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Tax Expenditures and Tax Reform

Allaire U. Karzon

REVIEW ESSAY

Tax Expenditures and Tax Reform

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*Reviewed by Allaire Urban Karzon**

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* Associate Professor of Law, Vanderbilt University School of Law. B.A. 1945, Wellesley College; J.D. 1947, Yale Law School.

I. Introduction

During 1985, traditionally antagonistic Republican and Democratic leaders endorsed remarkably similar proposals for comprehensive tax reform. If this reform materializes, it will be in large part because tax technicians of both parties have adopted a common approach in analyzing the Internal Revenue Code (the Code) to identify areas ripe for revision, namely, the tax expenditure analysis. *Tax Expenditures*[1] reviews the impact and development of this immensely significant concept since its introduction in 1968 by the late Stanley S. Surrey,[2] the foremost tax policymaker of our time.

II. Original Tax Expenditure Concept

While serving as Assistant Secretary of the Treasury for Tax Policy in the 1960's,[3] Surrey formulated the approach of separating all provisions of the Internal Revenue Code into two broad categories: those provisions essential to the normative structure of the income tax and necessary to distinguish net income from gross income, and those provisions not essential for these purposes.[4] According to Surrey's thesis, the latter provisions, cast in the form of exclusions, exemptions, deductions, or credits, were "grafted on to the structure of the income tax proper" to achieve nontax, social, or economic policy objectives; the provisions had "no basic relation to that structure and [were] not necessary to its operation."[5] According to this new theory, these Code sections represented "a vast subsidy apparatus that uses the mechanics of the income tax as the method of paying the subsidies."[6]

In contrast to provisions that are essential to determine net income, such as the deduction under Code section 162 for ordinary and necessary business expenses, these tax expenditure provisions

> serve ends which are similar . . . to those served . . . by direct government expenditures in the form of grants, loans, interest subsidies, and federal insurance or guarantees of private loans. The interplay is such that for any given program involving federal monetary assistance, the program may be structured to use the tax system to provide that assistance—where it will usually be called a 'tax incentive'—or structured to use a direct Government

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1. S. Surrey & P. McDaniel, Tax Expenditures (1985).
2. *Id.* at 184.
3. Griswold, *In Memoriam: Stanley S. Surrey*, 98 Harv L. Rev. 329, 330 (1984).
4. Tax Expenditures, *supra* note 1, at 184-86.
5. S. Surrey, Pathways to Tax Reform 6 (1973).
6. *Id.*

expenditure.[7]

Surrey coined the phrase "tax expenditures" to describe these special provisions because he perceived them as consisting of two parts:

> the imputed tax payment tbat would have been made in the absence of the special provision (all else remaining the same) and the simultaneous expenditure of that payment as a direct grant to the person benefited by the special provision. The exemption, deduction, or other type of tax benefit is thus seen as a combined process of assumed payment of the proper tax by the taxpayer involved and an appropriation by the Government of an expenditure made to that taxpayer in the amount of tbe reduction in his actual tax payment from the assumed payment—that is, the tax reduction provided by the special provision.[8]

Commonly, tax expenditure programs serve as incentives to taxpayers to take certain action the government wishes to foster. Thus, Congress enacted the investment tax credit and the deduction for accelerated depreciation to encourage the purchase of equipment and machinery to modernize industry; deductions for charitable contributions to foster private support of philanthropic projects that the government otherwise might be required to fund in full; the deduction for campaign contributions to encourage broader citizen participation in political candidates' support; the special tax benefits for qualified pension plans to encourage private, employer-funded plans for retirement security; and special provisions for child care assistance, pollution control facilities, and coal mine safety equipment for the avowed purpose of encouraging these activities in the name of the public good.[9]

Tax expenditures also can consist of specific tax disincentives for policy purposes. Thus, Congress intended the denial of the investment credit to property used predominantly outside the United States[10] to deter taxpayers from modernizing foreign plants and thus to encourage United States operations and the employment of United States labor. Some combinations of positive tax assistance and negative tax treatment that clearly favor certain classes of taxpayer activity rest on policy grounds that are difficult to discern. For example, although the investment tax credit normally applies to tangible personalty used in a business or investment activity, the credit is not available if the taxpayer uses this property to furnish lodgings, such as apartment dwellings; how-

7. *Id.*
8. *Id.* at 6-7.
9. *See id.* at 126-27.
10. I.R.C. § 48(a)(2)(A) (1985).

ever, the credit is reinstated specially for "coin-operated vending machines and coin-operated washing machines and dryers"[11] acquired for these same apartment units. In addition, although the investment credit generally is denied for new buildings, the credit is granted specially for commercial greenhouses and for structures used for "the commercial production of mushrooms."[12] Other tax expenditure provisions act as a form of relief against certain nontax, involuntary personal hardships. Classic examples of these "compassionate" tax expenditures are the additional exemptions for old age and blindness and the deductions for medical expenses and casualty losses.[13]

