregulated the airline industry, this change represented a transformation that fits seamlessly into the effort to substitute private for public decision making.[8]

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[5] The term "environmental deregulation" is sometimes used to describe this phenomenon as applied to pollution standards. *See, e.g.*, David W. Case, *The EPA's Environmental Stewardship Initiative: Attempting To Revitalize a Floundering Regulatory Reform Agenda*, 50 EMORY L.J. 1, 32 (2001) ("The public and political backlash that eventually derailed the Reagan administration's environmental deregulation strategies served to greatly curtail such procedural efforts as well."); Howard A. Latin, *Environmental Deregulation and Consumer Decisionmaking Under Uncertainty*, 6 HARV. ENVTL. L. REV. 187, 189 (1982) ("The cumulative effect of many deregulation initiatives will be to assign the principal responsibility for environmental decisionmaking to the private market system."); Philip Weinberg, *Masquerade for Privilege: Deregulation Undermining Environmental Protection*, 45 WASH. & LEE L. REV. 1321, 1321 (1988) ("Deregulation of the environment became a dominant theme in the campaign of Ronald Reagan, and as President he reversed the machinery his predecessors, and preceding Congresses, had built.").

[6] The check-the-box regulations were part of a broad effort, prompted in part by the Contract with America, to reduce the burden of governmental regulation on private actors. *See NYSBA Tax Section Strongly Endorses Check-the-Box Entity Classification Proposal*, 95 TAX NOTES TODAY (Aug. 31, 1995), 95 TNT 173-64 (reprinting N.Y. STATE BAR ASS'N, REPORT ON THE "CHECK THE BOX" ENTITY CLASSIFICATION SYSTEM PROPOSED IN NOTICE 95-14 (1995)) ("[T]he current entity classification system imposes substantial compliance costs on taxpayers, both in terms of the resources required to address entity classification issues and the effect of the uncertainties in the law."). *See generally* Steven A. Dean, *Attractive Complexity: Tax Deregulation, the Check-the-Box Election, and the Future of Tax Simplification*, 34 HOFSTRA L. REV. 405 (2005) (describing how desire for tax simplification motivated push for check-the-box regulations).

[7] *See* Treas. Reg. § 301.7701-3(c) (specifying election requirements). The form on which the election is made merely requires taxpayers to provide information about the entity, such as the date of its formation and the identity of its owners. I.R.S. Form 8832 (2010), *available at* http://www.irs.gov/pub/irs-pdf/f8832.pdf.

[8] Given the breadth of the phenomenon, it is not surprising that deregulation would assume a variety of forms. Then-Professor Stephen Breyer, for example, distinguished

Of course, presented with Yogi Berra's proverbial fork in the road, taxpayers took it. Granting taxpayers greater autonomy blunts the capacity of the tax law to raise revenue and lessens its power to influence private behavior. The tax law generally attempts to link tax treatment to the economic substance of a transaction, and tax elections upset that relationship by allowing taxpayers to opt for the most advantageous treatment, regardless of economic substance.[9] As a result, the structures and transactions made possible by the deregulatory check-the-box rules have produced sweeping systemic disruption. Indeed, these changes arguably eclipse the alphabet soup of credit default swaps (CDSs) and collateralized debt obligations (CDOs) unleashed by financial deregulation.[10] As taxpayers embraced their newfound capacity to choose and change the classification of entities—particularly in the international context—longstanding tax rules that took a strict entity classification regime for granted became paper tigers.[11]

This Article provides policymakers—and, perhaps more importantly, their watchdogs—with a framework for evaluating deregulatory tax reforms. It does so by examining the role tax deregulation has played in three decades of business tax reform. This Article further argues that tax deregulation is generally undesirable—even in instances where its impact is less dramatic—by examining tax deregulation through the lenses of responsive regulation and fiscal arbitrage.

Responsive regulation suggests that empowering taxpayers to self-regulate may enhance taxpayer cooperation by promoting posi-

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between "generic" and "case-by-case" deregulation. Stephen Breyer, *Reforming Regulation*, 59 TUL. L. REV. 4, 6 (1984) (advocating greater emphasis on latter type of reform). He considers the elimination of the Civil Aeronautics Board, the action that deregulated the airline industry, as the quintessential example of case-by-case deregulation. *Id.* at 14–16.

[9] *See* George K. Yin, *The Taxation of Private Business Enterprises: Some Policy Questions Stimulated by the "Check-the-Box" Regulations*, 51 SMU L. REV. 125, 130 (1997) ("In general, the tax system does not permit taxpayers to elect the rules applicable to them. Rather, the system generally attempts to impose tax rules that follow and are consistent with some economic characteristic of the taxpayer or the taxpayer's activities."). Fans of *The Matrix* may see the freedom granted to taxpayers through tax deregulation as a more banal, less benign version of Neo's discovery of his power to manipulate the rules of the matrix. *See* THE MATRIX (Warner Bros. Pictures 1999).

[10] *See* Joni L. Walser & Robert E. Culbertson, *Encore Une Fois: Check-the-Box on the International Stage*, 76 TAX NOTES 403, 405–06 (1997) (describing "dazzling" array of tax planning opportunities available pursuant to check-the-box regulations).

[11] *See* Diane M. Ring, *One Nation Among Many: Policy Implications of Cross-Border Tax Arbitrage*, 44 B.C. L. REV. 79, 96–100 (2002) (describing use of check-the-box "to avoid some of the limitations and restrictions of the subpart F regime," which otherwise controls taxation of multinational corporations).

tive compliance spirals.[12] As interpreted by Valerie Braithwaite and others, responsive regulation reveals that tax deregulation's focus on taxpayer autonomy can be both appropriate and useful.[13] Employing the responsive regulation methodology, deregulatory strategies can serve as tools that regulators use to calibrate the intensity of their oversight to match the behavior and attitude of different types of taxpayers.[14] By "escalating" or deregulating down their control over taxpayers, tax regulators may be able to encourage the development of cooperative taxpayer norms.[15] However appealing a robust link between increased autonomy and increased compliance may be as a theoretical matter, developing such a link in practice presents a variety of challenges.[16]

At the same time, tax deregulation permits policymakers to engage in fiscal arbitrage, effectively reaping the political benefits of spending without investing the political capital that direct spending requires.[17] By substituting an economically equivalent tax benefit for

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12 *See infra* Part II.B.2 (exploring responsive regulation in greater detail).

13 *See generally* TAXING DEMOCRACY: UNDERSTANDING TAX AVOIDANCE AND EVASION (Valerie Braithwaite ed., 2003) [hereinafter TAXING DEMOCRACY] (employing responsive regulation framework in tax context).

14 *See* IAN AYRES & JOHN BRAITHWAITE, RESPONSIVE REGULATION: TRANSCENDING THE DEREGULATION DEBATE 4 (1992) ("[R]egulation should respond to industry conduct . . . . The very behavior of an industry or the firms therein should channel the regulatory strategy to greater or lesser degrees of government intrusion. . . . By credibly asserting a willingness to regulate more intrusively, responsive regulation can channel marketplace transactions to less intrusive and less centralized forms of government intervention.").

15 *Id.* (describing responsive regulation paradigm for regulators' relationship with regulated industry).

16 Private parties may accept greater autonomy while failing to embrace sincerely their compliance obligations. *See* Kimberly D. Krawiec, *Cosmetic Compliance and the Failure of Negotiated Governance*, 81 WASH. U. L.Q. 487, 491–92 (2003) ("[T]he indicia of an effective compliance system are easily mimicked and true effectiveness is difficult for courts and regulators to determine, particularly *ex post*."). Likewise, regulators may offer only a simulacrum of greater autonomy to regulated entities. *See* Miriam Hechler Baer, *Governing Corporate Compliance*, 50 B.C. L. REV. 949, 954 (2009) ("[C]orporate compliance regulation . . . is at best an illusory delegation of responsibility . . . .").

17 This analysis assumes that even politically popular actions require policymakers to expend valuable political capital. A rational, self-interested politician will, of course, only deploy political capital if such an expenditure results in a net political benefit. Through fiscal arbitrage, such a politician minimizes her expenditures of political capital while maximizing political benefit. One could even stretch the analogy to argue that fiscal arbitrage eliminates political inefficiencies just as financial arbitrage eliminates market inefficiencies. If one sees a Senate filibuster as a source of inefficiency, fiscal arbitrage that enabled use of the reconciliation process (thereby avoiding the filibuster) could be seen as efficiency enhancing. The inefficiency of the filibuster has perhaps received the most attention in the context of judicial confirmation. *See, e.g.*, John Cornyn, *Our Broken Judicial Confirmation Process and the Need for Filibuster Reform*, 27 HARV. J.L. & PUB. POL'Y 181, 194 (2003) (lamenting "[t]he indefinite, needless, and wasteful delay caused by filibusters of judicial nominations").

a spending provision, a policymaker can create what can be thought of as a political "profit" analogous to the profits derived from financial arbitrage. Just as an arbitrageur might buy cheaply in one market and sell at a higher price in another simply by relabeling the product, fiscal arbitrage allows policymakers to "buy" inexpensive tax breaks while "selling" substantively identical—but more highly valued—spending provisions. Fiscal arbitrage thus allows a policymaker to increase the return on his investment of political capital. For example, tax deregulation can permit lawmakers to benefit from cognitive fiscal arbitrage in order to direct resources to favored constituencies—like tax preferences for hedge fund managers—in ways that the broader public systematically undervalues.[18] Combined with budgetary and procedural fiscal arbitrage, such efforts can undermine important sources of fiscal restraint.

Part I of the Article sets the stage by defining tax deregulation and offering several examples of deregulatory tax reforms. Part II takes a step back from the nuts and bolts of deregulation by first disentangling tax deregulation from the related notion of tax simplification and then developing a normative framework for evaluating tax deregulation. Part III applies the normative framework developed in Part II to the examples discussed in Part I and identifies the most desirable deregulatory tax reforms.

I
Deregulation and Taxes

Even before the current financial crisis thrust deregulation into the headlines, scholars had spent decades debating its costs and benefits.[19] Oddly, that has not been the case with tax deregulation. Although lower tax rates and reduced tax complexity figure prominently in the tax scholarship of the past thirty years, tax deregulation itself has been relatively rarely and only recently addressed.[20]

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[18] *See* Marjorie E. Kornhauser, *Cognitive Theory and the Delivery of Welfare Benefits*, 40 Loy. U. Chi. L.J. 253, 264 (2009) ("For example, the public might not tolerate handing out dollars to every hedge fund trader, but will not notice if these traders receive the money by means of favorable tax treatment."). This Article refers to this phenomenon as cognitive fiscal arbitrage. *See infra* Part II.B.3.

[19] *See* Stephen G. Breyer, Regulation and Its Reform 5 (1982) (proposing case-by-case framework for analyzing costs and benefits of individual regulatory reforms); Richard A. Posner, *Theories of Economic Regulation*, 5 Bell J. Econ. & Mgmt. Sci. 335, 335–36 (1974) (describing competing theories of regulation and endorsing one type of capture theory); George J. Stigler, *The Theory of Economic Regulation*, 2 Bell J. Econ. & Mgmt. Sci. 3, 3 (1971) ("[A]s a rule, regulation is acquired by the industry and is designed and operated primarily for its benefit.").

[20] Only the responsive regulation scholarship focusing on tax administration addresses tax deregulation, and even it avoids the term deregulation. *See, e.g.*, Valerie Braithwaite, *A*

To lay the foundation for the normative discussion in Parts II and III of this Article, this Part provides a definition of tax deregulation. It also provides three illustrations of deregulatory tax reforms: safe harbor leasing, the best method rule for transfer pricing, and the liberalization of nonrecognition rules for divisive reorganizations. Together, these reforms demonstrate both the longevity and the reach of deregulation in the tax context.

A. *Defining Tax Deregulation*

Defining tax deregulation is challenging. Even more difficult is explaining how it has gone unrecognized for so long. The collective failure to acknowledge the phenomenon of tax deregulation is remarkable in part because the impact of deregulation has been pervasive, affecting rules of all kinds.[21] The broad reach of the tax laws themselves make it even more difficult to imagine that deregulation and taxation would never intersect.[22] It would have been extraordinary for this sea change in regulatory culture to bypass what may be the single most economically significant regulatory regime.

One could rationalize this lacuna by concluding that tax deregulation is simply a contradiction in terms.[23] At first blush, tax deregulation is an oxymoron on the order of water dehumidification. If deregulation generally means abandoning command-and-control policies in favor of alternatives that grant private actors increased autonomy at regulators' expense, tax deregulation calls for giving taxpayers greater authority to determine their own tax treatment.[24]

Since the tax laws distinguish among transactions according to both their economic substance and their formal characteristics, it is

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New Approach to Tax Compliance, *in* TAXING DEMOCRACY, *supra* note 13, at 1, 4 ("Responsive regulation steps away from a command and control approach to regulation . . . ."). Alice Abreu has articulated a similar concept which she refers to as "taxpayer empowerment." Alice G. Abreu, *Taxes, Power, and Personal Autonomy*, 33 SAN DIEGO L. REV. 1, 6 (1996) (defining empowerment as "the ability to affect either the amount of tax that will be collected or the identity of the bearer of the resulting economic burden").

[21] The phenomenon of deregulation has been so pervasive that even President Carter has claimed to have deregulated a range of industries. *See* LIZABETH COHEN, A CONSUMERS' REPUBLIC: THE POLITICS OF MASS CONSUMPTION IN POSTWAR AMERICA 393 (2003) (noting President Carter's boasts of deregulating industries from trucking to financial services).

[22] *See, e.g.*, Dobson v. Comm'r, 320 U.S. 489, 494–95 (1943) ("No other branch of the law touches human activities at so many points.").

[23] That would be true, for example, if (i) deregulation serves the economic interests of customers or other third parties rather than the direct objects of regulation, and (ii) deregulatory tax changes have no particularized impact beyond the affected taxpayers.

[24] A more conservative definition of deregulation might limit it to the dismantling of a comprehensive regulatory apparatus governing an entire industry. *See infra* note 129 (citing Judge Posner's definition of deregulation).

not obvious that moving beyond command-and-control is possible in the tax context. While environmental laws can articulate emissions targets and allow private parties to find low-cost ways of meeting them,[25] it makes little sense to think of tax laws as specifying a revenue target and inviting taxpayers to determine the best way of collecting that amount.

However, the hallmark of deregulation—an increase in private autonomy at the expense of direct governmental control—can easily be recognized in a number of significant business tax reforms implemented in recent decades: the introduction of the check-the-box regulations, the advent of safe-harbor leasing in the early 1980s, the adoption of the best method rule for transfer pricing in the mid-1990s, and the recent liberalization of nonrecognition provisions relating to divisive reorganizations.[26]

The introduction of the check-the-box entity classification rules offers what may be the most striking instance of the deregulation of the federal income tax.[27] The older regulatory system prescribed pass-through or corporate treatment to entities based on specified characteristics. In light of the emergence of new types of state law business entities—the most notable being the limited liability company[28]—tax policymakers revised their approach to entity classification. Particularly, authorities were concerned that these new entities allowed taxpayers to exploit gaps in the prevailing four-factor test.[29]

The new regime explicitly empowers taxpayers to choose, and even change, those classifications.[30] Changing the classification of an entity can constitute a significant transaction on its own. The classification of an entity has dramatic implications for both its tax treatment and the results of its transactions.[31] To achieve those results, the

[25] *See infra* notes 140–42 and accompanying text (discussing market-based environmental regulation).

[26] *See infra* Part I.B.

[27] *See supra* note 4 (discussing check-the-box regulations).

[28] *See* Susan Pace Hamill, *The Limited Liability Company: A Catalyst Exposing the Corporate Integration Question*, 95 MICH. L. REV. 393, 393–95 (1996) (describing rise of limited liability company).

[29] *See* David A. Weisbach, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, 84 CORNELL L. REV. 1627, 1629–30 (1999) ("The argument for abandoning the four-factor test is that it was enormously inefficient. It merely caused people to shift their organizational structures without collecting any tax.").

[30] *See* Treas. Reg. § 301.7701-3 (2010) (setting forth rules for elective classifications); *see also* Heather M. Field, *Choosing Tax: Explicit Elections as an Element of Design in the Federal Income Tax System*, 47 HARV. J. ON LEGIS. 21, 22 (2010) ("Pursuant to these regulations, an unincorporated business entity could choose its tax classification merely by checking a box on a form . . . .").

