ARTICLE

CHOOSING TAX: EXPLICIT ELECTIONS AS AN ELEMENT OF DESIGN IN THE FEDERAL INCOME TAX SYSTEM

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Taxpayer choice pervades the federal income tax system. This choice can be made either implicitly, whereby the taxpayer arranges his economic and/or legal affairs so as to qualify for his desired tax treatment, or explicitly, whereby the taxpayer merely tells the Internal Revenue Service how he wishes to be treated for tax purposes, without having to take any specific non-tax actions or structure his financial or legal dealings in any particular way. Scholars often focus on implicit taxpayer choice and seek to hinder that type of tax planning. However, explicit taxpayer choice garners little scholarly attention. This hole in the literature is surprising given that explicit taxpayer choices, in the form of tax elections, generally reflect pure tax-planning opportunities that are affirmatively granted to taxpayers by Congress and the Treasury Department and given that tax elections continue to be added to the Internal Revenue Code. To help fill this gap, this Article provides a framework for understanding how explicit tax elections are and should be used in the federal income tax system. Specifically, by drawing on a wide variety of tax elections, this Article discusses problems that may be caused by the use of explicit tax elections, identifies and assesses four major functions served by explicit tax elections, and derives a few generally applicable recommendations about how to design explicit tax elections so as to maximize their efficacy and minimize criticisms of their use. Despite the many compelling criticisms of the availability of explicitly provided taxpayer choices, this Article argues that carefully conceived explicit elections can be valuable tools in the design and administration of the tax system. Moreover, by isolating and analyzing situations where Congress and the Treasury affirmatively turn over to the taxpayers the right to determine their own tax consequences, this study of explicit elections can provide insight into the broader balance of power between taxpayers and the government. And, at the very least, this Article brings scholarly attention to the under-studied role of explicit elections in the tax system.

I. Introduction

Taxpayers wield significant power to choose how they will be treated for federal income tax purposes.[1] In fact, all tax planning reflects taxpayers'

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[1] Taxpayer choice is contrary to the notion that taxes are compulsory transfers of funds to the government. *See, e.g.,* United States v. LaFranca, 282 U.S. 568, 572 (1931) ("A 'tax' is an enforced contribution to provide for the support of government."); Adams v. Comm'r, 110

choices to find some way to obtain particular tax benefits. Most taxpayer choice is exercised implicitly through taxpayer action—the taxpayer arranges his economic and/or legal affairs so as to qualify for his desired tax treatment.[2] But other taxpayer choice is explicit—the taxpayer merely tells the Internal Revenue Service ("IRS" or "Service") how he wishes to be treated for tax purposes; he need not take any specific non-tax actions or structure his financial or legal dealings in any particular way in order to obtain his preferred tax treatment. For example, before 1997, an unincorporated business entity could make an implicit choice about its tax classification; if it wanted to be taxed as a partnership, it could choose partnership tax classification by arranging its legal and business affairs to ensure that the entity lacked a majority of the following corporate characteristics: limited liability, continuity of life, free transferability of interests, and centralized management.[3] The check-the-box regulations, effective as of 1997, turned this implicit choice into an explicit choice. Pursuant to these regulations, an unincorporated business entity could choose its tax classification merely by checking a box on a form; the entity could adopt whatever provisions regarding limited liability, management, continuity of life, and transferability of interests best suited the business, unconstrained by the tax consequences.[4]

The literature regarding tax planning (and its less benign cousins, tax avoidance and tax evasion[5]) pays significant attention to the role of implicit

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T.C. 137, 139 (1998), *aff'd* 170 F.3d 173 (3d Cir. 1999), *cert. denied* 528 U.S. 1117 (2000) (explaining that "uniform, mandatory participation in the Federal income tax system . . . is a compelling governmental interest" (citing Hernandez v. Comm'r, 490 U.S. 680, 699–700 (1989) and United States v. Lee, 455 U.S. 252, 260 (1982))); ORG. FOR ECON. CO-OPERATION & DEV., THE OECD CLASSIFICATION OF TAXES AND INTERPRETATIVE GUIDE 4 (2004), *available at* http://www.oecdwash.org/PUBS/ELECTRONIC/SAMPLES/revenue_methodology 2004.pdf (defining taxes as "compulsory, unrequited payments to general government"); *cf.* Treas. Reg. § 1.901-2(a)(2)(i) (as amended in 2008) ("A foreign levy is a tax if it requires a compulsory payment pursuant to the authority of a foreign country to levy taxes."). However, the extent to which the federal income tax is truly compulsory is questionable, given the tax elections discussed herein, other opportunities for taxpayers to reduce their taxes through tax planning, and taxpayers' imperfect compliance with the tax laws.

[2] For example, when a taxpayer makes an investment in a business, the investor and the business can choose whether the investment will be taxed as debt or as equity by choosing financial terms for the investment. Thus, the choice of the particular financial terms for the investment implies a choice of tax treatment for the investment.

[3] Treas. Reg. § 301.7701-2(a)(1) to (3) (1960) (amended Dec. 18, 1996).

[4] Treas. Reg. § 301.7701-3 (as amended by T.D. 8697, 1997-1 C.B. 215). However, the line between implicit tax choices and explicit tax choices can be difficult to draw in some situations. For example, although a taxpayer who receives a compensatory grant of restricted stock has the ability to make an explicit § 83(b) election about the timing of tax on that stock, the taxpayer and his employer also likely negotiated about the form of compensation, and thus, the explicit § 83(b) election is only available because the employer made the implicit choice to provide some of the taxpayer's compensation in the form of restricted stock. *See also infra* text accompanying notes 192–95.

[5] The ultimate exercise of taxpayer choice involves the fundamental decision of whether to comply with the tax law at all. There is a wealth of literature discussing how taxpayers choose between complying and evading the tax law. *See, e.g.*, Leslie Book, *Study of the Role of Preparers in Relation to Taxpayer Compliance with Internal Revenue Laws*, *in* 2 NAT'L TAXPAYER ADVOCATE, 2007 ANNUAL REPORT TO CONGRESS 44 (2007), *available at* http://

taxpayer choice.[6] Scholars generally conclude that the ability of taxpayers to select their tax treatment by arranging their business affairs in particular ways is detrimental to societal welfare, especially where such arrangements lack economic substance.[7] Thus, commentators generally seek to stymie the exercise of implicit taxpayer choice.[8]

Despite this emphasis on "design[ing] an income tax with a basic structure that does not encourage tax planning,"[9] little scholarly attention has been paid to tax elections that explicitly invite taxpayers to choose their preferred tax treatment.[10] This dearth of discussion is surprising given that

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www.irs.gov/pub/irs-utl/arc_2007_vol_2.pdf; Jeff T. Casey & John T. Scholz, *Beyond Deterrence: Behavioral Decision Theory and Tax Compliance*, 25 LAW & SOC'Y REV. 821 (1991); Michael J. Graetz et al., *The Tax Compliance Game: Toward an Interactive Theory of Law Enforcement*, 2 J.L. ECON. & ORG. 1 (1986); Marjorie E. Kornhauser, *Normative and Cognitive Aspects of Tax Compliance: Literature Review and Recommendations for the IRS Regarding Individual Taxpayers*, *in* 2 NAT'L TAXPAYER ADVOCATE, *supra*, at 44; Leandra Lederman, *The Interplay Between Norms and Enforcement in Tax Compliance*, 64 OHIO ST. L.J. 1453 (2003). This Article discusses a different kind of choice—choices that taxpayers make *within* the bounds of the tax law.

[6] *See, e.g.*, Michael S. Knoll, *Tax Planning, Effective Marginal Tax Rates, and the Structure of the Income Tax*, 54 TAX L. REV. 555 (2001) (discussing how the marginal tax rates encourage taxpayers to take actions that reduce taxes); David M. Schizer, *Frictions as a Constraint on Tax Planning*, 101 COLUM. L. REV. 1312 (2001) [hereinafter Schizer, *Frictions*] (discussing that taxpayers can avoid the tax consequences of reforms by making relatively small changes to their business deals); *cf.* MYRON S. SCHOLES ET AL., TAXES AND BUSINESS STRATEGY: A PLANNING APPROACH (3d ed. 2005) (discussing how businesses can take actions that allow them to effectively tax plan). Tax shelters are merely an extreme manifestation of tax planning through the arrangement of a taxpayer's affairs in a particular way (i.e., implicit taxpayer choice), so the literature regarding tax shelters is included as part of the literature on limiting implicit taxpayer choice. *See, e.g.*, Joseph Bankman, *The Tax Shelter Problem*, 57 NAT'L TAX J. 925 (2004); Shannon Weeks McCormack, *Tax Shelters and Statutory Interpretation: A Much Needed Purposive Approach*, 2009 U. ILL. L. REV. 697 (2009); David A. Weisbach, *Ten Truths about Tax Shelters*, 55 TAX L. REV. 215, 222–25 (2002) (arguing that since there is no way to distinguish tax shelters from "legitimate" tax planning, one should be suspicious of all tax planning); George K. Yin, *Getting Serious About Corporate Tax Shelters: Taking a Lesson from History*, 54 SMU L. REV. 209 (2001).

[7] *See, e.g.*, Knoll, *supra* note 6, at 555–56; Schizer, *Frictions*, *supra* note 6 (noting that tax planning can lead to waste and inequity); Joel Slemrod & Shlomo Yitzhaki, *The Costs of Taxation and the Marginal Efficiency Cost of Funds*, 43 IMF STAFF PAPERS 172, 178 (1996) (discussing that the costs of tax planning include "regular deadweight loss—the inefficiency caused by the reallocation of activities by taxpayers who switch to nontaxed activities; . . . and avoidance costs—the cost incurred by a taxpayer who searches for legal means to reduce tax liability); Weisbach, *supra* note 6, at 222–25 (arguing that all tax planning is inefficient and "positively bad for society").

[8] *See, e.g.*, Schizer, *Frictions*, *supra* note 6 (discussing the extent to which tax planning can be curtailed by relying on "frictions"); David M. Schizer, *Sticks and Snakes: Derivatives and Curtailing Aggressive Tax Planning*, 73 S. CAL. L. REV. 1339 (2000) [hereinafter Schizer, *Sticks*] (discussing how tax reforms can be designed to "aggravate the planning option"); Daniel N. Shaviro, *Economic Substance, Corporate Tax Shelters, and the Compaq Case*, 88 TAX NOTES 221, 223 (2000) (discussing the desirability of an economic substance approach to curtailing "socially undesirable tax planning").

[9] Knoll, *supra* note 6, at 556.

[10] There is some scholarship that examines specific elections. *See, e.g.*, Lori Farnan, *A Mandatory Section 338: Can It Be Implemented*, 42 FLA. L. REV. 679 (1990); Heather M. Field, *Checking In on "Check-the-Box"*, 42 LOY. L.A. L. REV. 451 (2009). There is also some literature discussing the common law doctrine of election, i.e., the concept that where a tax-

tax elections generally reflect pure tax-planning opportunities[11] that are affirmatively bestowed upon taxpayers by Congress or the Treasury.[12] In the limited situations where scholars have addressed the availability of explicitly provided choices in the form of tax elections, they generally criticize tax elections as complex, costly, revenue-reducing, and inequitable, while paying little more than lip service to tax elections' potential value.[13]

Nevertheless, explicit elections are littered[14] throughout the Internal Revenue Code ("Code").[15] Explicit elections have been part of the tax system since at least the 1920s,[16] and both Congress and the Treasury continue

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payer has "a free choice between two or more alternatives" and makes "an overt act . . . communicating the choice to the Commissioner," the taxpayer is bound by his choice. *See, e.g.*, Aubree L. Helvey & Beth Stetson, *The Doctrine of Election*, 62 TAX LAW. 335 (2009) (citing I.R.S. Tech. Adv. Mem. 2002-52-059 (Dec. 27, 2002)); Steve R. Johnson, *The Taxpayer's Duty of Consistency*, 46 TAX L. REV. 537, 577–80 (1991) (discussing various doctrines that impose consistency requirements on taxpayers). Additionally, there are some articles addressing issues of compliance with, and revocation of, tax elections. *See, e.g.*, MICHAEL B. LANG & COLLEEN A. KHOURY, FEDERAL TAX ELECTIONS ch. 2 (1996); Victoria A. Levin, *The Substantial Compliance Doctrine in Tax Law: Equity vs. Efficiency,* 40 UCLA L. REV. 1587 (1993); John MacArthur Maguire & Philip Zimet, *Hobson's Choice and Similar Practices in Federal Taxation*, 48 HARV. L. REV. 1281, 1285–93 (1935); Edward Yorio, *The Revocability of Federal Tax Elections*, 44 FORDHAM L. REV. 463 (1976). However, there are many fewer pieces discussing whether taxpayers should be entitled to choose how they will be taxed; to date, the most comprehensive discussion of this question is included as the first chapter in Michael Lang and Colleen Khoury's treatise on federal tax elections. *See* LANG & KHOURY, *supra*, at ch. 1 (lamenting the "dearth of authority" and trying to "cast some light, albeit indirectly at times, on these questions"). However, even Lang and Khoury's treatise, which was last updated in 1996, primarily focuses (quite usefully and admirably) on collecting and explaining the details of particular elections. *See id.* H. David Rosenbloom also spends just a few pages discussing the role of tax elections in our tax system. *See* H. David Rosenbloom, *Banes of an Income Tax: Legal Fictions, Elections, Hypothetical Determinations, Related Party Debt*, 26 SYDNEY L. REV. 17, 22–27 (2004).

[11] As explained above, in order to exercise explicit choice, a taxpayer need not arrange his business or economic affairs in any particular way. Thus, explicit elections generally lack non-tax business consequences. As a result, a taxpayer only needs to take tax consequences into account when making a decision about whether or not to make an explicit election. In this respect, the tax consequences are driven solely by taxpayer preference, divorced from the substance or form of the underlying facts.

[12] In comparison, tax-planning opportunities via implicit taxpayer choices exist anywhere there are multiple different tax regimes. Implicit choices are merely byproducts of generally applicable tax laws, whereas explicit choices reflect a specific intent to grant choices to taxpayers.

[13] *See infra* Part II.

[14] The TAX ELECTIONS DESKBOOK, which provides technical information about how and when to make specific elections, lists well over 300 tax elections. PRACTITIONERS PUBL'G CO., TAX ELECTIONS DESKBOOK ch. 1 (11th ed. 2005) [hereinafter TAX ELECTIONS DESKBOOK]; *see also* Treas. Reg. §§ 301.9100-1 to -21 (as amended in 2008) (identifying about 200 elections and providing guidance about the technical aspects of making such elections).

[15] Unless otherwise stated, all "section" references and references to the "Code" herein refer to the Internal Revenue Code of 1986, as amended, and the Treasury Regulations promulgated thereunder.

[16] *See, e.g.*, Revenue Act of 1921, ch. 136, § 240, 42 Stat. 227, 260 (current version at I.R.C. § 1501 (2006)) (making the filing of consolidated returns optional rather than mandatory); Revenue Act of 1918, ch. 18, § 223, 40 Stat. 1057, 1074 (1919) (current version at I.R.C. § 6031(a) (2006)) (allowing some married couples to choose to file a joint return rather than two separate returns). *See generally* Maguire & Zimet, *supra* note 10, at 1288–91

to add them to the Code and the Treasury Regulations,[17] sometimes without any explanation as to why the determination of the applicable tax treatment should be completely ceded to the taxpayer.[18] Thus, this Article seeks to provide a framework for understanding and evaluating the use of explicit tax elections in the federal income tax system. Using this framework, this Article argues that explicit tax elections, in limited circumstances and when properly designed, can be employed to accomplish valuable policy goals.

In order to develop this framework, Part II of this Article explains how common criticisms of tax planning may resonate particularly strongly in the context of explicit tax elections. Then, based on an examination of numerous elections available in the federal income tax system,[19] Part III describes four major functions served by explicit elections: reconciling discontinuous regimes, facilitating tax classification, promoting simplicity and administrability, and otherwise condoning tax planning. The Part assesses each of these four functions of explicit elections by examining arguments in favor of and against each such use and by identifying key considerations that should be taken into account when evaluating each such use of an election. Part IV, which presents the last part of the framework, draws on experiences with many tax elections in order to distill a few generally applicable recommendations about how to design explicit tax elections so as to maximize their efficacy and minimize criticisms of their use. Part V concludes.

Ultimately, this Article provides a framework for analyzing how explicit tax elections are used and should be used in the federal income tax. This Article concludes that, despite the many compelling criticisms of explicitly provided taxpayer choices, well-designed tax elections can be useful tools in the administration of the federal income tax. Moreover, by focusing on tax elections, which are, admittedly, only a narrow subset of the choices afforded to taxpayers, this Article isolates and analyzes some of the situations where Congress and the Treasury decided that it was appropriate to allow taxpayers to determine their own tax treatment and engage in tax plan-

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(mentioning several elections available prior to 1935, including the two cited in this footnote and the "election to pay tax by installment," among others).

[17] *See, e.g.*, I.R.C. § 108(i) (enacted in the American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 1231(a), 123 Stat. 115, 338–41 (to be codified in 26 U.S.C.), allowing taxpayers to elect to defer the inclusion of income from certain cancellation of indebtedness income); *id.* § 172(b)(1)(H) (2006) *amended by* American Recovery and Reinvestment Act of 2009 at § 1211, 123 Stat. 335–36 (to be codified in 26 U.S.C.) (allowing certain small businesses to elect to carryback net operating losses beyond the normal two-year carryback period); Treas. Reg. § 1.482-9(n) (2009) (providing that certain taxpayers could elect to apply new transfer pricing regulations retroactively).

[18] *See, e.g.*, H.R. Rep. No. 108-755, at 634–35 (2004) (Conf. Rep.) (noting that the conference agreement adds an election to newly added § 362(e), despite the absence of that election in either the House or Senate bills and without giving much explanation for the addition of the election).

[19] This Article's inquiry is generally limited to the U.S. federal income tax as applied to individuals, corporations, and partnerships because those are the disciplines with which the author is most familiar. However, this Article's discussion of explicit elections can be expanded to include other tax regimes as well, such as the estate tax.

ning. This analysis provides insight into, and invites further scholarly discussion of, broader questions about the role of taxpayers in determining their own tax treatment and about the relationship between taxpayers and the tax system.

II. The Trouble with Explicit Elections

Many tax academics seem to have an instinctive distaste for explicit elections in the tax system.[20] While there is not an extensive body of literature explaining the aversion to the use of explicit elections,[21] scholars' discomfort with the use of tax elections is not surprising given that explicit elections raise many of the same normative concerns as general tax planning opportunities,[22] which have garnered a substantial amount of academic attention.[23] The availability of tax planning opportunities is criticized as complex, costly, wasteful, revenue reducing, and inequitable,[24] and these critiques may resonate particularly strongly in the context of explicit elections.[25]

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[20] *See, e.g.*, George K. Yin, *The Taxation of Private Business Enterprises: Some Policy Questions Stimulated by the "Check-the-Box" Regulations*, 51 SMU L. Rev. 125, 129–34 (1997) (questioning why the taxation of business enterprise should be determined by explicit taxpayer election). Anecdotal evidence of this distaste for the use of elections in tax law also comes from conversations that the author had with other tax professors in starting to think about this project (one of whom frankly said about elections, "My tendency is not to like them.") and from the resistance encountered in response to the author's proposal for an explicitly elective approach to the taxation of partnership mergers, divisions, and incorporations. *See* Heather M. Field, *Fiction, Form, and Substance in Subchapter K: Taxing Partnership Mergers, Divisions, and Incorporations*, 44 San Diego L. Rev. 259 (2007).

[21] *See supra* note 10.

[22] References herein to tax planning opportunities include the availability of implicit choices, whereby taxpayers can arrange their economic and legal affairs so as to obtain favorable tax treatment rather than less favorable tax treatment. While Judge Learned Hand famously noted in *Helvering v. Gregory,* 69 F.2d 809, 810 (2d Cir. 1934), that "[a]ny one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes," the policy issues raised by tax planning lead commentators to seek ways to curtail tax planning. *See supra* notes 7–8.