Although Congress achieved these disparate, nontax objectives by using the mechanisms of the Internal Revenue Code, Surrey was the first to point out that these provisions were not necessary to determine net income. According to Surrey, these provisions were functionally equivalent to direct spending programs, which should be evaluated in the context of government programmatic spending as a whole and as an integral part of the overall governmental budgeting process.[14]

This Review will focus primarily on the conceptual issues affecting the composition of the tax expenditure list and their relevance to current proposals for new tax legislation. In this context, the tax expenditure theory has been pre-eminently successful in shaping tax reform. The Review will not delve into the other aspect of Surrey's thesis, which calls for executive and congressional action to alter the budget procedure by integrating direct spending programs with the indirect tax expenditure programs and by adopting one amalgamated budget for the purpose of controlling overall federal spending. This facet of the Surrey thesis has not yet gained widespread congressional acceptance on the practical level. For those concerned with tighter control of the federal budget to reduce the deficit, however, this latest work amply describes and persuasively advocates the value of such an integrated budget policy.[15]

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11. I.R.C. § 48(a)(3)(C) (1985).
12. I.R.C. § 48(p)(3) (1985).
13. PATHWAYS TO TAX REFORM, *supra* note 5, at 127-28.
14. *See id.* at 175-79, 247; TAX EXPENDITURES, *supra* note 1, at 31-68.
15. *See* TAX EXPENDITURES, *supra* note 1, at 31-68, 99-117.

III. Economic Background for Development of Tax Expenditure Concept

The economic setting that prompted the formulation of the tax expenditure concept is strikingly similar to the situation confronting Congress today in the mid-1980's. In 1967 the administration was facing growing budget deficits caused by increases in spending for the Great Society Programs and the Vietnam War and was considering two alternatives: a tax increase or a cut in government spending.[16] The 1968 legislative solution embraced both: a tax increase in the form of a ten percent tax surcharge and a six billion dollar reduction in items enumerated in the direct budget plus a mandated ceiling for new spending on direct budget items. Surrey, however, observed that the budget ceilings would control only direct spending programs and that monies "spent" on comparable programs implemented through the tax system would escape all limitations.[17]

The observation led to Surrey's dual categorization of the Code into the structural, normative provisions and the tax expenditure provisions and to his proposal of a "tax expenditure budget" that would quantify in dollars and cents the amount of lost revenue "spent" on each enumerated tax expenditure. His goal was to achieve an integrated budget proposal through which an informed Congress could scrutinize comparative government programs with full knowledge of both the direct and indirect tax monies appropriated to each program.[18]

A. *Establishing the Norm to Measure Deviations*

The first step in the development of this theory was to define "income." Surrey adopted the Haig-Simons definition that income was the sum of a taxpayer's personal consumption plus his increase in net worth during the taxable year.[19] Ever the pragmatist, however, Surrey never embraced the literal Haig-Simons definition of income, but modified it to reflect "widely accepted definitions of

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16. Pathways to Tax Reform, *supra* note 5, at 1.
17. *See id.* at 2-3.
18. *See id.* at 3-4.
19. *Id.* at 12 (citing H. Simons, Personal Income Taxation 50 (1938)). To illustrate, assuming a calendar year measuring period, if a taxpayer's net worth on January 1 is 100X and his net worth on December 31 is 160X and if during that year his personal consumption, *i.e.*, amounts spent other than to earn income or to produce income, is 35X, then his income for that year is a total of 95X (consisting of his increase in net worth of 60X plus his 35X in personal consumption). *See* Pathways to Tax Reform, *supra* note 5, at 20-21.

income and standards of business accounting and . . . the generally accepted structure of an income tax."[20] Nevertheless, definitional problems exist. For example, it is difficult to decide whether particular items, such as expenses for moving, education, and child care for working parents, are incurred in the process of earning income and, hence, are part of the normative income tax structure or whether these expenses represent nondeductible, personal consumption items to be labeled tax expenditures.[21]

B. *Explaining Code Complexity Through Tax Expenditures*

It has become standard political rhetoric to hurl accusations of complexity at the income tax system.[22] Surrey would channel such criticism toward the indirect spending programs, which are housed arbitrarily in enormous numbers of tax expenditures that encumber the Code. According to Surrey, these tax expenditures constitute the genuine cause of the Code's complexity.[23] He asserts: "An income tax is a complex tax, but we should not fault it as a tax because of the complexities forced on it when it is required also to carry out a whole host of expenditure programs."[24]