[31] The resulting freedom in choosing one's classification has had profound consequences for the tax system, few of which are consistent with check-the-box's simplification

check-the-box rules merely require taxpayers to submit a form with tax authorities shortly before or after the desired effective date.[32]

Although a basic understanding of tax deregulation can be divined from this example, a coherent definition of tax deregulation demands identifying not only what tax deregulation is, but also what it is not. Tax deregulation, broadly construed, could encompass any changes in the tax laws that increase taxpayer autonomy. The reduced tax burden achieved by reducing tax rates, for example, permits taxpayers greater freedom to swap labor for leisure and all the other opportunities that a higher after-tax income provides. Yet tax deregulation is distinct from that expansive notion of tax libertarianism.[33] Instead, the term refers specifically to rule changes that offer taxpayers greater freedom in their roles as taxpayers—i.e., greater freedom in structuring transactions and reporting their results to tax authorities.

To understand the nature of the structuring and reporting autonomy that tax deregulation generates, it is easiest to begin with an extreme example: a tax that offers taxpayers no opportunity to control their tax treatment. A so-called "head tax" imposes an identical lump-sum burden on each individual taxpayer.[34] Taxpayers have no opportunity to alter that burden by, for example, marrying, shifting income among individuals or time periods, or recharacterizing wages as investment proceeds. Such taxes have been enacted but are relatively

objective. *Cf.* Dean, *supra* note 6, at 453–57 (describing rule complexity and tax planning opportunities for foreign corporations created by check-the-box election); Ring, *supra* note 11, at 96–100 (describing impact of check-the-box election in context of foreign business organizations). So-called check-and-sell transactions—in which taxpayers change the classification of a foreign entity immediately prior to a sale to secure advantageous tax treatment—provide one illustration. Tax authorities unsuccessfully attempted to rein in these transactions by issuing regulations. *See* Prop. Treas. Reg. § 301.7701-3(h)(1), 64 Fed. Reg. 66,591, 66,594 (Nov. 29, 1999) (proposing change); I.R.S. Notice 2003-46, 2003-28 I.R.B. 53 (withdrawing Prop. Treas. Reg. § 301.7701-3(h)).

[32] *See* Treas. Reg. § 301.7701-3(c)(1)(iii) (specifying timetable for filing classification elections); I.R.S. Form 8832 (2010), *available at* http://www.irs.gov/pub/irs-pdf/f8832.pdf (explaining how to change entity classification under check-the-box regime).

[33] A good illustration of the tax libertarian impulse is the Tea Party's Contract from America. *The Contract from America*, CONT. FROM AM., http://www.thecontract.org/the-contract-from-america/ (last visited Mar. 13, 2011). It calls for the "[p]ermanent[ ] repeal [of] all tax hikes, including those to the income, capital gains, and death taxes, currently scheduled to begin in 2011" as part of its effort to promote "individual liberty, limited government, and economic freedom." *Id.*; *cf.* LIAM MURPHY & THOMAS NAGEL, THE MYTH OF OWNERSHIP 15 (2002) (explaining that notion "that pretax market outcomes are presumptively just" underlies libertarian conclusion that increased taxpayer autonomy is desirable in and of itself).

[34] *See* Maureen B. Cavanaugh, *Democracy, Equality, and Taxes*, 54 ALA. L. REV. 415, 421 (2003) (defining head tax as one "that is exactly the same regardless of individual economic circumstances").

rare.[35] The absence of autonomy that is the essence of a head tax makes it supremely efficient, if unappealing.[36] Since taxpayers cannot lower their tax burden by acting strategically, wasteful tax planning simply does not occur.

An income tax that offered taxpayers absolutely no autonomy would, like the head tax, prescribe the precise tax consequences of any taxpayer behavior. Taxpayers would have no freedom to alter those results. A tax system as complex as the U.S. income tax, however, inevitably offers taxpayers opportunities to shape their tax fate.

For example, the U.S. income tax encourages married couples to report their income jointly.[37] By deciding if and when to marry, taxpayers can materially increase or decrease the amount of income tax they pay.[38] A couple willing to bear the legal consequences could divorce in one year and remarry in the next to optimize their tax treatment.[39] This capacity to influence tax outcomes by arranging one's affairs in a specific manner is "structural autonomy."[40]

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[35] The most notable recent exception occurred in Britain under Margaret Thatcher, with predictably disastrous results. *See* Eric M. Zolt, *Prospects for Fundamental Tax Reform: United States vs. Japan*, 83 TAX NOTES 903, 905 (1999) ("While a head tax may strike some as fair, the fall of Margaret Thatcher's government regarding replacing a property tax with a per person 'community charge' illustrates the political costs of misreading what the public considers fair.").

[36] Michael J. Graetz, *Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 26 BROOK. J. INT'L L. 1357, 1378 (2001) ("All taxes have efficiency costs; they change incentives to engage in various activities and affect the allocation of resources. If economic efficiency were the sole goal of tax policy, we would see only per capita taxes, head taxes.").

[37] *See* I.R.C. § 7703 (2006) (defining marital status). Married taxpayers may not file as individuals, but they can file "married filing separately" returns. Such returns are taxed on a higher rate schedule than individual returns and are not eligible for certain credits, such as the Earned Income Tax Credit. I.R.C. § 32(d) (2006). "Married filing separately" is generally less advantageous than joint filing. Field, *supra* note 30, at 64–65 n.248.

[38] *See* Field, *supra* note 30, at 64–65 (discussing tax planning opportunities available to married couples).

[39] Marital status for tax purposes is determined on the last day of each year. I.R.C. § 7703(a)(1). In extreme cases, tax authorities have successfully challenged taxpayer attempts at sham divorces. *See, e.g.*, Boyter v. Comm'r, 74 T.C. 989, 990, 1001 (1980) (rejecting annual tax-motivated Haitian divorces of taxpayers domiciled in Maryland on ground that "Maryland would not recognize the foreign divorces as valid to terminate the marriage"). In less dramatic cases—in which the state law status of a divorce is unquestioned—the tax law contemplates that a divorced couple that continues to live together might be treated as unmarried but nonetheless ineligible for specific types of preferential treatment ordinarily granted to recently divorced couples. *See, e.g.*, I.R.C. § 71(b)(1)(C) (2006) (providing that payment may not be treated as alimony if "the payee spouse and the payor spouse are . . . members of the same household at the time such payment is made").

[40] The terms "structural autonomy" and "reporting autonomy" are modeled after categories used to describe complexity in the tax system. David Bradford separates complexity into three elements: rule complexity, transactional complexity, and compliance complexity. DAVID F. BRADFORD, UNTANGLING THE INCOME TAX 266–67 (1999). Rule complexity

In contrast, "reporting autonomy" implicates only those choices a taxpayer makes in characterizing their status and activities when reporting them to tax authorities. The most straightforward example of reporting autonomy may be the realization requirement.[41] While the term "realization" may be unfamiliar, the realization requirement is a feature of the income tax that any shareholder or homeowner understands. Under a realization regime, economic gain or loss may accrue over time as the value of the shares or home rises and falls, but no income or loss needs to be reported before a sale of the shares or the home.[42] In a sense, the realization requirement represents a concession to the administrative difficulties that would arise from a system in which economic income is taken into account on a current basis.[43] Whatever the justification, giving taxpayers the capacity to choose when to trigger gains and losses by disposing of property offers them extraordinary control over the timing of their income.[44]

Both structural and reporting autonomy may come at the expense of tax simplicity. Individual taxpayers, particularly those whose incomes consist only of wages, have relatively simple tax lives.[45] As a result, they enjoy relatively little autonomy. Conversely, a typical bus-

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relates to the process of understanding the relevant tax rules. Transactional and compliance complexity are functions of actions taken—and choices made—by taxpayers. The structuring choices taxpayers make determine the transactional complexity costs they incur. Compliance complexity is affected by reporting choices made by taxpayers.

[41] Alice Abreu discusses the ways in which the income tax "empowers" taxpayers, including through rules such as realization. Abreu, *supra* note 20, at 8–9 ("Because the grant of the power to choose can affect who is taxed and how much they are taxed, an analysis of the ways in which tax systems empower and a determination of who it is that they empower should become a standard part of tax policy analysis.").

[42] *See* David J. Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 U. PA. L. REV. 1111 (1986) (describing realization requirement and its alternatives).

[43] To avoid potential valuation and liquidity issues, a taxpayer is generally only taxed on a disposition of an asset, not on fluctuations in its value. *See* I.R.C. § 1001 (2006) (determining "gain from the sale or other disposition of property" by comparing "adjusted basis" in property (usually amount paid less depreciation taken previously) to amount received upon disposition). By choosing when to dispose of property, taxpayers also choose when the economic income from the property will be taxed. The realization requirement may be desirable for administrative reasons, but it is not inevitable.

[44] The extent of taxpayer control is famously illustrated by a Supreme Court case allowing troubled savings and loans institutions to trigger losses for tax purposes with virtually no nontax implications. *See* Cottage Sav. Ass'n v. Comm'r, 499 U.S. 554, 559–60, 565–66 (1991) (rejecting government claim that exchange of mortgage derivatives in question should be ignored for tax purposes "because the underlying mortgages were essentially economic substitutes").

[45] *See* BRADFORD, *supra* note 40, at 268 ("Although the statutes and regulations fill thousands of all but unreadable pages, actual compliance with current law is . . . simple for the majority of individual taxpayers. Taxpayers who do not claim itemized deductions and whose income is mainly from wages can very quickly and easily compute their taxes.").

iness taxpayer may enjoy quite a bit of both structural and reporting autonomy while being burdened with significantly more complexity.[46] Tax deregulation provides taxpayers a combination of greater reporting and structural autonomy and enables taxpayers to choose the tax consequences of their activities.

Returning to the joint filing example, policymakers could increase individuals' structural autonomy by respecting a valid marriage or divorce from any jurisdiction.[47] An election permitting a couple to file jointly irrespective of their marital status would provide greater reporting autonomy.[48] Often, taxpayers will exploit that increased autonomy to achieve a reduced tax burden.[49]

In some cases, taxpayers may affirmatively choose a higher tax burden to promote nontax interests.[50] For example, foreign investors in the United States may choose to pay more tax than necessary by forgoing available tax benefits in order to avoid filing a U.S. tax return. In that case, they may rationally have chosen to protect their financial privacy at the risk of a higher tax burden. For some foreign taxpayers, anonymity may warrant taking a significant risk by declining to file a "protective" return.[51]

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[46] *See, e.g.*, *id.* at 270–71 (discussing tax complexity of business transactions).

[47] Current law, by contrast, requires that the marriage or divorce be valid in the taxpayer's domicile to be respected for tax purposes. *See, e.g.*, Lee v. Comm'r, 64 T.C. 552, 559 (1975) ("Since we have found the domicile of both parties to be California, we must look to California law to determine the marital status of Harold and Louise during the years in issue, and specifically to the effect under California law of the Mexican decree.").

[48] In some cases, the two types of autonomy will be in tension. For example, under a nonelective regime, taxpayers have the freedom to change their tax burden by marrying or divorcing. If joint filing were purely elective, marriage or divorce would be irrelevant and taxpayers would lose some amount of structural autonomy. In other cases, structuring and reporting autonomy may exhibit a synergistic relationship. The check-the-box election illustrates that potential for synergy. Taxpayers' freedom to classify entities gave them new opportunities to engage in tax planning.

[49] *See* Abreu, *supra* note 20, at 12 (referring to this increased autonomy as "avoidance power").

[50] One could imagine, for example, a same-sex couple attempting to pay the heightened tax burden referred to as the "marriage penalty" in protest against federal rules precluding married gay or lesbian couples from filing jointly as other married couples do. *See* Anthony C. Infanti, *Tax Protest, "a Homosexual," and Frivolity: A Deconstructionist Meditation*, 24 St. Louis U. Pub. L. Rev. 21, 58 (2005) (challenging married same-sex couples to reject "the darkness of the tax closet" by filing joint returns).

[51] A protective return is a return reporting no U.S. taxable income, filed merely to "protect the right to receive the benefit of the deductions and credits" in the event that a foreign taxpayer is later determined to be subject to U.S. tax. Treas. Reg. § 1.874-1(b)(6) (2002); *see also* Stephen E. Shay et al.,*"What's Source Got To Do With It?" Source Rules and U.S. International Taxation*, 56 Tax L. Rev. 81, 130 (2002) ("[N]otwithstanding the risk-adverse nature of the taxpayer's advisors, the sensible business judgment often is not to file [a protective income tax return]. Absent a return, it would be extremely difficult for the Service to be aware that there might be an issue.").

B. *Deregulatory Business Tax Reforms*

Deregulatory efforts to increase structural and reporting autonomy implicate a broad swath of the federal income tax, particularly its corporate provisions. This Section highlights three examples of deregulatory business tax reforms. Safe harbor leasing is one of the earliest high-profile examples of tax deregulation.[52] The introduction of the best method rule in the 1990s represented a significant change in the operation of the transfer pricing rules designed to prevent cross-border tax abuses by multinational businesses.[53] Recent modifications to the requirements for divisive tax-free corporate reorganizations provide the final example.[54]

These three examples address three very different—but fundamental—challenges posed by the income tax.[55] Those challenges are, respectively: (i) identifying the owner of favorable tax attributes, (ii) allocating income among related taxpayers, and (iii) determining when economic income should be taxed. Historically, such determinations have been made pursuant to command-and-control regimes that,

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[52] Safe harbor leasing was introduced by statute. *See* I.R.C. § 168(f)(8) (Supp. V 1982) (repealed 1982). The provision was soon repealed. Tax Equity and Fiscal Responsibility Act of 1982 §§ 208–209, I.R.C. § 168(f), (i), (j) (2006); *see also* Alvin C. Warren, Jr. & Alan J. Auerbach, *Transferability of Tax Incentives and the Fiction of Safe Harbor Leasing*, 95 HARV. L. REV. 1752, 1752 (1982) ("The Economic Recovery Tax Act of 1981 introduced a federal income tax 'safe harbor' for leasing transactions in order to distribute the benefits of the investment tax credit (ITC) and the newly enacted Accelerated Cost Recovery System (ACRS) throughout the corporate sector.").

[53] The best method rule was implemented via regulation. *See* Treas. Reg. § 1.482-1(c) (2010); *see also* Robert G. Clark, Comment, *Transfer Pricing, Section 482, and International Tax Conflict: Getting Harmonized Income Allocation Measures from Multinational Cacophony*, 42 AM. U. L. REV. 1155, 1191–92 (1993) ("In response to comments on the proposed regulations, the IRS acknowledged that problems exist with imposing a rigid hierarchy for applying valuation methods and therefore promulgated the 'best method rule.'").

[54] I.R.C. § 355(b)(3) (Supp. I 2006) (treating affiliated groups as single entity for purposes of active trade or business requirement). This provision was passed in 2006 as part of the Tax Increase Prevention and Reconciliation Act of 2005. Pub. L. No. 109-222, § 202, 120 Stat. 348 (2006). In introducing the legislation, Senator Baucus stated that the purpose of the new amendment was to "simply apply a 'look through' rule for the 'active trade or business' test on an affiliated group level, so that parent holding companies could count the active businesses of its subsidiaries." 151 CONG. REC. S7616 (daily ed. June 29, 2005) (statement of Sen. Max Baucus).

[55] As Part II shows, labeling these provisions "simplification" is at best incomplete. By shifting the balance away from command-and-control regulation and toward increased private autonomy, these reforms deregulated more than they simplified. That increase in autonomy is easiest to recognize in the case of the best method rule. The adjective most frequently used to describe the best method rule is "flexible." *See, e.g.*, T.D. 8552, 1994-2 C.B. 93, 95 ("The best method rule adopts a flexible approach under which the determination of which method is most accurate depends on the facts and circumstances of the case.").

with varying degrees of success, attempt to categorize actions and events according to their underlying economic substance.[56] Each of the reforms described below takes a different approach by affirmatively shifting the balance between public and private control in favor of taxpayer autonomy.