[23] *See, e.g.*, Shaviro, *supra* note 8; Schizer, *Frictions*, *supra* note 6; Schizer, *Sticks*, *supra* note 8; Weisbach, *supra* note 6.

[24] *See, e.g.*, Schizer, *Sticks*, *supra* note 8, at 1351–54.

[25] It is important to note that each general criticism may not be equally applicable to every individual tax election. That is, some elections may create more complexity than others, some elections may result in more revenue reduction than others, and some elections may create more inequity than others.

Explicit elections can create complexity in several ways.[26] A taxpayer must determine whether he is eligible to make the election;[27] if eligible, the taxpayer must analyze the benefits and burdens of each alternative available pursuant to the election, just as taxpayers must do when considering other tax planning opportunities.

Determining which alternative is more favorable may be relatively easy where all of the relevant facts are known and where the election applies only to a single event with no impact on the future, such as a taxpayer's decision whether to take the standard deduction or itemize deductions in a particular year.[28] However, determining whether an election is favorable can be difficult, particularly if the election binds the taxpayer for future tax years, as with many accounting elections[29] or the election to file consolidated returns.[30] Deciding whether or not to make an election may also be difficult if the decision requires the taxpayer to predict what his economic and tax situation will be in the future,[31] as in the choice of business tax regime[32] or the

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[26] *See* TAX ELECTIONS DESKBOOK, *supra* note 14, ¶ 1C (discussing the "inherent complexity" of elections); Am. Bar Ass'n, *Report of the Task Force on International Tax Reform*, 59 TAX LAW. 649, 662, 690 (2006) ("[e]very election . . . increases complexity and compliance burdens. . . . Taxpayers must determine which election choice is most favorable"); Yin, *supra* note 20, at 130 (calling elections "inherently costly and complex for the taxpayer"); Yorio, *supra* note 10, at 463 ("Before a taxpayer makes a Code election, he should analyze at least three critical factors."). The following discussion regarding the complexity problems raised by explicit elections draws on these resources.

[27] Some elections have numerous eligibility requirements. For example, in order to elect to be treated as an S corporation, the corporation may not have more than 100 shareholders, may not have more than one class of stock, and may not have certain types of shareholders. I.R.C. § 1361(b)(1) (2006). Determining whether some of these eligibility requirements are satisfied can be less straightforward than it appears. *See, e.g.*, *id.* § 1361(c)(1) (2006) (treating certain members of a family as a single shareholder); *id.* § 1361(c)(5) (2006) (addressing whether debt will be treated as a second class of stock); Treas. Reg. § 1.1361-1(b)(3) to -1(b)(5) (as amended in 2008) (setting forth rules for determining whether there is more than one class of stock); *infra* Part IV.B (discussing the impact of eligibility limitations as a key consideration in designing elections). *See generally* JAMES S. EUSTICE & JOEL D. KUNTZ, FEDERAL INCOME TAXATION OF S CORPORATIONS ch. 3 (2008) (devoting an entire chapter to the eligibility criteria for making a Subchapter S election).

[28] *See* I.R.C. § 63 (2006).

[29] *See, e.g.*, *id.* §§ 441(f), 444 (2006) (choosing a taxable year).

[30] *See id.* § 1501 (2006); Treas. Reg. § 1.1502-75(a)(2) (as amended in 2009).

[31] In some circumstances, this difficulty in determining which elective alternative is better may actually reduce the incentive to plan and the risk of abuse. Thus, where this uncertainty is present, elections may not be particularly problematic. *See infra* Part III.D.2.

[32] Subject to eligibility requirements, a business can elect to be taxed as a partnership under Subchapter K of the Code, as a corporation under Subchapter C of the Code, or as a small business corporation under Subchapter S of the Code. The desirability of one regime rather than another depends on a variety of factors, including predictions about the amount of future income/loss of the business. *See, e.g.*, Darryll K. Jones & David Kirk, *Choice of Entity Planning After JGTRRA: Brainstorming the Triple Split*, BUS. ENTITIES, March/April 2004, at 18 (discussing various considerations relevant to choosing among these business tax regimes); John W. Lee, *A Populist Political Perspective of the Business Tax Entities Universe: "Hey the Stars Might Lie but the Numbers Never Do"*, 78 TEX. L. REV. 885 (2000) (same); Leslie H. Loffman & Sanford C. Presant, *Choice of Entity—Business and Tax Considerations*, *in* 799 PRACTISING LAW INST., TENTH ANNUAL REAL ESTATE TAX FORUM 307 (2008) (same). In addition, certain businesses can elect to be taxed pursuant to one of numerous specialized regimes

decision whether or not to make a section 83(b) election for property received in connection with the provision of services.[33] If, after weighing the benefits and costs of an explicit election, a taxpayer decides to make the election, the taxpayer is not required to alter his economic transaction to achieve the desired tax treatment. Thus, it is easier to engage in tax planning using explicit elections than using implicit elections. However, even after deciding to make an election, implementing the explicit election can still be complex—the taxpayer must determine the method for making the election, including identifying what format the election must take and determining when the election must be filed.[34] These kinds of requirements are specific to explicit elections as a category (as opposed to implicit elections) and vary from election to election. Sometimes the requirements are so unclear and the details so complicated that an entire treatise is dedicated solely to explaining how and when to make each election.[35]

Once the technical requirements for making an election are determined, the taxpayer must prepare and file the election accordingly. All of these complexities are exacerbated by the possibility of errors along the way—errors in determining eligibility for the election, evaluating the pros and cons of making the election, identifying the manner and time frame for the election, and actually making the election.[36] As a result, taxpayers may try to

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for taxing particular types of businesses. *See, e.g.*, I.R.C. §§ 851–855 (2006 & Supp. I 2007) (regulated investment companies); *id.* §§ 856–859 (2006 & Supp. I 2007) (real estate investment trusts); *id.* §§ 860A–860G (2006) (real estate mortgage investment conduits).

[33] *See generally* Michael S. Knoll, *The Section 83(b) Election for Restricted Stock: A Joint Tax Perspective*, 59 SMU L. REV. 721 (2006) (discussing a variety of considerations relevant to determining whether a § 83(b) election should be made, including risk of forfeiture, volatility in stock price, and changes in tax rates, among others).

[34] Where there is clear guidance about how to make the election and an IRS form on which the election must be made, it can be relatively straightforward to determine how to make the election. *See, e.g.*, Treas. Reg. § 301.7701-3(c) (as amended in 2006) (specifying some of the technical details about when and how to make an entity classification election); IRS, ENTITY CLASSIFICATION ELECTION, IRS FORM 8832 (2007), *available at* http://www.irs.gov/pub/irs-pdf/f8832.pdf (providing the form on which entity classifications are made). However, this is often not the case. For example, until regulations were proposed in August 2008, taxpayers lacked guidance about how to make an election under § 336(e). *See* Regulations Enabling Elections for Certain Transactions Under Section 336(e), 73 Fed. Reg. 499965-02 (proposed Aug. 25, 2008) (proposing regulations that explain how to make § 336(e) elections). Similarly, practitioners pushed the IRS to quickly issue guidance that explains the details for making an election under recently enacted § 108(i). *See* Amy S. Elliott, *ABA Section of Taxation Meeting: Practitioners Request Guidance on New COD Deferral Election*, 123 TAX NOTES 831 (2009).

[35] *See generally* TAX ELECTIONS DESKBOOK, *supra* note 14, ¶ 1A. This treatise is a very useful manual for explaining how to make elections, but it does not provide any policy or normative insight into the use of elections.

[36] *See* Levin, *supra* note 10, at 1588 ("Because the elections are so complicated, even well-trained, meticulous tax professionals are bound to make errors."); Yin, *supra* note 20, at 130 (noting "the possibility of error in making that choice" and using the experience with Subchapter R of the 1954 Code as an example of a tax provision where an election "proved to be a trap for the unwary"). Where taxpayers do not make an election correctly, they can be denied their desired treatment. *See, e.g.*, Miller v. Comm'r, 99 F.3d 1042 (11th Cir. 1996) (failure to "unequivocally and unambiguously communicate[ ]" the election makes the desired election ineffective).

argue that a technically deficient election should still be effective,[37] may seek leave to file a late election,[38] or may desire to revoke an ill-advised election,[39] all of which add complexity to the tax system.

This complexity for taxpayers is often mirrored by the administrative burden placed on the IRS.[40] The IRS must process explicit elections to ensure taxpayer eligibility and compliance with the technical requirements for the time and manner of making the election.[41] In addition, some elections require Service consent,[42] which forces the Service to devote resources to determine whether to allow the election in a particular circumstance. Further, the IRS must deal with taxpayers who wish to file late elections or who wish to revoke ill-advised elections. The IRS makes many private letter rulings on these issues,[43] and sometimes litigation ensues.[44] To the extent that the issues arise because of the requirement that the explicit election be com-

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[37] *See, e.g.*, Tax Elections Deskbook, *supra* note 14, ¶ 1F (discussing the doctrine of substantial compliance); Levin, *supra* note 10 (same).

[38] Tax Elections Deskbook, *supra* note 14, ¶ 1E (discussing extensions of time for making elections); Treas. Reg. § 301.9100-1 to -3 (as amended in 1997) (providing rules regarding extensions of time to file elections).

[39] *See, e.g.*, Yorio, *supra* note 10, at 465.

[40] *See generally* Lang & Khoury, *supra* note 10, ¶ 1.02[1][c].

[41] Of course, this process may be more or less burdensome for the Service, depending on how complex the eligibility requirements are for the particular election. Additionally, the Service is often tasked with the responsibility for setting these technical requirements because the statute often does not specify how or when a particular election is to be made. *See, e.g.*, I.R.C. § 754 (2006) (explicitly leaving to the Secretary the responsibility of determining how and when the election is made). Lang and Khoury identify an administrative problem with this approach, explaining that "[a]lthough an argument can be made that such matters are best left to regulations, delays in the regulatory process often mean that even the most basic questions of election procedure, such as the time for filing, are undecided for years after the governing statute has been enacted." Lang & Khoury, *supra* note 10, ¶ 1.02[1][c] n.21.

[42] *See, e.g.*, I.R.C. § 442 (2006) (allowing a taxpayer to change its accounting period only if the change is approved by the Secretary); Treas. Reg. § 301.7701-3(c)(iv) (as amended in 2006) (limiting elective changes in entity classification to situations where certain factual requirements are satisfied and the Commissioner permits the change). *See generally* Lang & Khoury, *supra* note 10, ¶ 2.05 (discussing consent requirements). To alleviate some of this administrative burden, the Service has provided for procedures pursuant to which a taxpayer can obtain automatic consent for certain elections. *See, e.g.*, Rev. Proc. 2008-52, 2008-36 I.R.B. 587, 606 (providing "procedures by which a taxpayer may obtain automatic consent for a [specifically identified elective] change in method of accounting").

[43] *See, e.g.*, I.R.S. Priv. Ltr. Rul. 2008-24-003 (June 13, 2008) (allowing a late entity classification election); I.R.S. Priv. Ltr. Rul. 98-35-012 (Aug. 28, 1998) (same). The administrative burden of dealing with late elections is partly alleviated by Treasury Regulations which already provide for an automatic extension of the time in which a taxpayer can file an election. Treas. Reg. § 301.9100-2 (1997). However, the Service must still deal with the many taxpayers who request discretionary extensions under Treas. Reg. § 301.9100-3 (1997), and this requires the Service to make a factually intensive determination as to whether the "taxpayer acted reasonably and in good faith." Treas. Reg. § 301.9100-3(a), (b) (1997).

[44] *See, e.g.*, Cloutier v. United States, 709 F.2d 480 (7th Cir. 1983) (involving ability to make a late election); Georges v. IRS, 916 F.2d 1520 (11th Cir. 1990) (involving ability to revoke an election).

municated to the IRS in a particular manner, many of these administrative complications are unique to explicit tax elections.[45]

The complexity and administration requirements that may be created by explicit elections come at a cost. Taxpayers must either spend the time and energy themselves to undertake the election analysis, or they must pay tax advisors to do so. Either way, the tax planning necessitated by the availability of explicit elections may be expensive. Thus, resources are likely wasted by taxpayers in the election analysis[46] and by the IRS in administering the election.[47] However, although these costs may waste societal resources, explicit choices allow a taxpayer to achieve a particular tax treatment without having to alter his non-tax economic and legal arrangements, as is necessary with implicit choices.[48] Thus, explicit elections may actually distort business and economic choices less than implicit tax planning opportunities. This minimization of distortion may reduce "standard deadweight loss"—"the inefficiency caused by the reallocation of activities by taxpayers who switch" to lower-tax activities that the taxpayers would not otherwise prefer.[49] The net effect of these costs (both created and saved) on the efficiency of the tax system is likely situation-specific, depending on how and to what extent affording the explicit choice of tax treatment in a particular situation leads taxpayers to change their behaviors. More broadly, the net effect depends on what impact the availability of the election has on the performance of the economy and overall societal welfare.

While the efficiency consequences of the use of explicit elections may not be entirely clear and may vary from election to election, it is virtually axiomatic to say that explicit elections reduce tax revenue.[50] Explicit elections, by definition, affect taxes only; they lack non-tax legal impact. Ac-

[45] For example, entity classification elections must be filed with the IRS in a specific time window. Treas. Reg. § 301.7701-3 (as amended in 2006). In response to the administrative burden imposed by taxpayers who often requested leave to file late, the IRS recently issued guidance providing for "a longer period and simplified procedure to request relief from unfiled or misclassified check-the-box elections." Jeremiah Coder, *IRS Extends Filing Period for Entity Classification Requests*, 124 Tax Notes 976 (2009) (discussing Rev. Proc. 2009-41, 2009-39 I.R.B. 1). In contrast, implicit elections do not pose such burdens because the election is made via the way the taxpayer arranges his economic and legal affairs and not via the filing of a form with the IRS.

[46] Using the terminology of Professors Slemrod and Yitzhaki (as Dean Schizer did in Schizer, *Sticks*, *supra* note 8, at 1349–53), these costs include "avoidance costs" (i.e., "the cost incurred by a taxpayer who searches for legal means to reduce tax liability") and "compliance costs" (i.e., "the costs imposed on the taxpayer to comply with the law"). *See* Slemrod & Yitzhaki, *supra* note 7, at 178.

[47] These costs are "administrative costs" (i.e., "the costs of . . . maintaining a tax administration"). Slemrod & Yitzhaki, *supra* note 7, at 178.

[48] For example, the adoption of new entity classification regulations effective in 1997 turned an implicit choice into an explicit choice and thereby eliminated the need for unincorporated entities to agree to particular business terms in order to achieve a desired tax treatment. *See supra* text accompanying notes 3–4.

[49] *See* Slemrod & Yitzhaki, *supra* note 7, at 178.

[50] Reuven S. Avi-Yonah, *To End Deferral as We Know it: Simplification Potential of Check-the-Box*, 74 Tax Notes 219, 221 (1997); Yin, *supra* note 20, at 130.

cordingly, a well-advised rational taxpayer will almost always[51] exercise the election in a way that minimizes its tax liability, at the expense of the fisc.[52] Moreover, the opportunity to use an explicit tax election to reduce tax liability may facilitate tax shelter activity,[53] particularly given that, with an explicit election (as opposed to an implicit election), taxpayers need not alter their non-tax economic arrangements in order to obtain favorable tax treatment.[54] That is, explicit elections generally lack "frictions" that impede the use of the election for tax minimization purposes.[55] Further, taxpayers and their advisors may devise unanticipated ways to use explicit elections to reduce tax liability. For example, the use of the entity classification election for foreign entities has been heavily criticized as leading to abuse,[56] and the safe-harbor leasing election was ultimately repealed in response to taxpayer abuse.[57]

The ability of taxpayers to use explicit elections to reduce their tax liabilities may also lead to inequity. While all taxpayers who are eligible for a particular election are treated equally in the sense that they have the same right to make the choice, the availability of an election "allows persons undertaking the same activity to obtain different tax results" simply because some taxpayers choose not to make the election.[58] Additionally, an election, while technically available to all eligible taxpayers, may be functionally available only to the wealthiest, most sophisticated group of taxpayers, who can best navigate the complexity of the election process.[59] As with tax planning in general, other taxpayers may lack the knowledge or resources to pay for advice that would enable them to take full advantage of the election.[60]

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[51] One significant (but difficult to explain) exception is that businesses sometimes elect to use the slower straight line depreciation rather than accelerated depreciation. *Cf.* Karl Ove Aarbu & Jeffrey K. MacKie-Mason, *Explaining Underutilization of Tax Depreciation Deductions: Empirical Evidence from Norway*, INT'L TAX AND PUB. FIN., May 2003, at 229 (discussing possible explanations for taxpayer choices to claim less than the maximum amount of depreciation).

[52] Effectively, this enables taxpayers who are eligible to make an election to reduce their tax liabilities, while ineligible taxpayers lack the opportunity to reduce their taxes. This consequence implicates the intensely ideological questions of which taxpayers should see their tax bills reduced, and who should be empowered to decide which taxpayers experience a reduction in their tax bills.

[53] For example, the § 754 election was central to certain tax shelters like the "Son of BOSS" structures. *See, e.g.*, Brandon Ridge Partners v. United States, No. 8:06-cv-1340-T-24MAP, 2007 WL 2209129, at *4 (M.D. Fla. July 30, 2007).

[54] *See generally* Joshua D. Blank, *Confronting Continuity: A Tradition of Fiction in Corporate Reorganizations*, 2006 COLUM. BUS. L. REV. 1, 57 (2006).

[55] *See generally* Schizer, *Frictions*, *supra* note 6.

[56] *See* Field, *supra* note 10, at 487–91 (collecting authorities and summarizing the criticisms of using the entity classification election for foreign entities).

[57] Blank, *supra* note 54 (citing Alan J. Auerbach & Alvin C. Warren, *Transferability of Tax Incentives and the Fiction of Safe Harbor Leasing*, 95 HARV. L. REV. 1752 (1982)).

[58] STAFF OF THE JOINT COMM. ON TAXATION, 100TH CONG., A RECONSIDERATION OF TAX EXPENDITURE ANALYSIS 65 n.149 (Comm. Print 2008).

[59] *See generally* Rosenbloom, *supra* note 10, at 23–26.

[60] However, to the extent that an explicit election is used in lieu of an implicit election, the use of an explicit election may actually increase fairness by enabling lower-income and less

Moreover, explicit choices, like the availability of tax planning in general, may impact taxpayers' perceptions of the fairness of the tax system.[61] Taxpayers may fear that they are "leaving money on the table" because of their lack of knowledge, sophistication, or high-quality advice, while richer taxpayers with high-priced advisors take advantage of elective loopholes. If this is so, it could undermine taxpayer confidence in the tax system, leading to reduced rates of voluntary compliance and greater enforcement needs.[62]

Similarly, the ability of taxpayers to make explicit elections about their own tax treatment seems antithetical to the notion of a compulsory tax system.[63] This deviation from a compulsory system may appear even more egregious with explicit elections because the more favorable tax treatment can be obtained merely by filing a form, without any private costs of restructuring the underlying transaction.[64] Thus, explicit elections, which cede to the taxpayer control over the tax consequences of particular events and which divorce the tax consequences from the substance of the underlying transaction, may be tantamount to partial deregulation of the tax system.[65]

Notwithstanding all of the foregoing, it would be virtually impossible to eliminate all choice, whether implicit or explicit, from the income tax.[66] As long as there are multiple possible tax classifications, treatments, or applicable regimes, taxpayers will have choices among them. Congress can try to design a system that minimizes the incentives to alter behavior in order to exercise tax choices, but the choices remain.[67] If taxpayers can make implicit tax choices by arranging their substantive affairs to obtain one tax treatment rather than another, there may be situations in which it is preferable, for efficiency, equity, administrability, or other reasons, to allow the choice to

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sophisticated taxpayers to avail themselves of the choice at lower cost. *See infra* notes 87–91 and accompanying text.