Surrey made this comment in 1973 when the "tax expenditure apparatus" totalled only $65 billion and equalled about twenty-five percent of the stated federal budget.[25] The tax expenditure-induced complexity has soared dramatically since then. In fiscal 1984 indirect "spending" through tax expenditures rose to over $259 billion while direct government spending amounted to only $880 billion.[26] The major source of objective information available to Congress in its attempts to control this swelling tax expenditure

20. PATHWAYS TO TAX REFORM, *supra* note 5, at 12-15 (quoting Annual Rep. of the Secretary of the Treas. on the State of the Finances for Fiscal Year 1968, at 327, 329-30). For example, Surrey did not include two controversial items as income: imputed income from rent on owner-occupied homes and imputed income from services performed within the family unit. He accepted these as structural exclusions from the U.S. income tax system. Had he followed economic theory literally, the exclusion of these items from tax would have been tax expenditures and his analysis would have lost its chance of popular acceptance.

21. *Id.* at 19. Questions persist whether listing medical expenses and charitable contributions as tax expenditures is proper. *See id.* at 20.

22. President Reagan has described the income tax system as a "complicated, frustrating, unfair mystery of legalistic gobbledegook." Wall St. J., Apr. 15, 1985, at 1, col. 6.

23. PATHWAYS TO TAX REFORM, *supra* note 5, at 32, 34.

24. *Id.* at 35 (footnote omitted).

25. *Id.* at 32.

26. *See* TAX EXPENDITURES, *supra* note 1, at 6. The Congressional Budget Office statistics reveal that between fiscal years 1974 and 1981 tax "spending" grew at a faster rate (179%) than direct government spending (145%). It projects by 1987 a further 92% increase in tax expenditures compared with a 71% increase in direct spending. *Id.*

apparatus lies in the annual tax expenditure budget that the President and the Office of Management and Budget are required to submit under the Budget Reform Act of 1974,[27] a crucial piece of legislation for which Surrey was responsible. This budget is a line-item compilation of tax expenditure provisions categorized by spending function together with an estimate of the annual revenue loss due to each provision. Congress has come to rely on the data provided in the tax expenditure budget to identify those Code provisions perceived to be nonessential, the chief causes of complexity and inequity, and, thus, the prime candidates for reform.

IV. Influence of Tax Expenditure Analysis in Current Tax Reform Proposals

The influence of the tax expenditure budget is evident in the three major tax proposals pending before Congress in 1985. While varying in detail and reflecting contrasting political convictions, these proposals possess one common attribute: in large part, they approach the subject of tax reform by focusing on items historically characterized as tax expenditures. The three tax proposals under discussion are: (1) the "Fair Tax Act of 1983,"[28] sponsored by two Democrats, Senator Bill Bradley and Representative Richard Gephardt (the Bradley-Gephardt Bill); (2) the "Fair and Simple Tax Act of 1984,"[29] sponsored by two conservative Republicans, Representative Jack Kemp and Senator Robert W. Kasten, Jr. (the Kemp-Kasten Bill); and "The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity" (the President's Proposal).[30] Although all three proposals involve some alterations in the Code structure to reduce both the number of brackets and the effective marginal rates, they also purport to be "revenue neutral," collecting sufficient additional revenue from other revisions to compensate for revenue lost from the structural changes.[31] All three proposals select as targets for amendment or deletion varying provisions that the respective proponents consider inequitable, all of which appear in the classic tax expenditure lists.

To illustrate, all three proposals would make the following

27. Budget Reform Act of 1974, Pub. L. No. 93-344, §§ 601, 3(a), 88 Stat. 297.

28. S. 1421, 98th Cong., 1st Sess.; H.R. 3271, 98th Cong., 2d Sess. (1984).

29. H.R. 6165, 98th Cong., 2d Sess.; S. 2948, 98th Cong., 2d Sess. (1984).

30. Fed. Taxes (P-H), Bull. 25, May 1985.

31. *See Bradley-Gephardt and Kemp-Kasten Bills* (Report of the American Bar Association Section of Taxation, Committee on Basic Tax Structure and Simplification), 38 Tax Law. 381, 383-88 (1985); Fed. Taxes (P-H), Bull. 25, *supra* note 30, at 7.

changes:[32] a) eliminate the $100/$200 exclusion of dividends under Code section 116;[33] b) tax the presently untaxed items of unemployment compensation,[34] the increase in value of insurance policies occurring in the hands of life insurance companies,[35] and the interest received on state and local municipal bonds issued for nongovernmental purposes;[36] and c) narrow the scope of Code section 117 to repeal the exclusion for scholarships and fellowships in excess of tuition and related expenses.[37] Both congressional bills would repeal the exclusion under Code section 305(e) for dividends reinvested in public utility stock.[38]

