ARTICLE

TRANSFORMING TAX EXPENDITURES

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For decades, reformers have advocated the repeal of tax expenditures—disguised government spending through special preferences in the Internal Revenue Code. And yet, tax expenditures persist, impairing federal tax receipts by more than $1.8 trillion in 2024. This Article introduces a novel mechanism for tax expenditure reform. To the extent that direct statutory repeal proves impossible or impractical, lawmakers can achieve an equivalent result through a strategy of legislative anti-repeal. By radically expanding a tax expenditure's legal scope, then adjusting progressive income tax rates to account for revenue loss and distributional considerations, lawmakers can effectively eliminate tax expenditures from the tax base and integrate them into the rate structure—a process this Article defines as "base-rate transformation."

Base-rate transformations reframe conventional understandings of repeal and restrictive reform, as well as traditional reform narratives oriented around a mantra of "broad base, low rates." Under certain conditions, statutory expansion operates as de facto repeal—or as restrictive reform. The crucial insight is that, for tax expenditures, the stakes of legal change lie largely in how lawmakers address any adjustments to statutory rates. From a normative perspective, base-rate transformations have implications for customary tax

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norms such as equity, efficiency, and complexity, as well as the political economy of tax expenditure reform. More generally, base-rate transformations challenge standard framings of tax expenditures and press for a more holistic approach to legislative changes to these provisions.

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INTRODUCTION

A foundational tenet of contemporary tax reform in the United States involves the repeal or restrictive reform of tax expenditures.[1] Whether denominated as special preferences, loopholes, pernicious deviations from a comprehensive tax base, or disguised government spending or regulation, tax expenditures make easy villains.[2] Policymakers, members of

[1] For an early expression of this tenet, see Stanley S. Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 HARV. L. REV. 705 (1970). The scope of tax expenditures—and the concept's intellectual coherence—is controversial. *See, e.g.*, Richard Krever, *Analysing Implicit Tax Expenditures*, 35 MELB. U. L. REV. 426 (2011) (taking a cross-country comparative approach to tax expenditures).

[2] Congress defines tax expenditures as provisions of law that "allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability." *See* Congressional Budget Act of 1974, Pub. L. No. 93-344, § 3(a)(3), 88 Stat. 297, 299. The idea that tax expenditures deviate from a normative tax base, however, raises serious conceptual and definitional issues. *See* Boris I. Bittker, *A "Comprehensive Tax Base" as a Goal of Income Tax Reform*, 80 HARV. L. REV. 925, 926–27 (1967).

the media, and academics argue that the presence of tax expenditures in the Internal Revenue Code (the Code) impairs the classical tax virtues of equity, efficiency, and simplicity.[3] The conventional solution is repeal, with possible replacement by direct spending.[4] And yet, tax expenditures persist.[5] As of 2024, the U.S. Department of the Treasury (Treasury) identified 165 tax expenditures worth trillions of dollars in revenue over a ten-year budget window.[6]

This Article introduces a novel approach to tax expenditure reform. As a structural alternative to statutory repeal or tailored reform, this Article proposes radical expansion, coupled with correlative adjustments to progressive income tax rates—a process that this Article defines as "base-rate transformation." This approach represents a significant shift in tax policy thinking. By generalizing the benefits of tax expenditures across the tax base and adjusting rates

[3] These critiques are not limited to any specific ideology or political orientation. *See, e.g.*, Chuck Marr & Brian Highsmith, *Reforming Tax Expenditures Can Reduce Deficits While Making the Tax Code More Efficient and Equitable*, CTR. FOR BUDGET & POL'Y PRIORITIES 1, 11 (2011) (noting tax expenditure reform proposals from both Democrats and Republicans), https://www.cbpp.org/sites/default/files/atoms/files/4-15-11tax.pdf [https://perma.cc/L2LY-C23D].

[4] *See* STANLEY S. SURREY, PATHWAYS TO TAX REFORM: THE CONCEPT OF TAX EXPENDITURES 179–80 (1973); *see also* Daniel N. Shaviro, *Rethinking Tax Expenditures and Fiscal Language*, 57 TAX L. REV. 187, 201 (2004) (arguing that tax expenditure budgets were "meant to serve as a hit list, identifying tax provisions that should be repealed and either disappear altogether or else reappear as direct spending, and not just placed on a par with direct spending whenever budgetary balance was evaluated").

[5] Tax expenditures' durability is not simply a story of political economy. Academic skepticism about tax expenditure analysis also contributes to these provisions' persistence. *See* Shaviro, *supra* note 4, at 187–88.

[6] Off. of Tax Analysis, U.S. Dep't of the Treas., *Tax Expenditures FY2025* (2024). *See* Tax Pol'y Ctr., *What Is the Tax Expenditure Budget?*, TAX POL'Y BRIEFING BOOK (Jan. 2024) (finding $1.8 trillion in total tax expenditures for 2024), https://taxpolicycenter.org/briefing-book/what-tax-expenditure-budget [https://perma.cc/NS2N-KWHA]; *see also* Linda Sugin, *Tax Expenditures, Reform, and Distributive Justice*, 3 COLUM. J. TAX. L. 1, 9 (2011) ("Congress has embraced tax expenditures and increased their number."). Sugin notes that current tax expenditure budgets list more than three times as many provisions than Treasury's earlier iterations.

accordingly, this approach aims to simplify the tax code, reduce distortions caused by targeted tax incentives, and maintain desired levels of distribution and revenue generation. In this sense, base-rate transformations mirror the net effects of conventional repeal, in that base-rate transformations, when carried out in an ideal manner, essentially neutralize tax expenditures' equity, behavioral, and revenue effects. But legislative change is almost never ideal, and the stakes of base-rate transformations lie in their relationship to other second-best policy solutions.

A simple example illustrates the equivalency between conventional repeal and base-rate transformations.[7] Consider a pernicious special deduction that is claimed by 20% of taxpayers in a flat amount of $500 per claimant.[8] Congress repeals this special deduction by excising the relevant provision from the Code. After repeal, prechange claimants pay tax on $500 of additional taxable income, while prechange nonclaimants, who did not benefit from the special deduction, pay tax on the same income. To decouple repeal of the special deduction from repeal's intrinsic revenue-raising effects,[9] Congress reduces generally applicable statutory rates such that total revenue remains constant.[10] Although prechange claimants and nonclaimants both benefit from lower rates, prechange claimants have more taxable income. For this

[7] This Article develops a series of numeric models to illustrate base-rate transformations. *See infra* Part III.C.

[8] This analysis treats the desirability of repeal as a baseline assumption, albeit one that is clearly counterfactual in some circumstances. For a discussion that addresses poorly targeted tax expenditures, see *infra* Part III.A.

[9] The amount of revenue raised is the $500 deduction, multiplied by prechange claimants' marginal tax rates.

[10] One reason to repeal tax expenditures is to raise revenue without the need to increase statutory rates. The political economy of wholesale rate increases, as compared to one-off eliminations of tax expenditures, is an empirical one. Intertemporal issues and the possibility of bundling or logrolling complicate the legislative analysis. *See* Jason Oh, *Will Tax Reform Be Stable?*, 165 U. PENN. L. REV. 1159, 1219 (2017) (arguing that, over time, "[t]ax expenditures are enacted and modified in an ad hoc manner").

reason, prechange claimants pay more in tax after this correlative rate adjustment, while prechange nonclaimants pay less.[11]

Alternatively, Congress could extend this special deduction to the other 80% of taxpayers—a radical expansion of the deduction's scope. Now, all taxpayers receive the special deduction. Prechange claimants pay tax on the same income, while prechange nonclaimants pay tax on income that is $500 less. To maintain constant total revenue (and thus allow for a like-to-like comparison with the repeal scenario), statutory rates must increase.[12] Prechange claimants and nonclaimants both suffer under higher statutory rates, but prechange nonclaimants have less taxable income. After adjusting the rate structure, prechange claimants pay more in tax, and prechange nonclaimants pay less. Depending on how Congress redraws rates, the amount of tax paid by claimants and nonclaimants can be the same as that paid in the repeal scenario.[13] Under these conditions, repeal and expansion yield identical results, and, ceteris paribus, lawmakers, policymakers, and the public should be indifferent between these legislative strategies.[14]

Comparable intuitions apply in the context of reform, where tax expenditures are modified rather than eliminated. Repeal and universalization are endpoints along a continuum of policy change,[15] and restrictive or expansive reform simply

[11] This change has efficiency implications, in that deadweight loss is less. *See infra* Part III.C.

[12] This increase could occur over time. *See infra* Part III.B.

[13] That is, effective tax rates are identical between the two scenarios, which implies that deadweight social loss also is the same. This conclusion is demonstrated mathematically in Part III.C, *infra*.

[14] For various reasons, including the relative salience of changes in tax rates and the tax base, this indifference is unlikely to hold. *See, e.g.*, Ari Glogower & David Kamin, *The Progressivity Ratchet*, 104 MINN. L. REV. 1499, 1554–57 (2020) (discussing "the unique political salience of the top statutory tax rates").

[15] More accurately, repeal and universalization are edges in a multidimensional policy space. *See* Matthew D. McCubbins, Roger G. Noll & Barry R. Weingast, *Structure and Process, Politics and Policy:*

represents incremental movement between these extremes. For any reform that restricts a tax expenditure's scope (and, under the conceits of the prior example, leads to a reduction in statutory rates), there exists a corresponding base-rate transformation that expands the tax expenditure's scope, subject to a generally applicable rate increase. Without more (and there is, of course, more in the legislative process), no intrinsic principle favors a reduction in scope over an expansion. Base-rate transformations are the yin to the yang of repeal and restrictive reform.

The crucial insight is that, for tax expenditures, the stakes of legal change lie largely in how lawmakers address any adjustments to statutory rates.[16] Whether lawmakers should favor restriction or expansion depends on the political availability and as-applied nature of these correlative rate changes—and on not the fact of tax expenditures' restriction or expansion as an independent matter. In some cases, the optimal policy response may favor universalization over repeal.[17] Current discourse, however, generally neglects universalization as a meaningful alternative in tax reform.[18]

Administrative Arrangements and the Political Control of Agencies, 75 VA. L. REV. 431, 435–37 (modelling policymaking within a two-dimensional policy space).

[16] For decades, rates have factored into the tax expenditure literature, explicitly or implicitly. *See* SURREY, *supra* note 4, at 126–74.

[17] *See infra* Parts III.D & III.E.

[18] The academic and policy literature on the repeal or restrictive reform of tax expenditures is legion. For foundational work that emerged in the 1970s, see William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309 (1972); SURREY, *supra* note 4; Surrey, *supra* note 1. For a small selection of more recent treatments, see, e.g., Lily L. Batchelder, Fred T. Goldberg, Jr. & Peter R. Orszag, *Efficiency and Tax Incentives: The Case for Refundable Tax Credits*, 59 STAN. L. REV. 23 (2006); Conor Clarke & Edward Fox, Note, *Perceptions of Taxing and Spending: A Survey Experiment*, 124 YALE L.J. 1252 (2015); Steven A. Dean, *The Tax Expenditure Budget Is a Zombie Accountant*, 46 U.C. DAVIS L. REV. 265 (2012); Jason S. Oh, *The Social Cost of Tax Expenditure Reform*, 66 TAX L. REV. 63, 64 (2012); Edward A. Zelinsky, *James Madison and Public Choice at Gucci Gulch: A Procedural Defense of Tax Expenditures and Tax Institutions*, 102 YALE L.J. 1165 (1993). For historical overviews of the

By developing the structure and contours of base-rate transformations, this Article remedies that omission.

One additional caveat: this Article approaches tax expenditures from a policy-agnostic perspective. In general, tax expenditures ostensibly serve some social or other normative policy function.[19] For example, taxpayers may elect to pay tax on a three-year moving average of their income from farming and fishing businesses, rather than their actual income from these businesses in the current taxable year.[20] Presumably, this averaging protects farmers and fishers from income fluctuations, perhaps due to volatile prices or resource yields. In turn, these income fluctuations distort lifetime tax liabilities in a progressive rate structure predicated on annual assessment. Of course, this special provision also could reflect venal special interest lobbying, an express desire to subsidize agricultural activities, or a particular solicitude for those whose livelihood stems from the land or sea. These various supporting rationales imply different outcomes under a repeal-or-reform analysis.[21] Instead of delving into these rationales, this Article assumes that tax expenditures (as a constructed category) are subject to repeal or restrictive

concept, see Shaviro, *supra* note 4, at 199–206; JOHN F. WITTE, THE POLITICS AND DEVELOPMENT OF THE FEDERAL INCOME TAX 271 et seq. (1985).

[19] Identifying this social function is harder for some tax expenditures than others. *See, e.g.*, Dennis J. Ventry, Jr., *The Accidental Deduction: A History and Critique of the Tax Subsidy for Mortgage Interest*, 73 L. & CONTEMP. PROBS. 233, 257–58 (2010) (describing critiques about the home mortgage interest deduction's logic and effectiveness that emerged in the 1950s); *see also infra* Part V.B (discussing the pass-through deduction in § 199A).

[20] I.R.C. § 1301. Presumably, taxpayers elect a three-year average when their resulting tax liability is lower. Treasury estimates that this provision reduces federal tax revenue by more than $200 million annually. *See* Off. of Tax Analysis, *supra* note 6, at 24. Treasury lists six additional tax expenditures that benefit agriculture. *See* Off. of Tax Analysis, *supra* note 6, at 9.

[21] Indeed, there might be good policy reasons to universalize income averaging. *See* Lee Anne Fennell & Kirk J. Stark, *Taxation over Time*, 59 TAX L. REV. 1, 2–3 (2005) (comparing income averaging to age-based income tax systems).

reform.[22] This approach emphasizes lawmakers' options in the reform process, rather than the normative specifics of reform.

This Article proceeds as follows. Part I briefly surveys the academic literature on tax expenditure reform and proposes a structural definition of tax expenditures that emphasizes the connections between the tax base and tax rates. Part II establishes the arithmetic relationship between the legal definitions of the tax base and tax rates—what this Article terms the "base-rate identity." Part III details the operation of base-rate transformations as a vehicle for tax expenditure reform, including several numeric examples that demonstrate the computational equivalence between repeal and base-rate transformations. Part IV develops various policy considerations that inform the choice between conventional repeal or restrictive reform, on the one hand, and base-rate transformations, on the other. Part V explores three case studies that elaborate the idea and operation of base-rate transformations in the context of tax benefits for health insurance,[23] general welfare transfers such as the Earned Income Tax Credit,[24] and the deduction for business income earned by noncorporate taxpayers either directly or through pass-through entities.[25]

I. TAX EXPENDITURES: THE CAREER OF A CONCEPT

As an idea in U.S. tax policy, tax expenditures present a pair of paradoxes. First, the staff of the Joint Committee on Taxation (JCT) and the Office of Tax Analysis in Treasury prepare exhaustive annual reports, known as tax expenditure budgets, that list these "special" provisions with line-by-line

[22] Many empirical questions about tax expenditures' efficacy are "quite difficult to resolve." *See* David M. Schizer, *Limiting Tax Expenditures*, 68 TAX L. REV. 275, 280 (2015).

[23] *See* I.R.C. §§ 105, 106 (establishing an exclusion for employer-provided health insurance plans).

[24] I.R.C. § 32.

[25] I.R.C. § 199A.

numeric revenue costs.[26] But, as a concept, tax expenditures elude precise definition,[27] and, among policymakers, economists, and legal experts, no general consensus exists about the content of—or dollar values attached to—items in these tax expenditure budgets.[28] Second, with a surprising degree of solidarity, commentators support repeal or substantive limitation (what this Article denotes as restrictive reform) for an extensive suite of tax expenditures,[29] including popular tax benefits for health care, homeownership, retirement savings, and charitable contributions.[30] Notwithstanding a general scholarly and public policy impetus for tax expenditure reform, these headline

[26] These reports also quantify the projected revenue losses associated with each tax expenditure. For the reports, see Off. of Tax Analysis, *supra* note 6, at 24–37; Staff of Joint Comm. on Tax'n, 118th Cong., Estimates of Federal Tax Expenditures for Fiscal Years 2023–2027, at 31–42 (Comm. Print 2023).

[27] *See* Shaviro, *supra* note 4, at 191 ("The distinction between taxes and spending thus depends on pure form."); David A. Weisbach & Jacob Nussim, *The Integration of Tax and Spending Programs*, 113 YALE L.J. 955, 957 n.1, 972–82 (2004) ("The term 'tax expenditures' is subject to much dispute.").

[28] *See* J. Clifton Fleming & Robert J. Peroni, *Can Tax Expenditure Analysis Be Divorced from a Normative Tax Base?: A Critique of the "New Paradigm'" and Its Denouement*, 30 VA. TAX REV. 135, 145–48 (2010) (critiquing efforts to divorce tax expenditure analysis from conceptions of economic income).

[29] *See* Oh, *supra* note 18, at 64 (noting support from politicians and policy experts for tax expenditure repeal); *see also* Daniel Hemel & Kyle Rozema, *Inequality and the Mortgage Interest Deduction*, 70 TAX L. REV. 667, 668–70 (2017) (analyzing the distributional consequences of repeal for the home mortgage interest deduction); David M. Schizer, *Limiting Tax Expenditures*, 68 TAX L. REV. 275, 291 (2015) ("A tax expenditure . . . that is counterproductive obviously is a promising candidate for repeal.").

[30] *See, e.g.*, Robert Bellafiore, *Tax Expenditures Before and After the Tax Cuts and Jobs Act*, TAX FOUND. (Dec. 18, 2018), https://taxfoundation.org/data/all/federal/tax-expenditures-pre-post-tcja [https://perma.cc/CFB2-B6BF]; *Policy Basics: Federal Tax Expenditures*, CTR. ON BUDGET & POL'Y PRIORITIES (Dec. 8, 2020), https://www.cbpp.org/research/policy-basics-federal-tax-expenditures; Frank Sammartino & Eric Toder, *Tax Expenditure Basics*, TAX POL'Y CTR. (Jan. 22, 2020), https://www.taxpolicycenter.org/publications/tax-expenditure-basics [https://perma.cc/YG9G-8DKN].

provisions—and many more obscure tax expenditures—still stand.

These tensions within terminology—that tax expenditures are simultaneously highly specified and protean, at once targets for change and lasting pillars of statutory law[31]—were, to a significant extent, present from the concept's beginnings as a policy construct in the 1950s and 1960s.[32] And yet, the concept has traveled well over time, both politically[33] and as the organizing principle for a robust academic literature.[34] As Congress deploys the Code increasingly for social purposes

[31] Since the 1980s, the home mortgage interest deduction has been described as the "third rail" of U.S. tax reform. *See* Ventry, *supra* note 19, at 234–35 (providing a list of rhetoric that "immunized" the home mortgage interest deduction from reform and "entrenched" the policy over time).

[32] *See* Shaviro, *supra* note 4, at 199–203.

[33] For example, the first Trump Administration's signature legislative achievement, the Tax Cuts and Jobs Act of 2017 (TCJA), reduced the estimated revenue lost to tax expenditures claimed by rank-and-file taxpayers. This reduction occurred even though the total number of JCT-identified tax expenditures increased. The TCJA accomplished this reform by doubling the standard deduction, which dramatically reduced the proportion of taxpayers claiming itemized deductions. The TCJA also capped individuals' deductions for state and local taxes and prospectively limited the home mortgage interest deduction for large borrowings. Eric Toder, *The Tax Cuts And Jobs Act Reduced Tax Expenditures But by Much Less than the 1986 Tax Reform Act*, TAX POL'Y CTR. (Dec. 10, 2019), https://taxpolicycenter.org/taxvox/tax-cuts-and-jobs-act-reduced-tax-expenditures-much-less-1986-tax-reform-act [https://perma.cc/KU73-KFZ6]. Similarly, the Biden Administration's 2025 budget advocated eliminating various "loopholes" that benefit high earners. The Biden Administration's 2025 budget also proposed expanding tax expenditures for housing. *See* Off. of Mgmt & Budget, *Budget of the U.S. Government, Fiscal Year 2025*, at 90 (2024) ("The Budget expands the existing Low-Income Housing Tax Credit and proposes a new Neighborhood Homes Tax Credit.").

[34] *See, e.g.*, *Special Issue on Economic Analysis of Tax Expenditures*, 64 NAT. TAX J. 451 (2011). For a brief history of tax expenditures in policy and political debates, see C. Eugene Steuerle, *The New Old Tax Expenditure Debate, Part 1*, 95 TAX NOTES 1521 (June 3, 2002); C. Eugene Steuerle, *The New Old Tax Expenditure Debate, Part 2*, 95 TAX NOTES 1671 (June 10, 2002); C. Eugene Steuerle, *The New Old Tax Expenditure Debate, Part 3*, 95 TAX NOTES 1817 (June 17, 2002) [hereinafter Steuerle, *Part 3*].

within the individual income tax system,[35] tax expenditures are "everywhere and organizing everything."[36] But, as a concept, tax expenditures are also somewhat diluted in their intellectual coherence, "like a nova entering its red giant phase."[37] This Part outlines various conceptual approaches to tax expenditures, then proposes a structural definition for tax expenditures that highlights the interplay between the tax base and statutory rates.

A. Loophole Rhetoric

Since the advent of the modern income tax in the early twentieth century, colloquial understandings of tax "loopholes" have motivated calls for legal change.[38] Although the category of loopholes is not coextensive with tax expenditures,[39] the two terms have similar negative valence when the stakes involve reform.[40] Congress enables loopholes

[35] *See* Weisbach & Nussim, *supra* note 27, at 997–98 (describing an increase over time in "[s]ocial tax expenditures"); *see generally* Steuerle, *Part 3*, *supra* note 34 ("By the beginning of the 21st century, [there emerged] a set of tax expenditures that is much more geared toward social spending than business and investment expenditures.").

[36] This language, not originally applied to tax expenditures, is from Daniel T. Rogers, *Republicanism: The Career of a Concept*, 79 J. AM. HIST. 11, 11 (1992).

[37] *Id.*

[38] *See, e.g.*, *Two Reports on Tax*, THE WASHINGTON POST, Mar. 15, 1912, at 4 (noting opponents' critiques of a pre-Sixteenth-Amendment income-based excise tax proposal as "crudely drawn and afford[ing] many loopholes for the evasion of the taxes sought to be imposed"); *see generally* LAWRENCE ZELENAK, FIGURING OUT THE TAX: CONGRESS, TREASURY, AND THE DESIGN OF THE EARLY MODERN INCOME TAX (2018) (establishing the legislative and administrative development of the early U.S. income tax).

[39] *See* Heather M. Field, *A Taxonomy for Tax Loopholes*, 55 HOUS. L. REV. 545, 554 (2018).

[40] *See* Boris I. Bittker, *Income Tax "Loopholes" and Political Rhetoric*, 71 MICH. L. REV. 1099, 1112–14 (1973) (noting that linguistic substitutes "for 'tax loopholes' to avoid [the term's] pejorative connotation . . . rarely achieve[]" that objective). The Biden Administration's 2025 budget referred to some tax expenditures as "loopholes." *See* Off. Mgmt. & Budget, *supra* note 33, at 45–46 (identifying the "so-called 'like-kind exchange loophole'").

by commission and omission, as well as by inaction in the face of pernicious tax planning or changing economic circumstances.[41] Conventional tax expenditure analysis assumes that tax expenditures tend toward inequity because of infirmities in the tax legislative process, and expert-produced tax expenditure budgets, regardless of their effectiveness, are expressly designed to inform lawmakers about overuse and abuse by taxpayers.[42] The linkage between tax expenditures and pejorative loophole rhetoric implies a clear policy solution: closure by repeal.[43]

Since the 1990s, the burgeoning of tax expenditures as affirmative social policy tools has pressured the connections between loophole rhetoric and tax expenditures. Many current tax expenditures apply broadly and have significant popular support—whether or not that support is justifiable.[44] For example, in the housing context, Congress has enacted affirmative preferences for interest paid on certain home

[41] *See* Gerard M. Brannon, *Tax Loopholes as Original Sin*, 31 VILL. L. REV. 1763, 1765–66 (1986) (arguing that many loopholes result from "the original sin of sloppy thinking about defining income").

