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REGULATORY TAX PENALTIES

DAVID I. WALKER*

ABSTRACT

Regulatory tax penalties are provisions of tax law that are targeted at and raise the effective cost of non-tax behavior. Generally, they are meant to shape behavior rather than raise revenue. This Article focuses on tax penalties taking the form of disallowed federal income tax deductions or credits and considers such provisions from both a descriptive and normative perspective. The descriptive section asks why we encounter these provisions in the tax code – why tax penalties instead of non-tax regulation? This Article offers two explanations – one constitutional, the other procedural – but both relate to the inherent ambiguity of denying deductions or credits. First, as a result of the breadth of the taxing power, the powerful maxim that deductions are a matter of legislative grace, and confusion as to whether a denied deduction or credit imposes a penalty or removes a subsidy, use of the tax code to regulate activity that burdens First Amendment rights or raises federalism concerns faces a much lower degree of constitutional scrutiny than equivalent direct regulation. Second, even when equivalent non-tax regulation would be subjected to equal scrutiny, these features and others assist in the enactment of disincentives that are structured as disallowed tax deductions or credits. For example, structuring a disincentive as a disallowed deduction or credit allows proponents to frame the intervention as the elimination of a subsidy rather than the imposition of a penalty. This Article provides empirical evidence supporting the idea that such framing would be useful in overcoming opposition to regulatory intervention. Taken together, these process advantages may dominate legislative strategy, particularly when symbolic rather than instrumental effects of legislating provide the primary motivation for the sponsors. However, the Article goes on to argue that several of these process advantages are troubling from a normative perspective and that ultimately the social welfare implications of regulatory tax penalties are indeterminate.

* Associate Professor, Boston University School of Law. Acknowledgements….

INTRODUCTION

In the early 1990s, President Clinton proposed legislation limiting the deductibility of executive salaries.[1] He successfully argued that taxpayers should not be subsidizing excessive CEO pay.[2] The legislation enacted, Internal Revenue Code (IRC or Code) § 162(m), is economically equivalent to a direct fine or penalty levied on excessive executive salaries. Had the legislation taken that form, however, no one would have argued that it represented the elimination of a subsidy. So does § 162(m) penalize companies that continue to pay excessive executive salaries (as many do), or does it eliminate a taxpayer subsidy?

How about the provision of the tax code that disallows deductions for business advertising with respect to public referenda?[3] Direct attempts to curtail such spending have been invalidated on First Amendment grounds.[4] But when the tax rule was challenged, the Supreme Court held that the deduction disallowance did not penalize the taxpayer, it simply reflected an unwillingness to subsidize political advocacy, which had no constitutional implications.[5] Tax penalty or "non-subsidy"?

This Article will not answer these questions. Sorry. However, it will argue that the *ambiguity* of disallowed tax deductions – the difficulty in determining whether they penalize or simply avoid subsidizing – helps explain why executive pay regulation is found in the tax code and why the disallowance of deductions for political advocacy survived constitutional challenge.

This Article provides both a positive and a normative analysis of regulatory tax penalties, which I define as provisions of the federal income tax that are targeted at and raise the effective cost of non-tax behavior, such as executive pay or political advocacy. Generally these penalties take the form of disallowed deductions or credits, and they often appear to be designed to discourage certain non-tax behavior, although that is not the only possible interpretation. Consider again § 162(m), which, more technically, denies corporate tax deductions for excessive non-performance based pay for senior executives.[6] One can view this provision as discouraging non-performance based pay or encouraging performance based pay. It is clearly a regulatory tax penalty, however, in the limited sense that it is directed at non-tax behavior (executive pay practices) and that it raises the effective after-tax cost of engaging in certain behavior (providing too much non-performance based pay).[7]

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[1] *See* Keith Epstein & Eamon Javers, *How Bill Clinton Helped Boost CEO Pay*, BUS. WEEK, Nov. 27, 2006.

[2] *See, e.g.*, William J. Clinton, Remarks to Business Leaders (Feb. 11, 1993) (available at: http://www.presidency.ucsb.edu/ws/index.php?pid=47010) (stating that "the Tax Code should no longer subsidize excessive pay of chief executives and other high executives").

[3] I.R.C. § 162(e).

[4] *See* First National Bank of Boston v. Bellotti, 435 U.S. 765 (1978) and discussion *infra* Part x.

[5] *See* Cammarano v. CIR, 358 U.S. 498 (1959) and discussion *infra* Part x.

[6] Salary, as traditionally understood as a fixed amount of compensation over a period, is the paradigm of non-performance based pay. Stock and stock option compensation are examples of performance based pay in that the payoff from these instruments is tied to the stock performance of the company.

[7] This is not to suggest that providing economic incentives is the only purpose behind the enactment of tax penalties. Provisions such as § 162(m) may also serve an expressive or a symbolic function. *See infra* Part II.B.2.c.

The positive analysis provided by this Article is not meant to be exhaustive. Rather, it focuses on two features that help explain why we observe regulatory tax penalties that are structured as the denial of a deduction or credit.

First, there is constitutional jurisprudence that privileges certain tax penalties over non-tax equivalents. As a result of the breadth of the taxing power, the powerful maxim that deductions are a matter of legislative grace, and confusion as to whether a denied deduction imposes a penalty or removes a subsidy, Congress is able to target activities through the tax code with little or no judicial review when equivalent direct regulation would face exacting scrutiny and a much greater likelihood of invalidation.[8] An important example is the disallowance of deductions for certain lobbying and voter outreach expenses under IRC § 162(e).[9] Less far reaching direct regulation of corporate advertising on public referenda was struck down as inconsistent with the First Amendment in *First National Bank of Boston v. Bellotti*,[10] but a First Amendment challenge to the Treasury Regulations that preceded § 162(e) was not seriously entertained by the Court.[11]

Second, in cases in which tax and non-tax regulation are equally feasible constitutionally, the ability to structure a disincentive as a disallowed deduction or credit provides significant advantages in the enactment of legislation. As a result, tax penalties provide a sponsor with an attractive means of advancing legislation, particularly symbolic legislation for which the mere act of enactment may be the primary goal.[12] Of course, it may be administratively convenient to structure a regulation as a tax penalty, just as it may be for positive tax incentives or subsidies, but the process advantages associated with tax penalties go well beyond mere administrative convenience.

Consider again the provision denying deductions for excessive non-performance based executive pay. Casting this regulation in the form of a disallowed deduction rather than an outright ban or a tax-like penalty scheme implemented outside of the Code takes advantage of the long-standing deference paid to Congress by the courts when Congress creates, revokes, or conditions tax deductions, i.e., invokes the "legislative grace" maxim.

Obviously, there is substantial overlap between regulatory tax penalties, as I define them, and negative tax expenditures, as defined in the literature growing out of the work of Stanley Surrey. Surrey actually defined tax incentives as a subset of tax expenditures related to voluntary taxpayer behavior. *See* Stanley S. Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 HARV. L. REV. 705, 712 (1970). My approach is similar. I do not treat the terms "tax penalty" and "negative tax expenditure" as synonymous as many commentators do. For one thing, making the concept of negative tax expenditures operational requires the definition of a normative tax base. For the purposes of this Article, however, it is not necessary to define a normative tax base, and I will not attempt to do so. Although similar, my definition of regulatory tax penalties is somewhat broader than that adopted by Eric Zolt. *See* Eric M. Zolt, *Deterrence Via Taxation: A Critical Analysis of Tax Penalty Provisions*, 37 UCLA L.REV. 343, 348 (1989) (stating intention to "focus[] only on those provisions for which Congress' motive is to penalize illegal or undesirable nontax activities"). My definition of regulatory tax penalty does not depend on finding any particular congressional motive.

[8] Although it is not clear why Congress' discretion should be greater in this area than others, deductions have long been held to be a matter of legislative grace, not of right. *See* New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934); *see also* Helvering v. Independent Life Ins. Co., 292 U.S. 371, 381 (1934) ("[u]nquestionably Congress has the power to condition, limit, or deny deductions from gross income in order to arrive at the net that it chooses to tax").

[9] *See infra* Part II.B.1.b.

[10] 435 U.S. 765 (1978).

[11] *See Cammarano,* 358 U.S. 498 and discussion *infra* Part x.

[12] *See infra* Part II.B.2.c for a discussion of symbolic legislation.

More importantly for enactment, structuring the penalty as a disallowed deduction enables proponents to *frame* the intervention as the elimination of a subsidy for excessive non-performance based pay rather than as the imposition of a penalty. This rhetorical device is important when the tax penalty is aimed at economic regulation that might be resisted by free market-oriented legislators.

More generally, tax penalties of this form appear to take advantage of public and congressional confusion over whose money is at stake when a deduction is disallowed. Interestingly, these tax penalties are consistent with the long-standing tradition of denying deductions to wrongdoers in determining liability in tort. Classically, under both English and American law, a wrongful converter of property could not deduct his costs in calculating liability to the rightful owner.[13] This doctrine may reflect similar confusion over the distinction between penalties and revoked subsidies, but it reinforces the idea that the right to deductions is contingent, and in particular, is contingent on refraining from disfavored behaviors.

Additionally, although a tax penalty is a "remarkably crude policy instrument"[14] that applies a one-size-fits-all-offenses sanction, disallowing a deduction allows Congress to avoid hard questions about the nature and extent of the appropriate penalty, questions that might expose superficial or otherwise inadequate analysis. Moreover, by avoiding congressional subject matter committees, the tax penalty approach potentially undermines the efficacy of special interests opposing the penalty.[15]

Next, enactment aside, there are administrative differences between tax and non-tax penalties that are not seen on the subsidy side of the ledger. For example, the maxim that deductions are a matter of legislative grace has routinely been invoked by the courts to shift the burden onto the taxpayer to show that it is entitled to a deduction (and to avoid a tax penalty).[16] Regulated parties do not have to prove that direct fines or penalties have been improperly levied, so this distinction can be viewed as an aid to enforcement of tax penalties or simply as unfairness arising from artificial distinctions.

In cases in which both tax and non-tax regulation are feasible, the preference for tax penalties simply reflects a decision about legislative strategy. Given the enactment advantages, it is not surprising to observe tax penalties, particularly when legislation is

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[13] *See, e.g.,* Livingstone v. Rawyards Coal Co., L.R. 5 App. Cas. 25 (1880) (Lord Hatherley) ("There is no doubt that if a man furtively and in bad faith robs his neighbour of property…the Court of Equity in this country will…punish fraud by fixing the person with the value of the whole of the property which he has so furtively taken, and making him no allowance in respect of what he has so done as would have been justly made to him if the [man had taken the property] through a mistake.").

[14] Zolt, *supra* note x, at 344-45. The denial of a deduction, the classic tax penalty, has the effect of imposing a 35% penalty on an offending individual or corporation paying tax at the highest marginal rate, but the penalty has lesser or even no effect on corporate taxpayers with large accumulated losses or individual taxpayers in lower brackets. This Article focuses primarily on process and does not consider whether alternative tax penalty approaches, such as excise taxes, might be more efficient. *Cf.* Lily Batchelder et al, *Efficiency and Tax Incentives: The Case for Refundable Tax Credits,* 59 STAN. L.REV. (2006) (arguing that tax incentives generally are most efficiently structured as refundable tax credits).

[15] *See* Edward A. Zelinsky, *James Madison and Public Choice at Gucci Gulch: A Procedural Defense of Tax Expenditures and Tax Institutions*, 102 YALE L.J. 1165 (1993) (arguing that special interest lobbying is more effective in non-tax committees than tax committees because a single special interest or alliance of special interests often will dominate the former and because the deliberations of the former often are less public)

[16] *See, e.g.,* Stroud v. U.S., 906 F.Supp. 990 (D.S.C. 1995), *aff'd in part, vacated in part on other grounds*, 94 F.3d 642 (4th Cir. 1996).

largely symbolic. In both cases, far from being haphazard or incoherent, as one commentator has suggested, tax penalties turn out on closer examination to be reasonably predictable.[17]

Although the enactment advantages described seem intuitive, this Article also reports the results of a survey used to test certain elements of the theory – specifically, the impact of disincentive structure and framing on public perception. Several hundred law students were asked to rate their support for hypothetical regulation of "excessive" executive pensions. Consistent with the suggestions above, the students were less inclined to support direct penalties on excess pensions than they were to support the elimination of a deduction, although the two interventions were structured to be economically equivalent. Moreover, support for deduction curtailment was greater when the disallowance was framed as the elimination of a subsidy than when the change was presented in neutral language without any mention of subsidization.

Although the process advantages and other differences between tax penalties and direct regulation may help explain the popularity of tax penalties (and relative dearth of tax-like non-tax penalties) in federal regulation today, many of these "advantages" are suspect from a normative perspective, raising concerns about social welfare and preservation of democratic values. For example, the fact that tax penalties structured as denied deductions allow Congress to avoid questions about appropriate penalties for violators is unlikely to result in high quality legislation. Further, although framing effects may be unavoidable, we should be uncomfortable if tax penalties are enacted when equivalent non-tax regulation would have been rejected. Tax penalties and non-tax regulation are not necessarily equivalent, but when they are, artificial distinctions created by the courts or sustained in the public or congressional imagination are unlikely to produce efficient results.

One way to get a handle on the normative effects of tax penalties is to imagine a world without them. The current individual and corporate income tax structures provide a broad apparatus from which Congress may hang tax penalties; and Congress has often utilized this public policy tool, particularly in the area of corporate governance, enacting tax disincentives for what it deems to be excessive executive compensation, excessive golden parachute payments, and greenmail payments. Even with the most fertile imagination, it is hard to imagine Congress voluntarily forsaking regulatory tax penalties, but replacement of the individual income tax with a consumption tax or adoption of certain schemes for integrating the corporate and individual taxes could reduce or eliminate Congress' opportunity to utilize tax penalties.[18]

The welfare implications of eliminating tax penalties in this manner are indeterminate. On the one hand, any change that makes it more difficult for Congress to implement penalties could result in less regulation, for good or ill. Some tax penalties, such as Code § 162(f), which disallows deductions for fines and penalties paid, were probably enacted to avoid an appearance of subsidizing "bad" behavior. The appearance

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[17] *See* Zolt, *supra* note x. Tax penalties may appear to be haphazard and incoherent because Congress' decisions to intervene and regulate seem haphazard and incoherent. If we take that decision as a given, the choice of tax penalties over alternative regulatory schemes is reasonably predictable.

[18] Calvin Johnson has recently suggested replacing the corporate income tax on publicly traded companies with a tax based on market capitalization. *See* Calvin H. Johnson, *Replace the Corporate Tax with a Market Capitalization Tax*, TAX NOTES, Dec. 10, 2007 at 1082. Such a change would eliminate most regulatory tax penalties aimed at corporations.

of subsidy arises if businesses are allowed to deduct these payments as ordinary and necessary business expenses. If the income tax were to disappear, the potential appearance of subsidy would disappear, and no further action would be necessary. Eliminating this largely symbolic legislation would enhance social welfare.

On the other hand, if Congress is determined to intervene – if the driving force for enacting symbolic legislation is very high irrespective of the existence of the income tax – eliminating tax penalties could result in substantively different and potentially *less* efficient regulation. Consider, for example, the difference between the outright prohibition on loans to executives recently enacted as part of the Sarbanes-Oxley Act, which Roberta Romano has called an example of "quack corporate governance,"[19] and a more flexible tax penalty that might have been applied to such loans. Although tax incentives often are rightly criticized,[20] in some situations tax penalties provide Congress with a relatively low cost means of making political statements. In a world in which direct regulation in the mode of SOX were to dominate, we might look back nostalgically on the era of tax penalties, despite their drawbacks.

In addition to its intrinsic interest, it is hoped that the analysis provided in this Article will assist those thinking about positive tax subsidies. Many commentators, going back to Stanley Surrey and Paul McDaniel, have criticized tax subsidies as unnecessarily complicating the Code and have advocated that these provisions be replaced with direct expenditures or eliminated altogether.[21] Other commentators, viewing federal regulation as a whole, have seen efficiency advantages in locating certain non-tax provisions in the Code.[22] In one sense, this Article can be seen in the spirit of the apologists, as looking outside the Code in seeking to understand the presence of non-tax provisions in the Code.

[19] *See* Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521 (2005).

[20] This Article will not consider the underlying efficacy of particular tax penalties and non-tax regulation. I have written skeptically elsewhere regarding the effectiveness of tax penalties in shaping corporate governance, and that appears to be the consensus view. *See* David I. Walker, *Tax Incentives Will Not Close Stock Option Expensing Gap*, TAX NOTES, Aug. 5, 2002 at 851 (arguing that a Senate proposal to limit the deduction for stock options to the amount expenses for financial reporting purposes would not likely achieved its desired purpose); Gregg Polsky, *Controlling Executive Compensation Through the Tax Code* (working paper); [add others]. However, tax penalties directed at other behavior may be more effective. This Article will take no position on these questions, as both the descriptive and normative focus of this Article is on process.

[21] Commentators generally agree that most tax subsidies can be readily replaced with non-tax subsidies and vice versa. *See, e.g.,* STANLEY S. SURREY, PATHWAYS TO TAX REFORM: THE CONCEPT OF TAX EXPENDITURES 129 (1973) ("Skilled tax technicians and budgetary experts can take any tax expenditure and devise a budgetary expenditure approach to serve the same goals"), STANLEY S. SURREY & PAUL R. MCDANIEL, TAX EXPENDITURES 99 (1985) ("Any financial aid or incentive program may be written either as a tax expenditure or as a direct program."), David A. Weisbach & Jacob Nussim, *The Integration of Tax and Spending Programs*, 113 YALE L.J. 955, 961 (2004) ("virtually any program can be implemented … through a direct spending program or through a tax program"); Eric J. Toder, *Tax Cuts or Spending – Does it Make a Difference?*, 53 NAT. TAX J. 361, 363 ("it would be possible to design tax programs that eliminate most federal spending"). [Add others.]

[22] *See* Edward A. Zelinsky, *Efficiency and Income Taxes: The Rehabilitation of Tax Incentives*, 64 TEX. L.REV. 973 (1986). (suggesting that utilization of the IRS's pre-existing channel of communication with taxpayers would reduce the cost of IRS implementation of some non-tax programs); Weisbach & Nussim, *supra* note x (arguing that we need to think about tradeoffs …); Nancy Staudt, *Redundant Tax and Spending Programs*, 100 NW. U. L.REV. 1197 (suggesting that the redundancy between tax and non-tax programs that some commentators criticize could be advantageous in some circumstances).

However, the normative implications of my work differ from theirs. Typically, these commentators have explained why use of the tax code might be efficient and normatively welcome. Although some of my observations speak to efficiency, most of my explanations for the presence of regulatory tax penalties do not. They relate more to the process of enactment than the efficacy of what's enacted and raise normative concerns. This analytical approach, I believe, may shed light on tax subsidies as well.

I. TAX PENALTIES IN CONTEXT

It will be helpful to begin with a brief overview of the tax expenditure debate, the nature and prevalence of tax penalties, and the regulatory options available to Congress and their implications.

