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I. Introduction

The current tax system integrates structural revenue raising provisions with policy-driven tax incentive, or subsidy, provisions designed to induce taxpayers to engage in activities favored by Congress for extrinsic political or social reasons. The wisdom of this dual mission has been the subject of extensive analysis and criticism.[1] Indeed, the Tax Reform Act of 1986[2] marked a distinct shift away from the use of tax incentives.

It now has become apparent that this country is likely to reverse much of the 1986 tax reform and to resume using the tax system to provide incentives for business and other socially desirable activities. Both President Clinton's original tax proposal to Congress,[3] which underwent significant modification before enactment as the Omnibus Budget Reconciliation Act of 1993,[4] and the Revenue Act of 1992,[5] which was vetoed by President Bush, were replete with the kind of tax incentives that the 1986 Act sought to eliminate.[6]

At this stage in tax evolution, one either could warn again of the dangers of using the tax system to advance social and economic goals, or accept the inevitable and attempt to insure that tax incentives are structured in the best possible way. Adopting the latter course, this Article offers a new and useful framework for structuring tax policy in the 1990's in order to minimize harmful economic and social side ef-

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1 See notes 16-17.

2 Pub. L. No. 99-514, 100 Stat. 2085.

3 H.R. 1960, 103d Cong., 1st Sess. (1993).

4 Pub. L. No. 103-66, 107 Stat. 312.

5 H.R. 11, 102d Cong., 2d Sess. (1992).

6 For example, both bills contained enterprise zone tax incentives. H.R. 1960, note 3, at §§ 3101-3104; H.R. 11, note 5, at §§ 1101-1131.

fects of tax incentives. The Article identifies the most pernicious type of tax incentives as periodic subsidies, that is, subsidies that are available to taxpayers over a period of years, rather than on a one-time basis. Periodic subsidies are inefficient and are likely to decrease the horizontal equity of the tax system. Drawing on the jurisprudence of just compensation law and on economic theory, the Article concludes that Congress should refuse to succumb to the temptation to use periodic tax incentives as an instrument of tax and economic policy but, instead, should employ only one-time subsidies. In reaching this conclusion, the Article takes issue with the recent scholarship of Professors Michael Graetz[7] and Louis Kaplow[8] whose advice to eschew transition relief for tax changes apparently has gained substantial currency among tax policymakers.

Section II introduces the framework for tax policy analysis that should be substituted for the traditional approach and sets forth the dichotomy of one-time and periodic tax subsidies. Section III explores the inherent weakness of periodic subsidies as a tax policy tool by discussing the fundamental problems of repeal—inequity and economic inefficiency. The Article criticizes Professors Graetz's and Kaplow's conclusion that there is no need for transition relief when periodic tax subsidies are eliminated. Section IV provides support for the analysis and conclusions in Section III by reference to the commercial real estate debacle in the 1980's. The periodic tax subsidies enacted in 1981 and their repeal in 1986 are implicated as major contributing factors. Section IV identifies owner-occupied real estate as another beneficiary of periodic subsidies and a potential victim of their removal. Finally, the Article concludes with a legislative prescription for dealing with these issues in the future.

II. A New Tax Policy Framework for Tax Incentives

A. The Traditional Approach: Tax Expenditures

All tax incentive provisions have one thing in common, regardless of their form. They are designed to generate a movement of capital or labor into a particular activity by reducing the effective tax on income from that activity. A tax incentive provision works only when it has the effect of reducing a participant's tax. The resultant reduction in the federal government's revenue collection attributable to the tax incentive provision can be viewed as a subsidy to the tax-favored activ-

[7] Michael J. Graetz, Legal Transitions: The Case of Retroactivity in Income Tax Revision, 126 U. Pa. L. Rev. 47 (1977-1978) [hereinafter Tax Revision].

[8] Louis Kaplow, An Economic Analysis of Legal Transitions, 99 Harv. L. Rev. 509 (1986).

ity. Stanley Surrey referred to the lost revenue attributable to a tax incentive provision as a "tax expenditure."[9]

Commentators sometimes disagree about which tax provisions represent subsidies and which represent integral parts of the income tax structure because they involve measurement of income.[10] Structural components are the so-called normative elements of a revenue raising system. They include the definition of income, the specification of accounting periods, the determination of entities subject to tax, and the specification of tax rate schedules and exemption levels.[11] Thus, a change in tax rates, for example, does not constitute a subsidy. Rather, tax rates represent a cooperative agreement on burden sharing once the tax base has been established.

In contrast, a tax subsidy is a special preference that represents a departure from the normal tax structure, designed to favor a particular industry, activity or class of people.[12] In that sense, tax subsidies represent an alternative to direct government financing of the recipients of those preferences and should be analyzed as such. Examples of tax subsidies include cost recovery deductions exceeding economic depreciation[13] and various targeted tax benefits ranging from the deduction for research and development expenses[14] to the exclusion for scholarships.[15]

Although tax rates are not tax subsidies, the economic benefit of any tax subsidy through deduction or exemption is influenced signifi-

9 Stanley S. Surrey, Pathways to Tax Reform: The Concept of Tax Expenditures vii-viii (1973) [hereinafter Pathways].

10 Compare Bruce Wolk, Discrimination Rules for Qualified Retirement Plans: Good Intentions Confront Economic Reality, 70 Va. L. Rev. 419, 421-22 (1987) (concluding the current tax treatment of qualified pension plans is a subsidy) with Edward A. Zelinsky, 66 N.C. L. Rev. 315, 315-16 (1988) (concluding the current tax treatment of qualified pension plans is not a tax expenditure).

11 See Stanley S. Surrey & Paul R. McDaniel, The Tax Expenditure Concept: Current Developments and Emerging Issues, 20 B.C. L. Rev. 225, 228 (1979). While the authors would include accelerated depreciation as a tax subsidy, curiously, the government's tax expenditure budget views all depreciation matters as structural. Office of Management and Budget, Tax Expenditures, Budget of the United States Government: Analytical Perspectives, Fiscal Year 1995, at 53-78 (1994) [hereinafter OMB Tax Expenditures]. But see Staff of Joint Comm. on Tax'n, 103d Cong., 2d Sess., Estimates of Federal Tax Expenditures for Fiscal Years 1995-1999, at 5 (Comm. Print 1994).

12 Surrey & McDaniel, note 11, at 228.

13 See IRC § 168.

14 See IRC § 174.

15 See IRC § 117. One commentator has suggested that the bifurcation of tax provisions into the two categories, tax subsidy and structural, should be avoided because it merely reduces the analysis to one of definitions. Instead, all tax provisions should be viewed as expenditures in order to evaluate whether they adequately achieve the desired social or economic goal. Michael J. McIntyre, A Solution to the Problem of Defining a Tax Expenditure, 14 U.C. Davis L. Rev. 79 (1980).

cantly by the tax rates. The greater the tax rate, the greater will be the subsidy impact of a special deduction or exclusion.

Long before the 1980's, Stanley Surrey and his adherents argued that activities should be encouraged, if at all, through direct government subsidies instead of tax incentives. They contended that using the tax system to subsidize activities was undesirable,[16] and that if the social policy objectives were desired, direct government grants would be preferable to tax incentive provisions.[17]

Under what now has become accepted as traditional tax policy analysis, based upon Surrey's insight, tax incentive provisions are categorized according to the manner in which they operate: by exclusion, deduction or credit.[18] Traditional analysis focuses on the upside down

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[16] See generally Surrey, Pathways, note 9. There were several prongs to their arguments. First, tax incentives created undue tax complexity that must be dealt with largely by accountants, who typically are generalists in the tax law. Second, tax incentives usually provided subsidies in an inequitable manner because those taxpayers who were in the highest tax bracket received the greatest tax reduction from the more common tax incentive provisions that operated through exemptions or deductions (unlike those that operated through tax credits). Third, the overall subsidy amount was unknown because accurate measurements depended on what taxpayers would have done absent the subsidy, in addition to what they actually did. Some 20 years ago, Treasury attempted to address the last of these objections by creating a tax expenditure budget. The TEB, published annually, attempts to estimate the amount of revenue forgone due to tax incentive provisions. See, e.g., OMB Tax Expenditures, note 11. While generally accepted in concept, there has been disagreement over what constitutes a tax subsidy and what constitutes a normal measurement of income. See note 10.

[17] Direct government grants have been criticized, however, as being even less desirable than tax incentives because of the need for large government bureaucracies to dispense the subsidies. Edward A. Zelinsky, Efficiency and Income Taxes: The Rehabilitation of Tax Incentives, 64 Tex. L. Rev. 973, 1010-12 (1986). By contrast, tax incentives are automatic in that taxpayers themselves choose whether to take advantage of them. In addition, direct grants, typically made by application to a government agency, are susceptible to favoritism and discrimination among similarly situated taxpayers simply because a human must make a judgment as to who gets subsidies that are limited in amount. By contrast, a tax incentive provision is neutral, once it has been enacted, because it does not require an individual's judgment as to who is entitled to receive it.

Although Professor Surrey answered those criticisms, in large part, in several articles dating back more than 20 years, see, e.g., Stanley S. Surrey, Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures, 83 Harv. L. Rev. 705 (1970), tax expenditures nevertheless have appeal to many lawmakers and their advisors, as well as citizens who simply distrust public expenditure programs. Misappropriation of government funds such as the recent HUD scandal only add to that distrust. See Gwen Ifill, After Years of Obscurity, HUD Emerges in Scandal; Cabinet Members, Aides, Contractors Tainted, Wash. Post, May 30, 1989, at A7.

[18] Certain types of receipts that increase a taxpayer's wealth may be wholly or partially excluded from a taxpayer's income to attract capital to the activity generating those receipts. For example, investments in municipal bonds yield interest income that is exempt from the regular federal income tax. The exemption is designed to channel private money to local governments by allowing those governmental entities to borrow money more cheaply than their corporate counterparts, whose interest payments are fully taxable to the bondholders. Prospective purchasers of the tax-exempt bonds are willing to accept a lower

nature of tax subsidies that operate through exclusions or deductions by comparing them to direct expenditures. Thus, tax policy analysis under the traditional approach would ask whether the tax system is a more efficient means for providing the subsidy than a direct grant and, if so, whether the subsidy should take the form of an exclusion, deduction or credit, bearing in mind the equity of each mechanism.

B. *A New Framework: One-Time vs. Periodic Subsidies*

A comparison of tax incentive provisions with direct grants and the trichotomy of alternative forms of subsidy, while important, is typically where analysis of tax incentive provisions ends. Tax policy analysis should take the further, and I believe essential, step of dividing tax incentive provisions into two categories: (1) those that provide one-time subsidies in the year of acquisition of the property or commencement of the activity and (2) those that operate each year the property is owned or the activity is conducted by artificially increasing the after-tax yield from the property or activity. This additional step is even more important than the steps under the traditional approach. Such a distinction becomes particularly important whenever a decision is made to discontinue a tax subsidy.

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yield on those bonds than for comparable taxable bonds because the yield is not subject to tax.

Other tax incentive provisions operate through deductions. Special deductions for expenses for research and development of new technology, IRC § 174, represent an example of this type of tax incentive provision. In addition, accelerated depreciation (that is, depreciation for tax purposes that exceeds or is expected to exceed the amount of actual reduction in value of the depreciable property through deterioration or obsolescence) is a tax incentive provision that operates by means of a deduction. See IRC § 168; see also IRC § 197. Both provisions reduce a taxpayer's income in computing tax liability by an amount greater than the cost of earning that income. Prospective purchasers of property eligible for tax incentive deductions are willing to accept a lower yield from that property than from property not entitled to those tax incentive deductions because they will be able to use the deductions to offset their true economic income and reduce their tax liability from the property. This tax savings effectively increases their yield on that property.

A tax incentive provision also may operate through a tax credit, which is a dollar-for-dollar reduction in a taxpayer's actual tax liability. The investment tax credit, which was repealed by the Tax Reform Act of 1986, Pub. L. No. 99-514, § 211, 100 Stat. 2085, 2166-70, is an example of this type of tax incentive provision. Previously, a taxpayer who purchased business equipment was allowed a credit against his tax liability of 10% of the cost of that equipment. Former IRC § 38 (before repeal in 1986). In essence, the equipment only cost the taxpayer 90% of its price as the government effectively paid the remaining 10%.

Unlike an exclusion or deduction, the recipient's marginal tax rate does not affect the benefit of a tax credit. In contrast, the benefits of an exclusion or deduction are disproportionately greater for the high marginal bracket taxpayer. For example, a $100 deduction would give a $36 benefit to someone in the 36% tax bracket, while only a $15 benefit for someone in the 15% bracket.