1. Safe Harbor Leasing

As any student in an introductory law school tax class learns, identifying a taxpayer's income is only one of many steps in the process of determining how much tax must be paid. Often, the greater challenge involves determining the "timing" of that income and whether deductions and credits are available to offset it.[57] Because such credits and deductions ordinarily can only reduce tax obligations to zero, even the most generous tax benefit may be of no help to taxpayers operating at a loss or whose tax benefits exceed their income in a given year. Like a shipwreck survivor adrift on the ocean, a business can die of thirst while floating in a sea of theoretically valuable tax benefits.[58]

The determination of which entity may take advantage of a deduction or credit is normally made by reference to the ownership of the property to which those tax attributes relate.[59] In other words, if a taxpayer does not own property, the tax law does not entitle her to enjoy the tax benefits derived from that property. Without transferring the underlying property, it is generally difficult to shift the attendant tax benefits.[60] The safe harbor leasing rules created a

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[56] The common law rules governing the assignment of income from one taxpayer to another offer an example of such a regime. *See* Lucas v. Earl, 281 U.S. 111, 115 (1930) (providing that income generally may not be assigned among taxpayers so that "tax [cannot] be escaped by anticipatory arrangements and contracts however skillfully devised"). The recently enacted economic substance statute, codifying a longstanding common law doctrine, offers another illustration. *See* 26 U.S.C.A. § 7701(o) (West 2010) (providing that transactions will be taxed in accordance with their economic substance, no matter how taxpayers attempt to classify them).

[57] Michael J. Graetz & Deborah H. Schenk, Federal Income Tax: Principles and Policies 648–51 (6th ed. 2009) (discussing centrality and value of timing decisions to taxpayers).

[58] One such benefit is Net Operating Losses (NOLs), which offer business taxpayers the opportunity to write off a business loss in years other than those in which the loss is incurred. *See* I.R.C. § 172 (2006) (providing that taxpayers can carry over net business losses to different taxable years). Yet this benefit may not be able to save some taxpayers. A taxpayer that never earns any income will receive no benefit from the tax law's generous NOL provisions no matter how many such losses they accumulate.

[59] *See, e.g.*, I.R.C. § 167(a) (2006) (providing that owner of property used in trade or business is entitled to "reasonable allowance for [its] exhaustion, wear and tear").

[60] Tax shelter transactions that accomplish a transfer of tax benefits are the exceptions that prove the rule. *See* Compaq Computer Corp. v. Comm'r, 277 F.3d 778, 779–80 (5th

(short-lived) exception by separating enjoyment of tax benefits from ownership.[61]

Safe harbor leasing offers taxpayers a means of extracting cash from otherwise useless tax benefits by assigning them to another taxpayer. Safe harbor leasing is not unique simply because it permitted taxpayers to allocate favorable tax attributes among themselves.[62] What is unusual about safe harbor leasing is the extent to which Congress explicitly empowered taxpayers to transfer those benefits to other entities.[63] Allowing taxpayers to monetize idle tax benefits[64]

Cir. 2001) (describing steps taken—including forty-six trades, hiring of third-party arbitrage specialists, and use of margin accounts—to shift favorable tax attributes).

61 Safe harbor leasing met a quick demise as a result of public backlash. This response seems to have been provoked more by press accounts of particular abuses than by an aversion to its design or concerns about its cost. *See* Alvin C. Warren, Jr. & Alan J. Auerbach, *Tax Policy and Equipment Leasing After TEFRA*, 96 HARV. L. REV. 1579, 1581 (1983) (concluding that "several widely publicized cases of safe harbor leasing that were considered abusive" pushed Congress to modify safe harbor leasing rules, in part by replacing safe harbor leases with finance leases). Finance leasing, the more modest successor to safe harbor leasing, remains an important feature of the tax landscape. *Id.* at 1581–82 ("[S]afe harbor leasing was repealed for property leased after December 31, 1983, and was replaced by a new statutory category, 'finance leases,' effective in 1984."). Both finance leases and safe harbor leases are essentially alternative ways of financing the purchase of capital equipment. Absent tax implications, the titles "lessee" and "lessor" would simply be replaced by "purchaser" and "lender." *See* Alex Raskolnikov, *Contextual Analysis of Tax Ownership*, 85 B.U. L. REV. 431, 471–72 (2005) ("If a lease were recharacterized as a sale combined with a loan from seller-lessor to buyer-lessee, the lessee would be treated as the owner of the property and would be precluded from deducting the entire amount paid to the lessor as rent. The lessor, in turn, would be denied depreciation deductions.").

62 Transactions such as the one in which Compaq shifted the benefits of foreign tax credits from a non-taxpaying entity to a taxpaying entity work in much the same way. *See Compaq Computer Corp.*, 277 F.3d at 782 (rejecting Tax Court's finding that "the intention and effect of the transaction were to capture a tax credit, not substantive ownership").

63 Warren & Auerbach, *supra* note 52, at 1762–63 (discussing safe harbor leasing as aberration from general tax rules).

64 Indeed, this was Congress's goal:

> Congress was concerned . . . that the investment tax credits would be of little use to companies that needed to buy new machinery but had no profits and thus no taxes to reduce. So the legislators allowed such companies, in effect, to sell their tax breaks to wealthier businesses, which would buy the machinery on paper, take the tax credits and lease the equipment back to the poorer companies, which would then use it.

George J. Church & Evan Thomas, *Stewing in Its Own Largesse: Congress Discovers that Log Rolling Helped Flatten the Economy*, TIME, Feb. 1, 1982, at 16; *see also* Philip J. Harmelink & Nancy E. Shurtz, *Sale-Leaseback Transactions Involving Real Estate: A Proposal for Defined Tax Rules*, 55 S. CAL. L. REV. 833, 854 (1982) ("Congress was concerned that many corporations would lack both sufficient profits to use the tax benefits and the funds necessary to make the desired capital investments."); Emil M. Sunley, *Depreciation and Leasing Under the New Tax Law*, 35 NAT'L TAX J. 287, 289 (1982) ("Under the [common safe harbor leasing technique], the user 'sells' the property to the investor/lessor for a cash payment and a note. The user then leases the property back with the rental payments just equal to the payments on the note.").

created what Alan Greenspan called "food stamps for undernourished corporations."[65] By entering into a safe harbor lease, a taxpayer could in essence sell bare tax benefits to another private party.[66]

In a typical safe harbor leasing transaction, the transfer of tax benefits from a hypothetical Lean Corp. to a hypothetical Lush Corp. might be accomplished by having Lush purchase capital equipment from Lean, only to lease the property back to Lean.[67] For property worth $100, Lush might pay Lean $27.20 as a down payment.[68] That down payment will be the only cash to change hands since rent and finance charges will offset one another.[69] In exchange, Lush—now deemed to be the owner of the $100 property for tax purposes—will be entitled to claim tax benefits with a present value of $27.20.[70] Assuming that Lean is in dire financial straits, it could absorb the $27.20 of additional income it earns from the transaction without adverse tax consequences.[71] Lush, on the other hand, will effectively deduct the down payment.[72] The end result is difficult to distinguish from a purchase of tax benefits from Lean by Lush.

By creating a market in tax benefits, Congress pursued a classic deregulatory strategy. Much like cap-and-trade in the environmental context, the market for tax benefits created by safe harbor leasing allowed private actors to allocate financial rewards for desirable behavior (here, capital investment). In a narrow sense, the result of a safe harbor lease is precisely the same as a command-and-control alternative:[73] It makes the underlying tax benefits fully refundable.[74] Rather than receiving cash directly from the government in the form

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65 Church & Thomas, *supra* note 64, at 16.

66 This represented both "a significant deviation from the traditional dominance of substance over form in determining ownership for tax purposes" and a substantial change from prior law. Warren & Auerbach, *supra* note 52, at 1762. As Warren and Auerbach note, "[a]lthough leveraged leases were used to transfer the [Investment Tax Credit] and accelerated depreciation before the 1981 Act, transfer of these tax benefits, which are attributes of ownership, required the transfer of sufficient nontax ownership rights to the lessor." *Id.* at 1762–63.

67 The taxpayer with unusable credits sells the underlying property and leases it back from the purported purchaser. *See* Sunley, *supra* note 64, at 289 (outlining basic mechanics of such transactions).

68 *See* Warren & Auerbach, *supra* note 52, at 1764–65 (showing that $27.20 is present value of this investment).

69 *Id.* at 1763.

70 *Id.* at 1765.

71 *Id.* at 1766.

72 *Id.*

73 If the income tax allowed taxpayers to receive a refund whenever their credits and deductions more than offset their tax liabilities, the inability to transfer tax benefits would be less problematic. Some particular provisions do allow such refunds for individuals. *See, e.g.*, I.R.C. § 32 (2006) (providing for refundable Earned Income Tax Credit). Since such refunds are generally not available, tax benefits are often more valuable to one taxpayer

of a refund, businesses that make investments but pay too little in tax to digest available tax incentives could sell those benefits to a counterparty.[75]

2. *Section 482's Best Method Rule*

Multinational enterprises enjoy tremendous geographic freedom in the way they structure their affairs.[76] With their research, manufacturing, and sales infrastructure scattered across the globe, these corporate taxpayers face extraordinary challenges in allocating the resulting income into particular jurisdictions for taxation purposes—a process referred to as "transfer pricing." Imagine a business that not only sells, but also develops, contact lenses. Transfer pricing attempts to allocate a hypothetical dollar of profit among the relevant jurisdictions when those contact lenses are developed, manufactured, and sold in different jurisdictions by the various interrelated entities within a multinational corporation.[77]

Transfer pricing often simulates pricing in arm's-length transactions in order to appropriately allocate tax liability.[78] By compelling commonly controlled taxpayers to interact as though they were unrelated, the arm's-length standard ensures that multinationals do not manipulate the prices paid in related-party transactions to lower their

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than they are to another. Safe harbor leases permitted a tax-indifferent entity with an essentially useless tax benefit to "sell" it to a taxpaying entity.

[74] Despite the rough economic equivalence of safe harbor leasing and a direct subsidy for business investment, as a tax expenditure, safe harbor leasing offered legislators an opportunity to engage in cognitive and procedural (but not budgetary) arbitrage. *See* Warren & Auerbach, *supra* note 52, at 1779 (concluding that both refundability and explicit transferability of relevant tax benefits would suffice as mechanisms to achieve policy objectives of safe harbor leasing). By comparison with an equivalent command-and-control tax expenditure, the safe harbor leasing rules granted taxpayers a relatively high degree of autonomy. Using a deregulatory approach meant that policymakers sacrificed a considerable degree of their power to control the parameters of the benefit. *See id.* at 1773 ("The fiction of leasing thus dominates the purpose of the safe harbor in determining the amount of tax benefits that can be transferred.").

[75] *Id.* at 1763 (explaining that in typical safe harbor leasing transaction, lessor made "cash payment to the lessee for tax benefits [that] is characterized as a down payment on the purchase price"). Although the source of the incentive payment distinguishes safe harbor leasing from most tax expenditures, safe harbor leasing otherwise fits the tax expenditure mold quite comfortably.

[76] *See* Avi-Yonah, *supra* note 3, at 1589–90 (describing geographic dispersion of operations of Intel and General Motors).

[77] This is not as easy as it may sound. *See* Bausch & Lomb Inc. v. Comm'r, 933 F.2d 1084, 1090–91 (2d Cir. 1991) (resolving multimillion dollar dispute between U.S. tax authorities and developer, manufacturer, and seller of contact lenses).

[78] *See* I.R.C. § 482 (2006) (empowering Treasury Secretary to reapportion income, deductions, credits, or allowances to prevent tax evasion).

global tax bill.[79] If left unchecked, multinationals could over- or under-charge related counterparties in different jurisdictions, allowing them to shift profits to locations offering favorable tax treatment without altering their underlying business operations.[80]

Although it is hard to find fault with the arm's-length standard at a conceptual level, reducing that standard to practice can be challenging. Because the arm's-length principle requires tax authorities and taxpayers to quantify a counterfactual—what would the price be but for the relationship between the parties?—there is no obvious way to arrive at the correct result.[81] To account for differences among taxpayers and industries, tax regulations provide multiple allocation techniques.[82] Before the introduction of the best method rule, the regulations also specified a "[p]riority of methods" that both taxpayers and the government were obligated to observe.[83]

By contrast, the best method rule invites taxpayers to determine which method allows them to best demonstrate their compliance with transfer pricing rules. Thus, it increases taxpayer autonomy by transferring the power to choose a method from tax authorities to taxpayers. That deregulatory change provides taxpayers with greater latitude to characterize their activities.[84] Rather than "imposing a rigid hierarchy for applying valuation methods," the regulations call for taxpayers to choose the best possible method for their particular circumstances.[85] Taxpayers must then prepare a detailed contemporaneous report comparing their own pricing practices to the results pro-

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[79] Reuven S. Avi-Yonah, *The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation*, 15 VA. TAX REV. 89, 90 (1995).

[80] *Id*. ("[T]ransfer pricing manipulation is one of the most common techniques of tax avoidance. This is especially true in the international sphere, as there are great differences in effective tax rates among jurisdictions.").

[81] *See* Brian Lebowitz, *Profit Sharing as a New World Order in International Taxation*, 52 TAX NOTES INT'L 585, 586 (2008) ("What would happen if, contrary to fact, a group of related companies, or geographic units of a single company, were unrelated companies acting at arm's length regarding each other? Addressing this question requires delineating numerous features of this hypothetical world.").

[82] *See* Treas. Reg. § 1.482-3(a) (2010) (outlining transfer pricing options).

[83] Prop. Treas. Reg. § 1.482-2(d)(2)(iii), 57 Fed. Reg. 3571, 3580 (Jan. 30, 1992) (describing priority of methods applicable to transfers of intellectual property); *see also* Avi-Yonah, *supra* note 79, at 107–08 (1995) (describing operation of early arm's-length transfer pricing regulations).

[84] It could be argued that the flexible approach of the best method rule favors the government more than taxpayers. Since tax authorities are not bound by taxpayers' choice of methods, the rule may be "an illusory delegation of responsibility." Baer, *supra* note 16, at 954.

[85] Clark, *supra* note 53, at 1191–92.

duced by their chosen method.[86] Authorities can request that report and test its conclusions.[87]

3. *Liberalizing the Divisive Reorganization Requirements*

The realization requirement described above identifies points in time at which a taxpayer's legal entitlements have been altered sufficiently to justify imposing taxation.[88] In some situations, Congress has determined that despite meeting the realization threshold, further deferral of tax liability is warranted. In those cases, it creates a statutory exception called nonrecognition.[89] The final example of a deregulatory tax reform directed at businesses involves one such exception, a type of tax-free corporate reorganization called a divisive reorganization. In a divisive reorganization, an existing corporation spins off part of its operations, assets, and liabilities into a completely new and independent corporation.[90]

For example, a Wall Street bank (Bank Inc.) might be compelled by post–financial crisis regulations to separate its proprietary trading from the remainder of its operations. One means of accomplishing that division without triggering corporate- or shareholder-level taxes would be for Bank Inc. to form a new subsidiary (Trading Corp.) to house its proprietary trading operations and then distribute Trading Corp.'s shares pro rata to Bank Inc.'s existing shareholders as a dividend. The result would be two corporations owned by the same group of shareholders, but otherwise independent of one another.

The basic statutory provisions regarding nonrecognition have long played a central role in the corporate income tax.[91] Since the

[86] Treas. Reg. § 1.6662-6(d)(2) (2010). At the margins, taxpayers undoubtedly choose methods that provide more favorable results. Since they must explain their choices to tax authorities, however, their capacity to take aggressive positions is constrained.

[87] *See* Treas. Reg. § 1.6662-6(d)(2)(iii) (2010) (specifying documentation requirements for exception to transfer pricing valuation misstatement penalty). Taxpayers have an opportunity to demonstrate their desire to cooperate with authorities, and regulators are able to identify and focus their attention on taxpayers that fail to do so. That direct interaction between taxpayers and tax authorities creates an avenue for generating increased compliance.

[88] *See supra* notes 41–44 and accompanying text (discussing realization).

[89] *See, e.g.*, I.R.C. § 1031 (2006) (providing tax deferral for certain types of property exchanges).

[90] *See* I.R.C. § 355(a)(1) (listing basic requirements for tax-deferred corporate divisions).