The three proposals differ in other specifics, but in most instances the provisions targeted for change are recognized as tax expenditures. The Bradley-Gephardt Bill proposes[39] a) to repeal the exclusions both for employer-provided "cafeteria plan" fringe benefits under Code section 125[40] and for employer-provided dependent care assistance under Code section 129[41] and to modify Code section 79(a) to include employer-paid premiums on employee group term life insurance in an employee's gross income;[42] b) to curtail the exclusions for employer contributions to employee accident, health, and disability plans under Code sections 105 and 106;[43] and c) to levy a partial tax on the present one-time, tax-free gain granted to persons over age fifty-five on the sale of a principal

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32. *See* 38 TAX LAW., *supra* note 31, at 390; FED. TAXES (P-H), Bull. 25, *supra* note 30, at 438, 441, 445, and 449.

33. This exclusion is listed in the 1983-88 Tax Expenditure Estimates published by tbe Congressional Joint Committee on Taxation. ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 1983-1988 (Mar. 7, 1983), 10-18, *cited in* TAX EXPENDITURES, *supra* note 1, at 7 [hereinafter cited as 1983-88 TAX EXPENDITURE ESTIMATES]. The item appears in cat. 376, entitled "Otber Advancement and Regulation of Commerce."

34. *See id.* at cat. 603, entitled "Unemployment Compensation."

35. *See id.* at cat. 376, entitled "Other Advancement and Regulation of Commerce."

36. *See id.* at cat. 502, entitled "Higher Education" (exclusion of interest on state and local government loan bonds); cat. 551, entitled "Health Care Services" (exclusion of interest on state and local government hospital bonds); and cat. 271, entitled "Energy Supply" (exclusion of interest on state and local government industrial development bonds for energy production facilities).

37. *See id.* at cat. 502, entitled "Higher Education."

38. *See id.* at cat. 376, entitled "Other Advancement and Regulation of Commerce;" *see also* 38 TAX LAW., *supra* note 31, at 390.

39. *See* 38 TAX LAW., *supra* note 31, at 390-91.

40. This item was enacted in 1984 and therefore was not listed in the 1983-88 TAX EXPENDITURE ESTIMATES, *supra* note 33.

41. *See* 1983-88 TAX EXPENDITURE ESTIMATES, *supra* note 33, cat. 505, entitled "Other Labor Services."

42. *See id.* at cat. 601, entitled "General Retirement and Disability Insurance."

43. *See id.* at cat. 551, entitled "Health Care Services."

residence under Code section 121.[44] The Kemp-Kasten Bill lists two additional exclusions for repeal:[45] a) amounts received for workmen's compensation, as damages for personal injuries or sickness, and under accident or health insurance plans under Code section 104;[46] and b) services received through employer-provided group legal service plans under Code section 120.[47]

In the area of business deductions and credits, all three proposals unanimously concur on repealing two highly debated tax expenditures:[48] the investment tax credit[49] and percentage depletion for oil and gas income.[50] The two congressional bills also would repeal[51] expensing of qualified research and experimental expenditures under Code section 174,[52] expensing of amounts spent to clear farm land under Code section 182,[53] the sixty month amortization of startup business costs under Code Section 195,[54] and the expensing of exploration, development, and intangible drilling costs under Code section 263(c).[55]

Personal deductions and credits, by definition, are not necessary for the production of income, and thus constitute classic tax expenditures. The three proposals all revise tax expenditures in this category. Both the Bradley-Gephardt Bill and the President's Proposal would repeal the deduction for adoption expenses under Code section 222.[56] The Bradley-Gephardt Bill[57] would repeal the deduction for nonbusiness state and local personal property and sales taxes under Code section 164.[58] In close tandem, the Presi-

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44. *See id.* at cat. 371, entitled "Mortgage Credit and Thrift Insurance."

45. *See* 38 TAX LAW., *supra* note 31, at 391.

46. *See* 1983-88 TAX EXPENDITURE ESTIMATES, *supra* note 33, cat. 601, entitled "General Retirement and Disability Insurance."

47. *See id.* at cat. 506, entitled "Social Services."

48. *See* 38 TAX LAW., *supra* note 31, at 398, 399-400; FED. TAXES (P-H), Bull. 25, *supra* note 30, at 442.

49. *See* 1983-88 TAX EXPENDITURE ESTIMATES, *supra* note 33, cat. 376, entitled "Other Advancement and Regulation of Commerce."

50. *See id.* at cat. 271, entitled "Energy Supply."

51. *See* 38 TAX LAW., *supra* note 31, at 398-400.