[61] *Cf.* Eric A. Posner, *Law and Social Norms: The Case of Tax Compliance*, 86 VA. L. REV. 1781, 1798 n.38 (2000) (citing Massimo Bordignon, *A Fairness Approach to Income Tax Evasion*, 52 J. PUB. ECON. 345 (1993) (arguing that tax compliance is a function of perception of fairness of government spending and of compliance of other taxpayers)).

[62] Danshera Cords, *Tax Protestors and Penalties: Ensuring Perceived Fairness and Mitigating Systemic Costs*, 2005 BYU L. REV. 1515 (2005) (linking taxpayer confidence in the fairness of the tax system with voluntary compliance).

[63] Rosenbloom, *supra* note 10, at 23; *see also* Yin, *supra* note 20, at 130 ("In general, the tax system does not permit taxpayers to elect the rules applicable to them."). However, as noted above, this raises the question of whether the United States does and should have a "compulsory" income tax system. *See supra* note 1.

[64] In contrast, tax planning using implicit elections will generally only be valuable to taxpayers when structuring a transaction to obtain more favorable tax treatment "generate[s] more tax savings than additional private costs." Schizer, *Sticks*, *supra* note 8, at 1349–50.

[65] *See* Steven A. Dean, *Attractive Complexity: Tax Deregulation, the Check-the-Box Election, and the Future of Tax Simplification*, 34 HOFSTRA L. REV. 405 (2005).

[66] Presumably, a head tax, in which all individuals would be taxed the same amount, would eliminate choice from the tax system, but this approach suffers from many other problems. *See generally* Peter Smith, *Lessons from the British Poll Tax Disaster*, 44 NAT'L TAX J. 421, 421–36 (1991) (describing the failure of such a proposal in the United Kingdom).

[67] *See* Knoll, *supra* note 6, at 56.

be made explicitly rather than implicitly.[68] Moreover, whether or not it is wise policy to use explicit elections, they are part of the tax system; they have been since the early part of the twentieth century,[69] and they continue to be added to the Code.[70] Accordingly, it is useful to think carefully about how explicit elections are used in the income tax—in order to evaluate whether existing explicit elections should be removed from the Code, to make educated decisions about whether new explicit elections should be added to the Code, and to determine what factors should be taken into account when designing explicit elections. Thus, the next Part of this Article seeks to understand how explicit elections are, and should be, used in the income tax system.

III. Explicit Elections as Tools in the Federal Income Tax

At the most basic level, all explicit elections involve situations where multiple possible tax treatments could apply to a single economic event or its close substitute.[71] These types of situations arise often in the Code, but typically the applicable tax treatment is determined based on the form or substance of the transaction or based on policy considerations.[72] However,

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[68] *See, e.g.*, David A. Weisbach, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, 84 Cornell L. Rev. 1627 (1999) [hereinafter Weisbach, *Line Drawing*] (arguing in favor of the explicit entity classification election on efficiency grounds).

[69] *See, e.g.*, Revenue Act of 1921, ch. 136, § 240, 42 Stat. 227, 260 (current version at I.R.C. § 1501 (2006)) (allowing corporate groups to elect whether or not to be treated as a consolidated group for tax purposes); Russell S. Bock, *Elections vs. Tax Simplification*, 22 Taxes 304 (1944) (discussing, among other elections, the election to take the standard deduction, as provided for in the Individual Income Tax Act of 1944); W.J. Schwanbeck, *Elections and Options Available to Taxpayers in the 1954 Code*, 32 Taxes 748 (1954) (enumerating tax elections available under the Internal Revenue Code of 1954).

[70] *See supra* note 17 (identifying a few examples of explicit elections adopted in 2009); *see also, e.g.*, I.R.C. § 108(a)(2)(C) (Supp. I 2007) (added by the Mortgage Forgiveness Debt Relief Act of 2007, Pub. L. No. 110-148, § 2(c)(2)), 121 Stat. 1803, 1804 (providing insolvent taxpayers with an election with respect to discharge of indebtedness on a qualified personal residence)); *id.* § 164(b)(5)(A) (2006) (added by American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 501, 108 Stat. 1418, 1520–21 (allowing taxpayers to elect to deduct state and local sales taxes instead of state and local income taxes)); *id.* § 355(b)(3)(C) (Supp. I 2007) (added by Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, § 202, 120 Stat. 345, 348 (adding a transitional election to the change in the active trade or business requirement for tax-free corporate divisions)).

[71] For example, the grant of restricted stock (a single economic event) can be taxed either at grant or upon lapse of the restriction; a § 83(b) election allows a taxpayer to choose the former rather than the latter. I.R.C. § 83(b) (2006). Another example is that different tax treatments can apply depending on whether an acquisition of a corporation's business is accomplished as a purchase of the corporation's stock or as a purchase of the corporation's assets (i.e., formal transactions that are close economic substitutes for each other). A § 338 election is available to treat the former like the latter. *Id.* § 338(a) (2006).

[72] For example, financial products may resemble both debt and equity, but their tax treatment as either debt or equity is determined based on the substance of the business arrangement. *See generally* David P. Hariton, *Distinguishing Between Equity and Debt in the New Financial Environment*, 49 Tax L. Rev. 499 (1994); William T. Plumb, *The Federal Income Tax Significance or Corporate Debt: A Critical Analysis and a Proposal*, 26 Tax L. Rev. 369 (1971) (providing a comprehensive discussion of the factors that distinguish debt from equity);

sometimes the Code or Treasury Regulations allow the taxpayer to explicitly choose the applicable tax treatment.[73] As discussed above, it seems antithetical to the notion of a compulsory tax system to allow tax treatment to be determined based solely on the taxpayer's desires. So, the question is why, and under what circumstances, should the tax system explicitly call on the taxpayer to select which of the potential tax treatments will apply to a particular economic event. As this Part will explain, the federal income tax uses explicit elections for numerous purposes, including reconciling discontinuous regimes, facilitating tax classification, promoting simplicity and administrability, and condoning tax planning. Ultimately, this Part demonstrates that, despite the compelling concerns discussed in Part II, explicit elections can serve valuable roles in the tax system, particularly where the tax system itself is imperfect.

A few important caveats are warranted regarding this discussion of explicit tax elections. First, this Part draws primarily on explicit elections available in the federal income taxation of individuals, corporations, and partnerships, as these are the areas of tax law with which the author is most familiar.[74] Many explicit elections in other parts of the Code (particularly in the gift and estate tax) are not addressed herein but do merit further study.[75] Second, the elections discussed herein are divided based on the author's research and analysis regarding their impact. The categorization often corresponds to the legislative or regulatory intent behind allowance of taxpayer choice, but sometimes it does not, particularly where such goals are not well articulated[76] or where there have been significant changes to the tax system since the election was originally adopted.[77] Third, this is not an exhaustive list of possible functions for explicit elections in the tax system. Others may

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Katherine Pratt, *The Debt-Equity Distinction in a Second-Best World*, 53 VAND. L. REV. 1055, 1065–94 (2000).

[73] *See, e.g.*, I.R.C. §§ 83(b), 338 (2006); Treas. Reg. § 301.7701-3 (as amended in 2006).

[74] Note that, even within these fields, this Article does not address all available explicit elections.

[75] This discussion is conceived as a useful place to begin discussions about explicit elections; perhaps additional papers can apply this Article's analysis to those elections. For example, the author has written a separate paper regarding transitional elections, which discusses the role of explicit elections in the specific context of changes in the law. *See* Heather M. Field, *Taxpayer Choice in Legal Transitions*, 29 VA. TAX REV. (forthcoming 2009).

[76] For example, the legislative history does not explain why the § 362(e)(2) election was added to the Code. *See generally infra* Part III.D.3 (discussing this election).

[77] For example, the § 338 election was added to the Code in 1982, in an effort to limit taxpayers' ability to achieve stepped-up basis when purchasing the stock of a target corporation and paying only one level of tax. *See* H.R. REP. NO. 97-760, at 535 (1982) (Conf. Rep.). However, repeal of the so-called *General Utilities* doctrine in 1986 dramatically changed the corporate tax regime in which § 338 operated, and that change largely eliminated the opportunities for achieving stepped-up basis with one level of tax that § 338 originally limited. *See* Mark J. Silverman, *Section 338*, *in* 827 PRACTISING LAW INST., TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS 155, 350 (2008). Now, a § 338 election generally results in two levels of taxes—tax on the actual stock sale and tax on the deemed asset sale—and functions primarily as the method through which a stock sale can be taxed as an asset sale. *Id.* at 231–67.

argue that there are greater or fewer important categories, that the categories should be defined somewhat differently than defined here, or that an entirely different categorization system is appropriate.[78] While this Article attempts to create a framework for understanding the most significant ways explicit elections are used in the income tax system, one of the goals of this Article is to focus scholarly attention on how explicit elections are used and to encourage discussion on this and other issues. Finally, it is important to remember that elections may serve more than one purpose and, thus, may fall into more than one category. Similarly, while this Article has tried to identify unique functions of elections, there is overlap between some categories. Accordingly, the discussion of a particular election as an example of a particular role of explicit elections does not mean that is the only function served by that election.

A. *Reconciling Discontinuous Regimes*

Very different tax results can follow from transactions that take different forms but that are substantively, economically, or theoretically quite similar. For example, the tax treatment of the sale of all of the stock of a corporation can differ markedly from the tax treatment of the sale of all of the assets of a corporation, even though both transactions result in the sale of the corporation's entire business.[79] This is a result of discontinuous tax regimes—one set of tax rules applies to transactions taken in one form, and another set of tax rules applies to substantively similar transactions taken in another form. The sets of rules are discontinuous in that a small change in the transaction's form can cause a different tax regime to apply, thereby resulting in a large change in the tax consequences.[80] Discontinuities can create serious tax policy problems—they encourage tax-motivated changes to the underlying transaction, thereby potentially undermining the goals of efficiency and neutrality, leading to concerns about abuse, and prompting "major struggles between taxpayers and the government."[81]

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[78] For example, explicit elections could be divided into two categories: substantive elections (i.e., elections dealing with which tax liability rules apply) and procedural elections (i.e., elections dealing with the audit process, the collection process, and other issues relevant to the way in which the law is administered).

[79] *See generally* Martin D. Ginsburg & Jack S. Levin, Mergers, Acquisitions, and Buyouts: a Transactional Analysis of the Governing Tax, Legal, and Accounting Considerations chs. 2 & 3, ¶¶ 1.05–.06 (Aspen Publishers, 2009) (discussing the tax consequences of stock acquisitions and asset acquisitions).

[80] *See* Jeff Strnad, *Taxing New Financial Products: A Conceptual Framework*, 46 Stan. L. Rev. 569, 597–98, 602–05 (1994) (explaining that continuity exists when "portfolios that are nearly identical have nearly identical tax treatments. In particular, small changes in any portfolio will not cause a 'jump' in the tax results.").

[81] *Id.* at 603. Such struggles can include complex and possibly protracted audits and litigation in situations where the taxpayer undertakes tax-motivated changes to the form (but not the substance) of a transaction in an effort to achieve a different tax treatment and the Service challenges the taxpayer's preferred tax treatment. This, of course, assumes that the Service can detect such taxpayer actions, which is not always the case.

Explicit elections have been used to help reconcile such discontinuities in the tax law. For example, § 338, which allows taxpayers to elect to treat certain stock purchases as asset purchases, softens the harshness of the discontinuity between stock and asset purchases,[82] and § 1501, which allows taxpayers to elect to treat certain groups of corporations as a single taxpayer, smoothes the discontinuity between the tax consequences of operating a business through a single corporation and operating a business through a group of separate corporations.[83] Similarly, where there is a purchase of a partnership interest, a § 754 election enables the buyer to receive an adjustment to the inside basis of a partnership's assets as if the buyer had purchased its share of the partnership's assets rather than purchasing interests in the partnership.[84] These explicit elections allow a taxpayer to choose to tax one transaction pursuant to tax rules that would ordinarily apply only to a similar economic transaction undertaken in a different form. Thus, explicit elections can help bridge the gap between the relevant regimes. As a result, substantively similar transactions can, at the taxpayer's discretion,[85] be taxed similarly despite the transactions' different forms.[86]

In addition to this potential equity benefit, using explicit elections to alleviate discontinuities can effectively replace an implicit choice with an explicit one. In doing so, elections can confer a neutrality benefit.[87] The mere existence of a discontinuity in the tax law provides taxpayers with the opportunity to make a choice—taxpayers can structure their transactions so as to be subject to one regime or another. For example, a taxpayer can choose to structure an acquisition of a business as a stock purchase or as an asset purchase, and a taxpayer can choose to run a business in a single corporation

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[82] I.R.C. § 338(a), (h)(10) (2006). *See generally* GINSBURG & LEVIN, *supra* note 79.

[83] I.R.C. § 1501 (2006). *See generally* GEORGE L. WHITE, CONSOLIDATED RETURNS: ELECTIONS AND FILING A-29 to -37 (Tax Mgmt. 2006) (discussing the differences between filing as separate corporations and filing as a consolidated group).

[84] I.R.C. §§ 754, 743(b) (2006).

[85] Note, however, that equivalent tax treatment for the substantively similar transactions is not mandatory. Equivalent treatment is afforded only if the explicit election is made. Hence, while the election advances the goal of horizontal equity, achievement of that goal is not assured. *See infra* Part III.A.2, discussing whether explicit elections reconciling discontinuities should be made mandatory.

[86] Note that the election allows the transactions to be taxed "similarly," not "identically." Even when the elections are made, there remain some tax differences between stock and asset purchases, between separate entity and single entity treatment, and between the purchase of a partnership interest and the purchase of partnership assets. These elections merely mitigate the discontinuities between the regimes. For example, for purposes of determining whether a purchasing corporation is liable for the target corporation's old taxes (pursuant to the collection provisions in Subtitle F of the Code), a stock acquisition is not treated the same way as an asset transaction even if a § 338 election is made. Treas. Reg. § 1.338-1(b)(3) (as amended in 2009).

[87] *Cf.* David W. LaRue, *A Case for Neutrality in the Design and Implementation of the Merger and Acquisition Statutes: The Post-Acquisition Net Operating Loss Carryback Limitations*, 43 TAX L. REV. 85, 218 (1987) (explaining that the goal of "functional neutrality" "calls for impartiality in the tax recognition and treatment of acquisitions which are functional equivalents of one another").

or in multiple related corporations. However, non-tax business factors, such as concerns about protection from liability, may impede certain taxpayers from exercising this implicit choice.[88]

Turning an implicit choice into an explicit choice allows more taxpayers to avail themselves of the choice between the discontinuous tax regimes and eliminates the bias against taxpayers who, for business reasons alone, would have difficulty structuring their transactions to achieve the more favorable tax treatment. Moreover, even for taxpayers who are able to arrange their economic affairs so as to be subject to their desired tax treatment, the discontinuities in the tax law create a tax bias in favor of one economic decision or another. As a result, taxpayers have incentives to make significant changes to the form—but not the substance—of their economic arrangements.[89] Although it is commonly understood that tax laws affect taxpayer behavior,[90] the tax law should, to the extent possible, minimize that influence on taxpayer decisions.[91] Accordingly, using explicit elections to alleviate discontinuity reduces taxpayers' incentives to alter their business decisions regarding the structure of a business or business transaction in order to obtain specific tax treatments. Thus, explicit elections enable taxpayers to focus on the non-tax business and legal consequences, rather than the tax ones, when planning and effectuating transactions. This can enhance efficiency by relieving taxpayers of the need both to waste resources to restructure a desired transaction and to use a transaction structure that is suboptimal from a business perspective in order to obtain a particular tax treatment.

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[88] For example, the purchaser of all of the assets of a corporation generally does not succeed to the corporate liabilities, but the purchaser of all of the stock of a corporation will generally succeed to the liabilities of the corporation (at least indirectly, via ownership in the corporation that retains its responsibility for preexisting liabilities). *See* Boris I. Bittker & James S. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 10.40[1] (2007). *See also* Field, *supra* note 20, at 278–81 (discussing business exigencies that are relevant to the choice of form of a partnership merger, division or incorporation).

[89] *See, e.g.*, Ajay Mehrota, *Mergers, Taxes, and Historical Materialism*, 83 Ind. L.J. 881, 886 & n.19 (2008) ("tax benefits may influence the structure of—if not the decision to execute—a merger"); David A. Weisbach, *Formalism in the Tax Law*, 66 U. Chi. L. Rev. 860, 869 (1999) (describing how taxpayers can change their behavior to take advantage of tax rules that "mistax" certain transactions). Moreover, there is an extensive body of literature about how to structure transactions in light of the tax consequences of different forms. *See, e.g.*, Kevin M. Keyes, *Structuring Stock and Asset Acquisitions – Section 338 and Other Selected Issues*, *in* 770 Practising Law Inst., Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings 743 (2007).

[90] *See, e.g.*, U.S. Gov't Accountability Office, Understanding the Tax Reform Debate: Background, Criteria, & Questions 38 (2005), *available at* http://www.gao.gov.new.items/d051009sp.pdf ("Generally, taxes alter or distort decisions about how to use resources, creating economic inefficiencies.").

[91] *See* LaRue, *supra* note 87, at 218. Where the tax law is unbiased across economic decisions of taxpayers, the taxpayers are generally free to take the actions that are optimal from a non-tax business perspective. However, if tax law is biased in its treatment of taxpayers' economic decisions, those decisions may be distorted, thereby possibly causing taxpayers' decisions about whether and how to undertake transactions to be suboptimal from a non-tax business perspective.

Notwithstanding the potential policy benefits of using explicit elections to reconcile discontinuous tax regimes, this use raises several issues.

1. *Which Discontinuities Should Be Reconciled?*

The tax system contains many discontinuities, and policymakers must determine what situations are sufficiently similar from an economic or theoretical perspective that the discontinuity ought to be mitigated. This concept of substantive "sameness" and equalization of tax treatment underlies each of the elections mentioned above. For example, § 338, by allowing certain stock purchases to be taxed as asset purchases,[92] likens certain indirect asset acquisitions to direct asset acquisitions.[93] Similarly, affiliated groups of corporations are allowed to file a single consolidated return[94] because Congress and the Treasury realized that "[i]n substance, there was little distinction between a corporation that chose to conduct its business by means of divisions and another corporation that preferred to operate its various businesses through subsidiaries."[95] And when a partnership interest is purchased, a § 754 election allows an optional inside basis adjustment[96] that is "intended to . . . approximate the result of a direct purchase of the [partnership's] property by the transferee partner."[97] This reflects the aggregate theory of partnerships, which conceives of the ownership of a partnership interest as the ownership of a direct interest in the partnership's underlying assets.[98]

These laudable efforts to equate the tax treatment of similar situations further functional neutrality[99] but can quickly become complicated when Congress must define which situations will be treated as sufficiently similar

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[92] I.R.C. § 338(a), (b) (2006).

[93] *See generally* BITTKER & EUSTICE, *supra* note 88, ¶ 10.41 (providing history behind the enactment of § 338); LANG & KHOURY, *supra* note 10, ¶ 4.01[1]. Part of the rationale behind the enactment of § 338 was to *limit* situations in which taxpayers could undertake stock purchases and be taxed as if they had undertaken asset purchases. *See* H.R. REP. NO. 97-760, at 535 (1982) (Conf. Rep.); *see also* LANG & KHOURY, *supra* note 10, ¶ 4.01[3]; R. Lawrence Heinkel, *I.R.C. Section 338 – An Analysis and Proposals for Reform*, 59 NOTRE DAME L. REV. 158, 158–70 (1983).

[94] I.R.C. § 1501 (2006).

[95] KEVIN M. HENNESSEY ET AL., THE CONSOLIDATED TAX RETURN ¶ 1.01 (2008); *see also* S. REP. NO. 65-617, at 9 (1918) (adopting consolidated filing "because the principle of taxing as a business unit what in reality is a business unit is sound and equitable"). *See generally* Andrew J. Dubroff & John Broadbent, *Consolidated Returns: Evolving Single and Separate Entity Themes*, 72 TAXES 743 (1994) (discussing the basic principles of consolidated group filing, including that "a consolidated group should be taxed as if it were a single corporation and as if its members were divisions of the corporation").