A. Nature and History of Regulatory Tax Penalties

On hearing the term tax penalty, most people think of fees that are assessed for late filing or underreporting taxable income. Of course, those penalties are meant to shape behavior – to encourage accurate and timely filing of returns. But this Article is concerned with tax penalties that are meant to regulate *non-tax* behavior, ranging from political activities to executive compensation. While some regulatory tax penalties are structured as excise taxes or surcharges that are similar to late filing fees, regulatory tax penalties more commonly involve curtailing or denying deductions or credits for otherwise deductible/creditable expenses. IRC § 162(m) is a prime example. Corporations normally are permitted to deduct employee compensation. However, § 162(m) of the Code disallows a corporation a deduction for non-performance based pay provided to certain senior executives that exceeds $1 million annually. For example, Bank of America CEO Kenneth Lewis received a salary of $1,500,000 for 2006.[23] Salary is non-performance-based pay. Given § 162(m), Bank of America would be permitted to deduct from its taxable income only $1,000,000 of that amount; the remaining $500,000 would be a non-deductible expense.[24]

Why does Congress impose regulatory tax penalties? Ostensibly, the rationale is that disallowing a deduction or credit or imposing an excise tax increases the after-tax cost of the disfavored activity – here, paying large salaries to executives – which will discourage taxpayers from undertaking the activity. Congress may view the tax penalty as a means of correcting for market failure. Alternatively, Congress may wish to express disapprobation or, in the case of disallowed deductions or credits, to avoid being seen as "subsidizing" disfavored activity by allowing taxpayers to deduct/credit such expenditures.[25] The enactment of some tax penalties may be driven by optics rather than substance.[26]

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[23] *See CEO Compensation Survey/2006*, WALL ST. J., Apr. 9, 2007, at R9.

[24] The $1 million limitation applies to all compensation received by the executive within the year. To simplify exposition, this calculation assumes that all other compensation received by Lewis qualified as performance based.

[25] [Note on debate on allowing Exxon a deduction for Valdez clean up costs?]

[26] As this description suggests, I do not use the term "penalty" as a synonym for "punishment," but as an antonym of "subsidy." Subsidies may be granted to favor the recipient, to encourage activity, or to express approbation; just as penalties may be used to disfavor, to discourage, or to express disapprobation.

This Article focuses on regulatory tax penalties that are embedded in the federal income tax, but the concept of using taxes to regulate commerce predates the modern income tax. In the late 19th century and early 20th century, Congress often used its taxing power to circumvent limitations on its direct regulatory power.[27] For example, in 1886 Congress imposed a disproportionately high excise tax on yellow margarine to discourage its use and support butter production. Although it was clear that this tax was imposed for regulatory rather than revenue-generating purposes (the tax imposed on white margarine that did not compete with butter was 1/40th the tax on yellow margarine), the Supreme Court upheld the statute, refusing to look behind the form of the legislation.[28]

As another example of a regulatory excise tax, consider the 1934 National Firearms Act imposing a license tax on dealers of dangerous firearms. This act was challenged on the grounds that it was not a true tax but a regulatory measure that infringed on power reserved to the States.[29] Again, the act was upheld, with the Court stating that it was "beyond the competency of courts" to "undertake, by collateral inquiry as to the measure of the regulatory effect of a tax, to ascribe to Congress an attempt, under the guise of taxation, to exercise another power denied by the Federal Constitution."[30]

Given the limited view of Congress' power to regulate commerce at the time, it is clear that these regulatory taxes could not be replaced with direct regulation. This was the whole point. Congress turned to regulatory taxes when other avenues were closed off.[31] Today, of course, Congress' power to regulate commerce is much more expansive, but we will see that other impediments to direct regulation continue to make tax penalties an enticing alternative.

When Harvard Law Professor (and former Treasury Department tax policy chief) Stanley Surrey kicked off the debate over tax expenditures in the 1970s, tax penalties were at something of a nadir. The old excise taxes that Congress had used to circumvent limitations on direct regulation had largely been repealed, and tax penalties embedded in the federal income tax were less important than the subsidy provisions. In his 1973 book, Pathways to Tax Reform: The Concept of Tax Expenditures, Surrey focused almost exclusively on subsidies delivered through the Code. He noted that tax disincentives

[27] *See* ERIK M. JENSEN, THE TAXING POWER: A REFERENCE GUIDE TO THE UNITED STATES CONSTITUTION 180 (2005).

[28] *See id*. at 181.

[29] *See* Sonzinsky v. United States, 300 U.S. 506, 512 (1937) (cited in JENSEN, *supra* note x, at 181).

[30] *Sonzinsky*, 300 U.S. at 514. To be sure, Congress was not always successful in using the tax code to regulate via the back door. In the Child Labor Tax Case (Bailey v. Drexel Furniture Co.), 259 U.S. 20 (1922), the Supreme Court invalidated a statute applying a ten percent tax on the net profits of businesses knowingly employing children under certain ages in certain circumstances. The Court noted that in light of the severity of the tax and the scienter requirement it would have to "be blind not to see that the so-called tax [was] imposed to stop the employment of children within the age limits prescribed." As such, the provision did not levy a tax within the meaning of Article 1, Section 8 of the Constitution and impermissibly trod on ground reserved to the states. *See* JENSEN, *supra* note x, at 182.

[31] Although Congress was unsuccessful in the particular case, it is noteworthy that the Child Labor Tax Act, discussed *supra* note x, was enacted within a year of the Supreme Court's rejection of Congress' effort to regulate child labor directly. *See* Hammer v. Dagenhart, 247 U.S. 251 (1918) (decided June 3, 1918, and rejecting direct regulation of child labor). The Child Labor Tax Act was enacted on Feb. 24, 1919.

were relatively rare, but still listed seven Code provisions that he labeled disincentives, including denials of deductions for the following: lobbying and political contributions, payments of fines and penalties, bribes and kickbacks, payment of treble damages in antitrust cases, and net gambling losses.[32] Surrey speculated that the reason for the relative paucity of tax penalties was that Congress was "wary of mixing morals and enforcement against nontax pursuits" into the Code.[33]

Any reticence on Congress' part seems to have disappeared over the last thirty years. In addition to § 162(m) discussed above, Congress has enacted §§ 280G and 4999, which deny a corporate tax deduction and impose an individual excise tax for the payor and recipient, respectively, of certain excessive "golden parachute" severance payments, §§ 162(k) and 5881, which utilize a similar approach to discouraging greenmail, and § 901(j), which disallows credits for taxes paid to foreign countries that the U.S. does not recognize, with which the U.S. has severed diplomatic relations, or which have been designated as supporting international terrorism.[34]

Moreover, during recent years, numerous bills have been introduced in Congress that would have imposed tax penalties on various disfavored business practices. For example, in 1997, Senators Levin and McCain introduced the Ending Double Standards for Stock Options Act, which would have disallowed a corporate tax deduction for stock option expense that was not also deducted from reported earnings.[35] In the 109th Congress alone, at least fifteen bills were introduced that would impose penalties through the denial of tax deductions.[36]

Although most of the tax penalties that have been proposed or adopted during the last thirty years have been aimed at public companies, not all have. Notable counterexamples include Code § 280E, which denies deductions for expenses incurred in the sale of illegal drugs and § 280F, which limits the depreciation deduction for luxury automobiles.[37] Of course, these provisions apply to corporations as well as individuals, but even in the second case, the effect has been felt primarily by small businesses and sole proprietors, rather than public companies.[38]

Tax-like penalties clearly exist outside of the Code. Consider, for example, the federal Corporate Average Fuel Efficiency (CAFE) standards.[39] Vehicle manufacturers that fail to meet the required sales-weighted average fuel economy standard for any model year are fined $5.50 per vehicle for every tenth of a mile per gallon by which their fleet falls short of the standard.[40] This is clearly a tax in an economic sense. However,

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[32] *See* SURREY, *supra* note x, at 336-337.

[33] *Id*. at 337.

[34] Until 1993 this provision was also used to disallow tax credits for companies doing business in South Africa.

[35] S. 576, 105th Cong. (1997). Although this bill did not become law, it may have helped to prod the Financial Accounting Standards Board to adopt an accounting standard requiring stock option expense to be recognized.

[36] For example, H.R. 575, the "Say No to Drug Ads Act," would disallow deductions for certain prescription drug advertisements. The 109th Congress extended from January 3, 2005, to January 3, 2007.

[37] Limiting the depreciation deduction for luxury automobiles may be necessary to avoid allowing owners deductions for personal consumption. Thus, § 280F, instead of imposing a penalty, may remove a subsidy. Either way, however, the effect of § 280F is to reduce the attractiveness of business use of luxury cars.

[38] [Confirm.]

[39] *See* 49 U.S.C. § 32901-32919 (2006).

[40] *See id*. at § 32912.

where tax-like penalties apply outside of the Code, e.g., the CAFE standards, there generally is no obvious deduction or credit to curtail.[41]

B. Alternative Means of Discouraging Behavior

Several means of discouraging disfavored behavior are available to Congress.[42] Most obviously and most coercively, Congress can prohibit activity and back up such prohibitions with public enforcement and sanctions or provide for private enforcement through civil litigation. In the business context, examples include the recent ban on company loans to executives mentioned above and the rules prohibiting insider trading. Less coercively, Congress may assess penalties or user fees on those conducting disfavored activities. Tax provisions generally fall into this category. Tax provisions rarely purport to prohibit activity. The rules revoking tax exempt status for public charities that engage in prohibited political activity are a notable exception, but most tax disincentives involve the denial of a deduction or credit or imposition of an excise tax that are more in the nature of user fees than bans.

One may question whether the distinction between prohibitions and penalties is meaningful, but this distinction is important both theoretically and practically. Robert Cooter divides disincentives into prices and sanctions.[43] In his terminology, a sanction is a disincentive that results in an abrupt jump in cost when a violation occurs; whereas prices result in smooth, continuous costs.[44] The § 162(m) limitation on deductions for excessive non-performance based executive compensation results in a Cooter price. Engaging in the disfavored conduct simply increases a firm's after-tax cost of compensation from sixty-five cents for each dollar paid to one dollar for each dollar paid, and only to the extent that the disfavored pay exceeds the specified threshold.[45] The deductibility of the first million dollars of salary is unaffected by the denial of a deduction for salary paid in excess of this amount. Compare the effect of violating the wage controls contained in the Defense Production Act of 1950.[46] The effect of paying wages in excess of the limits set by the regulator was loss of deduction for the excess payments plus a fine of up to $10,000 and/or imprisonment for up to a year.[47] The addition of the fine and possibility of prison resulted in a discontinuous cost function broken at the maximum permissible wage. This is an example of a Cooter sanction.

Congress has still other means of increasing the cost of disfavored activity. Congress often schedules public hearings that appear to be little more than an attempt to browbeat offenders into reforming their practices. Often these hearings include explicit or implicit threats of legislation if "voluntary" compliance is deemed insufficient, but even if no legislation follows, the threat of public hearings and public exposure and disapprobation tends to discourage the disfavored activity. Alternatively, Congress may

[41] *See infra* Part x (discussing natural limits of regulatory tax penalties).

[42] The following discussion is not meant to exhaust the menu of regulatory options. For example, in the environmental arena, one would encounter feasibility-based limitations and cap and trade systems. [cite] However, all of these mechanisms can be described within the Cooter framework described below.

[43] *See* Robert Cooter, *Prices and Sanctions*, 84 COLUM. L. REV. 1523 (1984).

[44] *See id*. at 1523-24.

[45] This assumes a marginal corporate tax rate equal to the statutory rate of 35%.

[46] Pub. L. No. 774, 81st Cong., 2d Sess. (Sept. 8, 1950).

[47] *See* Pedone v. U.S., 151 F.Supp. 288 (Ct. of Claims 1957) (discussing the Act and rejecting challenge to the disallowance of deductions for wages paid in excess of the caps).

mandate disclosure of disfavored activity, which both increases the costs of participation and harnesses the power of daylight and market forces to encourage change. Some tax provisions, such as public filing requirements for tax-exempt organizations, can be seen as falling into this category.

Of course, Congress can also discourage activity "A" by actively promoting "not A." Consider pollution. Rather than penalizing polluters, Congress can reward those who mitigate pollution. Rather than fining auto manufacturers who fail to meet CAFE standards, Congress could reward manufacturers who produce more fuel efficient vehicles.

As we consider why Congress chooses to regulate certain activity through the tax code versus other possible venues and through tax penalties instead of subsidies, it is hard to overestimate the importance of institutional factors. Tax penalties are naturally structured as the denial of a deduction or credit or imposition of an excise tax. Tax subsidies generally take the form of an added deduction, credit, or exclusion from tax. It is not surprising, then, that tax disincentives normally are structured as Cooter prices instead of sanctions, since the natural way for Congress to penalize through the Code is through denying a deduction or a credit. Although there are exceptions, these denials generally result in a smoothly increasing after-tax cost of engaging in disfavored activities.

C. Tax Penalties in the Tax Expenditure Debate

Stanley Surrey began arguing in the late 1960s that the Code was an inefficient means of delivering subsidies.[48] He advocated and ultimately achieved an annual accounting of "tax expenditures" comparable to the direct federal spending budget to increase visibility and congressional accountability. Tax expenditures, as Surrey and others have defined them, are positive, i.e., pro-taxpayer, deviations from a normative income tax. Of course, as Boris Bittker and others argued, the normative income tax baseline is arbitrary.[49] A provision, such as the deduction for charitable contributions, may be necessary to properly define income in the eyes of some and represent a tax expenditure subsidy for others.[50]

Most or all of the tax penalties discussed in this Article would be considered by most observers to be negative tax expenditures. These provisions have the effect of increasing taxes beyond those that would be assessed under a normative income tax regime. But again, of course, the normative baseline is arbitrary. Surrey considered the

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[48] *See* Surrey, *supra* note x (Tax Incentives); SURREY, *supra* note x; SURREY AND MCDANIEL, *supra* note x.

[49] *See, e.g.*, Boris I. Bittker, *Accounting for Federal "Tax Subsidies" in the National Budget*, 22 NAT'L TAX J. 244 (1969).

[50] *Compare* William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309, 344-375 (1972) (arguing that the deduction for charitable contributions is consistent with an ideal income tax on personal consumption and accumulations) *with* SURREY & MCDANIEL, *supra* note x, at 205 (arguing that charitable contributions represent consumption and are properly categorized as tax expenditures).

failure to allow a deduction for all wagering losses to be a tax penalty.[51] Others view wagering losses as non-deductible consumption.[52]

Although I will argue that ambiguity in the normative baseline – the difficulty in distinguishing between penalties and eliminated subsidies – helps explain tax penalties taking the form of disallowed deductions, I do not think it necessary to attempt to define that baseline in the present Article. First, although most of the tax penalties we will consider would represent negative deviations from a normative tax under almost anyone's definition, the provisions clearly raise the effective cost of non-tax behavior. Second, it seems reasonably clear that those penalties have been enacted to discourage certain non-tax behavior, to express disapprobation, or to avoid the appearance of subsidy. Hence, my definition of regulatory tax penalties: provisions targeted at and raising the effective cost of non-tax behavior.

Although the concepts of negative tax expenditures and regulatory tax penalties, as so defined, may not be perfectly co-extensive, there is certainly sufficient overlap to merit consideration of the tax expenditure literature. Unfortunately, that literature has little to say about tax penalties. Perhaps that is because tax penalties were relatively rare when Surrey started his crusade, but there is another possible explanation. It has been argued that Surrey had a hidden motive: While Surrey purported to be concerned with the inefficiency of tax expenditures, his real concern was that tax expenditures detracted from the progressivity of the Code.[53] He did not want tax expenditures to be replaced by identical (equally regressive) non-tax subsidies, but to disappear completely or be replaced with progressive or proportional subsidies. This motivation was not deeply hidden. One of Surrey's primary complaints had to do with the "upside down effect" of tax subsidies. Given a progressive marginal rate structure, tax deductions provide greater subsidies for expenditures by taxpayers in high brackets than low brackets.[54]

Given that premise, it would not be surprising that Surrey failed to focus on tax penalties, which, when taking the usual form of a disallowed deduction, have the opposite effect. The "upside-down effect" implies that the loss of a deduction that would be available under the normative code has a disproportionately harsher effect on high bracket taxpayers than low bracket taxpayers.

In any event, tax penalties have been largely ignored in the tax expenditure literature. A notable exception is a 1989 article by Eric Zolt, which follows the Surrey model in analyzing tax penalties.[55] Zolt found tax penalties lacking. He concluded that

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[51] *See* SURREY & MCDANIEL, *supra* note x, at 224.

[52] *See* Daniel Shaviro, *The Man Who Lost Too Much: Zarin v. Commissioner and the Measurement of Taxable Consumption*, 45 TAX L.REV. 215, 230-33 (1990) (analyzing the consumption aspects of gambling).

[53] *See* Daniel N. Shaviro, *Rethinking Tax Expenditures and Fiscal Language*, 57 TAX L. REV. 187, 201 (2004).

[54] Consider, for example, a $100 charitable deduction by wealthy individual "A" who pays tax at a 35% marginal rate and low income individual "B" who pays tax at a 10% marginal rate. Assuming that B itemizes her deductions (which is doubtful), the deduction for charitable contributions reduces B's after-tax cost of the donation by $10. A's cost is reduced by $35. Surrey asked rhetorically whether we could imagine direct expenditure programs designed in this upside down fashion. *See* SURREY, *supra* note x (Pathways), at 136.

[55] *See* Zolt, *supra* note x. Zolt defined tax penalties more narrowly than I have. He "focuse[d] only on those provisions for which Congress' motive is to penalize illegal or undesirable nontax activities." *See id.* at 348.

they were "remarkably crude policy instruments" and difficult to defend on economic grounds.[56]

I certainly agree with Zolt that tax penalties, like tax expenditures generally, are crude policy instruments. The denial of a deduction, the classic tax penalty, has the effect of imposing a 35% penalty on an offending individual or corporation paying tax at the highest marginal rate, but the penalty has lesser or even no effect on corporate taxpayers with large accumulated losses or individual taxpayers in lower brackets. Thus, two taxpayers may face widely different penalties for undertaking the same disfavored behavior. Moreover, the denial of a deduction is a one-size-fits-all-offenses penalty. For a corporation paying tax at the highest marginal rate, the tax penalty for paying executive salaries in excess of $1 million or for lobbying federal officials is exactly the same – 35% of the money spent. It seems unlikely that a 35% penalty provides optimal deterrence for such disparate activities. It's fair to say that these provisions are remarkably crude deterrents.

However, the crudeness of tax penalties should not lead to automatic condemnation. As Zolt noted, tax penalties entail low administrative costs and these provisions may serve a symbolic function.[57] To some degree, these benefits offset the crudeness of the incentives provided. Recently, Weisbach and Nussim have taken on the job of rehabilitating tax expenditures by considering the benefits as well as the costs.[58] Their focus again is on tax subsidies (they only just mention tax penalties), but they argue that institutional considerations, such as administrative costs, specialization, and coordination, should determine whether federal programs are implemented via the tax code or through other avenues. Although Weisbach and Nussim agree with Surrey that identical tax and non-tax subsidy programs could be implemented, they argue that given institutional differences, we should not expect the optimal tax and non-tax subsidy to look the same. The optimal tax subsidy is likely to be crude, taking advantage of low administrative costs. The optimal non-tax subsidy is likely to be more focused and tailored, taking advantage of agency specialization and coordination.[59]

I agree with Weisbach and Nussim that institutional considerations are an important factor in the optimal design of tax and non-tax programs, and that these factors clearly play a role in the decision to place disincentives in the tax code. However, as we will see in Parts II and III, the driving force for the creation of tax penalties goes well beyond optimizing institutional design.[60]

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[56] *See id*. at 344-45.

[57] *See* Zolt, *supra* note x, at 345.

[58] *See* Weisbach & Nussim, *supra* note x.

[59] *See id*.