The investment tax credit[19] and the deduction for research and development expenses[20] represent examples of the first category of incentives. Once received by the taxpayer, the subsidy cannot be removed or altered.[21] The decision to purchase the property or engage in the activity is affected by the one-time payment, which would be considered together with the current and long-term financial projections for the activity. This type of tax incentive can be turned on and off by the government without concern for ignoring the taxpayer's reliance because the taxpayer's subsidy cannot be affected by later government policy. To be sure, the following year Congress could increase the subsidy so that taxpayers who waited a year could obtain a greater benefit than those taxpayers who acted earlier. A taxpayer's reliance argument, however, would be no greater than the consumer who purchased an item of clothing at full price when he could have waited for the item to go on sale. The taxpayer may feel unhappy, but has not suffered a direct subsidy reduction; he has received exactly what he bargained for notwithstanding the post-acquisition price reduction.

The second type of tax incentive operates through subsidies made in periodic (generally annual) installments. Examples include accelerated depreciation[22] and tax-exempt interest on municipal bonds.[23] In enacting the tax incentive provision, the government has promised the taxpayer that if she acquires the property, the federal government each year will subsidize the economic yield. For example, accelerated depreciation promises the owner an annual subsidy in the amount of the reduced tax liability resulting from the accelerated portion of the depreciation (reduced by the present value of the anticipated tax on the extra gain at time of sale).[24] Similarly, municipal bonds promise the owner an annual subsidy in the amount of the forgone federal tax on the interest received from the issuer. Thus, in deciding whether to acquire property or engage in the desired activity, the taxpayer makes a present value calculation of an annuity of tax subsidies beginning in the year of acquisition and ending with the year of expected disposi-

[19] IRC § 38 (before repeal in 1986).

[20] IRC § 174.

[21] Recapture of the investment tax credit upon early disposition of the property, IRC § 50(a), is part of the original subsidy bargain.

[22] IRC § 168.

[23] IRC § 103.

[24] Periodic deductions, such as nonaccelerated depreciation, do not necessarily represent subsidies. For example, depreciation represents a mechanical means of allocating the cost of property over the property's life; in that sense, it attempts to mirror, as much as practicable, the property's decline in value. As such, this deduction and other periodic deductions do not represent subsidies, but rather are structural as an inherent part of the measurement of income.

tion (or full depreciation of the property or maturity of the tax-exempt bond). Thus, the taxpayer has a legitimate reliance interest in expecting the subsidy to continue for the life of the activity, unless the duration of the subsidy otherwise was limited initially.[25]

The economic consequences of periodic subsidies are more variable and unpredictable than those of one-time subsidies. The financial impact of a one-time tax subsidy can be computed in a fairly straightforward manner. A taxpayer can value the subsidy because tax rates will be known for the year of the subsidy. Therefore, policymakers can set the subsidy at the appropriate level to elicit the desired activity.

Periodic subsidies, on the other hand, involve economic benefits extending beyond the year of the taxpayer's expenditure. Accordingly, a subsequent event such as a change in the tax rates affects the subsidy. For example, a reduction in tax rates in subsequent years effectively reduces the amount of a periodic deduction or exemption subsidy. If the after-tax yield to a taxpayer in a tax-subsidized activity declines, property customized for or dedicated on a long-term basis to that activity suffers a reduction in value as well. Thus, although changes in tax rates are not themselves subsidies, changes in tax rates from a long-standing norm will affect the level of a subsidy. Periodic subsidies, therefore, represent something of an unguided missile in tax policy.

Whether a subsidy takes the form of an exclusion, deduction or credit, however, often is not the most relevant feature in analyzing the effect of the subsidy. The most significant feature of a subsidy from an economic viewpoint in many cases is whether it is periodic and, therefore, whether taxpayers act currently with the expectation of obtaining benefits in future years.

This feature may have practical political ramifications as well. A one-time subsidy requires an immediate outlay by the government to fund the subsidy. Accordingly, it would have to be accounted for entirely in the year it is availed of by the taxpayer, through purchase or expenditure, in the form of lower tax collections, thereby creating a greater budget deficit in that year. In contrast, a periodic subsidy of

[25] The low income housing credit, a technically complex tax subsidy, see IRC § 42, allows a tax credit in annual installments over 10 years for qualified low-income rental housing. It has elements of both a periodic subsidy and a series of one-time subsidies. The credit appears to be in the nature of a periodic subsidy because although qualification to receive the credit is determined at the outset, the credit is available in installments. Yet, it also has elements of a series of one-time subsidies because eligibility to continue receiving the tax credit installments depends upon continued qualification each year the credit is claimed (which entails more than merely refraining from disposing of the property), see IRC § 42(g) (defining "qualified low-income housing project"), and there are provisions for recapture of a portion of previously claimed credits if eligibility is not continued throughout a 15-year compliance period, see IRC § 42(j).

equivalent value could be accounted for over its entire life. Therefore, although a one-time subsidy may be a theoretical substitute for a periodic subsidy,[26] it may not be a politically viable one.

A government's choice of a periodic subsidy instead of a one-time subsidy masks its real cost. In effect, it allows the government easy tax subsidy payment terms because it is accounted for through reduced tax collections in years subsequent to the year in which the subsidized taxpayer engaged in the desired activity or made the desired expenditure. It therefore creates the illusion that subsidy payments are to be made in the future, whereas the government has committed itself in the initial year to make those payments. In essence, the government has borrowed money in the initial year to make a subsidy payment in the amount of the present value of the series of periodic tax benefits, and will repay that borrowing, plus interest, in installments. The ability to obfuscate the real cost of the tax subsidy through the use of a periodic subsidy, however, should not dictate its use.

II. The Fundamental Problems in Removing Periodic Subsidies

A. *Equity*

1. *Periodic Subsidies Contrasted with One-Time Subsidies*

Repeal of a periodic tax subsidy on which the taxpayer has acted in reliance is inequitable and can have a serious destabilizing effect on the economy. As a result, Congress should not remove a periodic subsidy without either transition relief for or compensation of the recipient.

The inequity created by repeal of a periodic tax subsidy can be understood best by observing the dynamics of a periodic subsidy. Introduction of a subsidy may result in some degree of extraordinary profits for recipients. If a lengthy adjustment period is needed for taxpayers to respond to the subsidy, the subsidy could result in windfalls to those recipients who already engage in, or otherwise would have engaged in, the desired activity, or to those who respond to the subsidy quickly. Those windfall benefits would continue until a sufficient amount of the encouraged activity develops to allow market forces to bid down profits from those activities. Excess profits are created during the adjustment period to encourage the desired behavior. The government cannot attempt to recoup the windfalls because to do so would blunt the incentive effect of the subsidy.

[26] If a constant tax rate is assumed, every periodic subsidy of fixed duration can be equated with a one-time subsidy by means of a present value computation.

Moreover, during the adjustment period, property particularly suitable for the subsidized activity, if in limited supply, would increase in value because the return that it generates, including the subsidy, would increase. The property's increase in value largely would reflect the present value of the excess profits during the adjustment period.

The removal of the subsidy is precisely the reverse side of the coin. When a periodic tax subsidy is reduced or eliminated before the activity is terminated (or prior to an announced termination date), an owner who already has made the expenditure cannot undo that decision. The owner's profit from the activity reflects and is dependent on the subsidy. The owner's reduced profit (or losses) resulting from elimination of the subsidy will continue until aggregate market output in the activity adjusts and is reduced sufficiently to raise prices. During the adjustment period, the owner will suffer reduced income or operating losses. The longer the adjustment period, the greater the overall economic impact of the subsidy's repeal on the owner. Likewise, the value of the activity or property dedicated to the activity will be reduced, reflecting its reduced return, which then would not include the subsidy that has been removed. That economic loss would not merely offset the previous windfall because those who suffer the loss may or may not have been recipients of the previous windfall.[27]

A periodic subsidy represents a government promise of future benefits or subsidy payments that are intended to cause taxpayers to make current expenditures and changes in their investments. A taxpayer's decision to make that expenditure is based upon the estimated present value of the stream of subsidy payments.[28] Removing the subsidy for those who already have responded represents a breach of promise.

The injury resulting from this breach of promise should be analyzed by reference to two distinct interests that the recipient has in the subsidy and for which the recipient may be entitled to protection: first, the interest in continuing to receive the subsidy itself for the agreed-upon term, and second, the right to retain a capitalized value of the

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[27] For example, a taxpayer who purchased property for its then fair market value, which already reflected the value of the subsidy, will have paid a premium for the subsidy benefits. Removal of the subsidy will cause a loss to that taxpayer equal to that premium, that is, the portion of that taxpayer's purchase price attributable to the subsidy.

[28] Professor Graetz, however, would argue, in effect, that such a present value calculation would have been irrational because the taxpayer would have been unreasonable to expect the subsidy payments to continue for the duration of the defined term—for example, years to maturity of a tax-exempt bond, or the entire recovery period of a depreciable asset. Rather, "[i]n the market context, only behavior that takes into account probabilities of change is treated as reasonable." Graetz, Tax Revision, note 7, at 66. Treasury, at least in 1977, took a contrary view. See Treasury Dep't, Blueprints for Basic Tax Reform 187, 200-01 (1977) (favoring grandfathering and phase-ins).

subsidy for disposition. From the perspective of both equity and long-term economic efficiency,[29] the recipient of a subsidy should be entitled to continue receiving the periodic subsidy promised, even if the subsidy results in large gains to the recipient. Moreover, in some cases a transferee of the subsidized property or activity also should be entitled to the continuing benefits of the subsidy. If a periodic subsidy is to be removed, however, the recipient should be compensated by the government for the value of the removed subsidy that has been capitalized into the price of the subsidized property or activity.[30]

One-time subsidies, in contrast, generally can be removed without inequity to its recipients.[31] When a tax incentive elicits oversupply and therefore production of an unneeded item, the government should be able to eliminate it prospectively. Otherwise, the economy would be saddled forever with any artificially induced market inefficiency.

Repeal of a one-time subsidy is always prospective. To be sure, even one-time subsidies can elicit changes in behavior that reverberate throughout the economy and can have far-reaching effects. That is true regardless of whether the subsidies are made through the tax system or directly. For example, a one-year investment tax credit, if effective, will cause manufacturers to increase their purchases of productive equipment and machinery because of the reduced cost of the machinery. Those purchases should allow expanded production and reduce end product production costs, as well as end product prices, because of the increased supply of the end product. Thus, purchasers of the end product share the reduction in the cost of machinery resulting from the one-time subsidy. The sharing ratio depends upon the elasticity of demand for the end product (that is, the effect of a price change on the amount demanded) and the length of the adjustment period.

Users of that product may come to depend upon lower prices of the product and adjust their behavior and choices accordingly. For example, they may come to depend upon an adequate supply of the product at its prevailing price, even though that price prevails only because of a government subsidy. If the one-time subsidy is eliminated, the cost structure of new producers increases, thereby reducing the supply of that product and pushing up the price. The product user again shares the cost increase. Does that user now have any argument that he reasonably relied upon the subsidy for the product and is entitled to continue buying that product at the subsidized price?

[29] See text accompanying notes 49-58.
[30] See text accompanying note 45.
[31] See text accompanying notes 49-58.

This example illustrates the destabilizing effect on the economy of all subsidies, whether made through the tax system or otherwise, and whether one-time or periodic. Turning the spigot on and off can significantly impact the economics of the subsidized property or activity. Subsidies, therefore, should be used sparingly and then only when overriding policy justifications dictate.

One-time subsidies, however, do not create an interest to recipients on which they can rely for similar subsidies in the future. The immediate recipient of the one-time subsidy (in the illustration, the producer) makes its economic decisions based upon that knowledge, but should be precluded from claiming reliance on any implied promise or expectation that the subsidy will be repeated in future years.[32]

For the user of the product manufactured by the subsidy recipient and others further down the chain, the introduction and later removal of the subsidy are similar to all other changes in cost or demand structure affecting their products. Although the subsidies can be destabilizing, they do not create reliance interests. The user should not be able to rely on the government's continuation of the subsidy.

To be sure, the government's introduction and later removal of a subsidy destabilizes certain financial aspects of businesses that buy from or sell to a direct recipient of the subsidy. But, not all aspects of business are predictable. For example, foreign relations and other external factors all influence the supply and demand of, and therefore pricing and cost structures of, various products and services. A business does not have a right to rely on tomorrow's circumstances being exactly the same as yesterday's. Nevertheless, the government's erratic action in installing and removing subsidies simply adds to business uncertainties and, therefore, is likely to affect the economy adversely, unless the subsidies are designed to offset other destabilizing events, or the benefits to the economy of the subsidies override the detrimental destabilizing effects.

In any event, the harm resulting from destabilizing effects of one-time subsidies is very different in degree from the harm resulting from the removal of periodic subsidies, on which recipients have relied directly in making long-term business decisions. The first elicits objections from businesses that it is difficult to plan purchases and production and that government subsidization policy has made it more difficult.[33] The second, however, elicits objections rising to the

[32] A more difficult problem results when there is an implied promise or an expectation that arises from previous conduct that the one-time subsidy will be repeated in future years. See Section V (discussing this issue in the context of the home mortgage interest deduction).

[33] Paul Craig Roberts, Rescuing Real Estate Will Save Banks and the Economy, Too, Bus. Wk., Feb. 18, 1991, at 18.

level of breach of promise against the government. That objection in the private law context is the type that gives a remedy of damages to the injured party.[34] Although these differences may seem a matter of degree, they are so large that they become differences in kind.