[96] *See* I.R.C. § 743(b) (2006). When a § 754 election is in effect, a § 743(b) adjustment changes the partnership's basis in its assets (i.e., inside basis). The net effect of this inside basis adjustment is to treat the purchasing partner, for basis purposes, as if the partner had purchased its proportionate share of the partnership's assets for fair market value.

[97] H.R. REP. NO. 108-755, at 622 (2004) (Conf. Rep.).

[98] *See generally* WILLIAM S. MCKEE ET AL., FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 1.02 (2008).

[99] *See* LaRue, *supra* note 87, at 218.

so that taxpayers can elect one tax treatment or another.[100] For example, with respect to both the consolidated group election and the § 338 election, similarity requires satisfaction of a threshold stock ownership requirement.[101] Only where a corporation owns (or, in the case of a § 338 election, purchases) at least eighty percent of the vote and value of the stock of another corporation does the Code equate the ownership (or purchase) of stock with the ownership (or purchase) of the underlying assets.[102] Since corporate tax generally respects the corporation as an entity separate and distinct from its owner,[103] the Code allows the owner (or purchaser) of the stock to be treated like the owner (or purchaser) of the underlying assets only where there is ownership (or purchase) of the vast majority of the interests in the corporate entity.[104] Absent that high level of stock ownership or purchase, the chain of related corporations is not considered sufficiently similar to a single corporation, and the stock purchase is not considered sufficiently similar to an asset purchase. In such cases, no election would be allowed to treat the ownership (or purchase) of stock as the ownership (or purchase) of the underlying assets.

But what level of stock ownership or purchase should be required? When determining a level at which ownership of an entity's stock is tantamount to ownership of the entity's business, this eighty percent vote and value threshold may seem reasonable, but the contours of this requirement have varied over time: from a subjective "substantial ownership" test when consolidated filing began,[105] to a ninety-five percent control test beginning in

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[100] *Cf.* David A. Weisbach, *The Irreducible Complexity of Firm-Level Income Taxes: Theory and Doctrine in the Corporate Tax*, 60 TAX L. REV. 215, 252 (2007) (commenting that proposals to coordinate asset and stock acquisitions "are immensely complex because they must draw a line between those cases where conformity is allowed and those where it is not"). Note that this Article does not attempt to define equality or sameness for purposes of determining whether or not an election should be used to bridge the gap between the tax treatment of two formally different factual situations.

[101] I.R.C. §§ 1501, 1504(a)(2) (2006) (requiring that a corporation own at least eighty percent of the vote and value of a subsidiary in order for the corporation and the subsidiary to be eligible to file a consolidated return); *id.* § 338(d)(3) (2006) (requiring that the purchaser purchase at least eighty percent of the vote and value of the stock of the target corporation in order to be eligible to make a § 338 election). Additionally, in order to be eligible to file a consolidated return, subsidiary corporations must not be one of certain types of excluded corporations. *See id.* § 1504(b) (2006). Other limitations on the § 338 election include that the purchase of the target stock must occur within a twelve-month period. *Id.* § 338(d)(3).

[102] *Id.* §§ 338(d)(3), 1504(a)(2).

[103] *See, e.g.*, Moline Properties v. Comm'r, 319 U.S. 436, 439–40 (1943) (treating a corporation as separate and distinct from its shareholder-owner).

[104] In contrast, partnership taxation generally reflects a combination of entity and aggregate theories. It is the aggregate theory that conceives of the ownership of a partnership interest as the ownership of a direct interest in the partnership's underlying assets. *See supra* note 98 and accompanying text. Thus, under the aggregate theory, the purchase of any amount of partnership interest could be considered theoretically the same as the purchase of interests in the underlying assets, meriting the availability of the inside basis adjustment. I.R.C. § 743(b) (2006).

[105] *See* WHITE, *supra* note 83, at A-15 (citing Reg. 41, Art. 77 (1917)).

1921,[106] to an eighty percent voting control test beginning in 1954,[107] and finally to an eighty percent vote and value control test beginning in 1984.[108] Along the way, the IRS and the courts have interpreted these control tests in a variety of circumstances, thereby helping to shape these tests.[109] Moreover, there are many possible alternatives, including numerous other definitions of control throughout the Code,[110] and any threshold test for defining similarity can itself create a discontinuity.[111]

Even this brief discussion of the control test for consolidated filing demonstrates the difficulty of determining which economic arrangements are so substantively similar to other formally-distinct economic arrangements that the differences in the tax treatments of those arrangements should be mitigated. This issue raises the question of the relationship between form and substance in the tax law and is a specific manifestation of the question that plagues analyses that rely on notions of horizontal equity—the "application [of the principle of horizontal equity] rests on a determination that parties are in equal positions; and the determination of equality rests on a choice of the contact points that are to be compared, about which reasonable people can disagree and often do so."[112] However, any use of an explicit

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[106] Revenue Act of 1921, ch. 136, § 240(c), 42 Stat. 227, 260 (current version at I.R.C. § 1504 (2006)).

[107] When lowering the threshold ownership requirement from ninety-five percent to eighty percent, the Conference Report indicated that "[t]his change will make it possible for a substantially greater number of multicorporate businesses, which in effect operate as economic units, to report their income for tax purposes as a single taxpayer." H.R. Rep. No. 83-1337, at 87 (1954) (Conf. Rep.). Note that, at this time, there was still a two percent additional surcharge tax imposed on companies exercising the privilege of filing consolidated returns; this was later repealed in 1964. Revenue Act of 1964, Pub. L. No. 88-272, § 234, 78 Stat. 19, 113–16 (codified as amended in scattered sections of 26 U.S.C.).

[108] I.R.C. § 1504(b). *See generally* White, *supra* note 83, at A-15 (chronicling the changes to the control requirement for consolidated filing).

[109] *See* White, *supra* note 83, at A-15 to -24.

[110] *See, e.g.*, I.R.C. § 368(c) (2006); William J. Rands, *Corporate Tax: The Agony and the Ecstasy*, 83 Neb. L. Rev. 39, 59–64 & n.99 (2004) (listing several different control tests and discussing the problem of so many different tests for control); Sec. of Taxation, Am. Bar Ass'n, *Comments on Proposed Change to Section 368(c) Definition of Corporate Control*, 83 Tax Notes 1357 (1999). Additionally, other proposals for treating stock and asset acquisitions similarly have employed different definitions for equating stock and asset acquisitions. *See* Weisbach, *supra* note 100, at 244–56 (discussing two proposals for coordinating the treatment of stock and asset sales, one of which focuses on whether "substantially all of the assets" are transferred or whether a "major portion" of assets are transferred, and one of which asks whether, among other things, at least seventy percent of the gross fair market value and at least ninety percent of the net fair market value of the assets of a corporation have been acquired).

[111] For example, an eighty percent vote and value threshold for the availability of an election to file consolidated tax returns means that a corporation, eighty-one percent of whose stock is owned by another corporation, can be taxed very differently than a corporation that only has seventy-nine percent of its stock owned by another corporation. Consolidated return filing is available in the former situation but not in the latter. I.R.C. § 1504(a)(2) (setting a clear eighty percent threshold). This is true even though there is not a large difference between eighty-one percent and seventy-nine percent ownership.

[112] Jeffrey H. Kahn, *The Mirage of Equivalence and the Ethereal Principles of Parallelism and Horizontal Equity*, 57 Hastings L.J. 645, 650 (2006). *Compare* Louis Kaplow, *A Note on Horizontal Equity*, 1 Fla. Tax Rev. 191 (1992) (arguing that the concept of horizontal equity

election to reconcile discontinuous tax regimes must deal with the issue of defining similarity, perhaps by focusing on those situations where the discontinuity creates significantly problematic behavioral responses. That is, discontinuities in need of reconciliation may be identified by focusing on situations where significant deadweight loss is created as a result of changes in behavior by taxpayers responding to the tax discontinuity.[113] Ultimately, an explicit election should be considered as a tool for mitigating a discontinuity only when policymakers determine that two situations are sufficiently similar so that equity, neutrality, and efficiency are served by allowing those situations to be taxed in similar manners.

2. *Can the Discontinuity Be Eliminated Rather Than Merely Reconciled?*

If a discontinuity in the tax regime is sufficiently problematic from an equity, neutrality, or efficiency perspective that an explicit election is considered as a possible solution, perhaps the discontinuity should be eliminated rather than merely reconciled. A discontinuity can be eliminated by changing the underlying tax laws so that multiple different tax regimes no longer apply to substantively similar economic transactions. For example, the discontinuity between asset sales and stock sales could be eliminated if the corporate tax system were fully integrated. Under a fully integrated system, shareholders would be taxed directly regardless of whether the sale of a business was structured as an asset sale or stock sale.[114] However, changing the tax laws to eliminate discontinuity typically requires major systemic change,[115] which can be difficult to accomplish even if many leading schol-

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is simply a version of the notion of vertical equity), *with* Richard A. Musgrave, *Horizontal Equity, Once More*, 43 NAT'L TAX J. 113 (1990).

[113] *See infra* Part III.A (discussing how taxpayers take advantage of discontinuities in the tax law by making implicit choices).

[114] *See generally* U.S. DEP'T OF THE TREASURY, BLUEPRINTS FOR BASIC TAX REFORM (1977). Full corporate integration refers to the adoption of a comprehensive system that merges the individual and corporate tax regimes such that the income of a corporation would be taxed only once at the shareholder level. *See generally* U.S. DEP'T OF THE TREASURY, REPORT ON INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS: TAXING BUSINESS INCOME ONCE (1992) [hereinafter TREASURY INTEGRATION REPORT].

[115] For example, discontinuity between the sale of a corporation's stock and the sale of a corporation's assets arises because of the two levels of tax (corporate level and shareholder level) that apply to corporate income. Upon the sale of a corporation's assets, the corporation is taxed on its gain and, if the corporation distributes the proceeds to the shareholders, the shareholders will also be taxed. In contrast, upon the sale of corporate stock, only the shareholders are taxed; no corporate level tax is imposed when corporate stock is sold. Thus, the existence of corporate double taxation creates discontinuity between the tax treatments of these forms for selling a business. In order to eliminate the discontinuity, the double tax on corporations could be eliminated and replaced with a system that taxes corporate income once, directly at the shareholder level. This is the essence of full corporate integration. *See* TREASURY INTEGRATION REPORT, *supra* note 114. Of course, the adoption of such a system would be a fairly radical departure from our existing regimes for taxing business entities, which have applied for decades. Moreover, such a change would affect much more than the treatment of asset sales

ars support the change.[116] Nevertheless, before an explicit election is used to mitigate the impact of discontinuous tax regimes, an inquiry should be made as to whether the discontinuity can and should be eliminated by changing the underlying tax regimes.

Even if the underlying tax regimes are unlikely to be modified, a discontinuity can be eliminated with a less drastic change by making the elective treatment mandatory. For example, in 2004, Congress made inside basis adjustments mandatory, rather than elective, upon the purchase of interests in a partnership with a substantial built-in loss.[117] This change requires that, for inside basis purposes, certain purchases of partnership interests be treated like purchases of the partnership's assets.[118] In order to remedy the treatment discontinuity between purchases of partnership interests and purchases of the underlying partnership assets, this change could be extended to require inside basis adjustments upon all purchases of partnership interests. Similarly, § 338, which is now generally elective,[119] could be made mandatory; all qualified stock purchases could be required to be treated as asset purchases, thereby eliminating much of the discontinuity between asset and stock purchases without fundamentally altering the current corporate tax system.[120]

In addition to dealing with discontinuities, mandatory treatment avoids many of the policy criticisms of elections. For example, with mandatory treatment, taxpayers are relieved from having to decide whether or not to make an election and from having to determine how and when to make the election. Further, both the IRS and the taxpayers avoid dealing with late elections or revoking unwise elections. This could promote administrability, reduce waste of resources, and increase revenue.

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and stock sales; it would also change the way in which business operations, contributions, distributions, and restructurings are treated for tax purposes.

[116] For example, over the last thirty years, many scholars have called for some degree of corporate integration, but Congress has not heeded these calls, although the impact of the double tax has been mitigated with the reduction in tax rates on qualified dividends. *See, e.g.*, A.L.I., Federal Income Tax Project: Integration of the Individual and Corporate Income Taxes (1993) (Alvin C. Warren, Jr., rep.); Treasury Integration Report, *supra* note 114; Michael J. Graetz & Alvin C. Warren, *Integration of Corporate and Individual Income Taxes: An Introduction*, 84 Tax Notes 1767 (1999); Charles E. McLure, Jr., *Integration of the Personal and Corporate Income Taxes: The Missing Element in Recent Tax Reform Proposals*, 88 Harv. L. Rev. 532 (1975).

[117] American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 833(b), 118 Stat. 1418, 1589–91 (2004) (codified as amended at I.R.C. § 743(a) (2006)).

[118] I.R.C. § 743(a), (b) (2006).

[119] The consistency rules of subsections (e) and (f) of § 338 provide a relatively narrow exception to the elective nature of § 338. I.R.C. § 338(e), (f) (2006).

[120] This approach eliminates the discontinuity between asset sales and stock sales where the sale involves eighty percent or more of the corporation's value. *Id.* § 338(d)(3)(2006) (providing that § 338 applies only where there is a purchase of eighty percent or more of the vote and value of the target corporation). Note, however, that making the § 338 election mandatory does nothing to eliminate the discontinuity between smaller asset sales and stock sales. Eliminating the discontinuity between these smaller asset and stock sales would require more fundamental change in the corporate tax system. *See supra* note 115.

However, mandatory treatment could have a variety of adverse consequences. For example, extending mandatory § 743 inside basis adjustments to all purchases of partnership interests may be undesirable because inside basis adjustments can be very complex to make[121] and because retention of the elective approach allows taxpayers to gauge whether the benefits of the election—here, inside basis adjustments—outweigh the costs and complexity of making the election. Additionally, efforts to eliminate discontinuities by making elective treatment mandatory could just create other discontinuities. For example, if the § 338 treatment (i.e., asset sale treatment for "qualified stock purchases")[122] is made mandatory,[123] then a purchase of eighty-one percent of the stock of a target corporation would be taxed very differently than the purchase of seventy-nine percent of the stock of a target corporation.[124] Further, as with consolidated filing, which was originally required[125] but then made elective,[126] there may be value in allowing taxpay-

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[121] *See generally* McKee et al., *supra* note 98.

[122] I.R.C. § 338(d)(3) (defining "qualified stock purchase" to be a transaction or series of transactions in which eighty percent or more of the stock of a target corporation is purchased within a twelve-month period).

[123] Additionally, an effort to make § 338 mandatory would likely face significant opposition from taxpayers because a stock sale (without a regular § 338 election) is subject to only one level of current tax (measured based on the gain inherent in the *stock*), but a stock sale with a regular § 338 election generally results in the imposition of two levels of current tax on the transaction (tax on the actual stock sale and tax on the deemed asset sale). *Id.* § 338(a) (2006). Thus, regular § 338 elections are generally not taxpayer favorable, except in limited situations. *See generally* Ginsburg & Levin, *supra* note 79. In contrast, § 338(h)(10) elections are commonly desirable when taxpayers are eligible for such an election (i.e., where the target corporation is an S corporation or is a member of an affiliated or consolidated group). I.R.C. § 338(h)(10)(A) (2006); Treas. Reg. § 1.338(h)(10)-1(c) (as amended in 2007). This is because a stock sale with a § 338(h)(10) election generally results in the imposition of only one level of current tax (measured based on the gain built into the target's *assets*), while still providing cost basis in the post-transaction assets. I.R.C. § 338(h)(10)(A) (treating the target as if it had sold its assets and disregarding the actual stock sale). Nevertheless, to the extent taxpayers may value the flexibility and freedom to choose whether or not § 338(h)(10) applies, taxpayers may lobby against making even the § 338(h)(10) election mandatory.

[124] Of course, this same type of discontinuity will still exist even if the treatment remains elective, as long as there is a threshold above which an election can be made and below which an election cannot be made. *See supra* note 111. As a result, policymakers should be very careful when selecting eligibility requirements for elections. *See infra* Part IV.B (explaining that any eligibility requirements for elections can create discontinuities and discussing how to define eligibility limitations for elections). Even where eligibility requirements for elections create discontinuities, the availability of an election can mitigate the stark consequences of existence of a bright line. For example, under mandatory § 338 treatment, the purchase of eighty-one percent of the stock of a target *would* be taxed differently than the purchase of seventy-nine percent of the stock of a target, but where § 338 is elective, the purchase of eighty-one percent of the stock of a target *might* be taxed differently than, but also might be taxed in the same way as, the purchase of seventy-nine percent of the stock of a target. Thus, despite the existence of discontinuities even when there are elections, an elective approach may afford taxpayers flexibility in structuring their transactions in a manner that is optimal for non-tax purposes. In turn, the use of elections to reconcile discontinuities in the tax law may reduce the severity of the inefficiencies and inequities created by those discontinuities.

[125] Revenue Act of 1918, ch. 18, § 240, 40 Stat. 1057, 1081–82 (1919) (current version at I.R.C. § 1501 (2006)) (extending mandatory consolidated group filing to the corporate income tax).

ers to have the flexibility to be treated in a way that reflects the economic realities of their businesses.[127] Nevertheless, if a discontinuity is sufficiently problematic that an explicit election is used (or is being considered) to mitigate the impact of the discontinuity, the policy objectives served by the election may be even better served by mandating the treatment that reconciles the discontinuity. This possibility should be fully explored before accepting an explicit election as a solution to the discontinuity.

3. *Should Discontinuity-Reconciling Explicit Elections Be Unidirectional?*

Assuming that a discontinuity should be reconciled but cannot be eliminated and that an explicit election is used to reconcile the discontinuity, a key feature of the election that must be determined is the election's directionality. The implicit choice[128] presented by the mere existence of a discontinuity is inherently multidirectional. For example, a taxpayer who might otherwise undertake a stock purchase can restructure the transaction as an asset purchase in order for the transaction to be taxed as an asset purchase, and vice versa. However, when the Code provides explicit choices that deal with tax discontinuities, these elections are generally unidirectional. For example, a § 338 election allows stock purchases to be treated as asset purchases, but there is no explicit election that enables asset purchases to be treated as stock purchases. Similarly, an election under § 1501 allows multiple related corporations to be treated as a single economic unit, but there is no explicit election that allows multiple economic units operated within a single corporation to be taxed as multiple separate corporations. In contrast, the author has proposed a multidirectional explicit election for partnership mergers, divisions, and incorporations.[129] For example, there are three basic forms for incorporation of a partnership—"assets-over," "assets-up," and "interests-over"[130]—and the proposal would allow a partnership incorpora-

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[126] Revenue Act of 1921, ch. 136, § 240, 42 Stat. 227, 260 (current version at I.R.C. § 1501) (making consolidated filing elective).

[127] *See* White, *supra* note 83, at A-37 (noting that Congress adopted an elective approach to consolidated filing in order to provide business owners with the flexibility to have their businesses taxed in accordance with economic realities).

[128] *See supra* Part III.A (discussing how discontinuous tax regimes provide taxpayers with an implicit choice: the ability to make a choice among the tax regimes by structuring their economic affairs in a particular manner).

[129] *See* Field, *supra* note 20.

