Draft—1/19/2010

Compliance Spirals, Fiscal Arbitrage and Tax Deregulation

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Tax deregulation is a poorly understood but pervasive phenomenon. Traditionally, it has been conflated with the related, but distinct, notion of tax simplification. Rather than merely dismissing tax deregulation as a flawed offshoot of simplification—an example of Murphy and Nagel's "'everyday' libertarianism"—this Article draws a principled distinction between tax deregulation and tax simplification. It identifies both useful and harmful characteristics of tax deregulation by drawing on two important bodies of scholarship. The responsive regulation framework shows how tax deregulation can promote compliance by facilitating self-regulation. The tax expenditure literature suggests caution is warranted when deregulation permits taxpayers latitude in crafting tax results.

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INTRODUCTION

The upheaval that continues to disrupt financial markets has reinvigorated longstanding debates about the risks and rewards of deregulation.[1] With the benefit of hindsight, some rule changes that promoted private autonomy by eliminating regulatory speed bumps now appear less benign.[2] Even deregulation's most ardent advocates concede that deregulation may have played a role in unleashing the ongoing financial turbulence.[3]

Nevertheless, the fears of deregulation skeptics have often proven unfounded.[4] In many cases, reduced regulatory burdens have benefitted not only the more lightly regulated industries themselves but also third parties, particularly consumers.[5] That less intrusive regulatory approach and the notion that private decision makers may sometimes promote public goals more effectively than regulators can through command-and-control regulation have gained broad

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[1] *Compare* POSNER, A FAILURE OF CAPITALISM xii (2009) ("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* A Financier Comments on A Failure of Capitalism, The Atlantic, Jun 17, 2009 *at* http://correspondents.theatlantic.com/richard_posner/2009/06/a_financier_comments_on_a_failure_of_capitalism_the_book.php (responding to Posner, Lawrence Hillibrand warns against responding to the financial crisis with excessive regulation by observing that "one important theme that failed to get appropriate consideration in your book it 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.").

[2] The deregulation of the banking industry, including the elimination of the depression-era restrictions on banks known as Glass-Steagall, illustrates that shift. *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* "[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…." POSNER *supra* note 1 at 326.

[3] Posner and others place significant blame for the current financial crisis on the misguided deregulation of the financial system. *See* POSNER *supra* note 1 at 317 ("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 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.")

[4] Airline deregulation provides an example of fears, particularly those related to the safety of deregulated air travel, gone unrealized. Alfred E. Kahn, *Surprises of Airline Deregulation*, 78 AM. ECON. REV. 321 (1988) ("The last ten years have fully vindicated our expectations 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.").

[5] *See infra* note 46 and accompanying text.

acceptance.[6] Unfortunately, determining ex ante which deregulatory reforms will achieve that goal is difficult.

The impact of deregulation has been pervasive, affecting rules of all kinds.[7] The tax laws appear to represent an important exception to deregulation's reach,[8] a lacuna made more surprising by the broad scope of the tax laws themselves.[9] It would be remarkable if this sea change in regulatory culture had bypassed what may be the single most economically significant regulatory regime. One could rationalize that surprising result by concluding that tax deregulation is simply a contradiction in terms.[10]

In fact, the hallmark of deregulation, an increase in private autonomy coming at the expense of direct governmental control,[11] can easily be recognized in a number of significant business tax reforms implemented in recent decades.[12] 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. Created in the mid-1990s, the check-the-box rules replaced regulations that had long been pilloried as needlessly burdensome.[13] The new rules offered taxpayers an unprecedented degree of flexibility to choose and change entity classifications.[14] Other reforms, including safe harbor leasing in the early 1980s, the introduction of the best method transfer pricing rule in the mid-1990s and the recent liberalization of the tax-free divisive reorganization requirements, produced a similar shift in power from public to private hands.[15] Each grants taxpayers greater control over their own tax treatment.

Although an entrenched phenomenon, tax deregulation remains poorly understood. Confusion with respect to tax deregulation runs deep in part because it has been difficult to

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[6] *See infra* note 30 and accompanying text

[7] *See* LIZABETH COHEN, A CONSUMERS' REPUBLIC: THE POLITICS OF MASS CONSUMPTION IN POSTWAR AMERICA 393 (2004) (noting President Carter's boasts of deregulating a range of industries from trucking to financial services).

[8] Remarkably, internet searches for the phrase "tax deregulation" turn up more cellular biology than tax results. One of the only tax-related results is a website published by Taiwan's Council for Economic Planning and Development listing "Major Tax Deregulation Bills Passed, May 2008-June 2009." http://www.cepd.gov.tw/encontent/m1.aspx?sNo=0012043.

[9] "No other branch of the law touches human activities at so many points." Dobson v. Commissioner, 320 U.S. 489, 494-95 (1943).

[10] 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. Take, for example, the deregulation of the airline industry and its impact on consumers. *See infra* note 46. A libertarian would approve of that deregulatory effort in part because it freed private actors (the airlines) from public strictures, not because of its positive impact on consumer welfare. A utilitarian, by contrast, would care less about the impact of deregulation on the airlines themselves than its impact on the airlines' customers.

[11] *See infra* note 33 and accompanying text.

[12] *See infra* Subpart II.C.

[13] *See, e.g.*, NYSBA Tax Section, Report on the "Check The Box" Entity Classification System Proposed in Notice 95-14, Part III.A, *reprinted in NYSBA Strongly Endorses Check-the-Box Entity Classification Proposal*, TAX NOTES TODAY, Sept. 5, 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.").

[14] *See generally,* Steven Dean, Attractive Complexity: Tax Deregulation, The Check-the-Box Election, and the Future of Tax Simplification, 34 Hofstra L. Rev. 405 (2005).

[15] *See infra* Subpart II.C.

distinguish from the related, but conceptually distinct, notion of tax simplification.[16] While both simplification and deregulation call for easing burdens the tax law imposes on taxpayers, they do so in different ways.

Simplification principally targets the non-tax costs that tax rules impose on private actors. By enhancing taxpayer autonomy, deregulatory tax reforms may reduce those costs. But, as the check-the-box rules demonstrate, they may—counterintuitively—please taxpayers by increasing those costs.[17] For that reason, conceiving of tax deregulation as an aspect of tax simplification casts doubt on its normative significance.[18] It implies that tax deregulation is no more than an incoherent offshoot of simplification, built on the false premise that taxpayer costs fall as taxpayer choice grows.[19] Without the normative rationale derived from simplification, tax deregulation becomes just one more manifestation of the "'everyday' libertarianism" in tax policy that values increased taxpayer autonomy as an end in itself.[20]

This Article concludes that tax deregulation is more—for good and ill—than tax simplification gone astray. It arrives at that result from two directions. It examines tax deregulation through the lens of the responsive regulation literature and draws on the lessons of the tax expenditure literature. Together, they demonstrate the folly of ignoring tax deregulation.

Responsive regulation suggests that empowering taxpayers to self-regulate can enhance taxpayer cooperation by promoting positive compliance spirals.[21] At the same time, by drifting close to the poorly defined border that separates tax expenditure from tax reform, tax deregulation trips alarms on topics ranging from institutional competence to regulatory capture.[22] In some circumstances, tax deregulation permits policymakers to engage in fiscal arbitrage—in effect reaping the political benefits of spending while paying the relatively modest political costs of reducing taxes. Viewed from these two perspectives, tax deregulation reveals itself to be distinct from simplification.

As interpreted by Valerie Braithwaite and others, responsive regulation suggests that tax deregulation's focus on taxpayer autonomy may be both appropriate and useful.[23] Employing the responsive regulation methodology, deregulatory strategies can serve as tools regulators use to calibrate the intensity of their oversight to match the behavior and attitude of different types of taxpayers.[24] By "escalat[ing] up" or "deregulat[ing] down" their control over taxpayers, it may be possible to encourage the development of cooperative norms between taxpayers and their regulators.[25]

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[16] *See infra* Subpart II.B.

[17] That would be true whenever tax deregulation allows taxpayers to derive benefits worth >$1 at a cost of $1 in increased expenditures. *See infra* Subpart II.B.

[18] In other words, tax deregulation's value would depend solely on its objective impact on tax complexity.

[19] Prior work has argued that any deregulatory tax reform that would not actually produce an objective reduction in tax complexity should be rejected. *See* Dean *supra* note 14 at 408-09.

[20] *See* LIAM MURPHY & THOMAS NAGEL, THE MYTH OF OWNERSHIP 15 (2002) (explaining that the notion "that pretax market outcomes are presumptively just" underlies the conclusion that increased taxpayer autonomy is desirable in and of itself).

[21] *See infra* Subpart I.B.

[22] *See infra* Subpart I.C.

[23] *See* TAXING DEMOCRACY: UNDERSTANDING TAX AVOIDANCE AND EVASION (Valerie Braithwaite, ed. 2003) (presenting essays employing the responsive regulation framework in the tax context).

[24] Ian AYRES & JOHN BRAITHWAITE, RESPONSIVE REGULATION: TRANSCENDING THE DEREGULATION DEBATE 4 (1992).

[25] AYRES & JOHN BRAITHWAITE *supra* note 24 at 4.

Since it calls for delivering benefits to private actors through the tax system, tax deregulation opens the door to all of the risks associated with tax expenditures.[26] As a result of its hybrid nature—a spending provision masquerading as a tax rule—a tax expenditure allows tax policymakers to arbitrage critical differences between taxing and spending.[27] Tax deregulation accomplishes that fiscal arbitrage by empowering taxpayers to create favorable tax results for themselves, further blurring the link between legislative or regulatory action and its fiscal consequences. At a minimum, the resulting lack of transparency undermines the compliance benefits that responsive regulation attributes to tax deregulation.