[42] For a description and critique of tax expenditure budgets' role to inform about abuse, see Dean, *supra* note 18, at 267–70.

[43] *See* Bittker, *supra* note 40, at 1113 (noting that repeal is "the fate that might be hypothesized for a loophole of the classical variety"); Stanley S. Surrey, *The Congress and the Tax Lobbyist: How Special Tax Provisions Get Enacted*, 70 HARV. L. REV. 1145, 1148–49 (1957) ("[D]espite an absence of consensus on any particular list of provisions there seems to be considerable agreement that Congress in its tax legislation has adopted provisions favoring special groups or special individuals and that these provisions run counter to our notions of tax fairness."); *see also* Brannon, *supra* note 41, at 1763–64 (describing political rhetoric about tax reform that "has a good-guy/bad-guy theme" with respect to "special interest provisions"); Field, *supra* note 39, at 564 ("[T]he speaker, by affixing the "loophole" label, has concluded that a particular preference violates one or more norms of good tax policy.").

[44] WITTE, *supra* note 18, at 285 ("[I]t is incorrect to perceive the tax expenditure system as primarily a method of distributing hidden benefits to very narrow and highly organized groups . . . . As it is, most of the money is spread very broadly among large segments of the population and corporate world.").

loans and for gains on the sales of principal residences.[45] Congress also has failed to tax imputed income from owner-occupied housing.[46] From a political perspective, however, the chances of direct repeal seem remote.[47] Indeed, the Biden Administration proposed expanding tax benefits for housing, particularly for first-time homeowners.[48] Although tax expenditure analysis emerged from loophole rhetoric, the linkage has eroded over time.[49]

Still, any origin story for tax expenditures must account for loophole rhetoric, and this connection explains, in part, policy experts' generally one-sided perspectives on repeal. Loopholes imply closure as a solution, and the ethos of tax expenditures revolves around limitations and the targeting of benefits. Of course, tax expenditures may present a more fundamental problem. For example, tax expenditures may compare unfavorably to regulation because tax relief functions as a substitute for direct spending that itself operates poorly.[50] Loophole rhetoric tends to emphasize provision-by-provision reform, rather than a more holistic approach to government action.

B. Disguised Spending and Upside-Down Subsidies

[45] *See* I.R.C. §§ 163(h)(3), 121.

[46] *See* Ventry, *supra* note 19, at 236 (discussing imputed income).

[47] *See* Ventry, *supra* note 19, at 281–83 (outlining replacements for the home mortgage interest deduction but arguing that "politicians appear addicted to subsidizing housing regardless of cost"). The TCJA severely curtailed the home mortgage interest deduction through both direct and indirect means.

[48] *See* Off. Mgmt. & Budget, *supra* note 33, at 17 (proposing credits for "middle-class first-time homebuyers" and "middle-class families who sell their starter home . . . to another owner-occupant").

[49] Loophole rhetoric is complicated by changes over time in the moral valence of tax planning. *See* Steven A. Bank, *When Did Tax Avoidance Become Respectable?*, 71 TAX L. REV. 123, 125–28 (2017).

[50] *See* Brian Galle, *The Tragedy of the Carrots: Economics and Policy in the Choice of Price Instruments*, 64 STAN. L. REV. 797, 849 (2012) ("[T]he most basic problem with tax expenditures is not, as critics until now have complained, that they are part of the tax code, but rather that they are expenditures."); *see also infra* Part I.D.

Tax expenditures also are characterized as disguised spending through the Code, which emphasizes two potentially deleterious effects of these provisions' use. First, by routing government action through the tax system, tax expenditures create a "submerged state" that exerts power over markets in ways not salient in the legislative process or to the general public.[51] This submerged state can subvert democracy and circumvent public policy norms, which supports a legislative requirement for annual tax expenditure budgets that ostensibly surface these aspects of state action. Some equivalency exists between revenue-losing tax provisions and direct government spending. Making the former explicit places the categories on more equal ground.[52] Notwithstanding the questionable empirics of such information's value in the political process, the implication again leans towards the repeal or substantive reform of tax

[51] *See* Suzanne Mettler, THE SUBMERGED STATE: HOW INVISIBLE GOVERNMENT POLICIES UNDERMINE AMERICAN DEMOCRACY 4–5 (2011) ("[T]he policies of the submerged state remain largely invisible to ordinary Americans."); *see also* Suzanne Mettler, *From Pioneer Egalitarianism to the Reign of the Super-Rich: How the U.S. Political System Has Promoted Equality and Inequality over Time*, 68 TAX L. REV. 563, 603 (2015); *see generally* BRIAN BALOGH, A GOVERNMENT OUT OF SIGHT: THE MYSTERY OF NATIONAL AUTHORITY IN NINETEENTH-CENTURY AMERICA (2009) (establishing a tradition of indirect government action in the nineteenth century); CHRISTOPHER HOWARD, THE HIDDEN WELFARE STATE: TAX EXPENDITURES AND SOCIAL POLICY IN THE UNITED STATES (1999) (tracing the histories of the home mortgage interest deduction, the earned income tax credit, the jobs tax credit, and tax benefits for employer pensions).

[52] *See* Victor Thuronyi, *Tax Expenditures: A Reassessment*, 1988 DUKE L.J. 1155, 1186–87 (1988) (defining tax expenditures as "substitutable tax provisions" that "can be replaced with a nontax-based federal program that fulfills the current tax provision's purposes at least as effectively as does the current provision itself").

expenditures.[53] Individual tax expenditures' purpose weighs heavily in this analysis.[54]

The idea of disguised spending implicates the structure of tax expenditures, many of which confer "upside-down subsidies" if structured as deductions in a system with progressive statutory rates.[55] Consider a special deduction of $500 for all taxpayers.[56] In a progressive rate structure, high-income filers receive a greater dollar benefit than filers in lower tax brackets. For example, a marginal rate of 40% would generate a tax savings of $200, while a marginal rate of 22% would generate a tax savings of $110.[57] High-income filers receive a greater dollar benefit for the same pretax economic outlay.[58] This design contravenes policy norms that favor equal subsidies for comparable activities and progressive distributional outcomes.[59]

[53] This framing motivated parts of the Tax Reform Act of 1986, which, in part, limited tax expenditures to finance broad-based rate reductions. *See* Daniel Shaviro, *Beyond Public Choice and Public Interest: A Study of the Legislative Process as Illustrated by Tax Legislation in the 1980s*, 139 U. PA. L. REV. 1, 5 ("[T]he 1986 Act was the all-time leading example of tax reform.").

[54] *See* Thuronyi, *supra* note 52, at 1197–98 (distinguishing tax expenditures' "subsidy purpose" from "tax structure issues raised by the provision[s]").

[55] *See* Surrey, *supra* note 1, at 722 (coining the terminology). *See also* Thuronyi, *supra* note 52, at 1159 (noting that Surrey's characterization "shifts the focus of debate" by highlighting tax expenditures' frequently "absurd" distributional implications).

[56] This example parallels the example in the text accompanying notes 7–14, *supra*.

[57] These rates roughly reflect current law, which imposes a top marginal rate of 37%, plus a 3.8% net investment income tax, on the highest earners. *See* I.R.C. §§ 1, 1411. By contrast, a household with $80,000 of income (approximately the U.S. median for families) would face a marginal rate of 22%. *See* Rev. Proc. 2023-34, § 3.01, 2023-48 I.R.B. 1287.

[58] For a deductible outlay, the tax subsidy is equal to the taxpayer's marginal tax rate.

[59] Social policy considerations might favor upside-down subsidies, if, for example, high-income taxpayers made larger outlays that created outsized positive externalities. *See* Daniel J. Hemel, *Phaseouts*, 77 TAX L. REV. 53, 79–83 (2023) (describing income-contingent externalities). Because these

This structural interaction of tax benefits and progressive rates is compounded when high earners differ systematically from others across the income spectrum. High-income filers may have proportionately greater ability to finance tax benefits with debt.[60] The home mortgage interest deduction, for example, varies directly with loan size and inversely with interest rates.[61] To the extent that high-income filers' loan size grows faster than any interest rate reductions, these filers benefit disproportionately compared to middle- and lower-income taxpayers.[62] Similarly, high-income filers may make larger outlays that are largely inframarginal—that is, those filers would make such outlays regardless of any tax-system subsidy. Under a deduction-based tax expenditure, these larger outlays cost the government more while generating a smaller public benefit, compared to middle- and lower-income taxpayers whose (smaller) outlays may lie at a behavioral margin. Environmental tax expenditures, such as benefits for electric vehicles, may function this way, in that lower-income taxpayers would not buy an electric vehicle, absent a subsidy.[63] As with high-income filers' enhanced ability to borrow, any subsidy would be even more upside-down than a deduction incurred evenly across the income spectrum.

situations are likely unusual, tax deductions are not an appropriate default mechanic.

[60] This economic observation fuels debt-driven tax shelters.

[61] *See* I.R.C. § 163(h)(2).

[62] *See* Will Fisher & Chye-Ching Huang, *Mortgage Interest Deduction Is Ripe for Reform*, CTR. ON BUDGET & POL'Y PRIORITIES (June 25, 2013) ("Homeowners with higher incomes tend to have more expensive homes and thus more mortgage interest to deduct."), https://www.cbpp.org/research/mortgage-interest-deduction-is-ripe-for-reform. The Tax Cuts and Jobs Act increased the standard deduction, which, as a practical matter, eliminates most middle- and lower-income households' home mortgage interest deduction. *See id.*

[63] *Cf.* Gilbert E. Metcalf, *Using Tax Expenditures to Achieve Energy Policy Goals* (Nat'l Bureau of Econ. Rsch., Working Paper No. 13753, 2008) (modeling ethanol credits), https://www.nber.org/system/files/working_papers/w13753/w13753.pdf [https://perma.cc/9VAA-87MX].

In this context, substantive modification is a viable reform strategy. Lawmakers can avoid the regressive aspects of tax expenditures by converting deductions to credits or otherwise capping benefits for high-income taxpayers.[64] Comprehensive solutions are possible, such as alternative minimum taxes (AMTs) and overall limitations on itemized deductions. Notably, the corporate AMT and Pease limitation on itemized deductions both were repealed in 2017.[65] Instead, the standard deduction was increased,[66] which reduces the effects of tax expenditures in a way that arguably is regressive. Overall, these rationales do little to identify tax expenditures and have had limited effect in terms of eliminating the problem of upside-down subsidies.

C. Base Expansion and Efficiency-Oriented Reform

Another approach addresses tax expenditures from the perspective of comprehensive income taxation. This approach has two distinct phases. In the 1960s, Stanley Surrey, a preeminent tax lawyer, public servant, and academic, defined the term "tax expenditures" as avoidable deviations from an idealized construction of taxpayers' income.[67] The historical referent was economic income, defined in the Haig-Simons fashion as a taxpayer's consumption and increase or decrease

[64] *See* Batchelder, Goldberg & Orszag, supra note 18, at 57 (arguing that refundable credits retain constant value "in the face of different earnings patterns and degrees of income volatility"); *see also* Hemel, *supra* note 59, at 5–6 (identifying situations in which phaseouts may prove efficient).

[65] *See* An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018, Pub. L. No. 115-97, §§ 11046, 12001, 131 Stat. 2054, 2088, 2092–94 (2017) [hereinafter Tax Cuts and Jobs Act].

[66] *See id.* § 11021, 131 Stat. at 2072–73.

[67] In general, this definition of income was economic, with some concessions to custom and practicality. *See* John R. Brooks, *The Definitions of Income*, 71 TAX L. REV. 253, 274–78 (2018) (describing academic debates about the normative baseline against which tax expenditures are measured).

in wealth over a given period.[68] This broad (and open-ended) definition fit within Supreme Court doctrine that emerged in the mid-1950s, which described income as including "undeniable accessions to [a taxpayer's] wealth."[69] Shepherded by Surrey, the nomenclature of tax expenditures emerged concurrently with a post-World War II shift towards base-broadening as a reform strategy.[70] Again, this strategy implied tax expenditures' repeal,[71] since mere modification could not achieve comprehensive income taxation. From this perspective, lawmakers could reconstruct desirable preferences as explicit spending outside of the tax system.[72]

Yale Law School professor Boris Bittker critiqued this approach—and a strategy of legislative repeal—by highlighting the conceptual and pragmatic challenges to implementing a truly comprehensive tax base. Bittker advocated incremental reform with a focus on distributional outcomes, as well as considerations such as administration and social policy. An idealized construction of income mattered less, or not at all. Too much judgment inhered in the construction of Haig-Simons income, and current law deviated

[68] S*ee* HENRY C. SIMONS, PERSONAL INCOME TAXATION 50 (1938) ("Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question."); *see also* Robert M. Haig, THE CONCEPT OF INCOME—ECONOMIC AND LEGAL ASPECTS, in THE FEDERAL INCOME TAX 1, 7 (Robert M. Haig ed., 1921), *reprinted in* Am. Econ. Ass'n, READINGS IN THE ECONOMICS OF TAXATION 54 (Richard A. Musgrave & Carl S. Shoup eds., 1959); Georg van Schanz, *Der Einkommensbegriff und die Einkommensteuergesetze*, 13 FINANZ-ARCHIV 1, 1–87 (1896).

[69] *See* Comm'r v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955).

[70] *See* Brooks, *supra* note 67, at 270–71.

[71] *See* Shaviro, *supra* note 4, at 201 (arguing that the tax expenditure budget "was meant to serve as a hit list").

[72] *See* Stanley S. Surrey & Paul R. McDaniel, *The Tax Expenditure Concept: Current Developments and Emerging Issues*, 20 B.C. L. REV. 225, 255–56 (1979) (holding the repeal or reform of tax expenditures to the same standards applied to direct spending).

too far from any reasonable metric of economic income.[73] Comprehensive income taxation was itself a political project.[74] Instead, Bittker advocated stepwise legislative change focused on pragmatic values instead of ideals.[75] Although much legislation meets Bittker's standard, Surrey's approach, coupled with an efficiency-oriented economic analysis, has governed major tax reform since the 1980s.

The dominant strand in recent tax reform efforts has revolved around the mantra of "broad base, low rates." The intuition is that base-broadening reforms—typically, loophole-closing and the elimination of tax expenditures—allow for generalized rate cuts under an assumption of constant revenue.[76] In practice, lawmakers may set higher or lower revenue targets, then engage in base-broadening to obtain the lowest possible statutory rates under the new revenue constraint.[77] Because the deadweight loss of taxation varies directly with the square of the effective tax rate imposed, lower rates minimize behavioral distortions while raising the desired amount of revenue.[78] Under this construct, comprehensive income taxation is highly efficient. Because a comprehensive base has the broadest possible (or feasible) base, movements towards such a base enable the lowest and least distortionary marginal tax rates. This outcome

[73] *See* Bittker, *supra* note 2, at 933–34 (noting various incongruities and indeterminacies associated with an economic conception of a comprehensive tax base).

[74] *See* Shaviro, *supra* note 4, at 204–06 (noting the use of tax expenditure analysis "[a]s a weapon of political combat").

[75] *See* Bittker, *supra* note 2, at 982–84 ("[W]e cannot avoid an examination of each [tax preference] on its merits in a discouragingly inconclusive process that can derive no significant assistance from a 'no preference' presumption [by reference to a comprehensive tax base].").

[76] *See* Joel Slemrod, *Is This Tax Reform, or Just Confusion?*, 32 J. ECON. PERSP. 73, 74–75 (2018) (describing this type of reform in the Tax Reform Act of 1986).

[77] The budget reconciliation process, which avoids filibusters in the Senate, essentially requires Congress to establish a revenue target and then backfill taxing and spending measures to meet this target.

[78] *See* Hemel, *supra* note 59, at 77–78 (discussing the efficiency implications of phaseouts).

simultaneously advances distributional goals, to the extent reflected in the statutory rate structure. Repealing or otherwise restricting tax expenditures is central to this project.

D. Comparative Institutional Advantage

A final perspective takes the policy implications of tax expenditures at face value, asking whether a particular government "program" (including revenue-raising functions) should be implemented through the tax system or another administrative vehicle. From this perspective, decisions about tax expenditures—existing or prospective—are "solely a matter of institutional design."[79] Efficiency remains the core criterion but is measured by administrative costs, rather than deadweight loss through peoples' behavioral changes. Relevant factors include the degree to which administrative actors can coordinate or specialize in policy functions, the variations in agency costs across administrative actors, and the advantages of redundancy (or close complements) politically and in policy instruments.[80] Reform proceeds holistically, with careful attention to the comparative advantages of various institutional actors.

The concept of tax expenditures has little relevance to this process. Under Surrey's theory of tax expenditures, programs' content is (at least partially) endogenous with respect to

[79] *See* Weisbach & Nussim, *supra* note 27, at 957 ("The problem is similar to the problem of splitting up a corporation into divisions.").

[80] *See* Nancy C. Staudt, *Redundant Tax and Spending Programs*, 100 NW. L. REV. 1197, 1199–1201 (2006) (discussing the political and administrative advantages of redundancy); David A. Weisbach, *Tax Expenditures, Principal-Agent Problems, and Redundancy*, 84 WASH. U. L. REV. 1823, 1824–25 (2006) (discussing principal-agent and redundancy problems in the context of administrative specialization and coordination); *see also* Michael Doran, *Legislative Organization and Administrative Redundancy*, 91 B.U. L. REV. 1815, 1819–20 (2011) (locating the source of administrative redundancy in "the internal structures of Congress"); Blaine G. Saito, *Context, Purpose, and Coordination in Taxation*, 55 CONN. L. REV. 375, 378 (2023) (applying "contextualized purpose" to better coordinate programs across administrative agencies).

implementation, and tax expenditures tend towards structural features that undermine policy goals. From the perspective of institutional advantage, these structural features are administrative costs vis-à-vis a more abstract ideal policy. Defining the scope of programs and administrative actors also presents challenges, especially if programmatic topics are correlated with specific actors, politically or otherwise. This literature also speaks only indirectly to repeal efforts—the background assumption is that the underlying policy should exist—which is less relevant in the context of this Article.

E. A Relational Definition of Tax Expenditures

This Article deploys an alternative definition of tax expenditures that focuses on the relationship between the tax base and statutory rates—the crucial levers in effecting a base-rate transformation. For this purpose, "tax expenditures" include targeted provisions in the Code, the removal of which would allow for a reduction in generally applicable statutory tax rates, if revenues were held constant. The limitation to "targeted" provisions excludes broadly applicable provisions that compute net income, such as those that authorize business expense deductions.[81] These provisions are not typically thought of as tax expenditures, and policymakers presumably would not repeal them wholesale.[82] Portions of these provisions are, however, conventional tax expenditures with the social policy nexus often associated with such terminology.[83] This Article draws examples from the canon of conventional tax expenditures while acknowledging the difficulties in a conceptual defense of this delineation.

[81] *See, e.g.*, I.R.C. §§ 162, 163, 212.

[82] *Cf.* I.R.C. § 162(m) (denying deductions for certain executive compensation).

[83] *See, e.g.*, I.R.C. §§ 162(f) (denying deductions for fines), 163(h) (denying deductions for personal interest other than home mortgage interest).

One advantage of this definition is that it focuses on the statutory construction of tax law, rather than policy or economic understandings of the tax system.[84] That is, this definition does not rely on distinctions between structural and nonstructural legal provisions, or the identification of deviations from a normative baseline, or the substitutability of direct spending for tax relief. In addition, this definition emphasizes the relationship between the tax base and rates. For a given revenue constraint, the breadth of the legally defined tax base and statutory rates vary inversely, and movements in one variable implicate the opposite for the second. The fundamental relationships implicated by this relational definition of tax expenditures are explored in Part II.

II. LAWMAKING AND THE BASE-RATE IDENTITY

Tax revenue is the arithmetic product of two quantities, the tax base and applicable tax rates.[85] From a conceptual perspective, the tax base comprises the assets, activities, or attributes subject to tax, while tax rates establish the share of the base payable to the government. In a progressive personal income tax, for example, the base is net income, and average rates rise as income increases.[86] More mechanically, taxpayers determine their share of the base and the applicable rates for each period to which the tax applies, then remit the

[84] In this sense, this Article's use of tax expenditures is the converse of the comparative institutional advantage school, which addresses tax expenditures only through their programmatic or policy aspects. As this Article demonstrates, a structural approach also yields insights.

[85] *See* Edward J. McCaffery, OXFORD INTRODUCTIONS TO U.S. LAW: INCOME TAX LAW 3 (2012) ("Any tax consists of the product of a base, or the 'what' of taxation, and a rate structure, or the 'how much' of tax."). More specifically, base and rate are integral to income taxes, consumption taxes, and ad valorem property taxes. Lump sum taxes (imposed uniformly on each taxable unit), excise taxes (imposed as a fixed amount per unit), and certain fees (to the extent they function like taxes) do not require value-oriented rates.

[86] Effective marginal and statutory rates also may be progressive.

resulting product to the taxing authority.[87] The sum of these remittances yields total government receipts.[88] This "base-rate identity"—that tax revenue equals taxpayers' share of the tax base multiplied by their applicable rates—has legal, economic, and political implications.[89]

[87] Surrogates also may calculate and remit taxes on taxpayers' behalf. For example, the United States' income tax relies on self-reporting and voluntary payment backstopped by third-party information reporting and remittance. *See* Eric A. Posner, *Law and Social Norms: The Case of Tax Compliance*, 86 VA. L. REV. 1781, 1782 (2000) (arguing that tax compliance "contradicts the standard economic model of law enforcement"); *see also* Joshua D. Blank & Ari Glogower, *The Tax Information Gap at the Top*, 108 IOWA L. REV. 1597, 1605 (2023) ("Tax information reporting plays a critical role in encouraging individuals to comply with the tax law and file their tax returns correctly."). Similarly, taxes nominally imposed on one person may be designed to burden another in an economic sense. For example, individual holders of capital may bear all or part of the real incidence of corporate taxation, *see* Jennifer Gravelle, *Corporate Tax Incidence: Review of General Equilibrium Estimates and Analysis*, 66 NAT'L TAX J. 185 (2013), or employees may shoulder employer-side payroll taxes through a reduction in wages, *see* Dorian Carloni, *Revisiting the Extent to Which Payroll Taxes Are Passed Through to Employees* (Cong. Budget Off., Working Paper 2021-06, 2021). These features do not change the fundamental computational mechanics of taxation.

[88] These mechanics do not account for costs incurred by the government to create and administer a tax instrument. *See* Shlomo Yitzhaki, *A Note on Optimal Taxation and Administrative Costs*, 69 AM. ECON. REV. 475, 476–77 (1979). These public costs, as well as private-sector compliance and planning costs, have important implications for both the optimal scope of a tax base and the optimal rate structure. *See* David A. Weisbach, *Ten Truths About Tax Shelters*, 55 TAX L. REV. 232, 235 (2002). This Article generally uses tax revenue to describe the gross amount raised by a tax instrument.

[89] For example, lawmakers may establish a rate structure in light of the scope of the tax base. Thomas D. Griffith, *Theories of Personal Deductions in the Income Tax*, 40 HASTINGS L.J. 343, 360–63 (1989) (arguing that tax expenditures cannot be evaluated against the nominal rate structure, since "[i]t is more likely" that lawmakers "enact a rate structure with the understanding that its distributional impact will be modified by [tax expenditures]"). The base-rate identity can be expressed as:

$R = \sum_{t=1}^{n} b_t \times r_t$,

where R is total receipts, n is the total number of taxpayers, b_t is a given taxpayer's share of the base, and r_t is that taxpayer's applicable rate.