[130] To incorporate using the "assets-over" form, the partnership contributes all of its assets over to the newly formed corporation in exchange for stock in the corporation and the corporation's assumption of the partnership's liabilities, and then the partnership distributes the stock to the partners in liquidation of the partnership. To incorporate using the "assets-up" form, the partnership distributes all of its assets and liabilities up to its partners in liquidation, and then the partners contribute the assets to the newly formed corporation in exchange for stock in the corporation and assumption of the liabilities that had been assumed by the partners. To incorporate using the "interests-over" form, the partners contribute their partnership interests to a newly formed corporation in exchange for stock in the corporation. *See id.* at 273–78 (describ-

tion undertaken in an "assets-over" form to elect to be taxed as an incorporation undertaken as an "assets-up" or "interests-over" transaction, and vice versa.[131]

An explicit election should respond to the problems created by the discontinuity. If either the tax consequences or the non-tax business factors push very strongly in favor of one form of transaction only, then the behavioral bias of the tax law runs primarily in one direction only[132] and only a unidirectional election is needed to counter that bias. For example, the § 338(h)(10) election involves *tax factors* that weigh very heavily in favor of one form. When a buyer corporation wants to acquire a subsidiary of a parent corporation, the buyer generally has a very strong tax-motivated preference in favor of an acquisition that is taxed as an asset acquisition rather than as a stock acquisition.[133] Thus, the discontinuity between the tax treatment of asset purchases and stock purchases creates a behavioral incentive

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ing the different ways to undertake incorporations and explaining the tax treatment of each); *see also* Rev. Rul. 84-111, 1984-2 C.B. 88 (same). Some state laws also allow partnerships to undertake a formless incorporation, and the tax law treats such incorporations as "assets-over" transactions. Rev. Rul. 2004-59, 2004-1 C.B. 1050.

[131] *See* Field, *supra* note 20, at 296–97. The proposal would also allow a similar multidirectional election for partnership mergers and divisions:

> Taxpayers would implement the form of merger, division, or incorporation most preferable from a business perspective. Regardless of the form of transaction chosen, the entities involved in the transaction could elect which construct would apply to the transaction for federal income tax purposes. For incorporations and mergers, the parties would choose among the assets-over, assets-up, and interests-over constructs; for divisions they would choose between the assets-over and assets-up constructs.

Id.

[132] Assume two transaction forms (Form A and Form B) that are taxed differently (under Regime A and Regime B). The tax law bias can favor Form A or Form B, or the tax law bias can depend on the facts and circumstances of the situation. Similarly, non-tax business factors can favor Form A or Form B, or the business bias can depend on the facts and circumstances. Where the business bias and the tax bias both point strongly in the same direction, there may be few neutrality and efficiency problems with the discontinuity, so no explicit election may be needed. Where the tax bias points in one direction (for example, toward Form A), and the business bias points in either the other direction (toward Form B) or is dependent on the facts and circumstances, a unidirectional election (that allows transactions undertaken in Form B, the possibly favored business form, to be taxed as if they were undertaken in Form A, the favored tax treatment) solves the problem. Similarly, where the business bias points in one direction (for example, toward Form B), and the tax bias points in either the other direction (toward Form A) or is dependent on the facts and circumstances, again, a unidirectional election (that allows transactions undertaken in Form B, the favored business form, to be taxed as if they were undertaken in Form A, the possibly favored tax treatment) solves the problem. Only where both the tax bias and the business bias are unclear and dependent on the facts and circumstances of the particular situation is a multidirectional election (where transactions undertaken in Form A can be taxed as if they were undertaken in Form B, and vice versa) needed to address the neutrality and efficiency problems of taxpayers restructuring their transactions in response to the tax and business incentives.

[133] *See generally* Ginsburg & Levin, *supra* note 79, ¶ 206.1.2. However, the tax consequences of the transaction to the seller may cause the selling corporation to have exactly the opposite preference depending on the difference between the target company's inside basis and outside basis. *See id.* Nevertheless, the overall tax bias generally favors a transaction that is taxed as an asset sale because a transaction that is taxed as a stock sale could ultimately be subject to an extra layer of tax. *See id.*

for the buyer to try to structure the transaction so that it will be taxed as an asset purchase, even if a stock purchase would be more desirable from a non-tax business perspective. To reduce this behavioral influence of the tax law and, thereby, mitigate the impact of the discontinuity, all that is needed is a unidirectional explicit election that allows the stock purchase to be treated as an asset purchase; hence, the § 338(h)(10) election is unidirectional.

Further, the election to file as a consolidated group involves the impact of *non-tax business factors* that push strongly in one direction. Non-tax business factors commonly encourage a business to segregate portions of its operations into different wholly-owned corporations. However, the discontinuity in the tax regimes can encourage taxpayers to keep the entire business operating in a single corporate entity even if that is suboptimal from a business perspective. To reduce this behavioral influence of the tax law and mitigate the impact of the discontinuity, only a unidirectional election (whereby a group of separate corporations can choose to be treated as a single corporation) is needed. This is because a business that desires separate treatment for different aspects of its operations can obtain that tax treatment fairly easily through self-help, merely by segregating those operations into different subsidiary corporations. Thus, only an election in the opposite direction is needed to address the problems created by the tax discontinuity.

However, if neither the tax consequences nor the non-tax business factors weigh heavily in favor of one form of transaction or another, a multidirectional election may be needed. Where both the tax incentives and non-tax incentives regularly vary depending on the facts and circumstances, the behavioral impact of the discontinuity in the tax law can run in multiple directions. In such a case, in order to mitigate the impact of the discontinuous tax regimes, an election should allow the taxpayer to choose among multiple possible tax treatments, regardless of the actual form of transaction.

B. Facilitating Tax Classification

In addition to reconciling discontinuous tax regimes, explicit tax elections can also facilitate tax classification. The tax law regularly requires that a set of facts be classified into one tax category or another (for example, distinguishing debt from equity,[134] employees from independent contractors,[135] and capital expenditures from immediately deductible expenses[136]).

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[134] I.R.C. § 385 (2006) (authorizing the IRS to promulgate regulations for distinguishing debt from equity); *see also* Plumb, *supra* note 72 (the seminal work on distinguishing debt from equity for tax purposes).

[135] Rev. Rul. 87-41, 1987-1 C.B. 296 (articulating factors for distinguishing employees from independent contractors for tax purposes); *see also* HELEN E. MARMOLL, EMPLOYMENT STATUS – EMPLOYEE V. INDEPENDENT CONTRACTOR (Tax Mgmt. 2001) (discussing in detail the tax distinction between employees and independent contractors).

[136] *Compare* I.R.C. § 162 (2006) (allowing the immediate deduction of certain expenses), *with* § 263 (2006) (requiring that capital expenditures be capitalized and not currently de-

The tax consequences can vary dramatically depending on these classifications.[137] Each such classification question presents a discontinuity in the tax law, but in contrast to the discontinuity problems discussed in Part III.A (where different tax regimes apply to economically similar but clearly formally distinct transactions), classification questions present discontinuities in the tax law in the absence of clear formal distinctions between the relevant factual scenarios.[138] That is, classification questions involve situations where it can be particularly difficult to determine where one discontinuous tax category ends and another begins. This difficulty occurs because there is a virtually continuous array of factual situations between two endpoints.[139]

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ducted); *see also* James Edward Maule, Deduction Limitations: General pt. IV (Tax Mgmt. 2000) (discussing the capitalization requirements as a limitation on the deductibility of expenditures).

[137] For example, interest payments on a financial instrument that is classified as debt are generally deductible by the payor, but dividend payments on a financial instrument that is classified as equity are not deductible by the payor. *See* I.R.C. § 163 (2006 & Supp. I 2007). This is true even though the instruments may provide very similar economic and legal rights.

[138] The discontinuities addressed in Parts III.A and III.B differ in important respects, and thus elections dealing with those discontinuities serve different functions. Part III.A involves discrete factual scenarios to which the discontinuous tax regimes could apply, and it is perfectly clear which tax regime applies to the particular situation; there is no balancing of facts and circumstances and no judgment call required to categorize a particular set of facts. The function of the election is to allow one set of factual scenarios to be taxed as if it were another. In contrast, this Part involves virtually continuous arrays of factual situations between two fixed endpoints, where it can be difficult to determine where the application of one tax regime should end and the application of the other tax regime should begin. In these situations, the function of the election is to differentiate between the sets of factual scenarios. Nevertheless, particularly at the endpoints of the continuous array of factual scenarios where it may be reasonably clear how to classify the particular scenario, an election that facilitates classification may also serve an additional purpose of reconciling the discontinuous tax regimes. For example, the American Law Institute's ("ALI") proposed reorganization election discussed herein may serve both the purpose of facilitating tax classification (for those situations in the middle of the continuous array of factual scenarios, where it is difficult to substantively identify whether the transaction should be treated as a carryover basis or cost-basis transaction) and the purpose of reconciling discontinuous tax regimes (for those situations at the far endpoints of the array of factual scenarios, where it may be somewhat clearer which tax regime should apply and where the election could help to soften the harshness of the difference between the tax regimes that treat some corporate acquisitions as taxable cost-basis transactions and other corporate acquisitions as nontaxable carryover basis transactions). *See infra* notes 144–146 and accompanying text.

[139] For example, consider the debt/equity distinction. Common stock in a corporation is clearly equity, and a plain vanilla note—i.e., with a short fixed term, market rate interest payable in cash at least annually, no subordination or conversion rights, etc.—is clearly debt. These are the endpoints of the equity/debt array—i.e., the extreme examples where it is very easy to classify a factual situation into one category or another. However, there are a huge number of possible combinations of rights that an interestholder may have. As an interest deviates from the extreme examples, it moves farther down the line toward the other end. For example, if, rather than common stock, a holder owns preferred stock, entitling the holder to preferred dividends and a preferred but capped amount payable to the holder upon liquidation, this interest is somewhat more debt-like than common stock and is slightly more toward the middle of the debt/equity array. Ultimately, all of the financial interests have to be classified as debt or equity, but the challenge in making that classification is determining where one category ends and the other begins.

Most classification determinations depend on the substance of the situation and require careful analysis of the relevant facts and circumstances, often using multi-factored tests.[140] Alternatively, a classification determination can be made using an explicit election. For example, the entity classification election provided under Treasury Regulation section 301.7701-3 (commonly called the check-the-box election) allows most unincorporated business entities to elect whether to be taxed as corporations or as pass-through entities.[141] This explicit election for entity classification replaced a prior multi-factored test, which tried to measure the extent to which the entity resembled a corporation.[142] The adoption of an explicitly elective approach to entity classification was made because of the Service's acknowledgement that:

> [M]any states recently have revised their statutes to provide that partnerships and other unincorporated organizations may possess characteristics that have traditionally been associated with corporations, thereby narrowing considerably the traditional distinctions between corporations and partnerships. . . . One consequence of the narrowing of the differences under local law between corporations and partnerships is that taxpayers can achieve partnership tax classification for a non-publicly traded organization that, in all meaningful respects, is virtually indistinguishable from a corporation.[143]

That is, the convergence of the characteristics of different types of business entities made it at best formalistic, and at worst futile, to try to use substantive facts and circumstances to classify businesses as corporations or as partnerships for tax purposes.

Another example of classification by election is the American Law Institute's ("ALI") proposed explicit election that would allow corporate acquisitions to be treated, at the option of the acquirer and target, as nontaxable carryover basis transactions or taxable cost basis transactions (hereinafter "the ALI's proposed reorganization election").[144] The ALI explained that

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[140] *See, e.g.*, I.R.C. § 385 (2006) (authorizing regulations setting forth factors that enable debt and equity to be distinguished from each other); Treas. Reg. § 1.263(a)-1 to -5 (2004) (providing guidance for distinguishing currently deductible expenses from capital expenditures); Plumb, *supra* note 72 (providing a comprehensive discussion of the factors that distinguish debt from equity).

[141] Treas. Reg. § 301.7701-3 (as amended in 2006). *See generally* Field, *supra* note 10, at 463–70 (providing a detailed description of the operation of the check-the-box regulations).

[142] *See* Morrissey v. Comm'r, 296 U.S. 344, 357 (1935) (explaining that the key issue in distinguishing corporations from partnerships is corporate resemblance); Former Treas. Reg. § 301.7701-2(a) (1960) (making it more difficult to achieve corporate status under the corporate resemblance test).

[143] I.R.S. Notice 95-14, 1995-14 I.R.B. 7.

[144] A.L.I., Federal Income Tax Project: Proposals on Corporate Acquisitions and Dispositions and Reporter's Study on Corporate Distributions 24–50 (1982) [hereinafter A.L.I. Proposed Reorganization Election] (William D. Andrews, rep.). The ALI's pro-

"the reorganization definition was frequently uncertain in its definition" and that "the search for substantive differences among acquisitions by which to determine their tax classification has been essentially fruitless."[145] Thus, the ALI advocated for an explicit election approach, which divorced tax classification from corporate procedural choices.[146] Accordingly, explicit elections, like the check-the-box election and the ALI's proposed reorganization election, enable the tax classification of business entities and transactions, respectively, without giving rise to the horizontal inequity created by drawing arbitrary lines between types of factual scenarios with no meaningful differences.

Thus, an explicit election may be a simple and efficient approach to an otherwise difficult and costly exercise in line drawing, particularly where there is a largely continuous range of similar factual situations. An explicit election may be the way to differentiate between situations to which Regime A applies and to which Regime B applies while creating the least amount of deadweight loss.[147] On this measure, Professor David Weisbach praised the Service's choice to replace the multi-factor corporate resemblance test with the elective check-the-box regulations because it "drop[s] traditional concerns and instead focus[es] on efficiency."[148] Using an explicit election for entity classification may be efficiency-enhancing because the availability of an explicit choice frees taxpayers from the burden of having to make an implicit choice, whereby the taxpayer would structure a transaction in a possibly suboptimal manner in order to achieve a desired tax treatment. For example, under the check-the-box regulations, taxpayers have become free to choose the combination of management, liability, interest transferability, and continuity of life terms that are optimal for the business, without being influenced by the tax implications of including those terms.

In addition to possible equity and efficiency enhancements, using explicit elections for classification purposes has the potential to confer additional benefits.[149] Explicit elections can simplify the classification process for taxpayers by eliminating the detailed inquiry required by a facts and

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posed corporate reorganization election was never adopted. Moreover, since the ALI's proposal (published in tentative form in 1977 and published in final form in 1982), the definition of "reorganization" has been refined through the modification of Treas. Reg. § 1.368-1 and through the issuance of various IRS documents, so there are fewer definition problems with identifying transactions that qualify as reorganizations. *See, e.g.*, T.D. 8760, 1998-1 C.B. 803; T.D. 7745, 1981-1 C.B. 134. These developments in the law may weaken the arguments in favor of an election like the proposed reorganization election. Nevertheless, it was proposed as, and can help demonstrate the potential role of, a classification election.

[145] A.L.I. Proposed Reorganization Election, *supra* note 144, at 24, 28, 35 (also explaining, among other things, that existing law regarding reorganizations "contain[ed] a very intricate scheme of classification of acquisition transactions, some of whose boundary lines raise continuing, difficult, definitional problems").

[146] *Id.* at 24–50.

[147] *See* David A. Weisbach, *Line Drawing*, *supra* note 68.

[148] *Id.* at 1630.

[149] *See, e.g.*, Field, *supra* note 10, at 471–73, 480–87 (discussing the policy benefits created as a result of the adoption of the check-the-box election).

circumstances test. Elections can also confer corresponding administrability benefits on the Service.[150] In addition, classification via an explicit election increases taxpayer certainty regarding a desired classification—taxpayers need not rely on a judgment made after weighing facts and circumstances, which might put them in tenuous positions in close cases. Moreover, an explicit election can reduce the premium that facts and circumstances tests place on taxpayer knowledge, sophistication, and ability to obtain expensive advice.

Notwithstanding the foregoing potential benefits of using explicit elections for classification purposes, the check-the-box election, while worthy of praise, has not achieved all of these benefits,[151] and the success of the proposed ALI reorganization election cannot be evaluated because it was never adopted. It is therefore difficult to assess the potential success of other explicit classification elections. Even where the use of explicit elections for classification purposes could be designed so as to accomplish the above-described policy objectives, classification elections raise a number of issues.[152]

1. When Do Substance-Based Classification Tests Cease to Be Meaningful or Useful?

The argument that explicit elections are useful for classifying factual scenarios that are "virtually indistinguishable" suffers because of the need to determine which factual differences have tax import and which differences are meaningless for tax purposes.[153] For example, the check-the-box regulations, together with the statutory definition of "corporation,"[154] suggest that features like limited liability are not important for determining whether a domestic[155] business entity should be taxed as a corporation or as a

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[150] For example, when the check-the-box regulations replaced the corporate resemblance test for purposes of classifying business entities, the IRS was "relieved from having to inquire into the specific state law rights and responsibilities of the entity and its members and from having to examine the specific terms included in the entity's operating agreement." *Id.* at 473. This change meant that the IRS could more easily, and with fewer resources, determine which entities are corporations and which entities are partnerships for tax purposes.

[151] *See id.* at 495–96 (concluding that the check-the-box regulations fall short of their promise because of difficulties in the application of the check-the-box regulations to foreign entities and because the regulations do not eliminate the multi-regime system for taxing businesses, among other reasons).

[152] This discussion focuses only on the criticisms relating exclusively to the use of explicit elections for classification purposes. General criticisms of the use of explicit elections are discussed in Part II, *supra*.

[153] It is important to distinguish between legal and economic distinctions that lack significance, on one hand, and legal and economic distinctions that are significant but that are difficult to identify.

[154] I.R.C. § 7701(a)(3) (2006).

[155] *But see* Treas. Reg. § 301.7701-3(b) (as amended in 2006) (providing that the default classification for foreign entities depends in part on whether the owners of the foreign entity have unlimited liability for the business's debts).

pass-through entity.[156] However, incorporation under state or federal law is important for tax purposes.[157] Commentators continue to debate whether limited liability, incorporation under state or federal law, and other features of business entities *should* impact tax classification.[158]

Similarly, in proposing its reorganization election, the ALI argued that differences in "corporate procedure" should not result in different tax treatment for transactions with similar "financial import."[159] Thus, the ALI concluded that, "at least in the case of a complete acquisition of all interests in all assets in another corporation, there are not substantive differences among forms of transactions sufficient to explain or justify the difference between carryover and cost-basis treatment."[160]

Ultimately, these debates are just specific instances of the greater, commonly discussed, theoretical question about how similarity and difference are determined.[161] This issue of meaningful difference[162] may help explain why explicit elections are not used more commonly in classification determinations. When there is tax importance to the differences between two possible classifications of a particular set of facts, allowing the tax classification to be determined solely by the taxpayer may be inequitable and may lead to abuse. For example, even though it is often difficult to distinguish between capital expenditures and immediately deductible expenditures,[163] they are

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[156] The Treasury considered, but explicitly rejected, the use of limited liability as a key factor in distinguishing corporations from flow-through entities. *See* 45 Fed. Reg. 75, 709 (Nov. 17, 1980) (proposing regulations that provided that "an organization in which no member has personal liability for the debts of the organization be classified as an association taxable as a corporation"); I.R.S. Announcement 83-4, 1983-2 I.R.B. 31 (withdrawing the proposed regulations). *But see* Jeffrey A. Maine, *Linking Limited Liability and Entity Taxation: A Critique of the ALI Reporters' Study on the Taxation of Private Business Enterprises*, 62 U. Pitt. L. Rev. 223 (2000) (arguing in favor of determining tax classification based on limited liability).

[157] The treatment of incorporated entities as corporations for tax purposes is reflected in the statute itself, while most of the other entity classification rules are in the regulations. I.R.C. § 7701(a)(3).

[158] *See, e.g.*, A.L.I., Federal Income Tax Project: Taxation of Private Business Enterprises 55–56 (1999) [hereinafter A.L.I. Private Enterprise Study] (George K. Yin & David J. Shakow, reps.); Maine, *supra* note 156.

[159] A.L.I. Proposed Reorganization Election, *supra* note 144, at 35.

[160] *Id.*

[161] *See supra* Part III.A.1.

[162] It is left to the reader, and to any legislator or administrator proposing a classification election, to define "tax equals" in any particular situation. This Article does not attempt to explore the philosophical arguments about what makes factual scenarios "same" or "different" for tax purposes. Rather, this discussion is intended to highlight the point that the propriety of using an explicit election for a particular classification problem may turn, at least in part, on the extent to which the factual situations that could be subject to the election are sufficiently similar.