52. *See* 1983-88 TAX EXPENDITURE ESTIMATES, *supra* note 33, cat. 251, entitled "General Science and Basic Research."

53. *See id.* at cat. 351, entitled "Farm Income Stabilization."

54. *See id.* at cat. 376, entitled "Other Advancement and Regulation of Commerce."

55. *See id.* at cat. 271, entitled "Energy Supply."

56. *See* 38 TAX LAW., *supra* note 31, at 403; FED. TAXES (P-H), Bull. 25, *supra* note 30, at 440; *see also* 1983-88 TAX EXPENDITURE ESTIMATES, *supra* note 33, cat. 506, entitled "Social Services."

57. *See* 38 TAX LAW., *supra* note 31, at 403.

58. *See* 1983-88 TAX EXPENDITURE ESTIMATES, *supra* note 33, cat. 851, entitled "General Revenue Sharing."

dent's Proposal and the Kemp-Kasten Bill would repeal a different aspect of that same personal tax expenditure—the deduction for state and local income taxes.[59] Both congressional bills would limit the deduction under Code section 213 to medical expenses that exceed a ten percent floor in lieu of the present five percent floor.[60] The Bradley-Gephardt Bill and the President's Proposal would convert the credit for dependent care expenses to a deduction.[61]

All three proposals modify the tax expenditures inherent in the deduction of interest on an owner-occupied home[62] and on other personal debt under Code section 163,[63] as distinguished from interest incurred on a debt arising in a business or other income producing activity. The Bradley-Gephardt Bill would reduce the deduction for home mortgage interest.[64] The Kemp-Kasten Bill and the President's Proposal would preserve the deduction for mortgage interest on a principal residence.[65] The Kemp-Kasten Bill would deny deductions for personal nonbusiness interest (other than on a principal residence) unless related to payment of educational expenses;[66] the Bradley-Gephardt Bill would limit this deduction to the amount of the taxpayer's investment income;[67] and the President's Proposal would limit the deduction to a ceiling measured by the amount of the taxpayer's investment income plus $5000.[68]

V. Significance of Omissions from Tax Expenditure List

The prior discussion demonstrates the influence of the tax expenditure budget in formulating tax reform measures, no matter what the political persuasion of the sponsors. Consequently, this

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59. *See* 38 Tax Law., *supra* note 31, at 404; Fed. Taxes (P-H), Bull. 25, *supra* note 30, at 439.

60. *See* 1983-88 Tax Expenditure Estimates, *supra* note 33, cat. 551, entitled "Health Care Services;" 38 Tax Law., *supra* note 31, at 403.

61. *See* 1983-88 Tax Expenditure Estimates, *supra* note 33, cat. 504, entitled "Training and Employment Services;" *see also* 38 Tax Law., *supra* note 31, at 403; Fed. Taxes (P-H), Bull. 25, *supra* note 30, at 437.

62. *See* 1983-88 Tax Expenditure Estimates, *supra* note 33, cat. 371, entitled "Mortgage Credit and Thrift Insurance."

63. *Id.* at cat. 376, entitled "Other Advancement and Regulation of Commerce." This lists as a tax expenditure that portion of the interest deduction for nonhome mortgage and nonbusiness interest that exceeds investment income.

64. *See* 38 Tax Law., *supra* note 31, at 403, 406-07.

65. *Id.* at 404, 406-07; *see also* Fed. Taxes (P-H), Bull. 25, *supra* note 30, at 447.

66. *See* 38 Tax Law., *supra* note 31, at 404, 406.

67. *Id.* at 403, 406.

68. *See* Fed. Taxes (P-H), Bull. 25, *supra* note 30, at 447.

latest work by Surrey and McDaniel is essential reading for those involved in the legislative process as active participants or as interested spectators seeking to understand the present state of the tax laws and what still may lie ahead. It is also appropriate to stand back and examine the composition of the entire tax expenditure budget to determine if any significant omissions exist. Given the penchant of legislators to resort to the tax expenditure budget as a shopping list of Code sections ripe for reform, a special provision that deviates from the structural tax norm but fails to appear on the tax expenditure list may gain an unwarranted immunity from congressional scrutiny.