2. *The Right to Continuation of the Periodic Subsidy for the Duration of the Activity*

The clearest example of a periodic subsidy for which recipients should be protected by continuation of the subsidy is the exclusion from gross income of interest from state and local bonds.[35] Because a tax-exempt bondholder is not taxable on the interest from the bond, market forces cause the yield or interest rate on a tax-exempt bond to be significantly lower than an equivalent taxable bond. The relevant financial comparison of the two bonds should be their respective after-tax yields rather than pretax yields. The issue price of these bonds, by virtue of market forces, reflects the value of the tax exemption so that the after-tax yield from such bonds approximately equals the after-tax yield of taxable bonds of equivalent credit quality and term. Viewed another way, a prospective purchaser of a tax-exempt bond pays a premium for the bond compared to the price that would be paid for a taxable bond of equivalent pretax yield. The premium reflects the value of the exemption from income tax of the stream of interest payments to be earned on the bond.

The exclusion from income of the interest appears to be a subsidy to bondholders. In reality, however, a large part of the subsidy is transferred to the issuing state or municipality because the exemption permits the state or municipality to borrow money by issuing the bonds at a lower-than-market interest rate. The allocation of the subsidy between the issuer and the private investor depends on the supply and demand of tax-exempt obligations which, in turn, depends on the investors' marginal income tax rates.

If the tax exemption for existing state and municipal debt obligations were eliminated, the owners of those bonds would have a justifiable complaint that they relied on the government's promise of interest income exclusion in making their investment decisions for the term of the bond. These bonds should be entitled to continued exclusion, regardless of whether new bonds issued by states or municipalities are eligible for similar tax-exempt status.[36] Indeed, those

[34] See, e.g., Restatement (Second) of Contracts § 346 (1979).

[35] IRC § 103.

[36] This issue of transition relief is explored further below. See text accompanying notes 45-48.

investors paid for the promise of tax exemption by paying a premium for the bond relative to an equivalent taxable bond.

Arguably, the risk of reduction or loss of the subsidy, for example, the removal of the tax exclusion for the interest, is discounted by the market and, therefore, also is capitalized in the bonds' value. If that is the case, the government's subsidy is more of an expectation of likely government action or inaction, for which there is no commitment, than it is a promise. Therefore, the tax exclusion would not be fully capitalized, causing the interest rate on the bonds to include a risk premium reflecting the possibility of the change in the law. But it appears certain, given the longstanding existence of the exclusion, that the tax exemption is regarded by investors as a promise. Accordingly, virtually all of the exclusion is reflected in the bond's value.

Thus, it is no more justifiable for the government to terminate unilaterally a periodic subsidy that has already elicited the desired behavior by recipients, without transition relief (that is, grandfathering or compensation) than it is for the government to coerce repayment of a one-time subsidy. This equivalence leads one to conclude that a periodic subsidy should not be removed for current recipients unless transition relief is provided. To restate the proposition, a periodic subsidy should be continued for the current recipient who reasonably anticipated that the subsidy would continue and acted in reliance on it.

For administrative reasons, this proposition might be subject to a possible caveat, which, even if accepted, does not cast doubt on the correctness of the general proposition and which I do not concede. Perhaps some periodic subsidies should not fall within the general proposition against repeal without transition relief, where overall public good from repeal outweighs the harm to the subsidy recipient from repeal. This might occur when (1) the subsidy caused wasteful overproduction of a particular product or substantial enrichment of taxpayers whose actions were not affected by the subsidy, and (2) the administrative cost of determining the appropriate amount of compensation and operating a compensation system exceeded the amount of compensation that would be due. For example, if the depreciation recovery period of five-year property were extended by legislation to seven years two years after the taxpayer put the property into service, and the property is readily saleable, then a system of determining and adjudicating just compensation may cost more to administer than it pays out in compensation. This situation would tend to be limited to periodic subsidies that affect the value of property with a relatively short anticipated life and changes in taxpayer position in response to the subsidy are easily reversed. In the case of reversible response, most of the inequity can be undone, although the taxpayer's opportunity cost in forgoing alternative investments will be lost. Nevertheless, acceptance of this caveat as a matter of administrative convenience, which I do not concede, should not in any way affect the correctness of the more general proposition. Most importantly, however, a periodic subsidy should not be removable, without relief, merely because it is determined that it was ill-conceived and a policy error from the outset, or simply too generous. If the uncertainty of the continued subsidy were accepted at its inception, its removal would be part of the risk assumed by the taxpayer. If the uncertainty were not accepted and the subsidy was assumed to be permanent for the life of the activity, however, its removal would be the substantial economic equivalent of a required repayment of a one-time subsidy,[37] and should be rejected. The solution to the problem of the possibility of an unwise periodic subsidy on which taxpayers will rely is not to permit its retroactive removal but, rather, to refrain from instituting the subsidy in the first place. These issues are explored more fully below.

3. *The Right to Receive or Be Compensated for the Capitalized Value of the Periodic Subsidy Upon its Removal*

A second problem with periodic subsidies involves the protection of the recipient's interest in a somewhat more debatable manner: the protection of the capitalization of the subsidy in the value of the subsidized property or activity. For example, if a new provision is enacted entitling a taxpayer to accelerated depreciation if the taxpayer purchases and uses in his business a certain kind of property, say equipment, one would expect demand for that equipment to increase. Until suppliers of that equipment could adjust their output, one would also expect the price of that equipment to increase in the short run, reflecting the increased demand. The purchaser of the equipment would be willing to pay a price higher than was previously economic because the subsidized return on that equipment increased. The prevailing market price of the equipment, therefore, at least in the short run, would reflect all or part of the increase. In effect, the purchaser and the supplier of the equipment would share the value of the subsidy which, in the short run, would be capitalized, at least in part, in the price of the equipment. The smaller the elasticity of supply of the equipment (that is, the smaller the effect a change in price will have on the amount supplied) in the short run, the greater the extent to which the subsidy is capitalized in the price of the equipment. In the long run, suppliers likely would be able to adjust to the increased de-

[37] This proposition is the corollary to the proposition set forth in note 26 that a periodic subsidy is substantially the economic equivalent of a one-time subsidy.

mand and the price of the equipment would reflect more closely the cost of producing that equipment. To the extent that there is scarcity in a material component of the equipment, however, limiting the supplier's ability to increase output without incurring substantial additional costs, and to the extent that the transition period is lengthy, a significant amount of the subsidy would be reflected in higher prices of the subsidized equipment.

Nevertheless, as long as the present value of the subsidy exceeds the increased cost of the equipment, a purchaser will find it economic to buy the equipment. If the equipment is not transferable or is otherwise not readily adaptable to another owner's use, removing the subsidy for future purchasers of the equipment will not adversely affect the original purchaser who responded to the subsidy, so long as the subsidy itself is not taken away from that purchaser (in this example, as long as the purchaser continues to be eligible for the accelerated depreciation). Indeed, it may even benefit the original purchaser in the long run by increasing its competitors' costs, thereby allowing it greater profits.

If, however, the subsidized property or activity generally is viewed as a store of value or a potentially appreciating asset (for example, where its quantity is fixed or limited), capitalization of the subsidy in the price of the subsidized property presents an additional problem. Elimination of the subsidy for future purchasers of the property, in effect, would eliminate the portion of the resale value of the property attributable to the capitalized value of the subsidy. To the extent a taxpayer who responds to the subsidy has a reasonable expectation that the subsidy will be available to future purchasers, that taxpayer may have a vested interest in the subsidy that should be protected. Thus, if the subsidized property is transferable, the benefit of the subsidy, once instituted, should be permanent. In that sense, the subsidy should be viewed as attaching to the property rather than the owner. That type of subsidized property generally represents in the economy a store of value that owners intend to realize upon resale. The unanticipated removal of that kind of subsidy causes an unfair reduction in an owner's wealth.

Returning to the illustration involving tax-exempt bonds, it is clear that the periodic subsidy now accorded tax-exempt bonds by means of the exclusion of interest from gross income is capitalized in the value of the bonds. The issue price of the bonds at original issue and the subsequent market price of those bonds reflect the value of the subsidy. If that subsidy were eliminated for future holders of the bonds that already have been issued, the bonds would suffer a significant reduction in value, even if the interest income exclusion remained available to the original holders. Such a policy change would render the bonds illiquid, at least at their pre-policy change value, thereby destroying an important attribute of the financial asset, its ready marketability. In that event, only financially distressed holders or those whose tax rates somehow were reduced to zero would seek to dispose of those bonds at the resale price, which would be substantially below the original issue price (regardless of what happened to market interest rates). Holders with continuing financial stability or taxable income also would experience detriment. Interestingly, loss of liquidity experienced by those holders would not be offset against any government savings because the continued exclusion would permit the interest to escape taxation. The described inequity results because the market value of the bonds at any time, and therefore any holder's purchase price, incorporates the tax exemption. In substance, the periodic subsidy in the form of an income exclusion has attached to the bonds themselves rather than being personal to the holders of those bonds. The bonds should continue to be viewed in that light to reflect the reasonable expectations of the bond purchasers who, in reliance upon the promise of present and future tax exemption of the interest from those bonds, purchased those bonds at the original issue price (or, in the after-market, at a price reflecting the tax exemption for the term of the bond).[38]

To the extent that the subsidized property (such as the equipment in the first illustration) is a depreciating asset with a relatively short limited life or liquidity of the property is not an important attribute because, for example, it has a dedicated use that is not easily changed, the problem, as a practical, although not as a theoretical matter, becomes less significant. As long as the owner can and likely will continue to realize the value of the subsidy through continued use of the property, wealth reduction due to loss in resale value may be sufficiently small relative to the cost of determining and administering compensation to the owner that, arguably, it may be ignored. Where, however, the owner is unable to continue to realize the value of the subsidy through continued use of the property or liquidity of the property is an important component of its value, which will be the case, generally, if the subsidized property is of a long or unlimited economic life (such as the tax-exempt bond), the problem becomes much more significant. The market value of the property and, therefore, its purchase price is tied inextricably to its expected future market value

[38] Real estate represents another example of long-lived property, the market value of which is determined in part by its expected future value. The argument for capitalization of the subsidies accorded both commercial and owner-occupied residential real estate presents certain other complexities. These issues are explored more fully in Section V.

upon resale. Accordingly, even retroactive relief by continuation of the benefits of the periodic subsidy to the original owner will not correct the problem, because the resale value of the property is dependent upon the availability of the subsidy to future owners. A prospective purchaser, to whom the subsidy will not be available, would be unwilling to pay a price equivalent to the fair market value of the property when the subsidy existed. Perhaps that future economic loss is justifiable because those benefits are in the nature of speculative profits. Nevertheless, when property is constructed or purchased largely because of its anticipated market value, based in part on the existence of the subsidy, the taxpayer's equities appear to be more than those of a mere speculator. An owner very well may have some vested interest in the availability of a tax subsidy to a prospective purchaser if that availability is necessary to maintain the value of the property.[39]

Even if desirable, it may be impossible to compensate the owner for her loss. Determining the magnitude of the owner's loss would be very difficult if compensation were in the form of an outright payment because the amount of loss is dependent upon secondary and tertiary market consequences. Indeed, Professor Graetz has noted that elimination of the tax benefit could cause a reduction in the supply of formerly subsidized property, resulting in an increase in the economic return from the existing property by virtue of its relative scarcity. Professor Graetz concludes that full compensation would have to take these market adjustments into account.[40]

The size and speed of the adjustment resulting from the elimination of a tax benefit and the impact of the elimination on the owner of property receiving the benefit depend upon many factors. For example, Professor Graetz suggests that the value of any grandfathered subsidized housing after a prospective repeal of the subsidy would result in a windfall to their owners.[41] Any windfall would occur after a market adjustment period, which could be quite lengthy in the case of long-lived property. Moreover, the windfall could be erased (as could a portion of the value of other, never-subsidized property) if the subsidy were reintroduced for newly-built property in the future. These market adjustments and fluctuations, which are inherent when subsi-

[39] For example, suppose Congress proposed elimination of the home mortgage interest deduction available to owners of owner occupied residential real estate. See IRC § 163(h). Elimination of the deduction would increase the after-tax cost of the mortgage payment and therefore the after-tax cost of owning the residence, a property generally purchased with mortgage financing. One would expect a reduction in home prices to follow. This example is explored in greater detail in Section V.

[40] Graetz, Tax Revision, note 7, at 62-63.

[41] Id. at 63.

dies are introduced as a fiscal policy tool, likely make it impossible to quantify the loss accurately. That impossibility, however, should not suggest that no compensation is warranted when a periodic subsidy is removed. Rather, it suggests that determining the compensation amount would require simplifying assumptions and likely would result in some degree of over- or undercompensation.