[163] *See, e.g.*, J. Aaron Ball, *A Merger Mystery: Outlining a Legislative Solution for the Problem of Distinguishing Deductible Expenses from Capital Expenditures Discussed in* Wells Fargo v. Commissioner, 14 DePaul Bus. L.J. 55, 57–77 (2001) (discussing the difficulty in distinguishing capital expenditures from immediately deductible expenses); John Lee et al., *Restating Capitalization Standards and Rules: The Case for Rough Justice Regulations (Part One)*, 23 Ohio N.U. L. Rev. 631 (1997).

considered fundamentally different because capital expenditures generally create or enhance "separate and distinct assets"[164] or confer "significant long-term benefits,"[165] while immediately deductible expenditures generally do not. Capitalization prevents an immediate deduction because the taxpayer is not poorer; the taxpayer's wealth is just in the form of an asset rather than cash. This difference is meaningful for tax purposes because allowing the immediate deduction of capital expenditures would allow "distortion of taxable income through current deduction of expenditures relating to the production of income in future years."[166] Taxpayers would likely try to exploit this distortion if they were allowed to elect how their expenditures were classified. Hence, this classification is an unlikely candidate for an explicit election.

2. *Can the Need for Classification Be Eliminated?*

Even where the differences between potential classifications are not meaningful for tax purposes, or where an election may be the most efficient classification method, allowing taxpayers to choose among the classifications may exacerbate rather than solve the classification problem. For example, some commentators have argued that the traditional differences between equity and debt have eroded over time with the development of new theories of the firm and that "[t]he recent explosion in financial contract innovation has laid bare the deficiencies of the debt-equity distinction."[167] Nevertheless, given Congress's efforts to police the debt-equity line,[168] and given concern over financial products that exploit the differences between the tax treatment of debt and equity,[169] allowing taxpayers to choose between debt and equity

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[164] Comm'r v. Lincoln Savs. & Loan Ass'n, 403 U.S. 345, 354 (1971).

[165] INDOPCO, Inc. v. Comm'r, 503 U.S. 79 (1992); *see also* Preamble to Proposed Regulations, 67 Fed. Reg. 77,701, 77,702 (Dec. 19, 2001); *cf.* Treas. Reg. §§ 1.263(a)-4, -5 (2004) (pulling back on the "significant future benefits" formulation of the capitalization test, but identifying a number of specific categories of capitalizable expenditures, some of which are informed by the future benefit standard).

[166] Preamble to Proposed Regulations, 67 Fed. Reg. at 77,702. *But see* Deborah A. Geier, *The Myth of Matching as a Tax Value*, 15 Am. J. Tax Pol'y 17 (1998) (arguing that, for tax purposes, capitalization is not dependent on the principle of matching the timing of the deduction of expenditures and the inclusion of the income to which the expenditures relate).

[167] Pratt, *supra* note 72, at 1057, 1072–88; *see also* Adam O. Emmerich, *Hybrid Instruments and the Debt-Equity Distinction in Corporate Taxation*, 52 U. Chi. L. Rev. 118 (1985). *But see* Hideki Kanda, *Debtholders and Equityholders*, 21 J. Legal Stud. 431 (1992) (arguing that the economic natures of debt and equity differ).

[168] *See* I.R.C. § 163(l) (2006) (enacted in 1997 to deny an interest deduction for interest payable in equity); *id.* § 385 (2006) (asking the Treasury to promulgate regulations distinguishing debt from equity). *See generally* Richard J. Kovach, *The Janus-Like Nature of Treasury Regulations: Recent Promulgations Illustrate How Regulators Can Simplify as Well as Complicate Administration of the Internal Revenue Code*, 29 Ohio N.U. L. Rev. 89, 99–101 (2002) (describing the IRS's failed effort to promulgate regulations under § 385).

[169] *See, e.g.*, Herwig J. Schlunk, *Little Boxes: Can Optimal Commodity Tax Methodology Save the Debt-Equity Distinction?*, 80 Tex. L. Rev. 859, 861 (2002).

classification may be tantamount to an admission of defeat.[170] Instead, the better response may be to recognize that an explicit election is really only a second-best solution, if that, to any classification question. Thus, particularly where the facts are virtually indistinguishable (at least the facts that are important for tax purposes), it might be better to abolish the distinction among the categories.[171]

Any method for drawing a line inherently assumes the defensibility of the categories on either side of the line.[172] For example, in proposing the reorganization election, the ALI affirmatively argued in favor of retaining both the carryover basis and cost-basis modes of treating corporate acquisitions.[173] However, as Professor Weisbach noted, "[e]ven the most enlightened line drawing cannot solve the central problem with the distinction."[174] Thus, absent an argument explaining the distinction between the relevant tax regimes, a fairer, simpler, and more neutral solution would be to make classification irrelevant by imposing the same tax treatment regardless of classification. As numerous commentators have concluded, taxing debt and equity alike eliminates the classification question and removes the tax bias imposed on taxpayers' choices regarding how to raise capital.[175]

Nevertheless, eliminating dichotomies like the debt-equity distinction and the distinction between corporations and partnerships requires fundamental change in the tax law. Thus, short of that major change, an explicit election may be a useful tool for classification in the limited situations where the election is designed to most fully achieve the potential benefits, where the legal and economic distinctions between the sets of facts lack significance for tax purposes, and where the disadvantages to using explicit elections[176] do not outweigh the benefits.

C. Advancing Simplicity & Administrability

A significant number of elections confer primarily simplicity and administrative benefits. For example, a taxpayer's ability to choose between

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[170] This is a version of the deregulation argument against the use of explicit elections in general. *See* Dean, *supra* note 65. *But see* Samuel D. Brunson, *Elective Taxation of Risk-Based Financial Instruments: A Proposal*, 8 HOUS. BUS. & TAX L.J. 1 (2007) (proposing that taxpayers be able to elect which of two tax treatments apply to their financial instruments).

[171] *See* Dean, *supra* note 65.

[172] That is, Regime A and Regime B are each appropriate ways to tax the situations to which they apply, and the situations to which Regime A applies are sufficiently different from the situations to which Regime B applies, so as to justify different tax treatment.

[173] A.L.I. PROPOSED REORGANIZATION ELECTION, *supra* note 144, at 39–41.

[174] David A. Weisbach, *Thinking Outside the Little Boxes: A Response to Professor Schlunk*, 80 TEX. L. REV. 893 (2002); *see also* Plumb, *supra* note 72, at 691 (explaining this problem by referencing WILLIAM SHAKESPEARE, JULIUS CAESAR act 1, sc. 2 ("The fault, dear Brutus, is not in our definition but in our dichotomy.")).

[175] *See, e.g.*, Plumb *supra* note 72; Pratt, *supra* note 72; TREASURY INTEGRATION REPORT, *supra* note 114, at 17–60.

[176] *See supra* Part II.

taking the standard deduction and taking itemized deductions is, very fundamentally, an election intended to provide simplicity—the availability of the standard deduction relieves a taxpayer from having to keep track of all of his itemizable deductions.[177] Similarly, in the partnership tax context, complying with all of Subchapter K may be unwieldy and expensive for partnerships with a lot of members;[178] § 771 allows such partnerships to elect out of the regular Subchapter K regime and into a modified version of the partnership tax regime that reduces the reporting and audit burdens on both the partnerships and the Service.[179]

Many accounting elections fall into this category. For example, taxpayers who use a financial accounting period that varies from fifty-two to fifty-three weeks can elect to use that same accounting period for tax purposes as well.[180] This election simplifies the taxpayer's tax and financial bookkeeping requirements.[181] Additionally, some elections bind the taxpayer to apply the same treatment to all items within a single year,[182] and some require the taxpayer to continue the same treatment from year to year unless the Service consents to change.[183] These obligations provide an administrative benefit because taxpayers commit to consistency in reporting, which minimizes the risk that taxpayers will be able to distort their incomes or whipsaw the government by taking different approaches to accounting issues within a year or from year to year. Thus, especially where changes in a taxpayer's choice can result in distortion of income, consideration should be given to the possibility of making the election effective not only for the year in which the election is made, but for the long term.

It should be noted that some simplifying elections also have the impact of reducing the taxpayer's tax burden, or at least deferring the taxpayer's obligation to pay tax, thus providing the taxpayer with the time value of money. In these situations, the Code sometimes imposes a charge on the taxpayer in exchange for the right to avail himself of the simpler approach. For example, an entity can elect to use a taxable year that results in up to three months of deferral, but it must make certain payments that are designed to eliminate the benefit of the deferral.[184] Additionally, certain taxpayers opting to defer the inclusion of a significant amount of income under

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[177] S. Rep. No. 91-552 (1969).

[178] Staff of Joint Comm. on Taxation, 103d Cong., Technical Explanation of the Tax Simplification Act of 1993 55–56 (Comm. Print 1993) (discussing the hardships that confront large partnerships).

[179] I.R.C. §§ 771–777 (2006).

[180] *Id.* § 441(f) (2006).

[181] *Id.*

[182] *See, e.g.*, *id.* § 446 (2006) (chosen accounting method applies to all tax items). Taxpayers generally cannot use the accrual method for deductions and the cash receipts method for income within a single taxable year.

[183] *Id.* § 442 (2006) (limiting taxpayers' ability to change their annual accounting periods).

[184] *Id.* § 444(a), (e) (2006).

the installment method[185] can be subject to an interest charge on the deferred tax liability.[186] Thus, explicit elections can be useful in adding simplicity and administrability to the tax system, but where the added simplicity materially and artificially reduces the tax burden on the taxpayer, the imposition of an additional charge in order to compensate the fisc for the lost revenue should be considered.

D. Condoning Tax Planning

Other explicit elections merely have the impact of condoning tax planning without serving one of the other enumerated functions in significant respects. Of course, all explicit elections cede to the taxpayer the ability to choose which tax rules apply to a particular situation, thereby effectively enabling tax planning. However, elections discussed in this Part generally enable tax planning without materially contributing to the accomplishment of the other functions of elections. Some of these elections that enable tax planning may be provided deliberately by Congress, but others are likely a result of compromise or indifference. Regardless of the genesis of a particular election, its existence inherently condones tax planning.

There may be some inherent value in giving taxpayers the ability to act on the tax system rather than just having the tax system act on them because "[c]hoice makes people feel powerful and in control of their lives. . . . Choices provide personal autonomy, something we value as a culture and nation."[187] However, as discussed above, taxpayer choice and taxpayers' ability to engage in tax planning suffers from many criticisms.[188] Thus, where elections serve the primary purpose of providing choice and enabling tax planning, the rationale for empowering taxpayers should be carefully examined. Accordingly, this Part attempts to identify a variety of possible justifications for elections that primarily enable tax planning, including elections that are intentionally designed to do so, elections that empower taxpayers to choose their own tax treatment where planning opportunities are sufficiently constrained, elections that allow taxpayers the opportunity to select a method for implementing a policy goal articulated by Congress, and elections that enable taxpayers to reveal information about their personal circumstances. Some of these explanations are more compelling than others, and some justifications are compelling only in limited circumstances. Moreover, there are some elections that effectively enable tax planning, but fail to meet any of these limited justifications for tax-planning elections. These

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[185] Technically, installment method treatment is the default rule, and the election that is available to taxpayers is *out* of the installment method treatment. *Id.* § 453(a), (d) (2006). However, the choice to accept the default treatment and not to opt out reflects a choice itself.

[186] *Id.* § 453A (2006).

[187] Alice G. Abreu, *Taxes, Power, and Personal Autonomy*, 33 SAN DIEGO L. REV. 1, 50–52 (1996).

[188] *See supra* Part II.

elections are the most troubling, and Congress should be wary of these uses of explicit elections.

1. Intentionally Encouraging Tax Planning

Occasionally, Congress enacts tax laws expressly designed to encourage taxpayers to plan their economic affairs in a way that confers the optimal tax result to the taxpayer. For example, eligible taxpayers can elect whether or not to take the Hope Scholarship Credit (now called the American Opportunity Tax Credit) or the Lifetime Learning Credit.[189] Taxpayers generally will choose the option that provides them with the largest subsidy for their educational expenditures,[190] and perhaps taxpayers will take the availability of the credits into account when deciding whether or not to make post-secondary educational expenditures. Thus, with respect to tax expenditures that are generally intended to promote a social goal,[191] such as education, explicit elections provided in tax expenditures enable a taxpayer to accept the subsidy only when it is actually beneficial—i.e., when it best reduces the taxpayer's tax burden.

Another example involves a combination of implicit and explicit choices that enables taxpayers to save for retirement in a tax-efficient manner. Taxpayers can make an implicit choice to contribute to tax-favored retirement savings accounts like employer-sponsored qualified plans or individual retirement accounts.[192] When doing so, taxpayers can make the explicit choice between two different tax-favored approaches. By checking a box on a form filed with the trustee of the account,[193] taxpayers can elect to have the retirement contributions treated as "traditional"-style—i.e., subject to tax upon distribution, but not subject to current tax[194]—or "Roth"-style—i.e., subject to current tax, but not subject to tax on distribution.[195] The tax-favored status of qualified plans is intended to "encourage employers to establish non-discriminatory retirement plans for their employees," and the availability of multiple different tax treatment options for those retirement

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[189] I.R.C. § 25A(b)(1), (c), (e), (i) (2006), *amended by* American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 1004, 123 Stat. 115, 313–16 (to be codified in 26 U.S.C.).

[190] Often times, taxpayers will only be eligible for one credit or the other. Even in that situation, the taxpayer has to affirmatively elect to receive the Hope Scholarship Credit, and the taxpayer can elect out of receiving any educational credit at all. *Id.*

[191] Staff of Joint Comm. on Taxation, 110th Cong., A Reconsideration of Tax Expenditure Analysis 12–13 (Comm. Print 2008) (discussing "social spending" tax expenditures).

[192] *See, e.g.*, I.R.C. § 401(k)(2) (2006) (allowing elective deferrals of compensation under a qualified plan).

[193] Although the taxpayer's choice as to his preferred approach for taxing the retirement account is not communicated directly to the Service, it is communicated to the Service indirectly, via the account trustee.

[194] I.R.C. § 402 (2006 & Supp. I 2007).

[195] *Id.* § 402A (2006). Note that the taxpayer must specifically designate that his contribution is intended to be a Roth contribution to a qualified Roth contribution program. *Id.*

savings, among which the taxpayer can elect, enables taxpayers to arrange their affairs so as to save for retirement in the manner they find most tax-favorable.[196]

When the tax law is designed to subsidize certain actions and incentivize taxpayers to undertake those actions, explicit elections advance that social policy goal by giving taxpayers power to plan their affairs so as to achieve the best combination of economic and tax consequences. However, the use of explicit elections to encourage tax planning assumes that the tax system is an appropriate tool for encouraging people to alter their behavior.[197] Moreover, the provision of choice, and particularly the increasing number of choices for retirement planning, can make the tax system even more complex for taxpayers.[198] Ultimately, a high degree of complexity in making the choice can undermine the explicit election's goal of encouraging people to engage in tax planning. Faced with too many choices, a taxpayer may be more likely to make a choice that does not provide him the greatest benefit, or the taxpayer may decline to make a choice at all.[199] Thus, if an explicit election is included in the Code in an effort to encourage people to use the tax system to plan their economic affairs, Congress should be wary of providing too many choices and of making those choices too complex.

2. *Empowering Taxpayers Where the Planning Opportunities Are Constrained*

Where planning opportunities are relatively constrained,[200] explicit elections can also provide taxpayers with some degree of personal autonomy.[201]

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[196] Staff of Joint Comm. on Taxation, 101st Cong., Description of Present-Law Tax Rules Relating to Qualified Pension Plans (Comm. Print 1990); *see also* H.R. Rep. No. 105-148, at 336–38 (1997) (explaining that the tax law changes that enable different types of IRAs are intended to encourage savings by providing a different tax-favored savings vehicle that may be "more suitable for their savings needs"). *See generally* David A. Pratt, *Nor Rhyme Nor Reason: Simplifying Defined Contribution Plans*, 49 Buff. L. Rev. 741, 746–47 (2001).

[197] *See generally* Thomas L. Hungerford, *Tax Expenditures: Good, Bad or Ugly?*, 113 Tax Notes 325 (2006).

[198] *See* Daniel Halperin, *Fun and Games with the Roth IRA*, 112 Tax Notes 167 (2006) (criticizing the increasing complexity of options for retirement savings, focusing on changes to the Roth IRA); *see also* Barry Schwarz, The Paradox of Choice: Why Less is More (2004) (arguing that too much choice can be paralyzing). *See generally supra* notes 26–39 (discussing the complexity created by elections in general).

[199] *See* President's Advisory Panel on Federal Tax Reform, Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System 91 (2005) (explaining that taxpayers are "paralyzed by the range of tax-preferred savings choices").

[200] *See* Schizer, *Sticks*, *supra* note 8, at 1349 n.32 (discussing the possibility of "severely constraining the planning option").

[201] *See* Abreu, *supra* note 187. However, as discussed herein, there are many downsides to the provision of choice. One important consideration is that, to the extent that taxpayers are given the ability to make some choices about their tax treatments, they may want an increasing amount of choice, and they may feel emboldened to seek out additional implicit and, perhaps, illegal opportunities to choose to reduce their tax burdens. *Cf.* Joshua D. Rosenberg, *A Helpful and Efficient IRS: Some Simple and Powerful Suggestions*, 88 Ky. L.J. 33, 36 n.7 (1999–2000) (noting that small areas of noncompliance may lead to noncompliance in other areas).

The key issue is identifying situations in which the practical ability to exercise the election is limited in a meaningful way so as to prevent taxpayers from significantly reducing their taxes and from using the tax rules in an unintended way. Two considerations that may help identify such situations are: (1) the imposition of third-party tradeoffs, where making or failing to make the election affects not only the electing taxpayer, but also other taxpayers; and (2) the existence of factual uncertainty, where the tax consequences of making or failing to make the election depend on events that will occur in the future, that are uncertain, and that are largely outside the taxpayer's control. The § 83(b) election, while far from perfect, helps to illustrate these factors. Very generally, § 83(b) allows taxpayers who receive property subject to a substantial risk of forfeiture to elect to pay current tax on the property rather than deferring the payment of tax until the restrictions lapse.[202]

While most tax elections affect only the electing taxpayer and, of course, the fisc,[203] the § 83(b) election also affects third parties because a taxpayer's decision whether or not to make the § 83(b) election determines the timing and amount of the compensation deduction available to the transferor of the property.[204] Notably, the incentives of the transferee and transferor may be adverse; the transferee may want to defer taxation and the transferor may want to accelerate the compensation deduction, or vice versa.[205] Accordingly, the transferor will have a vested interest in having information about, and potentially being involved in, the transferee's decision. Further, the transferee and transferor may negotiate over whether the transferee will make a § 83(b) election.[206] Thus, the presence of a non-electing third party who has an arm's length relationship with the taxpayer and whose tax burden is directly affected[207] by the election can limit[208] the elect-

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[202] I.R.C. § 83(a), (b) (2006).

[203] For example, a taxpayer's decision to take the standard deduction or to itemize deductions affects him alone and does not directly affect any other taxpayers. *Id.* § 63(b), (e) (2006).

[204] *Id.* § 83(h) (2006).

[205] The preferences of the employer and employee depend on their individual situations. *See* Knoll, *supra* note 33 (discussing when and whether a § 83(b) election is in the interests of the employee and/or employer).

[206] *See id.* (suggesting that the employee and employer jointly decide whether an election should be made).

[207] Of course, other non-electing taxpayers are indirectly affected by the election as well, in that the election may reduce the total amount of money collected by the government.