Ultimately, tax deregulation presents opportunities both for meaningful improvements in public welfare and for significant harm. This Article provides policymakers with a framework to evaluate deregulatory tax reforms in order to determine which are most likely to produce the former with a minimum of the latter. It does so by examining the role that tax deregulation has played in three decades of business tax reform.

Part I of the Article sets the stage by introducing deregulation, responsive regulation and tax expenditure analysis. Part II brings tax deregulation into focus, both by distinguishing it from tax simplification and by providing three examples of deregulatory tax reforms. Part III refines the concepts of the compliance spiral and fiscal arbitrage. It then uses those concepts to identify the characteristics of deregulatory tax reform that is likely to strike an optimal balance between the compliance benefits and the political distortions tax deregulation can cause.

I. DEREGULATION AND TAXES

Even before the financial crisis thrust deregulation into the headlines, scholars had spent decades debating its costs and benefits.[28] Oddly, that is not the case with tax deregulation. Although lower tax rates and reduced tax complexity figure prominently in tax scholarship of that period, tax deregulation itself has been relatively rarely and recently addressed.[29] Nevertheless, there are two threads of scholarship that shed important light on tax deregulation. Responsive regulation embraces deregulation, including tax deregulation, as a means of encouraging cooperation between private actors and regulators. When employed in the tax context, the quid pro quo that responsive regulation envisions raises unique concerns. As the tax expenditure literature suggests, tax deregulation may be more politically disruptive than deregulation generally.

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[26] *See infra* Subpart I.C.

[27] "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." Marjorie E. Kornhauser, *Cognitive Theory and the Delivery of Welfare Benefits,* 40 LOY. U. CHI. L.J. 253, 264 (2009).

[28] *See* George Stigler, *The Theory of Economic Regulation*, 2 THE BELL JOURNAL OF ECONOMICS AND MANAGEMENT SCIENCE 3 (1971); Richard A. Posner *Theories of Economic Regulation*, 5 THE BELL JOURNAL OF ECONOMICS AND MANAGEMENT SCIENCE 335 (1971); STEPHEN BREYER, REGULATION AND ITS REFORM (1982).

[29] Only the responsive regulation scholarship focusing on tax administration addresses tax deregulation, and even it does so avoiding the term deregulation. *See, e.g.*, Valerie Braithwaite, *A New Approach to Tax Compliance in* TAXING DEMOCRACY *supra* note 23 at 4 [hereinafter *New Approach*] ("Responsive regulation steps away from a command and control approach to regulation….").

A. Deregulation

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.[30] Although it is difficult to draw clear conclusions regarding the cumulative impact of years of deregulatory reforms,[31] the drive to liberate businesses from government red tape has become a staple of both Democratic and Republican administrations and continues to garner widespread support.[32] That broad-based consensus exists despite differences of opinion regarding the scope of the transformation deregulation implies[33] and the justification for those changes.[34]

For some, government control over private decision making is objectionable as a matter of principle. For a libertarian, even relatively subtle public control can be problematic.[35] More broadly, personal autonomy—as opposed to economic efficiency[36]—concerns have long played a role in motivating the popular anti-regulation movement.[37] Privacy and individual liberty often

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[30]*See* Joseph Kearney & Thomas 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 clout to the cause of regulatory reform.") Even President Obama has emphasized the need to protect private enterprise from excessive government interference. *See* President Obama's Speech to Joint Session of Congress. Transcript found at: http://www.guardian.co.uk/world/2009/feb/25/full-text-barack-obama-congress-address ("History reminds us that at every moment of economic upheaval and transformation.... government didn't supplant private enterprise; it catalysed private enterprise. It created the conditions for thousands of entrepreneurs and new businesses to adapt and to thrive.").

[31] *See* Ayres & Braithwaite *supra* note 24 at 7 ("Even in 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 Posner, *The Effects of Deregulation on Competition: The Experience of the United States*, 23 FORDHAM INT'L L.J. S7, S8 (2000) [hereinafter Posner, *Deregulation*]("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….").

[32] *See supra* note 30.

[33] 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." *See* Posner, *Deregulation supra* note 31 at S7. Others see that phenomenon as part of a much broader trend away from a rigid command-and-control regulatory system. *See, e.g.*, Orly Lobel, *The Renew Deal: The Fall of Regulation and the Rise of Governance in Contemporary Legal Thought*, 89 MINN. L. REV. 342, 379-380 (2004):

> "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."

[34] *See, e.g.*, Kearney & Merrill *supra* note 30 at 1403 (explaining that Ford thought deregulation would be anti-inflationary and Carter supported deregulation to counter stagflation while later presidents sought to promote productivity and economic growth).

[35] *See* Cass Sunstein & Richard Thaler, *Libertarian Paternalism is Not an Oxymoron*, 70 U. CHI. L. REV. 1159, 1165 (2003) (acknowledging that some libertarians will object to even the relatively non-coercive regulatory strategy labeled "libertarian paternalism" as a "government effort[] to influence choice in the name of welfare.")

[36] For some, utilitarian notions encompass virtually every form of well-being. John Stuart Mill famously framed liberty in utilitarian terms. JOHN STUART MILL, ON LIBERTY.

[37] *See generally*, MICHAEL PERTSCHUK, REVOLT AGAINST REGULATION: THE RISE AND PAUSE OF THE CONSUMER MOVEMENT, 69-118 (1982) (documenting the breadth of the anti-regulatory movement in the United States).

loom large for advocates of limited government. From that perspective, shifting authority from public to private hands becomes desirable even if such changes impose significant efficiency costs on society.[38] Over the last century, the pendulum swung widely on the question of the compatibility of economic regulation with individual liberty.[39] Today, even the most narrowly targeted taxes can be designed in such a way as to pass constitutional muster and tax rules can burden the most intimate of decisions.[40]

In contemporary legal scholarship, the shift away from command-and-control regulation towards regimes that offer the objects of regulation greater flexibility is primarily a matter of increasing economic efficiency.[41] In the environmental context, for instance, deregulation often takes the form of market-based regulatory strategies that impose "financial penalties… on harm-producing behavior" and create "financial rewards" for "harm-reducing behavior."[42] As compared to the traditional "best available technology"[43] style of regulation, providing private actors with more latitude allows them to achieve environmental objectives at less overall cost.[44]

When such savings are passed along to consumers, the public benefits not only by enjoying cleaner air and water, but also by paying relatively low prices for goods and services.[45]

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[38] "In addition to the economic argument for deregulation, it has been asserted that substituting the private market for administrative regulation would advance private autonomy by replacing official discretion with the impersonal rules of market exchange." Richard B. Stewart, *The Reformation of American Administrative Law,* 88 HARV. L. REV. 1667, 1693 (1975)

[39] "In the Lochner era itself, of course, the police power could not be used to help those unable to protect themselves in the marketplace." Cass R. Sunstein, *Lochner's Legacy*, 87 COLUM. L. REV. 873, 880 (1987). 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.

[40] For example, today, even the most narrowly targeted taxes can be designed in such a way as to pass constitutional muster. The proposed tax on AIG bonuses were not generally considered to be constitutionally problematic. *See* Conor Clarke, *Laurence Tribe: Is Taxing AIG legal?,* The Atlantic Bus. Channel, Mar. 17, 2009, http://business.theatlantic.com/2009/03/laurence_tribe_is_taxing_aig_legal.php (citing Professor 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. Online, Mar. 26, 2009. http://online.wsj.com/article/SB123802257323941925.html (reaching the same conclusion). Taxes certainly influence private behavior, but 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, 1189-1203 (1995) (discussing the failed attempts to challenge the "marriage penalty" on constitutional grounds).

[41] *See, e.g.*, Posner, *Deregulation supra* note 31 at S18 ("[M]ost economists agree that the net effect of the deregulation movement in the United States has been to increase efficiency, with resulting increases in consumer welfare.").

[42] Richard H. Pildes & Cass R. Sunstein, *Reinventing the Regulatory State*, 62 U. CHI. L. REV. 1, 112 (1995). Cap and trade programs accomplish that by allowing businesses to "purchas[e] permission" to emit pollutants and to "trade their 'licenses' with other people." *Id.* at 113

[43] Richard H. Pildes & Cass R. Sunstein, *Reinventing the Regulatory State*, 62 U. CHI. L. REV. 1, 97 (1995). 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.*

[44] "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." Richard H. Pildes & Cass R. Sunstein, *Reinventing the Regulatory State*, 62 U. CHI. L. REV. 1, 112 (1995).

[45] *See supra* note 41.

Deregulation of industries from telecommunications to air travel has been credited with providing precisely that result.[46] By creating space for innovation and competition, deregulation allows the market's invisible hand to narrow the gap between public and private objectives.

The 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 would distort private behavior.[47] The resulting deadweight losses are no more desirable than those attributable to inefficient environmental or financial regulation.

It is tempting to think that deregulation could offer the same economic efficiency benefits in the tax context as it does elsewhere. 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. In practice, the mechanisms through which taxpayer freedom would promote economic efficiency are not obvious. Environmental deregulation allows competitive forces to 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.[48]

B. Responsive Regulation

Concluding that the traditional economic efficiency rationale for deregulation falters when applied to taxation suggests that tax deregulation serves another purpose. Responsive regulation offers an alternative normative justification for deregulation, including tax deregulation, that is not framed in efficiency—or liberty—terms. Instead, it incorporates deregulation as a mechanism regulators can employ to elicit compliance from those they regulate.