Policy debates, however, often obscure the mathematical relationship expressed by the base-rate identity in favor of heuristics about the economic implications of legal changes in the tax base and rates. Emblematic of these heuristics, for example, is the "broad base, low rates" approach to tax reform that emerged in the 1970s and 1980s—and that continues to influence today's tax policy debates.[90] To a significant extent, these heuristics muddy the boundaries between the legal and economic concepts expressed by this terminology. Just as commentators distinguish taxation's nominal (or legal) incidence from its real (or economic) incidence,[91] lawmakers should take care to differentiate tax rates and bases as nominally defined by law from those terms' economic referents. This Part explicates—and argues for—a clearer delineation between the legal and economic definitions implicated by the base-rate identity.

By divorcing nominal and real conceptions of the tax base and rates, an alternative perspective emerges. Although the tax base and rates have discrete conceptual and economic foundations, their practical application is more muddled. Policymakers and commentators deploy these terms in both positive and normative ways, and the interaction between these descriptive and prescriptive aspects has produced persistent controversy.[92] Legal definitions of the tax base and

[90] *See* DEP'T OF THE TREAS., BLUEPRINTS FOR BASIC TAX REFORM 2 (1977) (describing model income and consumption tax plans that feature broad bases and low rates); 1 REPORT OF THE ROYAL COMMISSION ON TAXATION 9–10, 15 (1966) (advocating comprehensive taxation based on "economic power" at lower marginal rates for individuals) [hereinafter CARTER COMM'N REP.]. For current approaches, see, e.g., ORG. FOR ECON. COOP. & DEV., CHOOSING A BROAD BASE-LOW RATE APPROACH TO TAXATION 11 (2010) (noting the prevalence, since 1980, of broad base-low rate tax reforms worldwide).

[91] *See* Sugin, *supra* note 6, at 20.

[92] *See* Shaviro, *supra* note 4, at 204–05 ("Tax expenditure analysis [ ] may have been viewed as a stalking horse for greater progressivity."); *see also* Bittker, *supra* note 2, at 982–83 ("If I am right in asserting that most professed supporters of the [comprehensive tax base] concept favor a host of important departures from the Haig-Simons standard, there ought to be an equally drastic revision of their rhetoric, including a renunciation of the claim that we can or should eliminate all, or even most, "preferences" and "special provisions.").

rates have a mathematical fluidity that maps incompletely onto the terms' economic understandings, and lawmakers already leverage this distinction to titrate policy outcomes.

This Part first establishes the economic and legal aspects of tax bases and rates when constrained by a fixed revenue requirement. Then, this Part elaborates several examples of the base-rate identity as deployed by lawmakers, namely classified property taxes, capital gains preferences, depreciation recapture for real property, and the dividends received deduction. These disparate examples typically are not grouped together, but they emerge as a cognizable category when analyzed in the context of base-rate transformations, as developed further in Part III.

A. Tax Bases, Rates, and Revenue Constraints

The base-rate identity implies a fundamental mathematical relationship: holding tax revenue constant, the tax base and rates vary inversely. That is, for a given number of dollars needed to fund government—a public revenue constraint—a larger (or broader) tax base allows for proportionately lower rates, and a smaller (or narrower) tax base requires proportionately higher rates. This relationship between the tax base and tax rates has conceptual and practical implications in the design and reform of tax systems. Some of these implications flow from the economics of the base-rate relationship. Others are legal in nature, in the sense that they derive from the language and interpretation of the legislation enacting the tax. The relationship between these economic and legal implications is integral to reform efforts but also is frequently underspecified in those efforts.

1. Economic Definitions

Traditional tax policy analysis frequently begins with an ideal tax base and scrutinizes how various choices in the tax

system affect this base.[93] Then, the base is subjected to a rate structure—progressive, proportionate, or regressive—to produce revenue.[94] In effect, this process moves through the base-rate identity stepwise, treating each operand as having independent significance. For decades, the distinction between the tax base and rates drove the questions asked by legal academics, economists, and policymakers. In the 1970s and 1980s, these questions (and their answers) coalesced in the political sphere as the "broad base, low rates" approach to tax reform.[95]

This schematic emerged, in part, from early efforts to conceptualize economic income. For purposes of taxation, Henry Simons defined income as the sum of an individual's consumption and net change in wealth over a specified time period.[96] Simons leveraged this tautology—earnings are either spent or saved—to advocate for the equal inclusion of income from different sources, including income from capital.[97] Although practical considerations tempered Simons's holistic approach to the concept of income,[98] his project was essentially base-broadening. Rates played a secondary role.[99]

In the early 2000s, these approaches were supplemented by "sufficient statistics" methodologies in economics that test incremental policy adjustments with a focus on discrete changes in tax liability, rather than by reference to an ideal

[93] *See, e.g.*, William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113, 1113–14 (1974).

[94] *See, e.g.*, Joseph Bankman & Thomas Griffith, *Social Welfare and the Rate Structure: A New Look at Progressive Taxation*, 6 CAL. L. REV. 1905, 1906 (1987).

[95] *See* DEP'T OF THE TREAS., *supra* note 90, at 53–54 ("[A] low-rate, broad-base tax promises a general improvement in incentives.").

[96] *See* SIMONS, *supra* note 68, at 50.

[97] *See* Brooks, *supra* note 67, at 276; *see also* Andrews *supra* note 93, at 1123 (establishing rates after constructing "a cash flow, consumption-type" base).

[98] *See* Brooks, *supra* note 67, at 256, 269.

[99] *See* SIMONS, *supra* note 68, at 218 (advocating limited changes to the rate structure).

tax base or optimal rate structure.[100] This approach is compatible with analysis based on marginal costs and benefits,[101] and it emphasizes that the tax base and rate structure sometimes are difficult to distinguish. Base-rate transformations track this literature, in that they focus on changes in tax due and effective marginal rates, rather than changes in the nominal base or nominal rates. In addition, base-rate transformations foreground the availability of incremental policy changes—along many axes—when implementing reform.

2. Legal Definitions

The base-rate identity implies that lawmakers can make trade-offs between the legal definitions of the tax base and tax rates under a revenue constraint without triggering the conventional economic consequences associated with such changes. As emphasized by the sufficient statistics movement in economics, the crucial variable for taxpayers' behavior is their ultimate tax liability, as well as effective marginal rates (that is, how taxpayers' tax liability changes with behavior). Legal definitions may or may not affect these variables.

Consider a taxing authority that requires $1 million in tax revenue. If the relevant tax base is $5 million across all taxpayers, then average tax rates—again, across all taxpayers—must be 20%. Doubling the tax base to $10 million permits a halving of rates to 10%; conversely, halving the tax base to $2.5 million implies a doubling of rates to 40%.[102] Each

[100] *See* Raj Chetty, *Sufficient Statistics for Welfare Analysis: A Bridge Between Structural and Reduced-Form Methods,* 1 ANN. REV. ECON. 451, 452, 454 (2009); *see also* Dmitry Taubinsky & Alex Rees-Jones, *Attention Variation and Welfare: Theory and Evidence from a Tax Salience Experiment*, 85 REV. ECON. STUD. 2462, 2462–64 (2018).

[101] *See* David A. Weisbach, Daniel J. Hemel & Jennifer Nou, *The Marginal Revenue Rule in Cost-Benefit Analysis*, 160 TAX NOTES 1507, 1507 (2018).

[102] *See* James Repetti, *The Uneasy Case for a Comprehensive Tax Base* 1, 14 (B.C. L. Sch. Legal Stud. Rsch. Paper Ser. 99, 2006). Repetti points out that these rates are tax-inclusive, which is a typical formulation for income

system raises the same amount of revenue. To the extent that these operations also apply to each taxpayer individually,[103] these taxes are homologous in their economic consequences. From a neoclassical perspective, none of these taxes affects behavior more or less than the others. Setting aside administrative costs,[104] both alternatives impose the same real burden as the original tax, as well as the same marginal rates.

Although the same economically, these three tax systems appear nominally different when complying with the tax reform mantra of "broad base, low rates." Indeed, these changes could be strictly legal (or formal) in nature: lawmakers could finance a blanket 50% rate reduction by counting every dollar of current income twice, or a 50% rate increase by counting only half of each dollar of income. These numeric equivalencies underlie the idea of base-rate transformations. More formally, for any tax system with a legally defined base of B and rates of R, there are any number of alternative tax systems with bases of B' and rates of R' that impose the same economic burden as the initial tax system. The operation of these types of base-rate transformations is explored more concretely in Part III.

B. The Base-Rate Identity in Action

Lawmakers already leverage the base-rate identity to construct tax instruments. This Part illustrates the base-rate identity through several examples in which base adjustments are used to indirectly specify effective rates. These examples

taxes. *Id.* The tax-exclusive rates—more relevant when calculating economic factors such as excess burden or deadweight loss—are 25%, 11.1%, and 66.7%, respectively. *Id.*; *see also* Andrews, *supra* note 93, at 1114 n.2, 1119 n.10 (comparing tax-inclusive and tax-exclusive rates for income and cash-flow consumption taxes).

[103] That is, each taxpayer's share of the base is doubled or halved, and their applicable rate receives the reverse treatment.

[104] In this example, the alternative systems impose incremental administrative costs of an entirely computational nature. These incremental costs are likely trivial. *See* Kathleen Delaney Thomas, *The Psychic Cost of Tax Evasion*, B.C. L. REV. 617, 617 (2015).

involve classified property taxes; the preference for capital gains, including on sales of small business stock in § 1202; the intermediate rate applicable to the recapture of straight-line depreciation for real property; and adjustments to the corporate dividends received deduction in the Tax Cuts and Jobs Act of 2017 (TCJA).[105] The mechanics of these diverse tax instruments are not typically grouped together, though they fit the same intellectual paradigm. The essential intuition is that base-rate transformations exist under current law, although they are not typically categorized as such.

1. Classified Property Taxes

State and local property taxes often use base adjustments as a substitute for explicit rate changes. After the tax revolts of the 1970s put downward pressure on revenue from real property taxes,[106] states and localities adopted classification systems that imposed different tax burdens on different categories of real property. Typically, classification systems imposed higher tax burdens on commercial property, while residential and farming property faced lower burdens.[107] Sometimes, these systems operated within state constitutional limitations on tax rates or overall revenue. More generally, classification emerged as a common mechanism to titrate contributions to state and local revenue.

Most states achieve classification by adjusting the tax base, as opposed to imposing different rates on real property. For example, in Colorado, the same nominal mill levy applies to all real property located within a taxing jurisdiction. Real

[105] Pub. L. No. 115-97, 131 Stat. 2054 (2017).

[106] *See* Ariel Jurow Kleiman, *Tax Limits and the Future of Local Democracy*, 113 HARV. L. REV. 1885, 1890–91 (2020) (arguing that participants in these tax revolts sought to increase public control over government as well as constrain tax revenue).

[107] *See* Nai Jia Lee & William C. Wheaton, *Property Taxes Under "Classification": Why Do Firms Pay More?* 5 (Working Paper, 2010), https://economics.mit.edu/sites/default/files/2022-09/Property%20Tax%20Under%20Classification-%20why%20do%20firms%20pa.pdf [https://perma.cc/AW3M-GLDZ].

property, however, is appraised at fair market value, then assigned an assessed value based on the property's use. Residential property is assessed at approximately 7%, commercial and industrial property is assessed at 29%, and agricultural and certain renewable energy property are assessed at 26.4%. Oil and gas property is assessed at up to 87.5%.[108] After uniform millage rates are applied to each property classification, the result is a set of graduated effective rates based on use.[109]

Base adjustments allocate control over property taxes across taxing jurisdictions, which can be numerous and overlapping in a given geographic area. States typically determine assessment ratios, while local taxing jurisdictions set millage rates annually in an administrative process.[110] These arrangements allow rates to fluctuate based on revenue need, while exacting the same relative contributions from each property classification. In addition, property tax limitations, such as millage rate caps, can apply at different levels—state, county, district, or city—with varying effects. This application of the base-rate identity allows for more

[108] COLO. REV. STAT. § 39 (2023); *see* Colo. Dept. Pub. Local Affairs, *Chapter 6—Property Classification Guidelines and Assessment Percentages*, https://arl.colorado.gov/chapter-6-property-classification-guidelines-and-assessment-percentages [https://perma.cc/W7C6-GMS2]. Before 2020, the assessment percentages for residential and nonresidential real property were adjusted annually so that residential real property paid 45% of all property taxes (known as the Gallagher amendment). *See* S. Con. Rsch. 20-001, 72d Gen. Assem., Reg. Sess. (Colo. 2020). Lawmakers also have adjusted assessment rates to provided targeted and temporary tax relief. *See* Sen. Bill 21-293, 73d Gen. Assem., Reg. Sess. (Colo. 2021), https://leg.colorado.gov/sites/default/files/2021a_293_signed.pdf [https://perma.cc/52U9-CL3N]. Other jurisdictions also use classified property tax systems. *See* Lee & Wheaton, *supra* note 107, at 4 (describing the growth in classified property taxes since 1913).

[109] Depending on incidence, these rates can be progressive or regressive. *See* Kleiman, *supra* note 106, at 1912 (discussing the incidence of property taxes across different groups, including renters).

[110] For large metropolitan areas, assessment ratios may be set by counties. *See* COOK CNTY., ILL. CODE OF ORDINANCES § 74-60 (2024), https://library.municode.com/il/cook_county/codes/code_of_ordinances [https://perma.cc/X3X7-RCTF].

nuance than platonic statutory definitions of bases and rates.[111]

2. Capital Gains Preferences

Between 1934 and 1986, Congress extended preferential rates to long-term capital gains through an exclusion, rather than explicitly lower statutory rates.[112] That is, taxpayers included only a percentage of their long-term capital gains in their total taxable income, then paid tax on that income at statutory rates. Before 1942, the capital gains exclusion varied with holding period, with higher percentages for taxpayers who owned capital assets for longer. Between 1942 and 1978, the exclusion was a flat 50%, with supplemental minimum taxes that applied after 1969. During this period, Congress effectively taxed long-term capital gains at half the rate of ordinary income; after 1965, the exclusion implied a rate of 35%, compared to a 70% top rate on ordinary income.[113] In 1978, Congress expanded the exclusion to 60%, which essentially reduced the rate for long-term capital gains to 28%. In 1982, top rates on ordinary income fell to 50%, yielding another decrease in rates for long-term capital gains to 20%. Then, the Tax Reform Act of 1986 eliminated the exclusion for long-term capital gains and lowered top statutory rates to 28%.[114] Subsequent changes have focused

[111] Simons noted this type of base-rate interplay, arguing that, in times of economic contraction, assessed values may exceed real values. A proper adjustment is to reduce rates. *See* SIMONS, *supra* note 68, at 33 n.20, 50.

[112] During this period, Congress sometimes subjected long-term capital gains to minimum taxes and maximum rates. *See* Gerald Auten, *Capital Gains Taxation*, in THE ENCYCLOPEDIA OF TAX'N & TAX POL'Y 58 (1999).

[113] When top marginal rates peaked at 94% in 1944, capital gains faced an implicit rate of 47%. *See* Tax Pol'y Ctr., *Historical Highest Marginal Income Tax Rates, 1913 to 2023* (2023), https://taxpolicycenter.org/statistics/historical-highest-marginal-income-tax-rates [https://perma.cc/V967-KUDX].

[114] Pub. L. No. 99–514, §§ 101, 301, 100 Stat. 2085, 2096–99, 2216–17 (1986). *See* Auten, *supra* note 112, at 58–59; James D. Gwartney & Randall G. Holcombe, *Optimal Capital Gains Tax Policy: Lessons from the 1970s, 1980s, and 1990s*, JOINT ECON. COMM. 2–3 (1997).

on statutory rates, rather than the interplay between an exclusion and rates.[115] This history illustrates how Congress used nominal changes in the tax base and statutory rates to adjust the capital gains preference over time.

Today, this strategy is evident in Congress's revisions to § 1202, the statutory exclusion for gain from the sale of qualified small business stock.[116] When Congress enacted § 1202 in 1993, the provision granted a 50% exclusion for gains from qualified small business stock. With a capital gains rate of 28%, the effective rate on such sales was 14%. When Congress lowered the general capital gains rate to 15% in 2003, it kept the statutory rate applicable to qualified small business stock at 28%, which virtually eliminated the § 1202 preference by reducing the rate advantage to a single percentage point—at least until Congress increased the exclusion to 100% after the Great Recession.[117] This example shows how the base-rate identity can achieve something like de facto repeal for a tax preference. Just as base adjustments can change effective tax rates (as for long-term capital gains), rate adjustments can eliminate preferences embedded in the base.

3. Depreciation Recapture for Real Property

Fee ownership of improved real property consists of two distinct financial assets, land and improvements such as buildings. Under the Code, improvements are depreciable,

[115] Starting in 1990, Congress adjusted the capital gains preference through changes in statutory rates. *See* I.R.C. § 1(h); *see also Federal Capital Gains Tax Rates 1988–2011*, TAX FOUND. (2011), https://files.taxfoundation.org/legacy/docs/fed_capgains_taxrates-20100830.pdf [https://perma.cc/Y5WD-6DTF].

[116] I.R.C. § 1202.

[117] *See generally* Beckett G. Cantley, *The New Section 1202 Tax-Free Business Sale: Congress Rewards Small Businesses That Survived the Great Recession*, 17 FORDHAM J. CORP. & FIN. L. 1127, 1130–49 (2012) (tracing the history of I.R.C. § 1202). Congress implemented a temporary 75% exclusion for 2009 and 2010 before implementing a 100% exclusion. This temporary exclusion was an express stimulus measure. *See id.* at 1139–40.

while land is not.[118] Both assets may appreciate over time, however, and at different rates. Depreciation deductions generally reduce the owner's ordinary income, while the sale of real property may produce long-term capital gain, if the owner holds the property for investment or in a trade or business.[119] Recapture rules limit or eliminate this potential arbitrage involving rates, while recognizing that depreciation for tax purposes almost always exceeds the costs of actual wear and tear.

On a sale of real property for gain,[120] previously claimed straight-line depreciation is recaptured at a 25% rate.[121] Any residual gain is taxable at the rates applicable to long-term capital gains, which are lower—20%—under current law. For example, if an owner claimed $1,000 of depreciation with respect to real property, the owner could reduce taxes due by $370 at a top marginal rate of 37%.[122] If the owner sold that real property for a $2,000 gain, the owner would pay $250 in tax on the recaptured $1,000 of depreciation and $200 in tax on the remaining $1,000 gain, for a total of $450 in tax. Because the recapture rate for real property is 25%, the owner benefits from rate arbitrage (to the extent of $120) when claiming depreciation on real property.[123]

One rationale for the hybrid 25% rate for depreciation recapture involves the difficulty in allocating the returns to improved real property among that property's components, namely land and improvements. If land appreciates more rapidly than improvements, then gains with respect to real property predominantly reflect that appreciation. Because land is not depreciable, recapture of these gains does not

[118] *See* I.R.C. §§ 167, 168.

[119] *See* I.R.C. §§ 1221, 1231.

[120] *See* I.R.C. § 1001.

[121] *See* I.R.C. § 1(h)(1)(E), (6). Accelerated depreciation on real property, which is limited after 1986, is recaptured at ordinary income rates. *See* I.R.C. § 1250; *see also* I.R.C. § 168(e)(6) (defining qualified improvement property, for which limited expensing is allowable under current law).

[122] These rates do not account for taxes on net investment income. *See* I.R.C. § 1411 (imposing a 3.8% surtax on various types of passive income).

[123] The arbitrage benefit is equal to $370 minus $250.

address rate arbitrage. In the preceding example, if 75% of the owner's $2,000 gain was attributable to the land, then only $500 of the gain reflects excess depreciation that warrants recapture. If the Code recaptured this depreciation at ordinary income rates, the owner would pay $300 in tax with respect to the land and $185 in tax with respect to the improvements. This total, $485, is roughly the amount payable under a flat 25% rate. The hybrid 25% recapture rate for real property makes sense because improved real property comprises both land and improvements, and these components have different economic characteristics.[124] This example illustrates how an intermediate rate can compensate—incompletely and approximately—for a tax base that diverges from economic realities.

4. The Dividends Received Deduction

A final example involves changes to the dividends received deduction enacted by the TCJA in 2017. Before the TCJA, corporate tax rates generally were 35%, but corporations could deduct 70% or 80% of their dividend income as partial relief from three-level corporate taxation.[125] Under these rules, corporations paid tax on dividends at effective rates of 10.5% and 7%.[126] When the TCJA reduced corporate tax rates to 21%, Congress also reduced the percentages for the dividends received deduction to 50% and 65%.[127] These reductions maintained the effective rates on these intercompany dividends at 10.5% and (approximately) 7%.[128] By modifying the tax base, Congress preserved proreform rates on certain types of transactions—a final example of lawmakers

[124] For a contrary view, see Richard L. Schmalbeck & Jay A. Soled, *Unifying Depreciation Recapture*, 48 CONN. L. REV. 531, 536 (2015) (arguing for recapture of depreciation on real property at full ordinary income rates).

[125] *See* I.R.C. § 243(a)(1), (c) (2017).

[126] These effective rates equal statutory rates, multiplied by one minus the deduction rate (that is, 35% × (1 – 70%) and 25% × (1 – 80%)).

[127] *See* I.R.C. § 243(a)(1), (c).

[128] The actual rate is 7.35%, which equals 21%, multiplied by one minus 65%.

leveraging the base-rate identity to achieve specific policy outcomes.

III. TRANSFORMING TAX EXPENDITURES

For targeted tax expenditures, base-rate transformations operate as a type of *de facto* repeal. This Part outlines the basic mechanics of base-rate transformations involving tax expenditures, as well as factors that affect whether lawmakers should consider this strategy for a given tax expenditure. Some tax expenditures may be more susceptible to base-rate transformations than others.

Base-rate transformations involve two discrete components. The first step is a radical expansion of the subject provision's scope, going from a narrow carve-out from the tax base to something approaching a universal benefit. This step eliminates the subject provision from the nominal tax base, as legally constructed. The second step requires correlative adjustments to statutory rates and rate brackets to forestall revenue loss and mitigate adverse distributional effects.[129] This step internalizes the subject provision as part of the statutory rate structure. Taken together, these steps leverage the base-rate identity to reconfigure legal definitions of the tax base and rates in a way that effectively eliminates the subject provision, in whole or in part, without the need for formal statutory repeal.

A. Radical Expansion

In a base-rate transformation, lawmakers eliminate a tax expenditure from the tax base by radically expanding the provision's application—the converse of conventional statutory repeal. By definition, radical expansion narrows the nominal tax base, as established by law. Whether radical

[129] *See* GREG ESENWEIN, CONG. RSCH. SERV., REP. NO. RS22242, TAX REFORM AND THE GOAL OF REVENUE NEUTRALITY 3 (2005) (noting that revenue neutrality is, effectively, an assumption that allows comparison with repeal and restrictive reform options). Within this framework, repeal also requires potentially complex adjustments to the rate structure.

expansion affects the real (or economic) tax base depends on two factors: universal application and uniform benefits, each of which is explored below.

To the extent that radical expansion achieves these criteria, lawmakers can mitigate—or even avoid—the economic costs of narrowing the nominal tax base by adjusting the statutory rate structure. If these criteria are not fully met, base-rate transformations will incur economic costs, though they still may improve on the status quo. In this sense, base-rate transformations arbitrage the nominal-real distinction for the tax base and rates.