[91] *Gregory v. Helvering*, which gave birth to the economic substance doctrine, involved an attempt to spin off a portion of a company's assets tax free. 293 U.S. 465, 470 (1935) (rejecting validity of taxpayer's transactions because "to hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose").

mid-1980s, they have taken on a new importance.[92] The tax-free reorganization rules provide a valuable respite from the corporate- and shareholder-level taxes that a corporate division would ordinarily trigger.[93] Nonrecognition rules have been structured to provide tax benefits for divisions that address corporate business exigencies, rather than those that serve the interests of shareholders by distributing accumulated profits.[94] The most important of those requirements, the "active trade or business" test, calls for each of the corporations in a simple spinoff—i.e., both the one preexisting corporation and the two post-division corporations—to operate a substantial business with a meaningful track record.[95] Historically, the determination of whether a corporation was engaged in such a business has been made on a corporation-by-corporation basis.[96] If an otherwise adequate predivision business were divided among several entities to satisfy regulatory requirements, it might be the case that none of those corporations would meet the requirement independently.[97]

As a result, satisfying the active trade or business requirement frequently forced businesses to restructure their assets and activities in advance of the divisive reorganization, sometimes at significant cost.[98] Critics of the prior rules objected to the apparently arbitrary require-

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92 Since 1986, corporate divisions—dividing the assets and operations of a single corporation into two separate corporations—generally result in current taxation at both the corporate and shareholder levels. *See* Michael L. Schler, *Simplifying and Rationalizing the Spinoff Rules*, 56 SMU L. REV. 239, 244 (2003) ("In the Tax Reform Act of 1986 . . . , Congress eliminated most of the methods for a corporate group to transfer assets outside the group without gain recognition.").

93 *See id.* at 244–45 ("[A]fter the 1986 Act, the principal remaining method of achieving this result is under § 355 (or a divisive D reorganization). This has caused taxpayers to attempt to stretch § 355 to its limits, and has put much pressure on the requirements of § 355.").

94 In *Gregory*, the Supreme Court decided that the corporate division in question was not motivated by business exigencies, but rather by shareholder interests, such that it was not eligible for nonrecognition. 293 U.S. at 469.

95 I.R.C. § 355(b) (Supp. I 2006). In *Gregory*, for example, the newly formed Averill Corporation did nothing but hold an appreciated minority position in the stock of Monitor Corporation. 293 U.S. at 467. Under the modern statute, these limited holdings, as merely passive investments, would violate the active trade or business requirement.

96 *See* Debra J. Bennett, *New Code Sec. 355(b)(3): The Affiliated Group Active Trade or Business Requirement*, TAXES, Aug. 2006, at 7, 7–9 (describing historical operation of active trade or business requirement in affiliated group setting).

97 *Id.* at 8–9 ("[T]he question becomes why, from a policy perspective the rules exist in the context of affiliated groups that are engaged in the active conduct of a trade or business but have compartmentalized their businesses so that the active trade or business requirement of Code Sec. 355(b)(2)(A) cannot be satisfied.").

98 *See* Schler, *supra* note 92, at 263 ("The restructuring of a group that is necessary to meet the trade or business requirements . . . can take an enormous amount of time and effort.").

ment that businesses either structure their operations in a particular, possibly disadvantageous manner in anticipation of a future division or engage in a substantively meaningless preliminary transaction.[99] In 2006, Congress revised the applicable statute to apply the active trade or business test on an aggregate basis, greatly reducing the need for both types of tax planning.[100] Under this test, the active trade or business requirement can be met by looking at the activities of a collection of related corporations, referred to as a "separate affiliated group," rather than those of each individual corporation.[101]

The 2006 reform constituted a typical deregulatory tax reform. It did not create a market for tax benefits like safe harbor leasing or encourage self-regulation of the sort promoted by the best method rule. Nevertheless, the changes to the divisive reorganization rules gave businesses more freedom to alter the timing of the corporate- and shareholder-level taxes that would otherwise accompany a corporate division. It should be noted that, although the revised requirements have increased taxpayer autonomy, they have not necessarily increased simplicity as hoped.[102]

Coupled with the other requirements for nonrecognition treatment, the 2006 reform increased business taxpayers' structural autonomy in the same way that the hypothetical rule recognizing marriages and divorces from any jurisdiction would.[103] Both changes would grant taxpayers greater flexibility to achieve favorable tax results by severing relationships. Put another way, these changes would facilitate tax planning by eliminating either the need (i) to establish residency in, for example, Haiti to ensure a sufficiently

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99 *See id.* ("[T]he restructuring makes no business sense and is done solely to satisfy the statutory requirement.").

100 *See* I.R.C. § 355(b)(3); *see also* Robert Willens, *Holding Companies and the Active Business Test*, 113 TAX NOTES 87, 87–88 (2006) (explaining how changes to divisive reorganization rules eliminated need for "corrective action" to satisfy active trade or business test on stand-alone basis); *infra* note 102 (describing amendment of active trade or business test).

101 I.R.C. § 355(b)(3).

102 *See* Martin J. McMahon et al., *Recent Developments in Federal Income Taxation: The Year 2007*, 8 FLA. TAX REV. 715, 792 (2008) (describing these legislative reforms as "simplify[ing] the active trade or business test by looking at all corporations in the distributing corporation's and the distributed subsidiary's affiliated groups to determine if the active trade or business test is satisfied" but noting that "[p]roposed regulations to carry out the amendment are anything but simple").

103 *See supra* note 47 and accompanying text (discussing current law requirement that marriage and divorce be recognized in taxpayer's jurisdiction of residence). Eliminating structural constraints, however, will not always increase taxpayer autonomy. For example, if loosening the active trade or business test forces a corporation into nonrecognition when it would have preferred a current tax liability, the changes would have *reduced* its autonomy.

strong link to Haiti to be confident that a Haitian divorce will be considered relevant by U.S. tax authorities, or (ii) to create a particular corporate structure to ensure that the entity in question satisfies a stand-alone active trade or business test.[104]

II
Evaluating Tax Deregulation

The preceding examples suggest the ubiquity of tax deregulatory efforts. This Part shows that tax deregulation's broad impact has been masked by a longstanding confusion between tax deregulation and tax simplification. The check-the-box election provides a relatively straightforward example of this confusion. People have also characterized the other deregulatory tax reforms described in the previous Part as providing some relief from tax complexity, though the validity of that claim is questionable.[105]

On its face, such widespread and longstanding confusion between simplification and deregulation is troubling. More worrisome still is the degree to which that confusion obscures the difficult normative questions raised by tax deregulation. Determining whether deregulation is desirable or harmful, always a difficult task, becomes impossible when it is mistaken for simplification.[106] This Part begins the

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[104] Rather than incurring the expense and disruption of relocating to a permissive jurisdiction or satisfying onerous requirements of their home jurisdiction, couples could fly to Haiti or Mexico, confident that tax authorities would respect a "quickie" Haitian or Mexican divorce. Similarly, by eliminating the need for predivision maneuvering, the modification to the active trade or business test serves the same purpose, providing taxpayers with greater freedom to achieve their desired tax treatment by engaging in the corporate equivalent of divorce.

[105] *See, e.g.*, 1 Boris I. Bittker & James S. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 11.05[5] (7th ed. Supp. II 2010) ("The 2006 Legislative amendment to § 355(b)(3) was intended as a simplification; by treating affiliated groups as a single entity for § 355(b) active business requirement, it was thought that corporations would no longer need to engage in various restructuring efforts in order to position themselves for a spin-off transaction."); Avi-Yonah, *supra* note 79, at 140 (describing proposed regulations ultimately replaced by best method rule as "incredibly complex, requiring the application of statistical methods far beyond the understanding of most tax directors of even the largest corporations"); Gordon L. Poole et al., *Financing of United States-Flag Vessels*, 56 Tul. L. Rev. 1171, 1266 (1982) ("The Economic Recovery Tax Act of 1981 (ERTA) opened up significant financing opportunities by eliminating the burdensome restraints which often made leasing complicated and undesirable. ERTA provides a new simplified definition of 'true lease.' This definition permits, through lease transactions, full transferability of investment tax credits and tax depreciation between taxpayers.").

[106] Views on deregulation have always been relatively fluid. Since the onset of the financial crisis, even longtime advocates of deregulation have been publicly critical of its role in precipitating the crisis. *See supra* note 2 (discussing criticism). In some cases, widespread fears regarding the impact of deregulation have proven unfounded, such as those regarding the safety of deregulated air travel. *See* Alfred E. Kahn, *Surprises of Airline Deregulation*, 78 Am. Econ. Rev. 316, 321 (1988) ("The last ten years have fully vindicated our expecta-

process of resolving that confusion and provides a normative framework for evaluating tax deregulation.

A. Tax Simplification and Tax Deregulation

Despite deregulation's extensive impact on the tax system, tax deregulation has proceeded surreptitiously. Outside of Australia, where responsive regulation strategies have been affirmatively embraced by tax authorities, tax deregulation might seem to be more theory than fact.[107] In one sense, that blind spot is purely semantic. Although tax simplification predated deregulation by several decades,[108] by the 1980s the concept of simplification had evolved to encompass deregulatory reforms.

Simplification describes an objective reduction in the costs taxpayers incur to understand, comply with, and arrange their affairs to minimize their tax obligations.[109] Deregulation, by contrast, represents an effort to shift authority from public to private hands. Such a shift may or may not produce lower costs.[110] Since taxpayers can often improve their bottom lines by increasing their tax planning expenditures, liberating taxpayers through deregulation may in fact generate greater tax complexity.[111]

A classic definition of tax simplification thus focuses on reductions in three types of complexity.[112] The first is rule complexity, which encompasses the costs associated with understanding relevant

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tions that deregulation would bring lower fares . . . , an increased range of price-quality options, and great improvements in efficiency . . . , all this along with a 35 percent or so decline in accident rates.").

107 Unlike their Australian counterparts, U.S. tax authorities have not explicitly embraced responsive regulation strategies such as tax deregulation. *See* Sagit Leviner, *A New Era of Tax Enforcement: From 'Big Stick' to Responsive Regulation*, 42 U. MICH. J.L. REFORM 381, 385 (2009) (suggesting U.S. tax enforcement pursue responsive regulatory strategies modeled on Australian approach, which advocates for "a dynamic and gradual application of less to more severe sanctions and regulatory interventions," coupled with "a deeper understanding of the motives, circumstances, and characteristics of taxpayers").

108 *See* HENRY C. SIMONS, FEDERAL TAX REFORM 28–30 (1950) (encouraging simplification of income tax long before 1980s).

109 A more comprehensive definition of tax complexity would include the government expenditures to explain, ensure, and monitor taxpayer compliance. *See Tax Reform: Hearing Before the H. Comm. on Ways & Means*, 109th Cong. 42, 42–43 (2005) (statement of Joel B. Slemrod, Professor of Economics and Director of the Office of Tax Policy Research, University of Michigan) (discussing compliance costs).

110 In my prior work, I have argued that any deregulatory reform that would not produce an objective reduction in tax complexity should be rejected. *See* Dean, *supra* note 6, at 408–11 (noting costs of such reform).

111 *See id.* at 420–21 (noting example of significant complexity that decreases overall tax burden).

112 *See* BRADFORD, *supra* note 40, at 266–67 (distinguishing among three types of complexity).

tax rules. Next, transactional complexity describes the costs taxpayers incur to structure their affairs to minimize their tax burdens. Finally, compliance complexity captures expenses related to filing returns and satisfying ongoing requirements. Each form of complexity also imposes ancillary costs on tax authorities.[113] Today, the term tax simplification is often misused to describe reforms that deregulate but do not actually simplify the tax law. More precisely, changes that grant taxpayers increased autonomy tend to be characterized as simplification measures regardless of their cumulative impact on compliance, rule, and transactional complexity.

The deregulatory check-the-box rules exemplify that pattern. They were introduced expressly as a simplification measure[114] and still tend to be seen as the product of a successful simplification effort.[115] In fact, while replacing the old four-factor test had a positive impact on compliance complexity, elective entity classification had an indeterminate impact on rule complexity and a negative effect on transactional complexity.[116] For example, in response to taxpayer confusion, authorities felt compelled to issue regulatory guidance regarding the characterization of elective classification changes not long after the introduction of the check-the-box regulations.[117] Measured in terms of the aggregate expenditures by taxpayers and tax authorities, the

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[113] *See* Slemrod, *supra* note 109, at 44 (calculating complexity of tax law by including both public and private costs).

[114] I.R.S. Notice 95-14, 1995-1 C.B. 297, 298 ("[T]he purpose of this approach is to simplify the rules in order to reduce the burdens of both taxpayers and the Service.").

[115] *See, e.g.*, Heather M. Field, *Checking in on "Check-the-Box*,*"* 42 Loy. L.A. L. Rev. 451, 464 (2009) (describing check-the-box regulations as "simplified elective entity classification regime"); David R. Sicular, *The New Look-Through Rule: W(h)ither Subpart F?*, 115 Tax Notes 349, 366 (2007) ("[C]heck the box was a handy simplification over planning under the *Kintner* regulations.").

[116] The recent effort by the Obama administration is the latest (failed) attempt to rein in the complexity associated with those entity classification rules. Lee A. Sheppard, *Check-the-Box Repeal Likely To Be Enacted*, Tax Notes Today, Jul. 8, 2009, 2009 TNT 128-1 ("The Obama proposal would treat tax nothings as C corporations for all purposes of the code, not just for subpart F. A first-tier foreign entity wholly owned by a U.S. person could still be checked, as could a same-country affiliate with a single foreign owner."); Kim Dixon, *Obama Tones Down Global Company Tax Goals*, Feb. 1, 2010, http://www.reuters.com/article/idUSN0119192320100201 (discussing President Obama's "scal[ing] back" of ambitious plan to "close loopholes global companies use when accounting for taxes on profit earned overseas" due to lukewarm response from Congress, including fellow Democrats).

[117] Although taxpayers insisted that they "be allowed to choose which form to apply to an elective conversion" in order "to produce the most favorable tax results," authorities decided to allow "only one [transaction] form for each type of elective conversion." T.D. 8844, 1999-2 C.B. 661, 662.

check-the-box rules arguably increased, rather than decreased, the tax law's complexity.[118]

While both simplification and deregulation call for easing burdens that the tax law imposes on taxpayers, as shown in Figure 1, they do so in different ways.[119] Simplification principally targets the nontax costs that tax rules impose on private actors and related costs borne by tax authorities.[120] By enhancing taxpayer autonomy, deregulatory tax reforms may reduce those costs. But, as the check-the-box rules demonstrate, they may both please taxpayers and increase those costs.[121] As a result, deregulation and simplification efforts are not as compatible as one might expect.

As shown in Figure 1, a rule change may fit into any one of four quadrants. The check-the-box regulations, for example, would belong in Quadrant II if they produced transactional complexity costs in excess of the compliance complexity costs they eliminated.[122] If the reverse were true, they would belong in Quadrant I. The partnership anti-abuse rule grants tax authorities broad discretion to "recast transaction[s]" when those transactions achieve results that are inconsistent with the intent of the partnership tax laws.[123] As a result, the partnership anti-abuse rule, in contrast with the check-the-box rules, limits taxpayers' structural autonomy[124] and would belong in either Quadrant III or IV depending on its aggregate impact on tax complexity.[125]

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118 Dean, *supra* note 6, at 453–57.

119 Deregulation provides taxpayers with greater autonomy by easing restrictions on taxpayer behavior. Simplification reduces the costs of tax planning and tax compliance, though not necessarily actual tax liabilities.

120 *See supra* note 40 (explaining different kinds of complexity).

121 This would be true whenever tax deregulation allows taxpayers to derive benefits worth more than one dollar at a cost of one dollar in increased expenditures.

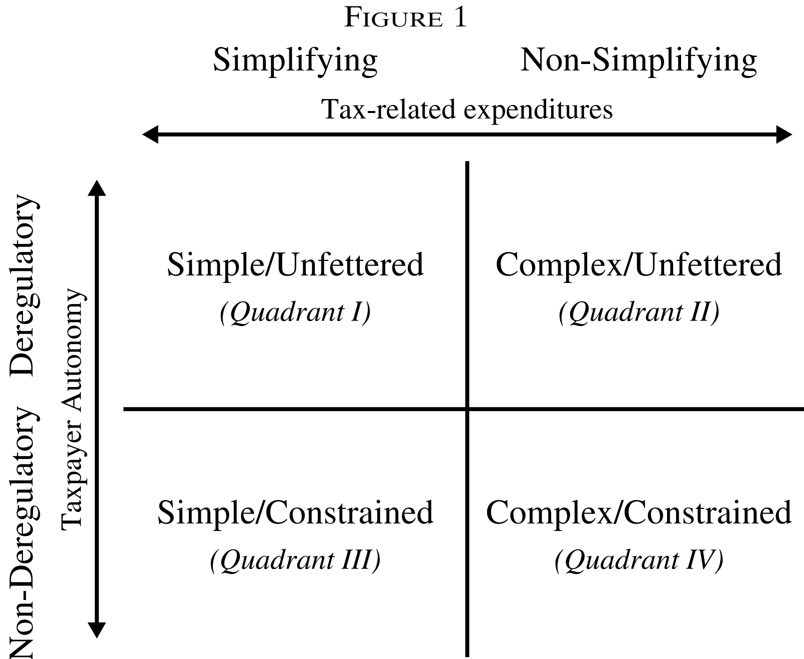
122 The increased transactional complexity would be the result of increased tax planning. The decreased rule complexity would largely result from the elimination of the unwieldy four-factor test.