In *Responsive Regulation*, Ian Ayres and John Braithwaite argue that "public policy can effectively delegate government regulation… to the regulated firms themselves…."[49] 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 firm therein… channel[s] the regulator towards greater or lesser degrees of government intervention."[50]

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[46] *See* Posner, *Deregulation supra* note 31 S17-18 (crediting airline deregulation with "an enormous increase in the volume of air traffic coupled with a substantial fall in real prices" and telecom deregulation with unleashing "an enormous heterogeneity of demands for telecommunications services, to which a newly competitive industry responded with imagination and alacrity. The direction of innovation changed dramatically, from reducing the cost of existing services to creating new services.").

[47] *See* Joel Slemrod and Shlomo Yitzhaki, *The Costs of Taxation and the Marginal Efficiency Cost of Funds,* Staff Papers International Monetary Fund, Vol. 43, No. 1 (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 some of the costs of imposing taxes).

[48] *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 the "competitive market" in tax shelter innovation and sales populated by tax shelter promoters, investment banks and accounting firms).

[49] AYRES & JOHN BRAITHWAITE *supra* note 24 at 4.

[50] AYRES & JOHN BRAITHWAITE *supra* note 24 at 4.

In recent years responsive regulation has become the focus of an increasing amount of tax scholarship.[51] 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 own tax obligations."[52] Cooperative taxpayers can be granted significant latitude to engage in "self-regulation" while non-cooperative behavior would produce a "transfer of power from the taxpayer to the tax office, and a concomitant loss of freedom on the part of the taxpayer."[53]

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 a reward for demonstrating—trustworthiness.[54] 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.[55] By granting cooperative taxpayers greater autonomy in meeting their tax obligations, tax authorities are also able to focus their enforcement resources elsewhere. The end result is a higher level of compliance combined with a lighter regulatory burden on the typical taxpayer.

C. Secret Spending

Just as responsive regulation provides a useful framework for understanding the public objectives tax deregulation can serve, the tax expenditure literature offers a means of identifying the unique risks it poses. Even though tax rules are much the same as any other laws from a responsive regulation perspective, in some respects tax laws are quite different.[56] The principal risk posed by tax deregulation is that it will serve as a vehicle for policymakers to engage in fiscal arbitrage.

Every regulatory regime demands a careful balance between the pursuit of collective goals and the preservation of private autonomy. Tax laws can adversely affect the rulemaking process by serving as a second, secret language for policymakers.[57] As generations of leading

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[51] *See, e.g.*, John Braithwaite, Markets in Vice, Markets in Virtue (2005) [hereinafter VICE, VIRTUE (describing Australia's experience with responsive regulation in the tax context); TAXING DEMOCRACY *supra* note 29.
[52] *See* Valerie Braithwaite *supra* note 29 at 2.
[53] *See* Valerie Braithwaite *supra* note 29 at 4.
[54] *See* RUSSELL HARDIN, TRUST (2006) (exploring the significance of trust and trustworthiness).
[55] *See infra* Subpart III.A.
[56] Although any form of legislative or regulatory action can provide economic benefits to particular constituencies, tax laws are unique in that the benefits they grant to not impose offsetting burdens on other limited constituencies. Tax preferences affect the public generally by reducing revenues, but do not usually impose harms on specific individuals or groups in the way that other regulatory preferences do. For example, deregulating the airline industry provided a benefit to emerging airlines at the expense of more established market participants.
[57] Stanley Surrey is credited with popularizing the tax expenditure concept. *See* STANLEY 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 "Governmental 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. Murphy & Nagel refer to our tendency to rely on readily available information such as budget and tax expenditure budget data as a form of myopia. MURPHY & NAGEL *supra* note 20 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.")

scholars have shown, the tax system can provide a potent means of camouflaging government spending that can distort decision making by both politicians and their constituents.[58]

As originally conceived by Stanley Surrey, tax expenditure analysis provided a means of identifying the budget impact of the ways in which the income tax deviated from an idealized income tax.[59] If deregulation serves as an inducement, encouraging public-regarding behavior from taxpayers, it is not surprising that deregulatory reforms can provide benefits to taxpayers.[60] Just like the many other exclusions, accelerated deductions and income deferrals the tax laws provide, those deregulatory reforms do not require the federal government to write a check to a private party, but in substance they are no different from the direct expenditures that appear on the federal budget. That is no less true when tax benefits are part of the quid pro quo of responsive regulation.

Despite having played a central role in nearly a half century of fiscal discourse, tax expenditure analysis still raises as many questions as it answers.[61] Implicit in Surrey's analysis was the presumption that because tax expenditures can be simultaneously large and hidden from public view they can permit legislators to engage in fiscal arbitrage—exploiting imperfections in the political and legislative processes by disguising spending measures as tax provisions—and should therefore be treated with skepticism.[62] Through the creation of a formal tax expenditure budget to parallel the budget for direct expenditures Surrey's goal of greater parity between those

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[58] *See* Surrey *supra* note 57; David A. Weisbach & Jacob Nussim, *The Integration of Tax and Spending Programs*, 113 YALE L.J. 955 (2004); 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 (1993).

[59] *See* Surrey *supra* note 57 at 6 (describing Surrey's vision of a pure income tax encumbered by extraneous tax expenditures).

[60] *See infra* note 151 and accompanying text.

[61] *See, e.g.*, Boris I. Bittker, *Accounting for Federal "Tax Subsidies" in the National Budget*, 22 NAT'L TAX J. 244 (1969); Douglas A. Kahn & Jeffrey S. Lehman, *Tax Expenditure Budgets: A Critical Review*, 54 TAX NOTES 1661 (Mar. 30 1992); Daniel N. Shaviro, *Rethinking Tax Expenditures and Fiscal Language*, 57 TAX L. REV. 187 (2004). Even the definition of a tax expenditure remains unsettled. The Budget Act operationalizes Surrey's notion by describing tax expenditures as "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability." Congressional Budget and Impoundment Control Act of 1974, Pub. L. No. 93-344, § 3(a)(3), 88 Stat. 297, 299 (1974). One alternative, employed in a recent tax expenditure budget prepared by the Joint Committee, creates a more objective baseline derived from the existing income tax. *See* Staff of Joint Comm. on Taxation, 110th Cong., A Reconsideration of Tax Expenditure Analysis (Comm. Print 2008), available at http://www.jct.gov/x-37-08.pdf (describing rationale of new approach). That approach modifies the Budget Act's formulation so that "special" is determined not by reference an ideal income tax, but by reference to the income tax as it currently exists. A third method skirts the difficulty of objectively defining non-normative tax provisions by simply insisting on a true equivalence between the tax preference in question and a direct spending alternative. Victor Thuronyi, *Tax Expenditures: A Reassessment*, 1988 DUKE L.J. 1155 (1988).

[62] "It can generally be said that less critical analysis is paid to these tax expenditures than to almost any direct expenditure program one can mention. The tax expenditures tumble in to 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." Surrey *supra* note 57 at 6. Others are less certain that tax expenditures are systematically under-examined. *See* Zelinksy *supra* note 58 (arguing that by concentrating a variety of spending decisions into a single legislative process, tax expenditures are more easily scrutinized than other expenditures).

two different types of expenditures has been, to a significant extent, realized. Some might even argue that the balance has shifted too far in favor of direct expenditures.[63]

The shortcomings of tax expenditure analysis—and the persistence of fiscal arbitrage—reflect the complexity of the relationship between spending and taxes.[64] The most obvious problem occurs where the definition of a tax expenditure is underinclusive.[65] When that is true, policymakers have a clear incentive to substitute tax rules in place of spending provisions.[66] The resulting off-budget expenditures will tend to subvert the public's ability to monitor government spending and encourage excessive use of the tax system to achieve extraneous goals.[67] In the current era of budget deficits, one would expect such opportunities for surreptitious outlays to be increasingly tempting and troublesome.[68]

Even when the tax expenditure budget does fully capture the cost of tax expenditures, policymakers may still have reason to engage in fiscal arbitrage, favoring tax expenditures over direct expenditures.[69] For example, cognitive psychologists have shown how superficial differences between substantively identical fiscal alternatives can affect the way in which individuals respond to them.[70] Because they facilitate the exploitation of cognitive biases, including through the careful use of fiscal language, tax expenditures continue to distort the

[63] As discussed below, some scholars maintain that Surrey's presumption is often, if not always, precisely backward, so that in many instances tax expenditures should be preferred over direct expenditures. *See infra* notes 74-76 and accompanying text.

[64] *See* Boris I. Bittker, *Accounting for Federal "Tax Subsidies" in the National Budget*, 22 NAT'L TAX J. 244 (1969) (describing complexities implicated by the tax expenditure concept).

[65] *See* Bittker *supra* note 64 at 250 (noting that "a consistent application" of the tax expenditure concept would include a variety of traditionally excluded tax rules such as corporate reorganizations and other non-recognition provisions among them).

[66] Although all deregulation measures raise a similar risk (policymakers substituting reduced regulatory burdens for direct spending in response to budget pressures), tax deregulation poses it in a uniquely stark manner. That is in part because the costs of providing deregulatory tax benefits are borne by taxpayers collectively while other forms of deregulation (e.g. financial or environmental) impose corresponding costs on particular groups of constituents. That extreme asymmetry of focused benefits and diffuse costs heightens public choice concerns of capture and rent-seeking. It is also true because tax expenditures are malleable—then can be specifically targeted particular taxpayers and can be scaled to any size.

[67] *See* Surrey *supra* note 57 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").

[68] *See, e.g.*, PRESIDENT'S FISCAL YEAR 2010 BUDGET 114 at http://www.gpoaccess.gov/usbudget/fy10/pdf/fy10-newera.pdf (projecting a deficit of just under $7 trillion between 2010 and 2019).

[69] The recent healthcare debate has underscored how important labels can be. *See* Adam Nagourney & David M. Herszenhorn, *Republicans Call Health Legislation a Tax Increase*, N.Y. TIMES, October 1, 2009. ("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.")