[60] To be fair, Weisbach and Nussim specifically state that the analysis of their present article is limited to the institutional design aspect of tax expenditures. They recognize that other factors, including agency costs and public choice elements, play a role. In fact, Weisbach has begun exploring these issues in subsequent work. *See* David A. Weisbach, *Tax Expenditures, Principal Agent Problems, and Redundancy* (working paper, June 2006).

II. TAX PENALTIES THAT BYPASS CONSTITUTIONAL/STRUCTURAL BARRIERS TO NON-TAX REGULATION

Why *tax* penalties? Why does Congress embed penalties in the Code rather than regulating directly? There are several reasons, but this Article focuses on the following underappreciated rationale. In short, Congress has broad power to implement penalties through the Code and would encounter significant hurdles in creating similar non-tax penalties. In some cases, discussed in this Part, Congress is able to target activities through the tax code with little or no judicial review when equivalent direct regulation would face exacting scrutiny and a much greater likelihood of invalidation. In other cases, discussed in the following Part, non-tax regulation is equally feasible constitutionally, but structuring the regulation as a disallowed deduction – a tax penalty – significantly assists enactment.

A. The Power to Create Tax Penalties

As noted above, in an earlier era in which Congress's power under the Commerce Clause was viewed as being more limited than it is today, Congress often turned to excise taxes to regulate undesirable behavior. This proved to be an effective strategy. Today, despite occasional setbacks,[61] Congress's power under the Commerce Clause is seen as being quite far-reaching. Nonetheless, the taxing power continues to provide an important regulatory tool.

Modern regulatory tax penalties generally are embedded in the federal income tax. Given the 16th Amendment, which provides:

> The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration

the power of Congress to assess taxes on incomes is plenary, or nearly so.[62]

The 16th Amendment clarifies the power of Congress to tax incomes, but it does not define the term. Commentators generally agree that the aim of the amendment was to confirm Congress's power to tax *net* income,[63] but the amendment simply refers to "income," leaving open the possibility that a non-apportioned tax on gross income would be constitutional. This is an open question.[64] In any event, perhaps as a result of the uncertainty and certainly recognizing that some deductions are needed to properly define the tax base, courts have long provided Congress with extremely broad discretion to

[61] *See, e.g.*, United States v. Lopez, 514 U.S. 549 (1995) (holding that the promulgation of the Gun-Free School Zones Act of 1990 exceeded Congress' Commerce Clause authority); United States v. Morrison, 529 U.S. 598 (2000) (same holding with respect to the Violence Against Women Act of 1994).

[62] *See* JENSEN, *supra* note x.

[63] *Id.* at 118.

[64] The open question is whether basis recovery is constitutionally protected. *See* Joseph M. Dodge, *The Constitutionality of Federal Income Taxes and Federal Tax Provisions* 20 (working paper, Nov. 3, 2006) (arguing the minority position that basis recovery is not constitutionally protected and that for purposes of the 16th Amendment "income" equals "gross income"). No one seriously argues that specific deductions for business expenses are constitutionally protected, although eliminating all deductions for ordinary and necessary business expenses would be problematic. *See* JENSEN at 118.

create, revoke, or condition deductions from gross income. Deductions, it is often said, are a matter of "legislative grace."[65] Or as the Court stated in *Helvering v. Independent Life Ins. Co*., "[u]nquestionably Congress has the power to condition, limit, or deny deductions from gross income in order to arrive at the net that it chooses to tax."[66]

As Erwin Griswold noted, this is a statement of congressional power, and the upshot is that denying a deduction is a particularly robust means of federal regulation.[67] Thus, it is no surprise that most modern tax penalties take the form of disallowed deductions or credits, and tax penalties taking this form will be the focus of this Part.[68]

Of course, the taxing power and Congress' ability to condition deductions are not unlimited. These powers are subject to Fifth Amendment due process, which would lead to the invalidation of a provision that was found to be arbitrary and capricious, but the hurdle before a party seeking to invalidate a tax penalty on due process grounds is very high indeed.[69]

B. Tax Penalties and the First Amendment

Congress' broad taxing power, the idea that deductions are a matter of legislative grace, and confusion as to whether a denied deduction imposes a penalty or removes a subsidy allow Congress to target disfavored behavior through the Code in cases in which equivalent non-tax regulation would face a high risk of invalidation under the First Amendment.[70] The clearest example of this is IRC § 162(e), which denies business deductions for certain lobbying and political expenditures. Per § 162(e), taxpayers may not deduct expenditures directed at influencing legislation; campaigning for or against candidates for public office; influencing the public with respect to elections, legislative

[65] New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934) (noting that the "power to tax income … extends to the gross income").

[66] 292 U.S. 371, 381 (1934).

[67] *See* Erwin N. Griswold, *Note: An Argument against the Doctrine that Deductions Should be Narrowly Construed as a Matter of Legislative Grace*, 56 HARV. L. REV. 1141, 1143 n. 8 (1943).

[68] Although not a tax penalty as I have defined it, since the provision did not regulate non-tax behavior, the *Independent Life* case is an interesting example of the power of Congress to place conditions on tax deductions. Under the tax law at the time, Congress allowed life insurance companies that owned real estate that was leased to others to deduct the ordinary and necessary expenses associated with the property. Congress allowed no deductions for insurance company owned and occupied property. *See Independent Life*, 292 U.S. at 379. If a life insurance company owned real estate that was partially occupied by the company and partially leased out, Congress allowed deduction for ordinary and necessary expenses, but only if the company included in its gross income an amount equal to the rental value of the portion it occupied. *See id*. In other words, in this in-between case, Congress conditioned the deduction for real estate expenses on inclusion of imputed income from self-occupancy. The taxpayer argued that this provision constituted an impermissible direct tax on the property, but the Court disagreed. The taxpayer was not required to include an imputed income amount. It only had to do so if it wanted to take the deduction for expenses, which was a matter of legislative grace. *See id.* at 380.

[69] *See* JENSEN, *supra* note x; *see also*, Dodge, *supra* note x at 4 (noting that equal protection attacks on tax provisions have usually failed).

[70] The combination also supports certain subsidies that would be difficult to administer directly consistent with the 1st Amendment, e.g., deductions for charitable contributions made to religious organizations under § 170 and the exclusion of the rental value of parsonages provided free of charge to ministers under § 107. *See* Edward A. Zelinsky, *Are Tax "Benefits" Constitutionally Equivalent to Direct Expenditures?*, 112 HARV. L.REV. 379 (1998) (exploring the constitutional equivalence of tax subsidies and direct subsidies).

matters, or referenda; or lobbying certain executive branch officials. There are exceptions that allow for deductible lobbying of local councils, but deductions for advertising or lobbying with respect to state or federal matters are severely curtailed.[71]

1. IRC § 162(e) Predecessor Regulations Upheld in *Cammarano*

In *Cammarano v. Commissioner*, the Court considered a challenge to Treasury Regulations that mimic current Code § 162(e), denying a deduction for "sums of money expended for lobbying purposes, the promotion or defeat of legislation, [and] the exploitation of propaganda, including advertising other than trade advertising…."[72] State-wide referenda were at issue in the appeals consolidated in *Cammarano*, specifically ballot measures that would have prohibited sales of beer and wine in Arkansas and eliminated private retail sales in the State of Washington.[73] The issues in the two cases were identical. The Cammaranos, who were involved in wholesale beer distribution in Washington and "fighting for their [business] lives",[74] helped finance a publicity campaign urging defeat of the ballot measure and attempted to deduct the expenditure as a business expense.[75] The IRS, following the Treasury Regulations, denied the deduction. Before the Supreme Court, the taxpayers argued, inter alia, that they were being denied a deduction for engaging in activity protected by the First Amendment.[76] The Court found no constitutional issue, opining that the taxpayers were "simply being required to pay for [their political] activities entirely out of their own pockets, as everyone else engaging in similar activities is required to do under the … Code."[77]

2. Direct Regulation of Corporate Voter Outreach Invalidated in *Bellotti*

The Court in *Cammarano* did not see a constitutional issue. But suppose that instead of disallowing a tax deduction for political advocacy, Congress had imposed a direct penalty that was the economic equivalent. Suppose the Cammaranos paid tax at a 30% marginal rate and that Congress had imposed a civil penalty on businesses engaging in the political activities currently specified in § 162(e) equal to 30% of the relevant expenditure. Suppose the Cammaranos paid $1000 advocating against a ballot measure directly affecting their business interests. As an ordinary and necessary business expense, the expenditure would be deductible, reducing the effective cost of advocacy to $700.[78] However, the $300 civil penalty imposed on the expenditure of $1000 would

[71] In addition to the exception permitting deductions for some lobbying of local councils and similar bodies, § 162(e) provides a de minimis exception for in-house expenditures under $2000. *See* I.R.C. § 162(e)(5)(B).

[72] Cammarano v. CIR, 358 U.S. 498, 499-500 (1959).

[73] *See Cammarano*, 358 U.S. at 500-501. The facts of Cammarano would actually fall within the exception to the advocacy ban overruled in the *Bellotti* case discussed below, making it even more striking that the disallowance in Cammarano was upheld.

[74] *See id.* at 515 (Douglas J. concurring).

[75] *See id.*

[76] *See id*. at 512-513.

[77] *See id.* at 513.

[78] I.R.C. § 162.

restore the effective cost of advocacy to $1000, producing the same result as the deduction disallowance imposed by the Treasury Regulations.[79]

Although the two approaches are economically equivalent, this direct regulatory approach, unlike the tax provision at issue in *Cammarano*, would trigger a high degree of scrutiny under the Courts' First Amendment jurisprudence.[80] In *First National Bank of Boston v. Bellotti*, the Supreme Court struck down a Massachusetts statute barring corporations from expending funds to influence voter opinion on public referenda that did not materially affect the corporation's business.[81] The Court held that the banned speech lay "at the heart of the First Amendment's protection," was subject to "exacting scrutiny," and required (but lacked) a compelling justification.[82]

To be sure, the Massachusetts statute at issue in *Bellotti* was not an exact direct regulatory analog to § 162(e). *Bellotti* involved a criminal statute, the violation of which could result in personal and corporate fines and potentially the imprisonment of the employees involved – a classic Cooter sanction.[83] Disallowance of deductions under § 162(e) carries none of the stigma of a criminal violation and operates as a Cooter price. However, while the criminal sanctions may have factored into the outcome in *Bellotti*,[84] it is not clear from the opinion that a similar provision applying civil sanctions would have been subjected to less exacting scrutiny.

The *Bellotti* Court focused not on the rights of the corporate speaker but on the First Amendment interest in ensuring public access to a variety of viewpoints, particularly where the speech dealt with referenda and was "intimately related to the process of governing."[85] Suppression of such speech would appear to raise a constitutional issue however it is achieved, although the balancing of the state's interests would undoubtedly depend on the severity of the suppression.

Moreover, the prohibition in *Bellotti* carved out an exception for voter outreach on matters "materially affecting … the … business … of the corporation."[86] Section 162(e) includes no such exception. Even the dissent of Justice White in *Bellotti*, joined by Justices Brennan and Marshall, appeared to acknowledge that suppression of speech

[79] Of course, as discussed above, there would inevitably be differences in the two approaches. *See supra* note x and accompanying text. For example, not all business taxpayers face the same marginal rate of tax. Thus, some businesses would be better off and others worse off if Congress were to replace I.R.C. § 162(e) with a direct sanction based on a fixed penalty schedule, e.g., 30% of the expenditure.

[80] To be sure, despite the First Amendment, some direct regulation in this area is permissible. Corporate contributions to federal election campaigns have been barred under federal law since 1907, and the constitutionality of this bar is well established. *See* Federal Election Comm. v. Beaumont, 539 U.S. 146 (2003). Of course, § 162(e) is not restricted to corporate or business taxpayers, but to ease the case for alternative regulation, we will assume that this is the constituency Congress had in mind. Corporate speech is often afforded a lower degree of First Amendment protection. *See* note x, *infra*. Thus, direct regulation analogous to § 162(e) is most likely to be permissible if restricted to corporations.

[81] 435 U.S. 765 (1978).

[82] *See id*. at 776, 795. Massachusetts offered two justifications: guarding the role of the individual in the electoral process and protecting shareholders whose views differed from those expressed by management. The Court held that these interests were either not implicated by the case or not served by the legislation. *See id*. at 787-88.

[83] *See id*. at 768.

[84] The Court expressed concern that the risk of criminal penalties would suppress corporate speech regarding issues that arguably had a material affect on their business. *See id* at 785, n. 21.

[85] *See id.* at 783-86.

[86] *Id*. at 768.

related to matters materially affecting corporate business would be problematic under the First Amendment.[87]

Of course, the majority did not hold that the regulation in *Bellotti* was per se invalid. It held that the statute was subject to exacting scrutiny and that the state had failed to provide compelling justification or to show that the rule was narrowly drawn to avoid unnecessary infringement. The opinion clearly contemplates that the state could have provided evidence that would have satisfied these burdens and justified the regulation.[88] The point, however, is that the level of scrutiny placed on direct regulation in *Bellotti*, and which, I think, would be placed on a closer analog to § 162(e) enacted outside of the tax code is orders of magnitude greater than the constitutional "review" conducted in *Cammarano*.

3. Why Didn't the *Cammarano* Court See a First Amendment Problem?

The key distinction between *Bellotti* and *Cammarano* and the key to understanding why the tax regulation in *Cammarano* received a free pass on the First Amendment issue is to recognize the ambiguity that arises when a tax deduction is disallowed. Does the disallowance impose a penalty on the taxpayer or merely remove a tax subsidy? There was no ambiguity in *Bellotti*. Direct sanctions, whether criminal or civil, are always viewed as penalties.[89] The disallowed deduction in *Cammarano*, however, was viewed as a refusal to provide a subsidy, and that difference is critical in the Court's First Amendment jurisprudence.

The "non-subsidy" view of the Treasury regulations was implicit in the lead opinion in *Cammarano*, but it was made explicit in Justice Douglas's concurrence, where he said:

> [Congress] has not undertaken to penalize taxpayers for certain types of advocacy; it has merely allowed some, not all, expenses as deductions. Deductions are a matter of grace, not of right. To hold that this item of expense must be allowed as a deduction would be to give impetus to the view favored in some quarters that First Amendment rights must be protected by tax exemptions. But that proposition savors of the notion that First Amendment rights are somehow not fully realized unless they are subsidized by the State. Such a notion runs counter to our decisions.[90]

Clearly, however, not all tax legislation that impinges on First Amendment rights is permissible. To determine the ground rules we must consider the Court's unconstitutional conditions jurisprudence.

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[87] *See id*. at 807-08 (White J. dissenting) (noting that "there may be certain communications undertaken by corporations which could not be restricted without impinging seriously upon the right to receive information" but arguing that these concerns are not "implicated by a ban on corporate speech on referenda "having no connection with business affairs").

[88] *See, e.g., id*. at 789 ("If appellee's arguments were supported by record or legislative findings that corporate advocacy threatened imminently to undermine democratic processes, thereby denigrating rather than serving First Amendment interests, these arguments would merit our consideration.")

[89] Of course, economically a direct sanction could offset a subsidy provided elsewhere, e.g., through a tax deduction, a direct benefit provided by a state, etc.

[90] *See id*. at 515 (citations omitted).

a. Unconstitutional Conditions

In a nutshell, the unconstitutional conditions doctrine holds that the government cannot condition a benefit, including a tax benefit, on the surrender of a constitutional right even if the government could withhold the benefit in the first place.[91] For example, although the government is not required to provide unemployment benefits, the Court concluded that conditioning such benefits on the recipient's willingness to work on her Sabbath impermissibly burdened free exercise rights.[92]

But not all conditions are impermissible. As Kathleen Sullivan has described, the Court has concluded that the Constitution prohibits Congress from conditioning tax deductions or other benefits on the sacrifice of constitutional rights if the conditions are coercive.[93] But determining when a condition is coercive requires a normative evaluation that the Court has not expounded. Rather, the Court relies on shortcuts, such as the distinction between penalties and non-subsidies, concluding that coercion, and hence a constitutional violation, is not possible when Congress merely declines to subsidize a right.[94]

So, in his concurrence, Justice Douglas admitted that the Cammaranos were exercising First Amendment rights, and he suggested that a penalty placed on the exercise of these rights would have been impermissible, but, unfortunately for the Cammaranos, neither Douglas nor the rest of the Court viewed the Treasury regulations as having imposed a penalty. All agreed that *Speiser v. Randall*,[95] a case relied upon by the Cammaranos, was distinguishable in this respect. That case invalidated a California statute that conditioned a veterans' property tax exemption on the taking of a loyalty oath. Because the oath and the exemption were unrelated, the Court concluded in *Speiser* that the loss of the exemption was a penalty for refusing to take the oath.[96] In *Speiser*, the penalty, loss of property tax exemption, was not germane to the condition, the swearing of a loyalty oath. Justice Douglas emphasized the difference, suggesting that if Congress had denied a taxpayer *all* deductions for ordinary and necessary business expenses as a consequence of engaging in voter outreach, that would have constituted a penalty on the exercise of First Amendment rights.[97]

Sullivan has argued that "conclusory labels" often substitute for analysis in the Court's evaluation of cases like these.[98] The Court, in her view, often classifies the denial of a deduction or some other benefit a penalty when it wants to strike down the provision and a non-subsidy when it doesn't.[99] This complaint seems well-founded, but

[91] *See* Kathleen M. Sullivan, *Unconstitutional Conditions*, 102 HARV. L.REV. 1413, 1415 (1989).

[92] *See* Sherbert v. Verner, 374 U.S. 398, 410 (1958).

[93] *See* Sullivan, *supra* note x, at 1428; *see also Sherbert*, 374 U.S. at 404 (finding that unemployment benefits system that forced an applicant to choose between forfeiting benefits and abandoning precepts of her religion "put[] the same kind of burden upon the free exercise of religion as would a fine imposed against appellant for her Saturday worship").

[94] *See* Sullivan, *supra* note x, at 1439.

[95] 357 U.S. 513 (1958).

[96] *See id.* at 518, 529.

[97] *See Cammarano*, 358 U.S. at 515.

[98] *See* Sullivan, *supra* note x, at 1420.

[99] *See id*. In *Cammarano*, both the lead opinion and the concurrence said in effect that the Treasury Regulations disallowing deductions for lobbying simple defined the tax base. But of course at

surely the inherent ambiguity in the intent and effect of disallowing tax deductions helps explain the apparent inconsistencies.

b. Distinguishing Penalties from Non-Subsidies

There are several possible ways of identifying penalties and distinguishing them from non-subsidies. The lack of germaneness, or a logical link between the targeted behavior and repercussion, used by Douglas to distinguish the statute in *Speiser* from the regulation at issue in *Cammarano* is one possible basis,[100] but there are others. Another basis for finding a penalty, suggested by Seth Kreimer, is a lack of equality of treatment between those similarly situated.[101] The Court in *Cammarano* alluded to this approach in suggesting that the government's likely intent in denying the deduction for lobbying and voter outreach was that "everyone in the community should stand on the same footing … so far as the Treasury of the United States is concerned" with respect to the purchase of "publicity [that] can influence the fate of legislation which will affect [it]."[102] Presumably, their idea was that because private citizens who might favor the referenda would not be entitled to deduct their advocacy expenses, equality demanded that the Cammaranos not be allowed to deduct their advocacy expenses either. A statute that leveled the playing field in this way would not penalize the Cammaranos, but simply deny them a potential subsidy. This seems logical enough, but arguably the Cammaranos and ordinary citizens were *not* similarly situated absent the deduction. Any benefit received by ordinary citizens advocating in favor of the referendum (ranging from psychic benefits to lower beer prices) would not be taxed. The benefits to the

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one level one could say the same thing about the veterans' property tax exemption conditioned on the taking of a loyalty oath in *Speiser*. The question that should be asked is whether the legislature has permissibly defined the tax base.