1. Universal Application

In the context of base-rate transformations, "universal application" refers to the proportion of taxpayers eligible for benefits under a particular tax expenditure. If 40% of taxpayers claim a specific statutory exemption, radical expansion would attempt to extend that exemption to all taxpayers. Tax expenditures, however, depend on behavior or status, which vary across taxpayers. One approach would treat these variations as trivial. For example, the child tax credit (CTC) applies only to taxpayers with one or more qualifying children.[130] If Congress amended the CTC to conclusively presume that all households have at least one qualifying child, the CTC would apply universally and no longer would adjust taxpayers' relative tax liabilities based on the actual size of their families.[131] By unlinking taxation from reality, this change also would pressure definitions of the taxable unit and invite unintended errors and intentional tax

[130] *See* I.R.C. § 24. Treasury and JCT treat the CTC as a tax expenditure. *See* Off. of Tax Analysis, *supra* note 6, at 19; Staff of Joint Comm. on Tax'n, *supra* note 26, at 4 (each noting that the CTC serves as an adjustment for family size and structure).

[131] Similarly, decoupling the Earned Income Tax Credit from income requirements would transform that credit into a basic income grant. *Cf.* I.R.C. § 32 (requiring earned income to receive a tax benefit).

gaming[132]—drawbacks that already exist to some extent under current law.[133] This type of unlinking, however, would universalize access and potentially ameliorate disparities with respect to race and class.[134] Although this route to universal application has significant implications for the CTC's policy substance, this type of substance-agnostic reform is an option that remains open for lawmakers.

Alternatively, radical expansion could occur along more substantive lines. Tax expenditures often target specific behaviors within a broader set of common economic or social activities, and universal application may proceed by generalizing the subject tax expenditure to this broader set. Consider the home mortgage interest deduction (HMID), which permits an itemized deduction for interest paid on up to $750,000 of mortgage debt incurred to buy, build, or substantially improve a taxpayer's principal residence or vacation home.[135] Although only some taxpayers borrow to acquire a principal residence,[136] taxpayers overwhelmingly participate in the housing market in some capacity. For the

[132] For example, childless married individuals might divorce in order to double their credits for fictional children. *See* I.R.C. § 1 (stating rates for filing units). This type of gaming, of course, is possible under current law. *See* I.R.C. § 164 (imposing a marriage penalty for deducting state and local taxes).

[133] *See* Jacob Goldin & Ariel Jurow Kleiman, *Whose Child is This? Improving Child-Claiming Rules in Safety-Net Programs*, 131 YALE L.J. 1719, 1725–27 (2022) (describing how child-claiming rules fail to accommodate the full range of family structures).

[134] *See also* Jacob Goldin & Katherine Michelmore, *Who Benefits from the Child Tax Credit?* 2 (Nat'l Bureau of Econ. Rsch., Working Paper No. 27940, 2021) (finding "striking differences in patterns of CTC eligibility based on a child's race), https://www.nber.org/system/files/working_papers/w27940/w27940.pdf [https://perma.cc/H9QY-7M2K].

[135] *See* I.R.C. § 163(h)(3), (4).

[136] Of those who borrow to acquire a principal residence, even fewer claim the HMID as an itemized deduction. *See* Tax Pol'y Ctr., *What Are Itemized Deductions and Who Claims Them?*, TAX POL'Y BRIEFING BOOK (Jan. 2024) (noting that, after the TCJA, approximately 10% of households itemize deductions), https://taxpolicycenter.org/briefing-book/what-are-itemized-deductions-and-who-claims-them [https://perma.cc/4CTF-8UBC].

HMID, lawmakers could achieve universal application by giving a housing tax benefit to all households.[137] Renters could deduct rent paid, and a formula-based housing deduction could be created for homeowners who do not itemize deductions or incur qualifying mortgage debt. This mechanism for radical expansion preserves the link between taxation and behavior, which may offer administrative advantages and restrain tax gaming.

2. Uniform Benefits

Radical expansion creates "uniform benefits" to the extent that taxpayers receive a common reduction in tax from the relevant tax expenditure. If a specific statutory exemption yields deductions for taxpayers that average $2,000 but range between $1,000 and $10,000, radical expansion could give each taxpayer a fixed deduction of $2,000, regardless of that taxpayer's behavior or status.[138] Alternatively, taxpayers could receive variable deductions based on a characteristic that appropriately figures into the rate structure. That is, the rate structure could be adjusted to "price out" the deduction. The most obvious characteristic is income, exclusive of the tax expenditure; other candidates could include family size, age, or geographic location.[139] When undertaking radical expansion, uniformity simply requires that benefits correspond with statutory rates to produce a normatively desirable structure of effective and marginal rates.

Just as for universal application, lawmakers have two routes to achieve uniform benefits. One route treats differences in behavior or status as trivial. The child and dependent care credit (CDCC) offers an example. The CDCC

[137] These benefits might incorporate an offset for (untaxed) imputed income, which is greater for taxpayers who own their homes debt-free.

[138] It is common to group taxpayers for purposes of distributional or other analysis. *See* Michael J. Graetz, *Paint-By-Numbers Tax Lawmaking*, 95 COLUM. L. REV. 609, 640–41 (1995).

[139] Under current law, age and other life-cycle factors are not explicitly factored into the rate structure. There are, however, compelling reasons for doing so. *See* Fennell & Stark, *supra* note 21, at 2–3.

provides a partially refundable credit equal to a variable percentage of the costs of market-based care, up to a fixed dollar amount.[140] Take a two-earner household with one child that pays $4,000 for third-party childcare in 2024.[141] Under current law, $3,000 of this household's childcare costs are creditable at progressive rates between 20% and 35%.[142] A radical expansion of the CDCC could impute creditable costs to otherwise-qualifying households that do not pay for market-based care, or that pay less than the maximum creditable costs for market-based care.[143] Imagine a two-earner household that pays $2,000 for occasional third-party childcare (and perhaps supplements with family care), and a single-earner household with one child, a stay-at-home caregiver, and no out-of-pocket childcare expenses.[144] Under a radical expansion of the CDCC, both of these households could claim $2,000 in creditable costs.[145] The CDCC transforms from a rebate for the costs of market-based care to an across-the-

[140] *See* I.R.C. § 21. The American Rescue Plan Act of 2021 significantly expanded the CDCC for 2021 only, Pub. L. No. 117-2, § 9631, 135 Stat. 4, 159–61 (2021), and subsequent legislative proposals would increase and modify the CDCC. *See* Margot Crandall-Hollick, *More Can Be Done to Improve the Child and Dependent Care Credit*, TAX POL'Y CTR. (Sept. 4, 2024) (describing a bipartisan proposal to expand the CDCC), https://taxpolicycenter.org/taxvox/more-can-be-done-improve-child-and-dependent-care-credit [https://perma.cc/QVP4-FEFL]. This discussion of § 21 ignores coordination rules with employer-provided dependent care assistance programs. *See* I.R.C. §§ 21(c), 129.

[141] This analysis assumes that these expenses otherwise qualify for § 21.

[142] I.R.C. § 21(a)(2). The creditable rate declines as household income increases. A portion of the CDCC is refundable; in 2024, this amount was $1,700. Rev. Proc. 2023-34, § 3.05, 2023-48 I.R.B. 1287, 1291.

[143] This radical expansion treats household size as a component of the normative rate structure, rather than as a special adjustment to a normative tax base. *But see* Off. of Tax Analysis, *supra* note 6, at 19; Staff of Joint Comm. on Tax'n, *supra* note 26, at 4 (each taking the opposite position for purposes of constructing a normative baseline against which to measure tax expenditures).

[144] Bipartisan proposals for expanded "caregiver" tax benefits essentially operate under the principles of radical expansion. *See, e.g.*, Credit for Caring Act of 2024, H.R. 7165, 118th Cong. § 2 (2024).

[145] Of course, these households might not receive the same credit.

board rate adjustment based on family size and structure,[146] not unlike the CTC[147] or the currently suspended personal exemption.[148] Indeed, this example emphasizes how the idea of radical expansion reframes policy changes within the tax expenditure space.

Uniform benefits also may have a substantive tether. Revisit the example of radical expansion of the HMID, in which universal application implies a basic housing tax benefit for all households. A fixed-dollar deduction—say, $6,000 annually for each household—would decouple this benefit from taxpayers' actual housing costs and fully excise the HMID from the tax base.[149] Alternatively, a variable-dollar tax benefit also might have advantages. Because housing costs vary systemically across geographic regions and the urban-suburban-rural divide, a deduction based on actual housing-related outlays might improve equity (by taxing individuals on something closer to their real economic income) and efficiency (by making individuals indifferent to geography for tax purposes).[150] But households' housing costs also depend on taxpayers' tastes and means—consumption preferences and income constraints that the tax system should take into account. For this reason, the uniformity criterion may require numeric caps, floors, or phaseouts (or

[146] Even though structured as a refundable credit, the CDCC can be viewed as an adjustment to the tax base—a partial exclusion for childcare costs. This adjustment may exceed filers' total costs from childcare, although the credit's limitations are much lower than average costs of full- or part-time childcare. *See* Adam Grundy, *Estimated Revenue for Child Day Care Services Climbed as Child Care Options Declined in 2021*, U.S. CENSUS BUREAU (Jan. 9, 2024) (finding that states' average childcare costs ranged from $4,810 to $15,417 annually), https://www.census.gov/library/stories/2024/01/rising-child-care-cost.html [https://perma.cc/VK94-QAG9].

[147] *See* I.R.C. § 24.

[148] *See* I.R.C. § 151(b)–(d). The TCJA suspended personal exemptions through 2025. *See* I.R.C. § 151(d)(5).

[149] For examples of statutory housing benefits, see I.R.C. §§ 107, 135, 911.

[150] *See generally* David Abouy, *The Unequal Geographic Burden of Federal Taxation*, 117 J. POL. ECON. 635 (2009) (examining inefficiencies generated by not indexing tax liability based on local geographies).

some combination of these limitations) on any cost-based housing tax preference.[151] More generally, radical expansion may come with stipulations about the amount of benefits granted to various claimants—a typical strategy in tax expenditure reform.[152]

3. Incomplete Expansion

Political processes or other considerations may preclude an ideal radical expansion that achieves both universal application and uniform benefits.[153] For the HMID, a housing benefit for all homeowners and renters may exclude the itinerant, the homeless, and those with nonmarket living arrangements. Similarly, politicians may prefer to give full CDCC benefits to households with cash costs for caregiving, leaving only a partial benefit for households with stay-at-home caregivers. In these situations, the base-rate transformation cannot be complete, and the subject provision will not move out of the tax base—at least, not entirely. Something of the tax expenditure will remain.

Repeal-seeking lawmakers should proceed with incomplete base-rate transformations, if the transformation improves on existing law and is not worse than other reform options. The relevant metric is the degree to which a radical expansion has universal application and creates uniform benefits.[154] Any excess or deficiency leads to distortions. This analysis is complex, since radical expansions may—and are intended to—affect (many) more taxpayers than just those who claimed the

[151] *See, e.g.*, PAMELA J. JACKSON, CONG. RSCH. SERV., REP. NO. 7-5700, FUNDAMENTAL TAX REFORM: OPTIONS FOR THE MORTGAGE INTEREST DEDUCTION (2008). These caps and floors could be linked to geography and other factors. *Cf.* I.R.C. § 164(b)(5)(H) (allowing for the determination of sales tax deductions using tables).

[152] *See generally* David M. Schizer, *Limiting Tax Expenditures*, 68 TAX L. REV. 275, 321–42 (2015) (detailing seven types of limits on tax expenditures, including various types of caps, floors, and phaseouts).

[153] It also may be difficult to determine whether some benefits are, in fact, uniform.

[154] *See supra* Part III.A.1–2.

original tax expenditure. Benefits may shift in idiosyncratic ways, and distributional distortions may prove difficult or impossible to correct through the rate structure.

For tax expenditures, a botched radical expansion carries greater potential risks than its converse, an incomplete repeal. Radical expansion and repeal are structural cousins: in this Article's terminology, repeal could be described as "radical contraction." Furthermore, repeal falls short when it does not apply universally, or when it fails to reduce all taxpayers' benefits to a uniform value of zero. Grandfathering is a common example of incomplete repeal.[155] Old claimants retain some or all of their tax benefits, while new potential claimants receive nothing. For tax expenditures, repeal risks only the revenue loss associated with the original provision. By contrast, radical expansion risks potential revenue loss from all new claimants.[156] For this reason, risk-averse lawmakers may prefer to initiate base-rate transformations for tax expenditures that already apply broadly, with relatively small levels of benefits per taxpayer. Many large tax expenditures, such as the CTC, possess this characteristic.[157]

B. Correlative Adjustments in Theory

The second step in a base-rate transformation involves correlative adjustments to the statutory rate structure—tax brackets and nominal rates. This analysis assumes that, in addition to preserving effective marginal rates, lawmakers prioritize three other norms: revenue neutrality, distributional neutrality, and efficiency as expressed through taxpayers' effective marginal rates.[158] Revenue neutrality

[155] *See* Michael J. Graetz, *Legal Transitions: The Case of Retroactivity in Income Tax Revision*, 126 U. PA. L. REV. 47, 60–61 (1977).

[156] If 20% of the U.S. population claims a given tax expenditure, then radical expansion risks revenue loss associated with extending that tax expenditure to the remaining 80% of the U.S. population.

[157] *See supra* notes 130–134 and accompanying text.

[158] These norms grew to dominate tax reform discourse from the 1980s through the early 2000s. *See* PRESIDENT'S ADVISORY PANEL ON FED. TAX

means that total government receipts remain constant, before and after reform. Distributional neutrality implies that the same individuals pay the same amount of tax, before and after reform.[159] Efficiency refers to taxation's effects on individuals' marginal behavior. Each of these norms has a temporal component, in that government revenue, the distribution of tax burdens, and taxpayers' incentives may change over time. And none of these norms is absolute. Lawmakers should deviate from revenue, distributional, and behavioral neutrality as normatively appropriate and politically expedient.

This Section explores revenue neutrality, distributional neutrality, and effective marginal rates in the context of base-rate transformations. Correlative adjustments to the rate structure are crucial in base-rate transformations, in that they illustrate the fundamental parallels between universalization and repeal for tax expenditures.[160] In practice, lawmakers may not make these adjustments, or they may make these adjustments incompletely. But these adjustments are arithmetically possible across a wide range of radically expanded tax expenditures.[161] Conventional repeal, of course, also implicates correlative rate adjustments within the analytic framework of revenue neutrality,

REFORM, SIMPLE, FAIR, AND PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM 42, 49 (2005) (discussing these norms in the context of tax reform involving multiple tax instruments); Shaviro, *supra* note 53, at 23–24 (describing these norms with respect to the Tax Reform Act of 1986). More recently, the TCJA marked a clear departure from both norms—though the law also severely curtailed tax expenditures through the doubling of the standard deduction, which limited the number of filers who itemized deductions. *See* Slemrod, *supra* note 76, at 75, 87–90 ("[T]he Tax Cuts and Jobs Act was neither revenue neutral nor distributionally neutral, while the Tax Reform Act of 1986 was designed to be both.").

[159] *See* Graetz, *supra* note 138, at 640–41.

[160] For an example of this process with respect to the repeal of tax expenditures, see TAX POL'Y CTR., THE TAX REFORM TRADEOFF: ELIMINATING TAX EXPENDITURES 2–4 (2017), https://www.urban.org/sites/default/files/publication/93201/2001499-the-tax-reform-tradeoff-eliminating-tax-expenditures-reducing-rates_3.pdf [https://perma.cc/NR4H-Q3DH].

[161] *See infra* Part III.C.

distributional neutrality, and efficiency. This Section contrasts the stakes of these adjustments in both the expansion and contraction context.

1. Revenue Neutrality

Radical expansion, the first step in base-rate transformations, narrows the nominal tax base. To maintain constant revenue before and after this change, nominal rates must increase—a fundamental application of the base-rate identity. This increase may entail more than numeric adjustments to statutory rates. Lawmakers may change stated bracket cutoffs or implicit zero-rate brackets, such as the exemption provided by the standard deduction.[162] The range of tools to maintain revenue neutrality is substantial.

In addition, lawmakers may treat revenue neutrality as more of a conceptual constraint than a practical one. The overall goal of legislation may be to raise revenue or enact tax cuts, and base-rate transformations simply provide information about reforms that maintain the tax system's basic parameters. Alternatively (and more importantly), lawmakers may revisit the rate structure from the perspective of fundamental tax norms, such as equity and efficiency. Base-rate transformations give a starting point for asking these normative questions. Finally, rate adjustments may map incompletely onto radical expansion for reasons of political economy. Expansion may be incomplete or uneven, and rate adjustments may fall short or exceed the values needed to maintain constant revenue. Each of these factors also applies to the conventional repeal of tax expenditures, though traditional tax expenditure analysis frequently omits these considerations.

[162] *See* I.R.C. § 63(a), (b)(1), (c). For examples of these adjustments, see *infra* Part III.C.

2. Distributional Neutrality

To some extent, the norm of distributional neutrality is in tension with a desire to repeal or reform tax expenditures. If some taxpayers benefit inappropriately from tax expenditures, those taxpayers should pay more, not the same, after reform. Still, the political economy of reform historically has favored maintaining taxpayers' relative tax liabilities, then letting their post-reform behavior determine subsequent changes in tax liability.[163] This type of distributional neutrality is hard to achieve when repealing or restricting tax expenditures, and it is similarly difficult to achieve in base-rate transformations.

A more-typical construction of distributional neutrality examines cohorts of taxpayers, rather than taxpayers as individuals. Divisions by income thresholds or quintiles or deciles are common.[164] Base-rate transformations should be able to satisfy this version of distributional neutrality, which obscures intra-cohort variations.[165] Because base-rate transformations adjust the generally applicable rate structure, taxpayers with the same income—however they arrive at that amount—should fare the same.

More generally, the distributional effects of tax expenditure reform—through repeal or base-rate

[163] *Cf.* Graetz, *supra* note 138, at 648 (noting that, for the Tax Reform Act of 1986, "much of the tax increase for upper-income taxpayers was in the form of retroactive tax increases on pre-1986 tax shelter investments, [which] had only a temporary impact in increasing taxes of upper-income people, even though the provisions themselves, as well as the accompanying rate reductions, were permanent changes"). Tax reform also faces incremental legislative changes that can erode reform's coherence. *See* Michael J. Graetz, *Tax Reform Unraveling*, 21 J. ECON. PERSP. 69, 70–72 (2007) (describing the almost-immediate legislative pressure to unwind the Tax Reform Act of 1986).

[164] *See* Graetz, *supra* note 138, at 639–40 (noting that both types of divisions distort distributional analysis).

[165] *See* Graetz, *supra* note 138, at 639 ("Distinctions among families in the same income class are not captured in the distributional table even though in many instances intragroup differences may be more significant than intergroup differences.").

transformations—depend on how correlative rate adjustments are made.[166] To the extent that these adjustments are done at each income level (or by income cohorts), there are no distributional differences for either reform strategy. Concerns that relate to the construction and measurement of distributional outcomes exist for revenue-neutral repeal as well as base-rate transformations.

3. Efficiency

Under a neoclassical approach, effective marginal tax rates affect individuals' decision-making, particularly in the choice between incremental labor (which generates taxable income) and leisure (which is untaxed). Higher marginal rates reduce labor supply and generate deadweight loss, while lower marginal rates have the reverse effects. Although economists have challenged this conventional wisdom over the last two decades, effective marginal tax rates remain a material consideration when evaluating changes in law.

The base-rate identity implies that changes to the nominal tax base can be offset exactly by correlative changes in the statutory rate structure, without affecting effective marginal tax rates. When making correlative adjustments for a base-rate transformation, the objective is to identify changes to the rate structure that reverse the effects of radical expansion. In some cases, this task will be straightforward. For a tax expenditure that effectively becomes an additional standard deduction,[167] the statutory standard deduction can be reduced by the same dollar amount as the effective additional standard deduction.[168] Other situations require more complex solutions.[169] If, for example, the HMID becomes a

[166] Distributional considerations may address wealth as well as income. *See* Sugin, *supra* note 6, at 7.

[167] *See supra* notes 130–134, 140–148 and accompanying text (discussing the CTC and CDCC).

[168] This reduction is subject to interactions with itemized deductions. *See* I.R.C. § 63(d).

[169] *See infra* Part III.C.

geographically variable housing benefit, then the rate structure also must account for these geographic variations.[170]

There is some tension between the desire to maintain effective marginal rates and the desire to maintain revenue neutrality. As a standard trope of "broad base, low rates" tax reform, revenue neutrality implies that repealing or limiting tax expenditures is efficient. Lawmakers can use the no-longer-foregone revenue to finance statutory rate cuts, which reduce effective marginal rates for all taxpayers.[171] For base-rate transformations, radical expansion loses revenue, which lawmakers must make up by adjusting the statutory rate structure. This base-rate adjustment also must maintain pre-reform effective marginal rates, which imposes an additional constraint.

Finally, taxpayers' behavior may diverge from neoclassical norms, perhaps because of behavioral psychology, salience, or fiscal illusion.[172] Psychological considerations, such as loss aversion and the endowment effect, may affect how taxpayers view the elimination or expansion of a tax expenditure. Similarly, base changes may be more or less salient to taxpayers than changes in tax rates. Finally, "fiscal illusion"—the idea that people perceive different forms of government spending differently—may affect the political economy of repeal compared to base-rate transformations.[173] These factors do not point in a single direction or favor a single

[170] Doing so may be welfare-enhancing without regard to the base-rate transformation. *See* David Y. Albouy, *The Unequal Burden of Federal Taxation* (Nat'l Bur. of Econ. Rsch., Working Paper No. 13995, 2008) (modelling the effects of geographic cost-of-living variations and federal itemized deductions on taxpayers' locational decisions), https://www.nber.org/system/files/working_papers/w13995/w13995.pdf [https://perma.cc/8C7X-D722].

[171] This intuition may not hold when the lost tax benefit applies broadly and lowers those taxpayers' marginal rates by more than the post-repeal across-the-board rate cut.

[172] *See, e.g.*, David Gamage & Darien Shanske, *Three Essays on Tax Salience: Market Salience and Political Salience*, 65 TAX L. REV. 19, 20–21 (2011) (distinguishing market salience from political salience).

[173] *See id.* at 24 (describing this well-traveled term as "emotion laden and potentially misleading").

style of reform—and their effects may vary for different tax expenditures. For this reason, these factors are best considered within the context of specific legislative changes.

C. Correlative Adjustments in Application

In the tax expenditure context, base-rate transformations offer an alternative to statutory repeal or restrictive reform. Under certain conditions, base-rate transformations have the same distributional and efficiency consequences as these conventional reform options. This Section illustrates the equivalency between base-rate transformations and conventional reform options through a series of numeric examples that demonstrate an equivalence between repeal and base-rate transformations for hypothetical tax expenditures with various structures. In each example, most of the pressure is on correlative adjustments to reach equivalence. Each of these examples deploys a proxy for how a tax expenditure's benefits are distributed across society, and these proxies, either alone or in combination, may reflect more complex distributions of tax expenditures under current law. In this way, the principles in this Section are adaptable across a range of tax expenditures.

The examples in this Section use a baseline rate structure with a standard deduction (or zero bracket) of $10,000,[174] a 10% bracket for income from $10,001 to $20,000, a 20% bracket for income from $20,001 to $30,000, a 30% bracket for income from $30,001 to $40,000, and a 40% rate applicable to income of $40,001 and above. This statutory rate structure is progressive, in that rates apply to income within each band, regardless of the taxpayer's total income.[175] That is, taxpayers in each bracket pay a fixed amount of cumulative tax based on lower rate brackets, then a variable amount of tax based on

[174] These examples ignore itemized deductions and the standard deduction's simplification purpose. *See* John R. Brooks, *Doing Too Much: The Standard Deduction and the Conflict Between Progressivity and Simplification*, 2 COLUM. J. TAX L. 203, 205 (2011).