[70] *See* Edward 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) [hereinafter *Framing Effects*] ("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.").

political process even though a completely rational public would ignore purely formal distinctions among policy alternatives.[71]

Legislators' desire to circumvent parliamentary rules and procedures provides another potential motivation for fiscal arbitrage. The inherent limitations of the tax expenditure process—recasting tax provisions as tax expenditures does not ensure that they will be treated as spending provisions for all purposes—can undermine legislators' capacity to govern their own behavior. Direct expenditures can be presented as tax expenditures to avoid parliamentary obstacles such as the filibuster or to flout budget rules through the use of sunset provisions. For example, the reconciliation process may allow tax expenditures, but not direct expenditures, to avoid the need for a supermajority in the Senate.[72] Similarly, the increasing popularity of sunset provisions in tax legislation may in part be a symptom of legislators' efforts to skirt self-imposed budget rules.[73] As a result, fiscal arbitrage may represent as much of a threat to the legislative process as it does to the political process.

As tempting as it may be to limit opportunities for fiscal arbitrage by embracing a rigid bias against tax expenditures, it is not clear that tax expenditures are consistently inferior to direct expenditures. Persuasive arguments have been made that just the opposite is true.[74] Because tax expenditures can result in the centralization of fiscal decisions, they may facilitate, rather than frustrate, the oversight of rulemakers by the public.[75] In addition, there will inevitably be circumstances in which the existing bureaucratic tax infrastructure will allow government programs to be implemented more efficiently than they could be outside the tax system.[76]

Whatever the ideal balance between tax and direct expenditures may be, fiscal arbitrage has the potential to disturb it. As the reforms described below demonstrate, tax deregulation can both promote taxpayer compliance and be a vehicle for fiscal arbitrage. The next Part begins the process of creating the vocabulary necessary for distinguishing among deregulatory tax provisions based on their propensity to produce a desirable combination of the two.

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[71] *See Framing Effects* supra 70 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."); Daniel Shaviro, *Rethinking Tax Expenditures and Fiscal Language*, 57 TAX L. REV. 188 (2004) ("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.").

[72] *See* Rebecca Kysar, *The Sun Also Rises: The Political Economy of Sunset Provisions in the Tax Code*, 40 GA. L. REV. 335, 371-73 (2006) (describing use of reconciliation process to circumvent the filibuster in order to pass tax cuts).

[73] *See* Rebecca Kysar, *Lasting Legislation* [draft] (noting that legislative budget rules "ignore sunset provisions for spending programs with current year costs greater than $50 million, but do not do so in other cases. For purposes of estimation, sunset provisions always are assumed to take effect in the tax context….").

[74] *See* Weisbach *supra* note 58; Zelinksy *supra* note 58.

[75] Zelinksy *supra* note 58 at 1166 ("The core of my argument is that the institutions formulating and administering tax policy are more competitive and visible than their direct outlay counterparts….").

[76] *See* Weisbach *supra* note 58 at 960 (There is no reason to believe, however, that the tax collection function should necessarily be separated from other functions of government-and there may be good reasons to believe that it should not be.").

II. BUSINESS TAX REFORMS AND TAX DEREGULATION

Deregulation's influence can be seen in any number of features of today's federal income tax. After examining the longstanding confusion surrounding tax deregulation and tax simplification—the primary reason tax deregulation has received so little attention—this Part provides three examples of business tax reforms that illustrate the impact of that ambiguity. Safe harbor leasing is one of the earliest major examples of tax deregulation.[77] 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.[78] Recent modifications to the requirements for divisive tax-free corporate reorganizations provide the final example.[79] Together, they demonstrate both the longevity and the reach of deregulation in the tax context.

A. Tax Deregulation

At first blush, tax deregulation seems to be 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.[80] That raises the threshold question of whether 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, it makes little sense to think of tax laws specifying a revenue target and inviting taxpayers to determine the best way of collecting that amount.[81] Of course, like any other regulatory regime, the income tax is a complex amalgam of rules and requirements.[82] Modifying some of those elements to shift authority from public to private hands need not put the fox in charge of the proverbial henhouse. A taxpayer's choices have

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[77] "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." 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).

[78] "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.'" Robert G. Clark, *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).

[79] I.R.C. § 355(b)(3) (treating affiliated groups as a single entity for purposes of the active trade or business requirement). In a hearing before the Committee on Finance, Senator Baucus described 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 (2005).

[80] *See supra* note 33.

[81] *See supra* notes 42-44 and accompanying text.

[82] Before a taxpayer's liability with respect to a payment she receives can be determined a host of preliminary questions must be addressed, including its timing and character, whether the item of income belongs to the taxpayer in question and the availability of any potential offsets such as exclusions, deductions or credits.]

consequences, but for the most part their impact tends to be subtle, affecting, for example, the timing of income rather than its existence.[83]

For many individual taxpayers—particularly when wages constitute their only source of income—determining the amount of tax owed is relatively straightforward.[84] By contrast, a typical business taxpayer must resolve a variety of uncertainties, including those that relate to the character and timing of receipts and expenses, to know how much income they have in a particular year.[85] A purely command-and-control tax regime would prescribe the precise tax consequences of any taxpayer behavior, allowing taxpayers no freedom to alter those results. A tax system as complex as the U.S. income tax inevitably offers taxpayers opportunities to do just that.[86]

The choices a business taxpayer must make can be separated into two broad categories.[87] The first, reporting, is the process of describing a taxpayer's activities to tax authorities. The second, structuring, is the way in which taxpayers alter their business practices and transactions to ensure that they receive the most favorable tax treatment possible.[88] Tax deregulation generally provides taxpayers with either greater reporting or structuring discretion. Either shifts the balance between public control and private freedom further from pure command-and-control and closer to a system in which taxpayers are generally free to choose the tax consequences of their activities.

The quintessential example of a deregulatory tax reform is the introduction of check-the-box entity classification elections. The check-the-box rules changed both the way in which business entities are divided into classifications and the way in which taxpayers report the status of an entity to tax authorities.[89] While its reporting element fits the traditional command-and-

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[83] The income tax's realization requirement offers an illustration. *See* I.R.C. § 1001 (determining the "gain from the sale or other disposition of property" by comparing the price originally paid for the property against the amount received upon the disposition). By choosing when to dispose of property, taxpayers also choose when the economic income will be taxed. An alternative approach might require accrued economic income to be taxed each year.

[84] *See* DAVID BRADFORD, UNTANGLING THE INCOME TAX 268 ("Although the statutes and regulations fill thousands of all but unreadable pages, actual compliance with current law is… simple for the majority of taxpayers. Taxpayers who do not claim itemized deductions can quickly and whose income is mainly from wages can quickly and easily compute their taxes….")

[85] *See, e.g.*, BRADFORD *supra* note 84 at 271("For an individual who conducts at least some business directly… one of the irritations of life is determining which outlays are eligible for deduction.")

[86] The most straightforward example may be the realization requirement described above. *See supra* note 83. 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. 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. David J. Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 U. PA. L. REV. 1111, 1113–14 (1986).

[87] The two categories are modeled after the categories used to describe complexity in the tax system. Bradford separates complexity into three elements: rule complexity, transactional complexity and compliance complexity. *See,* BRADFORD *supra* note 84 at 266-67. The first form of complexity relates to the process of understanding the relevant tax rules. The second and third are a function of actions taken—and choices made—by taxpayers. Compliance complexity is affected by reporting choices made by taxpayers. The structuring choices taxpayers make determine the transactional complexity costs they incur.

[88] Drawing a bright line between the two can be difficult. Particularly when the tax treatment of a transaction depends in part on the way in which a taxpayer reports it, there can be significant overlap between reporting and structuring autonomy.

[89] Choosing the classification of an entity has sweeping implications for its tax treatment and the results of its transactions. Changing the classification of an entity can constitute a significant transaction on its own. To achieve

control model, taxpayers' ability to choose the classification of entities represented a profound deregulatory change affecting taxpayers' freedom to structure their tax affairs.[90] Rather than attempting to prescribe a particular tax treatment for entities with specified characteristics, the new rules explicitly empowered taxpayers to choose.[91]

B. Tax Simplification, Tax Deregulation and Everyday Libertarianism

Despite deregulation's extensive impact on the tax system, tax deregulation has proceeded largely unnoticed. Outside of Australia, where responsive regulation strategies have been affirmatively embraced by tax authorities, tax deregulation might seem to be more theory than fact.[92] In one sense, that blind spot is a purely semantic artifact. Although tax simplification predates deregulation by several decades, by the 1980s the concept of simplification had evolved to encompass deregulatory reforms.[93] Today the term simplification is often used to describe reforms that deregulate but do not actually simplify the tax law.[94]

The check-the-box rules exemplify that pattern. Even today, the check-the-box rules are typically seen as the product of a successful simplification effort.[95] In fact, while replacing the old four factor test had a positive impact on one type of complexity (compliance complexity), elective entity classification had an indeterminate and negative effect on others (rule and transactional complexity, respectively).[96] Measured in terms of the aggregate expenditures by taxpayers and tax authorities, the check-the-box rules arguably increased, rather than decreased, the tax law's complexity.[97]

As the check-the-box rules demonstrate, deregulation and simplification are not as compatible as intuition suggests. [98] Simplification describes an objective reduction in the costs taxpayers incur to understand, comply with and arrange their affairs to minimize their tax

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those results, the check-the-box rules require taxpayers to submit a form with tax authorities shortly before or after the desired effective date. *See* I.R.S. Form 8832.

[90] The process is replete with decidedly command-and control forms and deadlines. *See* IRS Form 8832.

[91] The resulting freedom had profound consequences for the tax system, few of which are consistent with check-the-box's simplification objective. *See* Dean *supra* note 14 at 453-57.