[100] As Sullivan notes, the Court has used germaneness to determine whether conditions placed on direct benefits results in a penalties or non-subsidies. *See* Sullivan, *supra* note x, at 1464. Echoing *Cammarano*, the Court concluded in *Maher v. Roe*, for example, that state funding for childbirth, but not abortion, did not impose a penalty on a woman seeking an abortion. 432 U.S. 464, 475 n.8 (1977). The Court distinguished a hypothetical law generally denying welfare benefits to women who had obtained abortions. The latter, non-germane condition on receiving welfare benefits would, the Court suggested, be viewed as a penalty. *Id*.

However, a lack of germaneness might speak to the presence of a penalty or to its severity. For example, as we have seen, disallowing a deduction for lobbying expenses is equivalent to allowing the deduction and imposing a fine equal to 35% of lobbying expense. The repercussion is proportionate and relatively modest. Disallowing all ordinary and necessary business deductions as a result of impermissible lobbying, as Douglas suggests in his hypothetical in *Cammarano*, would impose a much larger sanction, often a multiple of lobbying expense, and generally would not be proportional to lobbying expense. No doubt, the second approach would provide greater deterrent effect, but that fact does not preclude other arguments that I.R.C. § 162(e) imposes a penalty on offenders.

[101] *See* Seth F. Kreimer, *Allocational Sanctions: The Problem of Negative Rights in a Positive State*, 132 U. PA. L.REV. 1293, 1363-71 (1984). Kreimer also suggests the use of history and prediction as possible baselines for distinguishing penalties from non-subsidies. *See id*. at 1359-63,1371-74. Under an historical baseline, according to Kreimer, conditioning the continuation of a long-standing benefit on a adopting or refraining from a certain behavior is more coercive than conditioning a newly offered benefit on the same behavior. *Id*. at 1359. Absent signals from history or equality, Kreimer suggests that if an action makes a party worse off than we would have predicted, absent the special condition, the action can be viewed as a penalty. *Id*. at 1372.

[102] *Cammarano*, 358 U.S. at 513.

Cammaranos, the profits of a continued franchise, would be taxed. If this is right, the Treasury regulation did not serve to level the playing field; it tilted it in favor of consumers, and equality was not a logical basis for concluding that the Treasury regulation did not impose a penalty on the Cammaranos.[103]

It is difficult to share Justice Douglas's confidence that the Treasury regulations at issue in *Cammarano* did not penalize the taxpayers, but instead reflected a refusal to grant a subsidy. That might or might not be the best interpretation. Moreover, we cannot be sure whether the Justices actually believed that the regulations fell on the non-subsidy side of the baseline or whether *Cammarano* is an example of results-oriented labeling as suggested by Sullivan. Either way – whether the Court genuinely saw the Treasury Regulation as a non-subsidy or used that label to reach a desired outcome – the result was that the Court applied no real First Amendment scrutiny to a tax provision that was targeted at and undoubtedly discouraged behavior that Congress could not have

[103] In the simplest case, suppose that a referenda is proposed that would result in a zero-sum economic transfer from businesses to consumers and that the referenda would have no other effect. In this zero sum case, absent taxes, businesses should be willing to spend up to a dollar to avoid a transfer of a dollar and consumers would be willing to spend a dollar to achieve a transfer of a dollar. Now suppose, as is true under current law, that the additional business profit of a dollar is subject to tax, but that business lobbying is not deductible. If businesses are taxed at a 35% marginal rate, they would only be willing to spend 65 cents pre-tax to avoid a transfer of a dollar, because the incremental dollar profit pre-tax would only produce 65 cents after-tax. Meanwhile consumers would continue to be willing to spend a dollar to gain a dollar because their benefit (say, lower beer prices) would not be taxed. The playing field in this case is not level, but permitting a deduction for business lobbying would restore equilibrium. If business lobbying is deductible, businesses again would be willing to match consumer spending on lobbying, because a dollar spent by businesses to save a dollar would result in matched after-tax cost and benefit of 65 cents. *See* MICHAEL J. GRAETZ & DEBORAH H. SCHENK, FEDERAL INCOME TAXATION; PRINCIPLES AND POLICIES 245 (5th ed. 2005) (suggesting this neutrality analysis).

Of course, the playing field may not be level for other reasons. Consumer interests may face a greater collective action problem in organizing to lobby than businesses. But apparently the Court in *Cammarano* was not thinking of such possibilities when it spoke of a congressional goal that all "stand on the same footing … so far as the Treasury of the United States is concerned." *Cammarano*, 358 U.S. at 513.

Edward Zelinsky has suggested that in comparing tax benefits and direct expenditures it is useful to view the programs from the government's perspective as well as the recipients'. Zelinsky suggests, for example, that to the taxpayer a property tax exemption is equivalent to a direct subsidy, but from the government's perspective, property tax exemptions generally are much broader than targeted subsidy programs and entail much less government involvement. The difference in the level of involvement may justify the apparent inconsistency between direct subsidies to religion, which are invalid under the First Amendment, and property tax exemptions for churches, which are permissible. *See* Zelinsky, *supra* note x (HLR 1998) at 409-413.

This approach might also be helpful in distinguishing between penalties and non-subsidies in some situations, but in the particular case of political advocacy restrictions, it adds little to the analysis. In the case of advocacy, businesses would discern no practical difference between § 162(e) and an equivalent non-tax sanction. The loss of a deduction that would have reduced the effective cost of advocacy by 30% would be no different from a direct penalty of 30%. And in this case, there is no obvious difference when viewing the regulation from the government's vantage point. Section 162(e) and the direct regulation of advocacy that was invalidated in the *Bellotti* case required a similar degree of governmental involvement in distinguishing deductible/permissible expenditures from those that would be non-deductible or non-permissible.

addressed directly without exposing the legislation to a high degree of constitutional scrutiny.[104]

Again, Sullivan's criticism of the unconstitutional conditions doctrine seems well founded. After all, the penalty/non-subsidy distinction is only important to the Court's First Amendment analysis; the label matters not at all to people like the Cammaranos.[105] From an economic perspective, nothing turns on whether we classify § 162(e) a tax penalty or a non-subsidy. The important point is that the provision creates a relative disincentive for taxpayers to expend funds on disfavored activities.

4. Tax Penalties and the First Amendment Post-*Cammarano*

The § 162(e) experience suggests dramatically different judicial scrutiny of tax and non-tax regulation of First Amendment activity. Of course, *Cammarano* may simply have been wrongly decided, and a similar case might come out differently today, but there is reason to doubt the latter possibility. Subsequent cases have only reinforced the holding of the case. In *Regan v. Taxation with Representation of Washington*,[106] for example, the Court cited *Cammarano* in upholding the restriction against substantial lobbying by non-profit organizations eligible to receive tax deductible contributions.[107] The Court viewed tax deductibility of contributions as a subsidy and, thus, conditioning tax deductibility on refraining from lobbying was viewed as a limitation on a subsidy rather than a penalty.[108] A concurrence of three Justices felt that the ability of non-profits to set up § 501(c)(3) organizations that refrain from lobbying and are eligible to receive

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[104] The disincentive is clear if we compare the Cammaranos' expenses for advertising their beer and advertising to encourage defeat of the referendum. Assume the taxpayers are in a 30% marginal tax bracket and spend $1000 for each type of advertising. As a deductible business expense, the beer advertising reduces the Cammarano's taxable income by $1000 and their taxes by $300. The after-tax cost of the advertising is $700. Given I.R.C. § 162(e) (or technically its Treasury Regulation precursor), $1000 spent on advertising seeking to defeat the referendum is non-deductible, resulting in pre- and post-tax cost of $1000. Clearly § 162(e) discourages disfavored expenditures relative to "neutral" business expenses.

The economic effects of § 162(e) are made even more clear by comparing the results in a world with and without an income tax. In the absence of any taxes, a rational business person would be willing to spend up to a dollar (on, say, advertising beer or advertising to encourage defeat of a referendum) to produce incremental revenue of a dollar. Assuming that the incremental revenue is taxable, this one-for-one correspondence is maintained in the tax world only if the incremental expenditure is deductible. For a taxpayer in a 30% marginal tax bracket, for example, incremental pre-tax revenue of a dollar would leave incremental after-tax revenue of seventy cents, justifying pre-tax expenditure of a dollar, if deductible, since that expenditure costs the taxpayer seventy cents after tax. If the deduction is eliminated, however, the correspondence is dashed and the incentive to spend is reduced. Now the taxpayer would only be willing to spend up to seventy cents (pre- and post-tax) to generate incremental pre-tax revenue of a dollar.

[105] Seth Kreimer has argued that pushing a party below a natural baseline (i.e., applying a penalty) is more coercive than refusing to raise a party above the baseline (i.e., refusing to grant a subsidy). *See* Kreimer, *supra* note x, at 1353. That may be true in some cases and may follow from the phenomenon known as loss aversion. [Cite.] However, as discussed, it is difficult to see how the baseline matters to the Cammaranos, whose after-tax advertising expense was increased as a result of the disallowance.

Of course, even if one were confident that I.R.C. § 162(e) was best categorized as a regulatory tax penalty, deductions from federal income taxes may appear to be subsidies to the uninitiated. This public appearance may be important. We will return to this subject in Part x.

[106] 461 U.S. 540 (1983).

[107] *See id*. at 546.

[108] *See id*. at 544.

tax-deductible contributions while maintaining separate § 501(c)(4) organizations that participate in lobbying, but are not eligible to receive tax-deductible contributions, caused this case to resemble *Cammarano* rather than *Speiser*.[109] The ability to divide operations in this fashion meant that only lobbying activities would not be subsidized. Absent the § 501(c)(4) safety valve, the concurrence concluded that the limitation in § 501(c)(3) would have caused a non-profit to give up its subsidy on all operations in order to engage in substantial lobbying. This counterfactual, the concurrence suggested, would have constituted an impermissible penalty on the exercise of constitutionally protected speech.[110]

However, as discussed above, by focusing on germaneness only, the Court ignored several other possible bases for identifying penalties. For example, one could apply the equality test suggested by Kreimer by looking through the § 501(c)(3) organization to the contributors. In brief, if the contributors would receive taxable benefits as a result of successful lobbying, tax deductibility for the contributions would have served to level the playing field; if not, deductibility was indeed a subsidy under this test. Again, however, the important point is that viewing the restriction not as a penalty, but as prevention of a subsidy, essentially bypassed First Amendment scrutiny.

Legislation introduced by Senator Harkin in 1993 would have provided a very interesting test for the continued viability of the *Cammarano* analysis in a factual situation more closely resembling that case. Harkin's bill proposed to limit the deduction for tobacco advertising to 50% of expenditures.[111] Although this provision would satisfy the germaneness test apparently adopted by the Court in *Cammarano* and *Taxation with Representation*, it is difficult to see a restriction on a single type of advertising as revoking a subsidy. Because advertising normally is considered an ordinary and necessary expense that is subtracted from gross income in properly computing net income subject to tax, an equality analysis would confirm our intuition that this provision would have penalized firms for engaging in advertising a particular product.[112] However, based on *Cammarano* and *Taxation with Representation*, it seems likely that this legislation would have been subjected to a much lower degree of First Amendment scrutiny than analogous non-tax regulation.[113] Although some direct regulation of tobacco advertising is clearly permissible, Harkin's bill seemed well designed to use the tax code to skirt the constitutional uncertainty associated with direct regulation of tobacco advertising.[114]

C. Tax Penalties and Federalism Issues

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[109] *See id*. at 552.

[110] *See id*.

[111] S. Res. 609, 103d Cong., 1st Sess. (1993).

[112] Clearly the bill would have reduced the economic attractiveness of tobacco advertising relative to other means of enhancing profits, e.g., upgrading machinery, but that economic effect would be consistent with either the imposition of a penalty or the revocation of a subsidy.

[113] *See* Louis J. Virelli III, *Permissible Burden or Constitutional Violation? A First Amendment Analysis of Congress' Proposed Removal of Tax Deductibility from Tobacco Advertisements*, 2 U. PA. J. CONST. L. 529 (arguing that the tax legislation would have been held constitutional).

[114] The Harkin bill was not an anomaly. For example, legislation was introduced in the 109th Congress that would have disallowed all deductions for direct-to-consumer advertising of prescription drugs. See H. Res. 575, 109th Congress (titled the "Say No to Drug Ads Act").

Congress has disallowed tax deductions for certain fines and penalties as well as for bribes, kickbacks and other illegal payments, including fines and penalties paid to state and local government and payments illegal under state law. [115] The disallowances effectively increase the penalties imposed by the primary statutes and the deterrence of potential offenders that are tax-paying businesses. Although it may not be Congress' intent, in effect the tax system allows Congress to "piggyback" on state and local law enforcement in penalizing certain activities deemed impermissible under those laws. In some cases, direct enlistment of state and local law enforcement apparatus would be difficult under federalism principles. Thus, these provisions can be viewed as another example of the use of tax penalties to bypass constitutional limitations on direct regulation. However, it seems likely that tax penalties of this nature have more to do with appearance than substance, so review will be brief.

1. IRC § 162(f) and *Tank Truck Rentals*

For our purposes, analysis of § 162(c), which disallows deductions for illegal bribes, kickbacks, and other illegal payments, and § 162(f), which disallows deductions for "fine[s] or similar penalt[ies] paid to a government for the violation of any law," is identical. We will focus on § 162(f). This disallowance reaches, for example, fines incurred as a result of violating commercial or transport regulations, including tickets for overloaded trucks and fines for improper handling of trust funds, each of which, absent § 162(f), would be deductible under the permissive "ordinary and necessary business expense" standard. Disallowing the deduction for fines and penalties increases the effective cost of the proscribed activity and increases the deterrent effect of the fine or penalty.

However, whether § 162(f) results in achieving the optimal level of deterrence is a more difficult question. We can explore that question with the classic *Tank Truck Rentals* case.[116] *Tank Truck* pre-dated the enactment of § 162(f), which codified the common law result reached in the case. There, the taxpayer, the owner and operator of bulk liquid tankers, had paid fines for exceeding Pennsylvania's maximum highway weight limit.[117] As the Court explained, Pennsylvania restricted trucks to 45,000 pounds while the surrounding states allowed 60,000 pound cargos. Finding it "economically impossible" to do otherwise, trucking companies deliberately exceeded the Pennsylvania limitation, "in the hope, and at the calculated risk, of escaping the notice of the state and local police."[118]

The IRS disallowed the deduction for the fines paid in Pennsylvania on public policy grounds, and the Tax Court agreed that allowing a deduction "would frustrate sharply defined state policy."[119] Before the Supreme Court, the taxpayer argued that the fines were equivalent to tolls for the use of the highways. The Court disagreed, finding it "clear" that the fines were punitive because they were assessed only when the offenders

[115] I.R.C. § 162(f) (fines and penalties); I.R.C. § 162(c) (illegal bribes, kickbacks, and other illegal payments).

[116] Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30 (1958).

[117] *See id*. at 31.

[118] *See id*. at 32-33.

[119] *See id*. at 31.

were apprehended.[120] The Court affirmed the disallowance on public policy grounds, finding that deduction would thwart state policy: "To allow the deduction sought here would but encourage continued violations of state law…. This could only tend to destroy the effectiveness of the State's maximum weight laws."[121]

It is possible that allowing the deductions in *Tank Truck* would have undermined state policy, but it is at least as likely that disallowing the deductions resulted in over-deterrence of potential violators.[122] This is a baseline problem, but it is a problem that could be resolved if we had more facts about the Pennsylvania regulation.[123] Were the fines set with a view towards recovering the costs of overweight trucking? Was deductibility for federal income taxes considered in setting the fines? If so, was deductibility assumed or not?

The Supreme Court's rhetoric presumes, implicitly, that the fines were set under the assumption that they would not be deductible. Thus, allowing a deduction would undermine the desired deterrent effect. But it is as or more likely that the fines were set assuming deductibility or without considering federal tax consequences. If so, allowing the deduction would not undermine the state's policy.

Suppose, contrary to the Court's conclusion, that the Pennsylvania fines were imposed as user fees and were calibrated (roughly, no doubt) to reflect the wear and tear and other costs resulting from overweight trucks. Suppose, as well, that the regulator factored enforcement into the level of the fine. If, in other words, experience suggested that one out of every ten overweight truck trips resulted in apprehension and a fine, the fine set would be ten times the fine that would be assessed if enforcement were perfect. Taxes aside, that schedule of fines would lead to full compensation for road damage, and it would also result in optimal deterrence.[124] Shippers whose marginal gain from exceeding the load limit exceeded the expected fine would overload their trucks; others would not.

How would taxes figure into this equation? First, assume that the state ignored taxes in determining the fines for overweight trucking. In this case, deductibility would be consistent with achieving the state's objectives. The costs resulting from overweight trucks would be fully recovered since deductibility at the federal level would not affect the state's receipts. Moreover, potential violators would be optimally deterred. Suppose, for example, that the state had determined that the average cost of overloaded trucks was

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[120] *See id*. at 34. The Court did not explain why probabilistic assessment renders the fines punitive measures instead of user fees. Elsewhere, the Court recited facts that suggested quite strongly that Pennsylvania's system of load limits and enforcement worked as user fees, e.g., the statute allowed for single-trip permit purchase by overweight truckers in lieu of removal of excess weight. *Id*. at 36.

[121] *Id*. at 35.

[122] *See Note, Business Expenses, Disallowance, and Public Policy: Some Problems of Sanctioning with the Internal Revenue Code*, 72 YALE L.J. 108, 117 (1962) (noting that the content of the underlying sanction is altered whether the deduction for fines and penalties is allowed or not).

[123] *See id*. at 123 (suggesting, prior to codification, that the question of applying public policy limitations on tax deductions could be resolved by legislatures explicitly stating whether they wished that specific fine and penalties be deductible).

[124] Setting the expected fine equal to the cost imposed results in optimal deterrence only if the offender is risk neutral. *See* A. MITCHELL POLINSKI, AN INTRODUCTION TO LAW AND ECONOMICS (3rd ed.) 79-90. If the potential offender is risk averse and enforcement is less than perfect, this level of fine may result in over deterrence. *See id*. For a potential offender like Tank Truck Rentals – a business entity and a repeat player – risk neutrality is a reasonable assumption.

$1 per pound of excess weight per trip, and set its fines accordingly.[125] Absent taxes, a shipper would overload and pay the expected $1 per pound per trip fine if its gain from overloading exceeded $1 per pound per trip. Assuming the shipper's profits were taxable, however, $1 per pound per trip gain pre-tax, would leave only 65c after tax at a 35% marginal rate. Obviously, this after-tax rate of gain would not justify the payment of the fine, unless the fine was deductible. If the fine was deductible, the expected after-tax cost of 65c per pound per trip would maintain the equilibrium and optimal deterrence.[126]

Of course, if the fines were calibrated to recover costs and the state had assumed that they would be deductible for federal income tax purposes, the analysis is exactly the same. Deductibility would be consistent with the state's objectives. Disallowing the deduction for fines paid in either of these cases results in overdeterrence. The state fully recovers its costs, but since the gain from overloading is taxed, denying the deduction for fines paid results in some truckers *not* overloading in cases in which the benefit exceeds the harm.[127]

The foregoing analysis assumes that the state's objectives are to recover the costs imposed by overloaded trucks and deter truckers from overloading inefficiently by forcing them to internalize the costs of highway damage. In this situation, deductibility is consistent with the state's objectives unless the state assumed the fine would *not* be deductible and reduced the nominal fine to maintain optimal deterrence. This strikes me as unlikely, since the reduced fine would not fully compensate the state for the road damage, but it is possible.[128]

However, the Court in *Tank Truck* rejected the idea that the Pennsylvania fines were remedial, finding instead that they were punitive.[129] A number of courts have treated this distinction as if it were important to the deductibility question, but it is not obvious that it is.[130] To be sure, if, for some reason, Pennsylvania had determined that the appropriate penalty was $1 per pound per trip for overloading, and consciously decided that violators should bear this level of punishment on an after-tax basis, deductibility would thwart state policy. But what would be the rationale for such a policy? One possibility would be based on equality. It might be felt unfair that firms would be allowed to deduct overweight trucking fines as business expenses while ordinary taxpayers would be unable to deduct their speeding tickets. But, as discussed above,[131] the unfairness at the surface disappears once we realize that the profits from

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[125] If the expected rate of apprehension was one out of ten, the nominal fine would be set at $10 per pound of excess weight.