[175] That is, higher earners benefit from each lower bracket.

their income in their highest rate bracket. Table 1 illustrates this baseline rate structure.

Tbl. 1: Baseline Rate Structure

Bracket	From	To	Marginal Rate	Cumulative Tax
Bracket 0	-	$10,000	0%	-
Bracket 1	$10,001	$20,000	10%	-
Bracket 2	$20,001	$30,000	20%	$1,000
Bracket 3	$30,001	$40,000	30%	$3,000
Bracket 4	$40,001	-	40%	$6,000

Each example traces four hypothetical taxpayers: Individuals A and B, who each earn $15,000 of baseline taxable income, and Individuals C and D, who each earn $50,000 of baseline taxable income. Individuals B and D, however, claim tax expenditures that reduce their taxable income (and are subject to repeal). These hypothetical taxpayers are illustrative and represent lower- and higher-income taxpayers, respectively. These examples also do not use the prechange revenue baseline as a revenue constraint. Instead, repeal raises revenue—as does the corresponding base-rate transformation. This (mild) relaxation of the constant revenue assumption focuses attention on correlative adjustments and relieves pressure on the intrinsically normative decision of how to adjust rates after a tax expenditure's complete repeal.[176] These adjustments would operate similarly under a constant prechange revenue constraint.

1. Fixed-Dollar Benefits

Some tax expenditures may be (or may approximate) fixed-dollar benefits that apply to claimants across the income spectrum. An example is the CDCC, if claimants consistently

[176] *See supra* Part III.B.

spend more than the $3,000 credible maximum on eligible childcare costs.[177] Consider the basic framework described in the Introduction: a tax expenditure in the form of a $500 deduction claimed by some taxpayers, compared to no deduction in the absence of the preference. This fixed-dollar tax expenditure yields a $50 tax benefit for Individual B and a $200 tax benefit for Individual D, in each case compared to their nonclaimant counterparts, Individuals A and C.[178] Because Individual D benefits more than Individual B, this fixed-dollar benefit represents a classic upside-down subsidy. The full results for Individuals A, B, C, and D are in Table 2.

Tbl. 2: Fixed-Dollar Tax Expenditure

Individual	Taxable Income	Tax Due	Average Tax Rate
Individual A, Nonclaimant	$15,000	$500	3.3%
Individual B, Claimant	$14,500	$450	3.0%
Individual C, Nonclaimant	$50,000	$10,000	20.0%
Individual D, Claimant	$49,500	$9,800	19.6%

Repeal eliminates the $500 tax benefit and enforces the corresponding nonclaimant outcome on Individuals B and D. A base-rate transformation extends the $500 deduction to Individuals A and C, giving them the same benefit as prechange Individuals B and D. This expansion loses revenue, relative to repeal, and affects taxpayers' marginal rates around the bracket cutoffs. Therefore, the statutory rate structure must change to accommodate radical expansion.

[177] *See supra* notes 140–148 and accompanying text. The educator expense deduction, capped at $300, serves as another example, *see* I.R.C. § 62(a)(2)(D), as do benefits for electric vehicles, where taxpayers generally claim either zero dollars or the maximum benefit, *see* I.R.C. § 30D.

[178] The benefit is the deduction (or exclusion) of $500, multiplied by each individual's marginal tax rate (10% and 40%, respectively).

Because the deduction is fixed-dollar and universal, a corresponding reduction in all bracket cutoffs aligns taxpayers' outcomes with repeal. That is, the standard deduction drops from $10,000 to $9,500, the 10% bracket spans $9,501 to $19,500, and so forth. After universalization, any tax expenditure with fixed-dollar (or effectively fixed-dollar) benefits can be incorporated into the rate structure by reducing all bracket cutoffs by the fixed-dollar amount. Table 3 shows the transformed rate structure for this example.

Tbl. 3: Transformed Rates for Fixed-Dollar Tax Benefits

Bracket	**From**	**To**	**Marginal Rate**	**Cumulative Tax**
Bracket 0	-	$9,500	0%	-
Bracket 1	$9,501	$19,500	10%	-
Bracket 2	$19,501	$29,500	20%	$1,000
Bracket 3	$29,501	$39,500	30%	$3,000
Bracket 4	$39,501	-	40%	$6,000

The base-rate transformation essentially produces the prechange claimant outcome in terms of taxable income, with the prechange nonclaimant result in terms of tax due and marginal rates. After this base-rate transformation, Individuals A and B each pay tax of $500 with a marginal tax rate of 10%, and Individuals C and D each pay tax of $10,000 with a marginal rate of 40%. These bottom-line results are identical to repeal. The calculation of these results is different, however. Individuals A and B have taxable income of $14,500 (compared to $15,000 under repeal), but Individual B's standard deduction is $9,500—$500 less that the $10,000 standard deduction under the repeal scenario. Similarly, Individuals C and D have taxable income of $49,500 with a $500 reduction in their standard deduction. Because the standard deduction is smaller, each bracket's cutoffs are

reduced by $500, leaving high-income individuals' benefits from those lower rates unchanged.[179]

2. Proportionate Benefits

If tax expenditures vary in proportion to income, base-rate transformations require adjustments to statutory rates as well as bracket cutoffs. A real-world example of this type of tax expenditure is the TCJA's well-known pass-through deduction in § 199A, which gives a 20% deduction with respect to certain types of business income.[180] This Subsection considers a tax expenditure that produces a deduction equal to 5% of a taxpayer's income.[181] Individual B has a deduction of $750, while Individual D has a deduction of $2,500—three and a third times larger, which exactly reflects Individual D's greater income. As taxpayers earn more, they claim a proportionately larger deduction in dollar terms. Individual D's tax benefit of $1,000 reflects Individual D's larger deduction as well as her higher marginal rate, compared to Individual B's $75 tax benefit. From this perspective, proportionate tax expenditures provide a double upside-down benefit: higher earners receive a greater proportionate deduction as well as a greater proportionate tax benefit. Table 4 shows full results for Individuals A, B, C, and D.

[179] *See* Jason S. Oh, *Are Progressive Tax Rates Progressive Policy?*, 92 N.Y.U. LAW REV. 1909, 1973–74 (2017) (describing how intramarginal rate reductions can benefit high-earning taxpayers).

[180] For a fuller discussion of this provision, see *infra* Part V.C.

[181] A proportionate benefit could be progressive by varying inversely with taxpayers' income.

Tbl. 4: Proportionate-Benefit Tax Expenditure

Individual	Taxable Income	Tax Due	Average Tax Rate
Individual A, Nonclaimant	$15,000	$500	3.3%
Individual B, Claimant	$14,250	$425	2.8%
Individual C, Nonclaimant	$50,000	$10,000	20%
Individual D, Claimant	$47,500	$9,000	18.0%

Repeal eliminates these tax benefits for Individuals B and D, restoring their tax outcomes to those of Individuals A and C, who pay $500 and $10,000 in tax, respectively. Expansion does the reverse, providing a 5% reduction in taxable incomes across all taxpayers and giving Individuals A and C the same pre-reform benefits as Individuals B and D. Again, to maintain revenue parity with repeal, the rate structure requires adjustment.

In a base-rate transformation, this proportionate benefit requires two concurrent changes to the rate structure. First, bracket cutoffs must be reduced by 5% each. For example, the standard deduction falls from $10,000 to $9,500, and the 10% bracket extends to $19,000, rather than $20,000. Second, rates must be grossed up by 5%.[182] After this gross-up, the top marginal rate rises from 40% to 42.11%. In each case, the magnitude of these changes reflects the proportionate tax benefit. The resultant rate structure is shown in Table 5.

[182] That is, rates must be multiplied by one divided by the difference between one and the proportionate benefit of 5%.

Tbl. 5: Transformed Rates for Proportionate Tax Benefits

Bracket	From	To	Rate	Cumulative Tax
Bracket 0	-	$9,500	0%	-
Bracket 1	$9,501	$19,000	10.53%	-
Bracket 2	$19,001	$28,500	21.05%	$1,000
Bracket 3	$28,501	$38,000	31.58%	$3,000
Bracket 4	$38,001	-	42.11%	$6,000

Under a universal benefit and this rate structure, Individuals A and B pay $500 in tax, and Individuals C and D pay $10,000 in tax—exactly the same as if the tax expenditure were repealed. The computations differ. Individuals A and B have a nominal deduction of $750 and taxable income of $14,250, subject to slightly higher statutory rates. These individuals' marginal rate remains 10%, since a one-dollar increase in real income yields a $0.95 statutory inclusion subject to a grossed-up statutory rate of 10.53% and an additional $0.10 of tax due. The effective rate on this next dollar of income remains 10%. Individuals C and D's deduction is $2,500, making their taxable income $47,500. Although statutory rates are higher, effective marginal rates remain the same, since one dollar of real income produces a $0.95 statutory inclusion subject to a rate of 42.11%, or an additional $0.40 of tax due. Because this transformation adjusts brackets and rates simultaneously, marginal rates remain 10% for Individuals A and B and 40% for Individuals C and D.

3. Regressive and Progressive Fixed-Dollar Benefits

Fixed-dollar benefits also may be regressive or progressive with respect to claimants' income, either in statutory construction or in effect. These more-complex patterns remain susceptible to base-rate transformations. Essentially, the point is that base-rate transformations can accommodate a broad range of fiscal topographies; the technique is closer to

universal than niche. Consider, for example, a tax expenditure that either increases by $500 at $10,000 increments (regressive) or decreases by $500 at $10,000 increments (progressive). Table 6 describes this hypothetical tax expenditure.

Tbl. 6: Variable Fixed-Dollar Tax Expenditures

Income	Regressive Tax Expenditure	Progressive Tax Expenditure
Up to $10,000	$500 deduction	$2,500 deduction
From $10,001 to $20,000	$1,000 deduction	$2,000 deduction
From $20,001 to $30,000	$1,500 deduction	$1,500 deduction
From $30,001 to $40,000	$2,000 deduction	$1,000 deduction
$40,001 and above	$2,500 deduction	$500 deduction

For the regressive fixed-dollar tax expenditure, Individual B (in the 10% bracket) claims a fixed $1,000 deduction from income and a $100 tax benefit, while Individual D (in the 40% bracket) claims a fixed $2,500 deduction from income and a $1,000 tax benefit. Individuals A and C claim no tax benefits. Table 7 sets out these results.

Tbl. 7: Regressive Fixed-Dollar Tax Expenditure

Individual	Taxable Income	Tax Due	Average Tax Rate
Individual A, Nonclaimant	$15,000	$500	3.3%
Individual B, Claimant	$14,000	$400	2.7%
Individual C, Nonclaimant	$50,000	$10,000	20%
Individual D, Claimant	$47,500	$9,000	18.0%

Repeal eliminates these tax benefits and places Individuals B and D on par with Individuals A and C. By contrast, a base-rate transformation applies the results of Individuals B and D to Individuals A and C, then adjusts the rate structure to maintain revenue parity with repeal.[183] Again, two concurrent changes are required in this adjustment. First, bracket cutoffs must be adjusted downwards to account for the different tax benefits across income levels.[184] The standard deduction (zero bracket) falls to $9,000 because of the $1,000 deduction claimed by all 10%-bracket taxpayers, and, for the highest earners, the 40% bracket begins at $37,500 to account for those taxpayers' $2,500 deductions. Other brackets are adjusted accordingly.

Second, for higher-income brackets, the standard deduction also phases down, subjecting additional income to the 10% rate to smooth tax liabilities as high-earners' deductions increase.[185] Those earning in the erstwhile 20% bracket pay an additional $50 in tax, those earning in the former 30% bracket pay an additional $150 in tax, and those earning in the prior top bracket pay an additional $300 in tax, each deployed as a reduction in the standard deduction of $500, $1,500, and $3,000, respectively.[186] These adjustments,

[183] The tax expenditures' benefits remain as described in Table 6, even as bracket cutoffs are adjusted.

[184] These tax benefits remain tied to the income tiers described in Table 6.

[185] This phase-down also could be accomplished through the direct addition of a flat dollar amount to those brackets' tax due, or through an adjustment to the cutoffs for any submarginal bracket. Adjustments to the standard deduction are a relatively straightforward (and legislatively cognizable) mechanism to accomplish these results, but they are not the only mechanism.

[186] When, for example, individuals earn exactly $20,001 dollars, their tax expenditure deduction increases by $500 from $1,000 to $1,500 (subjecting $500 less to the 10% rate, for a $50 tax savings), and their standard deduction decreases by $500 from $9,000 to $8,500 (subjecting an additional $500 to the 10% rate, for a $50 increase in tax due). At exactly $30,001 of pre-benefit income, individuals' deductions increase by $500 (with an additional tax benefit of $100 at a 20% rate), and their standard deduction decreases by an additional $1,000 to $7,500 (subjecting another

based on changes in the regressive fixed-dollar tax expenditure, keep individuals' tax liabilities the same as repeal without affecting marginal rates. Table 8 displays this rate structure.

$1,000 to the 10% rate, for an additional $100 of tax due). The process continues at exactly $40,001 of pre-benefit income, where incremental tax benefits of $150 are offset by a tax detriment of $150 from subjecting an additional $1,500 of income to tax at a 10% rate. These offsetting mechanisms keep marginal rates identical across the conditions of repeal and base-rate transformations.

Tbl. 8: Transformed Rates for Regressive Fixed-Dollar Benefits

Bracket	From	To	Rate	Cumulative
Bracket 0	-	$9,000	0%	0
Bracket 1	$9,001	$18,500	10%	0
Bracket 2	$18,501	$28,000	20%	$950*
Bracket 3	$28,001	$37,500	30%	$2,850**
Bracket 4	$37,501		40%	$5,700***

* For taxpayers earning $20,001 to $30,000, Bracket Zero phases down to $8,500, and the Bracket 2 cumulative tax increases to $1,000.
** For taxpayers earning $30,001 to $40,000, Bracket Zero phases down to $7,500, and the Bracket 3 cumulative tax increases to $3,000.
*** For taxpayers earning $40,001 or more, Bracket Zero phases down to $6,000, and the Bracket 4 cumulative tax increases to $6,000.

These two adjustments equalize marginal rates among taxpayers subject to repeal and the base-rate transformation. Individuals A and B have income of $14,000 after a $1,000 deduction. Under the adjusted rate structure (with its lower standard deduction), Individuals A and B still pay $500 in tax and face a 10% marginal rate on additional income.[187] Individuals C and D have income of $47,500 after a $2,500 deduction, and their tax due is $10,000 after accounting for lower cutoffs for each bracket, as well as the (further) reduced standard deduction for those in the 40% bracket. These taxpayers' marginal rate remains 40%.[188]

For progressive fixed-dollar tax expenditures, rate adjustments operate similarly, with bracket phase-ups to

[187] That is, Individuals A and B have tax due of $500 on $5,000 of income at a 10% rate in Bracket 1, with a 10% rate on their next dollar earned.

[188] That is, Individuals C and D pay a 40% rate on $10,000 of income in Bracket 4 ($4,000), plus $6,000 of tax due from lower brackets after the standard deduction phase-down. For these individuals, the next dollar earned faces a 40% tax rate.

compensate for declining deductions under the tax expenditure. The progressive fixed-dollar tax expenditure in Table 6, for example, has a base-rate transformation as described in Table 9, with descriptive computations for Individuals A, B, C, and D similar to those described for regressive fixed-dollar benefits.

Tbl. 9: Transformed Rates for Progressive Fixed-Dollar Benefits

Bracket	**From**	**To**	**Rate**	**Cumulative**
Bracket 0	-	$8,000	0%	0
Bracket 1	$8,001	$18,500	10%	0
Bracket 2	$18,501	$29,000	20%	$1,050*
Bracket 3	$29,001	$39,500	30%	$3,150**
Bracket 4	$39,501		40%	$6,300***

* For taxpayers earning $20,001 to $30,000, Bracket Zero phases up to $8,500, and the Bracket 2 cumulative tax decreases to $1,000.
** For taxpayers earning $30,001 to $40,000, Bracket Zero phases up to $9,500, and the Bracket 3 cumulative tax decreases to $3,000.
*** For taxpayers earning $40,001 or more, Bracket Zero phases up to $11,000, and the Bracket 4 cumulative tax decreases to $6,000.

4. Regressive and Progressive Proportionate Benefits

Finally, regressive or progressive tax expenditures may provide benefits in proportion to claimants' income, either by statutory construction on in effect. Again, base-rate transformations work for these types of tax expenditures, and radical expansion can be equivalent to statutory repeal, depending on rate adjustments. This example deploys regressive and progressive proportionate benefits that range from zero to 20% of income, as set forth in Table 10.

Tbl. 10: Variable Proportionate Tax Expenditures

Income	Regressive Tax Expenditure	Progressive Tax Expenditure
Up to $10,000	No deduction	20% deduction
From $10,001 to $20,000	5% deduction	15% deduction
From $20,001 to $30,000	10% deduction	10% deduction
From $30,001 to $40,000	15% deduction	5% deduction
$40,001 and above	20% deduction	No deduction

In this example, the regressive proportionate tax expenditure delivers a small tax benefit to Individual B, who has a $750 deduction (5% of Individual B's $15,000 of income) and a tax benefit of $75 (at a rate of 10%), and a large tax benefit to Individual D, who has a $10,000 deduction (20% of Individual D's $50,000 of income) and a tax benefit of $4,000 (at a rate of 40%). These tax benefits are in comparison to Individuals A and C. Table 11 elaborates these numbers.

Tbl. 11: Regressive Proportionate Tax Expenditure

Individual	Taxable Income	Tax Due	Average Tax Rate
Individual A, Nonclaimant	$15,000	$500	3.3%
Individual B, Claimant	$14,250	$425	2.8%
Individual C, Nonclaimant	$50,000	$10,000	20%
Individual D, Claimant	$40,000	$6,000	12.0%

Repeal eliminates benefits for all claimants, with a strongly progressive effect; a base-rate transformation reaches the same outcome through different means. The proportionate tax expenditure applies to all taxpayers, rather than a subset. Then, this transformation requires three

adjustments to the rate structure. First, bracket cutoffs are reduced to reflect the larger proportionate benefits as income increases, with high-rate brackets seeing a greater decrease. The standard deduction is reduced from $10,000 to $9,500 based on the 10% bracket's 5% proportionate deduction, while the 40% bracket begins at $32,000, rather than $40,000, which reflects the 40% bracket's 20% proportionate deduction. These reductions apply to cutoffs for all brackets.

In addition, statutory rates are grossed-up based on each bracket's proportionate tax benefit, similar to the rate adjustments for flat proportionate-benefit tax expenditures. The 10% rate increases to 10.53% based on a 5% gross-up, while the 40% rate balloons to 50% under a 20% gross-up.[189] Intermediate rates are adjusted similarly. These grossed-up rates, combined with the relevant proportionate tax deduction, maintain marginal rates equal to the repeal scenario.

Finally, the standard deduction phases down for higher brackets to allow for continuous tax liabilities across brackets. With respect to the prechange 20%, 30%, and 40% brackets, taxpayers pay an additional $105.26, $438.60, and $1,144.48, respectively. For the 40% bracket, the additional tax requires that the 10% bracket start at a negative value. This adjustment could be accomplished by adjusting other brackets to avoid a bracket that taxes phantom income. For computational consistency, this example retains a consistent adjustment to the standard deduction, which, in this example, requires a negative zero bracket for taxpayers in the highest statutory rate bracket. These three operations are collected into the rate structure in Table 12.

[189] That is, the 10% rate is multiplied by one divided by the difference between one and 5%, and the 40% rate is multiplied by one divided by the difference between one and 20%.

Tbl. 12: Transformed Rates for Regressive Proportionate Benefits

Bracket	From	To	Rate	Cumulative
Bracket 0	-	$9,500	0%	-
Bracket 1	$9,501	$18,000	10.53%	-
Bracket 2	$18,001	$25,500	22.22%	$894.74*
Bracket 3	$25,501	$32,000	35.29%	$2,561.40**
Bracket 4	$32,001	-	50.00%	$4,855.52***

** For taxpayers earning $20,001 to $30,000, Bracket Zero phases down to $8,500, and the Bracket 2 cumulative tax increases to $1,000.

** For taxpayers earning $30,001 to $40,000, Bracket Zero phases down to $5,333.33, and the Bracket 3 cumulative tax increases to $3,000.

*** For taxpayers earning $40,001 or more, Bracket Zero phases down to ($1,372.55) (that is, an additional $1,372.55 of "phantom" income, on top of regular taxable income, is taxed at 10%), and the Bracket 4 cumulative tax increases to $6,000.

Progressive proportionate tax expenditures require comparable adjustments to the rate structure. For the progressive tax expenditure in Table 10, brackets are reduced, and rates increased, based on the proportionate tax benefit claimed at different income levels. The standard deduction phases up for filers with higher incomes, almost eclipsing the 10% rate bracket for individuals in the 40% bracket. These results are described in the rate structure in Table 13.

Tbl. 13: Transformed Rates for Progressive Proportionate Benefits

Bracket	From	To	Rate	Cumulative
Bracket 0	-	$8,500	0%	-
Bracket 1	$8,501	$18,000	11.76%	-
Bracket 2	$18,001	$28,500	22.22%	$1,117.65*
Bracket 3	$28,501	$40,000	31.58%	$3,450.98**
Bracket 4	$40,001	-	40.00%	$7,082.56***

* For taxpayers earning $20,001 to $30,000, Bracket Zero phases up to $9,500, and the Bracket 2 cumulative tax decreases to $1,000.
** For taxpayers earning $30,001 to $40,000, Bracket Zero phases up to $12,333.33, and the Bracket 3 cumulative tax decreases to $3,000.
*** For taxpayers earning $40,001 or more, Bracket Zero phases up to $17,701.75, and the Bracket 4 cumulative tax decreases to $6,000.

Although stylized, these examples illustrate arithmetic (and algorithmic) strategies for adjusting the rate structure to complete a base-rate transformation after a tax expenditure is radically expanded. In these examples, the rate structure applies universally, which requires identical treatment of filers with the same taxable income, before the relevant tax expenditure. To the extent that tax expenditures vary significantly within a single income level, these types of rate-structure transformations will result in differential treatment within the income level. These situations require more nuanced judgments about economic justice—something that base-rate transformations should force in any event.

Similar arithmetic strategies apply to tax expenditures with more idiosyncratic distributions across the income spectrum, for which correlative adjustments may represent an exercise in ad hoc curve-fitting under a set of constraints and assumptions. In and outside of government, budget experts frequently perform this type of exercise for proposed changes

in law.[190] The process for base-rate transformations should proceed similarly.

IV. POLICY CONSIDERATIONS

As a reform strategy in the tax expenditure context, base-rate transformations offer advantages and drawbacks compared to repeal or restrictive reform. This Part explores several (inexhaustive) factors that have implications for how lawmakers choose reform strategies. The framework for evaluation consists of the traditional tax policy norms of equity, efficiency, and simplicity; the overall takeaway is that substitutable instruments provide flexibility in reaching the most desirable policy outcome. When lawmakers can choose among equivalent legislative strategies, the likelihood of reaching appropriate outcomes increases, with different portfolios of risks should the chosen legislative strategy go awry. This strength is the principal reason to include base-rate transformations among policymakers' menu of potential reform options.