[92] 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 (2009) (suggesting U.S. tax enforcement pursue responsive regulatory strategies modeled on the Australian approach).

[93] *See* HENRY C. SIMONS, FEDERAL TAX REFORM (1950) (warning of the consequences of failure to simplify the income tax).

[94] More precisely, changes that grant taxpayers increased autonomy tend to be characterized as simplification regardless of their cumulative impact on compliance, rule and transactional complexity.

[95] The New Look-Through Rule: W(h)ither Subpart F, 2007 TNT 79-37, p. 133 (2007) ("check the box was a handy simplification over planning under the Kintner regulations")

[96] The recent effort by the Obama administration is only the latest attempt to rein in the complexity associated with those entity classification rules. *See* Lee A. Sheppard, *Check-the-Box Repeal Likely to Be Enacted*, 2009 TNT 128-1 (July 8, 2009) ("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."). By "repealing" check-the-box, the proposed reforms would eliminate some of the complex tax planning strategies multinational corporations use to minimize U.S. taxes.

[97] *See* Dean *supra* note 14 at 453-57.

[98] Although the check-the-box reform clearly increased taxpayer autonomy, its impact on complexity is debatable. *See* Dean *supra* note 14 at 453-57.

obligations.[99] Deregulation, by contrast, represents an effort to shift authority from public to private hands.[100] Such a shift may or may not produce lower costs. Since taxpayers can often improve their bottom lines by increasing their tax planning expenditures, liberating taxpayers may generate greater tax complexity.[101]

Outside of the tax context, it may be logical to associate increased private autonomy with decreased regulatory costs. Advocates of abandoning command-and-control environmental regulation, for example, have traditionally made just such an argument: given greater flexibility, regulated industries will find better, cheaper methods of achieving environmental objectives.[102] When it comes to tax, 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.

The existence of simplification reforms that cannot be counted on to simplify presents something of a puzzle. Recognizing that they are intended to deregulate rather than simplify only substitutes one puzzle for another. If tax deregulation does not promote efficiency by reducing taxpayers' regulatory compliance burden, why is tax deregulation so common? Murphy and Nagel offer one explanation by suggesting that tax may be something of an outlier in embracing deregulation for deontological rather than utilitarian reasons.[103]

They observe that that an "unexamined 'everyday' libertarianism" permeates contemporary tax policy discourse.[104] While opposition to regulatory impediments to economic autonomy in other areas tends to be rooted in a concern for efficiency, tax deregulation may instead reflect the libertarian impulse that Murphy and Nagel describe.[105] In other words, tax deregulation may be nothing more than an expression of "the unreflective ideas that we have unqualified moral entitlement" to be free of tax impediments to our economic activity.[106]

If tax deregulation were nothing more than that, it would be relatively easy to conclude that tax deregulation has no significance independent of tax simplification.[107] If a deregulatory measure like the check-the-box reform fails to pass muster on simplification grounds, it would need to be justified in expressly libertarian terms or discarded. The remainder of the article explores the implications of rejecting both the false equivalence between deregulation and simplification and the "everyday" libertarian rationale for tax deregulation. It does so by focusing on three instances of tax deregulation that occurred over the last three decades. Examining those reforms reveals that tax deregulation has potentially significant consequences wholly apart from its impact on complexity.

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[99] A more comprehensive definition of tax complexity would include the government expenditures to explain, ensure and monitor taxpayer compliance.
[100] *See supra* note 33.
[101] *See* Dean *supra* note 14 at 418-21.
[102] *See supra* notes 42-44 and accompanying text.
[103] MURPHY & NAGEL *supra* note 20 at 36.
[104] MURPHY & NAGEL *supra* note 20 at 36.
[105] *See supra* notes 41-46 and accompanying text.
[106] MURPHY & NAGEL *supra* note 20 at 36.
[107] *See supra* notes 98-101 and accompanying text.

C. Deregulatory Business Tax Reforms

The tax law is rife with examples of confusion between tax simplification and tax deregulation. The check-the-box election mentioned above offers one. Each of the three deregulatory reforms described below has likewise been called a simplification measure.[108] As this Subpart shows, that simplification label is at best incomplete. By shifting the balance away from command-and-control regulation and towards increased private autonomy, these reforms deregulated more than they simplified.

Safe harbor leasing, the best method rule and the liberalization of the divisive reorganization requirements address three very different—but fundamental—challenges posed by the income tax. They 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. Traditionally such determinations are made pursuant to command-and-control regimes that, with varying degrees of success, attempt to categorize actions and events according to their underlying economics.[109] 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

Safe harbor leasing is not unique simply because it permits taxpayers to allocate favorable tax attributes among themselves.[110] What is unusual about safe harbor leasing is the extent to which Congress explicitly empowered taxpayers to transfer those benefits.[111] By

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[108] *See, e.g.*, Gordon L. Poole, Barbara B. Powell, and Donald T. Gray Financing of United States-Flag Vessels, *56 Tul. L. Rev. 1171, 1266* (1982) ("The Economic Recovery Act of 1981 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."); ["The strict priority of methods contained in the proposed regulations is replaced by the Best Method Rule. Imposing a strict priority of methods can present several problems…Consequently, it was necessary to balance the need for more flexibility against the need for additional guidance as to which methods are most appropriate in a particular case." Harry Grubert, OTA Economist Reports on Taxes and CFC's, 93 TNT 145-103 (July 12, 1993)]; Boris I. Bittker & James S. Eustice, Federal Income Taxation of Corporations and Shareholders, 1999 WL 516605 (W.G.&.L.) specifically section 11.05[5] ("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 trade or 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….").

[109] 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 may not generally be assigned among taxpayers so that "tax [can] not be escaped by anticipatory arrangements and contracts however skilfully devised").

[110] 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. v. Comm'r, 277 F.3d 778 (5th Cir. 2001).

[111] "Safe harbor leasing has been heralded as a method to transfer the benefits of the investment tax credit and accelerated depreciation to firms that pay little or no income tax, and thereby to equalize the ability of taxpaying and nontaxpaying firms to obtain these benefits." Warren & Auerbach *supra* note 77 at 1752. "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." Phillip J. Harmelink & Nancy E. Shurtz, *Sale Leaseback Transactions Involving Real Estate: A Proposal for Defined Tax Rules*, 55 S. CAL. L. REV 833, 854 (). "Alan Greenspan...referred to [safe

entering into a safe harbor lease, a taxpayer could in essence sell bare tax benefits to another private party.[112] Ordinarily, the determination of which entity may take advantage of a deduction or credit is determined by reference to the ownership of the property to which those tax attributes relate.[113] Without transferring the underlying property, it is generally difficult to shift the attendant tax benefits.[114]

In a narrow sense, the result of a safe harbor lease is precisely the same as making the underlying tax benefits fully refundable.[115] Rather than receiving cash directly from the government, businesses instead receive payment from a private counterparty.[116] Although that feature distinguishes safe harbor leasing from most tax expenditures, safe harbor leasing fits the tax expenditure mold quite comfortably. Safe harbor leasing provided taxpayers with a special benefit by allowing them to monetize their otherwise useless deductions.[117]

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 fiscal arbitrage.[118] Enacting the provision allowed Congress to provide taxpayers with economic benefits worth more than $2 billion without engaging in any direct spending.[119] The fiscal impact of safe harbor leasing was ultimately reflected in the tax expenditure budget, providing legislators and their constituents an accurate picture of the provisions cost in terms of

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harbor leasing] as 'sort of the equivalent of food stamps for undernourished corporations...[which] basically subsidize capital investment in areas which the market wouldn't support.'" Richard J. Bronstein and Alan S. Waldenberg, *The Short Life and Lingering Death of Safe Harbor Leasing*, 69 A.B.A.J. 1844 (1983).

[112] This represented both "a significant deviation from the traditional dominance of substance over form in determining ownership for tax purposes" and a significant change from prior law. *See,* Warren & Auerbach *supra* note 77 at 1762-63 ("Although leveraged leases were used to transfer the ITC 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.")

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

[114] This was certainly true in the Compaq foreign tax credit transaction described above. *See* Compaq Computer Corp., 277 F.3d at 779-80 (describing steps taken—including 46 trades, third-party arbitrage specialists and the use of margin accounts—to shift favorable tax attributes).

[115] 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 not be problematic. *See, e.g.*, I.R.C. § 32 (providing for the refundable Earned Income Tax Credit). Since such refunds are generally not available, tax benefits are often more valuable to one taxpayer 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. *See* Emil M. Sunley, *Depreciation and Leasing under the New Tax Law*, 35 NAT'L TAX J. 287, 289 (1982) (Under a [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.")

[116] *See* Warren & Auerbach *supra* note 77 at 1763 (explaining that in a typical safe harbor leasing transaction the lessor made "a cash payment to the lessee for tax benefits [that] is characterized as a down payment on the purchase price…. the down payment is the only cash to change hands").

[117] *See* Warren & Auerbach *supra* note 77 at 1758-61 (explaining that start-up and loss companies—each not paying taxes and therefore unable to immediately capitalize on certain tax benefits associated with investments in business property, albeit for different reasons—were the intended beneficiaries of the safe harbor leasing provisions).

[118] *See* Warren & Auerbach *supra* note 77 at 1779 (concluding that both refundability and transferability of the tax relevant tax benefits would suffice as mechanisms to achieve the policy objectives of safe harbor leasing).