[126] *See* George G. Tyler, *Disallowance of Deductions on Public Policy Grounds*, 20 TAX L. REV. 665, 667-668 (1965) (arguing that neutrality is achieved in some cases by permitting the deduction).

[127] Suppose that the social costs of overweight trucking average $1/pound/trip and that the expected penalty is set at $1/pound/trip. If the gain from overloading is taxable, but fines are not deductible, a rational (and risk neutral) business would not risk incurring the fine unless the benefit from overloading was at least $1.54/pound/trip (assuming a 35% marginal tax rate). Firms that valued overloading between $1 and $1.54/pound/trip would be inefficiently deterred in this case.

[128] Suppose that the social costs of overweight trucking average $1/pound/trip. If the gain from overloading is taxable, but fines are not deductible, the optimally deterring penalty at a 35% marginal tax rate would be 65c/pound/trip. At this expected fine level, a shipper who valued overloading in excess of $1/pound/trip would overload; others would not.

[129] *See Tank Truck Rentals, Inc.*, 356 U.S. at 34.

[130] *See Note, Business Expenses, supra* note x, at 120-21 (summarizing cases).

[131] *See supra* note x and accompanying text (discussing equality arguments in the 1st A. context).

overloading are taxed in the former case, while the benefits of speeding outside of a business context generally are not.

Another possible justification for disallowing the deduction would be that the state set the fine for overloading at the maximum bearable burden for truckers and wished to deter as much overloading as possible within that constraint.[132] In this case, permitting a deduction for the fine would undermine the deterrent effect. But it is not obvious why the state would fail to take deductibility into account in determining the maximum bearable fine, particularly in a case like *Tank Truck* in which virtually all of the potential offenders would have been businesses entitled to deductions for ordinary and necessary expenses.

Without peering into the minds of the legislators, we cannot know whether deductibility of fines and penalties would undermine the policy behind a state's regulations. Perhaps in some cases it would and § 162(f) supports state policy. It seems likely, however, that in many cases allowing a deduction for fines and penalties would be the neutral approach since the gains from violation would be taxable. In those case, § 162(f) imposes a second layer of penalty and represents added deterrence imposed by the federal government on taxpaying businesses.

2. Non-Tax Alternatives to Piggyback Tax Sanctions

The constitutionality of § 162(f) is not subject to serious question. The provision falls squarely within the "deduction as a matter of legislative grace" framework. It is an example of Congress defining the net income it wishes to tax. Suppose, however, that the income tax were eliminated and that Congress was concerned that state deterrence of poor trust fund management and overloading of trucks was inadequate (a questionable supposition, to be sure).[133] Could Congress replace § 162(f) with a non-tax penalty that would discourage this undesirable behavior directly?

I assume that the Commerce Power is broad enough that Congress could enact federal highway load laws and enforce these laws with a cadre of federal law enforcement personnel, at least for purposes of patrolling the interstate highway system. But this approach would be extraordinarily costly, not to mention redundant and probably politically unacceptable. However, here Congress has an easy out utilizing the spending power. Congress could condition state highway funds on minimum requirements, effectively forcing the states to ratchet up highway fines to offset the loss of the tax deterrent.[134]

Where the spending power is unavailable, however, Congress would seemingly have difficulty "outsourcing" such tax penalties. How could Congress replace the deterrent effect of disallowed deductibility of fines resulting from violation of

[132] *See* Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169, 183 (1968) (demonstrating that when potential offenders are risk neutral the most efficient system of law enforcement is the one in which penalties are set as high as possible in order to minimize the costs of enforcement).

[133] Elimination of the corporate tax would decrease the deterrent effect of fines and penalties on businesses subject to the tax versus the status quo. Fines and penalties would remain non-deductible (as there would be no corporate tax and no deductions), but the gains from offenses would no longer be taxable. With a greater effective benefit and unchanged detriment, the incentive to incur fines and penalties would increase.

[134] [Cite.]

commercial regulations? Congress could not force states to increase penalties or enforcement since there would be no spending power hook,[135] and Congress could not require the states to enforce federal law in this area, assuming that it had the power to legislate.[136] It is not even clear that Congress could require the states to report violations. If violations were reported, what process would be required in order to assess "piggyback" federal fines for the underlying violation? Would a state finding of a violation serve as prima facie evidence of the violation of the parallel federal offense? The difficulties are significant.

3. Federalism Limitations Are Unlikely to Be Important Constraints

Sections 162(f) and 162(c) increase penalties and increase deterrence. In many, if not most cases, it is unlikely that the disallowance is required to avoid thwarting state policy. Allowing deductions for fines and penalties paid would be a neutral response if the benefits achieved by the offenses are taxable. Thus, these provisions can be thought of as added federal tax penalties.

However, it is not at all clear that the *purpose* of these provisions is to increase deterrence. It is unlikely that §§ 162(c) and 162(f) reflect a congressional view that the states are weak on corporate crime and that further deterrence is needed. More likely, these provisions were enacted to avoid the appearance of subsidizing illegal activity which could be created if fines and penalties were deductible as ordinary and necessary business expenses. If the income tax were to disappear, it is doubtful that Congress would rush to fill the void created by the elimination of these tax penalties.

These provisions are probably best understood as symbolic legislation – legislation created for the primary purpose of appealing to voters and promoting reelection, rather than as a means of influencing the behavior of those regulated.[137] Imagine that every time a business paid a large fine it was reported that 35% of that fine would be "subsidized" by the federal government through a tax deduction. Voters, not understanding that deductibility often is the neutral response, would be outraged.[138]

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[135] [Confirm.]

[136] *See* Printz v. United States, 521 U.S. 898, 925 (1997) ("Federal Government may not compel the States to implement, by legislation or executive action, federal regulatory programs").

[137] *See* Daniel Shaviro, *Beyond Public Choice and Public Interest: A Study of the Legislative Process as Illustrated by Tax Legislation in the 1980s*, 139 U. PA. L.REV. 1, 8 (1990). Legislation is generally viewed as serving direct instrumental purposes or fulfilling a symbolic or expressive function. *See* Mark Tushnet & Larry Yackle, *Symbolic Statutes and Real Laws: The Pathologies of the Antiterrorism and Effective Death Penalty Act and the Prison Litigation Reform Act*, 47 DUKE L.J. 1, 74-76 (1997). Unlike symbolic legislation, which is not directed at the behavior of the regulatee, expressive legislation is meant to adjust behavior by establishing or reinforcing social norms to which the regulatee responds. *See id.*; *see also* Michael S. Kirsch, *Alternative Sanctions and the Federal Tax Law: Symbols, Shaming, and Social Norm Management as a Substitute for Effective Tax Policy*, 89 IOWA L.REV. 863, 893-930 (evaluating alternative sanctions applied to tax avoiders under this framework). It is conceivable that §§ 162(c) and 162(f) serve an expressive function, but it seems more likely that these provisions are purely symbolic.

[138] This is not merely a speculative conjecture. Consider the outrage that followed when it was learned that Exxon would be permitted to deduct the $1 billion settlement it reached with state and federal government relating to the Exxon Valdez oil spill. Although ultimately unsuccessful, there was a movement in Congress to disallow this deduction, which is not foreclosed by § 162(f). *See* John D.

Disallowing the deduction eliminates the potential for outrage that might otherwise undermine satisfaction with incumbent legislators.

Of course, the potential appearance of subsidy, which is eliminated by § 162(f), exists only as long as § 162 exists. It is an accident of the structure of the income tax which allows the deduction of ordinary and necessary business expenses in arriving at net income subject to tax. If the income tax were repealed, the problem would vanish, and assuming, as I suggest, that § 162(f) is solely symbolic, we would not expect Congress to replace it, even though repeal would reduce the effective cost faced by businesses incurring fines and penalties.

III. Tax Penalty Advantages over Feasible Non-Tax Regulatory Options

Many tax penalties could feasibly be replaced by non-tax disincentives. Consider, for example, corporate governance provisions such as IRC § 162(m), which denies deductions for certain non-performance based executive pay, § 280G, which denies a deduction for excessive golden parachute payments, and the bill sponsored by Senators Levin and McCain that would have conditioned tax deductions for stock option compensation on firms' deducting the expenses for financial reporting purposes.[139] In each case, the tax penalty could have been replaced with a mandate (pay no more than $1 million per year in salary, limit golden parachutes to three times average compensation, expense those options!) that acted as a Cooter sanction or by a tax-like penalty administered outside of the tax code.[140]

In these cases, we have a puzzle: Given the decision to advance legislation, where is the proposed legislation to be situated, and why? One can imagine many considerations that would factor into the analysis, including, of course, the substantive efficacy of the regulation in each potential form and venue, but also the impact of the choice of venue on the likelihood of enactment and the ease of enforcement. Moreover, the attractiveness of potential venues would vary with the motivations of the sponsoring legislators.

There is a vast literature addressing the motives of the various players in the political process. Broadly, politicians are viewed as being motivated by self interest and the public interest.[141] Self-interested motivations include not just a desire for reelection, but for power and prestige, and possibly for attractive opportunities following a career in public service.[142] Undoubtedly, all of these motivations play a role in legislative strategy.

McKinnon, *Wages of Corporate Sin: Tax Breaks – Companies Facing Claims for Sleazy Behavior Could Get Windfall from the IRS*, WALL ST. J., Sep. 3, 2002, at A4.

[139] Ending Double Standards for Stock Options Act, S. 576, 105th Cong. (1997).

[140] *See supra* Part I.B for a discussion of Cooter prices and sanctions. In brief, a Cooter sanction results in an abrupt increase in cost when a violation occurs; a Cooter price results in smooth, continuous cost increases.

[141] *See, e.g.*, Shaviro, *supra* note x (Beyond Public Choice) (describing and critiquing both the public interest and public choice models); Jonathan R. Macey, *Public Choice and the Law*, *in* THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW (discussing the public choice model).

[142] *See* RICHARD F. FENNO, CONGRESSMEN IN COMMITTEES 1 (1973) (listing these goals as well as the goals of making good public policy and explicit personal gain); Shaviro, *supra* note x (Beyond Public Choice), at 81-87 (discussing personal motivations of members of Congress beyond "narrow monetary self-interest"); see also R. DOUGLAS ARNOLD, THE LOGIC OF CONGRESSIONAL ACTION 5-6 (1990) (arguing that reelection is the dominant motivation of members of Congress, but that the quest for reelection can lead

This is not the place to engage that debate, but I assume that pure public interest is not the sole criterion.[143]

Enactment could take on particular importance for either public spirited or privately motivated reasons. A legislator might honestly believe that the expressive power of a particular provision – its power to create or reinforce social norms – is more important than its direct instrumental effect. And, of course, even a legislator who was focused on the instrumental effect of a bill would care about enactment to some extent, since an un-enacted bill would have no instrumental effect. Thus, to a greater or lesser extent, sacrificing substantive efficacy for improved odds of enactment could be in the public interest.

On the other hand, there clearly would be self-interested motivations for focusing on enactment, given the power and prestige conferred on the successful legislative sponsor or perhaps specific benefits conferred on constituents.[144] Moreover, to the extent that the act of legislating is largely symbolic rather than instrumental – that demonstrating to voters that action has been taken is more important than the results – enactment would be the overriding concern of the sponsor. In these cases, we might expect an even greater tradeoff of substantive efficacy for improved odds of enactment.

Of course, these tradeoffs and the venue question also arise with respect to tax subsidies. Why should these provisions appear in the Code? In the tax expenditure literature, the administrative efficiency of utilizing the existing tax apparatus to implement non-tax incentives often figures prominently in the analysis.[145] This seems reasonable. Although there are drawbacks, there are efficiency advantages to implementing subsidies through the Code: Taxpayers have an existing reporting relationship with the IRS; the IRS is skilled at tracking and computing dollars; etc.

By the same token, where a disfavored activity involves normally deductible expenses or can be related to such expenses, tax penalties may be an administratively convenient choice for regulation. However, in my view, legislative sponsors would see advantages to incorporating disincentives within the tax code that go far beyond administrative convenience. Most of the advantages of tax penalties as regulatory devices facilitate enactment. Thus, within a theory of the legislative process in which enactment is important, it is not surprising to find tax penalties.

This Part considers the advantages of placing disincentives in the tax code. The *substantive* efficacy of tax penalties (or lack thereof) has been well detailed and will not be considered here.[146] Section A lays out the administrative efficiency and enforcement

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members to support both particular and general interests). Although some commentators use the phrase public choice theory to refer to the idea of legislation as product being sold to the highest bidder, the phrase also can be used to encompass other self-interested motivations of politicians.

[143] *See* Daniel A. Farber & Philip P. Frickey, *The Jurisprudence of Public Choice*, 65 TEX. L. REV. 873, 924-27 (1987) (concluding from the empirical evidence that many members of Congress act in the public interest but that interest groups also exert significant influence over legislation).

[144] *See* FENNO, *supra* note x, at 1 (suggesting that all congressmen probably share these goals but that their priorities vary).

[145] *See, e.g.*, Weisbach and Nussim, *supra* note x (arguing that administrative efficiency determines the location of policy programs, and specifically factors such as specialization, coordination, and economies of scale).

[146] *See, e.g.*, Polsky, *supra* note x (arguing that § 162(m) should not have been expected to benefit shareholders under either of the prevailing theories of the executive compensation setting process and concluding that the empirical evidence supports the view that it was not); Michael Doran, *Executive*

advantages of tax penalties. Of course, these instrumental advantages would not justify enactment of totally inefficacious legislation. Thus, Section B goes on to highlight the enactment advantages of tax penalties that also would not justify, but may explain their use, particularly as symbolic legislation. Section C briefly describes the natural limits on the use of the tax code to discourage non-tax behavior. As before, our focus in this Part is on tax penalties that take the form of disallowed deductions, but limitations on credits and imposition of excise taxes are also discussed when relevant.

A. Administrative Advantages of Tax Penalties

Substantive differences aside, there are numerous differences in implementation and enforcement of non-tax programs inside and outside the Code. Very broadly speaking, these could be categorized as administrative differences. This section will focus on two – one fairly obvious, the other less so.

1. Administrative Efficiency

At first blush, it may seem that it would be quite inefficient to administer non-tax programs through the Treasury and IRS, particularly in cases in which tax programs in some sense duplicate direct approaches. However, numerous commentators have questioned the conventional wisdom with respect to subsidy programs. In some situations, administering tax penalties through the Code may be efficient as well.

David Weisbach and Jacob Nussim have recently argued that tax subsidy programs should not be evaluated through a tax policy lens but through a larger institutional design perspective.[147] They begin with the assumption that Congress has chosen to regulate and then consider the pros and cons of structuring the regulation as a direct program or a tax expenditure.[148] In their view, the key to the analysis comes down to a tradeoff between specialization and coordination.[149] Placing programs in the tax sphere aids coordination, but sacrifices specialization, as IRS and Treasury staffers lack the expertise in poverty, housing, or corporate governance held by their counterparts at HHS, HUD, and the SEC.

Recently, Nancy Staudt has suggested that coordination may be overvalued, that redundancy can promote innovation and reduce the impact of program failure.[150] While Staudt and Weisbach/Nussim reach different conclusions regarding the desired level of program integration, both approaches support implementing some non-tax programs through the Code.

Other commentators, such as Edward Zelinsky, have pointed out specific advantages of program administration through the tax system. Zelinsky argues, for

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Compensation Reform and the Limits of Tax Policy (Tax Policy Center Discussion Paper , 2004) concluding that recently enacted § 409A "represents an ineffective and misguided approach to deferred compensation reform"); Bruce A. Wolk, *The Golden Parachute Provisions: Time for Repeal?*, 21 VA. TAX REV. 125 (2001) (discussing the gross up provisions used to reallocate the tax burden of §§ 280G and 4999 from company executives to shareholders); [others on §§ 162(m) and 280G, including Repetti].

[147] *See* Weisbach & Nussim, *supra* note x.

[148] *See id*.

[149] *See id*. at 992.

[150] *See* Staudt, *supra* note x.

example, that the cost of communication between the government and the populace is often lower with respect to tax incentives than direct subsidies because the communication channel – the annual tax filing requirement – is already in use.[151]

These points translate directly from tax subsidy to tax penalties taking the form of disallowed deductions or credits. If a tax deduction or credit is already in place and related to the disfavored activity at issue, what could be more straightforward and administratively convenient than conditioning continued access to the deduction or credit upon refraining from engaging in the disfavored activity? Take § 162(m) as an example. Congress was concerned about the amount and the form of executive compensation. For most businesses, executive compensation is a deductible expense. Thus, although the IRS and Treasury have no particular expertise in regulating corporate governance, *implementing* executive compensation regulation as a tax penalty added little cost for either the government or the firms regulated. To be sure, the Treasury was required to write detailed regulations implementing § 162(m), but, of course, the SEC would have had to write regulations had the job been given to them. This is not to say that the *substantive* regulation that might have come out of the SEC would not have been different and perhaps superior to that written by Congress and handed over to the Treasury. But this is Weisbach and Nussim's point; there is a tradeoff between specialization and coordination.

2. Shifting Burdens onto Regulated Parties

Tax and non-tax penalties differ in one "administrative" respect that has no parallel in the world of tax and non-tax subsidies. The mantra that deductions are a matter of legislative grace should simply be a statement about congressional power to enact tax legislation, but the maxim affects enforcement as well.[152] The catchphrase has been cited over a thousand times as courts place the burden on taxpayers to establish that they are entitled to deductions.[153] Although criticized,[154] this presumption against deductibility remains powerful and in the context of tax penalties yields a presumption in favor of the penalty applying. The taxpayer is required to show that the penalty does not apply in its case.

For example, in *Stroud v. U.S.*, the plaintiffs, a doctor and her husband, sought to deduct as business losses payments made to the federal government resulting from the doctor's breach of scholarship obligations.[155] The court noted that "[n]ot only must Plaintiffs show that the payments were ordinary and necessary business expenses, but they must show that § 162(f) does not apply."[156] As discussed above, IRC § 162(f) disallows deductions for fines or similar penalties paid to a government for the violation of a law.

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[151] *See* Zelinsky, *supra* note x (Efficiency and Income Taxes).

[152] *See* Griswold, *supra* note x, at 1143 n. 8 (arguing that the legislative grace mantra speaks to power and should not be construed as creating a presumption of non-deductibility).

[153] *See* Peter A. Lowy & Juan F. Vasquez, Jr., *Interpreting Tax Statutes: When Are Statutory Presumptions Justified?*, 4 HOUS. BUS. & TAX L.J. 389 (2004).