123 Treas. Reg. § 1.701-2 (1995).

124 *See* Abreu, *supra* note 20, at 58 (concluding that anti-abuse rule "denied [certain taxpayers] the opportunity to exercise choice").

125 If the partnership anti-abuse rule produced greater rule complexity than it eliminated in terms of transactional complexity, it would belong in Quadrant IV. If the opposite were true, it would belong in Quadrant III. Andrea Monroe argues that the rule had no impact on aggressive tax planning. *See* Andrea Monroe, *What's in a Name: Can the Partnership Anti-abuse Rule Really Stop Partnership Tax Abuse?*, 60 CASE W. RES. L. REV. 401, 437 (2010) ("The Treasury had hoped that the final [rule] would discourage taxpayers from entering into abusive partnership transactions, but the regulation had no such impact."). Monroe also argues that "[t]he Service rarely raises [the rule], the courts rarely apply it, and practitioners rarely consider it." *Id*. If she is correct, then it would have increased rule complexity (albeit modestly) without affecting transactional complexity, putting the partnership anti-abuse rule in Quadrant IV.

FIGURE 1



Outside of the tax context, it may be logical to associate increased private autonomy with decreased regulatory costs. As described in the next Section, advocates of abandoning command-and-control environmental regulation have traditionally made just such an argument: Given greater flexibility, regulated industries will find better, cheaper methods of achieving environmental objectives.[126] When it comes to tax, however, it is more difficult to draw conclusions about the relationship between taxpayer innovation and regulatory expenditures. Simply put, that is because a dollar devoted to tax planning often generates more than a dollar in tax savings.

B. Developing a Normative Framework for Tax Deregulation

This Section offers a normative framework for evaluating tax deregulation, providing a means by which policymakers may identify the unique benefits and costs of deregulatory tax reforms. It starts by presenting—and rejecting—the two primary rationales for deregulation: liberty and economic efficiency. Neither provides much insight into the benefits or harms of tax deregulation. It then offers two alternative means of evaluating these reforms. The responsive regulation literature highlights the beneficial characteristics of tax deregulation while the fiscal arbitrage concept shows its potential for mischief.

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[126] *See infra* notes 140–43 and accompanying text (discussing deregulatory reforms in environmental regulation).

1. *Liberty and Efficiency*

Deregulation, often cast in terms of regulatory reform, has been an important feature of the political landscape for more than a quarter of a century.[127] Although it is difficult to draw clear conclusions regarding the cumulative impact of years of deregulatory reforms,[128] the drive to liberate businesses from government red tape and substantively deficient rules has continued through successive Democratic and Republican administrations. This broad-based consensus persists despite differences of opinion regarding the scope of the transformation that deregulation implies[129] and the justification for those changes.[130]

For some, government control over private decision making is objectionable as a matter of principle.[131] A libertarian might find even

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[127] *See* Joseph D. Kearney & Thomas W. Merrill, *The Great Transformation of Regulated Industries Law*, 98 COLUM. L. REV. 1323, 1403 (1998) ("Every president from Gerald Ford to Bill Clinton has devoted significant political capital to the cause of regulatory reform."). Even President Obama has emphasized the need to protect private enterprise from excessive government interference. *See* Address Before a Joint Session of the Congress, 2009 DAILY COMP. PRES. DOC. 105 (Feb. 24, 2009) ("History reminds us that at every moment of economic upheaval and transformation . . . Government didn't supplant private enterprise; it catalyzed private enterprise. It created the conditions for thousands of entrepreneurs and new businesses to adapt and to thrive.").

[128] *See* AYRES & BRAITHWAITE, *supra* note 14, at 7 ("Even the United States, after 8 years of an administration with a stronger ideological commitment to deregulation than any in the history of the Western world . . . has hardly shifted the balance away from state regulation."); Richard A. Posner, *The Effects of Deregulation on Competition: The Experience of the United States*, 23 FORDHAM INT'L L.J. S7, S8 (2000) ("In the United States at least, there is no general movement toward reducing government intervention in the lives of its citizens. . . . The deregulation movement has actually coincided with increased regulation of health, safety, and the labor markets, which is why to speak of 'deregulation' in the large is misleading . . . .").

[129] When Posner refers to deregulation he means something very specific: "Deregulation in the United States means the removal or reduction of *comprehensive* controls over particular industries." Posner, *supra* note 128, at S8. Others see deregulation as part of a much broader trend away from a rigid command-and-control regulatory system:

> The command-and-control regulatory model of the New Deal era sought to control market rates, control entry into industries, and command the minimum conditions and requirements of production and service. . . . Responding to the increased complexity, diversity, and volatility of the new market, the Renew Deal aims conversely to promote diversification, pluralization of solutions, and increased competition.

Orly Lobel, *The Renew Deal: The Fall of Regulation and the Rise of Governance in Contemporary Legal Thought*, 89 MINN. L. REV. 342, 379–80 (2004).

[130] *See, e.g.*, Kearney & Merrill, *supra* note 127, at 1403 (noting that President Ford thought deregulation would be anti-inflationary and that President Carter supported deregulation to counter stagflation, while later presidents intended deregulation to promote productivity and economic growth).

[131] Take, for example, the deregulation of the airline industry and its impact on consumers. *See infra* note 145 (citing discussions of airline deregulation). A libertarian would approve of that deregulatory effort in part because it freed private actors (the airlines)

relatively subtle public control—such as Cass Sunstein and Richard Thaler's "libertarian paternalism"—problematic.[132] More broadly, autonomy concerns have long played a role in motivating the popular anti-regulation movement. Individual liberty often looms large for advocates of limited government and lower taxes.[133] From this perspective, shifting authority from public to private hands becomes desirable even if such changes impose significant efficiency costs on society.[134]

Over the last century, the pendulum swung widely on the question of the compatibility of economic regulation with individual liberty.[135] In the tax context, the government has broad constitutional authority to enact regulations that burden individual liberty. Modern constitutional law theory sees only a tenuous connection between fiscal policy and autonomy, allowing public actors considerably more freedom in their funding decisions than they are granted in regulating protected activities.[136] As a result, today even the most narrowly targeted taxes can be designed in such a way as to pass constitutional

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from public strictures, not because of its positive impact on consumer welfare. A welfarist, by contrast, would care less about the impact of deregulation on the airlines themselves than its impact on the airlines' customers.

[132] *See* Cass R. Sunstein & Richard H. Thaler, *Libertarian Paternalism Is Not an Oxymoron*, 70 U. Chi. L. Rev. 1159, 1165 (2003) (acknowledging that some libertarians will object to even relatively noncoercive regulatory strategy labeled "libertarian paternalism" as "government effort[ ] to influence choice in the name of welfare").

[133] *See, e.g.*, *The Contract from America*, *supra* note 33 (calling for lower taxes along with greater individual liberty and limited government).

[134] *See, e.g.*, Robert Nozick, Anarchy, State, and Utopia ix (1974) ("Our main conclusions about the state are that a minimal state, limited to the narrow functions of protection against force, theft, fraud, enforcement of contracts, and so on, is justified; that any more extensive state will violate persons' rights not to be forced to do certain things, and is unjustified . . . .").

[135] In *Lochner v. New York*, 198 U.S. 45 (1905), the Supreme Court refused to allow government regulation of labor contracts except to protect public health or morals. Since the end of the *Lochner* era, it has been all but taken for granted that economic regulation does not impermissibly encroach on an individual's liberty. *See* Cass R. Sunstein, Lochner*'s Legacy*, 87 Colum. L. Rev. 873, 877–82 (1987) (discussing changing notions of government as regulator).

[136] *See, e.g.*, Nelson Tebbe, *Excluding Religion*, 156 U. Pa. L. Rev. 1263, 1282 (2008) ("Constitutional law commonly allows the government to subsidize the exercise of certain constitutional rights and not others.").

muster.[137] It is also uncontroversial for tax rules to burden the most intimate of decisions.[138]

While liberty is an end in itself for some, others view increased autonomy through deregulation as a way to achieve greater efficiency. Although contemporary legal scholars do not always label these changes as deregulation, the shift from command-and-control regulation toward more flexible regimes endeavors to increase efficiency by providing more private autonomy. Environmental regulatory reforms designed to increase economic efficiency, for instance, typically are not referred to as environmental deregulation, though they exhibit such characteristics.[139] Deregulatory environmental reforms often take the form of market-based regulatory strategies that impose "financial penalties . . . on harm-producing behavior" and create "financial rewards" for "harm-reducing behavior."[140] As compared to the traditional "best available technology"[141] style of regulation, providing private actors with more latitude allows them to achieve envi-

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137 Taxation has long been exempt from the scrutiny that other types of regulation must survive. *See* Eduardo Moisés Peñalver, *Regulatory Taxings*, 104 COLUM. L. REV. 2182, 2198–2204 (2004) (describing longstanding exemption of tax rules from Fifth Amendment limitations such as Takings and Due Process Clauses); Lawrence Zelenak, *Are Rifle Shot Transition Rules and Other Ad Hoc Tax Legislation Constitutional?*, 44 TAX L. REV. 563, 625 (1989) (concluding that even when provision applies only to particular taxpayers, their constitutional challenge to "an ad hoc tax provision . . . should probably fail"). For example, the proposed tax on AIG bonuses was not generally considered to be constitutionally problematic. *See* Conor Clarke, *Laurence Tribe: Is Taxing AIG Legal?*, ATLANTIC (Mar. 17, 2009, 4:22 PM), http://www.theatlantic.com/politics/archive/2009/03/lawrence-trib-is-taxing-aig-legal/1590/ (citing Laurence Tribe's conclusion that "[i]t would not be terribly difficult to structure a tax, even one that approached a rate of 100%, levied on some or all of the bonuses already handed out (or to be handed out in the future) by AIG and other recipients of federal bailout funds so that the tax would survive bill of attainder clause challenge"); Richard A. Epstein, *Is the Bonus Tax Unconstitutional?*, WALL ST. J., Mar. 26, 2009, at A11 (reaching same conclusion).

138 Even when tax rules impose obstacles to our exercise of fundamental rights, that interference is not considered unconstitutional. *See, e.g.*, Richard L. Elbert, *Love, God, and Country: Religious Freedom and the Marriage Penalty Tax*, 5 SETON HALL CONST. L.J. 1171, 1189–1201 (1995) (discussing failed attempts to challenge "marriage penalty tax" on constitutional grounds).

139 It is not difficult to find exceptions to that pattern, but labeling private-autonomy-enhancing environmental reforms as environmental deregulation is decidedly the exception. *See supra* note 5 (noting examples of "environmental deregulation").

140 Richard H. Pildes & Cass R. Sunstein, *Reinventing the Regulatory State*, 62 U. CHI. L. REV. 1, 112 (1995). Cap-and-trade programs are a form of economic incentives that allow businesses to "purchas[e] permission" to emit pollutants and to "trade their 'licenses' with other people." *Id.* at 113.

141 *Id.* at 97. The authors note that in the environmental context, command-and-control regulations "usually take the form of regulatory requirements of the 'best available technology' ('BAT') . . . . BAT strategies . . . are a defining characteristic of regulation of the air, the water, and conditions in the workplace." *Id.*

ronmental objectives at lower overall cost.[142] Of course, flaws in the design of those financial incentives (or shortsightedness on the part of private actors) may produce behavior that is penny-wise and pound-foolish.[143]

When savings from deregulation are passed along to consumers, the public benefits not only by enjoying, in this instance, cleaner air and water but also by paying relatively low prices for goods and services.[144] Deregulation of industries like air travel has been credited with providing precisely that result.[145] By creating space for innovation and competition, deregulation allows the market's invisible hand to narrow the gap between public and private objectives. The obvious problem that arises when adapting this approach to the tax context is that the primary public purpose of the tax rules is to *increase* private costs, in the form of tax payments.[146]

It is tempting to think that deregulation could offer the same economic efficiency benefits in the tax context as it does elsewhere.[147]

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[142] *Id.* at 112 ("Often it would be far better, on economic grounds, for government (a) to create economic incentives to engage in socially desirable conduct, and (b) to permit the market to decide how companies respond to those incentives.").

[143] It is not difficult to imagine that the recent BP oil spill might be a result of just such a dynamic. Environmental regulations might have, for example, provided incentives for private actors to observe safe drilling practices rather than imposing specific requirements that regulators had determined to be safe. Miscalculation or decisions made in the short-term self-interest of managers (at the expense of the corporation) could cause those incentives to misfire so that inadequate safety measures were put in place. *See* Ian Urbina, *In Report on Gulf Spill, BP Sheds Some Light and Casts Much Blame*, N.Y. TIMES, Sep. 9, 2010, at A14 (noting allegations that BP's cost-cutting efforts may have contributed to explosion and resulting spill). Proving such a connection is no simple matter. *See* John M. Broder, *Investigator Finds No Evidence that BP Took Shortcuts To Save Money*, N.Y. TIMES, Nov. 9, 2010, at A16 (reporting findings of presidential panel investigating spill that "disputed the findings of other investigators, including plaintiffs' lawyers and members of Congress, who have charged that BP and its main partners, Transocean and Halliburton, had cut corners to speed completion of the well, which cost $1.5 million a day to drill").

[144] *Cf.* Kearney & Merrill, *supra* note 127, at 1401 (noting savings from deregulating natural monopolies).

[145] *See* STEVEN MORRISON & CLIFFORD WINSTON, THE ECONOMIC EFFECTS OF AIRLINE DEREGULATION 1–2 (1986) (arguing that airline deregulation "led to at least a $6 billion (in 1977 dollars) annual improvement in the welfare of travelers" and "at least a $2.5 billion . . . annual increase in industry profits"); Posner, *supra* note 128, at S17 (crediting airline deregulation with "an enormous increase in the volume of air traffic coupled with a substantial fall in real prices").

[146] The traditional measure of systemic noncompliance is called the "tax gap," which measures the difference between the revenues that the income tax should collect and the amount that it in fact does collect. Leandra Lederman, *The Interplay Between Norms and Enforcement in Tax Compliance*, 64 OHIO ST. L.J. 1453, 1455 (2003).

[147] Tax law presents an area in which the government directly interferes with the market's functioning by raising costs for producers, prices for consumers, or both. In a perfect world, tax laws would have no effect on private behavior. Unfortunately, even without the many tax preferences and tax penalties legislators intentionally create, taxes

Unfortunately, the mechanisms through which taxpayer freedom would promote economic efficiency are not obvious. Through environmental deregulation, competitive forces encourage private actors to develop innovative strategies to meet public objectives. Competition and innovation in taxation are more closely linked to compliance failures, such as tax shelters, than with a more smoothly functioning tax system.[148] Likewise, the notion that increased tax autonomy is desirable in and of itself is simply not consistent with the broad latitude we grant policymakers on fiscal questions, even when they implicate important liberty interests.[149] As applied to business entity taxpayers, autonomy becomes even more problematic given their more limited constitutional protections.[150] Contemporary tax policy discourse may be permeated by an unexamined "everyday libertarianism,"[151] but Murphy and Nagel conclude that this impulse embodies little more than "unreflective ideas that we have unqualified moral entitlement" to be free of tax impediments to our economic activity.[152] While there may not be "a patriotic duty to increase one's taxes," neither is there a right to structural or reporting tax autonomy.[153]

2. *Responsive Regulation*

As detailed above, market liberalism—either for its own sake in securing fundamental freedoms or in the service of a welfarist notion of promoting efficiency—falters as a justification for tax deregulation. Responsive regulation offers an alternative normative justification for

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would distort private behavior. *See* Joel Slemrod & Shlomo Yitzhaki, *The Costs of Taxation and the Marginal Efficiency Cost of Funds*, 43 INTERNATIONAL MONETARY FUND STAFF PAPERS 172, 178 (1996) (citing "deadweight loss—the inefficiency caused by the reallocation of activities by taxpayers who switch to nontaxed activities; the excess burden of tax evasion—the risk borne by taxpayers who are evading; and avoidance costs—the cost incurred by a taxpayer who searches for legal means to reduce tax liability" as costs of imposing taxes). The resulting deadweight losses are no more desirable than those attributable to inefficient environmental or financial regulation. In the abstract, allowing taxpayers more autonomy in the way they meet their obligations could help to minimize the distortions that tax burdens inevitably create.