[119] 1982 tax expenditure budget estimated $2.65 billion in lost revenues for 1982 because of safe harbor leasing. Cong. Budget Office, Tax Expenditures: Budget Control Options and Five-Year Budget Projections for Fiscal Years 1983-1987 (1982) available at http://www.cbo.gov/ftpdocs/59xx/doc5940/doc34-Entire.pdf.

forgone revenue. Nevertheless, legislators may have managed—albeit briefly—[120]to capture the political benefits of spending while paying only the political price of a tax cut.[121]

By comparison with an equivalent command-and-control tax expenditure (such as making the underlying benefits refundable), the safe harbor leasing rules granted taxpayers a relatively high degree of autonomy. By using a deregulatory approach, policymakers sacrificed a considerable degree of their power to control the parameters of the benefit.[122] That shift towards greater self-regulation may have served as a kind of leverage—exacerbating the framing problem by weakening the link between policymakers and forgone revenues—making the fiscal arbitrage more politically profitable.[123]

Responsive regulation of course calls for self-regulation of the sort encouraged by the safe harbor leasing rules.[124] Unfortunately, in this instance, self-regulation provided taxpayers with more freedom to structure transactions without enhancing regulators' capacity to assess the taxpayers' compliance posture.[125] Without that more robust link between taxpayers and tax authorities, there is little reason to believe that safe harbor leasing produced a superior compliance result than a command-and-control alternative. For responsive regulation's quid pro quo to be effective, tax authorities need to have the capacity to assess the behavior and motives of taxpayers. Safe harbor leasing's structural deregulation provides less of that information than even a command-and-control equivalent might have.[126]

2. Section 482's Best Method Rule

True to its name, the best method rule invites taxpayers to determine how best to demonstrate their compliance with transfer pricing rules. The arm's-length standard that governs transactions among related entities compels related taxpayers to interact as though they were

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[120] In part because of "several widely publicized cases of safe harbor leasing that were considered abusive" Congress quickly acted to modify the safe harbor leasing rules, in part by replacing safe harbor leases with finance leases. *See* Alvin Warren & Alan Auerbach, *Tax Policy and Equipment Leasing after TEFRA*, 96 Harv. L. Rev. 1579, 1581 (1983) [hereinafter *After TEFRA*].

[121] *See infra* notes 123 and 170.

[122] *See* Warren & Auerbach *supra* note 77 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…. Safe harbor leasing currently transfers an amount of benefits that bears no particular relationship to any… specification [of competitive neutrality].").

[123] The largely formal distinction between making the underlying tax benefits refundable and making them quasi-transferable via safe harbor leasing was thought to be significant in making safe harbor leasing politically palatable. *See* Sunley *supra* note 115 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.")

[124] *See supra* Subpart I.B.

[125] 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.

[126] 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 the temporary provisions encouraging repatriation of foreign profits offers a mixed picture. Businesses claiming the benefits 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 § 4 (describing requirements for a "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 the tax benefits financed job cuts rather than retention or creation).

unrelated.[127] It does so to ensure that multinationals do not manipulate the prices paid in related-party transactions to lower their global tax bill.[128] If left unchecked, by over- or under-charging related counterparties in different jurisdictions, multinationals could easily shift profits to locations offering favorable tax treatment without altering their underlying business operations.[129]

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 a result.[130] To account for differences among taxpayers and industries, U.S. transfer pricing rules provide an array of methods for arriving at an arm's-length price.[131]

The best method rule does not create that range of alternatives. Instead, it transfers the power to choose a method from tax authorities to taxpayers. Rather than "imposing a rigid hierarchy for applying valuation methods"[132] the regulations call for taxpayers to choose the best possible method for their particular circumstances which taxpayers must then support with a detailed contemporaneous report comparing their own pricing practices to the results produced by their chosen method.[133] Authorities can request that report and test its conclusions.

The best method approach fits squarely within the responsive regulation premise of greater self-regulation coupled with discretionary oversight.[134] 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.

Because the best method rule provides reporting—rather than structural—autonomy to taxpayers, the benefit taxpayers receive in exchange for that increased cooperation potential is relatively modest. At the margins, taxpayers undoubtedly choose methods that provide more favorable results. Since they must explain their choices to tax authorities, their capacity to take aggressive positions is constrained.[135] As a result, the best method rule creates almost no

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[127] I.R.C. § 482.
[128] *See* Reuven 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).
[129] "[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." Avi-Yonah *supra* note at 128.
[130] "A second problem with the arm's-length standard is that it requires answers to hypothetical questions: 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." Brian Lebowitz, *Profit Sharing as a New World Order*, 52 TAX NOTES INT'L 585 (2008).
[131] Treas. Reg. § 1.482-3(a).
[132] Clark *supra* note 78 at 1191-92.
[133] Treas. Reg. § 1.6662-6(d)(2).
[134] 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. *See* Treas. Reg. § 1.6662-6(d)(2)(iii) (specifying documentation requirements for exception to transfer pricing valuation misstatement penalty)
[135] It might be a stretch to consider that marginal benefit a true tax expenditure.

opportunity for fiscal arbitrage and grants taxpayers little more autonomy than is necessary to reveal their compliance posture.

3. Liberalizing the Divisive Reorganization Requirements

Over the last few years, an effort to revise the requirements for tax-free divisive corporate reorganizations has elicited both praise and some amount of disappointment.[136] The basic statutory provisions have long played a central role in the corporate income tax.[137] Since the mid-1980s, they have taken on a new importance. With the repeal of the so-called General Utilities doctrine, corporate divisions—dividing the assets and operations of a single corporation into two separate corporations—generally results in current taxation at both the corporate and shareholder levels.[138] The tax-free reorganization rules provide a temporary respite from the corporate- and shareholder-level taxes that a corporate division would ordinarily trigger.[139]

The prerequisites to that tax deferral—referred to as nonrecognition—largely function to distinguish divisions that address corporate business exigencies from those that serve the interests of shareholders by distributing accumulated profits.[140] The most important of those quintessentially command-and-control requirements, the "active trade or business" requirement, calls for each of the relevant corporations—in a simple spin-off that means the one pre-existing corporation and the two post-division corporations—to operate a substantial business with a meaningful track record.[141] Historically, the determination of whether a corporation is engaged in such a business has been made on a corporation-by-corporation basis.[142] If an otherwise adequate pre-division business was divided among several corporations for any reason, none of those corporations might meet the requirement.[143]

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[136] *See* Martin J. McMahon, et al., *Recent Developments in Federal Income Taxation: The Year 2007*, 8 FLA. TAX REV. 715, 792 (2008) (The legislative reforms "simplify 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…. Proposed regulations to carry out the amendment are anything but simple.")
[137] *See* Gregory v. Helvering, 293 U.S. 465 (1935).
[138] Michael L. Schler, *Simplifying and Rationalizing the Spinoff Rules,* 56 SMU L. REV. 239, 244 (2003) ("In the Tax Reform Act of 1986 (the 1986 Act), Congress eliminated most of the methods for a corporate group to transfer assets outside the group without gain recognition. This set of amendments is generally referred to as the repeal of the General Utilities doctrine.")
[139] *See* Schler *supra* note 138 at 244 ("[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.")
[140] In Gregory v. Helvering, the Supreme Court decided that the corporate division in question was not motivated by business exigencies, but by shareholder interests. Gregory v. Helvering, 293 U.S. 465 (1935).
[141] In Gregory v. Helvering, for example, the newly formed Averill Corporation did nothing but hold an appreciated minority position in the stock of Monitor Corporation. *Gregory,* 193 U.S. at 467. Under the modern statute, that would violate the active trade or business requirement. *See* I.R.C. 355(b).
[142] *See generally* Debra J. Benett, *New Code Sec. 355(b)(3): The Affiliated Group Active Trade or Business Requirement*, 84 TAXES 7, 7-9 (2006) (describing historical operation of the active trade or business requirement in the affiliated group setting).
[143] Benett *supra* note 142 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.")

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.[144] Critics of the prior rules objected to the apparently arbitrary requirement that businesses either structure their operations in a particular—possibly disadvantageous—manner in anticipation of a possible division or engage in a substantively meaningless preliminary transaction.[145] In 2006, Congress revised the applicable statute to apply the active trade or business test on aggregate basis, greatly reducing the need for both.[146]

In many ways, the 2006 reform constituted a typical deregulatory tax reform. Trumpeted as a simplification measure, it produced mixed results in complexity terms.[147] By eliminating frictions that served as obstacles to exploiting the preferential treatment provided by nonrecognition, legislators were able to engage in the starkest form of fiscal arbitrage.[148] Since nonrecognition provisions have fallen outside the definition of a tax expenditure since Surrey's day, the fiscal cost of the changes did not appear on the tax expenditure budget.[149]

This deregulatory adjustment to the divisive reorganization requirements did nothing to enhance authorities' ability to evaluate taxpayers' compliance posture. One could argue that by eliminating the need for taxpayers to engage in a pre-division transaction, the revised rules actually reduced the amount of information available to authorities. A taxpayers' willingness to engage in a transaction with meaningful non-tax implications might be viewed as weak evidence of good faith.[150] The loss of that evidence would reduce authorities' capacity to differentiate among cooperative and uncooperative taxpayers.

III. COMPLIANCE SPIRALS, FISCAL ARBITRAGE AND TAX DEREGULATION

Deregulatory tax reforms may or may not simplify the tax law. Responsive regulation suggests that tax deregulation may nevertheless be more than a pervasive form of everyday libertarianism. This Part compares and contrasts the three instances of tax deregulation presented above to highlight the characteristics of tax deregulation that promote compliance spirals and those that encourage fiscal arbitrage. It shows that by employing responsive regulation and tax expenditure concepts to evaluate and shape deregulatory tax reforms, policymakers can create normatively superior deregulatory strategies.

A. Promoting Taxpayer Compliance

As the three reforms described above demonstrate, granting increased autonomy to taxpayers ensures only that taxpayers will seek advantage in their newfound freedom. If

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[144] *See* Schler *supra* note 138 at 263 ("The restructuring of a group that is necessary to meet the trade or business requirement for P can take enormous amount of time and effort.").