A. *Tax-Free Receipt of Damages for Nonphysical Personal Injuries*

Two illustrations will point out the problem with overlooked tax expenditures. First, the Code long has excluded from gross income "the amount of any damages received . . . on account of personal injuries or sickness."[69] Congress initially intended this Code provision to allow tax-free receipt of compensatory damages for physical personal injuries, such as the loss of a limb, on the inchoate theory that this payment constituted a rough form of recovery of human capital rather than the receipt of taxable income. This exclusion has been expanding to cover not only physical injuries, but nonphysical personal injuries as well.[70] Damages for libel, slander, defamation of personal reputation (as distinguished from professional reputation),[71] alienation of affection, invasion of privacy, and damages for pain and suffering (beyond the amount of compensatory damages for actual physical personal injuries) now are received tax-free under Code section 104(a)(2).[72] No clear rationale underlies this blanket exclusion from tax for damages for nonphysical torts that cause subjective personal suffering, such as grief, anguish, mortification, or humiliation. To postulate that such amounts represent a recovery of human capital is unacceptable be-

69. I.R.C. § 104(a)(2) (1985).

70. *See, e.g.*, Seay v. Commissioner, 58 T.C. 32 (1972).

71. For example, in *Roemer v. Commissioner* the Tax Court held that damages in a libel suit were taxable because the injury was to the taxpayer's professional reputation. 79 T.C. 398, 406 (1982). The Ninth Circuit, however, reversed, holding that the injury involved the personal reputation of the taxpayer. *See* 716 F.2d 693, 696-97 (9th Cir. 1983). Hence the damages compensated a personal injury, which was tax free under § 104(a)(2). *See id.* at 700.

72. *See* J. FREELAND, S. LIND & R. STEPHENS, FUNDAMENTALS OF FEDERAL INCOME TAXATION 206-07 (4th ed. 1985).

cause the taxpayer patently has no tax basis for the enormous amounts that juries award for nonmeasurable trauma to the psyche. The exclusion can be predicated only on compassionate grounds.[73]

The wisdom of perpetuating this exclusion has not been submitted to Congress for annual reevaluation because the tax expenditure list does not include this exclusion. Yet, on its face the exclusion deviates from the structural norm of the income tax, making it a natural candidate for the tax expenditure label. Does a current policy justification exist for this exclusion? Is the tax-free treatment of these damages inviting the escalation of personal injury litigation with multi-million dollar awards for subjective nonphysical injuries? More particularly, is the Code section 104(a)(2) exclusion contributing to the medical malpractice crisis in which the uncertain amount of jury awards for pain and suffering is a major factor behind the drastic jump in insurance premiums? The tax-free status of these receipts deserves reexamination in a climate in which Congress and the President are aglow with a fresh sense of equity and are considering taxes on other receipts historically exempt on grounds of compassion, such as Social Security payments,[74] workmen's compensation, unemployment compensation, disability compensation, black lung benefits for coal miners, and employer-provided death benefits.[75] However, until the Code section 104(a)(2) exclusion appears in the formal tax expenditure budget, it may continue to elude the attention of the legislators and the public and permit some persons to realize enormous amounts of wealth tax-free.

B. *United States Taxation of Foreigners*

A second area in which the tax expenditure analysis contains serious omissions lies in the international field. Surrey's original 1973 exposition of the tax expenditure concept in *Pathways to Tax Reform* did not expressly address the international aspects of the

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73. *See id.* at 206.

74. *See* I.R.C. § 86 (1985).

75. *See* President's Tax Proposal, FED. TAXES (P-H), Bull. 25, *supra* note 30, at 30-31, 49-56, 437-38; 38 TAX LAW., *supra* note 31, at 390-91. The Kemp-Kasten Bill would repeal § 104 in its entirety and resolve the problem by taxing all damages for sickness or personal injuries, physical or nonphysical. *Id.* All the items enumerated in the text as hitherto tax-free but now targeted for taxability (other than the death benefit provision) appear in the 1983-88 TAX EXPENDITURE ESTIMATES, *supra* note 33, cat. 601, entitled "General Retirement and Disability Insurance" and cat. 603, entitled "Unemployment Compensation."

tax expenditure concept.[76] In the present work, however, the authors announce that rules governing the United States taxation of foreigners who receive income from the United States—as distinguished from rules governing the United States taxation of its own citizens and residents—"are not susceptible to tax expenditure analysis."[77]

The rationale that places foreigners beyond the reach of the tax expenditure analysis is puzzling. The authors concede that "[e]very country with an income tax will tax the foreigner on income from sources within the country. A contrary result would be almost impossible to maintain, since its own taxpayers are being taxed on income earned within the country."[78] Nevertheless, the authors question whether "a normative standard applicable to the treatment of the foreigners" exists.[79] According to their current analysis, because "[e]ach country seems to devise its source rules on an ad hoc basis,"[80] "there are not internationally accepted norms" for determining how a source country like the United States should tax foreigners.[81] Consequently, according to this argument, without internationally accepted norms, there can be no United States norm, therefore no deviations from that norm, and therefore no tax expenditures in analyzing United States rules on the taxation of the United States income of foreigners.