[154] *See id.*; Griswold, *supra* note x.

[155] *See* Stroud v. U.S., 906 F.Supp. 990 (D.S.C. 1995), *aff'd in part, vacated in part on other grounds*, 94 F.3d 642 (4th Cir. 1996).

[156] *Id*. at 994, n.8.

By contrast, penalty provisions established outside of the tax code bear no presumption of applicability. There is no presumption either way. Thus, structuring disincentives as disallowed deductions should aid enforcement by creating this pro-penalty presumption.

Note also that the burden of proof in tax cases is normally on the taxpayer,[157] whereas the burden in regulatory enforcement actions outside of the tax realm lies on the agency seeking to enforce a rule or order.[158] In this way as well, placing the penalty within the tax code stacks the deck in favor of the government.

B. Enactment Advantages of Tax Penalties

The fact that a provision like § 162(m) can be implemented at relatively low cost is an advantage to including it in the Code. Some observers might feel that the fact that the burden of proof with respect to compliance rests with taxpayers is a second advantage. However, if § 162(m) has had no salutary effect on executive compensation, these factors simply mitigate the mistake. If the ineffectiveness of § 162(m) was predictable, as it almost surely was, these factors do not explain its enactment.

However, as discussed, substantive efficacy is unlikely to be the sole motivation for legislation. Let us assume that symbolism plays a role in the drive to enact corporate governance and similar legislation. Under this model, enactment has value for its own sake, and structuring a disincentive as a disallowed deduction has significant advantages in enactment. This section reviews these advantages using the corporate governance tax penalties as the paradigm. However, rather than focusing on a specific existing tax penalty, such as § 162(m), I will create a hypothetical tax penalty for analysis: Suppose an influential senator were to conclude that the pensions provided to executives of U.S. corporations had gotten out of hand and was looking for a means of discouraging excessive pensions. The senator might consider proposing a ban on executive pensions, a cap on pension payments, an SEC-imposed penalty on excessive pension payments, or a limitation on the corporate tax deduction for executive pension payments. Presumably, Congress has the power to enact any of these. How will the choice of regulatory scheme affect enactment, implementation, and enforcement?

1. Overcoming Resistance to Interference with Private Contracting

The senator might prefer the outright ban as the most efficacious way of dealing with stealth compensation via pensions. "Why," she might ask, "do these guys need pensions on top of all those stock options?" But, being a realist, the senator knows that she must deal with a Congress composed of laissez faire capitalists who take freedom of private contracting very seriously, complete market skeptics who would not be opposed to aggressive regulation, and members with a range of views in between. Because the senator values enactment as well as the ultimate effect of the legislation enacted in

[157] *See* Griswold, *supra* note x, at 1143-44. This common law rule has been eroded to some extent by the enactment of I.R.C. § 7491, which shifts the burden of proof onto the government once the taxpayer provides credible evidence on a factual issue. However, this provision does not apply unless the taxpayer meets certain record keeping requirements and does not apply at all to large corporate taxpayers. *See* I.R.C. § 7491(a)(2) .

[158] *See* APA § 556(d) ("the proponent of a rule or order has the burden of proof").

reforming corporate practices, she would be sensitive to the likely responses of her colleagues.[159]

How will these alternative regulatory schemes be viewed? The first two options – the ban and the cap – represent substantial interferences with private contracting and are unlikely to receive broad support unless the harms of executive pensions greatly outweigh the benefits.[160] To be sure, Congress managed to overcome a similar hurdle when it included a prohibition on corporate loans to executives in the Sarbanes-Oxley Act. However, the loan ban was prompted by revelations of significant abuse.[161] At Enron, former CEO Ken Lay had borrowed $81 million from the company through a series of loans and repaid all but $7 million with stock received from option exercise. Through these loans, Lay effectively sold $74 million of stock back to the company without disclosing the sales to shareholders, at a time when Lay was continuing to publicly claim that all was well at Enron.[162] At Tyco, CEO Dennis Kozlowski and general counsel Mark Belnick received a combined $30 million in loans to purchase real estate,[163] and Kozlowski allegedly used millions in company loans intended to pay taxes on stock option gains to purchase artwork.[164] WorldCom loaned its CEO hundreds of millions of dollars at low interest rates,[165] and Adelphia loaned over $260 million to members of the controlling Rigas family.[166] In many cases, the interest and sometimes the principal of executive loans were forgiven by boards of directors with little apparent deliberation.[167] Moreover, the cost of forbidding such loans might appear to be modest. Unlike executive pensions which are ubiquitous, most companies and executives managed just fine without such loans. Nonetheless, the SOX ban on loans to corporate executives has received harsh criticism as heavy handed congressional interference with private contracting.[168]

A "hard" cap on executive pensions that took the form of a Cooter sanction is simply a ban above a threshold.[169] Imagine replacing § 162(m) with a non-tax fine meant to preclude delivery of non-performance based pay in excess of the $1 million limitation, for example, a fine equal to some multiple of the excess non-performance-based pay. A cap on excess compensation or on executive pensions may appear to allow slightly more freedom for private contracting than an outright prohibition on the activity, but both

[159] *See* ARNOLD, *supra* note x, at 8 (arguing that legislative sponsors design proposals to appeal to member preferences, which in his view are dominated by constituent preferences and the quest for reelection).

[160] The risk, of course, is that Congress may be mistaken in concluding that the harms of an activity outweigh the benefits for some or all participants. Generally, Cooter prices allow private parties greater leeway to overcome mistakes of this nature than Cooter sanctions.

[161] *See* Permanent Subcommittee on Investigations, The Role of the Board of Directors in Enron's Collapse (July 8, 2002); Testimony of Senator Levin (Feb. 11, 2003).

[162] *See* The Role of the Board, *supra* note x, at 53.

[163] *See* Levin Testimony, *supra* note x.

[164] *See* Mark Maremont et al, *Probe of Ex-Tyco Chief Focuses on Improper Use of Company Funds*, WALL ST. J., June 6, 2002, at A1.

[165] *See* Joann S. Lublin & Shawn Young, *WorldCom Loan to CEO of $341 Million is the Most Generous in Recent Memory*, WALL ST. J., Mar. 15, 2002, at A4 (reporting that loans to CEO Bernard Ebbers carried interest rates of 2.14 to 2.18%).

[166] *See* Levin Testimony, *supra* note x (citing proprietary report issued by the Corporate Library).

[167] *See id*.

[168] *See* Romano, *supra* note x.

[169] [Examples of disincentives taking this form?]

represent very serious interferences with private arrangements and would likely meet with significant resistance.

This narrows the options to the pair that are the focus of this Part – tax and non-tax disincentives that take the form of Cooter prices. Administrative costs aside, these two options can be designed to be economically equivalent. Assuming that most corporations pay tax at a 35% marginal rate, a 35% fine imposed by the SEC on excessive pension payments (however defined) would be equivalent to denial of a deduction for the same payment.[170]

a. The Impact of Framing a Disincentive as Revoking a Subsidy

However, although these two options could be designed to be economically equivalent, structuring the disincentive as the denial of a tax deduction or credit would facilitate enactment because the tax penalty would be viewed as a lesser interference with private contracting. This is primarily a question of framing, but framing the penalty as a deduction limitation provides an important advantage, which brings us back to the confusion between penalties and non-subsidies.

There is little doubt that the hypothetical SEC fine would be viewed as a penalty. As in the case of CAFE standards, businesses that chose to ignore the limitation would be required to remit a payment to the government. Such a scheme should be viewed as less coercive than a ban or hard cap, but no one would argue that the imposition of fines would somehow represent the revocation of a subsidy. But this is exactly how tax penalties are framed. As we have seen, Justice Douglas characterized the disallowance of deductions for political advocacy in *Cammarano* as the failure to provide a subsidy for such advocacy. Former President Clinton adopted a similar stance in proposing the legislation that ultimately became enacted as IRC § 162(m). As he told a group of businessmen at the time, "the Tax Code should no longer subsidize excessive pay of chief executives and other high executives."[171]

In this context, whether § 162(e), § 162(m), or a limitation on deductions for pension payments are, in fact, better viewed as penalties or revocation of subsidies is immaterial. The key is that they can be portrayed at least plausibly and perhaps persuasively as revocation or limitation of subsidies, while economically equivalent SEC penalties can only be portrayed as penalties.

Of course this is just rhetoric and framing, but framing may be crucial to public and political perception in this context. Edward McCaffrey describes framing as the "well-documented phenomenon under which individuals react to the purely formal way

[170] To be sure, not all corporations pay tax at the 35% statutory marginal rate. Many firms face a lower marginal rate of tax as a result of losses incurred in previous years.

There is precedent for the hypothetical SEC penalty scheme in the CAFE standards administered by the Department of Transportation. As discussed above, vehicle manufacturers are fined $5.50 per vehicle for every tenth of a mile per gallon by which their fleet falls short of the applicable fuel economy standard.

[171] William J. Clinton, Remarks to Business Leaders (Feb. 11, 1993) (available at: http://www.presidency.ucsb.edu/ws/index.php?pid=47010). [Include other examples, e.g., Levin on the deduction for stock option expense.]

in which a question is presented,"[172] and Edward Zelinsky has argued that framing effects help to explain the persistence of tax subsidies. Zelinsky explains, for example, that individuals react differently to paying "volunteer" firefighters directly and providing them with economically equivalent property tax exemptions.[173] In a sense, concerns over framing also lay at the root of Surrey's concerns with tax expenditures. Because tax subsidies are less salient than direct expenditures, they are easier to enact and maintain.[174]

My sense is that framing is equally important for the enactment of tax penalties, but for very different reasons. In placing subsidies in the tax code, Congress may be hiding the cost of federal programs from taxpayers. Placing penalties in the Code has little to do with revenue. If the disincentives are successful in altering behavior, there will be no revenue effects at all, and if unsuccessful, why wouldn't Congress want to visibly raise revenue from wrongdoers? Rather, the benefit of placing penalties in the Code is the ability to shift the rhetoric from "penalty" to "no subsidy," which defuses critics of regulatory intervention. Thus, it is my prediction that Congress and the public at large would react differently to a call for imposing a 35% surtax on executive pension payments above a threshold amount than to a proposal for disallowing corporate tax deductions that "subsidize" such payments.[175] As discussed in subsection c, below, student survey evidence supports this prediction.

b. Presumptions Against Allowing Deductions to Wrongdoers

Tax penalties that take the form of denied deductions and credits are consistent with long-standing common law presumptions against allowing deductions to

[172] Edward J. McCaffrey, *Cognitive Theory and Tax*, 41 UCLA L.REV. 1861, 1905-16 (1994) (suggesting several examples of the importance of framing in individuals' responses to tax incentives, including a preference for excludable "fringe benefits" over programs requiring inclusion and deduction).

[173] *See* Edward A. Zelinsky, *Do Tax Expenditures Create Framing Effects? Volunteer Firefighters, Property Tax Exemptions, and the Paradox of Tax Expenditure Analysis*, 24 VA. TAX REV. 797, 799 (2005) (providing survey evidence suggesting that direct payments were more likely to be viewed as vitiating volunteer status than economically equivalent tax exemptions); *see also*, Shaviro, *supra* note x (Beyond Public Choice), at 63 (suggesting that "people are simply more willing to allow others to take advantage of tax breaks than they are to give them payouts").

[174] *See* SURREY, *supra* note x (Pathways); *see also* ARNOLD, *supra* note x, at 200 (arguing that tax preferences have a "dual advantage" over direct spending of being equally salient to beneficiaries, but largely invisible otherwise); Zelinsky, *supra* note x (Framing) (suggesting that framing effects help explain the persistence of tax expenditures despite the promulgation of tax expenditure budgets).

Surrey and McDaniel noted as a purported advantage of tax expenditures directed at business that the provisions look less like subsidies than direct benefits. *See* SURREY & MCDANIEL, *supra* note x, at 107. Surrey and McDaniel suggested that tax incentives would "carry no [] negative psychological effect" in a capitalist economy. *See id*. However, Surrey and McDaniel seemed to have focused on the perception of the recipients. They did not consider, as far as I have discovered, whether the framing effect they identified would impact enactment.

[175] It seems clear that the alternative penalty/subsidy framing choice does have behavioral effects in some situations. Fetherstonhaugh and Ross showed that framing a $2,500 annual difference in social security benefits as a "credit for delaying retirement" or as a "penalty" for early retirement affected the preference for retirement at age 65 versus 68. However, framing had no statistically significant effect on preferences when the choice given was between retirement at age 62 and 65. *See* David Fetherstonhaugh & Lee Ross, *Framing Effects and Income Flow Preferences in Decisions About Social Security, in* BEHAVIORAL DIMENSIONS OF RETIREMENT ECONOMICS 187, 187-88 (Henry J. Aaron ed., 1999) (described in Zelinsky, *supra* note x (Framing), at 808-09).

wrongdoers in determining liability in tort as well as for tax. Perhaps this doctrine simply reflects the same confusion surrounding penalties and non-subsidies that we have witnessed before, but it does reinforce the idea that the right to deductions is not absolute, but is contingent, and in particular is contingent on refraining from engaging in disfavored behavior.

The history of denying deductions in determining the liability of willful tortfeasors far predates the U.S. income tax. Under English law, a wrongful trespasser could not deduct his costs in calculating his liability to the rightful owner, whereas an accidental converter could.[176] That rule continues to apply in this country. According to the draft of the Restatement (Third) of Restitution and Unjust Enrichment, the innocent converter of chattels has a potential claim against the rightful owner in restitution for improvements, which partially offsets the converter's liability to compensate the owner for the improved value of the chattels, whereas "the conscious converter has [no claim in restitution], whatever the benefits conferred on the owner."[177]

Illustrations abound. In one case involving mistaken conversion of timber, the court approved an instruction permitting the jury to calculate damages based on the value of the timber in Toledo, OH, where it was ultimately sold, deducting the cost of hauling and milling the timber.[178] However, in an analogous case involving willful conversion of timber, hauling, milling, and sale, the Supreme Court refused to allow any deduction in determining the defendant's liability. The defendant was liable for the improved value of the property without offset.[179]

The justification for denying deductions for expenses incurred by wrongful tortfeasors ranges from explicit punishment to lack of an equitable driving force for an offset, but the bottom line is clear: The wrongdoer is liable for the gross profits of the enterprise. A similar rule applies today in disgorgement proceedings brought by the SEC against perpetrators of securities fraud. Business expenses generally are not deducted in calculating the disgorgement liability of violators.[180]

Returning to the income tax realm, before Congress codified explicit public policy limitations on business deductions in IRC § 162, courts often applied common law limitations, denying deductions when allowance "would frustrate sharply defined national or state policies, proscribing particular types of conduct, evidenced by some

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[176] *See, e.g.*, Livingstone v. Rawyards Coal Co., L.R. 5 App. Cas. 25 (1880) (Lord Hatherley) ("There is no doubt that if a man furtively and in bad faith robs his neighbour of property…the Court of Equity in this country will…punish fraud by fixing the person with the value of the whole of the property which he has so furtively taken, and making him no allowance in respect of what he has so done as would have been justly made to him if the [man had taken the property] through a mistake.")

[177] Restatement (Third) of Restitution § 10 cmt. I (T.D. No. 1, 2001)

[178] *See* Winchester v. Craig, 33 Mich. 205 (1876).

[179] *See* E.E. Bolles Wooden Ware Co. v. United States, 106 U.S. 432 (1882). Cases involving conversion of coal are common as well. For example, in Pan Coal Co. v. Garland Pocahontas Coal Co., 125 S.E. 226 (1924) the court nicely stated the general rule as follows: "[I]f the trespass was willful, then the value [of the coal] at the … pitmouth would be the basis of recovery, the defendant not being allowed to deduct from that value any expense for mining or hauling the coal," but "[i]f the coal was removed through innocent mistake or inadvertence, [the defendant] would be compelled to pay for it, but at its value in place," i.e., with deduction for extraction. [See also, numerous other cases cited in Reporter's note to R3R.]

[180] *See* SEC v. Hughes Capital Corp., 917 F.Supp 1080 (D.N.J. 1996) ("the overwhelming weight of authority holds that securities law violators may not offset their disgorgement liability with business expenses").

governmental declaration thereof."[181] As we have seen, the Supreme Court invoked this doctrine in *Tank Truck Rentals* in disallowing deductions for fines paid by trucking companies for violation of state highway weight limits.[182]

To be sure, the common law limitation on tax deductions was closely circumscribed. Ordinary deductions associated with illegal businesses generally were and are allowed, and the cases generally disclaim any intention of using the Code instrumentally to reform bad behavior.[183] However, the tax cases that do invoke the public policy limitation on deductions often reflect the ambiguity between penalty and removal of a subsidy. Echoing Justice Douglas's non-subsidy argument in *Cammarano*, the Court viewed the disallowance of the deduction for fines paid in *Tank Truck Rentals* not as an additional penalty, but as necessary to avoid "dilut[ing] the actual punishment imposed" by the state.[184] Whatever the rationale, the wrongful conversion, securities fraud, and common law tax cases reinforce the perception that offsets or deductions are matters of grace, not of right.

c. Empirical Evidence on the Impact of Penalty Structure and Framing on Public Acceptance

I "predicted" in subsection a, above, that Congress and the public would react differently to a call for a direct penalty on excess executive pension payments than to a proposal to disallow tax deductions that subsidize such payments. I tested that prediction on the Boston University School of Law class of 2010. As described more fully in the Appendix, I prepared three versions of a survey question asking the first year law students to rate on a scale of 1 to 10 the degree to which they would oppose or support executive pension regulation, with a rating of 10 equating to strongest support. Each version of the survey included identical paragraphs describing the purported problem, in brief, growth of executive pensions far outpacing inflation. One version went on to propose a direct penalty of 35% on excess executive pension payments (defined as payments in excess of $1 million per year). On a scale of 1 to 10, average support for this proposal was 4.6.

The next version of the survey replaced the direct penalty with disallowance of deductions for pension payments in excess of $1 million per year, explaining that for "typical" firms, the effect would be a 35% increase in effective cost on the excess payments. Thus, as structured, the direct penalty and the tax penalty had equivalent economic effect. The word "subsidy" was not used in this version. This proposal received average support of 6.2.

The final version maintained the deduction disallowance proposal, but framed the proposal as the elimination of a taxpayer subsidy. Whereas the non-pejorative deduction

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[181] Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30, 33-34 (1958), discussed *supra* Part II.B.2.a.

[182] *See id*. *See supra* Part II.B.2.a for a fuller discussion of *Tank Truck Rentals*.