[145] *See* Schler *supra* note 138 at 263 ("[T]he restructuring makes no business sense and is done solely to satisfy the statutory requirement.")

[146] They did so by creating I.R.C. § 355(b)(3). *See supra* note 136.

[147] Even if the changes resulted in lower expenditures per divisive reorganization completed, in increase in divisive transactions could mean increased tax planning expenditures in the aggregate.

[148] *See* David M. Schizer, *Frictions as a Constraint on Tax Planning*, 101 COLUM L. REV. 1312, 1315 (2001) (describing frictions as "constraints on tax planning external to the tax law").

[149] *See supra* note 65 and accompanying text.

[150] Combining business activities within a single corporate shell would, at a minimum, create the risk that liabilities from one business could threaten other businesses.

responsive regulation scholars are correct, in some circumstances, tax deregulation may accomplish much more. John Braithwaite provides a specific example of the sort of partnership that responsive regulation can build in tax matters.

He envisions a "compliance-tax-rate spiral"—in which tax rates automatically fall as compliance increases—as a mechanism that might persuade businesses that they "could gain much from a more cooperative compliance culture."[151] By making the availability of a tax benefit expressly contingent on improvements in taxpayer compliance, Braithwaite's compliance spiral would provide taxpayers with an alternative to reducing their tax burdens by pursuing aggressive tax strategies. Cooperative behavior would be rewarded rather than penalized and the gains that usually accompany aggressive behavior would be tempered by higher tax rates.[152]

Whether reforming a command-and-control rule to give taxpayers greater authority over their own tax treatment produces a compliance spiral depends in part on the type of tax deregulation it represents. Employing the distinction introduced earlier, purely structural tax deregulation seems less likely to create a compliance spiral than reporting deregulation.[153] That pattern can be discerned in the three deregulatory reforms considered above. Of them, the best method rule—the one reporting reform—provides the greatest opportunity for tax authorities to distinguish among taxpayers based on each taxpayer's behavior.[154] Neither of the two structural reforms provides authorities with a reliable means of gauging a specific taxpayer's compliance posture.

The best method rule provides precisely the sort of mechanism that responsive regulation envisions. Taxpayers gain the power to self-regulate as tax authorities cede primary responsibility for assessing taxpayers' compliance.[155] In exchange for that concession, tax authorities receive two distinct benefits. First, taxpayers inclined towards public-regarding behavior act in good faith to provide regulators with a useful starting point in evaluating their compliance.[156] Second, by failing to follow suit, more aggressive taxpayers reveal their unwillingness to cooperate with authorities.[157] By shifting enforcement resources away from the first group and towards the second, regulators may be able to increase compliance among both.[158]

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[151] John Braithwaite, *Large Business and the Compliance Model in* TAXING DEMOCRACY *supra* note 23 at 189.

[152] That sort of self-help could help to explain why the United States has relatively high nominal corporate tax rates but relatively low average corporate tax rates. *See* TREAS. DEP'T., BACKGROUND PAPER TREASURY CONFERENCE ON BUSINESS TAXATION AND GLOBAL COMPETITIVENESS 41-43 (2007) available at http://www.treas.gov/press/releases/reports/07230%20r.pdf

[153] *See supra* text accompanying note 150.

[154] *See supra* note 50 and accompanying text.

[155] *New Approach supra* note 29 at 5 ("[I]f taxpayers are prepared to meet their obligations with minimum interference from the tax office, they should be left alone to get on with it.")

[156] *New Approach supra* note 29 at 6 ("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.")

[157] *New Approach supra* note 29 at 6 ("If the regulatee's choice is uncooperative, the regulator moves to a higher level of enforcement that imposes higher costs on the non-complier.")

[158] For taxpayers demonstrating good faith, the carrot of a less heavy-handed enforcement approach would generate goodwill and encourage taxpayers' inclination towards public-regarding behavior. For uncooperative taxpayers, deploying the stick of aggressive enforcement would overcome taxpayers' reluctance to adhere to the arms'-length standard. *See New Approach supra* note 29 at 6 ("[C]ostly enforcement resources are not wasted on those who are

Safe harbor leasing sits at the opposite end of the spectrum. In a sense, it does not promote self-regulation at all.[159] Instead, it averts the typical cat-and-mouse game between taxpayers and tax authorities over attempts to circumvent limits on the availability of tax benefits by providing taxpayers with a sanctioned route to their preferred destination. The result is more a cease-fire than the collaborative dynamic responsive regulation seeks to create. 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.[160]

The divisive reorganization reform produces a similar outcome. It certainly does not create an explicit link between tax benefits and tax compliance in the way that John Braithwaite proposes. Nor does it elicit taxpayer-specific information for tax authorities to use in distinguishing compliant from non-compliant taxpayers.

One distinction between the two structural tax deregulatory reforms derives from the fact that tax-free divisive reorganizations are a phenomenon specific to relatively sophisticated corporate taxpayers.[161] To the extent that such taxpayers can be viewed as a coherent group, a tax preference targeted towards them could promote a collective compliance spiral among those taxpayers.[162] 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. That implied link between deregulation and compliance could create an informal compliance spiral.

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willing to comply but are reserved for the smaller proportion of the population not willing to cooperate with the authority….")

[159] In the responsive regulation pyramid, "self-regulation" is associated with the motivational posture of "commitment" and "enforced self-regulation" with "capitulation." *See New Approach supra* note 29 at 3. One could easily conclude that safe harbor leasing is more indicative of "resistance" or even "disengagement. *Id.*

[160] One possible advantage of a regime like safe harbor leasing that relied heavily on transactions between private parties is that the presence of those private parties could police potential fraud on behalf of tax authorities. *See* Henry Barry, *Safe Harbor Leases: The Costs of Tax Benefit Transfers,* 34 STAN. L. REV. 1309, 1320 ("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 was 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.

[161] 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. *See* § 201(a) of the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172, 203.

[162] 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.*, *Statement of Richard M. Lipton on Behalf of the American Bar Association Section of Taxation Before the Committee on Finance of the United States Senate on the Subject of Tax Simplification April 26, 2001*, 54 TAX LAW. 617, 618 (2001) (suggesting "simplification" proposals including a look-through rule for corporate divisions that might have a 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 had strained relations between corporate taxpayers and tax authorities. Even household names such as 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, February 20, 2000, at [ ] (describing involvement of well-known corporate brands in tax shelter controversies). Such disputes pushed taxpayers and regulators towards the adversarial peak of responsive regulation's pyramid. Such a targeted deregulatory measure may well have helped divert corporate taxpayers and authorities from that path.

Regulators would, of course, be unable to limit the availability of favorable treatment to specific cooperative taxpayers. Nevertheless, so long as the relevant group of taxpayers—here the 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. 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 might gain momentum becomes more remote.

B. Tax Deregulation's Downside

By helping to promote compliance spirals, tax deregulation can serve public and private interests simultaneously. When deregulatory tax reforms veer towards tax expenditure status, the odds increase that private benefits will outweigh public benefits. In part, that is because such legislative or regulatory action tends to be structural tax deregulation. That structural deregulation generally does not reveal the compliance posture of particular taxpayers and so must rely on informal, collective compliance spirals. That limits their potential impact on the relationship between authorities and taxpayers.[163] At the same time, deregulatory tax expenditures (and near-tax expenditures) also present policymakers with significant opportunities for a fiscal arbitrage.[164]

The fiscal arbitrage opportunities presented by the divisive reorganization reform, for example, can be divided into two categories. First, even if their fiscal impact were economically identical, liberalizing the active trade or business requirement presumably would have been more politically palatable than a direct subsidy for pre-division restructuring transactions.[165] Second, since such nonrecognition provisions are not classified as tax expenditures, expanding access to tax-free corporate divisions would have no formal budget consequences.[166] The combination of those two elements allowed policymakers to deliver the equivalent of a significant subsidy to corporate transactions at a negligible political cost.

The fiscal arbitrage potential of safe harbor leasing falls into the first of those two categories. That is true whenever the fiscal impact of a deregulatory tax reform is fully captured in the tax expenditure budget.[167] The 1982 tax expenditure budget reflected a reduction in federal revenues by an estimated $2.6 billion as a result of the existence of the safe harbor

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[163] Obviously, not all tax expenditures are structural tax deregulation. Command-and-control tax expenditures, imposing precise requirements in exchange for clearly specified benefits are more typical. When a tax expenditure is created by increasing taxpayer autonomy, structuring flexibility is more important than reporting flexibility. Structuring autonomy allows taxpayers to modify their behavior to achieve substantively advantageous tax results. Reporting flexibility merely provides taxpayers with a procedural advantage.

[164] The nonrecogntion rules applicable to divisive corporate reorganizations offers an example of what can be thought of as a near-tax expenditure. Historically, such nonrecognition rules have been excluded from the definition of tax expenditures, but their exclusion has been criticized as arbitrary. *See supra* note 65.

[165] *See supra* note 70. In this particular instance, the difference was particularly stark as lawmakers described the provision as tax simplification rather than a tax break. *See infra* note 185. Ironically, it may have been possible to deliver that direct subsidy at a lower fiscal cost. That is because some businesses—perhaps as a result of non-transferable contract rights or licenses—would have been unable to reorganize at all. 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.

[166] *See supra* note 65 and accompanying text.