The authors buttress this piece of deductive reasoning with the following:

> *Nor is it possible for a country to set a legislative norm for taxation of foreigners, deviations from which constitute tax expenditures.* Two examples will show why. Suppose a country decides to treat services performed there by foreign lawyers as domestic source but services performed there by foreign opera singers as foreign source. Neither provision can be classified as a tax expenditure, because there is no norm stating that services must always be sourced in the country where performed nor that all types of services must be sourced under the same rule.[82]

The data does not persuasively support the authors' conclusion that a country cannot establish a norm for taxing foreigners, deviations from which would constitute tax expenditures. In the hypothetical illustrations quoted, reasonable persons easily could

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76. *See* TAX EXPENDITURES, *supra* note 1, at 156-79.
77. *Id.* at 166.
78. *Id.* at 165-66.
79. *Id.* at 166.
80. *Id.* (footnote omitted).
81. *Id.*
82. *Id.* (emphasis added).

reach a conclusion diametrically opposite to the authors' conclusion. Thus, in the first illustration, one could conclude that taxation of foreign lawyers on income received for services performed within the United States complies with the established United States norm under which services customarily are sourced in the country where performed.[83] In the second illustration, one could conclude that nontaxation of the income of foreign opera singers performing services within the United States is a deviation from the United States norm of taxing source income and is a tax expenditure designed to attract foreign opera singers to perform in this country. The authors' premise is that a uniform international norm, rather than a national norm, must be established before United States deviations properly can be labeled as tax expenditures. Why? Is it necessarily determinative for purposes of United States tax analysis how France or Australia or Chile or Uganda tax foreigners on source income?

The authors assert that no one country can establish a norm for the taxation of foreigners from which deviations would constitute tax expenditures. The authors' own data contradicts this statement. For example, they disclose that "Canada . . . does treat incentive departures from its normal withholding rate [on foreign investors] as a tax expenditure."[84] The Canadian experience proves that it is possible, both theoretically and pragmatically, for a country to adopt its own national norm for the taxation of foreigners on source income and to use the tax expenditure analysis to describe deviations from that norm.

A per country norm is not only feasible but essential because the likelihood of the creation of a uniform international norm in the foreseeable future is remote if not nonexistent. In the interest of equity for United States taxpayers, the tax expenditure concept must be extended to identify special tax privileges accorded to foreigners on receipt of United States source income so that legislators can reevaluate the wisdom of perpetuating these privileges. Failure to extend the tax expenditure concept in this manner discriminates against United States citizens and residents who are asked to shoulder the entire cost of tax reform without appropriate contribution from foreign investors who have benefited from United States economic opportunities.

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83. I.R.C. §§ 861(a)(3), 862(a)(3) (1985).

84. *See* TAX EXPENDITURES, *supra* note 1, at 277 n.35.

C. *Tax-Free Receipt of United States Portfolio Interest by Foreigners*

One piece of 1984 legislation would appear on a tax expenditure list if the list analyzed the taxation of foreigners with the same basic criteria applied to the taxation of United States persons. The United States generally imposes a withholding tax of thirty percent on all portfolio income received from United States sources by nonresident aliens if this income is not effectively connected with a United States trade or business.[85] In 1984, in order to achieve several nontax objectives, such as attracting foreign capital to the United States market, providing direct access for United States corporations to the Eurobond market, and helping finance government borrowing while keeping United States interest rates low, Congress repealed the long-established withholding tax on United States portfolio interest received by nonresident alien individuals and foreign corporations.[86] To obtain portfolio interest free from United States tax when the debt is in registered form, the foreign recipient, or certain institutions on his behalf, only need file a statement with the withholding agent that the beneficial owner of the debt instrument is not a United States person.[87] When the debt is in bearer form, foreigners will receive the interest free of the United States withholding tax if there are "arrangements reasonably designed" to make certain the debt is sold only to foreign investors, the interest is payable only outside the United States, and the debt instrument bears a legend warning United States holders of United States tax liability.[88] Because the authors, however, eliminate the entire foreign area from the tax expenditure analysis, this new benefit for foreign investors is not a tax expenditure. It thus will escape the rigorous annual congressional reexamination that is directed only against United States taxpayers.

Ironically, in 1976 the authors opposed legislation similar to that adopted in 1984—a broad recommendation to eliminate United States tax on all foreign portfolio investment income, not just on interest—on the grounds that this provision was "costly, ineffective, and inequitable."[89] In addition, they asserted that this

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85. I.R.C. §§ 871(a), 881(a) (1985). The 30% withholding rate is subject to reduction, of course, by treaties.

86. *Id.* §§ 871(h)(1), 881(c)(1) (1985).

87. *Id.* §§ 871(h)(2)(B), 871(h)(4), 881(c)(2)(B) (1985). No disclosure is required of the owner's identity or of the owner's country of residence.

