Section of Taxation

REPORT

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Letter from the Section Chair
Bill Elwell

I hope that you enjoy this issue of the Tax Section's Report. In addition to updates on the section's activities over the past several months, the Report includes the winning papers from our 2007 and 2008 annual law student writing competition, featuring discussions of the sunset provisions in the Tax Code and potentially unintended loss of tax revenue through an arcane federal contracting provision, respectively.

Many thanks to our editors, Steve Sherman and Kari Larson, who have once again put together an excellent issue of our semi-annual newsletter. The section thanks them for their efforts as we welcome John Bates as the new editor for future issues of the Report.

Our annual Tax Law Conference is March 6 at the Ronald Reagan Building and International Trade Center in Washington, D.C. This year's conference co-chairs are Danielle Rolfes and Terri McField. The annual Insurance Tax Seminar will be May 28-29, also in the nation's capital. Mark Kovey continues his role as the chair of this seminar. More details regarding these two premiere events are in this Report.

The section also has a number of exciting programs planned for the coming months, including the next in our very popular "Women in Tax Law" series, a program in New York City discussing current issues in crossborder financial products, analysis of the Textron and Regions cases, our annual Summer Intern Careers in Tax Law lunch, discussion of the effect of PAYGO budgeting rules on tax legislation, and other timely issues as we witness a historic change in the Presidency of the United States and consider various tax issues accentuated by the current financial crisis.

As in prior years, the section continues to sponsor a student writing competition. Please visit the section's Web site at www.fedbar.org/taxlaw_section.html, for announcements regarding section programs, or to be added to our email distribution list.

I assumed the role of Chair in October 2008 after the very capable Ed Froelich led our section through a successful year of conferences and programs. We also welcome Kari Larson as chair elect, Tim George as treasurer, and Martin Milner as secretary. I appreciate the opportunity to serve as section chair, and I know it will be a great experience to work with so many fine tax attorneys both within the government and the private sector.

The section relies upon volunteers, and I have been impressed by the energy and enthusiasm of the many section members who have pitched in to develop programs, monitor our budget, maintain the Web site, and help guide the section. The staff of the FBA here in Washington, D.C., has been a tremendous help on the logistical side. I am privileged to work with our fine steering committee mem-

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Section of Taxation Recent Events

32nd Annual Tax Law Conference

On March 5, 2008, the Section of Taxation held its 32nd Annual Tax Law Conference at the Ronald Reagan Building and International Trade Center in Washington, D.C. Approximately 340 attendees and speakers spent the day discussing developments in Tax Practice and Procedure, Ethics (including Circular 230), International Tax, Domestic Corporate Tax, Partnerships and Pass-Throughs, Benefits and Employment Taxes, Financial Products, and Tax Accounting. The conference also included an update from Capitol Hill on tax legislation as well as a special plenary session on private equity tax issues. The keynote speakers during the morning session were Donald Korb, Chief Counsel, IRS, and Michael Mundaca, Deputy Assistant Secretary (International Tax Affairs), Treasury Department, and the keynote luncheon speaker was Edward Kleinbard, Chief of Staff for the Joint Committee on Taxation. The conference featured 20 panel discussions that included leading tax practitioners and top policymakers from Capitol Hill, the Treasury Department, the Department of Justice, and the IRS.

As in past years, the Tax Law Conference was well attended by attorneys from the IRS and the Department of Justice, Tax Division, and offered private practitioners an excellent opportunity to meet their counterparts in government and discuss new developments in a collegial atmosphere. The panels also reflected a mix of government and private practitioners, which allowed helpful exchanges of views and concerns on a host of hot topics. Attendees at the seminar received 7 hours of CLE credits as well as two hours of ethics credit. The conference was capped by a memorable Kenneth S. Liles Award ceremony in which Eric Solomon, Assistant Secretary (Tax Policy), Treasury Department, graciously accepted the award before a packed house.

Breaking Through the Glass Ceiling

On April 17, 2008, the Section on Taxation held their fourth Women in Tax Law program. The event was entitled “Breaking through the Glass Ceiling,” and featured a panel discussion comprised of the following dynamic women in executive-level government, corporate, and private sector positions:

- Carol Campbell, IRS, Division Counsel, Wage and Investment
- Terry Coles, Vice President of Tax for the Americas Region, Shell Oil
- Sarah Hall Ingram, Chief of IRS Appeals
- Paula Junghans, Zuckerman Spaeder
- Pamela Olson, Skadden, Arps, Meagher and Flom
- Karen Gilbreath Sowell, Deputy Assistant Secretary (Tax Policy), U.S. Treasury Department.