If transition relief took the form of the continued periodic subsidy attaching to the property, great complexity could result. Not all competing properties on the market would offer the same tax attributes. Administering such a system could be very difficult.[42]

Repeal of a periodic subsidy also poses serious problems with regard to collateralized loans. Fluctuations in future fair market values are very important to a lender who has taken a security interest in the property as collateral for a loan and necessarily determined the amount of the loan and its security with reference to a capitalization of the periodic subsidy reflected in the market value of the property. A lender often views the value of the property to a prospective purchaser to be as important as does the property's owner. The value of the property only becomes important to the lender if there is a default on the loan and a required sale of the collateral. Repeal of a tax subsidy, even if only prospectively to future owners of the property, reduces the collateral's value, which included the present value of the anticipated subsidy.

Arguably, the reduction in property value is only temporary when a subsidy is removed. Presumably, the property's value will increase in the long run as the product supply in the formerly subsidized activity declines during the adjustment period and the product's price increases. As product price increases, the property particularly suitable for the activity will become more productive and increase in value. For example, some economists believe that, in the long run, real estate supplies will decline, demand will increase and the rental space market will reach equilibrium at higher prevailing rent levels and real estate price levels.[43] The duration of the adjustment period, however, likely will be uncertain, and all properties are not likely to be affected in the same way by market adjustments, in that some locations are likely to become more desirable and some less desireable over time.

[42] For example, a purchaser of property would have to obtain information and certification from the seller of the tax susidies, such as a short recovery period or an accelerated depreciation method, to which the property was entitled, the remaining basis in the property that was entitled to special treatment, and perhaps information from the seller's previous seller. The purchaser also would need a means of verification and of enforcement against the seller in the event of misrepresentation. One could envision a federal registry of property and subsidies to which the property is entitled.

[43] See notes 74 and 96.

Moreover, those owners and lenders who require current realization of fair market value on distressed property will suffer.

The price of financial assets, such as tax-exempt bonds, however, will decline instantly when the tax exemption is removed and an upward price adjustment will not occur, because of an unlimited supply of competing property. Accordingly, in the long run, market forces will not make the holder of such an asset whole again. To avoid the loss of value, the holder must retain the bond until maturity.

Moreover, the unfairness from the prospective removal of a periodic tax subsidy will be quite different when the subsidized item will not be resold because, for example, the property has a short useful life or its value is unique to the owner. In that situation, elimination of a periodic subsidy for those who purchase the subsidized property after removal of the subsidy (but not for the current owner) would not be subject to the objections discussed above.[44]

In sum, these inequities that would arise on repeal of a periodic subsidy and the complexity of any possible relief raise serious questions regarding the wisdom of their use.

4. *The Need for Transition Relief*

The government should have the option to remove uneconomic subsidies, even if they are the periodic type with long-term responses, and even if the subsidy has been capitalized into the value of the property. Forcing the government to continue all subsidies for future purchases would doom the economy to permanent inefficiency by resulting in subsidizing activities that already produce adequate supply of product or oversupply. If the subsidy is removed, however, transition rules should be enacted to prevent inequities, and in some cases, current owners should be entitled to compensation for their resultant wealth reduction.[45] To state the proposition advanced in this Section,

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[44] For example, the recovery period for automobiles justifiably could be lengthened from three years to five years, as it was in 1986, for all owners who purchased cars after 1986. Tax Reform Act of 1986, Pub. L. No. 99-514, § 201(a), 100 Stat. 2085, 2121-24.

[45] Compensation for tax changes to those individuals who own affected assets is not a new idea. Compare Martin Feldstein, Compensation in Tax Reform, 29 Nat'l Tax J. 123, 124-25 (1976) (viewing compensation as necessary to achieve horizontal equity) with Graetz, Tax Revision, note 7, and Kaplow, note 8 (viewing tax reform without compensation as the means to achieve horizontal equity).

The concept of compensation in this context also is consistent with jurisprudential thinking. Under Professor Frank Michelman's analysis, "fairness" requires compensation when a decision not to compensate would be viewed by a disappointed claimant as falling into a consistent practice having a "lesser long-run risk to people like him than would any consistent practice which is naturally suggested by the opposite decision." Frank I. Michelman, Property, Utility, and Fairness: Comments on the Ethical Foundations of "Just Compensation" Law, 80 Harv. L. Rev. 1165, 1223 (1967). As Professor Michelman notes, accepting

(1) a periodic subsidy should not be removed, even prospectively for transferees, if the current recipient of the subsidy reasonably anticipated that the property would be transferable, or, alternatively, (2) if the subsidy is removed, the current recipients should be compensated for the present value of the lost subsidy over an appropriate adjustment period. In many cases, only the second of these alternatives is feasible.

Initially, this proposition may seem objectionable or, at the very least, politically impossible to implement. Indeed, the right of a tax subsidy recipient to enjoy continued benefits from a tax provision, either through grandfathering or compensation, has been the subject of significant scholarship. Professor Graetz contends that policymakers should be free to make at least "nominally prospective" changes in the tax law without grandfathering or compensating those adversely affected by the change. "Nominally prospective" changes are changes that alter the rules only for post-enactment periods, but affect the tax treatment and value of assets acquired before enactment and, therefore, have retroactive impact.[46]

Professor Graetz's view essentially is premised on the proposition that a taxpayer whose tax liability is reduced by a tax subsidy is getting away with something, or, in his parlance, is the beneficiary of horizontal inequity. As the goal of tax change is to reduce that horizontal inequity, a change in the law with that objective should not necessitate either compensating the adversely affected taxpayer or grandfathering the tax subsidy as it affects the taxpayer.[47]

This Article takes a different view. The legislative choices regarding burden sharing are found in the structural components of the tax law (for example, tax rates). Burdens are and should be shared as provided by those structural components. Tax incentive provisions, in contrast, are equivalent to direct subsidy payments outside the tax system. As tax savings to a recipient are only the medium for such payment, they should be ignored when evaluating burden sharing. Just as one does not take into account direct subsidies in determining

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this approach often, but not always, leads to the utilitarian inquiry weighing efficiency gains against demoralization costs and settlement costs, and sometimes, but not always, leads to the same result. Id. at 1214-18. It appears unlikely that recipients of significant and narrowly-focused tax subsidies will see the personal loss they suffer made up by the long-run indirect benefits they will enjoy from a more rationale tax policy. See the discussion of real estate in Section IV. Thus, if fairness demands, as Professor Michelman suggests, the "assurance that society will not act deliberately so as to inflict painful burdens on some of its members unless such action is 'unavoidable' in the interest of long-run, general well-being," id. at 1235, removal of a subsidy without compensating or grandfathering its recipients will be regarded as unfair.

[46] Graetz, Tax Revision, note 7, at 49.

[47] Id. at 79-81.

whether the tax system is equitable, one should similarly ignore subsidies made indirectly through the tax system.

Removing a periodic subsidy after a taxpayer has acted upon it imposes an additional burden on that taxpayer unrelated to her income level or ability to pay. Accordingly, it results in a deviation from the burden sharing norm inherent in the structural components and lacks appeal to the distributional fairness on which the tax system as a whole relies.

Viewing tax incentive provisions as part of the burden sharing scheme, as Professor Graetz does, incorrectly leads one to view the elimination of periodic tax subsidies as a means of improving horizontal equity. On the contrary, periodic tax benefits which, in static terms, appear to create horizontal inequity, in dynamic terms, represent simply a collection of an amount promised and due from the government. When the subsidy terminated is a periodic subsidy enacted to encourage taxpayer behavior, it should be viewed analytically as a one-time subsidy, payment of which is made on the installment basis. The recipient of a periodic tax subsidy in the form of reduced tax liability, in reality, enjoys merely a deferred payment of a previous period's subsidy. The recipient already has paid for the subsidy by making what Congress determined to be a socially desirable expenditure in a previous year. The wisdom of the legislative policy choice should be addressed with respect to the year in which taxpayers respond to it, not in subsequent years.

This view does not depend upon whether the periodic tax subsidy represents a wise or even a sensible policy choice from an economic viewpoint, or whether it adds to overall equity in the economic system. Indeed, I would suggest that over the years, most periodic tax subsidies have proven to be mistakes that have caused the government to overpay for desired investments, largely by virtue of the proliferation of so-called tax shelters based upon the tax subsidies. Nevertheless, if one abides by the government's policy choice represented by the periodic tax subsidy, the enrichment of subsidy recipients should not be viewed narrowly as a matter of horizontal inequity that should be corrected through the tax system.

Professor Graetz's analysis and justifications for nominally prospective tax changes with retroactive effect underscore the uncertainty and danger of periodic subsidies because, once in place, they can be so easily reinterpreted as causing unjustified horizontal inequity. His analysis, therefore, represents another persuasive argument that periodic subsidies should be avoided.

If repeal of a periodic subsidy cannot be justified as increasing the horizontal equity of the tax system, the issue then is whether the government should provide transition relief when it terminates the payments of the subsidy. I have indicated that it should. Nevertheless, it is problematic whether the government would be willing to grandfather the periodic subsidy for the recipients and their transferees or to compensate subsidy recipients upon the removal of the subsidy, notwithstanding that principles of fairness may require it. As a practical matter, the subsidy removal often is motivated by a desire to end a perceived windfall to the subsidized segment of the economy. It is also possible that some taxpayers may obtain transition relief through lobbying efforts that other, similarly situated, but less affluent or well-connected taxpayers, could not. Thus, losses resulting from removal of a periodic subsidy may very well be inequitably distributed and are unlikely to be compensated.[48] This inability to deal equitably with the removal of periodic subsidies also argues forcefully against their use.

5. *One-Time Subsidies, in Contrast*

Problems of unfairness, compensation and transition relief that arise upon removal of periodic tax subsidies do not afflict one-time subsidies. After a one-time subsidy has been received, a taxpayer's return on investment is determined solely by market forces, unaugmented by further subsidy. The recipient neither looks to nor expects further governmental assistance from the subsidy. Accordingly, one-time subsidies could be removed equitably, without compensable harm to one who previously has been the recipient of the subsidy. Moreover, one-time subsidies would seem to avoid the perceived problem that some taxpayers are looting the treasury and continue to do so after the incentive is no longer necessary or desirable.

For example, if the subsidy accorded investors in state or municipal debt obligations were accomplished as a one-time subsidy, the elimination of the subsidy would not be objectionable. This could be accomplished by the federal government returning to an investor in state or municipal obligations by means of a tax credit or direct payment an amount equal to the premium paid by the investor for the income exclusion benefit of the tax-exempt obligation, relative to a taxable obligation of equivalent credit risk and term, that is, the present value of the stream of reduced annual interest payments resulting from the tax-exempt nature of the state or municipal bond. (Of course, a direct payment to the borrower, which would then issue taxable bonds, also would have accomplished the desired goal.) Repeal of such a tax credit could affect only later-issued bonds, not the bonds already outstanding. The resale price of the outstanding bonds also

[48] See Feldstein, note 45, at 124, who reached this conclusion almost two decades ago.

would not be affected because the return on the bond is fully taxable anyway and is not dependent upon any tax exclusion.

For example, in 1981, Congress could have chosen the one-time stimulus of the investment tax credit rather than accelerated cost recovery system depreciation (ACRS) for real estate. A one-time subsidy of that type for real estate (with appropriate recapture provisions if the real estate were disposed of before a certain time period had expired) would have provided taxpayers an incentive to construct buildings. Its repeal for future builders would have been of no direct consequence to the previous recipients.

6. *Summary*

This Section focused on the potential harm and inequity that can result from removal of periodic tax subsidies, and concluded that their use has serious shortcomings and should be avoided. If, however, Congress chose to use a periodic subsidy and then to terminate it, transition relief should be provided to prevent inequity to a recipient who made an investment based upon, and in reasonable reliance on, that subsidy. But transition relief in the form of continuation of the subsidy for the taxpayer may be inadequate, even if politically viable, and compensation may be politically unappealing. A one-time subsidy does not suffer from these shortcomings.

B. *Economic Efficiency and the Predictability of Tax Laws*

One-time subsidies also are superior to periodic subsidies in terms of economic efficiency. First, economic efficiency is served by predictable tax subsidies (assuming there are to be subsidies at all) so that those affected by subsidies can rely on that predictability. Making periodic subsidies uncertain in duration and subject to removal by legislative whim, is economically inefficient because it requires the government to include a risk premium in the subsidy. A risk premium overpays for desired activities unless the subsidy is removed before its expected term has expired.

In contrast, a one-time subsidy is completely predictable because there is 100% certainty that it will be obtained. A periodic subsidy can never attain that level of predictability so long as there is a risk of an uncompensated termination. Moreover, even if the duration of the periodic subsidy were assured, its value could not be assured because of potential changes in the structural components of the income tax (such as tax rates), income levels and market conditions. As a result, the need for risk premiums for periodic subsidies cannot be avoided.

Subsidy inefficiency likely would exceed even the risk premium attributable to the periodic subsidy. That would occur if subsidy recipients were successful in exploiting the political process to obtain unwarranted transition relief from a risk for which they were compensated. For example, if taxpayers who expected a periodic subsidy to last only a short time and valued it accordingly in a discount calculation[49] were successful in causing the term subsidy to be extended, those who found it beneficial to act, even based upon the short-term calculation, will receive a windfall, at the government's expense.