88. *Id.* §§ 871(h)(2)(A), 881(c)(2)(A), 163(f)(2)(B) (1985).

89. *See Elimination of U.S. Withholding Tax on Foreign Portfolio Investment*, in

legislation would be "inconsistent with international tax principles."[90] The authors recognized the inherent unfairness to United States citizen-taxpayers in this proposal by warning: "To unilaterally eliminate this revenue [from foreign investors on U.S. investment income] by dropping the withholding tax on investment income and to shift the burden of the revenue loss to U.S. taxpayers would be inconsistent with the basic requirements of tax equity between U.S. investors and foreign investors."[91]

The authors also voiced the same objection to a narrower suggestion to exempt interest received by foreigners from United States source tax.[92] The authors termed this suggestion a "tax gimmick" for the sole purpose of attracting foreign investment.[93] Yet in this 1985 work, they advance the proposition that this same "tax gimmick" should not be classified as a tax expenditure.

If in 1976 "firmly established basic principles of international tax law" existed under which all countries levying income taxes did tax foreigners on income from investments arising within their borders, then these basic principles still prevail in 1985. They constitute an accepted international norm—or justify the recognition of a generally accepted United States norm for taxation of foreign investors on United States source income—against which deviations could be measured and identified as tax expenditures. Failure to examine as tax expenditures those Code provisions concerning United States taxation of foreigners will weaken the comprehensive value of Surrey's concept.

The authors, to some extent, anticipated questions on their rationale for omissions from the tax expenditure list. They expected debate on the classification or inclusion of a particular item as a tax expenditure, and with the intellectual agility that marks the whole book, they observed that such debate "does not mean that the tax expenditure concept is fundamentally flawed."[94] This is, of

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FEDERAL TAX REFORM FOR 1976, at 139 (S. Surrey, P. McDaniel, & J. Pechman eds. 1976).

90. *Id.* at 140 (original emphasis omitted). Thus, the authors stated:

> One of the firmly established basic principles of international tax law clearly allows a country to impose a tax on income arising from activities within its jurisdiction or from investments in its corporations. There is no reason for the United States unilaterally to give up this clearly recognized international right to tax income whose source is in the United States.

Id. at 140-41.

91. *Id.* at 141-42.

92. *See id.* at 142. This suggestion, in fact, was adopted in 1984. *See supra* notes 86-88 and accompanying text.

93. *Id.*

94. TAX EXPENDITURES, *supra* note 1, at 196.

course, true. It also is hoped that, despite the loss of Professor Surrey, others will join Professor McDaniel in the task of sorting out these questions and addressing these broad issues so that the tax expenditure analysis will remain the dynamic force it has been.

VI. Conclusion: Elimination of Pejorative Connotation for Tax Expenditures

One last comment must be made. This new book reflects that the tax expenditure concept has matured. The concept has evolved into a more neutral, apolitical technique acceptable to persons of conflicting tax ideologies. This was not always the case. Originally the label carried with it a pejorative connotation. Tax expenditures were considered wasteful, to be excised from the Code. In his original work, Surrey adopted a dual stance, that of a tax technician and a tax moralist, and condemned most tax expenditure items. He commented: "Most of the tax expenditure programs should either be scrapped because the federal financial assistance they provide is not warranted by the nation's priorities or be replaced by direct assistance measures that can readily be devised."[95] His value judgments on the wisdom of eliminating certain tax expenditures that he found objectionable sometimes obscured the value of the technique he had devised. Even a close colleague observed: "Stanley may have carried his tax expenditures thesis a bit too far, too obsessively—almost theologically . . . ."[96]

This latest book evidences a separation of political value judgments from professional tax craftsmanship. The book early establishes a sound proposition:

> The classification of an item as a tax expenditure does not in itself make that item either a desirable or an undesirable provision; nor does it indicate whether the inclusion of the item in the tax system is good or bad fiscal policy. The classification of an item as a tax expenditure is purely informative, just as the presence of an item in the direct budget of a government is informative; it is simply a way of announcing that tbat the item is not part of the normative tax structure. This being so, it is appropriate to ask whether the presence of those items in the tax system is desirable or undesirable, given the existing budget policy, tax policy, and other relevant criteria.[97]

The tax expenditure concept, thus, has outgrown the charge that it is the favorite ploy of any ideological faction. With this publication, the concept emerges, not perfect, but still the best tool yet

95. Pathways to Tax Reform, *supra* note 5, at 209.
96. Griswold, *supra* note 3, at 344.
97. Tax Expenditures, *supra* note 1, at 5-6.

devised to assist policymakers in bridging political differences and in laying out a rational path through what otherwise would be a tax wilderness.