148 *See, e.g.*, Joseph Bankman, *The Tax Shelter Battle*, *in* THE CRISIS IN TAX ADMINISTRATION 9, 12 (Henry J. Aaron & Joel Slemrod eds., 2004) (describing "competitive market" in tax shelter innovation and sales populated by tax shelter promoters, investment banks, and accounting firms).

149 *See supra* notes 135–38 and accompanying text.

150 Of course, corporations receive the benefit of some constitutional protections. *See* Citizens United v. FEC, 130 S. Ct. 876, 899 (2010) ("The Court has recognized that First Amendment protection extends to corporations.").

151 MURPHY & NAGEL, *supra* note 33, at 34; *see also id.* at 34–36 (further developing this concept).

152 *Id.* at 36.

153 Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).

deregulation, including tax deregulation, that is not framed merely in market efficiency or liberty terms. Instead, it employs deregulation as a mechanism to elicit compliance from regulated entities. While reduced costs are "essential [to the] compliance generating dynamic" of responsive regulation,[154] responsive regulation scholars recognize that other concerns—like democracy and justice—may shape patterns of taxpayer compliance.[155]

In *Responsive Regulation*, Ian Ayres and John Braithwaite argue that "public policy can effectively delegate government regulation . . . to the regulated firms themselves."[156] In doing so, "[g]overnment should . . . be attuned to the differing motivations of regulated actors" so that "[t]he very behavior of an industry or firms therein . . . channel[s] the regulatory strategy to greater or lesser degrees of government intervention."[157]

In recent years responsive regulation has become the focus of an increasing amount of tax scholarship.[158] Scholars argue that tax authorities, just like those seeking to promote compliance with any other regulatory framework, should "show fairness and reasonableness to those . . . willing to cooperate, and focus enforcement capacity on those flagrantly ignoring their tax obligations."[159] Cooperative taxpayers can be granted significant latitude to engage in "self-regulation," while noncooperative behavior produces a "transfer of power from the taxpayer to the tax office, and a concomitant loss of freedom on the part of the taxpayer."[160]

Responsive regulation does not place any particular value on autonomy as an end in itself. Instead, taxpayers' freedom from command-and-control regulation serves as an opportunity to demonstrate—and provides a reward for demonstrating—trustworthiness.[161]

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[154] Braithwaite, *supra* note 20, at 5.

[155] *See generally* Michael Wenzel, *Tax Compliance and the Psychology of Justice: Mapping the Field*, *in* TAXING DEMOCRACY, *supra* note 13, at 41, 60 (discussing relationship between tax compliance and taxpayer perceptions of tax regime's justice and fairness). More broadly, responsive regulation suggests that generally "an authority that is legitimate and that is engaging seriously with the democratic will of the people does not need coercion . . . to win compliance." Valerie Braithwaite, *Responsive Regulation and Taxation: Introduction*, 29 LAW & POL'Y 3, 4 (2007).

[156] AYRES & BRAITHWAITE, *supra* note 14, at 4.

[157] *Id.* at 4.

[158] *See, e.g.*, JOHN BRAITHWAITE, MARKETS IN VICE, MARKETS IN VIRTUE 37–68 (2005) (describing Australia's experience with responsive regulation in tax context); TAXING DEMOCRACY, *supra* note 13 (presenting collection of scholarly essays on responsive regulation).

[159] Braithwaite, *supra* note 20, at 2.

[160] *Id.* at 4.

[161] *Cf. generally* RUSSELL HARDIN, TRUST (2006) (exploring significance of trust and trustworthiness).

Cooperative behavior earns greater autonomy, which, in turn, promotes increased cooperation. Ideally, that iterative process evolves into a self-reinforcing "compliance spiral" in which a light regulatory touch produces increased compliance.[162]

In addition, by granting cooperative taxpayers greater autonomy in meeting their tax obligations, tax authorities are also able to focus their enforcement resources elsewhere. Theoretically, the end result is a higher level of compliance combined with a lighter regulatory burden on the typical taxpayer.[163]

Two recent proposals provide content, in the tax context, to the responsive regulation premise of de-escalation in exchange for compliance. John Braithwaite provides the first, which he describes as a "compliance-tax-rate-spiral."[164] He suggests that a tax authority might establish five benchmarks of corporate tax compliance "set so that the aggregate increase in revenue from increased tax and increased penalties on non-compliers at each benchmark would be calibrated at the cost of a 2 percent tax cut."[165] Although he concludes that for the time being adopting such an approach would be "premature,"[166] it could one day "forge a more meaningful business-community-government partnership toward a decent tax system."[167]

The second proposal offers a similarly "radical departure from the traditional approach to tax administration," offering taxpayers greater autonomy by allowing them to elect between two different enforcement regimes.[168] Alex Raskolnikov proposes introducing a new option, which would allow taxpayers to avoid high penalties by demonstrating their commitment to compliance. For example, taxpayers could agree that "the government's position will be presumed correct unless proven otherwise by clear and convincing evidence."[169] Those taxpayers unwilling to accept such conditions, identified by Raskolnikov as "actors whose marginal compliance decisions depend

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[162] *See infra* Part III.B (discussing compliance spirals).

[163] Alex Raskolnikov argues for just such a bifurcated enforcement regime on welfarist grounds. *See* Alex Raskolnikov, *Revealing Choices: Using Taxpayer Choice To Target Tax Enforcement*, 109 COLUM. L. REV. 689, 693 (2009) ("Targeted tax enforcement . . . can produce stronger deterrence and improved voluntary compliance at a lower social cost . . . .").

[164] John Braithwaite, *Large Business and the Compliance Model*, *in* TAXING DEMOCRACY, *supra* note 13, at 188 (emphasis omitted). While reducing tax rates falls outside the definition of tax deregulation as I have discussed it, rate reductions could also provide the necessary incentive to taxpayers to induce compliance.

[165] *Id.* at 188–89.

[166] *Id.* at 188.

[167] *Id.* at 189.

[168] Raskolnikov, *supra* note 163, at 691.

[169] *Id.*

primarily on the expected tax penalty calculus," or "gamers," will remain subject to the current enforcement regime but will be subject to substantially higher penalties.[170]

For critics of responsive regulation, the feat of increasing compliance by increasing private autonomy smacks of alchemy. Their suspicion falls equally on policymakers (who may merely pretend to provide greater autonomy to regulated entities) and on regulated entities (who may fool regulators into seeing compliance improvements where there are none).[171] In some cases, the stakes of the debate can be exceedingly high.[172]

3. *Fiscal Arbitrage*

Despite nearly a half century of effort, the goal of eliminating differences in the treatment of direct spending and tax "spending" (so-called "tax expenditures") remains stubbornly out of reach.[173] As a result, policymakers have good reason to substitute tax benefits for direct spending.[174] Implicit in tax expenditure analysis is the presump-

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[170] *Id.* at 691–92 (proposing that government measures to deter tax avoidance be targeted to address multiple taxpayer motivations for avoidance). In responsive regulation terminology, those categories would correspond to the compliance postures of "commitment" and "game playing." Valerie Braithwaite et al., *Taxation Threat, Motivational Postures, and Responsive Regulation*, 29 LAW & POL'Y 137, 139 (2007).

[171] *See supra* note 16 (discussing risk of feigned delegation and compliance). Responsive regulation falls into a broader category labeled "new governance." *See* Cristie L. Ford, *New Governance, Compliance, and Principles-Based Securities Regulation*, 45 AM. BUS. L.J. 1, 27 (2008) (describing concept of new governance as "identif[ying] ongoing deliberation as the most legitimate and most effective mechanism for making decisions in complex organizational structures," with such deliberation "accomplished by decentralized, broadly participatory stakeholder groups"). *See generally* David A. Super, *Laboratories of Destitution: Democratic Experimentalism and the Failure of Antipoverty Law*, 157 U. PA. L. REV. 541 (2008) (attributing failure of decades of antipoverty law in general to democratic experimentalism, one facet of new governance).

[172] *Cf. id.* at 541 (arguing that new governance contributed to tragic consequences of Hurricane Katrina for New Orleans).

[173] Stanley S. Surrey is credited with popularizing the tax expenditure concept, which attempts to make tax benefits equivalent to direct spending for budget purposes. *See generally* STANLEY S. SURREY, PATHWAYS TO TAX REFORM: THE CONCEPT OF TAX EXPENDITURES (1973). By highlighting the equivalence between direct spending and tax expenditures, Surrey endeavored to prevent "[g]overnmental financial assistance programs" from being "grafted on to the structure of the income tax proper." *Id.* at 6. Of course any such system of accounting is inherently limited in its capacity to create a full and coherent picture of the fiscal landscape. Professors Murphy and Nagel refer to our tendency to rely on readily available information such as budget and tax expenditure data as a form of myopia. MURPHY & NAGEL, *supra* note 33, at 14 ("Myopia afflicts the contemporary legislative process in the United States in a simple and dramatic way, in the form of tables that set out the distribution of tax burdens associated with various tax reforms.").

[174] *See* SURREY, *supra* note 173, at 6 ("[L]ess critical analysis is paid to these tax expenditures than to almost any direct expenditure program one can mention. The tax

tion that because tax expenditures can be simultaneously large and hidden from public view, they can permit legislators to engage in fiscal arbitrage. Fiscal arbitrage describes the exploitation of imperfections in the political and legislative processes by disguising spending measures as tax provisions. The opportunities fiscal arbitrage creates for subterfuge suggest that it should be treated with skepticism.[175]

Unfortunately, as generations of leading scholars have shown, the tax system has long provided a potent means of camouflaging government spending, distorting decision making by both politicians and their constituents.[176] Tax expenditures can be large and familiar, as is true of the home mortgage interest deduction, or they can be more narrowly targeted.[177] Tax expenditures take the shape of deviations from income as characterized by the popular and comprehensive (but entirely theoretical) Haig-Simons definition.[178]

For example, because the best method rule promotes the Haig-Simons ideal of the economically accurate measurement of income, it would be difficult to characterize it as a tax expenditure. By contrast, both safe harbor leasing and the divisive reorganization reform grant taxpayers a special preference and represent a deviation from Haig-Simons income. The policies embodied in safe harbor leasing rules—principally promotion of capital investment—would almost certainly

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expenditures tumble into the law without supporting studies, being propelled instead by cliches, debating points, and scraps of data and tables that are passed off as serious evidence."). Still, the tax expenditure concept has been subject to serious criticism since its inception. *See, e.g.*, Boris I. Bittker, *Accounting for Federal "Tax Subsidies" in the National Budget*, 22 NAT'L TAX J. 244, 261 (1969) (questioning coherence of tax expenditure concept); Douglas A. Kahn & Jeffrey S. Lehman, *Tax Expenditure Budgets: A Critical Review*, 54 TAX NOTES 1661, 1663 (1992) (doubting normative baseline—pure income tax—implicit in tax expenditure analysis); Daniel N. Shaviro, *Rethinking Tax Expenditures and Fiscal Language*, 57 TAX L. REV. 187, 188 (2004) (questioning whether "a mere fiscal language innovation either can or should categorically shape political outcomes").

175 Others are less certain that tax expenditures are systematically under-examined. *See, e.g.*, David A. Weisbach & Jacob Nussim, *The Integration of Tax and Spending Programs*, 113 YALE L.J. 955, 957 (2004) ("[T]he decision to implement a 'nontax' program through the 'tax system' . . . is solely a matter of institutional design."); Edward A. Zelinsky, *James Madison and Public Choice at Gucci Gulch: A Procedural Defense of Tax Expenditures and Tax Institutions*, 102 YALE L.J. 1165, 1166 (1993) (arguing that by concentrating variety of spending decisions into single rulemaking process, tax expenditures are more easily scrutinized than other expenditures).

176 *See* Shaviro, *supra* note 174, at 187 (arguing that analysis of tax expenditures has had "little if any effect" on their persistence).

177 *See* JOINT COMM. ON TAXATION, 111TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2009–2013, 33 tbl.1 (Comm. Print 2010) (estimating 2011 cost of home mortgage interest deduction at $119.9 billion and cost of deduction for overnight-travel expenses of national guard and reserve members at $100 million).

178 *See* Martin D. Ginsburg, *Taxing the Components of Income: A U.S. Perspective*, 86 GEO. L.J. 123, 127 (1997) ("[Haig-Simons defines] personal income as the market value of rights exercised in consumption plus net increase in investment assets during the year.").

have been more effective if pursued through direct spending.[179] The divisive reorganization reforms present a more complex picture. It is certainly possible to imagine a regime under which the expenses of a predivision restructuring would be subsidized directly. That would have the advantage of limiting the benefit of the reform to businesses that actually have the option of restructuring (excluding those unable to restructure for regulatory, contractual, or other reasons). Such an arrangement would, of course, be a boon to legal advisors. More importantly, however, it might require a nontax agency—one unfamiliar with the policies and risks implicated by nonrecognition—to answer the tax-driven question of who should be entitled to reimbursement.[180]

Fiscal arbitrage is a product of the practical limits of tax expenditure analysis.[181] Although tax expenditure analysis demonstrates that spending and tax rules are often interchangeable, it is hardly a Rosetta Stone that translates every tax provision into its spending analogue. Inevitably, the true fiscal impact of changes in the tax laws sometimes goes unrecognized by the public. One consequence is that policymakers have opportunities to buy low (when the cost of a favorable tax provision is unwittingly borne by the public) and sell high (because the recipients of their largesse understand its value).

Relying on tax expenditures rather than direct spending thus enables legislators to engage in three types of fiscal arbitrage—budgetary arbitrage, cognitive arbitrage, and procedural arbitrage. The most basic problem, budgetary arbitrage, occurs where the definition of a tax expenditure is underinclusive.[182] If the tax-free treatment granted to certain corporate reorganizations should be classified as a tax expenditure but is not, government actors hoping to curry favor with corporate interests could make those provisions more generous, seemingly without any budgetary impact. In such circumstances, policymakers have a clear incentive to substitute tax rules in place of

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179 *See* Warren & Auerbach, *supra* note 52, at 1779 (concluding that using tax system, and concept of leasing in particular, as means of delivering subsidy to struggling businesses was misguided).

180 *See* Weisbach & Nussim, *supra* note 175, at 959 (employing institutional design theory to conclude that it makes sense for tax specialists to focus on tax matters while leaving other issues to different types of specialists). Asking a nontax agency to decide who should qualify for the subsidy would be problematic, even if not as absurd as "bespectacled revenue agents . . . parachuting into the Hindu Kush wearing night goggles, camouflage, and pocket protectors." *Id.* at 958.

181 *See, e.g.*, Bittker, *supra* note 174, at 247 (observing that tax expenditure concept is difficult to implement because of need for line drawing).

182 *See id*. at 250 (noting that "a consistent application" of tax expenditure concept would include variety of traditionally excluded tax rules such as corporate reorganizations and other nonrecognition provisions).

spending provisions. The resulting off-budget expenditures subvert the public's ability to monitor government spending, which encourages excessive use of the tax system to achieve non-revenue goals.[183] In the current era of budget deficits, opportunities for surreptitious outlays may become increasingly tempting and troublesome.[184]

Even when the tax expenditure budget does fully capture the cost of tax expenditures (eliminating the possibility of budgetary arbitrage), policymakers still have reason to engage in fiscal arbitrage, favoring tax expenditures over direct expenditures.[185] Cognitive psychologists have shown how superficial differences between substantively identical fiscal alternatives can affect the way in which individuals respond to them.[186] Because they facilitate the exploitation of cognitive biases, including through the careful use of fiscal language, tax expenditures continue to distort the political process even though a completely rational public would ignore purely formal distinctions among policy alternatives. Given the ubiquity of tax expenditure analysis, this cognitive arbitrage may be the most important form of fiscal arbitrage.[187]

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[183] *See* SURREY, *supra* note 173, at 6 (describing tax expenditures as "a vast subsidy apparatus that uses the mechanics of the income tax" but has "no basic relation to that structure").