Professor Kaplow acknowledges that "the prospect that legal provisions favoring an investment might be repealed makes the investment less attractive."[50] He, however, concludes that it generally is desirable to discourage this type of investment as inefficient. The efficient level of investment can be induced only when investors bear all the real costs and benefits of the investment decision. Shifting some of the cost to the government through transition relief results in overinvestment.[51] Thus, following Professor's Kaplow's logic, periodic subsidies should not be valued by potential investors as if they would last forever, but rather, for a fixed term of years only. Optimists who guess wrong and overvalue the subsidies should suffer like any other unsuccessful speculator; insulation from that suffering would be inefficient.

Ostensibly, Congress' decision to subsidize a particular activity subsumes the decision to bear the inefficiencies of departure from a pure market solution. Lamenting the inefficiency that results when the government bears the risk and cost of a change in policy evidences an inconsistency with the original policy decision.[52]

If instead the subsidy were determinable and taxpayers could be assured that it would remain in place, proper account could be taken of the subsidy in the investment decision process. Knowledge of the duration of a subsidy is necessary for accurate present value calculations. Thus, the lack of predictability, if accepted by taxpayers and policymakers, would make periodic tax incentives even more economically inefficient instruments of government fiscal policy. Although uncertainty may have become the norm recently, it surely does not represent economically efficient tax policy.

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[49] For similar analysis, see J. Mark Ramseyer & Minoru Nakazato, Tax Transitions and the Protection Racket: A Reply to Professor Graetz and Kaplow, 75 Va. L. Rev. 1155, 1173 (1989).

[50] Kaplow, note 8, at 528.

[51] Id. at 529.

[52] There is a crucial distinction between activities that do not bear their own externality costs, to which no transition relief should be allowed when the government imposes restrictions, and government subsidies through the tax system for which transition relief arguably should be allowed upon change of policy. This distinction is ignored by Professor Kaplow. See id. at 531.

Second, to the extent periodic subsidies are at risk of termination without transition relief, inefficiency costs are imposed on the economy through increased administrative and operational costs of the tax system. That is because, in part, termination of a periodic subsidy without transition relief likely will be regarded by its recipients as unfair. A tax system that is viewed as unfair requires a good deal of coercive governmental power to enforce. Administration of such a system will not come cheaply, either in terms of administrative out-of-pocket costs or nonpecuniary costs to a free market economy and free society. A self-assessment system depends largely on voluntary compliance. Such voluntary compliance would decrease as the tax system is regarded as generally more unfair. In Professor Michelman's lexicon, the demoralization costs of the repeal of a tax subsidy may be substantial and should not be ignored in evaluating the economic efficiency of policy choices.[53]

To be sure, investors will perceive unfairness only to the extent that they expected that the promise inherent in the subsidy would continue until the end of its expected term, and they did not understand any risk of early termination to be a risk already reflected in the price of the investment. If recipients generally regard the risk as already reflected in the price, any lack of protection through transition relief would not entail demoralization costs. Indeed, Professor Graetz has suggested that the uncertainty inherent in the political process of the continuation of any tax benefit represents a risk of property ownership that should be regarded as no different than other "market risks."[54] Professor Kaplow has made this same point in a more general way by extending it to all situations of "legal transitions" and seeing tax changes as no different than other changes in government policy. In Professor Kaplow's view, "uncertainty concerning government policy is analytically equivalent to general market uncertainty."[55] He argues that since market solutions for allocating risk are preferable to government remedies, transition rules inject economic inefficiency into policy changes. Thus, because it is desirable from an economic efficiency viewpoint for investors to take into account the

[53] Michelman, note 45, at 1214-18.

[54] Graetz, Tax Revision, note 7, at 87; see Michael J. Graetz, Retroactivity Revisited, 98 Harv. L. Rev. 1820, 1834 (1985) (reiterating this point and suggesting agreement by Richard Posner). Professors Ramsey and Nakazato agree with this position with regard to tax subsidies of uncertain duration, but have expressed the view that subsidies that are guaranteed at the outset and are protected thereafter from legislative change are more efficient because they reduce the cost to society of post-enactment lobbying for enactment of grandfather clauses. Ramseyer & Nakazato, note 49, at 1173.

[55] Kaplow, note 8, at 520. Kaplow makes the point that it is irrelevant to an investor whether his loss of value derives from government action or natural forces. Id. at 534-35.

risk of future government action, no transition relief is warranted.[56] Instead, the risk of loss of benefits is reflected in the price of the property.

Professor Kaplow's view that all risks of transition loss are properly imposed on property owners ignores the fact that the increased value in the subsidized investment was created by government assurances in the first place. Unlike government action to correct for natural market imperfections, for which Professor Kaplow regards transition relief as inferior to market solutions, removal of a government-created market condition such as a promised future subsidy, presents a much more compelling case for relief and likely will be regarded as such, thereby making transition relief necessary to avoid demoralization costs.

Professor Kaplow's view also ignores the possibility that those taxpayers adversely affected by the change will engage in lobbying activities to obtain special transition relief. The costs imposed by the use of the political process represent an additional inefficiency that will be incurred when removal of a periodic subsidy is attempted.[57]

Finally, opponents of transition relief have argued that the most economically efficient tax minimizes disincentives for desired future behavior so that business and investment decisions can be made free of these tax disincentives. Therefore, removing a past benefit after the desired conduct has been elicited would have resulted in the desired behavior without the concomitant cost to the government.[58] Periodic subsidies lend themselves best to this manipulation.

While this argument is objectionable from an equity viewpoint, it also fails from an economic efficiency viewpoint. First, it ignores demoralization costs. Second, it assumes that the imposition of a tax, retroactively, by means of a reduction in a previously granted tax subsidy, would be accepted by a gullible taxpaying public as a nonrecurring event. Such acceptance is highly unlikely and would more likely trigger uncertainty with regard to future subsidies, even one-time subsidies, and result in the associated inefficiencies discussed above.

[56] Id. at 531. Professor Kaplow's argument supporting retroactive tax provisions compares retroactive tax provisions to the law of nuisance. Just as the polluting factory that harms the health of the community and is forced by the government to curtail its pollution suffers a loss of value of its investment in the factory, a beneficiary of a tax provision that has been eliminated also suffers a loss in investment value. Legal transitions, in Professor Kaplow's view, are the same. Id. at 511-15.

[57] See Ramseyer & Nakazato, note 49, at 1173.

[58] See Saul Levmore, The Case for Retroactive Taxation, 22 J. Legal Stud. 265, 286-87 (1993).

In sum, periodic subsidies, even if not subject to removal, are less efficient than one-time subsidies. When risk of repeal is factored in, however, they become substantially less efficient.

III. Illustration: Commercial Real Estate

Periodic subsidies have represented a major component of the government's fiscal policy, and the Code is replete with them. The economic impact of the creation and removal of a periodic tax subsidy is illustrated most graphically by the accelerated depreciation deductions accorded to owners of real estate in the early 1980's[59] and their effective removal through enactment of the passive activity loss rules in 1986.[60] This Section illustrates shortcomings in the periodic tax subsidies accorded real estate during this period and the devastating consequences of their removal without adequate transition relief.

A. *Periodic Subsidy for Real Estate During the Early 1980's*

In 1981 Congress created significant tax incentives for real estate by means of accelerated depreciation. In substance, owners of real estate were able to recover the cost of their depreciable real estate (buildings and other improvements, but not land) over a 15-year period. Thus, for income tax purposes, a building would be regarded as having been used up and valueless after only 15 years even though, in virtually all likely situations, the building would have retained substantial value and in many cases increased in value during that same period. The recovery period was lengthened by subsequent legislation to 18 years[61] and later to 19 years.[62] But, even after these changes, the tax depreciation in most cases greatly exceeded the actual reduction, if any, in value of those buildings.

The legislative judgment to grant special deductions and, therefore, impose a lighter tax burden on real estate and real estate activities was motivated by a desire to increase the production of depreciable real estate for the good of the entire economy.[63] The supply of commer-

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59 Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 201, 95 Stat. 172, 204-19.

60 Tax Reform Act of 1986, Pub. L. No. 99-514, § 501, 100 Stat. 2085, 2233-41 (codified as amended at IRC § 469).

61 Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 111, 98 Stat. 494, 631-34.

62 Pub. L. No. 99-121, § 103, 99 Stat. 505, 509-10 (1985).

63 The Senate Finance Committee report summarized this objective.

> The committee agrees with numerous witnesses who testified that a substantial restructuring of depreciation deductions and the investment tax credit will be an effective way of stimulating capital formation, increasing productivity and improving the nation's competitiveness in international trade. The committee therefore believes that a new capital cost recovery system is required which

cial buildings increased from 1981 to 1986 as a result of new construction,[64] although it is impossible to prove that the 1981 legislation caused the building boom because of the inherent limitations on statistical analysis in a dynamic economy.[65]

Congress did not limit the special tax relief for real estate to new construction. It extended the provision to any depreciable real estate acquired by a taxpayer after the effective date of the legislation, so long as the new owner did not own a significant interest in it beforehand.[66] The accelerated depreciation allowed new owners to purchase old buildings and write off the cost of the buildings over the generously short recovery period of 15 years. The extension of the tax subsidy to existing property appears to have been pure governmental largesse, significantly increasing the purchases and sales of existing depreciable real estate.[67] New investors sought to acquire real estate and current owners sought to sell their old real estate and acquire existing properties from others to take advantage of the short recovery period.[68]

Taxpayers fortunate enough to own income producing real property received windfalls. The tax legislation actually increased the demand for and value of their property by allowing a prospective purchaser to

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> provides for the more rapid acceleration of cost recovery deductions and maintains or increases the investment tax credit.

S. Rep. No. 144, 97th Cong., 1st Sess. 47, reprinted in 1981-2 C.B. 412, 425.

[64] Indeed, as of 1987, in excess of one-third of all office space in the country had been built in the past 20 years and perhaps as much as one-half in metropolitan areas. Anthony De Palma, Planners Find Silver Lining in Office Glut, N.Y. Times, Mar. 12, 1989, at 40 (reporting on a 1987 survey conducted by the Massachusetts Institute of Technology Center for Real Estate Development).

[65] This assertion about market responses and events, as well as several others contained in this Article, is supported by anecdotal evidence rather than formal market studies. In defense of their use, when one is standing outside and getting wet, one need not cite the official weather report of a meteorologist to know that it is raining.

[66] IRC § 168(e)(4) (before amendment in 1986). Not only was ACRS unavailable if the taxpayer or a person related to the taxpayer owned the property during 1980 or before, but also "broad authority [was] granted to the Secretary to prescribe regulations to make ineligible for cost recovery under ACRS property transferred in a transaction the principal purpose of which is to make property eligible for more generous capital cost recovery." S. Rep. No. 144, 97th Cong., 1st Sess. 58-60, reprinted in 1981-2 C.B. 412, 431.

[67] As early as 1982, investment in real estate tax shelters already had jumped 25%, increasing from $1.6 billion in 1981 to $1.4 billion in only the first nine months of 1982. Leslie Wayne, Prepared to Lose It All? Try Tax Shelters, N.Y. Times, Dec. 12, 1982, at 86 (quoting Robert A. Stanger & Company, the largest tax shelter research firm in the country).

[68] "Nearly half a billion dollars' worth of real estate changed hands in the District [of Columbia] during the second quarter of this year [1984], bringing the total sales volume for the first half of the year to more than $848 million, according to Rufus Lusk & Son, Inc. Volume for the first half of the year was up nearly 30 percent from the corresponding period last year." Albert B. Crenshaw, Sales Volume in the District Grows by 30%; About $848 Million Worth of Real Estate Traded in First Half, Wash. Post, Aug. 25, 1984, at F1.

obtain a tax benefit from acquiring the existing property. Since vacancy rates were relatively low at that time,[69] the increased value did not result from increased occupancy. Much of the property already was operated at full capacity. Instead, the increased value of the property reflected the new tax subsidy accorded the property.[70]

After 1981, substantial capital flowed into real estate production and resulted in a building boom.[71] Prospective owners no longer needed to be assured of the same tenant demand, low interest financing and relatively low vacancy rate to project a profit from operating a newly constructed building or purchasing an existing building. Production soared and rental space, particularly office space, increased in supply.[72] Net income from operating property tended to decline as a result.[73] Some economists predicted that this phenomenon would continue until real estate activities earned no more on a net after-tax basis than had been the case prior to 1981.[74] However, during the

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[69] Michael D. Hinds, After Weathering Fears of a Glut, New York May Face a Space Shortage, N.Y. Times, May 13, 1984, at 30 (reporting that the vacancy rate in midtown Manhattan was as low as 7% in 1983 according to the international consulting firm of Jones Lang Wooton).

[70] The anecdotal evidence on the effects of the subsidy is consistent with what predictions based upon economic analysis would be. See articles cited in notes 74 and 96, in which economists discuss the opposite impact on prices from removal of the subsidies.