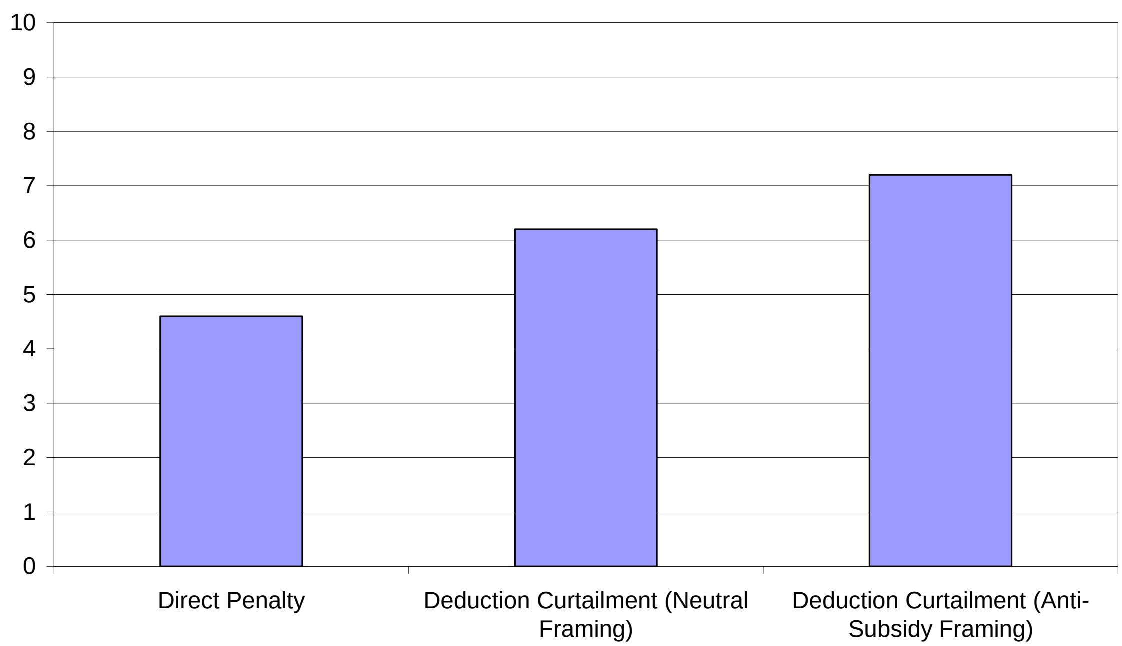
[183] *See* Commissioner v. Tellier, 383 U.S. 687 (1966) (allowing tax deductions for unsuccessful defense of securities fraud claims).

[184] *Tellier*, 383 U.S. at x (discussing *Tank Truck Rentals*). As discussed *supra* Part II.B.2.a, it is impossible to determine whether disallowance of the deduction results in adequate deterrence or over-deterrence without knowing the basis for the fine. However, it seems unlikely that the entity that established the fine took into account the tax treatment of profits and business expenses, including fines, in which case the disallowance resulted in over-deterrence.

disallowance proposal stated that the "change in law would increase the effective cost to Acme of providing a $3 million pension by $700,000," the non-subsidy version stated that "[e]liminating the tax subsidy … would save taxpayers about $700,000." Framed as the elimination of a taxpayer subsidy, the final version of the proposal received average support of 7.2. The differences between the mean support scores for the three versions were statistically significant.

This data, which is portrayed in following figure, suggest that structuring a disincentive as a disallowed deduction and framing the intervention as subsidy elimination may be powerful in shaping public opinion in favor of the intervention. But the data also suggest that while explicit framing as subsidy elimination improves acceptance, the mere fact of structuring the disincentive as a deduction disallowance rather than an affirmative penalty positively affects acceptance. The subjects did not equate economically equivalent intervention, but we cannot know whether the difference reflects confusion regarding the impact of disallowed deductions and direct penalties, an understanding (without being told) that a disallowed deduction represents subsidy revocation, or some other factor.

Figure
Mean Support for Executive Pension Regulation



2. Avoiding Tough Questions Regarding the Appropriate Penalty

Tax expenditure opponents bemoan the fact that the size of a tax incentive often is determined by the structure of the tax code.[185] Incentives can take the form of deductions or credits. A tax incentive structured as a deduction provides a subsidy equal to the taxpayer's marginal rate multiplied by the deductible expenditure. Credits provide

[185] *See* SURREY, *supra* note x (Pathways); [other cites].

greater flexibility, as Congress specifies the portion, generally the percentage and maximum amount, of an expenditure that will be "creditable."[186] Tax penalties have similar limitations.[187] Excise taxes could be used to fine-tune disincentives, but today, most regulatory tax penalties take the form of disallowed deductions. Assuming that the target of the penalty is actually paying tax, disallowing a deduction increases the taxpayer's after-tax cost of engaging in the disfavored activity by an amount equal to the expenditure multiplied by the marginal rate. To the extent that Congress considers the instrumental effects of tax penalties to be important, it clearly cannot be efficient to apply the same penalty schedule to every activity – paying excessive executive salaries, lobbying Congress, and failing to expense stock options – that Congress (or certain members) have sought to discourage by disallowing tax deductions.

But in one sense this half empty glass is half full. If Congress were to apply a non-tax, CAFE-type penalty[188] to excessive executive pensions, for example, it would have to establish a penalty schedule in addition to determining the threshold level of pension payments that triggers the imposition of the penalty. In the case of a tax penalty, such as § 162(m), Congress need only produce a threshold for the disallowance. The optimal penalty schedule promulgated as part of the direct regulation would cause violators to internalize the previously externalized harms of providing excessive pensions to senior executives. I suspect that, in the case of § 162(m), § 280G, and many other tax penalties, Congress had not quantified and probably could not quantify the social costs of the behavior at issue. Casting the disincentive as a tax penalty obviated the need to attempt to quantify the harms and expose the uncertainty.[189]

3. Overcoming Resistance of Special Interests

Recent regulatory tax penalties, particularly the penalties aimed at corporate governance, surely met substantial industry opposition. Did channeling this legislation through the tax committees aid in overcoming that resistance? Edward Zelinsky's analysis of the relative susceptibility of tax and non-tax committees to interest group capture suggests that it might have, but there are several reasons to question whether the effect would be significant.

Zelinsky has argued that special interest lobbying is more effective in non-tax committees than tax committees because a single special interest or alliance of special interests often will dominate the former and because the deliberations of the former often are less public.[190] In tax committees, according to Zelinsky, special interests compete and there's more daylight. He contrasts congressional agricultural committees with Finance and Ways and Means, suggesting that the influence of the farm lobby over

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[186] Of course, Congress could provide a deduction for less than 100% of an expenditure, but we rarely see this. I.R.C. § 274(n), which permits a deduction for 50% of expenditures on meals and entertainment, is a notable example.

[187] *See* Zolt, *supra* note x, at y.

[188] The federal Corporate Average Fuel Efficiency (CAFE) standards assess tax-like penalties on vehicle manufacturers that fail to meet the required fuel economy standards for any model year. CAFE penalties are discussed *supra* Part I.

[189] The complete denial of an otherwise available tax credit also obviates the need to define the penalty. See, e.g., IRC § 25A(b)(2)(D) (denying Hope Scholarship Credit for students convicted of felony drug offenses).

[190] *See* Zelinsky, *supra* note x (Madison).

agricultural committees would be substantial and largely uncontested, while farm interest would be forced to compete with other industries for tax benefits in Finance and Ways and Means. [191] Zelinsky certainly does not suggest that the tax committees are impervious to regulatory capture; his point is a relative one.[192]

Zelinsky's analysis implies that special interest subsidies emanating from non-tax committees should be more favorable than those flowing from tax committees. Zelinsky's model also might imply that non-tax committees would have a harder time, all else being equal, imposing unfavorable regulation on special interests, and that tax committees would be better able to apply penalties.

Although Sarbanes-Oxley shows that non-tax committees can take strong punitive action that is adverse to corporate interests when roused, it is possible that the phenomena highlighted by Zelinsky helps explain the use of tax penalties. However, there are at least three differences between the subsidies that Zelinsky focuses upon and regulatory tax penalties that make it somewhat difficult to draw this inference. First, Zelinsky focuses primarily on special interests achieving subsidies, while our concern here is with private interests attempting to block adverse regulation. There is some evidence suggesting that these two cases are not symmetric – that special interest influence is more effective in blocking than in obtaining legislation.[193] However, special interests still may have *relatively* greater blocking power in non-tax committees. Second, unlike special interest "pork-barrel" legislation that is often enacted under the radar screen, tax penalties often are proposed in the wake of a scandal and are purposively highly visible. Greater visibility overall may limit the ability of special interests to influence such legislation, but again, relative differences in the power of special interests to shape the legislation may persist.[194] Third, Zelinsky's analysis seems most persuasive to me in the context of narrowly focused legislation targeted at particular interests, e.g., farm subsidies. The corporate governance tax penalties addressed business interests generally. The competition that Zelinsky sees in the tax committees between narrow commercial interests may be less of a factor when the target is big business generally.

4. Other Enactment Advantages of Regulatory Tax Penalties

In some instances, structuring a disincentive as a tax penalty may be advantageous under congressional budgetary procedures. Under the statutory "pay-as-you-go" (PAYGO) provision in effect between 1990 and 2002 as well as the current House PAYGO rule, new tax expenditures or rate cuts have to be paid for with revenue increases.[195] These revenue increases could come from sources other than tax, but given

[191] *See id*. at 1177.

[192] *See id*. at 1167.

[193] *See* K. Schlozman & J. Tierney, Organized Interests and American Democracy 314-15, 395-96, 398 (1986). [Citation info from Farber & Frickey n. 81.]

[194] Particular thanks to Katie Pratt for suggesting these two points.

[195] *See* Budget Enforcement Act of 1990, Title XIII, Pub. L. No. 101-508, 104 Stat. 1388-573, codified as 2 USC § 902 (statutory PAYGO provision in force between 1990 and 2002); [add cite for current House PAYGO rule; current Senate rule?]. Although the statutory and House PAYGO rules are similar, there is one important difference. Under the statutory approach, compliance was assessed on an annual basis; under the House approach, each bill must satisfy PAYGO. Another difference, apparently, is that the current House rule is porous. See Another Bush Tax Cut, Wall St. J., Dec. 20, 2007, at A16

committee jurisdictional limitations, as a practical matter, tax cuts governed by PAYGO restrictions generally are paid for with tax increases or reductions in entitlement programs falling under the jurisdiction of the tax-writing committees.[196] Of course, sponsors of direct expenditures also need to find offsets and will naturally look for opportunities within the jurisdiction of the relevant subject matter committees, but one suspects that given the confluence of programs within the jurisdiction of the House Ways and Means and Senate Finance Committees, disincentives generating incremental tax revenue might be particularly valuable.

Finally, from a strictly pragmatic point of view, if our hypothetical senator had any doubt about the constitutionality of direct regulation of executive pensions, she might prefer structuring the disincentive as a disallowed deduction to take advantage of the judicial deference afforded such legislation. Of course, if the legislation is purely symbolic, its ability to withstand challenge may be unimportant. In fact, in some cases (anti-flag burning laws come to mind), congressional sponsors may benefit in status from the judiciary striking down their legislation. On the other hand, if our hypothetical sponsor sees expressive or other instrumental benefits in the enforcement of her legislation, this factor might be a plus for structuring the rule as a tax penalty.

5. An Example: Senator Levin's Crusade for Stock Option Expensing

I have argued that casting disincentives in the form of tax penalties eases enactment and enforcement. Although purely anecdotal, the history of Senator Levin's crusade for expensing of stock options suggests that politicians think about these factors and may shape their proposals accordingly.

In calculating the net income that they report to investors in their financial statements, corporations subtract a variety of expenses including expenses for employee compensation, but until quite recently compensation in the form of stock options did not have to be "expensed."[197] Option compensation was ignored for financial reporting purposes. Although this result was nonsensical, it was highly popular among Silicon Valley businesses and other high technology firms that relied heavily on option compensation, and these firms lobbied fiercely to maintain this status quo. The Financial Accounting Standards Board (FASB), which is responsible for accounting standards, concluded in the early 1990s that option compensation should be subtracted in

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(discussing House passage of an AMT patch in violation of its PAYGO rule). [Information in this paragraph needs to be confirmed.]

[196] *See* Elizabeth Garrett, *Harnessing Politics: The Dynamics of Offset Requirements in the Tax Legislative Process*, 65 U. CHI. L. REV. 501, 504 (1998).

[197] To be more exact, no expense was required to be recognized for the standard compensatory options issued by almost all U.S. businesses. *See* APB Opinion No. 25 (specifying an intrinsic value method of accounting for stock options under which only the positive difference between the market price of the stock underlying the option and the option exercise price is recognized as an expense); Kevin J. Murphy, *Executive Compensation*, *in* HANDBOOK OF LABOR ECONOMICS 2485, 2507-10 (Orley Ashenfelter & David Card eds., 1999) (Murphy provides data for a sample of option grants in 1992 and reports that 95% of options were granted with exercise price set equal to market price on the date of the grant, 2% had exercise prices in excess of the market price on the date of the grant, and 3% had exercise prices below the grant date market price. Only the latter group of options would have resulted in an expense for financial accounting purposes under APB 25.).

determining net income but repeatedly bowed to industry pressure and failed to require expensing.[198]

Senator Levin of Michigan was an early and vocal advocate for stock option expensing. He introduced a bill in the Senate in 1993 that would have directed the SEC to mandate expensing.[199] That bill never got out of committee. Undeterred, Levin returned in 1997 with John McCain and introduced the Ending Double Standards for Stock Options Act.[200] This bill, which stalled in 1997 and again in 2002 when it was reintroduced,[201] attempted to use a tax penalty to coerce businesses into expensing options. In essence, the bill provided that the tax deduction for option compensation would be available only to the extent that options were expensed for financial reporting purposes. Still undeterred, Senator Levin introduced a bill in 2003 that would have required the FASB to review stock option accounting and adopt an appropriate accounting treatment.[202] Again, this bill failed to make it out of committee. In 2004, Senator Levin's crusade ended when in the wake of the Enron, WorldCom, and Tyco scandals, the FASB adopted a rule requiring firms to expense the fair value of stock options.[203]

Although none of Senator Levin's bills reached the floor of the Senate for a vote, the progress is interesting from a legislative theory perspective. Levin began by trying to mandate his preferred accounting treatment, which could be viewed as attempting to ban the disfavored practice of leaving option expense off the books. Once that attempt failed, he tried a softer approach that left the choice of whether or not to expense up to individual businesses, but penalized those who failed to expense with the loss of a tax deduction. When even that attempt failed, he suggested, weakly, that the FASB be required to study the problem. Perhaps these varied attempts were haphazard, but I suspect that although each attempt ultimately failed, Levin concluded that shifting from ban to penalty and packaging the penalty as disallowing a deduction that perpetuated a double standard for options, increased his chances for success.

C. The Natural Limits of Regulatory Tax Penalties

Despite substantial advantages facilitating enactment, some disincentives simply cannot be readily accommodated in the tax code. It is not surprising, for example, that

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[198] *See* Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 123 (Oct. 1995) (encouraging companies to adopt the fair value method of accounting for option compensation, e.g., expensing, but allowing firms to continue to apply the method of APB Opinion No. 25, which results in no expense recognition for standard compensatory options).

[199] Corporate Executives' Stock Option Accountability Act, S. 259, 103rd Cong. (1993).

[200] S. 576, 105th Cong. (1997).

[201] Ending the Double Standard for Stock Options Act, S. 1940, 107th Cong. (2002).

[202] Stock Option Accounting Review Act, S. 181, 108th Cong. (2003).

[203] *See* Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 123R (revised 2004) (Dec. 2004) (mandating expensing of options beginning in 2005 and 2006). Senator Levin's stock option crusade did not entirely end with the promulgation of SFAS 123R. He recently introduced legislation that would conform employer tax treatment for stock options to the new accounting rules. *See* Ending Corporate Tax Favors for Stock Options Act, S. 2116, 110th Cong. (2007). *See also*, David I. Walker & Victor Fleischer, *The Hidden Costs of Book/Tax Conformity* (working paper) (criticizing Levin's and other proposals for conforming the book and tax treatment of equity compensation).

the CAFE standards, which are very much tax-like, are administered by the Department of Transportation rather than the Treasury.[204]

To be sure, CAFE penalties, like tax penalties, are Cooter prices. Manufacturers that fail to achieve the applicable fuel economy standard pay a fine that increases linearly (from zero) with every tenth of an mpg by which the company falls short.[205] However, shifting administration of this program to the Treasury, while possible, would be unrealistic. Most obviously, the Treasury lacks expertise in the area of fuel economy standards. However, this point only goes to the relative administrative convenience of administering the program through the Transportation Department rather than Treasury. One could make the same point about § 162(m). Neither the IRS nor the Treasury has any particular expertise in executive compensation regulation.

However, there are other differences between the CAFE standard program and tax penalties that go more to the heart of this Article: First, the data on which CAFE penalties are based is not currently available to the IRS. By contrast, the amount of compensation paid to executives, as well as other employees, has always been included in businesses calculations of taxable income and subject to audit. Limiting the deduction simply took advantage of an existing reporting relationship.

But that brings us to the critical difference between the CAFE standards and tax penalties like § 162(m) and the natural limits of those penalties. Even if the IRS were to administer the CAFE program (with a great deal of assistance from the EPA, let's say), the disincentive would have to be in the form of an excise tax. There is no existing tax deduction or credit associated with fleet fuel economy figures and nothing to curtail for non-compliance.[206] Excise taxes are not matters of legislative grace and are impossible to frame as revoked subsidies. Thus, once we conclude that the penalty cannot readily be cast in terms of a deduction or credit disallowance, the myriad process advantages to tax penalties described in this Article are off the table and non-tax penalties, all else being equal, are equally attractive.

IV. NORMATIVE IMPLICATIONS

The discussion thus far has been primarily descriptive. Parts II and III explained how structuring disincentives as tax penalties – specifically as disallowed deductions – instead of direct regulation overcomes constitutional hurdles and eases enactment. The goal has been to help explain the presence of tax penalties – why Congress might turn to the tax code given sociological facts (e.g., deduction confusion) and a path of constitutional jurisprudence (i.e., deference to Congress with respect to tax legislation).

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[204] *See supra* note x and accompanying text for a discussion of the mechanics of the CAFE standards.

[205] For example, a manufacturer of 100,000 passenger cars that failed to meet the 27.5 mpg passenger car standard by one-tenth of an mpg, would face a fine of $550,000. If the same manufacturer's fleet averaged only 26.5 mpg, the fine would increase to $5.5 million.

[206] Of course, if Congress were determined to utilize the tax system to regulate in this sort of situation, it could institute a tax credit conditioned on achievement of fuel efficiency standards. The conditioned credit could be designed to provide economically equivalent incentives. However, enacting a conditioned credit would require Congress to enact and fund a *credit*, much of which would go to foreign-owned automakers who have no trouble meeting the CAFE standards. A conditioned credit would be a very different kettle of fish both politically and economically.

But, of course, the fact that it is easier to enact tax penalties does not mean that the use of tax penalties enhances social welfare. This Part will consider the normative implications of regulation via tax penalties in two separate but complementary ways. First, we will reconsider the differences between tax and direct regulation from an explicitly normative perspective, asking, for example, not how framing affects enactment, but how framing affects the quality of legislative product. Second, we will reconsider many of the tax penalties that we encountered in the previous Parts, imagine a world without these tax penalties, and think about social welfare in that alternative world.

A. Normative Aspects of Tax Penalty Enactment "Advantages"

This section simply asks whether the enactment advantages of tax penalties – their ability to overcome constitutional hurdles or congressional resistance – are likely to be welfare enhancing. Sure, they're helpful to our hypothetical legislator, but are they good for society?

1. "Irreplaceable" Tax Penalties

Let's begin with tax penalties that overcome constitutional impediments to direct regulation. By way of example, we will focus on government regulation of corporate political advocacy. To the extent that the government won in *Cammarano* and lost in *Bellotti* because tax regulations mimicking § 162(e) were viewed as a non-subsidy while the regulation at issue in *Bellotti* was viewed as a penalty, this is nonsensical.