[167] *See supra* notes 69-71 and accompanying text.

leasing provisions.[168] Although that reduction was substantial, consistent with the cognitive tax literature considered above,[169] that amount was not perceived as the political equivalent of an equal amount of direct spending.[170]

The best method rule again provides a counterpoint.[171] One reason is that the rule—quite the opposite of a tax expenditure—seeks to promote the Haig-Simons ideal of the economically accurate measurement of income.[172] By contrast, both safe harbor leasing and the divisive reorganization reform grant taxpayers a special preference. Since the best method rule offers taxpayers reporting rather than structuring autonomy, the economic benefit it provides to taxpayers is limited.[173] No less important, taxpayers generate contemporaneous reports justifying their choices and authorities retain the discretion to overrule those choices.[174] As a result, the best method rule is a poor vehicle for the largesse that is essential to fiscal arbitrage.

C. Micro- and Macro-Compliance Spirals

The three deregulatory tax reforms considered above suggest that it is possible—on an ex ante basis—to identify deregulatory tax strategies that are likely to produce a desirable balance of public and private benefits. The insights offered by both the responsive regulation and tax expenditure literatures lead to the conclusion that navigating a course that enhances taxpayer compliance while limiting opportunities for fiscal arbitrage calls for a clear connection between the deregulatory tax benefit in question and taxpayer compliance. Ideally, the deregulatory provision will operate in a manner that reveals meaningful information about a particular taxpayer's compliance posture to tax authorities without delivering significant economic benefits to taxpayers.[175]

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[168] *See supra* note 119.
[169] *See supra* note 70.
[170] *See Safe-harbor leasing's stormy future*, BUSINESS WEEK, December 21, 1981 p. 104 (Industrial Edition) [hereinafter *Stormy future*] (concluding that political considerations played a role in rejecting alternative approaches out of concern that they "would appear on the federal budget as outlays rather than as reductions in revenues."). Today, other forms of fiscal arbitrage, including those motivated by self-imposed budget rules might lead policymakers towards a similar approach.
[171] The same pattern emerges from an institutional competence perspective. Because the best method rule is not a tax expenditure, it is nonsensical to think of implementing it through a non-tax bureaucracy. Just the opposite is true of safe harbor leasing. The policies embodied in those rules, principally promoting capital investment, would almost certainly have been more effective pursued through direct spending. The divisive reorganization reforms present a more complex picture. It is certainly possible to imagine a regime under which the expenses of a pre-division 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, it would require a non-tax agency to answer the entirely tax-driven question of who should be entitled to reimbursement.
[172] In practice, it inevitably falls short of that goal. By providing taxpayers with choices in the way they gauge and explain their compliance, the best method rule may even facilitate some amount of tax planning.
[173] *See supra* note 135 and accompanying text.
[174] 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.
[175] It is likewise true that the more tenuous the connection between specific compliance objectives and the increase in taxpayer autonomy a given reform provides, the greater the risk that tax deregulation will devolve into everyday libertarianism.

The above analysis reveals several patterns. The most striking is that structural tax deregulation appears to provide fewer benefits and pose greater risks than reporting deregulation.[176] It also appears that tax deregulation implemented at the regulatory, rather than the legislative, level seems more likely to promote improved compliance at relatively little cost to the fisc.[177] Finally, it appears that deregulatory reforms that exhibit significant tax expenditure characteristics should always be suspect.

Unfortunately, those observations indicate correlation rather than causation. It is not difficult, for example, to imagine a reporting deregulatory reform implemented at the administrative level that would have a negative compliance impact while facilitating fiscal arbitrage.[178] Likewise, even reforms that should be classified as tax expenditures might more than compensate for any resulting fiscal arbitrage by having a meaningful compliance impact.[179]

John Braithwaite's compliance spiral suggests a reliable and relatively straightforward means of identifying deregulatory tax reforms that present an attractive risk/reward profile. Gauging the type of compliance spiral that deregulation could produce in a given instance reveals both its fiscal arbitrage potential and the likelihood that such a positive compliance spiral will take root. Compliance spirals that operate on a broad scale—affecting a class of taxpayers—and those that implicate a specific taxpayer sit at opposite ends of a spectrum. At one end, with a high risk of fiscal arbitrage and a low likelihood of creating a compliance spiral lies the macro-compliance spiral. At the other, the micro-compliance spiral presents the opposite, and much more appealing, combination.

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. At the same time, if a taxpayer understands 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. That describes the operation of a micro-compliance spiral. If another taxpayer's treatment depends not only on his actions but 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—the link will inevitably be much weaker.[180]

The influence of the scale of the compliance spiral on fiscal arbitrage is more complex. In large part, the heightened risk of fiscal arbitrage is a function of the relationships among macro-compliance spirals, structural tax deregulation and tax expenditures. To create a macro-

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[176] *See supra* Subpart II.C. The best method rule, an example of reporting deregulation, illustrates both patterns. It provided taxpayers with relatively modest benefits and provided tax authorities with useful information.

[177] The best method rule was introduced by regulation, unlike safe harbor leasing and the divisive reorganization reforms (both introduced by statute).

[178] An extreme example would be the elimination of reporting requirements imposed through regulation. Such a deregulatory change would enhance taxpayer autonomy at the expense of tax authorities' ability to gauge taxpayers' compliance posture. It would hinder rather than help the creation of a compliance spiral.

[179] A special preference that is only given to taxpayers upon a demonstration of a cooperative compliance posture, for example, might do just that. It is also worth noting that the tax expenditure definition is highly contested.

[180] 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, certainly more difficult than observing the link between the treatment a specific taxpayer receives and changes in that taxpayer's compliance posture.

compliance spiral, policymakers could make an initial gesture towards the relevant group of taxpayers by instituting deregulatory changes, making improvements in the group's collective compliance posture a condition of further deregulation. Alternatively, they could offer only the promise of deregulation, contingent on such an improvement.

In either case, the benefit would need to be one that could be readily communicated to a class of taxpayers. It would also need to be both salient and relevant to as many taxpayers in that class as possible. That would favor deregulatory tax provisions with stronger expenditure characteristics—the closer they are to a check from the federal government, the stronger and more universal their appeal to members of the affected class. Structural deregulation provides policymakers with a greater capacity to craft such expenditures than does reporting deregulation.[181]

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.[182] Tax authorities bolster their capacity to distinguish among taxpayers inclined towards public-regarding behavior and those not so inclined.[183] By focusing enforcement resources on the latter group, authorities could simultaneously avoid alienating otherwise cooperative taxpayers and coddling the less cooperative.[184]

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. 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 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. 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.[185]

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[181] Of course, fiscal arbitrage permits policymakers to achieve that salience for beneficiaries at relatively low political cost. Even if the provision appears on the tax expenditure budget, constituents will not view it as the equivalent of a comparable amount of direct spending. *See supra* note 70.

[182] "To avoid a valuation misstatement penalty…. it is the taxpayer's responsibility to do the work at the time it is initiating a transaction. We are confident that giving taxpayers flexible pricing guidance, backed up with a reasonable documentation requirement and appropriate penalty enforcement, is the right formula for attaining section [transfer pricing] compliance." Margaret Milner Richardson, Richardson Outlines Progress in International Tax Issues, 94 Tax Notes Today 246-28 (quoting I.R.S. Commissioner Richardson).

[183] That sorting process is at the heart of other innovative efforts to improve taxpayer compliance. *See, e.g.*, Alex Raskolnikov, *Revealing Choices: Using Taxpayer Choice to Target Tax Enforcement*, 109 COLUM. L. REV. 689 (2009) (describing an alternative mechanism allowing taxpayers to self-identify as either "gamers" or "non-gamers").

[184] *See supra* notes 54-55 and accompanying text.

[185] Consistent with the notion that macro-compliance spirals require salient deregulatory tax changes, beneficiaries of the divisive reorganization reform would understand and appreciate its significance. On the other hand, since it would not be classified as a tax expenditure, the public might even be persuaded that it is costless. By presenting the change as a "simplification" measure, legislators may have accomplished just that. Congressional Record; 109th Congress, First Session - Wednesday June 29, 2005 Statements on Introduced Bills and Joint Resolutions - S. 1327. A bill to amend the Internal Revenue Code of 1986 to modify the active business definition under section 355; to the

The safe harbor leasing rules present a somewhat different picture. In some respects, they present a smaller risk of tax arbitrage. Although its fiscal arbitrage potential is not insignificant, its inclusion on the tax expenditure budget prevents some of the arbitrage possible with the divisive reorganization reforms.[186] Since safe harbor leasing implicates an even broader pool of taxpayers than the divisive reorganization reforms, the likelihood of a successful compliance spiral is even lower. At a minimum, that macro-compliance spiral would include businesses investing in significant amounts of capital equipment.[187] 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.[188]

CONCLUSION

Tax deregulation is not a new phenomenon. Policymakers have been modifying tax rules to offer taxpayers greater autonomy for at least a quarter of a century. Until now, the significance of tax deregulation has been obscured by its proximity to tax simplification. By employing the insights of the tax expenditure and responsive regulation literatures, this Article provides a means of understanding the unique blend of opportunities and dangers tax deregulation presents. In particular, by distinguishing between micro- and macro-compliance spirals it offers policymakers a robust tool for crafting deregulatory tax policies that combine a low risk of fiscal arbitrage with the greatest likelihood of enhancing taxpayer compliance.

Committee on Finance, 151 Cong. Rec. S7616-01 (quoting Senator 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.").

[186] By contrast with the divisive reorganization reforms—which had no formal budget implications—safe harbor leasing formed quite a significant line item on the tax expenditure budget. *See supra* note 119.

[187] 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 115 at 289 (estimating that 84% of the benefits of safe harbor leasing went to those transferring their tax benefits 1981)]; *Stormy future supra* note 170 (concluding that in some cases, more than half of the benefits went to transferees/lessors).

[188] 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. Just one, relatively manageable, example would be the level of resources devoted to enforcement with respect to the relevant group of taxpayers.