[71] Albert Scardino, Vacancy Sign Out in Manhattan Realty Boom, N.Y. Times, Mar. 29, 1986, at 1 (reporting nearly 25,000 new condominium apartments would enter the market during March 1986 to September 1987, which was more than in the previous five years combined).

[72] De Palma, note 64, at 40 (noting that building boom had created enough unrented space in New Jersey to meet demands for next several years).

[73] See id.

[74] Patric H. Hendershott & David C. Ling, Prospective Changes in Tax Law and the Value of Depreciable Real Estate, 12 Am. Real Est. & Urb. Econ. Ass'n J. 297 (1984). The authors analyze the reduction in the tax benefits by legislation that would have increased the depreciation recovery period for real property from 15 to 20 years. They point out that any such tax changes, even if applicable only to new property, still could cause a sharp decline in the value of existing properties. Id. at 316. More generally, they conclude that the reduced tax benefits from the longer life would lower property values and raise rents. The mix of the impact on those items would depend on the supply elasticity of real estate. At zero elasticity, the point at which any tax benefits would have no effect on the creation of new rentable property, the reduced tax benefits would be reflected completely in the reduced value of the property. At infinite elasticity, the point at which the supply of rentable space would expand or decline to adjust to market price conditions, the changes should be reflected completely in increased rents. At elasticities somewhere between, the mix would be somewhere between. In any event, any immediate decline in price would reflect the failure of real rents to jump immediately to their new equilibrium level under the assumption that the property would earn a market rate of return. Id. at 305-07. This economic analysis is summarized by the authors as follows:

> An increase in cost recovery periods will, ceteris paribus, lower property values and raise real rents. Full equilibrium requires that investment value of new properties to the marginal investor equals the reproduction costs (supply price) of new properties. With an infinite supply elasticity, the long-run change in real price and value is zero; the immediate decline in price reflects the fail-

> ure of real rents instantaneously to attain their new long-run equilibrium. With a finite supply elasticity, the immediate decline in price reflects both rent adjustment lags and decreased production costs in response to a lower demand.

Id. at 315.

On balance, the authors predict that a five-year extension in the tax lives of residential real property would have caused an immediate decline in the price of new residential properties of up to 4% and a long-run increase in real rents associated with the price decline of 10-12%. They also predicted a reduction in investment of real properties by 20% during the transition period. For commercial properties, they predicted that the price declines from a increase in the depreciable life would be 20-25% smaller than that for residential properties. Id.

It is important to note, however, that while the increase of depreciable life that the authors analyzed (from 15 years to 20 years) was predicted to have significant economic effects on real estate, in actuality, the change, when enacted in 1984 (to 19 years) probably only shortened the transition period from the adoption of a 15-year depreciable life. By 1986, the transition period likely had ended, so that based upon the authors' previous predictions, the consequences of the substantial elimination of tax subsidies for real estate that occurred in 1986 were far greater than the consequences of the earlier change. These subsidy changes included the elimination of the capital gain preference, IRC § 1202 (before amendment in 1986), the lengthening of depreciable lives, IRC § 168(b), and the enactment of the passive activity loss rules making tax benefits associated with the real estate unavailable in many circumstances, IRC § 469. One would expect the magnitude of the changes resulting from those changes to be far greater than those predicted from the mere lengthening of depreciable lives by five years. Moreover, the analysis set forth in this article was a partial equilibrium analysis that did not take into account secondary and tertiary consequences of the changes to real estate taxation. If the changes resulted in a substantial reduction in the creation of new rentable space, there also could be consequences to business activity and thus the demand for even the existing space. Therefore, severe changes could increase even the magnitude of changes that one would predict based upon a partial equilibrium analysis. Hendershott & Ling, supra, at 316.

See also James R. Follain, Patric H. Hendershott & David C. Ling, Understanding the Real Estate Provisions of Tax Reform: Motivation and Impact, 40 Nat'l Tax J. 363 (1987), in which the authors examine, among other things, the likely impact of the 1986 Act on various aspects of real estate and economic rents. They predict that rents will increase, owner costs will decrease and home ownership will increase. Specifically, they predict that equilibrium rent levels after the 1986 Act must increase to replace the reduced subsidy available in the form of tax benefits to owners. That increase will result from market forces and will be necessary so that real estate earns a rate of return comparable to that of other investments of similar risk. They predict that the exact magnitude of the rent increases also will depend on changes in interest rates and existing marginal tax rates. They assert that the transition period for the rent increases will be approximately three years in fast growing markets, and up to eight years in slow growing areas in which vacancy rates are somewhat higher. Id. at 369-70.

In addition, the authors predict value declines to the extent that rents do not quickly increase to their equilibrium levels. Id. at 370. Yet, they conclude on balance that "[i]n contrast to the conventional wisdom, the 1986 Act is unlikely to discourage real estate activity in the aggregate." Id. at 371. Their model assumes that regardless of how the real estate tax incentives change, all of the adjustments, in the long term, will be reflected in rent changes rather than the ultimate value of the real estate, which will be controlled by other factors in the long term. They concede that during the transition period, values will be affected until rents have increased, to reflect the eventual full absorption of rentable space. Id. at 370. Presumably, although not discussed by the authors, the gap between the current market value of real estate and the "true value" of the real estate, based on replacement cost, will be greatest when the transition period of below equilibrium rent level, 1980's, it appears that real estate operating yields may have declined even below the level predictable by the subsidy alone, because an expectation of appreciation may have influenced people to accept less in current yield in anticipation of large gains upon sale.

After 1981, capital flowed into real estate activities from sources other than real estate professionals.[75] One might characterize a real estate investor as participating in or acquiring a "tax shelter." A tax shelter is nothing more than an investment or activity purchased or engaged in by a taxpayer, at least in part, as a means of reducing the taxpayer's tax liability.[76] Any reduction in tax liability is regarded by the investor as a part of his economic yield from the activity, which is

and therefore operating losses, is longest. That must be because losses during the transition period would be aggregated with the purchase price of the property by a prospective purchaser, using appropriate present value discount factors, to equal the replacement cost of the property. Therefore, the current market value should be equal to the replacement cost minus the present discounted value of the transition period losses that would be suffered by an owner. This analysis also assumes that the property will be located appropriately for its "highest and best use," which means that it is not located in an area that could never generate full occupancy and in which replacement property would never be built (for example, the area is an inappropriate location for that type of building for the foreseeable future).

75 Leonard Sloane, Your Money; Oil Slide Hurts Tax Shelters, N.Y. Times, Feb. 22, 1986, at 32 (reporting on study by Robert A. Stanger & Company that a full two-thirds of all investments in tax shelters in 1985 was concentrated in the real estate market); see note 67. Less than one year later (but after the passage of the 1986 Act) the same investment advisory firm predicted that real estate limited partnerships, the most popular vehicle for investment in real estate tax shelters, would raise only one-half as much investment capital as in the preceding year (1985). Thomas Moore & Rosalind K. Berlin, The New Rules for Investors, Fortune, Dec. 8, 1986, at 33-34.

76 See Joseph J. Cordes & Harvey Galper, Tax Shelter Activity: Lessons from Twenty Years of Evidence, 38 Nat'l Tax J. 305, 307 (1985), in which the authors explain the two alternative economic definitions of a bona fide tax shelter: (1) the "pure tax shelters" resulting from legal but pure tax avoidance devices and (2) the "tax-preferred investments" that are not taxed as heavily as alternative investments. Treasury and the courts apparently have confused the two definitions by lumping together those investments that either exclude a portion of the activity's income or generate excessive deductions, because the excess deductions are seen as unjustifiably allowing the owner of the activity to avoid paying taxes on other income. The authors point out, however, that unlike the case of pure tax shelters, which are themselves legal tax avoidance devices (such as investments in municipal bonds whose interest is tax-exempt), the excess deductions are merely the mechanism whereby the income from a given investment receives its own tax preference. Limited real estate partnerships represent a primary example of tax-preferred shelters. Id. at 308-09. In addition to these two types of tax shelters, both of which are legal and specifically sanctioned by Congress, there is a third category of tax shelter involving abusive or illegal structures, which use "the form and trappings of legal transactions to evade taxes in a way neither consistent with Congressional intent nor sanctioned by law." Id. at 308. Accordingly, the authors conclude that significant distinctions should be drawn between illegal transactions, pure tax shelters and tax-preferred investments. Id. at 322.

weighed in the evaluation of whether to invest in the tax shelter as opposed to some other investment.[77]

B. *Congress' Response: The Passive Activity Loss Rules*

Public antipathy toward tax shelters may explain why Congress enacted a new set of anti-tax shelter provisions, the passive activity loss rules.[78] Those rules deal, in part, with the tax treatment of a taxpayer

[77] Real estate was by no means the only area in which nonprofessional investors sought to obtain some of the tax advantages associated with an activity. For example, tax advantages attracted capital to the development of important new technology. Without the tax incentives, the risks associated with potential failure of the research would have outweighed the expected gains from the eventual license of the technology to others. Other tax shelter activities included equipment leasing, coal mining and oil exploration.

Tax shelter investments take advantage of subsidies that artificially increase the economic return to investors, thereby making the investments more attractive to the potential investor and more competitive with alternative investments. See id. There is nothing magic or nefarious about any of them. If they did not operate to reduce a purchaser's tax liability by virtue of ownership of the investment, then there would be no tax incentive for the owner to purchase it. Indeed, if the tax incentive is sufficiently large, investors will engage in tax-favored activities that otherwise would have produced economic losses without the tax benefits. As long as the form of the transaction comports with its substance, the owner of the investment logically should be entitled to any tax benefits associated with it.

[78] IRC § 469. The Joint Committee on Taxation's explanation of why the passive activity loss rules would correct the defects of the previously unrestricted tax incentive provisions reflects the populist appeal of legislation to combat tax shelters.

> [I]n providing preferential depreciation for real estate or favorable accounting rules for farming, it was not Congress's primary intent to permit outside investors to avoid tax liability with respect to their salaries by investing in limited partnership syndications. Rather, Congress intended to benefit and provide incentives to taxpayers active in the businesses to which the preferences were directed. . . .
>
> Congress determined that, in order for tax preferences to function as intended, their benefit should be directed primarily to taxpayers with a substantial and *bona fide* involvement in the activities to which the preferences related.

Staff of Joint Comm. on Tax'n, 99th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1986, at 211-12 (Comm. Print 1987).

Congress leveled its attack primarily against a relatively small group of taxpayers—the high income taxpayers who had been able to reduce their tax liability by investing in tax shelters. By focusing its outrage on a group whose tax woes would engender little if any sympathy, Congress took the path of least resistance. This collective finger pointing purportedly was justified by various Treasury studies citing the very wealthy as the primary beneficiaries of tax incentives. Clearly, the inference was that the wealthy were the culprits of a failing tax system.

> [A] Treasury study revealed that in 1983, out of 260,000 tax returns reporting "total positive income" in excess of $250,000, 11 percent paid tax equaling 5 percent or less of total positive income, and 21 percent paid taxes equaling 10 percent or less of total positive income. Similarly, in the case of tax returns reporting total positive income in excess of $1 million, 11 percent paid tax equaling less than 5 percent of total positive income, and 19 percent paid tax equaling less than 10 percent of total positive income.

who has only a minor involvement in a trade or business or who owns rental property. In substance, the rules preclude a taxpayer from using losses from a passive activity to offset nonpassive income. A passive activity is either (1) an activity involving a trade or business in which the taxpayer does not "materially participate"[79] (has only minor involvement) or (2) any rental activity.[80] Nonpassive income includes income from salaries, investments and other sources aside from passive activities.[81]

Id. at 210 (citing Susan Nelson, Taxes Paid by High-Income Taxpayers and the Growth of Partnerships in Internal Revenue Service Statistics of Income 55 (Fall 1985)); see also Staff of Joint Comm. on Tax'n, 99th Cong., 1st Sess., Tax Reform Proposals: Tax Shelters and Minimum Tax 12 (Comm. Print 1985).

[79] IRC § 469(c)(1).

[80] IRC § 469(c)(2).

[81] The taxpayer's conduct of a trade or business is determined with reference to other Code sections. Trade or business, however, is defined in § 469 to be somewhat broader than the usual Code definition. See IRC § 469(c)(5)-(7).

A taxpayer materially participates in an activity only if he is involved in the operations of the activity on a regular, continuous and substantial basis. IRC § 469(h)(1). Although § 469 does not provide further guidance on what constitutes material participation, there are detailed regulations regarding the definition of material participation. See Reg. § 1.469-5; Temp. Reg. § 1.469-5T. Most importantly, those regulations provide that 500 hours of work in the activity for the year constitutes material participation. But, even a taxpayer with less involvement may be found to materially participate under one of several alternative mechanical tests. Temp. Reg. § 1.469-5T(a).