As Edward Zelinsky has argued, there may or may not be valid reasons for distinguishing between tax penalties and direct regulation from a constitutional perspective; it depends on the design of the particular provisions or programs.[207] He suggests, moreover, that it is insufficient to compare tax and non-tax regulation solely from the perspective of the regulated party. Tax provisions and direct regulation that are identical from the viewpoint of the regulated party, may be very different from the government's perspective, and that difference can have constitutional implications.[208] So, for example, Zelinsky argues that direct financial support of the Virginia Military Institute represented a qualitatively different level of involvement with single sex education than tax benefits available to educational institutions generally, including single-sex institutions.[209] If the degree of government involvement with discriminatory institutions is an important factor in First Amendment analysis, invalidation of the former should not necessarily doom the latter.

However, as noted above, it is difficult to see a substantial difference between the regulation at issue in *Bellotti* and *Cammarano* from either the government's or the regulated party's perspective.[210] From the taxpayer's perspective, the economic effect of the "non-subsidy" imposed by § 162(e) is the same as that of a direct penalty.[211]

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[207] *See* Zelinsky, *supra* note x (HLR 1998).
[208] *See id*.
[209] *See id*.
[210] *See supra* note x and accompanying text.
[211] To be sure, *Bellotti* involved a ban that took the form of a Cooter sanction, while *Cammarano* involved a tax penalty in the form of a Cooter price, but nothing in either opinion suggests that this difference was important to the outcome.

Moreover, the degree of government involvement in defining and restricting speech is similar. The legislation at issue in *Bellotti* and § 162(e) are quite similar in terms of generality. If anything, the tax provision is the more finely crafted rule, involving more exceptions and definitions. Nonetheless, one can easily imagine § 162(e) being lifted wholesale out of the Code and enacted as non-tax legislation.

At bottom, there is no principled reason for differing outcomes in *Bellotti* and *Cammarano*. If that's right, then the *Cammarano* court allowed Congress to violate First Amendment rights, or the *Bellotti* court unnecessarily tied the hands of the legislature in dealing with corporate political advocacy. If the latter, by eliminating one of two otherwise interchangeable regulatory schemes, the Court has precluded legislatures from selecting what may have been the more efficient approach. Either way, the outcome is far from optimal.

2. "Optional" Tax Penalties

We turn now to tax penalties that could be readily replaced with non-tax regulation, such as the corporate governance penalties. Some of the advantages that make these provisions appealing to sponsors are efficiency enhancing; others are not.

To begin somewhat tautologically, any direct efficiency advantages of placing a penalty in the tax code are welfare enhancing. Thus, enhanced administrative coordination,[212] more efficient communication between the regulator and the regulated,[213] and even benefits of redundancy[214] are all perfectly valid, welfare enhancing reasons for structuring disincentives as tax penalties. Moreover, some of the enactment advantages we reviewed in Part III may be welfare enhancing as well, including the possibility that structuring a disincentive as a tax penalty may help overcome special interest resistance.

However, the social value of other enactment advantages is far more questionable. For example, the fact that structuring a disincentive as a tax penalty allows Congress to avoid thinking explicitly about the magnitude of the harm in order to craft an appropriate penalty may assist enactment, but it does not seem like the kind of thing that would lead to high quality regulation. In some cases, going through the process of crafting a penalty might cause Congress to decide that the harm actually is minimal and does not justify the cost of regulation or that some other regulatory approach (perhaps a carrot instead of a stick) is warranted.[215]

Similarly, the idea that as a result of framing, members of Congress and the general public may be tricked into accepting tax penalties when they would object to economically equivalent direct regulation does not bode well for social welfare. It is possible that the underlying regulation advances social welfare and that the resistance to direct regulation *should* be overcome from a welfare perspective, but the reverse seems equally likely. More importantly, this framing exercise is obviously troubling from a standpoint of safeguarding democratic values and processes.

[212] *See* Weisbach & Nussim, *supra* note x.

[213] *See* Zelinsky, *supra* note x.

[214] *See* Staudt, *supra* note x.

[215] I do not mean to suggest that penalties specified in direct regulation are always well thought out and proportional to the harms addressed. Undoubtedly, however, more thought is given to such penalties than to the effective penalty of a disallowed deduction.

Finally, as Erwin Griswold argued, there is no obvious reason that taxpayers should bear the burden of proving entitlement to tax deductions (and relief from tax penalties) when that burden does not exist with respect to equivalent non-tax regulation.[216] Again, I have no view as to whether the burden is more likely to be efficiently allocated in one case or the other, but the unprincipled difference is troubling on fairness grounds.[217]

B. Social Welfare in a World Without a Corporate Income Tax (and Without Tax Penalties)

Commentators have long advocated eliminating tax expenditures or shifting such programs outside of the Code. These changes are virtually unthinkable under the existing tax system. The arguments for eliminating tax expenditures aren't getting any stronger, and thus far they've made little impact outside of the academic tax community. In fact, the academic debate may have shifter slightly in favor of (or less opposed to) tax expenditures in recent years.[218] So the idea of Congress simply agreeing to eliminate tax expenditures need not detain us. On the other hand, elimination of tax expenditures could be an unintended consequence of more radical restructuring of public finance, e.g., integration of corporate and individual income tax in a fashion that would eliminate the corporate tax or wholesale replacement of income taxes with consumption taxes.[219] So thinking about a world absent tax penalties is not a pointless exercise.

The welfare implications of eliminating regulatory tax penalties are indeterminate. Some tax penalties (e.g., corporate governance) could be readily reconstituted as non-tax disincentives; others (e.g., lobbying restrictions) could not. With respect to each tax penalty, there are four possible welfare outcomes depending on whether the tax penalty was welfare enhancing in the first place and whether it would be replaced with non-tax regulation.

1. Tax Penalty Elimination Reduces Welfare; Replacement May Mitigate

In some cases, tax penalties may represent an efficient means of regulation. If opportunities to structure disincentives as tax penalties were eliminated, welfare would be reduced. Welfare might be restored in part by replacing such tax penalties with less efficient direct regulation.

Needless to say, for a tax penalty to fall within this category, it must be the case that 1) regulation of some sort is welfare enhancing and 2) tax regulation is more efficient than the direct regulation alternative. Following Weisbach and Nussim's approach, a tax penalty might be more efficient if coordination benefits outweighed the cost of reduced specialization.[220] Moreover, under Staudt's analysis, the potential redundancy arising

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[216] *See* Griswold, *supra* note x.

[217] The difference could possibly lead to strategic legislating, but I doubt that many legislators are aware of the difference or, even if they are, that the difference would have much bearing on the decision to structure a disincentive as a tax penalty or direct regulation.

[218] *See, e.g.*, Weisbach & Nussim, *supra* note x; Staudt, *supra* note x.

[219] *See, e.g.*, Johnson, *supra* note x (proposing replacement of the corporate income tax on publicly traded companies with a tax based on market capitalization).

[220] *See* Weisbach & Nussim, *supra* note x.

from the tax regulation may be less costly than one might think due to offsetting benefits.[221] If such a tax penalty were to be eliminated, welfare would be reduced. Replacing the tax penalty with direct regulation might be a second best solution, or replacement might be inferior to forgoing regulation entirely, depending on the costs and benefits of the alternatives.

I cannot confidently place any existing tax penalties in this category, but the disallowance of deductions for certain lobbying and political expenditures under § 162(e) might be one example. It is certainly possible that increasing the after-tax cost of corporate lobbying discourages some harmful lobbying. If so, and if the corporate tax were to be eliminated, the cost/benefit analysis would shift in favor of greater lobbying, reducing social welfare. Congress would have difficulty restoring the status quo since direct regulation of corporate political speech is viewed by the courts with great suspicion. Thus, the second best solution might be no regulation of corporate lobbying if the tax penalty option was no longer available.

However, it is possible that Congress could find a less efficient, but still constitutionally permissible means of discouraging lobbying. For example, a positive subsidy conditioned on firms refraining from lobbying might pass constitutional muster. Enactment of this legislation might be the second best result in a regime that lacked a corporate tax.[222]

2. Tax Penalty Elimination Increases Welfare; Replacement May Be Worse

In other cases, eliminating a tax penalty would be welfare enhancing, but there is a risk that Congress would enact a costlier alternative in its place. For example, there is no evidence that §§ 162(m) or 280G have reduced the value or improved the structure of executive pay arrangements. To the contrary, in all likelihood, these provisions have skewed compensation away from the efficient mix, have provided camouflage for boosting executive pay, and have shifted costs of noncompliance onto shareholders.[223] Eliminating the corporate tax, and these provisions as a result of that change, would be welfare enhancing. However, in these situations, the overall welfare effect depends on whether Congress would elect to replace the defunct tax penalty with non-tax regulation.

Tax penalties that primarily serve a symbolic function are likely to fall into the category just described. Because they are enacted to enhance the welfare of their sponsors rather than investors or the general public, it would be surprising if they were socially beneficial. However, if the need to demonstrate to voters that action is being taken is high, in other words, if the symbolic value of legislating is high, welfare reducing tax penalties might be replaced with direct regulation that is even worse. Suppose, for example, that in 1993, when Congress decided that something had to be done about executive compensation, the corporate tax was not in existence. Congress might have held hearings, blustered, and done nothing substantive to address the perceived problem, but it might have implemented direct regulation of executive pay. It could not have

[221] *See* Staudt, *supra* note x.

[222] There is, of course, a third possibility. Permissible non-tax regulation of lobbying may be socially superior to § 162(e) today, and Congress either does not realize it or has ulterior motives for legislating via tax. This strikes me as unlikely, but possible.

[223] *See* Polsky, *supra* note x; [others].

banned executive compensation the way it banned executive loans in SOX, but it could have capped executive salaries at some multiple of average employee compensation.[224]

Of course, the direct regulation in this alternative universe could have been structured as an exact analog of § 162(m). A cap on excess compensation would only be worse than § 162(m) if it produced greater inefficiencies or more unintended consequences. If the penalty were set equal to thirty-five cents for each dollar of non-performance-based pay exceeding a million dollars annually, and if all of the § 162(m) definitions and exceptions were incorporated, there would be no difference. The risk is that once the mode shifts from deduction disallowance to direct regulation, more disruptive Cooter sanctions are likely to follow.

Of course, if the symbolic value of legislating is fairly low, eliminating the easy route of tax penalties may not result in alternative symbolic legislation, which, given the premise of this subsection, would be welfare enhancing. In a few cases, in fact, there would be virtually no impetus for replacing a tax penalty with a non-tax disincentive. Consider §§ 162(c) and 162(f).[225] These provisions respond to an appearance of subsidization as a result of the baseline deduction for ordinary and necessary business expenses. If the corporate income tax were to be eliminated, there would be no appearance problem to address, and it seems highly unlikely that a new penalty would be enacted. We do not know whether §§ 162(c) and 162(f) result in excessive or appropriate deterrence, but eliminating the provisions would marginally reduce compliance costs, and the penalties for the underlying offenses could be increased to offset any undesirable erosion in incentives. In all likelihood, social welfare would increase if these provisions disappeared as a result of an overhaul that eliminated the corporate income tax.

IV. CONCLUSION

The primary emphasis of this paper has been descriptive – to explain the appeal within the legislative process of structuring disincentives as disallowed deductions or credits and the robustness of such disincentives in the face of constitutional challenge. What these seemingly disparate phenomena share is the key role played by the ambiguity of disallowing a deduction or credit – the difficulty in determining whether the disallowance constitutes a penalty or eliminates a subsidy. That indeterminacy allows legislative proponents to frame disincentives as anti-subsidies, avoiding much of the resistance that would be created by direct regulation, and allows courts to classify tax disincentives touching on First Amendment or federalism issues as non-subsidies, thus bypassing serious constitutional challenge. In terms of legislative process more generally, while undoubtedly a large number of factors go into the decision to enact a disincentive or to structure it in a certain fashion, instrumental efficacy, it has been argued, is only one factor and perhaps is often not the dominant factor.

Are there lessons here that might lead to a fuller understanding of tax subsidies? Thorough analysis must await another day, but some preliminary thoughts spring to mind based on the analysis of Parts III and IV. First, undoubtedly legislative strategy and the design of subsidies are influenced by similar motivations. In other words, sponsors of

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[224] [Cite proposals.]

[225] Recall that § 162(c) disallows deductions for illegal bribes, kickbacks, and similar payments, while § 162(f) disallows deductions for fines and penalties paid to a government for violation of law.

legislation advocating positive incentives are surely concerned with instrumental efficacy, but they will also be attentive to the impact of structure on legislative "marketability." In some cases, ambiguity and framing may play a role in the choice between tax and non-tax incentives. For example, unlike direct assistance to homeowners, a deduction for home mortgage interest could be plausibly framed not as being a subsidy but as defining "disposable" income which should be subject to tax. In other cases, a non-subsidy rationale simply may not be plausible, but the tax subsidy route may be less salient and generate less resistance than would a direct subsidy.[226] Investment tax credits might be a good example of the latter class of tax subsidy.

Second, in both cases, the use of tax subsidies to overcome resistance to direct regulation raises normative concerns that are similar to those arising from the enactment of regulatory tax penalties. There is no reason to think that framing an incentive as a tax subsidy to overcome congressional or voter resistance is likely to be efficiency enhancing, and such obfuscation is unattractive from the perspective of safeguarding democratic processes. However, while tax penalties may sometimes represent a low cost means of delivering symbolic legislation (because as Cooter prices they can be ignored at less cost than direct regulation taking the form of Cooter sanctions), no such advantage can be claimed for tax subsidies. Tax subsidies, in other words, may in this regard be more suspect than tax penalties. This seems a fruitful subject for future work.

[226] *See* ARNOLD, *supra* note x, at 200 (arguing that tax preferences are less salient to voters than direct subsidies and thus more attractive to legislators attempting to serve special interests).

Appendix

Student Attitude Surveys – Executive Pensions

Each of approximately 250 first year law students at Boston University received one of the three versions of a survey question. The three versions follow. 241 responses were received. Summary statistics are as follows:

Regulatory Approach	N	Mean Support	St. Dev.	2 sample t tests One-tail P value
Direct Penalty	83	4.6	2.8	
				.0001
Deduction Curtailment (neutral framing)	82	6.2	2.7	
				.0103
Deduction Curtailment (anti-subsidy framing)	76	7.2	2.5	

[Version #1: Direct Penalty]

Student Attitude Survey – Executive Pensions

This ANONYMOUS survey is being administered by Professor David Walker and will provide data for his research. Your participation is entirely VOLUNTARY. There will be no repercussions if you decide not to participate. If you have any questions about this survey or the research, you may contact Professor Walker at 617-353-3174, at diwalker@bu.edu, or by stopping by his office. Thank you for your assistance.

Please consider the following:

Many observers feel that corporate executive retirement packages have grown too large. At the same time that businesses have been cutting back on pensions offered to rank and file employees, pensions received by chief executive officers (CEOs) and other corporate executives have mushroomed. A recent study of CEOs nearing retirement found that, on average, the executives were promised pension payments in excess of $1.5 million/year, with some executives being promised over $5 million/year.[*] While some observers consider these large pensions to be unfair and a matter of public concern, others argue that as long as pension payments are fully disclosed to investors, this private market should be allowed to operate freely without government interference.

Governments employ various tools to discourage behavior considered socially undesirable or to correct for market failure, including penalties, user fees, and excise taxes. Suppose Congress were to consider imposing penalties on executive pension payments beyond a certain level. For example, Congress might allow pension payments of up to $1 million/year for each former executive without penalty. However, pension payments in excess of this amount would result in a penalty of, say, 35% of the excess payment. The penalty would be paid by the corporation that made the excess pension payment. Thus, for example, if Acme Corp. paid its former CEO a pension of $3 million in 2008, the penalty would be 35% of the excess $2 million, or $700,000.

Would you be in favor of Congress imposing a penalty on excess pension payments as described above? Please rate your view on a scale of 1 (strongly object to imposing a penalty on excess executive pensions) to 10 (strongly support imposing a penalty) and enter the figure in the box below.

[*] *See* Lucian A. Bebchuk & Robert J. Jackson, Jr., *Executive Pensions*, 30 J. CORP. L. 823, 843 (2005).

[Version #2: Deduction Curtailment, Neutral Framing]

Student Attitude Survey – Executive Pensions

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Many observers feel that corporate executive retirement packages have grown too large. At the same time that businesses have been cutting back on pensions offered to rank and file employees, pensions received by chief executive officers (CEOs) and other corporate executives have mushroomed. A recent study of CEOs nearing retirement found that, on average, the executives were promised pension payments in excess of $1.5 million/year, with some executives being promised over $5 million/year.[*] While some observers consider these large pensions to be unfair and a matter of public concern, others argue that as long as pension payments are fully disclosed to investors, this private market should be allowed to operate freely without government interference.

Governments employ various tools to discourage behavior considered socially undesirable or to correct for market failure, including taxation. In calculating their taxable income, corporations currently are entitled to deduct amounts paid out to their executives as pensions, which, for most companies, reduces the effective cost of providing pensions by about 35%. Suppose Congress were to consider limiting the deductibility of executive pensions payments. Congress might allow a deduction for the first $1 million/year paid out to each former executive as a pension, but disallow deductions for pension payments in excess of this amount. For example, if Acme Corp. paid its former CEO a pension of $3 million in 2008, the first $1 million would be deductible, but the next $2 million would not be. In this case, the change in law would increase the effective cost to Acme of providing a $3 million pension by $700,000.

Would you be in favor of Congress limiting the deductibility of pension payments as described above? Please rate your view on a scale of 1 (strongly object to limiting deductibility of executive pensions) to 10 (strongly support limiting deductibility) and enter the figure in the box below.

[*] *See* Lucian A. Bebchuk & Robert J. Jackson, Jr., *Executive Pensions*, 30 J. CORP. L. 823, 843 (2005).

[Version #3: Deduction Curtailment, Anti-Subsidy Framing]

Student Attitude Survey – Executive Pensions

This ANONYMOUS survey is being administered by Professor David Walker and will provide data for his research. Your participation is entirely VOLUNTARY. There will be no repercussions if you decide not to participate. If you have any questions about this survey or the research, you may contact Professor Walker at 617-353-3174, at diwalker@bu.edu, or by stopping by his office. Thank you for your assistance.

Please consider the following:

Many observers feel that corporate executive retirement packages have grown too large. At the same time that businesses have been cutting back on pensions offered to rank and file employees, pensions received by chief executive officers (CEOs) and other corporate executives have mushroomed. A recent study of CEOs nearing retirement found that, on average, the executives were promised pension payments in excess of $1.5 million/year, with some executives being promised over $5 million/year.[*] While some observers consider these large pensions to be unfair and a matter of public concern, others argue that as long as pension payments are fully disclosed to investors, this private market should be allowed to operate freely without government interference.

In calculating their taxable income, corporations currently are entitled to deduct amounts paid out to their executives as pensions, which, for most companies, reduces the effective cost of providing pensions by about 35%. The deduction, in effect, results in a subsidy by U.S. taxpayers. Suppose Congress were to consider limiting the deductibility of executive pensions payments. Congress might allow a deduction for the first $1 million/year paid out to each former executive as a pension, but disallow deductions for pension payments in excess of this amount. For example, if Acme Corp. paid its former CEO a pension of $3 million in 2008, the first $1 million would be deductible, but the next $2 million would not be. Eliminating the tax subsidy on $2 million of pension payments would save taxpayers about $700,000, compared with current law.

Would you be in favor of Congress limiting the deductibility of pension payments as described above? Please rate your view on a scale of 1 (strongly object to limiting deductibility of executive pensions) to 10 (strongly support limiting deductibility) and enter the figure in the box below.

[*] *See* Lucian A. Bebchuk & Robert J. Jackson, Jr., *Executive Pensions*, 30 J. CORP. L. 823, 843 (2005).