A. Incomplete Rate Adjustments

One risk of tax expenditure reform is that any rate adjustments will not be revenue neutral. The relevant inputs are whether rate adjustments undershoot or overshoot revenue neutrality (which primarily implicates efficiency), whether rate adjustments favor higher- or lower-earners (which primarily implicates distribution), and whether the subject tax expenditure provides progressive, proportionate, or regressive benefits with respect to taxpayers' income (also relevant to distribution). This risk of incomplete rate adjustments applies to all strategies that address tax

[190] *See, e.g.*, PRESIDENT'S ADVISORY PANEL ON FED. TAX REFORM, *supra* note 158, at 48–57 (walking through these processes in the context of reform based on income and consumption taxation).

expenditures, including repeal, restrictive reform, and base-rate transformations.[191]

Rate adjustments undershoot revenue neutrality when tax increases are systematically too small and tax reductions too large for individuals at different positions in the income spectrum. In either case, total post-reform revenue is less than pre-reform revenue. Conversely, rate adjustments overshoot revenue neutrality when tax increases are consistently too large and tax reductions too small. As a result, total post-reform revenue is more than pre-reform revenue. Under either scenario, revenue differs before and after reform.

While base-rate transformations require rate increases, revenue-neutral repeal requires rate reductions. Because of this directional difference, legislative bias in adjustments may differ for the two reform strategies. If, for example, rate increases generally are too small, while rate reductions are too large, then this bias makes the reform strategies more similar in terms of revenue effects.[192] For both, legislative bias operates in the same direction—towards less revenue—and the empirical question is about magnitude. Although the scenario in which legislative bias operates in the same direction seems likely in practice, legislative bias could operate in opposite directions, which clearly would favor one strategy over the other.

If this type of legislative bias operates differently across different income levels, then incomplete rate adjustments have distributional effects—and therefore implications for equity. These implications almost certainly affect the choice among strategies. If rate increases are relatively higher for high earners, then base-rate transformations are progressive; if rate cuts are relatively higher for high earners, then repeal

[191] Indeed, for repeal and restrictive reform, the risk of incomplete rate adjustments frequently is overlooked in advocacy to end or curtail specific tax expenditures. *See supra* notes 16–18 and accompanying text.

[192] These outcomes seem more likely in reform packages, rather than in isolated reforms. For isolated reforms, the likely risk is a failure to adjust rates at all, or a rate adjustment that is temporally separated from reform.

strategies are regressive. The converse has the reverse implications.

The stakes of incomplete rate adjustments are magnified when a tax expenditure's benefits vary across income levels. If a given tax expenditure is progressive, then repeal without full rate adjustments is regressive, while expansion is progressive. The reverse is true for regressive tax expenditures.[193] Again, systematic biases in rate adjustments have significant policy implications. These biases also affect how repeal operates, and they implicate the choice between repeal and base-rate transformations.

Setting aside empirical questions about how rate adjustments may fail (which may differ for various tax expenditures, as well as in terms of political economy), the point is that, in a world of incomplete rate adjustments, the choice of strategy—repeal, restrictive reform, or base-rate transformation—has bottom-line implications. These implications arise because each strategy involves an implicit or explicit decision about the appropriate statutory rate structure.

B. Incomplete Expansion or Repeal

Another risk of tax expenditure reform is that, if the legislature's goal is repeal (or complete expansion), only partial repeal (or expansion) will be achieved. This result matters to the extent that rate adjustments are incomplete or misguided in light of partial repeal or expansion—so the precise stakes depend on how the rate structure changes, if at all, in connection with reform. If these risks are asymmetric between repeal and base-rate transformation, then one strategy is superior to the other.

Grandfathering represents a special case of incomplete repeal that favors radical expansion. For tax expenditure reform, grandfathering involves granting pre-reform

[193] Longstanding conventional wisdom is that tax expenditures are largely regressive. *See* Surrey, *supra* note 1, at 721–22 ("[M]ost tax incentives have decidedly adverse effects on equity.").

recipients all or part of the tax expenditure's value in the post-reform period.[194] If grandfathering is likely with respect to a tax expenditure, then base-rate transformations—which grandfather prior claimants while eliminating the practical and economic effects of such grandfathering—offer a compelling alternative to conventional repeal or restrictive reform.

C. Simplicity

Although conventional repeal removes a statutory provision while base-rate transformations expand the provision to all taxpayers, repeal is not clearly simpler than a base-rate transformation. Because the computational aspects of tax filings are mostly computerized (and if not computerized, then form-driven), any baroque math effectively can be hidden from taxpayers. Base-rate transformations, to the extent statutory language remains in the Code, risk adverse interactions with other aspects of income tax law. Proper drafting can avoid these interactions, but the risk for mistakes still exists.[195]

D. Political Economy

The political economy of repeal or restrictive reform for tax expenditures is potentially toxic.[196] Avoiding this toxicity,

[194] For example, the TCJA reforms for the home mortgage interest deduction partially grandfathered existing home loans. *See* I.R.C. § 163(h)(3)(F)(III) (grandfathering debt incurred before December 15, 2017, including debt refinanced after that date).

[195] *See* Sloan G. Speck, *Structural Tax Reform and the Next REIT Revolution*, 27 U. PA. J. BUS. L. (forthcoming 2025), U. Colo. L. Legal Stud. Rsch. Paper No. 25-2 (describing various risks of legislative noncoordination in tax law), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=5100851 [https://perma.cc/9XXJ-CMCV].

[196] *See* Lawrence Zelenak, *The Theory and Practice of Tax Reform*, 105 MICH. L. REV. 1133, 1145–47 (2007) (noting the political impediments to reform of the home mortgage interest deduction and tax benefits for health insurance). Although both of these topics were addressed by Congress

which may exist because certain broadly applicable tax expenditures are particularly salient to taxpayers or legislators,[197] is a principal motivator behind base-rate transformations. Base-rate transformations also may ease political economy considerations involving special interests and popular understandings of tax benefits. The idea that one reform strategy faces less legislative resistance is a core intuition behind lawmakers' reasons to prefer tax expenditures in the first place.

One countervailing factor is that rate adjustments may have more salience to taxpayers or legislators than changes to the base.[198] That is, taxpayers or legislators may prefer to avoid rate increases and seek rate cuts, even if the effects of both policies are the same because of the equivalency between repeal and base-rate rate transformations. If so, the potential for revenue loss from base-rate transformations is significant and perhaps weighs against the strategy—and the analysis for incomplete rate adjustments would apply.

subsequently, the resulting reforms did not meet the scope proposed by the President's Advisory Panel on Federal Tax Reform in 2005. *See* Tax Cuts and Jobs Act, Pub. L. No. 115-97, § 11043, 131 Stat. 2054, 2086–87 (2017) (limiting prospectively the principal amount of a home mortgage that can yield deductible interest); Patient Protection and Affordable Care Act, Pub. L. No. 111-148, § 9001, 124 Stat. 119, 847–48 (2010) (imposing a prospective "Cadillac" tax, repealed in 2019 without ever taking effect, on certain high-cost employer-sponsored health coverage).

[197] *See* Gamage & Shanske, *supra* note 172, at 51–53 (discussing market and political salience in the context of tax expenditures). Taxpayers' experience and interaction with various taxes and tax benefits may make those benefits more or less salient. *See* Andrew T. Hayashi, *The Legal Salience of Taxation,* 81 U. CHI. L. REV. 1443, 1458–61 (2014) (discussing endogenous and exogenous sources of heterogeneity among taxpayers).

[198] *See* Gamage & Shanske, *supra* note 172, at 32–33 & n.58 (discussing the salience of average and marginal tax rates); Jacob Goldin & Yair Listokin, *Tax Expenditure Salience*, 16 AM. L. & ECON. REV. 144, 148 (2013) (finding that taxpayers systematically underestimate the subsidy rate associated with two base-adjusting tax expenditures, the charitable contribution deduction and the home mortgage interest deduction); Oh, *supra* note 10, at 1178 (finding that "the major tax expenditures," among other "big moving pieces" of tax legislation, "have persistently been highly salient").

E. Expanding Options

As policymaking strategies, repeal and substantive reform tend to promote binary or discrete outcomes. For a given provision, repeal implies either existence or nonexistence, while substantive reform may tend towards fixed bundles of policy provisions. The mechanics of base-rate transformations emphasize a continuous range of outcomes that allow for a greater degree of optimization under constraints, especially with regard to rates. Repeal can be viewed similarly—as radical contraction, instead of radical expansion.

This approach to reform is compatible with the theory of the second best, which holds that, in an existing system with multiple parameters, optimizing a single parameter may not move the system towards a global (or even a local) optimum.[199] Instead, if one condition cannot be optimized, then deviations in other conditions are required to reach an outcome closer to optimal. Traditional repeal and substantive reform tend to elide these types of considerations, while base-rate transformations embrace them.

V. BASE-RATE TRANSFORMATIONS IN ACTION

This Part elaborates three case studies. The first case study is positive and traces the history of tax benefits for health insurance. The exclusion from income for employer-paid health insurance premiums is a frequent target of tax expenditure reformers, but, over decades of incremental legal change, the expansion of this benefit beyond employees has resulted in an ad hoc base-rate transformation that essentially has integrated health insurance costs (which are variable) into the rate structure.

The second case study addresses certain transfer payments (such as the Earned Income Tax Credit), standard

[199] *See* R.G. Lipsey & Kevin Lancaster, *The General Theory of the Second Best*, 24 REV. ECON. STUD. 11, 11 (1956); *see also* Richard S. Markovits, *Second-Best Theory and Law & Economics: An Introduction*, 73 CHI.-KENT L. REV. 3, 4–5 (1998) (discussing the implications of the theory of the second best for distributional outcomes).

deductions, and phaseouts for these benefits as fertile ground for base-rate transformations. Although nominally located in the tax base, these provisions are customarily thought to comprise part of the effective rate structure. The idea of base-rate transformations unifies and reframes these disparate distribution-oriented provisions.

The third case study involves the so-called "pass through deduction" under § 199A. Enacted in 2017, the pass-through deduction has attracted more opprobrium than virtually any other provision in the TCJA. A base-rate transformation would shed much of this provision's complexity and inefficiency, while potentially remaining politically palatable. This case study illustrates the mechanics of base-rate transformations, as well as certain challenges that base-rate transformations face in implementation.

A. Tax Expenditures for Health Insurance

The exclusion from income for employer-provided health benefits, including employer-provided health insurance (EPHI), is projected to reduce federal tax revenue by almost $250 billion in fiscal year 2025—the largest single tax expenditure identified by JCT and Treasury in their respective reports.[200] Economists and policy experts critique the EPHI exclusion as costly, inefficient, and undesirable from a distributional perspective,[201] and commentators from across

[200] *See* Off. of Tax Analysis, *supra* note 6, at 25 ($246 billion); Staff of Joint Comm. on Tax'n, *supra* note 26, at 38 ($227 billion). For this exclusion, Treasury's ten-year revenue cost estimate is more than $3.4 trillion. *See* Lawrence Zelenak, *Giving Credit Where Credits Are (Arguably) Due: A Half Century's Evolution in the Design of Personal Tax Expenditures*, 24 FLA. TAX. REV. 51, 81–82 (2020).

[201] For economists' critiques, see generally Jonathan Gruber, *The Tax Exclusion for Employer-Sponsored Health Insurance* 1 (Nat'l Bureau of Econ. Rsch., Working Paper No. 15766, 2010) ("[E]conomists have for years advocated reform of this tax expenditure [for EPHI]."), https://www.nber.org/system/files/working_papers/w15766/w15766.pdf [https://perma.cc/5GQY-KMML]. *See also* David Powell, *The Distortionary Effects of the Health Insurance Tax Exclusion*, 5 AM. J. HEALTH ECON. 428,

the political spectrum have called for the exclusion's reform.[202] For example, Treasury and political advisors advocated curtailing or repealing the EPHI exclusion in connection with both the Patient Protection and Affordable Care Act (ACA) in 2010 and the Tax Reform Act of 1986.[203] Lawmakers rejected these proposals, and the EPHI exclusion has enjoyed more

430–31 (2019) (finding, in a comprehensive analysis, that the exclusion for EPHI leads to annual deadweight loss of more than $13 billion). In addition, policy experts on the left and the right oppose the exclusion for EPHI. *Compare* Howard Gleckman, *Congress Could Improve Both the Tax Code And Health Coverage By Redesigning The Tax Subsidy For Employer-Sponsored Insurance*, TAX POL'Y CTR. (Jan. 21, 2020), https://taxpolicycenter.org/taxvox/congress-could-improve-both-tax-code-and-health-coverage-redesigning-tax-subsidy-employer [https://perma.cc/K2YZ-97PG], *and* Paul N. Van de Water, *Limiting the Tax Exclusion for Employer-Sponsored Insurance Can Help Pay for Health Reform*, CTR. ON BUDGET & POL'Y PRIORITIES (June 4, 2009), https://www.cbpp.org/sites/default/files/atoms/files/6-2-09health.pdf [https://perma.cc/8U3V-YAQ8], *with* Michael F. Cannon, *End the Tax Exclusion for Employer-Sponsored Health Insurance*, Pol'y Analysis No. 928, CATO INST. (May 24, 2022), https://www.cato.org/sites/cato.org/files/2023-06/policy-analysis-928-update.pdf [https://perma.cc/S7BH-UG7S], *and* Thomas P. Miller, *Kill the Tax Exclusion for Health Insurance*, NAT'L REV. (Aug. 19, 2014) (stating that Miller was a resident fellow at the American Enterprise Institute), https://www.nationalreview.com/2014/08/kill-tax-exclusion-health-insurance-tom-miller.

[202] *Compare* Milton Friedman, *How to Cure Health Care*, HOOVER INST. (July 30, 2001) (arguing that the exclusion for EPHI "raise[s] health costs"), https://www.hoover.org/research/how-cure-health-care-0 [https://perma.cc/DSE7-5UWV], *with* Jason Furman, *Health Reform Through Tax Reform: A Primer*, 27 HEALTH AFFAIRS 622, 631 (2008) ("Current tax expenditures for health care provide a pool of $200 billion that could be used to finance expanded or even universal coverage, with additional resources potentially left over for debt reduction or tax cuts.").

[203] *See* DEP'T OF THE TREAS., 1 TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH ix (1984) (proposing a monthly dollar cap that would limit the exclusion for "only about 30 percent of all employees"), https://home.treasury.gov/system/files/131/Report-Tax-Reform-v1-1984.pdf [https://perma.cc/79XF-DW36]; Furman, *supra* note 202, at 629 (proposing, in the debate that led to the ACA, "[a]t a minimum, putting a cap on the existing exclusion [for EPHI]").

than six decades of undisturbed tenure as a headline tax expenditure.[204]

When considered in a broader context, however, the EPHI exclusion's role has evolved dramatically over the last thirty-five years. Through iterative changes in taxation and health care provisioning, Congress transformed the EPHI exclusion from a base carve-out into something more appropriately characterized as part of the rate structure. Congress accomplished this base-rate transformation indirectly, over time, and without an express intent to produce unified policy. Since 1986, the story of the EPHI exclusion is not one of stymied tax expenditure reform. A more appropriate narrative focuses on Congress's uncoordinated actions to universalize an imperfect exclusion for health insurance costs—something more akin to an idiosyncratic expansion of the standard deduction to account for typical health care expenditures. This transformation has important implications for how policymakers conceptualize the EPHI in terms of costs and programmatic scope, as well as for the normative stakes of reform proposals.

1. Transforming Health Insurance Taxation

The EPHI's base-rate transformation emerges by comparing the tax treatment of EPHI coverage with the regulatory evolution of nonemployee health insurance in the United States over the last four decades. The baseline consequences of EPHI coverage have remained constant since the 1954 recodification of the Code.[205] For employees with EPHI, income does not include either the cost of premiums,

[204] *See* Zelenak, *supra* note 200, at 82 ("[T]he very absence of changes in the EPHI tax rules is in striking contrast with [statutory changes to other popular tax expenditures]."). In 1983, Congress repealed a limited exclusion for wage replacement payments during periods of disability or, before 1976, illness. *See* Social Security Act Amendments of 1983, Pub. L. No. 98-21, § 122(b), 97 Stat. 65, 87 (1983) (repealing I.R.C. § 105(d)). The broader exclusion for employer-provided health insurance remained, however.

[205] *See* H.R. REP. No. 591-8300, at 54 (1954).

whether paid by the employees or their employers,[206] or the value of medical care conferred through this insurance.[207] Employees (and their family members) receive the benefits of health insurance but are not taxed on this benefit's value. This type of employment-based health insurance coverage applies to approximately 55% of the U.S. population.[208]

Before 1987, working nonemployees, such as independent contractors and certain business owners, did not receive a generalized tax benefit for the costs of personal and family health insurance.[209] Instead, these individuals could claim an itemized deduction for their aggregate medical care costs, including health insurance premiums, in excess of a floor equal to 5% of adjusted gross income.[210] Starting in the 1960s, this itemized deduction lost value for taxpayers relative to the longstanding EPHI exclusion,[211] as health insurance plans began to include primary care and nonhospital benefits in addition to surgical and major medical care—and as the growth in national health care costs started to accelerate.[212]

To establish some degree of parity between employees and the self-employed, the Tax Reform Act of 1986 introduced a

[206] I.R.C. § 106(a). Employers generally may deduct these premiums as compensation expense. *See* Treas. Reg. § 1.162-10(a).

[207] I.R.C. § 105(a), (b).

[208] *See* KATHERINE KEISLER-STARKEY & LISA N. BUNCH, U.S. CENSUS BUREAU, REP. NO. P60-284, HEALTH INSURANCE COVERAGE IN THE UNITED STATES: 2023, at 3 (2024) (finding employment-based health insurance to cover 53.7% of people in 2023 and 54.4% of people in 2022), https://www2.census.gov/library/publications/2024/demo/p60-284.pdf [https://perma.cc/NPM4-645D]. Since 2010, this percentage has fluctuated between 54% and 59%. In the late 1990s and early 2000s, this percentage was approximately 65%. *See* Matthew Rae, Daniel McDermott, Larry Levitt & Gary Claxton, *Long-Term Trends in Employer-Based Coverage,* PETERSON-KFF HEALTH SYSTEM TRACKER (Apr. 3. 2020), https://www.healthsystemtracker.org/brief/long-term-trends-in-employer-based-coverage [https://perma.cc/7FP7-KWSP].

[209] *See* H.R. REP. NO. 99-841, vol. II, at 538 (1986) (Conf. Rep.).

[210] *See id.* (discussing § 213). The 1986 Act increased the floor to 7.5% of adjusted gross income (AGI).

[211] H.R. REP. NO. 84-423, at 5 (1972).

[212] *See* Rosemary Stevens, *Health Care in the Early 1960s*, 18 HEALTH CARE FIN. REV. 11, 19 (1996).

limited deduction for working nonemployees equal to 25% of the amounts paid for health insurance—half of the 50% benefit proposed in the Senate amendment to the House's original bill.[213] As first enacted, this already-anemic provision was scheduled to expire after 1989. Over the next decade, Congress extended the provision's sunset four times[214] and ultimately made the provision permanent in 1995.[215] Between 1995 and 1997, Congress revisited the amount of the deduction, increasing the deductible percentage to 30%, then 80%, then 100%, phased in over a ten-year period. In 1998, Congress shortened the phase-in period to five years, with full deductibility for working nonemployees' health insurance costs beginning in 2003.[216]

After the changes initiated by Tax Reform Act of 1986, current law allows working nonemployees to deduct all amounts paid for health insurance,[217] subject to various limitations,[218] and these individuals' income does not include the value of medical care provided by this insurance.[219] Working nonemployees take this deduction against gross income—above the line—rather than as an itemized deduction in lieu of the standard deduction.[220] This deduction mechanic, coupled with the exclusion of insurance benefits, is equivalent to an exclusion for the cost of health insurance

[213] *See* H.R. REP. No. 99-841, vol. II, at 538–39.

[214] *See* Pub. L. No. 101-239, § 6202(b)(3)(A) (1989); Pub. L. No. 101-508, § 11410(a) (1990); Pub. L. No. 102-227, § 110(a)(1) (1991); Pub. L. No. 103-66, § 13174(a)(1) (1993).

[215] *See* Pub. L. No. 104-7, § 1(a) (1995).

[216] *See* Pub. L. No. 105-277, § 2002 (1998).

[217] This category includes partners in partnerships and 2-percent shareholders in S corporations. *See* I.R.C. § 162(*l*)(5).

[218] Two of these limitations have an anti-abuse focus; they permit a deduction only to the extent of income from the activity and prohibit a deduction for individuals otherwise eligible for employer-provided health insurance. I.R.C. § 162(*l*)(2)(A), (B). A third limitation disallows any deduction for self-employment tax purposes. I.R.C. § 162(*l*)(4). By contrast, the costs of EPHI are deductible for employment tax purposes. *See* I.R.C. § 3121(a)(2)(A)–(B).

[219] *See* I.R.C. § 104(a)(3).

[220] *See* I.R.C. §§ 62(a), 63(b), 63(d).

premiums,[221] which places working nonemployees in an income tax position comparable to employees covered by EPHI.[222] Across seventeen years and seven acts of Congress,[223] lawmakers expanded the EPHI exclusion to working nonemployees.[224] This benefit applies to approximately one-tenth of the U.S. population.[225]

The Tax Reform Act of 1986 also codified the long-standing administrative exclusion from income for health insurance and medical benefits provided to active and retired members of the armed services and certain family members.[226] Although the EPHI exclusion could apply to some of these benefits, the separate statutory exclusion provides certainty with respect to unique aspects of military-facilitated health care, such as post-retirement rights to direct medical care through facilities operated by the U.S. Department of

[221] Both the EPHI exclusion and the self-employed health insurance deduction have the same effect on AGI. This structure is important for various limitations and phaseouts, such as contribution limits for Roth IRAs. *See* I.R.C. § 408A(c)(3).

[222] The two categories are treated differently for employment and self-employment tax purposes. *Cf.* Small Business Jobs Act of 2010, Pub. L. No. 111-240, § 2042, 124 Stat. 2504, 2560 (2010) (allowing such deductions for self-employment tax purposes for a one-year period in 2010); *see generally* Shu-Yi Oei & Diane M. Ring, *Tax Law's Workplace Shift*, 100 B.U. L. REV. 651, 674–77 (2020) (describing how employee and nonemployee workers are treated for healthcare incentives delivered through the tax system).

[223] This figure would be eight acts of Congress, when including the ministerial elimination of the phase-in schedule in 2010. *See* Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1004(d)(2), 124 Stat. 1029, 1035 (2010).

[224] Some self-employed individuals may be worse-off by virtue of the deduction's interaction with other tax provisions, and the deduction may not be mandatory. *See* James Edward Maule, *No Thanks, Uncle Sam, You Can Keep Your Tax Break*, 31 SETON HALL LEGIS. J. 81, 85–86, 135–36 (2006).

[225] *See* KEISLER-STARKEY & BUNCH, *supra* note 208, at 3 (finding that 10.2% of people in 2023, and 10.5% in 2022, have direct-purchase health insurance, including through ACA exchanges). Tax expenditure analysis estimates that this exclusion costs approximately $8 billion annually. *See* Off. of Tax Analysis, *supra* note 6, at 25.

[226] *See* I.R.C. § 134.

Veterans Affairs.[227] Again, the result is commensurate with the baseline EPHI exclusion: beneficiaries are not taxable on the insurance value of, or the actual services received through, these arrangements.[228] A small but significant percentage of the U.S. population—between 3% and 5% annually—is covered through military-based health care.[229]

The rest of the U.S. population does not have health insurance through their employment relationship, self-employment, or the military. For working-age individuals, however, the current policy landscape reflects the principles and norms of the EPHI exclusion. In 2010, the ACA enhanced EPHI by requiring certain large employers—with at least fifty full-time employees—to provide a standard health insurance package, subject to a penalty for noncompliance.[230] In addition, the ACA introduced a tax credit to encourage certain small employers to provide health insurance to their

[227] *See* STAFF OF S. COMM. ON THE BUDGET, 110TH CONG., TAX EXPENDITURES: COMPENDIUM OF BACKGROUND MATERIAL ON INDIVIDUAL PROVISIONS 121–23 (Comm. Print. 2008) (outlining unique features of health care provided to members of the military and their dependents), https://www.congress.gov/105/cprt/SPRT52491/CPRT-105SPRT52491.pdf. [https://perma.cc/4JT9-6N6Y].