[184] *See, e.g.*, OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, A NEW ERA OF RESPONSIBILITY: RENEWING AMERICA'S PROMISE, PRESIDENT'S FISCAL YEAR 2010 BUDGET 114 (2009), *available at* http://www.gpoaccess.gov/usbudget/fy10/pdf/fy10-newera.pdf (projecting deficit of just under $7 trillion between 2010 and 2019).

[185] When it works, the tax expenditure budget eliminates objective differences between tax and spending. It does not, however, eliminate the differences in the way they are perceived. The recent health care debate has underscored how important labels can be. *See* Adam Nagourney & David M. Herszenhorn, *Republicans Call Health Legislation a Tax Increase*, N.Y. TIMES, Oct. 2, 2009, at A22 ("Republican leaders hoping to derail Mr. Obama's health care effort have seized on a new line of attack: that the proposed overhaul is a vehicle for a barrage of hidden and not-so-hidden tax increases, and a violation of Mr. Obama's pledge not to raise taxes on families earning less than $250,000 a year.").

[186] *See* Edward A. Zelinsky, *Do Tax Expenditures Create Framing Effects—Volunteer Firefighters, Property Tax Exemptions, and the Paradox of Tax Expenditure Analysis*, 24 VA. TAX REV. 797, 799 (2005) ("For individuals succumbing to framing effects, labels obscure the similarities between policies that are substantively and procedurally identical but differently-named. . . . For these individuals, policies unacceptable when framed as direct expenditures become supportable when labeled as tax subsidies, even though the economic substance of the policies is the same.").

[187] Zelinksy suggests that the power of cognitive arbitrage offers one reason for the odd blend of persistence despite inefficacy that characterizes tax expenditure analysis. *See id.* at 798 ("While tax expenditure analysis has been enormously successful as a procedural program, it has largely been unsuccessful in substantive terms, failing to curb legislatures' use of tax systems for expenditure-type programs."); *see also* Shaviro, *supra* note 174, at 187 ("Tax expenditure analysis is like a hardy plant with shallow roots that spreads widely, resisting the occasional effort to extirpate it, while having little if any effect on the soils in which it sprouts.").

Legislators' desire to circumvent parliamentary rules and procedures provides another potential motivation for fiscal arbitrage.[188] Recasting tax provisions as tax expenditures does not ensure that they will be treated as spending provisions for all purposes, and this inherent limitation of tax expenditure analysis undermines legislators' capacity to govern their own behavior. For example, spending can be presented as a tax expenditure to avoid parliamentary obstacles such as the filibuster or to flout budget rules through the use of sunset provisions. The increasing popularity of sunset provisions in tax legislation may be in part a symptom of legislators' efforts to skirt self-imposed budget rules.[189] As a result, procedural arbitrage may represent as much of a threat to the parliamentary process as it does to the political process.

Whatever the ideal balance between tax and direct expenditures may be, fiscal arbitrage has the potential to disturb it. More importantly, by undermining formal and informal fiscal constraints, tax deregulation further darkens an already bleak budget landscape, exacerbating a fiscal crisis that has raged for years.[190]

The next Part applies the theoretical framework developed in this Part to evaluate the deregulatory tax reforms introduced in Part I. Ultimately, it concludes that, although different deregulatory tax reforms may vary in their relative potential for utility and mischief, tax deregulation is likely to be deleterious overall.

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[188] Rebecca Kysar provides an illuminating exploration of the challenges faced by congressional efforts at self-regulation. *See* Rebecca M. Kysar, *Listening to Congress: Earmark Rules and Statutory Interpretation*, 94 CORNELL L. REV. 519, 521 (2009) ("Just as if Ulysses had hidden tools to loosen his ties . . . Congress possesses the ability to interpret, to enforce, and ultimately to undo its precommitment devices.").

[189] *See* Rebecca M. Kysar, *Lasting Legislation*, 159 U. PA. L. REV. 1007, 1018–19 (2011) ("These estimates [of the cost of budget legislation] ignore sunset provisions for spending programs with current-year costs greater than $50 million, but do not for other programs. For purposes of estimation in the tax-cutting context, the committees assume sunset provisions take effect even though, for the most part, temporary tax cuts do not expire but instead are routinely renewed." (footnote omitted)).

[190] Deficits are not the only harm engendered by fiscal arbitrage. A litany of ills has been attributed to tax expenditures (and by implication, fiscal arbitrage). For example, differences in legislators' perceptions of substantively equivalent spending and tax provisions have brought about a regressive system of tax expenditures. *See* Zelinsky, *supra* note 186, at 803 ("Legislators . . . do not review tax subsidies with the same care they give to direct budgetary outlays. No legislature . . . would enact a direct spending program that conveys its benefits in upside-down fashion, nor would a legislature vote for such a tax subsidy if the subsidy's true nature were disclosed.").

III
Compliance Spirals, Fiscal Arbitrage, and Tax Deregulation

Deregulatory tax reforms neither promote economic efficiency nor vindicate important liberty interests, and it is unclear whether they simplify tax law. Nevertheless, deregulatory reforms that embrace the teachings of the responsive regulation literature may be valuable. This Part compares and contrasts the three deregulatory reforms presented in Part I to distinguish tax deregulation that promotes responsive regulation through compliance spirals from tax deregulation that merely encourages fiscal arbitrage.

While tax deregulation will ordinarily do more harm than good, by employing the framework developed in Part II to evaluate and shape deregulatory tax reforms, policymakers could pursue normatively superior deregulatory strategies. The remainder of this Part operationalizes that insight by examining the three examples of deregulatory tax reforms described above. The notions of compliance spirals and fiscal arbitrage together offer a robust method for identifying those reforms most likely to deliver on tax deregulation's promise of mutually beneficial cooperation between tax authorities and taxpayers with minimal damage to the fisc.

A. *Evaluating Tax Deregulation*

Whether reform of a command-and-control rule to give taxpayers greater authority over their own tax treatment is likely to generate a desirable blend of public and private benefits depends in part on the nature of the tax autonomy it provides. The three reforms presented above suggest several possibilities. Deregulatory efforts that increase structural autonomy may be more likely to become vehicles for fiscal arbitrage than deregulation proposals aimed at increasing reporting autonomy. Alternatively, reporting autonomy may offer tax authorities more opportunity to evaluate a taxpayer's compliance posture. Or it may be that tax deregulation implemented at the regulatory, rather than the legislative, level is more likely to promote improved compliance.[191]

Unfortunately, these observations do not indicate a causal relationship between the characteristics of a particular deregulatory provi-

[191] The best method rule, an example of reporting deregulation, illustrates all three patterns. It provides taxpayers with relatively modest benefits and provides tax authorities with useful information. The best method rule was introduced by regulation, unlike safe harbor leasing and the divisive reorganization reforms, both of which were introduced by statute.

sion and their effects. For example, both alternatives for offering taxpayers greater autonomy in the divorce context (i.e., increasing reporting or structural autonomy) have the same fiscal arbitrage potential.[192] More importantly, such speculation fails to identify the relationship between the costs and benefits of specific tax deregulation proposals.[193] This Section offers a framework for analyzing the relative benefits and harms of tax deregulation by viewing such proposals through the lenses of responsive regulation and fiscal arbitrage.

1. *Responsive Regulation: Promoting Taxpayer Compliance*

In the responsive regulation framework, assessing a private party's compliance posture is the essential precursor to choosing between rewarding heightened cooperation or making more vigorous use of sanctions.[194] Of the three deregulatory reforms considered above, the best method rule provides the most credible means for tax authorities to distinguish among taxpayers based on each taxpayer's behavior. Neither of the other reforms provides authorities with a reliable tool for gauging affected taxpayers' compliance postures.

The best method rule provides precisely the sort of mechanism that responsive regulation envisions.[195] In particular, the best method

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[192] *See supra* notes 47–48 and accompanying text (discussing tax autonomy implications of marriage and divorce decisions).

[193] Increased structural autonomy might facilitate a significant amount of fiscal arbitrage, but it might also increase compliance. Conversely, increasing reporting autonomy may lead neither to fiscal arbitrage nor to increased compliance. It is not difficult to imagine an administrative deregulatory reform that increases reporting autonomy, but which provides private benefits without any public benefit. An example might be allowing taxpayers to designate exchanges that satisfy the material difference standard of Treasury Regulation section 1.1001-3 (1996), which governs when a modification counts as an exchange for purposes of the realization requirement.

[194] *See* Ayres & Braithwaite, *supra* note 14, at 4 ("[R]egulation should respond to industry conduct . . . . The very behavior of an industry or the firms therein should channel the regulatory strategy to greater or lesser degrees of government intrusion. . . . By credibly asserting a willingness to regulate more intrusively, responsive regulation can channel marketplace transactions to less intrusive and less centralized forms of government intervention."); Braithwaite, *supra* note 20, at 4 (describing structure of responsive regulation regime as regulatory pyramid, under which most taxpayers can be encouraged to comply without coercion, but more coercive options are available to induce compliance if necessary); Raskolnikov, *supra* note 163, at 693 (arguing that enforcement based on taxpayer choice improves tax administration and compliance); *see also* Braithwaite, *supra* note 158, at 68–102 (providing example of Australian Compliance Model of responsive regulation, under which taxpayers were allowed to self-assess; those who did not engage in evasion or aggressive tax planning were rewarded with guaranteed procedural protections, and much greater emphasis was placed on enforcement capability and legal penalties for noncompliance).

[195] *See* Margaret Milner Richardson, *Richardson Outlines Progress in International Tax Issues*, Tax Notes Today, Dec. 15, 1994, 94 TNT 246-28 ("To avoid a . . . penalty . . . it is the taxpayer's responsibility to do the work . . . . We are confident that giving taxpayers

rule creates no opportunity for fiscal arbitrage and grants taxpayers little more autonomy than is necessary to reveal their compliance posture. In this regulatory scheme, taxpayers gain the power to self-regulate as tax authorities cede primary responsibility for assessing taxpayers' compliance.[196] In exchange for that concession, tax authorities receive two distinct benefits. First, taxpayers inclined toward public-regarding behavior have an opportunity to demonstrate their good faith by offering regulators a useful starting point in evaluating their compliance.[197] Second, and no less important, by failing to follow suit, noncomplying taxpayers reveal their unwillingness to cooperate with authorities.[198]

By shifting enforcement resources away from the first group and toward the second, regulators may be able to increase compliance among both. For taxpayers demonstrating good faith, the carrot of a less heavy-handed enforcement approach would generate goodwill and encourage their inclination towards public-regarding behavior. For uncooperative taxpayers, deploying the stick of aggressive enforcement would overcome their reluctance to adhere to the arm's-length standard.[199] In effect, taxpayers are forced to identify themselves as what Raskolnikov labels gamers and non-gamers.[200]

Safe harbor leasing sits at the opposite end of the spectrum. Safe harbor leasing does not promote self-regulation at all, at least in the

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flexible pricing guidance, backed up with a reasonable documentation requirement and appropriate penalty enforcement, is the right formula for attaining . . . compliance."). It would be interesting to evaluate the extent to which authorities capitalized on the compliance-enhancing potential of the best method rule.

196 *See* Braithwaite, *supra* note 20, at 4 ("[I]f taxpayers are prepared to meet their obligations with minimum interference by the tax office, they should be left alone to get on with it."); *see also supra* note 157 and accompanying text (discussing framework for designing successful responsive regulation regime).

197 *See id.* at 5 ("Taxpayers have the opportunity to persuade the tax office at the same time as the tax office is trying to persuade the taxpayer. . . . If the regulatee chooses a cooperative response, the regulator cooperates.").

198 *See id.* ("If the regulatee's choice is uncooperative, the regulator moves to a higher level of enforcement that imposes higher costs on the non-complier."). The best method approach fits squarely within the responsive regulation premise of greater self-regulation coupled with discretionary oversight. The direct linkage between the reporting requirement and the penalty provisions is consistent with the responsive regulation notion of affording taxpayers an opportunity to demonstrate cooperation while presenting the possibility of harsh sanctions for noncompliance.

199 *See id.* ("[C]ostly enforcement resources are not wasted on those who are willing to comply, but are reserved for the smaller proportion of the population not willing to cooperate with the authority . . . .").

200 *See* Raskolnikov, *supra* note 163, at 701 (distinguishing between gamers—"rational taxpayers whose marginal compliance decisions are made primarily based on the expected tax penalty calculation"—and all others).

sense that responsive regulation uses that term.[201] Taxpayers and tax authorities have long been engaged in a cat-and-mouse game over attempts to circumvent limits on the availability of tax benefits; safe harbor leasing rules merely provided taxpayers with a sanctioned route to their preferred destination. The result is more a capitulation by tax authorities than the collaboration that is responsive regulation's goal.[202] Taxpayers gain new freedom to achieve a favorable tax result, but because that result flows from a transaction between private parties, tax authorities acquire no insight regarding taxpayers' compliance posture.[203]

The divisive reorganization reform produces an outcome that is similar but not identical to that of safe harbor leasing. It certainly does not create a formal link between tax benefits and tax compliance in the way that John Braithwaite proposes.[204] Nor does it elicit the type of taxpayer-specific information that Raskolnikov's approach would generate and that tax authorities could use in distinguishing compliant from noncompliant taxpayers.[205]

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[201] In the responsive regulation pyramid, "self-regulation" is associated with the motivational posture of "commitment," which is a demonstrated initiative to comply with regulations. Braithwaite, *supra* note 20, at 3. One could easily conclude that safe harbor leasing is more indicative of "resistance" or even "disengagement," both of which "reflect a conscious holding back of cooperation." *See id.*

[202] One argument made in favor of safe harbor leasing was that private counterparties would serve a useful function by policing potential fraud on behalf of tax authorities. *See* Henry V. Barry, Note, *Safe Harbor Leases: The Costs of Tax Benefit Transfers*, 34 Stan. L. Rev. 1309, 1319–20 (1982) ("A second justification for the lease mechanism is that lessors perform a fraud monitoring function that would otherwise fall on an already overburdened IRS."). While lessors would certainly have no incentive to participate in fraud, there is no reason to believe that they would root out any but the most egregious examples of fraud. If it were indeed true that authorities lacked the ability to monitor such transactions themselves, aggressive planning—if not outright deception—would produce more benefits for all parties at little risk.

[203] A direct-spending or command-and-control tax alternative might have generated more information. For example, filing requirements imposed on taxpayers wishing to claim the hypothetical tax refund could have provided authorities with information regarding the nature of the underlying investment. Recent experience with temporary provisions encouraging repatriation of foreign profits offers a mixed picture. Businesses claiming the benefits of this provision were required to document their use of the proceeds to make investments in the United States that would create or retain U.S. jobs. *See* I.R.S. Notice 2005-10, 2005-10 I.R.B. 474, 476 (describing requirements for "domestic reinvestment plan"). In fact, not all repatriations facilitated by the provision resulted in the creation or retention of jobs. *See* Craig M. Boise, *Breaking Open Offshore Piggybanks: Deferral and the Utility of Amnesty*, 14 Geo. Mason L. Rev. 667, 717 (2007) (observing that in some instances tax benefits financed job cuts rather than retention or creation).

[204] *See supra* notes 164–67 and accompanying text.

[205] *See supra* notes 168–70 and accompanying text.

Tax-free divisive reorganizations are a phenomenon specific to relatively sophisticated corporate taxpayers.[206] To the extent that such taxpayers can be viewed as a coherent group, a tax preference targeted toward that group could promote a collective compliance spiral implicating affected taxpayers. At a time when even household brands were embroiled in tax shelter controversies, one could argue that this gesture played a role in easing tensions between taxpayers and authorities.[207] Although this particular reform was not explicitly conditioned on increased taxpayer compliance, it might be understood that in the future, similarly targeted measures would be politically difficult without such a compliance improvement.

Regulators would, of course, be unable to limit the availability of favorable treatment to specific cooperative taxpayers. So long as the relevant group of taxpayers—here, sophisticated corporate taxpayers that have complex organizational structures and engage in transactions such as tax-free divisive reorganizations—is both limited and clearly defined, that might not matter. That loose link between deregulation and compliance could create an informal compliance spiral. When the deregulatory gesture is available to a broader group, as was the case with safe harbor leasing, the likelihood that such a collective compliance spiral will gain momentum becomes more remote.