[208] Typically, this limit would be imposed via contract. For example, even though the § 83(b) election is made by the employee alone, the employer could, as a condition of the grant of the restricted property, require, or prohibit, the making of the § 83(b) election. *See generally id.* Similarly, the regular § 338 election can be made by the purchaser alone, but the seller may request a provision in the purchase agreement requiring the purchaser to, or prohibiting the purchaser from, making the election, and this may be subject to negotiation between the seller and the purchaser. *Cf.* GINSBURG & LEVIN, *supra* note 79, ch. 22 (suggesting different provisions regarding § 338 elections in the pro-buyer and pro-seller stock purchase agreements).

ing taxpayer's otherwise unfettered ability to choose.[209] This limit imposes a tax friction, or "statutory speed bump," which hinders the taxpayer's ability to exercise the explicit election in an abusive manner.[210]

In addition, for many elections, the taxpayer can know exactly how much tax he will owe if he makes one decision rather than another,[211] but the § 83(b) election is a gamble. A § 83(b) election often involves significant uncertainty[212] because the determination of whether a § 83(b) election is advantageous for the taxpayer depends on a variety of factors, including whether the taxpayer will forfeit the property before the restrictions lapse and whether the value of the property will increase or decrease between the time of the grant and the time when the restrictions on the property lapse.[213] The uncertainty as to the tax consequences of making or not making the § 83(b) election significantly limits a taxpayer's ability to engage in tax minimization.[214] For situations in which the use of elections to engage in tax planning is undesirable or can lead to abuse,[215] the uncertainty that arises from the inability of taxpayers to predict future facts may help to stem possibly abusive outcomes.[216]

This discussion does not provide an affirmative case for including explicit elections in the Code to enable taxpayers to engage in tax planning.

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[209] In contrast, where the tax election affects only the taxpayer, the taxpayer will generally make a pure tax choice, electing the alternative that enables him to pay the least amount of tax, without being affected by non-tax business consequences of the choice (business frictions) and without being constrained by the way in which third parties' tax consequences are affected (tax frictions). In many circumstances, this may not be troublesome, but in the absence of any frictions limiting the tax choice, there may be an increased risk of abusive tax behavior.

[210] *See* Leandra Lederman, *Statutory Speed Bumps: The Roles Third Parties Play in Tax Compliance*, 60 Stan. L. Rev. 695 (2007) (explaining how third parties acting at arm's length can provide a structural mechanism for increasing taxpayer compliance and assisting in enforcement of the tax laws); *see also* Schizer, *Sticks*, *supra* note 8, at 1349 n.32 (explaining that symmetry "can severely constrain the planning option"). Taxpayers' unfettered ability to make tax choices is similarly constrained when elections must be made jointly by multiple taxpayers who may have adverse interests, as the electing taxpayers are likely to negotiate about whether the election will be made. *See, e.g.*, Treas. Reg. § 1.338(h)(10)-1(c)(3) (as amended in 2007) (requiring that the § 338(h)(10) election be made jointly by the seller and the buyer).

[211] For example, a taxpayer's decision to take the standard deduction rather than itemized deductions lacks uncertainty; the taxpayer can know exactly how much tax he will owe under the alternative choices and can make the election in a way that will reduce his taxes with great certainty.

[212] Note that this is uncertainty regarding what the facts will be and not uncertainty regarding the rules of law that will be applicable to whatever facts arise.

[213] *See generally* Knoll, *supra* note 33.

[214] *See* Schizer, *Sticks*, *supra* note 8, at 1360–61 (arguing that uncertainty discourages planning).

[215] For example, foreign business entities have made entity classification elections in situations where there is great certainty about the tax consequences, and these elections have resulted in significant tax benefits to the foreign entities and have been described by many commentators as abusive. *See* Field, *supra* note 10, at 487–91 (summarizing abuses encountered when foreign entities make entity classification elections).

[216] On the other hand, certainty as to the tax result of an election can be good if the goal is to enable taxpayers to plan their affairs in a way that best reduces tax, as discussed in Part III.D.1, *supra*.

However, it suggests that, to the extent that there is a desire to use explicit elections to allow taxpayers to make choices about their tax treatment,[217] elections that involve third-party tradeoffs and factual uncertainty may not be as likely to pose the same threat of abuse as some other elections. Even though taxpayers may still try to use the election to engage in tax planning, the third-party tradeoffs and factual uncertainty reduce taxpayers' ability to use elections to significantly reduce their taxes.

3. *Allowing Taxpayers to Select a Method for Implementing a Policy Goal Articulated by Congress*

Explicit elections also exist in situations where Congress articulates a specific policy goal but does not specify how that policy goal is to be achieved. Instead, taxpayers are provided with a choice of methods among two or more options to implement the articulated policy goal, and thus taxpayers are given an opportunity to engage in tax planning. Where there is no single method that most effectively implements an articulated policy objective, allowing taxpayers to elect among different methods that are approximately equally effective may be reasonable. This is particularly true where there is an affirmative desire to allow taxpayers to make their tax treatment reflective of their economic arrangements[218] and where there are factual uncertainties and/or third-party tradeoffs involved in calculating the ultimate tax benefit of the different methods.[219]

For example, § 704(c)(1)(A) generally requires that taxpayers properly take account of precontribution gain or loss inherent in property contributed to partnerships.[220] The regulations provide the taxpayer with three methods for doing so,[221] and each method strikes a slightly different balance between the desire to accommodate the principle of nonrecognition of gains and losses upon contributions to partnerships[222] and the desire to tax precontribu-

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[217] This desire may arise in a specific circumstance or, more generally, in an effort to empower taxpayers to have a voice in the way the tax system applies to them.

[218] *See infra* Part III.D.4.

[219] *See supra* Part III.D.2.

[220] It is difficult to categorize the choice provided by § 704(c) as either explicit or implicit. On one hand, the choice of a § 704(c) method is explicit because the parties merely choose a tax method and communicate it to the Service. On the other hand, the choice of a § 704(c) method is implicit because the way in which the choice is communicated is via the actual allocation of income and loss among the partners. Nevertheless, § 704(c) provides a useful illustration of a situation in which Congress has articulated a particular policy goal and provided a choice to the taxpayer of the method for accomplishing that goal. Further, as compared to the election in § 362(e)(2), the options for § 704(c) methods provided to the taxpayer all reasonably accomplish the articulated objective, and, as discussed in the text, it is in these types of cases where there may be an argument to allow the taxpayers to choose their treatment. I.R.C. § 704(c) (2006); Treas. Reg. § 1.704-3 (as amended in 2005).

[221] Treas. Reg. § 1.704-3(b) (traditional method); *id.* § 1.704-3(c) (traditional method with curative allocations); *id.* § 1.704-3(d) (remedial method).

[222] I.R.C. § 721 (2006).

tion gains and losses back to the partner who contributed the property.[223] One of these § 704(c) methods may be slightly more effective in implementing the policy objectives than the other methods,[224] but each is a reasonable approach to implementing the goal of § 704(c)(1)(A).[225] Moreover, Congress explicitly stated its desire that taxpayers be provided with the flexibility to accomplish the stated policy objective,[226] and, given that the partners have different, and often adverse, incentives as to how to take account of precontribution gains and losses,[227] Congress anticipated little risk of abuse.[228] Nevertheless, Congress could have, and possibly should have, simply selected a single method for handling precontribution gains and losses.

Similarly, in an effort to prevent taxpayers from duplicating losses upon the contribution of loss property to a corporation, Congress enacted § 362(e)(2). Section 362(e)(2) generally provides that the loss inherent in property contributed to a corporation can be preserved through either the corporation's basis in the contributed property or in the contributor's basis in the corporate stock the contributor receives in the exchange, but not both;[229] the taxpayer has the ability to elect between the two alternatives.[230]

With § 362(e)(2), as with § 704(c)(1)(A), Congress articulated a policy goal and allowed taxpayers to choose how to accomplish the goal. However, with § 362(e)(2), the two options provided to the taxpayer are not equally plausible methods for accomplishing the articulated policy goal. Preserving the loss in the corporate stock accomplishes the policy goal of preventing "the importation of built-in losses"[231] significantly better than preserving the

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[223] *See* T.D. 8500, 1994-1 C.B. 183 (explaining that the § 704(c) regulations provide methods for "making allocations so that the contributing partner receives the tax burdens and benefits of any built-in gain or loss."); *see also* McKee et al., *supra* note 98 ¶ 11.04 (explaining how the different § 704(c) methods work).

[224] One could argue that the remedial method best reflects economic income and thus most effectively accomplishes the policy objective of § 704(c) because it most closely ensures that taxpayers will be allocated their rightful shares of gain and loss attributable to the contributed property regardless of whether the partnership has items of such gain and loss. Treas. Reg. § 1.704-3(d). However, the remedial method invokes fictions that depart from the reality of tax items actually recognized. *Id.*

[225] For example, the traditional method focuses on the actual items of tax gain and loss that are recognized. *Id.* § 1.704-3(a).

[226] H.R. Rep. No. 98-861, at 857 (1984); 57 Fed. Reg. 61,345 (Dec. 24, 1992) (explaining the rationale behind the proposed regulations).

[227] This is a variation on the concept of third-party tradeoffs discussed in Part III.D.2, *supra*.

[228] H.R. Rep. No. 98-861, at 857; 57 Fed. Reg. 61,345 (explaining the rationale behind the proposed regulations).

[229] Absent § 362(e)(2), if a taxpayer contributes loss property to a corporation in a nonrecognition transaction, that loss would be duplicated—the taxpayer would have loss built into the stock he holds in the corporation, and the corporation would have loss built into the asset contributed from the taxpayer (i.e., loss "imported" into the corporation). I.R.C. § 362(a) (2006) (corporation's basis in contributed property); *id.* § 358(a)(1) (2006) (contributing taxpayer's basis in stock received in the exchange). Section 362(e)(2) prevents the loss inherent in the contributed asset from being preserved in both places.

[230] *Id.* § 362(e)(2)(C) (2006).

[231] H.R. Rep. No. 108-755, at 1686 (2004) (Conf. Rep.).

loss in the corporation's basis in the property received.[232] Moreover, the legislative history fails to explain why taxpayers are being provided with this choice. Both the original House bill and the Senate amendment chose a single method for accomplishing the policy goal; both provided that the loss inherent in the contributed property would be preserved only in the contributor's stock.[233] The election was added in the conference agreement, and the legislative history merely states that the conference agreement allows the transferee and transferor to choose whether to preserve the loss in the contributing shareholder's stock or in the corporation's property.[234]

This type of election, where Congress articulates a policy goal but allows the taxpayers to choose how to effectuate that goal, may reflect political compromise or indifference.[235] In these types of situations, an election that allows a taxpayer to decide how to effectuate an articulated policy goal is much more defensible when the alternatives available pursuant to the election reflect methods that are more or less equally plausible approaches to the tax policy objective. If one alternative approach more effectively accomplishes the policy objective, Congress may well have a significant interest in which alternatives are elected by taxpayers. In such situations, Congress should not be indifferent to the result and should be wary of ceding to taxpayers the power to determine how to implement the policy objective. Moreover, even where an election would allow taxpayers to choose among equally plausible methods of accomplishing a policy goal, Congress should be careful of the possibility that deference to taxpayers regarding how to achieve a policy objective might suggest deregulation of the tax law[236] or reflect abdication of Congress's responsibility to establish the tax law.

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[232] As explained in note 229, *supra*, the loss inherent in contributed property can be preserved either in the shareholder's basis in the corporate stock or in the corporation's basis in the property received in the contribution. If the corporation takes the contributed property with the lower fair market value basis, and the loss is preserved in the basis of the shareholder's stock, then no loss has been imported into the corporation. However, if the shareholder reduces its outside basis in its corporate stock down to the fair market value of the contributed asset, and the loss is preserved in the property itself (owned by the corporation after the contribution), then a loss has been imported into the corporation even though there has been no duplication of that loss.

[233] *See* H.R. Rep. No. 108-755, at 1686.

[234] *See id.*

[235] The election provided by § 362(e)(2)(C) could also be a concession to taxpayers in light of the asymmetric treatment for contributions to corporations of property with built-in gains (which does get duplicated) and contributions to corporations of property with built-in losses (which does not get duplicated).

[236] *See* Dean, *supra* note 65, at 420 (explaining that tax reforms that defer to taxpayer preferences, i.e., deregulatory reforms, "will sometimes give rise to changes that have undesirable systemic consequences such as increasing waste" "[b]ecause the[ ] focus [of such reforms] is on private benefits and burdens rather than on systemic objectives, such as preserving societal resources.")

4. *Revealing Valuable Information About Taxpayers' Individual Situations*

Explicit elections also condone tax planning in situations where the taxpayers possess information that, when revealed, can enable their tax treatment to be tailored to their personal circumstances. In exercising his ability to make an explicit election, the taxpayer has the opportunity to make a statement about himself and his specific personal situation.[237] This communication can serve several functions.

Fundamentally, an election that discloses personal information can entitle the taxpayer to some beneficial tax treatment that is available only when particular circumstances exist. Of course, it is common for taxpayers to reveal personal information when filing their tax returns, whether or not they make many explicit elections. For example, a taxpayer who claims a dependency exemption indicates that the taxpayer has a dependent, which in turn enables the taxpayer to reduce his tax liability.[238] Explicit elections can, through their eligibility requirements, force the disclosure of additional detailed information about the electing taxpayer, and Congress can use these disclosure obligations to ensure that the beneficial tax treatment is only available for certain taxpayers.

For example, in the context of stock redemptions that completely terminate a shareholder's actual interest in a corporation, § 302(c)(2) allows taxpayers to explicitly elect to waive the family attribution rules. As a result, the redemption of the taxpayer's stock is more likely to be taxed as a sale than as a dividend to the extent of earnings and profits.[239] However, this election is only available where the taxpayer lacks, and will continue to lack, any significant involvement in, and control over, the corporation.[240] The taxpayer himself is in a better position than the IRS to determine the extent to which he is, and will continue to be, involved in the corporation. The requirements of the election also contain a monitoring obligation, in that the taxpayer has a continuing burden to inform the Service if any of the condi-

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[237] This Part discusses situations where the taxpayer's statement communicates more than just the taxpayer's desire to pay as little tax as possible.

[238] *See* I.R.C. § 151 (2006).

[239] Section 302 sets out five tests for determining whether a redemption will be treated as a sale or as a dividend to the extent of earnings and profits. *Id.* § 302(b) (2006). One such test requires that the shareholder's interest in the corporation is completely terminated. *Id.* § 302(b)(3). A shareholder's interest in a corporation is generally determined after taking into account the constructive ownership rules of § 318. *Id.* § 301(c)(1) (2006). As a result, a shareholder may be treated as constructively owning stock in a corporation even if he owns no actual stock after the redemption. However, if the attribution rules are waived under § 302(c)(2), the taxpayer will not be treated as constructively owning stock that is owned by his family members. *Id.* § 302(c)(2) (2006). This increases the possibility that the taxpayer could be treated as owning none of the corporation's stock after the redemption and thus increases the chances that the taxpayer will meet the complete termination test of § 302(b)(3). Thus, when the attribution rules are waived, the redemption is more likely to be taxed as a sale rather than as a dividend to the extent of earnings and profits.

[240] *Id.* § 302(c)(2).

tions allowing the election cease to be true.[241] Thus, by making the election, the taxpayer communicates to the Service information about his specific circumstances, which entitles him to receive the more favorable tax treatment.

Information-revealing elections can be valuable to the Service for more than just ensuring that particular tax benefits are only available to taxpayers in particular circumstances. The information revealed can also be used by the Service for determining how best to use its resources to enforce the tax laws. For example, Professor Alex Raskolnikov has proposed that taxpayers should be able to make an election between two different enforcement regimes that could apply to them.[242] Taxpayers who generally do not aggressively game the tax system will likely identify themselves by choosing the enforcement regime with lower penalties but with many pro-government presumptions.[243] On the other hand, gamers will likely elect the enforcement regime without the pro-government presumptions, even though it may impose higher penalties.[244] Professor Raskolnikov argues that the election provides information to the Service about the compliance attitudes of the taxpayers, thereby enabling the Service to target enforcement efforts to different types of taxpayers.[245]

However, the Service need not act on information provided by an election in order for there to be merit in an information-revealing election. Elections can also be valuable even if they only serve as an outlet for expression.[246] That is, there can be value in an election that enables a taxpayer to reveal information about himself, even if the Service does not care about or even understand the substance of the information reflected in the choice.

For example, a married couple's election to file returns either jointly or separately[247] often provides a pure tax-planning opportunity, pursuant to which the couple chooses the filing status that best reduces their aggregate tax burden.[248] However, a couple's choice to file jointly or separately can

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[241] *Id.* § 302(c)(2)(A).

[242] *See* Alex Raskolnikov, *Revealing Choices: Using Taxpayer Choice to Target Tax Enforcement*, 109 COLUM. L. REV. 689 (2009).

[243] *Id.* at 708–10.

[244] *Id.*

[245] *Id.* at 708–10, 740–54.

[246] Some elections reveal information not only to the Service, but also to third parties. For example, if an employer grants restricted property to an employee, but that property is subject to forfeiture if the employee quits within five years, an employee who refuses to make a § 83(b) election may be revealing that he expects to leave the company within the five-year forfeiture period.

[247] I.R.C. § 6013(a) (2006).

[248] Congress gave married couples the ability to file jointly in the 1940s, in response to the difference between the treatment of married couples living in community property states and married couples living in common law states. *See* S. REP. NO. 80-1013, at 22–25 (1948). *See generally* Boris Bittker, *Federal Income Taxation and the Family*, 27 STAN. L. REV. 1389, 1412–14 (1975). Rather than legislating a uniform tax treatment for married couples or continuing to allow state law rights of some married couples to effectuate income-splitting for federal income tax purposes, Congress adopted a compromise position and gave all married

also reflect the state of the couple's particular situation and convey information to the government about the way in which the two individuals view themselves and their relationship. For example, spouses that are separating may wish to file separately and keep certain financial information private from the other spouse.[249] Similarly, people who marry later in life may wish to continue to maintain separate financial records and filings. Further, as same-sex couples gain the right to marry in some states, the ability to file jointly in those states[250] may be symbolically important to such a couple. Thus, even though the ability of married couples to elect to file jointly or separately historically provided a pure tax-planning opportunity, this election also allows some modern families the opportunity to have the determination of their tax treatment reflect their personal circumstances. Nevertheless, particularly for the many couples who still treat the election as a pure tax-planning opportunity, the availability of the election is difficult to defend.

E. Conclusions About Functions of Explicit Elections

All explicit elections enable taxpayers to choose the tax rules that apply to them, and thus explicit elections empower taxpayers to minimize their tax burdens. However, this Part demonstrates that explicit elections may have some redeeming value. Particularly where the tax system already provides taxpayers some implicit choice between multiple tax regimes or where a simplicity or administrability goal can be served, explicit elections may help minimize the adverse consequences of our less-than-perfect tax system. Additionally, in the limited circumstances where Congress wants to afford tax-planning opportunities to taxpayers or where there may be inherent value in affording taxpayers some degree of personal autonomy within the tax system, explicit elections can be used to provide those opportunities. Nevertheless, the various functions of elections described herein are not equally useful, and even within functional categories, some elections may be more effective than others. Further, as discussed above, each use of explicit elections has significant limitations, so tax elections should be used with cau-

couples the choice of whether to split their income. *See id.* at 1412–14. As enacted, the ability of married taxpayers to file jointly or separately provided a pure tax-planning opportunity and allowed a tax reduction to the vast majority of married couples living in common law states. *See id.* at 1413. Today, this election is commonly used by taxpayers as an opportunity to reduce taxes without any other consequence. A married couple's accountant can tell the couple what its tax burden will be if the spouses file jointly and if the spouses file separately, and the married couple can just select the filing status that will provide the lower tax burden. It is often advantageous for married taxpayers to file jointly, but in limited circumstances, such as where one spouse has significant unreimbursed medical expenses and relatively low income, separate filing can provide a lower aggregate tax burden. *See generally* Martin J. McMahon, Jr. & Lawrence A. Zelenak, Federal Income Taxation of Individuals ¶ 44.02 (2007).

[249] *See id.*

[250] Even if a same-sex couple is legally married in their state of residence, they may not file as married for federal income tax purposes.

tion. However, by articulating and assessing the functions that explicit elections can serve, their benefits can be balanced against the criticisms of elections that were described in Part II, thereby enabling a more comprehensive analysis of the role of explicit choice in the tax law.