[228] *See* H.R. REP. NO. 99-841, vol. II, at 549 (1986) (Conf. Rep.).

[229] *See* KEISLER-STARKEY & BUNCH, *supra* note 208, at 5 (finding that, in 2023, 2.4% of people have TRICARE and 1.9% of people have VA and CHAMPVA), https://www2.census.gov/library/publications/2024/demo/p60-284.pdf [https://perma.cc/NPM4-645D].

[230] *See* I.R.C. § 4980H; STAFF OF THE JOINT COMM. ON TAX'N, GEN. EXPLANATION OF THE REVENUE PROVISIONS OF THE "RECONCILIATION ACT OF 2010," AS AMENDED, IN COMBINATION WITH THE "PATIENT PROTECTION AND AFFORDABLE CARE ACT" 37–42 (March 2010) (giving context and mechanics for the employer mandate) [hereinafter, ACA BLUEBOOK], https://www.jct.gov/publications/2010/jcx-18-10; *see also* Daniel J. Hemel, *Pooling and Unpooling in the Uber Economy*, 2017 U. CHI. L. FORUM 265, 269–70 (noting the prevalence of EPHI among these firms after the ACA).

employees.[231] These employer-oriented provisions sought to bring more individuals into the EPHI exclusion.[232]

Of at least equal importance, the ACA made health insurance coverage more available and affordable to lower-income households. The ACA encouraged states to expand Medicaid eligibility to households earning up to 133% of the federal poverty level,[233] and, as of 2024, forty states and the District of Columbia had done so.[234] Historically, Medicaid beneficiaries have excluded from income the full value of their insurance and benefits under the general welfare doctrine.[235] The effect is equivalent to the EPHI exclusion, except that beneficiaries' putative income comes from the federal government rather than from employers. For this reason, the ACA's Medicaid expansion brought more individuals into an

[231] *See* I.R.C. § 45R; ACA BLUEBOOK, *supra* note 230, at 26–30 (giving context and mechanics for the small business tax credit for EPHI).

[232] The provisions' effectiveness is unclear. *Compare* Asako S. Moriya, Thomas M. Selden & Kosali I. Simon, *Little Change Seen In Part-Time Employment as a Result of the Affordable Care Act*, 35 HEALTH AFFAIRS 119, 119 (2016) (finding limited evidence that firms substituted part-time for full-time employees to avoid offering the ACA's employer mandate), *with* Casey B. Mulligan, *The Employer Penalty, Voluntary Compliance, and the Size Distribution of Firms: Evidence from a Survey of Small Businesses*, 34 TAX POL'Y & ECON. 139, 164 (2020) (finding evidence that firms manipulate the fifty-employee threshold to avoid offering EPHI). *See also* David Gamage, *Perverse Incentives Arising from the Tax Provisions of Healthcare Reform: Why Further Reforms Are Needed to Prevent Avoidable Costs to Low- and Moderate-Income Workers*, 65 TAX L. REV. 669, 697–98 (2012) (describing the incentive effects of the penalty provisions in § 4980H(a) and (b)).

[233] *See* Nat'l Fed'n of Indep. Bus. v. Sebelius, 567 U.S. 519, 542 (2012).

[234] *See* Laura Harker & Breanna Sharer, *Medicaid Expansion: Frequently Asked Questions*, CTR. ON BUDGET & POL'Y PRIORITIES (June 14, 2024), https://www.cbpp.org/research/health/medicaid-expansion-frequently-asked-questions-0. The remaining ten states have a coverage gap, estimated to affect 1.6 million people, between Medicaid recipients and households eligible for premium assistance credits under the ACA. *See id.*

[235] *See* Alice Abreu & Richard Greenstein, *Defining Income*, 11 FLA. TAX REV. 295, 308 (2011) (addressing various government transfer payments); *see generally* Jasper L. Cummings, Jr., *The General Welfare Exclusion*, 169 TAX NOTES FED. 441 (Oct. 19, 2020) (surveying seventy-five years of I.R.S. rulings involving the general welfare doctrine and its antecedents).

EPHI-like regime. Medicaid covers between 15% and 20% of the U.S. population.[236]

In another effort to reach lower-income households, the ACA established an individual mandate to purchase health insurance,[237] as well as regulated state insurance marketplaces and progressive subsidies to defray the out-of-pocket costs of standard health insurance.[238] Under the ACA, households with incomes above the federal poverty level qualify for partial subsidies, delivered as refundable premium assistance tax credits, for health insurance purchased through an ACA marketplace.[239] The American Rescue Plan Act of 2021 (ARPA) increased these subsidies across all income levels, including high-earning households, for a limited time period.[240] For households with incomes up to 150% of the federal poverty level, ARPA effectively eliminated any out-of-pocket cost for purchasing a benchmark health insurance plan—at least for two taxable years.[241] Under ARPA, these households also experienced an EPHI-like regime, in that the premium assistance tax credits reimbursed taxpayers dollar-for-dollar for their out-of-pocket costs of health insurance, but the receipt of the credits

[236] *See* KEISLER-STARKEY & BUNCH, *supra* note 208, at 8.

[237] *See* I.R.C. § 5000A(a). Although the TCJA reduced the penalty for noncompliance to zero, the individual mandate remains on the books. *See* I.R.C. § 5000A(c)(3)(A).

[238] *See* I.R.C. § 36B. Self-employed individuals who receive the § 36B credit can deduct uncredited costs under § 162(*l*). Treas. Reg. § 1.162(*l*)-1T(a)(1).

[239] These subsidies phase out for households with incomes above 400% of the federal poverty level. *See* I.R.C. § 36B(b)(3)(A)(i); *see also* Gamage, *supra* note 232, at 687–89 (noting that taxpayers are ineligible for these subsidies when "affordable" EPHI is available); Oei & Ring, *supra* note 222, at 676–77 (describing the interaction of these subsidies with employee status). The ACA also authorized cost-sharing payments to insurance companies that participated in these marketplaces. *See* 42 U.S.C. § 18071.

[240] Pub. L. No. 117-2, § 9661, 135 Stat. 4, 182–83 (2021) (expanding health insurance premium tax credits for 2021 and 2022). The Inflation Reduction Act of 2022, Pub. L. No. 117-169, § 12001, 136 Stat. 1818, 1905 (2022), extended these enhanced credits through 2025.

[241] *See* American Rescue Plan Act of 2021, Pub. L. No. 117-2, § 9661, 135 Stat. 4, 182–83 (2021).

generated no taxable income. The outcome is identical to an exclusion from income equal to the value of the health insurance, and taxpayers also may exclude any benefits under this insurance.[242] Approximately 3% to 4% of the U.S. population acquires health insurance through an ACA marketplace.[243]

From a more holistic perspective, exclusion is the normative tax treatment for health insurance costs for working-age individuals, whether those individuals are employees, self-employed, current or former military personnel, or lower-income, and whether those individuals' health insurance comes from employer plans, the government, or regulated private markets.[244] This treatment emerged not from Congress's explicit design, but rather from incremental changes cobbled together across multiple decades, inside and outside of tax policy's traditional boundaries. There are, of

[242] *See* I.R.C. § 104(a)(3).

[243] *See* KEISLER-STARKEY & BUNCH, *supra* note 208, at 2 (finding that 3.6% and 4.0% of people had marketplace coverage during 2022 and 2023, respectively). Tax expenditure analysis places the annual cost of these credits at approximately $10 to $15 billion. *See* Off. of Tax Analysis, *supra* note 6, at 25.

[244] For nonworking retired individuals, the tax treatment of health care benefits, such as Medicare, is beyond the scope of this Article. One can, however, construct an exclusion regime from the structure of Medicare and Social Security. Medicare Part A is premium-free and effectively excluded from taxable income. Medicare Parts B and D require premiums that are not deductible, unless the requirements of § 213 are met. *See* I.R.C. § 213(a), (d). Individuals who purchase Medicare Parts B and D, however, overwhelmingly receive Social Security payments, at least 15% of which are excluded from income. *See* I.R.C. § 86(a). For individuals with maximum benefits, the minimum Social Security exclusion still exceeds the annual cost of Medicare Part B and D premiums for most individuals. *See 2024 Medicare Parts A & B Premiums and Deductibles*, CTR. FOR MEDICARE & MEDICARE SERV. (Oct. 12, 2023), https://www.cms.gov/newsroom/fact-sheets/2024-medicare-parts-b-premiums-and-deductibles [https://perma.cc/2TR6-8F2L]. For this reason, the minimum excluded portion of Social Security payments can be viewed as a reasonable proxy for health insurance costs.

course, gaps in this pastiche.[245] But the general effect is functionally similar to a zero-rate bracket, or an additional standard deduction, based on the value of taxpayers' health insurance.[246] The shift from an exceptional EPHI exclusion to a quasi-universal benefit for health insurance is a base-rate transformation—at least in part, since Congress made no explicit rate adjustments in response to this universalization. In 1954, Congress enacted a bespoke base carve-out for EPHI; by the 2020s, that provision had become part of a broad-based, systemic exclusion for health insurance costs.

2. Health Insurance and Tax Expenditure Analysis

By reframing the evolution of the EPHI exclusion as a base-rate transformation, this Section challenges conventional policy wisdom about tax benefits for health care, as well as narratives of reform involving those benefits. In terms of tax expenditure analysis, this reframing implies that tax expenditure budgets systematically overstate revenue losses attributable to health insurance tax benefits. Because these health insurance tax benefits principally have rate effects, these losses depend not just on a reference (or normative) tax base, but on a reference (or normative) rate structure. Individual rates have changed dramatically since 1986, and these changes should be considered when evaluating the legal evolution of the EPHI exclusion and related benefits.

This reframing also implies that questions of repeal or substantive reform for the EPHI exclusion are misguided.

[245] For example, approximately 10% of the working-age U.S. population does not carry health insurance. *See* KEISLER-STARKEY & BUNCH, *supra* note 208, at 5 (finding, in 2023, that 10.9% of people from 19 to 64 years old were uninsured).

[246] *See* Brooks, *supra* note 174, at 219–20 (demonstrating the equivalence between a standard deduction and a zero bracket with a floor to claim personal deductions); Theodore P. Seto & Sande L. Buhai, *Tax and Disability: Ability to Pay and the Taxation of Difference*, 154 U. PA. L. REV. 1053, 1143–44 (2006) ("The current zero-bracket is inadequate and not consistently implemented."). Taxpayers can, of course, claim itemized deductions in addition to any benefits for health insurance.

Instead, lawmakers should focus on identifying the components of health insurance benefits that apply universally and uniformly. Only health insurance benefits above or below these amounts require attention as components of the legal tax base. For example, lawmakers could revisit the ACA's since-repealed "Cadillac tax" on high-benefit health insurance plans.[247] Lawmakers then should focus their attention on statutory rates, including the standard deduction. To the extent that the EPHI's base-rate transformation did not appropriately address rates, those correlative adjustments should be made now.

B. Standard Deductions and Demogrants

A second case study considers the relationship between various tax and transfer programs designed to support low-income filers.[248] Specifically, standard deductions, demogrants, and phaseouts for these benefits help lawmakers achieve and enhance progressive rates across the income spectrum, including negative rates for low-earning taxpayers. The standard deduction is a fixed reduction in income available to all filers, while demogrants are universal cash transfers to all filers, regardless of need. Both types of benefits essentially create zero brackets for a fixed amount of economic income.[249] Neither concept is implemented in the U.S. tax system in a pure form. Under current law, the standard deduction is replaced by itemized deductions (essentially, personal deductions and tax expenditures) for some filers,[250] while demogrant-like programs are limited by earnings from

[247] *See supra* note 196.

[248] For discussions of the merits of tax-based transfer programs, see Anne Alstott, *The Earned Income Tax Credit and the Limitations of Tax-Based Welfare Reform*, 108 HARV. L. REV. 533 (1995); Weisbach & Nussim, *supra* note 27, at 1023–27.

[249] *See* Brooks, *supra* note 174, at 208 (arguing for the creation of a "true, independent" zero-bracket amount to separate "the progressivity and simplification purposes of the standard deduction").

[250] *See* I.R.C. § 63.

market labor, family size, and household income.[251] These features are, essentially, phaseouts that increase progressivity at the cost of higher marginal rates—sometimes strikingly higher—for lower-income filers.[252]

The progressivity implications of these instruments may not be salient to taxpayers. For example, in 1972, presidential candidate George McGovern proposed a refundable, universal tax credit of $1,000 per person, coupled with a flat nominal rate of approximately 33%. For a family of four, the credit would have offset exactly any tax due on $12,000 of income. Below that amount, the family would have received a net transfer from the federal government; above that amount, the family would have paid net income taxes to the government, increasing proportionately as the family's income grew. McGovern's opponent, Richard Nixon, had proposed several basic income plans similar to McGovern's. By citing the 33% flat rate, however, Nixon successfully painted McGovern's plan as a tax increase on lower-earning households. This example illustrates a "fiscal illusion" quality to the base-rate identity.[253]

This case study shows the political perils of base-rate transformations when conducted explicitly. Nominal rates may prove more salient than base adjustments or explicit transfers. This outcome, however, should not preclude base-rate transformations as a policy instrument—the political conversation may play out differently today than in 1972. Correlative rate adjustments through changes to bracket cut-offs, including any zero brackets, may prove more favorable than nominal rate increases.[254] And the type of implicit,

[251] *See* I.R.C. § 32.

[252] *See* Hemel, *supra* note 59, at 53–54 (noting that phaseouts increase taxpayers' marginal rates indirectly, where Congress could achieve similar objectives through adjustments to the nominal rate structure).

[253] *See supra* notes 172–173 and accompanying text.

[254] The Carter Commission Report imposed a tax on income presumptively available for discretionary use, based on a schedule of assumed fractions of discretionary income at different income levels. Then, progressive rates were applied to this discretionary income. *See* CARTER

longitudinal transformation evident in the exemption for health insurance premiums may prove even more favorable from a political economy perspective.

C. The § 199A Pass-Through Deduction

This Section provides a detailed case study of the mechanics and policy stakes of a hypothetical base-rate transformation involving the so-called "pass-through deduction" in § 199A of the Code. Enacted in December 2017 as part of the TCJA, the pass-through deduction permits a limited deduction equal to 20% of a taxpayer's business income for taxable years beginning before January 1, 2026. Few provisions of the first Trump Administration's signature legislative achievement have attracted more opprobrium than the pass-through deduction. Academic commentators have identified myriad problems with § 199A,[255] and a number of Democrats, including former President Biden, have advocated

COMM'N REP., *supra* note 90, at 5–6; *see also* Boris I. Bittker, *Income Tax Reform in Canada: The Report of the Royal Commission on Taxation*, 35 U. CHI. L. REV. 637, 640–41 (1968).

[255] For academic commentary, see Alice G. Abreu, *Tax 2018: Requiem for Ability to Pay*, 51 LOY. L.A. L. REV. 61, 79–83 (2018); Karen C. Burke, *Section 199A and Choice of Passthrough Entity*, 72 TAX LAW. 551 (2019); Michael J. Graetz, *Foreword: The 2017 Tax Cuts: How Polarized Politics Produced Precarious Policy*, 128 YALE L.J. FORUM 315, 331–34 (2018); David Kamin et al., *The Games They Will Play: Tax Games, Roadblocks, and Glitches Under the 2017 Tax Legislation*, 103 MINN. L. REV. 1439 (2018); Daniel Shaviro, *Evaluating the New US Pass-Through Rules*, 1 BRIT. TAX REV. 49 (2018); Linda Sugin, *The Social Meaning of the Tax Cuts and Jobs Act,* 128 YALE L.J. FORUM 403, 415–16 (2018). For think-tank and policy-oriented commentary, see Scott Greenberg, *Reforming the Pass-Through Deduction*, TAX FOUND. (June 21, 2018), https://taxfoundation.org/research/all/federal/reforming-pass-through-deduction-199a; Edward Kleinbard, Op-Ed, *Congress' Worst Tax Idea Ever*, THE HILL (Mar. 25, 2019), https://thehill.com/opinion/finance/434998-congress-worst-tax-idea-ever; Alexandra Thornton, *Broken Promises: More Special Interest Breaks and Loopholes Under the New Tax Law*, CTR. AM. PROG. (Mar. 1, 2018), https://www.americanprogress.org/article/broken-promises-special-interest-breaks-loopholes-new-tax-law.

eliminating or limiting the pass-through deduction—or allowing the provision to expire.[256]

For opponents of § 199A, repeal, reform, and lapse through inaction face political and practical obstacles. To the extent that these obstacles prove intractable, this Section offers an alternative legislative blueprint: Congress could radically expand, rather than restrict, § 199A's application.[257] This expansion could shift the pass-through deduction from a base-eroding provision to a generalized reduction in effective rates. Congress then could adjust statutory rates to forestall revenue loss and mitigate adverse distributional effects. The result is a base-rate transformation that aligns with traditional tax norms of equity, efficiency, and simplicity.

This Part first elaborates the operation and application of the pass-through deduction under current law. Then, this Part advances arguments against conventional legislative approaches to repeal or reform in the context of § 199A. Finally, this Part discusses the specific statutory changes necessary to effect a base-rate transformation of the pass-through deduction, as well as the stakes and sticking points of this particular transformation. The purpose of this analysis is not to advocate any single pathway for reforming § 199A, a project that is both necessary and important.[258] Instead, this analysis further develops the menu of options available to policymakers in the reform process.

This Article suggests that Congress cannot remedy § 199A's infirmities without addressing taxpayers across the

[256] Republicans generally favor revision or renewal of the pass-through deduction. *See* Andrew Lautz & Arianna Fano, *The 2025 Tax Debate: The Corporate Tax Rate and Pass-Through Deduction*, BIPARTISAN POL'Y CTR. (July 12, 2024), https://bipartisanpolicy.org/explainer/the-2025-tax-debate-the-corporate-tax-rate-and-pass-through-deduction.

[257] *But see* Small Business Tax Fairness Act, S. 2387, 117th Cong. § 2 (2021) (proposing various restrictions that would narrow the application of § 199A).

[258] Although the second Trump Administration may advocate for extension of § 199A, this extension may require reforms to the provision. The challenges to reform described in this Part generally apply to Trump Administration efforts to extend sunsetting legislative policies from the TCJA.

income distribution. Similarly, reforms that focus on § 199A's restrictions, or guardrails, face the serious task of imbuing a hastily drafted and undertheorized tax preference with some sort of conceptual coherence. Better, instead, to look in the opposite direction: a radical expansion of § 199A to embrace more taxpayers, most notably those with wage income. This expansion would, in effect, transform § 199A into a permanent part of the progressive rate structure. Many of § 199A's current guardrails could be eliminated, and statutory tax brackets could be adjusted—either contemporaneously or over time—to address distributional and revenue concerns. This base-rate transformation may have political advantages, and a carefully designed expansion may advance conventional tax policy norms such as equity, efficiency, and simplicity, without incurring additional revenue losses.

1. What Is the Pass-Through Deduction?

At the most fundamental level, the pass-through deduction allows individual taxpayers to deduct 20% of their qualified business income (QBI) from noncorporate business activities. The TCJA, however, layers a number of restrictions and guardrails on top of this basic computation—limitations on the provision's top-line tax expenditure. To a significant extent, these limitations define § 199A's policy contours. These limitations also introduce tremendous complexity in the provision's implementation and application, and, more crucially, these limitations present meaningful obstacles to conventional reform.

For all claimants, QBI is defined to include income and loss from a domestic qualified trade or business (QTB) conducted as a sole proprietorship or through a partnership or S corporation.[259] The statute expressly precludes a deduction with respect to passive income items such as capital gains and

[259] QBI also includes qualified REIT dividends and qualified publicly traded partnership (PTP) income. *See* I.R.C. § 199A(b)(1). Because these items are exempt from most of § 199A's limitations, they effectively represent a distinct tax benefit.

dividends.[260] QBI also excludes income from personal services, namely wages from employment,[261] reasonable compensation paid by an S corporation to a shareholder,[262] guaranteed payments paid by a partnership to a partner in exchange for services,[263] and other payments by a partnership to a partner, other than in the partner's capacity as a partner, in exchange for services.[264] Taken together, these service-oriented exclusions deny the § 199A deduction for income attributable to labor performed by a business owner, as contrasted to capital invested by the business owner or labor performed by nonowners.

If a taxpayer has QBI from one or more QTBs in a taxable year, all items of QBI are netted.[265] If this net amount is less than zero, there is no QBI for the year and no deduction under § 199A. The deficit is treated as negative QBI in the succeeding taxable year.[266] In effect, these loss accounting rules take a lifetime approach to tax benefits under § 199A, with the quirk that taxpayers' lives for this purpose begin with the TCJA's passage. For a given claimant, § 199A generates deductions only to the extent that the taxpayer has net positive QBI from all of the taxpayer's QTBs, starting in 2018. This limitation is powerful, compared to a hypothetical alternative that tracks prior-year losses on a business-by-business basis.[267] Current law can penalize taxpayers with a portfolio of QTBs, especially if that portfolio is designed to

[260] I.R.C. § 199A(c)(3)(B). This paper ignores the preferences for qualified REIT dividends and qualified PTP income, which are broader and more straightforward than the preference for QBI.

[261] I.R.C. § 199A(d)(1)(B) (excluding "the trade or business of performing services as an employee" from the definition of a QTB).

[262] I.R.C. § 199A(c)(4)(A); Treas. Reg. § 1.199A-3(2)(ii)(h).

[263] I.R.C. § 199A(c)(4)(B).

[264] Treas. Reg. § 1.199A-3(b)(2)(ii)(J).

[265] Income from a QBI may be reduced for higher-income taxpayers. *See infra* notes 274–281 and accompanying text.

[266] I.R.C. § 199A(c)(2); Treas. Reg. § 1.199A-1(c)(2)(i).

[267] See Am. Bar Assn. Sec. Tax'n, *Comments Concerning the Treatment of Losses and Certain Other Issues Regarding the Section 199A Deduction*, 72 TAX LAW. 401, 405 (2019) (requesting guidance with respect to various issues involving losses under § 199A).

match income and loss from various businesses on an annual basis to avoid current tax or the application of the passive activity loss rules.[268] This category of claimants generally is higher-income.

If a taxpayer's net QBI amount is positive, a further global restriction applies to preclude certain double tax benefits. Mechanically, 20% of the taxpayer's net QBI amount is compared to 20% of the taxpayer's taxable income, after reduction for any net capital gain.[269] The lesser of these two amounts is the taxpayer's deduction under § 199A.[270] For example, consider a taxpayer with $70,000 of net QBI, $30,000 of net capital gain, and $20,000 of itemized deductions. The taxpayer's taxable income is $80,000.[271] Under § 199A, the taxpayer can claim a deduction equal to the lesser of $14,000 (20% of $70,000 of QBI) or $10,000 (20% of $50,000, the difference between $80,000 of taxable income and $30,000 of net capital gain). In effect, the statute disallows the taxpayer's basic § 199A deduction to the extent of the taxpayer's itemized deductions and net capital gain.[272] These rules preclude taxpayers from benefiting from § 199A and preferential capital gains rates, the standard deduction, or itemized deductions with respect to the same dollar of taxable income.[273]

Two further restrictions apply to taxpayers with taxable income over a threshold amount, which in 2024 was $191,950 for individual filers and $383,900 for joint filers.[274] These restrictions phase in ratably over the next $50,000 or

[268] Aggregation rules may mitigate some of this disadvantage. *See* Treas. Reg. § 1.199A-4(a) (treating each trade or business—a concept of uncertain scope—as separate unless permitted to be aggregated under specific rules).