Rental activities generally are considered passive activities. IRC § 469(c)(2). An exception is made for post-1993 rental activities of certain real estate professionals. IRC § 469(c)(7). A rental activity is "any activity where payments are principally for the use of tangible property." IRC § 469(j)(8). For example, income from a car rental business or the operation of a hotel is viewed as received principally for services, not for the use of property. Temp. Reg. § 1.469-1T(e)(3)(viii)(Exs. 1, 4). Furthermore, the regulations provide many additional complications to what at first appears to be a straightforward rule. For example, the regulations are intended to cause rental losses to be passive, but prevent income from rental activities in several cases, such as rental of nondepreciable property or sales of rental property under certain circumstances, from qualifying as passive income. Temp. Reg. § 1.469-1T(e)(3).

There is a special prophylactic rule for limited partnership interests, the traditional vehicle through which tax shelters have been syndicated and passive losses passed through to investors. Therefore, "no interest in a limited partnership as a limited partner shall be treated as an interest with respect to which a taxpayer materially participates." IRC § 469(h)(2). The regulations, however, cut back on that absolute rule somewhat to avoid circumvention of the rules by taxpayers seeking to create passive income. Temp. Reg. § 1.469-5T(e).

The basic disallowance rule is that passive activity losses and passive activity credits for the taxable year are not allowed. IRC § 469(a). Passive activity losses means the amount by which the aggregate losses from all passive activities exceeds the aggregate income from such activities. IRC § 469(d)(1). Passive activity credit means the sum of all allowable tax credits from passive activities over the taxpayer's tax liability allocable to all passive activities. IRC § 469(d)(2). Disallowed losses and credits are carried over indefinitely to future years. IRC § 469(b); Reg. § 1.469-1(f)(4). As such, they remain available to offset passive income in future years. Because passive losses and credits may not be carried back, the timing of losses and gains can be very important.

The effect of the passive loss rules has been to preclude taxpayers from offsetting earned income and portfolio income (such as investment income from stocks, bonds and bank and money market accounts) with real estate and other tax shelter losses. By precluding the use of those losses, Congress effectively removed the tax subsidy from those activities. Indeed, because even cash operating losses from real estate and other tax shelter investments and actual reductions in value in the investments through deterioration or obsolescence cannot be used to offset nonpassive income until the investment is sold or discontinued, the antishelter rules not only removed the subsidy but, in many cases, also imposed a penalty on the activity.

Yet, Congress made no attempt to compensate property owners for either the loss of the subsidy or the loss in value of the property, which would not enjoy tax-preferred treatment in the hands of a prospective purchaser. In passing the 1986 Act, Congress appeared to recognize the importance of transition rules in preventing inequity, but failed to provide adequate protection. The passive loss provision contained special effective dates and phase-in provisions. On their face, those rules appeared to exclude current owners of real estate and other passive activities from much of the impact of the new rules.[82] These

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The general consequence of this framework is that passive losses cannot be used to offset certain types of income (although an exception is provided for losses from certain rental activities for lower income taxpayers, IRC § 469(i)), which is the central goal that the rules were designed to accomplish. First, passive losses cannot be used to offset "net active income." Net active income, in general, is the taxpayer's taxable income for the taxable year without regard to income or loss from passive activities and portfolio income. IRC § 496(e)(2)(B). Second, passive losses cannot be used to offset portfolio income. Portfolio income, although not defined in the Code, is income from interest, dividends, annuities or royalties not derived in the ordinary course of a trade or business (or from working capital used in the business) and gain attributable to property producing such income and property held for investment. See IRC § 469(e)(1). For these purposes, the term "investment" excludes any interest in a passive activity. The general consequences described above are subject to several important exceptions that are beyond the scope of this Article.

There also are special rules for an activity that ceases to be a passive activity (a "former passive activity"). See IRC § 469(f). Current and suspended passive losses of former passive activities are not freed up completely. Rather, passive deductions and credits for the year in which the activity ceases to be passive, as well as suspended passive deductions and credits, can be used to offset future income of any kind from that activity only. To the extent not used up, any remaining passive losses and credits continue to be treated as passive. IRC § 469(f)(1). The consequence of this ordering is that passive losses from the activity that are carried forward after application of the foregoing rules still can offset future income (active or portfolio) from that activity, but not other nonpassive income.

In contrast to the restricted use of passive losses from continuing activities, there is a complete freeing up of current and suspended losses when the activity is finally disposed of. The taxpayer must dispose of its entire interest in the passive activity or former passive activity in a fully taxable transaction. IRC § 469(g)(1). Dispositions by death or gift are subject to special rules. IRC § 469(g)(2), (j)(6).

[82] Generally, the passive activity loss rules were effective for years beginning after 1986. Reg. § 1.469-11. However, the rules were phased in for certain post-effective date losses.

phase-in rules, however, interacted with two other important changes contained in the 1986 Act: (1) the alternative minimum tax (AMT)[83] and (2) the investment interest expense limitation.[84] Most importantly, passive losses allowable under the phase-in rules constituted tax preference items for AMT purposes.[85] Under appropriate circumstances, the passive losses were rendered without tax benefit and, therefore, unusable to an investor. Moreover, by eliminating the subsidy entirely for prospective purchasers of the property, the 1986 Act did nothing to protect the value of the property that had become dependent on the subsidy.

Thus, the passive loss transition rules, allowing a gradual phase out of loss allowance for regular, but not AMT, purposes, were inadequate to protect the reliance interests of real estate and other tax shelter owners. They failed to protect either the resale value of the formerly subsidized property or the owner's continued ability to enjoy the subsidy, in the form of accelerated depreciation deductions, which the owner was promised.

C. *The Decline of Real Estate Prices and The Savings and Loan Crisis*

The crisis in the savings and loan (S&L) industry had many causes, ranging from unpredictable economic changes to bad business judgment to thievery.[86] One of its most significant causes was the decline in real estate prices that resulted from Congress' shift in tax policy toward real estate.

Many S&Ls invested in mortgages on new real estate projects that promised high yields during the 1980's due to generous depreciation

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Passive losses from a "pre-enactment interest" (an interest held on October 22, 1986, the date of enactment, or acquired thereafter pursuant to a written "binding contract" in effect on such date and at all times thereafter) were disallowed in the transition years to the extent of 35% in 1987, 60% in 1988, 80% in 1989 and 90% in 1990. IRC § 469(m).

[83] IRC §§ 55-59.

[84] IRC § 163(d).

[85] IRC § 58(b)(2).

[86] At a hearing today [July 18, 1990] conducted by the Oversight Board of the Resolution Trust [the corporation which is overseeing the bailout of the S&L industry], officials said that they had detected criminal misconduct at roughly half of the savings and loan institutions under Government control [some 247 institutions as of June 1990]. About 15 percent of the savings institutions were also involved in fraudulent transactions with other financial institutions involving joint real estate deals, loan swaps and other improper transactions. James R. Dudine, assistant director of investigations at the Resolution Trust, told the Oversight Board that Governmental lawyers have estimated that potential lawsuits for negligence could be filed against directors and officers in about 55 percent of the institutions seized by the Government.

Stephen Labaton, Savings Bailout to Use Up Cash in 3 Months, N.Y. Times, July 19, 1990, at D1, D11.

recovery rates.[87] The S&L industry was a ready participant in the real estate boom that promised high yields from loans involving new construction or purchases of existing buildings.[88] As long as real estate values increased during the early 1980's, those loans that had been made prudently were well-secured and safe. Many S&Ls lent money on outrageous projects with little economic feasibility to obtain front-end fees and what appeared to be high, but risky yields.[89] However, even more conservatively managed institutions lent money on real estate projects at prudent loan-to-value ratios (ratios of the amount of the loan to the fair market value of the project securing the loan). Those loans were well-secured as long as real estate values were maintained or increased, which occurred during the transition period of the early 1980's.

The values of those properties depended on the generous tax benefits accorded real estate. The availability of those tax benefits to prospective owners supported the market prices of the property even though the rental income may not have been sufficient to make them economic.

When the government withdrew the subsidies in 1986 by enacting the passive activity loss rules and lengthening depreciation recovery periods for property acquired after 1986, real estate had to be operated or sold without benefit of the tax subsidies. Investors, who could no longer use losses from real estate to offset other income, were less likely to provide the equity funds for new projects or to purchase existing projects.[90] As a result, a major source of equity for real estate acquisitions evaporated. Moreover, by the time Congress passed the

[87] According to a 1985 study conducted by the Brookings Institution, "purchases of computers and automobiles, together with investment in office buildings, shopping centers and other commercial real estate, accounted for 93 percent of the increase in business investment between 1979 and 1984." Gary Klott, How '81 Tax Incentives Have Affected Investing, N.Y. Times, July 5, 1985, at D1, D2.

[88] "From 1985 to 1987, construction and land loans of about 70 New England savings and loan associations analyzed by Keefe, Bruyette & Woods grew by almost 200 percent. Commercial real estate loans grew nearly 90 percent in the same period." Sarah Bartlett, Bad Real Estate Loans Hurt Northeast Banks, N.Y. Times, Nov. 15, 1988, at D1, D7.

The lavish lending practices toward developers is illustrated by United Virginia Bankshares, Inc., a large bank holding company, which in 1985 showed a 77% increase in real estate construction loans in only one year. See United Virginia Profits Increase, Wash. Post, July 9, 1985, at E5. Another example is the Mellon Bank Corporation of Pittsburgh, which expanded its real estate construction lending portfolio by nearly 50% in 1984. Eric N. Berg, Company News; Loss Seen by Mellon; Payout Cut, N.Y. Times, April 3, 1987, at D1, D4.

[89] See John Crockett, Clifford Fry & Paul Horvitz, Are S&L Participations in Real Estate Ventures Too Risky?, Real Est. Rev., Summer 1985, at 54.

[90] See note 75.

1986 Act, vacancy rates in many buildings had increased with the added supply of rentable space brought about by the tax subsidies.[91]

An insufficient number of buyers existed for real estate projects that were put on the market for sale. Prices for real estate stopped increasing and in many cases began to fall. Consequently, the S&Ls as well as other banking institutions that had been well-secured when real estate values were high became undersecured. That situation was particularly dangerous for institutions that had made nonrecourse loans. Defaults became more common,[92] prices declined further and the market became flooded with available real estate.

Even falling prices failed to attract new buyers. First, without tax subsidies, the projects were not worth as much as they had been previously. Second, the banking industry's reaction to the falling prices was precisely the opposite of what would be necessary to stop those declines. Many banks stopped making real estate loans altogether.[93] The Comptroller of the Currency imposed strict loans-to-borrower ratios so that no institution could have more than a certain percentage of its capital loaned to a single borrower.[94] Therefore, borrowers with temporary cash flow difficulties could not draw on long established banking relationships to ride out the difficulties. Rather, many were forced into financial distress situations making them ripe for foreclosures. Thus, few buyers were available even though real estate may have represented a good value in the current market under normal appraisal standards. Normal sources of funding, namely S&Ls and other financial institutions, disappeared from the real estate lending scene.[95]

Prudent policy for any individual S&L on the brink of insolvency dictated that it collect as much as possible of its outstanding real estate loans and refuse to loan additional amounts in a falling real estate

[91] Joeml G. Brenner, Banks Wary of Commercial Vacancy Rates; Loan Officers Approach Projects with Caution, Wash. Post, Nov. 6, 1989, at F1 (noting vacant office space in Washington and suburban Maryland).

[92] See Eva Pomice, The Panhandle Syndrome, U.S. News & World Rep., Jan. 29, 1990, at 43; Michael Quint, Northeast Banks Face Healthy Losses on Problem Loans, N.Y. Times, Dec. 15, 1989, at A1; Sandra Sugawara, Margaret K. Webb & Jerry Knight, Real Estate: It Could Be Worse, Wash. Post, Jan. 15, 1990, at F3; U.S. Seizes New Jersey Savings Bank, N.Y. Times, Dec. 9, 1989, at 33, 34.

[93] See Jerry Knight, Riggs Won't Keep Most NBW Loans; 8 Branches of Failed Bank to Be Closed, Wash. Post, Aug. 30, 1990, at C1, C4.

[94] Financial Institutions Reform, Recovery and Enforcement Act of 1989, Pub. L. 101-73, § 301(u), 103 Stat. 183, 310-11.

[95] Indeed, many such institutions disappeared forever, as lenders with substantial real estate portfolios were particularly susceptible to failure. See Financial Condition of the Bank and Thrift Industries: Hearings before the Subcomm. on Financial Institutions Supervision, Regulation and Insurance of the House Comm. on Banking, Finance and Urban Affairs, 99th Cong., 2d Sess., pt. III, at 492-95 (1986).

market. What represented prudent policy for any individual institution, however, became an unfortunate overall banking policy for sellers of real estate when all financial institutions adopted it. Thus, the surplus of owners needing to sell and the dearth of buyers with ready funding sources transformed predictable price declines into free falls.

The current real estate situation could be viewed as simply a correction of past excesses, which was necessary to stop the creation of new projects in an overcrowded and oversupplied market. Under that view, the price declines represent the natural market forces at work until excess capacity is absorbed, rents increase and price equilibrium is restored.[96] As a result, the federal government bears no responsibility for the situation because purchasers of real estate should accept the risks of market fluctuations if they expect to reap the rewards when those fluctuations operate in their favor.