Approximately 70 tax professionals attended the event. After being welcomed by Section chair Edward L. Froelich, Jeanne Folsom Ross moderated the hour-long panel discussion. Each speaker shared her personal story of how she became involved in tax law and what led her career to the position she holds today. The attendees then split into six small groups, each led by one speaker and facilitated by an FBA member. Over dinner, the participants asked follow-up questions, had one-on-one conversations with the speakers, and enjoyed getting to know one another. Planning for this event was undertaken by the following FBA members: Mary Gillmarten; Kari M. Larson; Patricia McDermott; Jeanne Folsom Ross; Nicole M. Reuling; and Teresa Dondlinger Trissell. The Section on Taxation would like to thank the law firm of Miller & Chevalier for hosting the event.

20th Annual Insurance Tax Seminar

The Insurance Tax Seminar in May 2008 was the 20th installment of this successful program sponsored by the Section of Taxation in conjunction with the Office of Chief Counsel of the Internal Revenue Service. The Seminar annually presents programs dealing with the taxation of insurance companies and their products, and is the most successful and widely attended conference directed at professionals specializing in insurance taxation matters.

The 2008 event was highlighted by a round table discussion of changes in the operation of the Office of Chief Counsel, with a panel of former Chief Counsels representing the last three decades and moderated by

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Donald L. Korb, the current holder of that position. The over 500 registrants, representing insurance company tax professionals, tax lawyers and other consultants and about 150 persons from IRS Offices of Examination, Appeals and Chief Counsel, were also treated to a presentation on tax legislative issues by Edward D. Kleinbard, the Chief of Staff of the Joint Committee on Taxation.

The 2008 Insurance Tax Seminar had 19 separate sessions on timely topics impacting the taxation of insurance companies and their products. Litigation, appeals and audit issues facing life insurance and other insurance companies were covered . Three sessions were devoted to the increasing number of instruments and financial products that contain some insurance features but also other financial elements that pose intriguing questions of interpretation for tax professionals. Recent developments in the taxation of insurance company "captives" and customized life insurance and annuity products were also explored in two other sessions. Other panel discussions dealt with recent tax developments in mergers and acquisitions, tax penalties applied to tax shelters and reportable transactions, and current tax legislative matters.

Careers in Tax Law Luncheon

On June 25, 2008, the FBA Section on Taxation hosted its annual "Careers in Tax Law" luncheon. For the second year in a row, the event was held on Capitol Hill, in the Dirksen Senate Building, and provided a forum for summer associates, law clerks, and young lawyers considering a career in tax law. Panelists from several agencies and all three branches of government discussed their own career paths, provided valuable insider advice, and shared their perspective on the practice of federal tax law. The six panelists included the Honorable Mark Holmes, U.S. Tax Court; Nathan Hochman, Assistant Attorney-General, Tax Division, Justice Department; Jeanne Ross, Attorney-Advisor, Office of Tax Policy, Treasury Department; Carol Campbell, Office of the Chief Counsel, Internal Revenue Service; Melissa Mueller, Tax Counsel, House Ways and Means Committee; and Russell Sullivan, Staff Director, Senate Finance Committee. After short presentations, the speakers answered a number of questions from attendees, and several of the panelists remained after the program to provide one-on-one advice for the prospective tax attorneys.

Presidential Candidate Tax Policy Breakfast

On Friday, September 19, 2008, the Federal Bar Association's Tax Section hosted a breakfast meeting to hear Margaret Milner Richardson, Tax Policy Adviser for the Obama-Biden Campaign, and Douglas Holtz-Eakin, Senior Policy Advisory for Sen. John McCain, discuss each presidential candidate's tax proposal. Donald Longano, currently a Principal in PricewaterhouseCoopers LLP National Tax Services, served as the Moderator. Private sector tax practitioners, government tax officials, and the press attended the meeting.

In addition to statements of each candidate's position on federal income taxes, Ms. Richardson and Mr. Holtz-Eakin responded to a broad range of policy questions from the audience on both individual and corporate taxation. The questions included topics such as capital gains and dividends taxes, alternative minimum tax, corporate income tax, estate tax, social security payroll tax, tax reform, and other tax policy issues.

Naturally, the senior advisers advocated for their candidate's specific proposal to address these tax issues, so the solutions varied. Significantly, though, both advisers generally agreed on the major issues that the future president would need to address. For example, both Ms. Richardson and Mr. Holtz-Eakin agreed that alternative minimum tax reform is very important, but unlikely absent comprehensive tax reform. Similarly, they both agreed that estate tax reform should be a top priority regardless of which candidate ultimately wins the election.