[269] Net capital gain is taxable at preferential rates. *See* I.R.C. § 1(h).

[270] *See* I.R.C. § 199A(a).

[271] That is, $80,000 of QBI, plus $30,000 of net capital gain, minus $20,000 of itemized deductions. *See* I.R.C. § 63.

[272] The $4,000 reduction equals 20% of $20,000.

[273] The implicit ordering rule is that the standard or itemized deductions offset non-QBI ordinary income first, then QBI, then net capital gain.

[274] Rev. Proc. 2023-34, § 3.27, 2023-48 I.R.B. 1287, 1293.

$100,000 of income for individuals and joint filers, respectively. The first restriction excludes certain service-oriented activities—specified service trades or businesses (SSTBs)—from the definition of a QTB, which means that these SSTBs do not generate a § 199A tax benefit for taxpayers with incomes over the threshold amount. The statutory list of SSTBs is cribbed from other parts of the Code and somewhat idiosyncratic in its coverage.[275] For example, the provision of services in the fields of health, law, accounting, performing arts, consulting, and athletics are SSTBs, while the provision of engineering and architectural services are not SSTBs.[276] One possible rationale for the SSTB limitation is that it supplements the income-independent service-oriented exclusions (for employees, for example) by categorically banning the § 199A deduction for enumerated activities that involve significant owner-provided labor.[277]

The second restriction, known as the wage-basis limitation, caps the § 199A deduction based on characteristics of the QTB that generates QBI, namely employee wages paid by the QTB and the unadjusted basis immediately after acquisition (UBIA) of qualified property used in the QTB.[278] This process is complicated. First, negative QBI from any QTB is allocated among QTBs with positive QBI. Then, the portion

[275] To the extent that § 199A ameliorates the effect of lower corporate tax rates on choice-of-entity decisions, SSTBs may serve as a proxy for sectors that cannot easily incorporate and therefore are unaffected by rate disparities between corporate and noncorporate vehicles. *See* David A. Weisbach, *Line Drawing Doctrine and Efficiency in the Tax Law*, 84 CORNELL L. REV. 1627, 1631 (1999) (noting the efficiency implications of legal distinctions between "substantially similar" arrangements).

[276] Engineering and architectural services could generate domestic production activities deductions under former § 199, which Congress repealed to enact § 199A. *See* I.R.C. § 199(c)(4)(A)(iii) (2017) (defining "domestic production gross receipts" to include "engineering or architectural services performed in the United States"). Successful lobbying by firms and professional associations preserved these fields' special status in the transition to the pass-through deduction.

[277] Of course, activities not on the prohibited list also involve significant owner-provided labor.

[278] I.R.C. § 199A(b)(2)–(6).

of the taxpayer's § 199A deduction from each QTB is limited by the greater of 50% of the wages paid by the QTB or 25% of the wages paid by the QTB plus 2.5% of the QTB's UBIA.[279] Wages and UBIA from QTBs with negative QBI, including carryforwards of prior years' negative net QBI, are disregarded.[280] This treatment of QTBs with negative QBI is not favorable for higher-income taxpayers, who are more likely to own interests in multiple QTBs. The wage-basis limitation can be rationalized as another restriction on returns to owners' self-provided labor, much like the wage income and SSTB limitations. Essentially, the wage-basis limitation tests the QTB for returns to capital or employee-provided labor.[281]

Finally, § 199A does not apply in taxable years beginning after December 31, 2025. Many of the TCJA's individual tax provisions carry a similar expiration date, while most of the TCJA's corporate tax provisions continue until modified by Congress.[282] Section 199A's sunset clause reflects the exigencies of the budget reconciliation process through which Congress passed the TCJA.[283] In addition, § 199A's sunset

[279] The first prong also limited domestic production activities deductions under former § 199, and the second prong purportedly was added to secure the vote of Sen. Bob Corker. *See* Shaviro, *supra* note 255, at 50 (noting that Corker personally might save $1 million in taxes annually as a result of the UBIA allowance); *see also* Seung Min Kim, *Why Corker Flipped on the Tax Bill*, POLITICO, Dec. 18, 2017 (describing the UBIA allowance as the "Corker kickback"), https://www.politico.com/story/2017/12/18/bob-corker-tax-bill-kickback-republicans-respond-302482.

[280] *See* Treas. Reg. § 1.199A-1(d)(2)(i).

[281] This rationalization unravels in various circumstances, such as those involving employee-owners of S corporations. *See* Amy E. Sheridan, *Compensation and Benefits Aspects of the New QBI Deduction*, 159 TAX NOTES 657, 657–59 (Apr. 30, 2018) (modelling how partners and S corporation shareholders can maximize § 199A benefits under statutory constraints).

[282] *Compare* I.R.C. § 1(j), *with* I.R.C. § 11(a).

[283] Specifically, legislation passed through the reconciliation process cannot increase deficits outside of the relevant temporal budget window. *See* Tax Pol'y Ctr., *How Did the TCJA Affect the Federal Budget Outlook?*, TAX POL'Y BRIEFING BOOK (Jan. 2024) (noting that extensions of the TCJA's

requires Congress to reconsider the provision, formally or informally, as the provision's expiration date approaches.[284]

2. Repeal, Lapse, and Reform

The pass-through deduction's opponents have three conventional legislative options to address § 199A, which seems likely to be extended in some form during the second Trump Administration. Congress could repeal § 199A, either entirely or only with respect to an income-defined subset of taxpayers. Alternatively, Congress could remedy § 199A's infirmities through substantive reform, while maintaining the provision as a presumptively desirable tax expenditure. Partial repeal and substantive reform are not mutually exclusive. Finally, Congress could choose not to act, in which case § 199A would expire in 2026 according to the statute's terms. Each of these three routes presents significant challenges.

Full repeal seems unlikely, either in this Congress or future Congresses. Republican lawmakers generally support § 199A in some form, and, during the Biden Administration's first year, Democrats tabled political platform planks that promised complete repeal. For example, in the 2020 general election, then-candidate Joe Biden proposed eliminating the pass-through deduction for individuals earning more than $400,000 per year[285]—a relatively small proportion of total claimants, but a very significant proportion of total tax benefits.[286] Although Biden Administration spokespeople

sunsetting provisions would increase revenue loss beyond the budget window), https://taxpolicycenter.org/briefing-book/how-did-tcja-affect-federal-budget-outlook [https://perma.cc/XQ5N-QRVU].

[284] *See* Jacob E. Gersen, *Temporary Legislation*, 74 U. CHI. L. REV. 247, 248 (2007) (elaborating how legislative sunsets "allocate[] agenda control and decisionmaking authority between current- and future-period majorities in Congress").

[285] *See* Libin Zhang, *Biden's Proposed Tax Increases in Simple and Multivariate Charts*, 171 TAX NOTES 703, 706 (May 3, 2021).

[286] *See* Lucas Goodman, Katherine Lim, Bruce Sacerdote & Andrew Whitten, *Simulating the 199A Deduction for Pass-Through Owners* 14, 16

mentioned this limitation as late as March 2021, the Administration's 2022 Greenbook, which details the effects of presidential revenue proposals, omitted any mention of the pass-through deduction.[287] As the provision's 2026 sunset approaches, myriad proposals would extend all or part of § 199A, perhaps as part of a political compromise over the competing principles expressed in the first Trump Administration's TCJA and the Biden Administration's ARPA, which broadened certain social support programs on a temporary basis.[288] Alternatively, the second Trump Administration could work with both Republican-controlled houses of Congress to extend § 199A through partisan legislation.

Indeed, the pass-through deduction was never particularly likely to sunset quietly at the end of 2025. In the tax legislative process, sunset provisions are notoriously plastic, as evidenced by the longstanding congressional practice of renewing annually a class of expiring provisions known as "extenders."[289] Also, in 2001 and 2003, the Bush

(Off. of Tax Analysis, Working Paper No. 118, 2019), https://home.treasury.gov/system/files/131/WP-118.pdf [https://perma.cc/K2QN-ZPEY].

[287] *See* DEP'T OF THE TREAS., GEN. EXPLANATIONS OF THE ADMIN.'S FISCAL YEAR 2022 REVENUE PROPOSALS (May 2021), https://home.treasury.gov/system/files/131/General-Explanations-FY2022.pdf [https://perma.cc/A383-254A].

[288] *See* Main Street Tax Certainty Act, H.R. 4721, 118th Cong. § 2 (2023); Main Street Tax Certainty Act, S. 1706, 118th Cong. § 2 (2023); *see generally* GARY GUENTHER, CONG. RSCH. SERV., REP. NO. IN12226, THE DEBATE OVER EXTENDING THE SECTION 199A DEDUCTION FOR QUALIFIED BUSINESS INCOME 1 (2024) ("There is bipartisan support in Congress for extending the Section 199A deduction beyond 2025."), https://crsreports.congress.gov/product/pdf/IN/IN12226.

[289] *See* Rebecca M. Kysar, *Lasting Legislation*, 159 U. PENN. L. REV. 1007, 1016 (2011). A historical example is the credit for research and development in § 41, which became permanent in 2015. *See* GARY GUENTHER, CONG. RSCH. SERV., REP. NO. RL31181, FEDERAL RESEARCH TAX CREDIT: CURRENT LAW AND POLICY ISSUES 3–4 (2022), https://crsreports.congress.gov/product/pdf/RL/RL31181. Current examples include a bevy of renewable and alternative energy credits. *See, e.g.*, I.R.C. § 25C.

administration passed similar time-limited tax cuts through the budget reconciliation process. In 2012 (and after a protracted, acrimonious political battle with Republicans), President Obama ultimately made a substantial portion of these tax cuts permanent.[290] This history indicates that the pass-through deduction's statutory expiration date should be viewed as a form of agenda-setting for future Congresses, rather than a statement of substantive policy.[291]

The pass-through deduction's long-term political economy also may prove difficult for any strategy that relies on the provision's repeal or lapse. Section 199A applies broadly across the income spectrum.[292] Since 2018, tens of millions of taxpayers have claimed deductions under § 199A, and the Office of Tax Analysis estimates that more than 80% of potential claimants fall outside of the highest income decile.[293] These potential voters may resist the expiration of an existing tax preference, even if their individual benefit is small compared to the dollar reductions claimed by high earners.[294] Moreover, the highest income decile receives more than 80%

[290] *See* Chye-Ching Huang, *Budget Deal Makes Permanent 82% of President Bush's TaxCuts*, CTR. ON BUDGET & POL'Y PRIORITIES, Jan. 3, 2013, https://www.cbpp.org/research/budget-deal-makes-permanent-82-percent-of-president-bushs-tax-cuts.

[291] *See* Gersen, *supra* note 284, at 266 (2007) ("Statutory expirations constrain the discretion of committee chairs by mandating that certain items be placed on the committee's agenda.").

[292] *See* Krista M. Jones-May, *Real People, Real Incomes: How New § 199A (the New Twenty-Percent Deduction) Can Help Individuals in Lower Income Brackets*, 18 APPALACHIAN J. L. 61 (2019) (arguing that § 199A operates in a straightforward manner for middle- and lower-income claimants); Andrew L. Snyder, Note, *The Lawyer, the Engineer, and the Gigger: § 199A Framed as an Equitable Deduction for Middle-Class Business Owners and Gig Economy Workers*, 25 FORDHAM J. CORP. & FIN. L. 634–35 ("[R]epealing the provision would deny an equitable deduction to middle-class business owners and [independent contractors]—particularly, those working within the gig economy.").

[293] *See* Goodman et al., *supra* note 286, at 16.

[294] *Cf.* Ventry, *supra* note 19, at 233–34 ("[A] near-unanimity of Americans still considered [the HMID] the key to homeownership even though a mere one-fourth reaped its benefits.").

of the deduction's benefits by dollar value.[295] This politically powerful cohort also may advocate in favor of extension or permanence.[296] The result is political pressure for retention from both ends of the income spectrum. Finally, § 199A's sunset falls after the 2024 presidential election, and unified Republican control of Congress and the Presidency strongly indicates that the provision will be renewed.[297] Any repeal effort presumably would need to wait years and address any legislative changes in the extension process; substantive reform, however, may occur intentionally or organically as Congress extends § 199A beyond 2026.

Substantive reform raises challenging conceptual and pragmatic issues in the § 199A context. As an initial matter, the underlying policy rationale for the pass-through deduction—in any form—is relatively obscure. Lawmakers clearly intended § 199A to compensate noncorporate businesses that did not benefit from the TCJA's fourteen-point corporate tax rate reduction from 35% to 21%.[298] From this perspective, the pass-through deduction provides some measure of equivalence in the effective tax rates for corporate

[295] Approximately $28 billion of $35 billion in total tax savings inure to the top income decile. *See* Goodman et al., *supra* note 286, at 16 (simulating tax savings by income deciles with "guardrails" under § 199A).

[296] *See* Shu-Yi Oei & Leigh Osofsky, *Legislation and Comment: The Making of the § 199A Regulations*, 69 EMORY L. J. 209, 234–36 (2019) (discussing interest group influence in the regulatory process for § 199A). President Biden's campaign position to limit § 199A's availability to high-income claimants may reflect these constituency effects. *See Understanding Joe Biden's 2020 Tax Plan*, COMM. FOR A RESPONSIBLE FED. BUDGET 4 (2020), https://www.crfb.org/sites/default/files/managed/media-documents2022-02/CRFB%20USBW%20Biden%20Tax%20Plan%20Analysis_FINAL%20DRAFT_07302020.pdf [https://perma.cc/6A6U-YFWL]. Moreover, the application of § 199A to REIT dividends and PTP income may draw additional—and powerful—interest groups into any reform efforts.

[297] *See* Erica York, *Donald Trump Tax Plan Ideas: Details & Analysis*, TAX FOUND. (Sept. 10, 2024), https://taxfoundation.org/research/all/federal/donald-trump-tax-plan-2024 [https://perma.cc/8CZ7-DDW3].

[298] *See* STAFF OF J. COMM. ON TAX'N, 115TH CONG., GENERAL EXPLANATION OF PUBLIC LAW 115-97, at 20 (Comm. Print 2018) (attempting to "[t]reat[] corporate and noncorporate business income more similarly to each other").

and noncorporate business activities.[299] The policy stakes involve choice-of-entity decisions for active businesses that are not publicly traded.[300] But if Congress intended to improve efficiency by making taxpayers indifferent between corporate and noncorporate vehicles, or by simplifying choice-of-entity analysis for tax purposes, the pass-through deduction failed miserably.[301] Alternatively, Congress may have intended to maintain the pre-TCJA presumption in favor of pass-through entities, though the reasons for preserving this presumption are dubious.[302] Any substantive reform takes a position, explicit or implicit, on these issues.

Furthermore, many of the pass-through deduction's deficiencies arise from intrinsic problems in separating returns to labor and capital when a single taxpayer provides both.[303] Section 199A's elaborate restrictions and guardrails arguably attempt to draw this distinction—ineffectively, in

[299] *See* Michael S. Knoll, *The TCJA and the Questionable Incentive to Incorporate*, 162 TAX NOTES 977, 981 (2019) (finding claims that "top-bracket taxpayers" have an incentive to incorporate after the TCJA to be "largely incorrect").

[300] *See* I.R.C. § 7704(a).

[301] *See* Bradley T. Borden, *Income-Based Effective Tax Rates and Choice-of-Entity Considerations Under the 2017 Tax Act*, 71 NAT'L TAX J. 613, 614–15 (2018) ("[C]hoice-of-entity decisions are more nuanced under the TCJA.").

[302] One possible justification is that disrupting choice-of-entity decisions impinges on reliance interests and imposes inappropriate transition costs. From this perspective, § 199A compensates owners of pass-through businesses for their expectations about their relative contributions to federal income tax revenue. *Compare* David M. Hasen, *Legal Transitions and the Problem of Reliance*, 1 COLUM. J. TAX L. 120, 172 (2010) (critiquing the "new view" of legal transitions, which favors uncompensated transitions), *with* Graetz, *supra* note 155, at 87 (disfavoring grandfathering as relief from retroactivity). Alternatively, § 199A can be viewed as a concession to stability in choice-of-entity decisions in light of uncertainty about future corporate tax rates. *See* Knoll, *supra* note 299, at 977–78 (arguing against "the general claim" that the TCJA would spur "a mass conversion of passthrough entities into C corporations").

[303] *See* Lily Kahng, *Who Owns Human Capital*, 94 WASH. U. L. REV. 607, 644 (2017) ("[T]he interdependent relationship between labor and capital . . . raises the question whether labor income and capital income can or should be viewed as separate.").

the view of many commentators.[304] In part, the provision's failings reflect the unorthodox processes through which the provision was enacted and regulations were promulgated.[305] But some of the provision's challenges are conceptual. Tax gaming plays a role, as taxpayers seek to convert ordinary income (typically labor income) into income subject to a lower rate or other preference (typically capital income).[306] Indeed, conversion strategies are endemic in tax systems that treat labor income and capital income differently.[307]

[304] *See e.g.*, David Kamin et al., *supra* note 255, at 1460–61 ("The heart of the problem is the absence of a policy justification for many rules governing the deduction."). Another problematic area involves rental real estate, where the issue is whether income reflects business returns, for which § 199A deductions are available, or investment returns, for which no § 199A deduction is available. An owner-operator must provide a sufficient level of services to qualify the activity as a business; then, all returns, even from those services, are QBI. *Cf.* Rev. Proc. 2019-38, 2019-42 I.R.B. 942, 942.

[305] *See* Shaviro, *supra* note 255, at 49–51 (2018) ("The pass-through rules stand front and centre in illustrating both the [TCJA's] sloppiness and its lack of principle."); *see also* Oei & Osofsky, *supra* note 296, at 211–13 (describing Treasury's relatively unorthodox approach to rulemaking when faced with a provision enacted "at warp speed"). An appropriate contrast is the (largely successful) legislative and regulatory processes surrounding the passive activity loss rules in § 469. *See* George K. Yin, *Getting Serious About Corporate Tax Shelters: Taking a Lesson from History*, 54 SMU L. REV. 209, 218–19 (2001) (describing § 469 as an "outcomes-oriented" provision that does not look to purpose or intent).

[306] *See* David Gamage, *The Case for Taxing (All of) Labor Income, Consumption, Capital Income, and Wealth*, 68 TAX L. REV. 355, 404–05 (2015) (arguing for taxing multiple tax bases as a response to conversion strategies); Mark P. Gergen, *How to Tax Capital*, 70 TAX L. REV. 1, 66 (2016) (describing how conversion strategies may implicate valuation issues); David A. Weisbach, *A Partial Mark-to-Market Tax System*, 53 TAX L. REV. 95, 123 n.79 (1999) (describing how a partial mark-to-market regime would curtail conversion incentives).

[307] *See* Richard M. Bird & Eric M. Zolt, *Dual Income Taxation and Developing Countries*, 1 COLUM. J. TAX L. 174, 187 (2010) (noting practical problems faced by tax systems that treat income from labor differently from income from capital); Edward D. Kleinbard, *The Right Tax at the Right Time*, 21 FLA. TAX REV. 208, 283 (2017) (outlining "a labor-capital income centrifuge" to separate income from each source).

If the normative version of § 199A provides a tax benefit to returns to capital, identifying and implementing adequate restrictions and guardrails is a mammoth task, one that probably is not achievable without serious compromises with respect to simplicity and administrability. In addition, the historical aggregation of business tax law creates planning wedges that may be impossible to mitigate without large-scale reform of business taxation. For S corporations, optimization problems involving reasonable compensation exist as long as S corporation owners also can be employees.[308] For partnerships, the practical continuum between guaranteed payments and risky distributive shares cannot be obviated or avoided by changes to § 199A.[309] In each case, smarter restrictions and guardrails are not a viable solution to the current problems in § 199A.

As implemented by Treasury, § 199A largely ignores the labor-capital distinction for sole proprietors.[310] Sole proprietors often provide personal services and cash or property to their businesses and earn an aggregate return. Allocating this return to these businesses' labor and capital components is difficult in the absence of an arm's length referent—and this difficulty acts as an invitation to valuation-based tax gaming.[311] If the sole proprietor reinvests returns, the problem compounds. The business's earnings may comprise returns to current-year labor, returns to initially invested capital, or returns to the reinvested earnings from prior years' labor. Under current law, the pass-through deduction avoids these complexities by granting its benefit to

[308] *See* Sheridan, *supra* note 281, at 659–60 (describing planning strategies to meet "the two-sevenths inflection point" to maximize benefits under § 199A). Even formula-driven solutions are susceptible to tax gaming.

[309] *See* Sheridan, *supra* note 281, at 661–62 (arguing that "QBI can be more easily maximized in partnership form").

[310] The exception is SSTBs for sole proprietors over the threshold amount. I.R.C. § 199A(d)(3).

[311] On the difficulties involved in the allocation of income components to labor and capital, see *supra* notes 306–307.

sole proprietors without regard to labor-capital distinctions.[312] This result favors taxpayers who structure their business activities as a sole proprietorship.[313] To the extent that § 199A's restrictions and guardrails are intended to focus the provision's benefit on returns to owner-provided capital, any reform proposal should account for the separability of labor and capital for sole proprietors.

3. Transforming the Pass-Through Deduction

If the prospects for § 199A's repeal, reform, or sunset are dim, then base-rate transformation may represent a viable reform vehicle. This transformation would expand § 199A to apply to virtually all taxpayers, then adjust statutory rate brackets to address revenue and distributional concerns. For § 199A, the central step in a base-rate transformation is to expand the provision's application to labor income. This step could be accomplished by eliminating restrictions that apply to employees, reasonable compensation paid by S corporations, and guaranteed payments paid by partnerships. The SSTB restriction also could be removed. The wage-basis limitation, loss rules, and investment activity-business activity distinction could be retained or removed, depending on Congress's policy goals. If these restrictions were retained, their penalty function would be starker, as measured against baseline rates. As long as the limitation on double benefits in § 199A(a) remains in place, the transformed § 199A deduction

[312] Compensation that creates (or increases the magnitude of) negative QBI has complex spillover effects on any other QBI earned by Taxpayer B. *See* Treas. Reg. § 1.199A-1(d)(2)(iii) (netting negative and positive QBI and carrying forward overall negative QBI); *see also* I.R.S., *Tax Cuts and Jobs Act, Provision 11011 Section 199A—Qualified Business Income Deduction FAQs*, Q&A 22 (Sept. 14, 2024), https://www.irs.gov/newsroom/tax-cuts-and-jobs-act-provision-11011-section-199a-qualified-business-income-deduction-faqs [https://perma.cc/295J-Y743].

[313] Sole proprietorships include businesses conducted by individuals though disregarded entities, such as single-member limited liability companies. I.R.S., *Sole Proprietorships* (last visited Sept. 26, 2024), https://www.irs.gov/businesses/small-businesses-self-employed/sole-proprietorships [https://perma.cc/ACK5-2SXA].

should not overlap other tax preferences. These changes would relieve much of the pressure on § 199A to distinguish labor income and capital income, and they would reduce incentives for tax gaming along various margins, such as choice of entity and employee-independent contractor status. Even if imperfectly designed, a base-rate transformation would eliminate § 199A as an impediment to other desirable reforms.[314]

CONCLUSION

This Article introduces, develops, and illustrates a novel mechanism for tax expenditure reform: base-rate transformations. As a policy strategy, base-rate transformations offer potential advantages—and disadvantages—compared to conventional repeal or substantive reform. Without taking a normative position on tax expenditures generally, this Article uncovers another option for lawmakers interested in the reform of tax expenditures, a perennial topic among lawmakers and policy experts.

[314] *See* Glogower & Kamin, *supra* note 14, at 1570–71 (arguing that § 199A's "greater harm" may be "the way in which it constrains policymakers from raising revenue from the highest income taxpayers through future reforms").