IV. Key Considerations for Designing Explicit Elections

Several key issues affect the balance between the possible benefits of an election and the potential problems it creates. Accordingly, this Part draws on experience with several elections in order to distill some generally applicable recommendations about how to design explicit elections so as to maximize their efficacy and minimize problems associated with their use.

A. Default Rules

Explicit elections generally provide taxpayers with an opportunity to opt out of a default treatment. Typically, this default treatment is specifically provided in the statute or regulations. For example, § 743(a) provides that there is no adjustment to the basis of partnership property upon the transfer of a partnership interest unless there is a § 754 election in effect. Further, the entity classification regulations provide that unincorporated domestic entities are generally treated as partnerships or disregarded entities (depending on the number of owners) unless the entity elects to be taxed as a corporation.[251] The default rules for several elections have changed over time.[252]

The choice of a default rule can have a significant impact on the consequences of the tax election, and commentators advocate different approaches to the design of default rules.[253] Default rules can be designed to meet tax-

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[251] Treas. Reg. § 301.7701-3(b)(1) (as amended in 2006); *see also id.* § 301.7701-3(b)(2) (providing slightly different default rules for the classification of foreign eligible entities not making elections).

[252] For example, taxpayers originally had to elect to take the standard deduction, but now the standard deduction is the default treatment, and taxpayers who want to itemize must elect out. *Compare* I.R.C. §§ 63, 144 (1976) (providing that the "standard deduction shall be allowed if taxpayer so elects" and that, otherwise, deductions must be itemized), *with id.* § 63 (2006) (providing that taxpayers are entitled to the standard deduction unless they elect to itemize their deduction). Similarly, the installment sale treatment used to be elective, but now it is the default. *Compare id.* § 453(a), (c) (1964) (providing that a taxpayer may use the installment method if he so elects), *with id.* § 453(a), (d) (2006) (the installment method shall apply unless the taxpayer elects out of its application); H. Rep. No. 96-1042, at 2 (1980) ("The bill eliminates the present law requirement that the installment method must be elected for reporting gains from sales of realty and nondealer personal property. Instead, the provision will automatically apply to a qualified sale unless the taxpayer elects not to have the provision apply with respect to a deferred payment sale.").

[253] *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, The Economic Structure of Corporate Law 15 (1991) (default rules in corporate law); Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 Yale L.J. 87 (1989) (default rules in contracts); Richard Craswell, *Contract Law, Default Rules, and the Philosophy of Promising*, 88 Mich. L. Rev. 489 (1989); Jason Scott Johnston, *Strategic Bargaining and the Economic Theory of Contract Default Rules*, 100 Yale L.J. 615 (1990); Erik

payer expectations and to provide to taxpayers what they would have wanted had they had complete information.[254] Alternatively, default rules can be "penalty defaults," which "purposefully set [the default rule] at what the parties would not want" in order to "give at least one party . . . an incentive to contract around the default rules and therefore to choose affirmatively the contract provision they prefer,"[255] thereby inducing "valuable information revelation with low transaction costs."[256] Although most of the academic literature discussing default rules comes from contract theory and corporate law theory,[257] much of the analysis is transferable into the setting of tax elections by treating the election as the taxpayer's opportunity to contract out of a default term in an implied agreement between the taxpayer and the government.[258]

When considering these alternative approaches in the context of tax elections, default rules that meet taxpayer expectations are generally preferable to penalty default rules. By meeting expectations, the default rules enhance equity because taxpayers who might fail to make an election because of their lack of knowledge, sophistication, or ability to afford advice are likely to get their desired treatment anyway and thus are less likely to be harmed as a result of their lack of knowledge. The ALI advocated for this approach in its proposed reorganization election, explaining that "in the absence of an effective election, acquisitions should be classified as simply and as consistently as possible with the likely expectations of those who are most apt to neglect to make a specific election."[259]

In contrast, a penalty default rule generally provides undesirable tax treatment to those taxpayers who, for whatever reason, fail to act. This could disadvantage less knowledgeable and less sophisticated taxpayers who might not know which choice to make (or even know that there is a choice to make). Moreover, using penalty default rules in tax elections would likely raise transaction costs,[260] given that significant numbers of taxpayers would not want the default treatment and would thus have to elect out. Thus, transaction costs are generally reduced by choosing default rules that meet taxpayer expectations because fewer elections need to be filed, which makes

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Maskin, *On the Rationale for Penalty Default Rules*, 33 FLA. ST. L. REV. 557 (2006); *cf.* Henry E. Smith, *Intermediate Filing in Household Taxation*, 72 S. CAL. L. REV. 145 (1998) (considering a penalty default in taxing household income).

[254] *See, e.g.*, EASTERBROOK & FISCHEL, *supra* note 253.

[255] Ayres & Gertner, *supra* note 253, at 91.

[256] *See id.* at 128.

[257] *See, e.g.*, EASTERBROOK & FISCHEL, *supra* note 253; Ayres & Gertner, *supra* note 253; Craswell, *supra* note 253; Johnston, *supra* note 253.

[258] For tax elections that impose third party tradeoffs or that are made jointly by multiple taxpayers, the election can be understood as a way to contract out of default treatment via an agreement among the government and all taxpayers who are directly affected by the election.

[259] A.L.I. PROPOSED REORGANIZATION ELECTION, *supra* note 144, at 41–42.

[260] For example, reversing the current default rules for the check-the-box regulations would mean that a huge number of additional elections would have to be filed, creating significant additional paperwork for taxpayers to prepare and for the IRS to process.

the exercise of the tax choice simpler for taxpayers and easier to administer for the Service. For example, the default rules for the entity classification election seem, very generally, to meet taxpayers' expectations; of the millions of domestic businesses formed since the enactment of the entity classification election, only approximately 174,000 newly-formed domestic entities filed entity classification elections.[261] Similarly, the vast majority of tax expenditures, such as § 121's exclusion from income for a portion of gain on the sale of a principal residence, reduce the current tax burden of (and thus, are generally desired by) taxpayers who are eligible for the tax expenditures. Thus, the default rules for elective tax expenditures typically provide that the taxpayer is entitled to the tax benefit unless the taxpayer elects otherwise.[262]

One common problem with the adoption of default rules that are intended to meet the expectations of the parties is defining that expectation.[263] However, this should not be particularly difficult in many tax contexts—it is well accepted that taxpayers generally want to reduce their tax liabilities. Further, taxpayers' behavior can help to demonstrate their preferences and expectations, thereby enabling Congress or the Service to change a default rule if it fails to meet taxpayer expectations. For example, the default rules in §§ 195, 248, and 709 provide that start-up and organizational expenditures are not amortizable.[264] However, the vast majority of eligible taxpayers elected to opt out of these default rules and into tax treatment that allowed amortization, indicating that the default rules provided in the Code failed to align with taxpayer preferences.[265] In order to better meet taxpayer expectations, the Treasury promulgated regulations under each of these provisions "deeming" taxpayers to make the election to amortize start-up and organizational expenditures unless the taxpayer affirmatively chooses otherwise.[266] In effect, these regulations acknowledge that the vast majority of eligible taxpayers want to elect to amortize these costs, and thus the regulations reverse the default rules in an effort to meet taxpayer expectations and thereby reduce the burden on the taxpayers and the Service.[267]

Notwithstanding the foregoing, there may be a limited role for penalty default rules in tax elections. For example, since penalty default rules can be

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[261] Field, *supra* note 10, at 472 (citing data obtained from the Statistics of Income Division of the IRS).

[262] *See, e.g.*, I.R.C. § 121(f) (2006); *see also, e.g.*, *id.* § 168(b)(1), (b)(5) (2006) (providing that the default depreciation method for most personal property is the accelerated double declining balance method and that the slower straight line method is only available if the taxpayer affirmatively elects).

[263] *See* Ayres & Gertner, *supra* note 253, at 93.

[264] I.R.C. §§ 195, 248, 709 (2006).

[265] T.D. 9411, 2008-34 I.R.B. 398.

[266] Treas. Reg. §§ 1.195-1T, 1.248-1T, 1.709-1T (2008) (issued in T.D. 9411).

[267] T.D. 9411 ("The manner of filing these elections is . . . in acknowledgment that the vast majority of taxpayers that incur costs that may be deducted under sections 195, 248, and 709 elect to deduct those costs. The change also reduces the administrative burden of making the elections.").

used to encourage the revelation of valuable information,[268] a penalty default rule may be appropriate where the government needs particular information from a taxpayer before affording the taxpayer certain favorable treatment. One example is a taxpayer's ability to elect to waive the family attribution rules for purposes of determining whether a stock redemption will be treated as a sale.[269] As discussed in Part III.D.4, under § 302, when a taxpayer and one or more of his family members own stock in a corporation, favorable tax treatment of the redemption of the taxpayer's stock may only be available if the taxpayer elects to waive family attribution. The taxpayer can only make the election by providing information to the Service explaining that the taxpayer lacks and will continue to lack any significant involvement in, and control over, the corporation.[270] That is, § 302(c)(2) effectively provides that Congress is only willing to afford the more favorable treatment to a taxpayer if certain facts are present, and thus the availability of the more favorable tax treatment is conditioned on the provision of specific information to the Service. Thus the penalty default works to limit the favorable tax treatment to those situations where the taxpayer communicates to the government that certain facts exist.

Nevertheless, absent a strong justification for the use of a penalty default, the tax law should generally employ default rules that meet taxpayer expectations because expectation-meeting default rules generally enhance the efficacy of an election while minimizing the burden imposed by the election on taxpayers and the Service. Ultimately, regardless of which type of default rule is adopted for a particular election, the default rule should be selected with care.

B. Eligibility Limitations

Every explicit election is subject to eligibility requirements that define the set of situations where the election is available. For example, a § 338 election is only available if, among other requirements, there is a purchase of eighty percent or more of a target corporation's stock,[271] and in order to make an entity classification election, a business cannot be incorporated under a state or federal incorporation statute.[272]

Any limitation on the availability of an election necessarily draws a line and treats some taxpayers differently than others. For example, a two-member domestic limited liability company ("LLC") is generally eligible to make an entity classification election, while a two-shareholder domestic corporation is not, even though both businesses may have substantially similar

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[268] *See* Ayres & Gertner, *supra* note 253, at 128.

[269] I.R.C. § 302(c)(2) (2006); *see supra* Part III.D.4 (discussing the election available pursuant to § 302(c)(2)).

[270] I.R.C. § 302(c)(2).

[271] *Id.* § 338(a), (d)(3) (2006).

[272] Treas. Reg. § 301.7701-2(b)(1) (as amended in 2009).

legal and economic arrangements.[273] This type of limitation on the availability of the election should be defensible both in the affirmative and in the negative; the election should be allowed in all situations where the function of the election is served, and the election should be prohibited where the function is not served. Over-inclusive and under-inclusive eligibility requirements can limit the efficacy of the election and can introduce inequities and inefficiencies, possibly creating as many problems as the election itself is intended to solve. For example, some scholars have argued that the entity classification rules[274] draw inappropriate lines,[275] and some scholars suggest that private businesses operated in incorporated entities should be treated the same way as private businesses operated in LLCs.[276] Moreover, difficulty in justifying the limitations on the election can cast suspicion on the use of the election at all. Thus, when designing or examining an explicit election, attention should be paid to ensure that the limitations on the election are appropriately drawn.

C. Technical Requirements for Making Elections

Administrative guidance is often needed to explain the technical requirements for making an election—i.e., addressing how the election is made, when the election is made, and by whom the election is made.[277] Congress's delegation of this responsibility to the Treasury is reasonable because the Treasury is often better-able to determine the precise format and timing for an election.[278] However, this relationship between statutorily-provided elections and administratively-provided rules implementing the election means that there will be a time lag between the enactment of any election and the promulgation of regulations that explain how to make the election.

That time lag should be minimized to the extent practicable because shorter time delays enable faster and better implementation of the policy

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[273] *Id.* §§ 301.7701-2(b)(1), -3(a).

[274] I.R.C. § 7701(a)(3) (2006) (defining "corporation"); Treas. Reg. §§ 301.7701-2, -3 (the entity classification regulations).

[275] *See, e.g.*, Field, *supra* note 10, at 499–522 (analyzing the limitations on the entity classification election and concluding that some of the limitations, including the denial of entity classification choice for incorporated entities, are difficult to defend).

[276] *See, e.g.*, A.L.I. Private Enterprise Study, *supra* note 158.

[277] For example, while § 338 allows taxpayers to elect to treat certain stock sales as asset sales, the statute specifically defers to regulations promulgated by the Treasury Department regarding the manner in which the election is made. I.R.C. § 338(g)(2) (2006); Treas. Reg. § 1.338-2 (2001); *see also, e.g.*, American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 1231(a), 123 Stat. 115, 338–41 (to be codified at 26 U.S.C. § 108(i)) (adding a new election enabling taxpayers to defer the inclusion of cancellation of indebtedness); Rev. Proc. 2009-37, 2009-36 I.R.B. 1 (describing the time and manner for making an election under § 108(i)).

[278] This is because the IRS, a bureau of the Treasury Department, is responsible for enforcing the tax laws, and thus the IRS and the Treasury have unique insight into exactly what information is needed and when that information is needed in order to effectively enforce the laws.

behind the election, and longer time delays can pose a significant impediment to taxpayers' use of the election. An extreme example of this lag involves the § 336(e) election. Very generally, § 336(e) provides that when a corporation, which owns eighty percent or more of the stock of a subsidiary, disposes of that stock, an election can be made to treat that stock disposition as an asset acquisition.[279] Section 336(e) was added to the Code in 1986,[280] but regulations explaining the consequences of a § 336(e) election and articulating the technical requirements for making a § 336(e) election were not proposed until August 2008.[281] The absence of these regulations for over twenty years effectively prevented the § 336(e) election from having any meaningful impact in the interim.[282] Thus, technical requirements for an explicit election should be explained as soon as possible after the adoption of the election because failure to clearly and quickly articulate the technical requirements for making an election can diminish the potential positive policy impact of the election.

Further, there are many elections in the Code with a wide variety of different technical requirements. These different technical requirements are so burdensome that an entire treatise is dedicated exclusively to listing the exact method and time frame for making each election.[283] Thus, any effort to coordinate the technical requirements of similar or related elections may help increase simplicity and reduce administrative costs.[284]

D. Combating Abuse

Tax elections reflect the ultimate in formalism; they are the essence of "rules" as opposed to "standards"[285] because they not only present bright lines that taxpayers can take into account when planning a transaction, but they also empower taxpayers to choose on which side of the line they wish to land without changing either the form or the substance of the transaction. This provides certainty in the tax law, but this certainty enables taxpayers to use the tax rules in ways that Congress may not have intended, even when

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[279] In many ways, the § 336(e) election is quite similar to the § 338 election.

[280] Tax Law Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986); H.R. REP. NO. 99-841 (1986).

[281] Prop. Treas. Reg. §§ 1.336-1 to -4, 73 Fed. Reg. 49,965 (Aug. 25, 2008).

[282] *See* Jasper L. Cummings, Jr., *Important Corporate Tax and Related Developments: 2005–2006*, *in* 726 PRACTISING LAW INST., TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS 1203–04 (2006) (noting that, in the absence of regulations, it was unclear whether taxpayers could make § 336(e) elections).

[283] TAX ELECTIONS DESKBOOK, *supra* note 14.

[284] For example, the Service has provided some coordination between the election to amortize start-up expenditures under § 195 and the elections to amortize organizational expenses under §§ 248 and 709. *See* T.D. 9411, 2008-34 I.R.B. 398.

[285] *See generally* Mark P. Gergen, *The Common Knowledge of Tax Abuse*, 51 SMU L. REV. 131 (2001); Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557 (1992); Cass R. Sunstein, *Problems with Rules*, 83 CAL. L. REV. 953 (1995); Weisbach, *supra* note 89, at 861–65.

taxpayers' actions technically comply with the letter of the law. Thus, as with many rules, the tax planning that is enabled by tax elections can easily be abusive.

For example, scholars have criticized the use of the entity classification election for foreign entities because it enables revenue-reducing tax planning that is inconsistent with the objectives of the Code provisions for taxing foreign income.[286] Additionally, in response to perceived abuses involving inappropriate treatment of losses in connection with sales of partnership interests or distributions from partnerships, Congress made certain downward inside basis adjustments mandatory rather than elective.[287]

In light of the risk of abuse and misuse of elections, proponents of explicit elections should be particularly sensitive to the possibility of abuse and should consider how to counteract the risk. If the abuses of an election are too severe, then repealing the election may be appropriate. For example, some commentators proposed eliminating the entity classification election for foreign entities.[288] Short of eliminating an election that presents some abuses, Congress and the Treasury should be as deliberate and detailed as possible in designing elections to constrain the availability of the election to only those situations where the election's use is intended. Unfortunately, this approach can create significant complexity and can be quite costly to undertake.[289]

Alternatively, abuse could be addressed not by changing the election itself, but by changing the underlying tax provisions that apply depending on which choice is made in the election. For example, in an effort to curb perceived abuses of the entity classification election for foreign entities, the Service attempted to modify the Subpart F rules rather than the election itself.[290] Another approach would be to require that the election operate in conjunction with anti-abuse rules. For example, taxpayers can make elections pursuant to § 754, but the resultant tax consequences remain subject to the general partnership anti-abuse provisions.[291] However, introducing an anti-abuse standard into the analysis may reverse some of the efficiency,

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[286] *See generally* Field, *supra* note 10, at 487–96 (noting that, among other problems, many commentators are concerned that "the elective nature of the [check-the-box] regulations as applied to foreign business entities undermines the appropriate application of the Subpart F and foreign tax credit regimes.").

[287] I.R.C. § 743(a) (2006) (mandatory inside basis adjustment upon the sale or exchange of a partnership interest when there is "substantial built in loss"); *id.* § 734(a) (2006) (mandatory inside basis adjustment upon the distribution of property to a partner when there is a "substantial basis reduction"); *see also* H.R. Rep. No. 108-755, at 1673–79 (2004) (Conf. Rep.) (explaining the risk of abuse requiring these changes).

[288] *See, e.g.*, Am. Bar Ass'n, *Report of the Task Force on International Tax Reform*, 59 Tax Law. 649, 669 (2006) (proposing to eliminate the elective nature of entity classification for foreign entities).

[289] This is often the case when rules are used instead of standards. *See generally* Kaplow, *supra* note 285; Sunstein, *supra* note 285; Weisbach, *supra* note 89, at 861–65.

[290] *See generally* Field, *supra* note 10, at 488–89 & nn.198–202.

[291] *See* I.R.C. § 701 (2006); Treas. Reg. § 1.701-2(d), exs. 8–9 (1995).

simplicity, and certainty gains conferred by the election.[292] Regardless of the particular approach taken to stymie abuse of elections, legislators and administrators should understand that all explicit elections pose the risk of abuse because they are inherently tax-planning opportunities. Thus, if possible, that risk of abuse should be monitored and addressed.

V. Conclusion

The purpose of this Article is neither to staunchly defend all of the existing explicit tax elections nor to advocate for the increased use of explicit elections throughout the tax system. Rather, this Article merely seeks to draw scholarly attention to the understudied role of explicit elections in the income tax, and this Article endeavors to provide a framework for discussing how those elections are and should be used. This framework acknowledges the compelling arguments against allowing taxpayers to choose which tax laws apply to them but also suggests that there can be a place for explicitly provided taxpayer choices in the tax law, particularly if implemented in a way that maximizes their benefits. Explicit elections are entrenched in the tax law, but they need not be merely endured; in limited circumstances and if designed carefully, explicit elections can be embraced as valuable tools in the design and administration of the tax system.

Moreover, the study of explicit elections can provide insight into the overall balance of power between the taxpayers and the government. Explicit elections involve the government affirmatively turning over to the taxpayers the right to determine their own tax consequences. While commentators often bemoan the taxpayers' seizing of the power to achieve tax consequences that may be unintended by the government—i.e., tax planning—studying explicit elections may help us better understand the role that taxpayers do and should have in determining their own tax treatment.

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[292] *See generally* Kaplow, *supra* note 285; Sunstein, *supra* note 285; Weisbach, *supra* note 89.