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[206] Part of the motivation for the reform of the divisive reorganization rules was that today these transactions frequently involve a relatively limited pool of sophisticated corporate taxpayers. *See* Schler, *supra* note 92, at 240 ("Today spinoffs are often done by large, publicly traded corporations with complex corporate structures."). By contrast, while a safe harbor lease required the lessor (the purchaser of the tax benefits) to be a corporation, there was no comparable limitation on the lessee, the primary beneficiary of the safe harbor lease. Economic Recovery Tax Act of 1981, I.R.C. § 168 (Supp. V 1976) (repealed 1982).

[207] It is not difficult to believe that the divisive reorganization reforms were intended partly as a means of generating goodwill—and increased voluntary compliance—on the part of taxpayers. *See, e.g.*, *Tax Code Complexity: New Hope for Fresh Solutions: Hearing Before the S. Comm. on Fin.*, 107th Cong. 39–40 (2001) (statement of Richard M. Lipton, Chair, Section on Taxation, American Bar Association) (suggesting that "simplification" proposals, including look-through rule for corporate divisions, might have positive impact on "willingness of the average taxpayer voluntarily to comply with his or her tax obligations"). A collective compliance spiral could be useful in counteracting enforcement challenges specific to a given group. For example, starting in the late 1990s, a wave of corporate tax shelters strained relations between corporate taxpayers and tax authorities. Even household names like Colgate became embroiled in hard-fought tax shelter litigation. *See* David Cay Johnston, *Corporations' Taxes Are Falling Even as Individuals' Burden Rises*, N.Y. TIMES, Feb. 20, 2000, at 1 (describing involvement of well-known corporate brands in tax shelter controversies). These disputes pushed taxpayers and regulators toward the adversarial peak of responsive regulation's pyramid. In the end, the targeted deregulatory measure may well have helped defuse this conflict between corporate taxpayers and authorities.

2. *Fiscal Arbitrage: Tax Deregulation's Downside*

By helping to promote taxpayer compliance, providing increased autonomy can simultaneously serve public and private interests. Unfortunately, while a compliance spiral tends to behave like a hothouse flower, fiscal arbitrage is a weed. Whenever a change in the tax laws provides taxpayers with a benefit that is the economic equivalent of a nontax benefit, fiscal arbitrage follows. Even when the tax expenditure budget eliminates budgetary arbitrage, procedural and cognitive arbitrage will persist. Only when a tax provision has a unique fiscal footprint (or, as with the best method rule, none at all) will there be no possibility of arbitrage.

The divisive reorganization reform provided opportunities for policymakers to engage in cognitive, procedural, and budgetary arbitrage. It is easy to see the effect of cognitive arbitrage in this measure. Congressional enactment of an economically identical proposal to create a direct subsidy for predivision restructuring transactions would be hard to imagine.[208] Procedural arbitrage exploited differences in the parliamentary treatment of tax and spending legislation.[209] Since nonrecognition provisions are not classified as tax expenditures, the reduced revenues that result from expanding access to tax-free corporate divisions would not have been reflected on a tax expenditure budget.[210] That combination of cognitive, procedural, and budgetary arbitrage allowed policymakers to deliver a subsidy to corporate

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[208] *See generally* Zelinsky, *supra* note 186 (discussing tax expenditures in context of so-called framing effects, which posit that manner in which choices are framed determines how such choices are perceived, and empirically testing for such effects in tax expenditure context). In the case of divisive reorganization reform, the contrast between making this change as a tax measure rather than through direct spending was particularly stark, as lawmakers described the provision as tax simplification rather than a tax break. *See infra* note 220 (citing references to measure as simplification). Ironically, it may have been possible to deliver that direct subsidy at a lower fiscal cost. Some businesses—perhaps as a result of nontransferable contract rights or licenses—would have been unable to reorganize at all. For example, if one business were divided into two corporate shells in an attempt to segregate risky aspects (say, chemical manufacturing) from non-risky activities (research and development of chemicals), one or both of those corporations might fail to meet the active trade or business test. The out-of-pocket cost of reorganization might not have been as much of an obstacle as a reluctance to combine the two parts of the business into a single corporate shell. In other words, the reform broadened access to tax-free corporate division treatment more than a direct subsidy for the costs of a reorganization would have.

[209] *See supra* notes 188–89 and accompanying text (explaining procedural arbitrage).

[210] An early critic of tax expenditure analysis complained that this type of omission was arbitrary. *See* Bittker, *supra* note 174, at 250 (identifying corporate reorganizations' nonrecognition as tax expenditure even though early tax expenditure literature did not acknowledge it as such).

transactions that is almost impossible to imagine being delivered directly.

Because safe harbor leasing did not enjoy the same special status as nonrecognition provisions, it was classified as a tax expenditure. As a result, its fiscal arbitrage potential was more limited. The 1982 tax expenditure budget reflected a reduction in federal revenues by an estimated $2.65 billion as a result of the existence of the safe harbor leasing provisions.[211] Of course, its classification as a tax expenditure did not prevent either procedural or cognitive arbitrage. As a result, it is not surprising that contemporary commentators suggested fiscal arbitrage may have motivated the use of tax deregulation to implement this subsidy.[212]

In contrast, there simply is no direct-spending equivalent to dispensing with a strict hierarchy of methods, so there is no opportunity for fiscal arbitrage with the best method rule. Although it presumably had some influence on the budget for which it was impossible to account, it is not appropriate to think of that as budgetary arbitrage.[213] Likewise, there can be no cognitive or procedural arbitrage without more than one fiscal form. Even if we assume that the creation of the best method rule allowed legislators to deliver a tax benefit to a favored constituency, it would not have been fiscal arbitrage.

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[211] CONG. BUDGET OFFICE, TAX EXPENDITURES: BUDGET CONTROL OPTIONS AND FIVE-YEAR BUDGET PROJECTIONS FOR FISCAL YEARS 1983–1987, at 8 (1982), *available at* http://www.cbo.gov/ftpdocs/59xx/doc5940/doc34-Entire.pdf [hereinafter TAX EXPENDITURES]. Tax expenditures can vary greatly in size. *See* JOINT COMM. ON TAXATION, 111TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2009–2013, at 26–47 (Comm. Print 2010) (showing range of costs of tax expenditures).

[212] It was widely acknowledged that both direct spending and command-and-control tax expenditure alternatives were rejected for political reasons. *See Safe-Harbor Leasing's Stormy Future*, BUS. WK., Dec. 21, 1981, at 104, 104 (concluding that political considerations played role in rejecting alternative approaches out of concern that they "would show up on the federal budget as outlays rather than as reductions in revenues"); Sunley, *supra* note 64, at 289 ("Many in the business community opposed a refundable credit since it would give the appearance of backing losers; that is, giving tax subsidies to unprofitable companies.").

[213] Since the best method rule offers taxpayers reporting rather than structuring autonomy, the economic benefit it provides to taxpayers is limited. No less important, taxpayers generate contemporaneous reports justifying their choices, and authorities retain the discretion to overrule those choices. A well-advised taxpayer may benefit from its choice of methods, but even that choice remains subject to review by the authorities. By contrast, a taxpayer engaged in a safe harbor lease transaction that meets the statutory requirements is assured of the benefits specified by the statute. As a result, the best method rule is a poor vehicle for the largesse that is essential to fiscal arbitrage.

B. Micro- and Macro-Compliance Spirals

This Section weaves the distinctions drawn above into a simple method for assessing the normative appeal of deregulatory tax reforms. Compliance spirals operate both on a broad scale—where they affect a large class of taxpayers—and on a small scale—where they implicate only a few taxpayers. This difference in scale creates different kinds of incentives. At one end of the spectrum are macro-compliance spirals, which create a high risk of fiscal arbitrage and a low likelihood of creating a compliance spiral. At the other, the micro-compliance spiral presents the opposite, much more appealing, combination: a low risk of fiscal arbitrage and a high likelihood of an effective compliance spiral.

The relationship between the probability of success and the nature of the compliance spiral in question is relatively straightforward. If tax authorities have the capacity to observe the behavior of particular taxpayers, they can readily adjust their enforcement intensity to suit each taxpayer.[214] At the same time, if a taxpayer believes that changes in her behavior will directly influence the intensity of the treatment she receives, she will be more responsive to the prospect of more favorable treatment.[215] That describes the operation of a Raskolnikovian micro-compliance spiral.[216] In a macro-compliance spiral, another taxpayer's treatment depends not only on his actions but on those of all the other taxpayers in a given class, so that if they collectively demonstrate a cooperative attitude, they will receive more favorable treatment. Thus, the link between the individual taxpayer's behavior and the amount of scrutiny the taxpayer receives will inevitably be much weaker.[217]

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[214] *See* Raskolnikov, *supra* note 163, at 707 (arguing that causing taxpayers to reveal their inclination towards cooperative or aggressive behavior would allow authorities "to match enforcement strategies with taxpayer types").

[215] If a taxpayer believes his behavior will elicit a direct response from a regulator, he will factor in the likely punishment or rewards from that regulator when deciding how to behave. *See* Braithwaite, *supra* note 164, at 198 (explaining that regulator who demonstrates that she is "willing to escalate" intensity of her enforcement efforts in response to particular taxpayer's level of cooperation "rarely actually finds it necessary to escalate" with respect to that taxpayer).

[216] Raskolnikov's "compliance regime" creates the potential for something like a micro-compliance spiral, with a single taxpayer identifying herself as a "non-gamer" and thereby voluntarily limiting her avoidance options (e.g., accepting more stringent standards for tax preparers) and receiving preferred treatment from tax authorities (e.g., receiving reimbursement of costs when an audit is conducted). Raskolnikov, *supra* note 163, at 715–40 (describing features of compliance regime applicable to non-gamers).

[217] The contingent nature of the connection between the deregulatory tax benefits and increased compliance in a macro-compliance spiral also creates opportunities for policymakers to misrepresent the existence of such a link. Attributing a change in the behavior of a class of taxpayers over a given period to a particular policy change would be difficult,

The influence of the scale of the compliance spiral on fiscal arbitrage is more subtle. If tax authorities are to successfully communicate with a relatively large group of taxpayers, the signal they use to invite taxpayer cooperation would need to be both salient and relevant to as many taxpayers in that class as possible. That would favor precisely those deregulatory tax provisions most likely to create the gravest risk of fiscal arbitrage. Policymakers will inevitably seek to maximize the salience of deregulatory provisions for its beneficiaries while relying on cognitive, procedural, and budgetary arbitrage to minimize its visibility to their (non-beneficiary) constituents.

Returning to the three illustrative deregulatory provisions, the contrast between micro- and macro-compliance spirals is striking. The best method rule seeks to create micro-compliance spirals. Affected taxpayers gain flexibility coupled with an obligation to produce contemporaneous documentation of their decision-making process that is available for review by regulators. Tax authorities bolster their capacity to distinguish between taxpayers inclined toward public-regarding behavior and those not so inclined—the same capacity for sorting that lies at the heart of Raskolnikov's proposal.[218] In some cases, this may mean taxpayers are given enough rope to hang themselves while authorities patiently await the outcome. The other two deregulatory reforms, by contrast, offer only the possibility of a macro-compliance spiral, linking the collective compliance posture of a class of taxpayers with the availability of tax benefits. For that reason, the divisive reorganization provisions could not create a robust connection between compliance and autonomy.[219] The result

certainly more difficult than observing the link between the treatment a specific taxpayer receives and changes in that taxpayer's compliance posture. It is also true that taxpayers could employ social norms to enforce compliance standards for themselves. *See* Braithwaite, *supra* note 164, at 189 (suggesting that "changing business culture so that business leaders disapproved of their business colleagues who did not comply with the law" could help promote compliance spirals). As a class of affected taxpayers becomes broader and more diverse, it becomes more difficult for each individual taxpayer to identify with that group. As the taxpayer's identification with the group grows weaker or stronger, so too does the power of the group norm to influence the taxpayer's behavior. *See* Marjorie E. Kornhauser, *A Tax Morale Approach to Compliance*, 8 FLA. TAX REV. 599, 613 (2007) ("Identification with the group plays a crucial role in norm formation and influence. The more a person identifies with a group, the more likely s/he is to internalize its norms and therefore cooperate, that is, follow them.").

218 *See* Raskolnikov, *supra* note 163, at 691–93 (describing alternative mechanism allowing taxpayers to self-identify as either "gamers" or "non-gamers"). By focusing enforcement resources on the latter group, authorities could simultaneously avoid alienating otherwise cooperative taxpayers and coddling the less cooperative. *See supra* text accompanying notes 161–62 (discussing incentives toward cooperation).

219 Although the reform may well have been helpful in persuading corporate taxpayers that self-interest could be compatible with public-regarding behavior, evaluating its success

seems uncomfortably like unlocking a liquor cabinet before leaving a group of teenagers unsupervised. It might be possible to determine if everyone has behaved themselves, but identifying a particular culprit (or culprits) in the event of misbehavior would not be. At the same time, given the stark asymmetry in the perception of this change on the part of affected taxpayers and the public, the risk of fiscal arbitrage would be high. Undoubtedly, the sophisticated corporate taxpayers eligible to capitalize on the divisive reorganization reforms appreciated their significance. The broader public may have mistakenly assumed that it was a costless simplification measure.[220]

The safe harbor leasing rules present a similar result. The inclusion of safe harbor leasing on the tax expenditure budget does eliminate the possibility of budgetary arbitrage.[221] Unfortunately, safe harbor leasing implicates an even broader and more diverse pool of taxpayers than the divisive reorganization reforms. As a result, the likelihood of a successful compliance spiral is even lower.[222] Although the tax expenditure budget worked precisely as Surrey would have wanted, the cognitive arbitrage potential of safe harbor leasing remained unaffected. Had a handful of transactions involving high-profile companies not captured the public's attention, it is not difficult

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would be difficult. As a result, determining whether further deregulation would represent an appropriate perpetuation of a compliance spiral—as opposed to merely being an exercise in fiscal arbitrage—would also be difficult.

[220] Legislators presented the change as a "simplification" measure. *See* 151 CONG. REC. 14,734 (2005) (statement of Sen. Max Baucus) ("Mr. President, virtually everyone supports tax simplification. But for some reason, it is awfully hard to accomplish. Today, I am pleased to join my friend and colleague from Mississippi, Senator Lott, in introducing tax legislation that is non-controversial and a clear tax simplification measure."). Since, like all other nonrecognition measures, it was not classified as a tax expenditure and thus did not appear as a line item on the tax expenditure budget, the public may have assumed it had no impact on revenues.

[221] By contrast with the divisive reorganization reforms—which had no tax expenditure budget implications—safe harbor leasing represented a significant line item on the tax expenditure budget. *See* TAX EXPENDITURES, *supra* note 211, at 8 (listing safe harbor leasing on tax expenditure budget).

[222] At a minimum, that macro-compliance spiral would include cash-strapped businesses investing in significant amounts of capital equipment. To the extent that the economic benefits of safe harbor leasing were captured by lessors, the group might properly be expanded to include them as well. *See* Sunley, *supra* note 64, at 289 (citing Treasury Department estimates that fifteen percent of benefits of safe harbor leasing transactions went to lessors as indication of efficiency of safe harbor leasing in transferring tax benefits). Even if safe harbor leasing represented a sufficient incentive to spur those taxpayers towards a more cooperative compliance posture, isolating its effect on them would be difficult. Empirically demonstrating the precise impact of the availability of safe harbor leasing on the collective attitude of such a large group would be almost impossible. To reliably accomplish that, one would have to control for all other potential influences. A relatively manageable example would be the level of resources devoted to enforcement with respect to the relevant group of taxpayers.

to imagine that fiscal arbitrage would have sustained safe harbor leasing even if it did nothing to promote increased cooperation between taxpayers and tax authorities.[223]

Conclusion

Tax deregulation has established itself as an important feature of the tax policy landscape. It has done so despite, or perhaps because of, a failure to grapple with its normative significance. By deploying the insights of a wide range of scholars, this Article crafts a robust tool for evaluating deregulatory tax provisions. In most cases, the likelihood of fiscal arbitrage will outweigh the prospects for a compliance spiral. Deregulatory provisions that aim to produce micro-compliance spirals offer the most promising risk/reward profiles, but even they may do more harm than good.

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[223] *See id.* at 290 (attributing reduction in value of safe-harbor leasing transactions to political uncertainty surrounding tax provisions). This analysis assumes that safe harbor leasing was a suboptimal means of promoting capital investment. *See* Warren & Auerbach, *supra* note 52, at 1779 (concluding that safe harbor leasing "has precluded consideration of alternative, and perhaps significantly better, resolutions" to structural issues in tax system).