Nevertheless, it should be recognized that the real estate boom was spurred by the federal government's creation of significant periodic tax subsidies for the industry in 1981. Congress removed them in 1986, and replaced them with what amounted to tax penalties. Those

[96] See Anthony J. Pellechio, Taxation, Rental Income, and Optimal Holding Periods for Real Property, 41 Nat'l Tax J. 97, 104-05 (1988) (predicting that the 1986 Act will cause rent increases ranging from 7.3% to 28% for residential rental property and 4.5% to 23% for commercial property). The analysis in Pellechio's paper progressed from the author's attempt to calculate a market value of property from its stream of pretax income and tax liabilities. Pellechio, supra, at 97-101. The author first concludes that the market value of the property, in the long run, will not be affected by tax changes, because the market value of the property will be determined by construction costs. Id. at 106 n.15. Thus, in the long run, the full effect of the tax change will be borne by rent rather than market value. The increased costs associated with ownership of the property by virtue of the increased tax liabilities from the impact of the 1986 Act on the owner will, after a suitable adjustment period, be reflected in higher rents. He concludes, however, that, in the short run, the impact will be borne by lower market values as well. Admittedly, the author's conclusions do not take into account the impact, if any, of the 1986 Act on the costs of producing rentable space, which would include raw land costs. Indeed, perhaps the reduction in raw land values will absorb the most severe impact of the 1986 Act's changes.

See also Jeffrey B. Fisher & George H. Lentz, Tax Reform and the Value of Real Estate Income Property, 14 Am. Real Est. & Urb. Econ. Ass'n J. 287 (1986), in which the authors analyzed the early Treasury proposals for tax reform that were not enacted, but were the precursors to the 1986 Act. Their model employs what they refer to as "the user cost framework." The user cost is the amount "charged by the owner of the asset to a renter-user on the presumed conditions of long-run market equilibrium where the renter pays all operating expenses." Id. at 295. That framework assumes that, in long-run equilibrium, the demand price of an asset equals the cost of the asset. As a result, all tax benefits or all tax detriments, as the case may be, are reflected in the rental price. Accordingly, rental prices, under the framework, completely reflect all tax benefits or tax penalties resulting from tax law change when the market is in long-run equilibrium. Id. at 296.

> Therefore the larger the tax benefits, ceteris paribus, the lower the rental price that the owner of a preferentially-treated asset has to charge to obtain the required after-tax rate of return. This also implies that the value of the asset per rental dollar increases, ceteris paribus, as the tax benefits increase.

Id.; see also note 74.

changes occurred at the same time that the S&L industry was undergoing a crisis. The real estate bust that followed the 1986 tax changes exacerbated the S&L crisis and resulted in a financial avalanche. The free fall in real estate caused financial ruin for many in the real estate industry who were unable to predict the fall. Perhaps, not much sympathy can be generated for speculators who sought to realize financial gains from ever increasing prices. In any event, investors who sold soon after 1986 were able to escape much of the problem. Those that remained sought to continue their speculation even after the removal of subsidies and perhaps simply guessed wrong.

But some victims of the post-1986 collapse were not afforded the choice to depart from the real estate arena. In particular, many S&Ls and other banking institutions were locked in. Their loan portfolios were created when the real estate securing the loans had value supported by the government subsidies. Only after the loans were made was the collateral devalued. The existence of federal deposit insurance will, of course, leave the federal taxpayers bearing the ultimate economic cost of many of these losses.[97]

D. *Method Chosen to Eliminate Subsidy*

The selection of the passive loss rules as the means to eliminate the subsidy for real estate and other tax shelter activities created considerable complexity, hardship and inequity. Most importantly, however, Congress did not provide the necessary protections, through adequate transition rules, to previous beneficiaries of the periodic real estate subsidies. The rules neither allowed current owners continued use of the subsidies in a meaningful way nor protected current owners (and lenders) from the wealth reduction effects of the subsidy's removal. Therefore, the economic consequences of their enactment should not have been terribly surprising. Transition relief of the type discussed in this paper should have been enacted.

[97] Although Robert L. Clarke, Comptroller of the Currency, has denied all responsibility for the banking crisis, it cannot be gainsaid that the banking regulatory system also bears a share of the responsibility. See Robert L. Clarke, The Limits of Bank Regulation, 6 Ann. Rev. Banking L. 227, 227 (1987) ("It is a misperception of the regulatory function to lay the blame for bank failures on bank regulators. The banking community and the public must realize that it is not our fault when banks fail."). The existence of deposit insurance, however, assured even the weakest institutions a steady source of funds with which to speculate in the absence of adequate regulation. "Entrepreneurialism, in its true capitalistic sense, does not exist in this [S&L] industry, and it cannot exist on the deposit insurance system which is backed by the full faith and credit of the United States." FHLBB Chairman Predicts High Profits for S&L's in 1985, Says Congress Must Act to Shore Up Declining FSLIC Fund, 44 Wash. Fin. Rep. 1055, 1056 (1985) (statement of Edwin Gray, Federal Home Loan Bank Board Chairman).

E. *Lessons to be Learned From the Real Estate Experience*

The meteoric rise and precipitous fall of real estate values during the 1980's appears to have been largely tax-driven. Those violent swings resulted in extraordinary profits for some, but extraordinary losses inequitably suffered by others. Although the entire blame for the S&L crisis cannot be laid on erratic changes in tax policy, the changes both in 1981 and 1986 appear to have contributed significantly to the problem initially and exacerbated the problem during the free fall period.

The collapse of real estate after the 1986 Act should not be viewed as merely an isolated and unique series of events. Rather, the results could be repeated in any other sector that is the beneficiary of periodic subsidies that are expected to be permanent, if those subsidies were removed without adequate transition relief. In some cases, such as real estate, it is doubtful whether any transition relief short of compensating subsidy recipients for the loss of the capitalized value of the subsidy would be adequate, a relief not likely to be forthcoming. In those cases, periodic subsidies should be avoided from the outset in favor of one-time subsidies.

IV. Illustration of Future Tax Policy Choice: Owner-Occupied Real Estate

The experience of real estate owners during the 1980's could be repeated if the periodic tax subsidies accorded other subsidized activities such as tax-exempt bonds and retirement savings were eliminated, even prospectively. Owner-occupied residential property appears to be a potential candidate in Congress' search for base broadening tactics. Economic destabilization could result if these periodic subsidies were eliminated, even if the elimination were prospective only and limited to future owners, because the value of the subsidies has been capitalized in the price of the properties.

Subsidies for owner-occupied housing include the deduction for home mortgage interest[98] and the deduction for real property taxes.[99] The interest deduction may be regarded as a subsidy to home ownership because interest payable on personal use property is not a cost of earning business or investment income.[100] Under an economic definition of income, home mortgage interest should not be deductible. The

[98] IRC § 163(h)(2)(D).

[99] IRC § 164(a)(1).

[100] There is, however, a body of thought to the effect that all interest should be allowed as a deduction, at least to the extent that the taxpayer has investment or business interest income. E.g., John Y. Taggart, Denial of the Personal Interest Deduction, 41 Tax Law. 195, 274 (1988).

residential real property tax deduction also should be regarded as a subsidy, because the property tax, even though levied by a government, is a cost of enjoying personal use property. As such, it too represents a consumption expenditure and should not be deductible under an economic definition of income.[101]

These deductions, if viewed as an encouragement to purchase a home, could be viewed as periodic subsidies. Elimination of these deductions would increase the after-tax cost of home ownership, in part because most homes are purchased with borrowed money representing a significant portion of the purchase price. Elimination of the home mortgage interest deduction would increase the after-tax cost of servicing the loan by denying the availability of the interest deduction as an offset to the homeowner's gross income in computing taxable income. In addition, real property taxes represent perhaps the second most significant cost to a homeowner. As a result of these increased after-tax costs, home ownership would become less desirable relative to renting (although likely not undesirable in an absolute sense because of consumer tastes) and outside of the financial capabilities of many would-be homeowners.

Arguably, the home mortgage interest deduction, if not the real property tax deduction, may be characterized more properly as a recurring one-time tax subsidy, than a periodic subsidy, on the theory that a home mortgage may be viewed as a series of extensions of credit, renewable each year, that can be repaid at the discretion of the homeowner. If the subsidy is considered a recurring one-time subsidy, which recipients had a reasonable expectation would be continued indefinitely, then the analysis applicable to periodic subsidies would be more appropriate than the analysis relating to nonrecurring one-time subsidies. An owner's claim for transition relief from the termination of a recurring one-time subsidy that was expected to be renewed may be somewhat less compelling than that of the recipient of a terminated periodic subsidy, for which there was an absolute promise. How much less compelling may depend upon the reasonableness of the taxpayer's expectation that the deduction would continue unchanged, which in turn may depend upon the degree to which taxpayers have been assured by the government of that continuation.

Transition problems created by the elimination of the subsidies would not be solved merely by making the changes prospective and

[101] A deduction for real property taxes as well as other state and local taxes has been justified, from time to time, on the grounds that taxpayers should not be required to pay federal tax on their income that already has been expended to pay state and local taxes. E.g., Brookes D. Billman, Jr. & Noël B. Cunningham, Nonbusiness State and Local Taxes: The Case for Deductibility, 28 Tax Notes 1107, 1118 (Sept. 2, 1985). In short, it is unfair to impose a tax on a tax.

grandfathering current homeowners because the subsidies no longer would be reflected in the market prices that prospective purchasers of homes would be willing to pay. Even the prospective elimination of the subsidies would be likely to produce a reduction in single-family home prices and, in some cases, the elimination of the homeowner's built-up equity (the value of the home less the mortgage on it). Thus, regardless of how desirable in theoretical policy terms, the elimination of the "middle class" subsidies to home ownership may be, even the prospective elimination would cause considerable economic dislocation and financial hardship to current homeowners, absent compensation for the loss by the government. Such compensation, as a practical matter, would be unlikely because the elimination of the subsidies would have derived from the desire to eliminate the governmental expenditure through the tax system rather than out of some sense of theoretical tidiness, however laudable that latter goal may be.

This Article does not attempt to justify the middle class subsidies accorded to home ownership or argue from a policy viewpoint the merits of those subsidies. Rather, it merely makes the point that those subsidies are reflected in the market price for homes, either because they are periodic or because they are one-time with a reasonable expectation of continuing indefinitely. Any proposal to eliminate those subsidies must take into account expectations and actions in reliance on those subsidies by homeowners (and lenders) and the economic dislocation resulting from the elimination of the subsidies. As a result, any proposal should provide transition relief for current homeowners who are adversely affected by the elimination, both through loss of deductions and reduced value of their homes.

Transition relief could take the form, in part, of continued allowability of deductions for current homeowners. Even this transition relief falls short of protecting home values dependent upon the availability of the tax subsidies to prospective purchasers. Perhaps no transition relief short of direct compensation for the capitalized value of the subsidy would be adequate. I do not recommend such relief as a policy matter or suggest that it is politically feasible. The unavailability of adequate transition relief is, however, a strong argument for retaining the current homeowner periodic subsidies, even though, if those subsidies were evaluated as an original proposition, they should be rejected.

V. Conclusion

Tax policymakers should be acutely aware of how tax policy decisions affect the economy. First, tax incentives, if effective, change economic behavior and cause people to engage in conduct that they otherwise would not have, absent the tax incentive. That conduct should not be punished later.

Second, sudden changes that shock the economy can have more serious consequences in the real world than would initially appear. Quick fixes for the economy, such as the creation of periodic tax subsidies or their unexpected removal, should be avoided where the reaction to the quick fix is likely to be long-term, and not easily reversible, changes in financial position in reliance on the quick fix.

Third, and most important, periodic subsidies are affected by the structural components of the tax system, such as tax rates. In addition, by their nature, they are also captives of the political process and are subject to elimination or reduction before their intended term has expired. Indeed, there is a substantial body of academic writing, which I believe to be misguided, concluding that no grandfathering or transition relief is warranted if a periodic subsidy is eliminated or reduced.[102] If these views were accepted (the 1986 Act is evidence that, in large part, they have been, at least at one time), then subsidizing activities using periodic subsidies injects significant uncertainty into the economy, which increases the economic inefficiency of subsidization.

One-time subsidies are not subject to those same shortcomings and present a superior policy tool to periodic subsidies. Therefore, enactment of periodic tax subsidies should be rejected unless Congress is willing to define, specifically limit and guarantee their duration. In the absence of such assurances, Congress should be prepared to live with periodic subsidies permanently or to compensate recipients if the subsidies are later removed. Use of certain periodic subsidies that involve the creation of transferable long-term benefits could require that the subsidy become a permanent part of the tax law if compensation is not politically viable.

As a practical matter, however, it is unlikely that Congress will be willing to retain every periodic subsidy enacted. Therefore, Congress should overcome the temptation to enact periodic tax subsidies.

[102] Graetz, Tax Revision, note 7; Kaplow, note 8.