The timeliness of the topic and the opportunity to raise these issues with senior advisers to both the Democratic and Republican presidential campaigns resulted in an exciting program, exemplifying the Tax Section's focus on providing opportunities for interaction between tax practitioners in public service and the private sector. The FBA Section on Taxation expresses its gratitude to the George Washington Law School for hosting the event, and to Kari Larson (Latham & Watkins); Mike Desmond (McKee Nelson); David Blair (Miller & Chevalier); and Edward L. Froelich (Morrison & Foerster) for their roles in organizing and facilitating this meeting.

Selecting Wine for Business Events

On October 23, 2008, the Federal Bar Association Section on Taxation sponsored its fifth event in the continuing Women in Tax Law series. The Women in Tax Law events, held bi-annually, provide women tax professionals in government and the private sector with opportunities for professional development and networking.

This most recent event, Selecting Wine for Business Events, included a tasting of six wines and a discussion of wine etiquette at business functions. The tasting and

discussion was conducted by local wine expert, Tim Healy. Mr. Healy provided advice on wine and food pairings, working with a sommelier at a restaurant, and selecting wines for entertaining at home. Kari Larson of Latham & Watkins LLP, chair-elect of the Section on Taxation, moderated the event. The event concluded with a networking reception. The Federal Bar Association would like to thank White & Case LLP for hosting this event.

Pictured l to r: Nicole Reuling, Mayer Brown LLP; Teresa Trissell, IRS Office of Chief Counsel; Tim Healy, featured speaker; Kari Larson, Latham & Watkins; and Jeanne Ross, U.S. Treasury Department.

10th Biennial Conference on Tax Administration and the Legislative Process

At the Airlie Conference Center near Washington, D.C., Congressional staff, current and former Administration officials, academics and tax practitioners met for the 10th Biennial Conference on Tax Administration and the Legislative Process. The discussion-based conference, which took place on November 5–6, 2008, covered topics such as the implications of the November elections on tax policy, health care reform, climate change and its effects on the tax system, revenue options, alternative tax systems, and the role of the U.S. in a global economy.

Pictured l to r: Fred Murray, Grant Thornton LLP; and Michael Desmond, McKee Nelson LLP.

Program on Code Sec. 382

On December 8th, the Federal Bar Association's Section on Taxation held a program on Code Sec. 382 sponsored by the firm of Pepper Hamilton LLP, in Washington, D.C. Mark Jennings, IRS Branch Chief, Associate Chief Counsel (Corporate) was a panelist and described the aspects of significant IRS guidance in the area and indicated further guidance that will elaborate on the relatively liberal notices released recently on application of the loss carryfoward rules under Code Sec. 382 in reaction to the current economic crisis. The event was well attended by several corporate tax practitioners and IRS corporate branch attorneys. The feedback from the event was positive and reported on in major tax publications.

CHAIR *continued from page 1*

bers as we plan an exciting schedule for 2009.

As always, I am happy to hear from you, the section members, about any ideas or suggestions you have to improve the section and fulfill the mission of the section to promote the welfare, interests, education, and professional growth and development of members of the section; to contribute to the formation of federal tax policy through section events, to promote high standards of professional competence and ethical conduct in the practice of federal tax law; and to provide opportunities for interaction between tax practitioners in public service and the private sector.

Save the Date

The Federal Bar Association

in conjunction with

The Office of Chief Counsel
Internal Revenue Service

present the 21st Annual

Insurance Tax Seminar

May 28–29, 2009
J.W. Marriott
Washington, D.C.

A Dialogue with Government Personnel on Property-Casualty and Life Insurance Tax Issues

Coordinated by Mark H. Kovey and Nancy Vozar Knapp

Why Attend the Insurance Tax Seminar?

- It provides a unique forum for a productive exchange of ideas between the IRS and the private sector.
- The seminar features ample opportunity to ask questions of panelists, who are experts on insurance taxation.
- Events include a reception and refreshment breaks designed for more informal dialogue among participants.
- Multiple break-out sessions allow choice among currently hot topics.

Who will be attending?

- Department of Justice personnel and IRS personnel from the Examination and Appeals Functions as well as from the Office of Chief Counsel.
- Attorneys, accountants, and others with an active interest in the federal income taxation of insurance companies and their products.

The **J.W. Marriott** is located at 1331 Pennsylvania Ave., NW, Washington, DC 20004. For reservations, call (202) 393-2000 or (800) 228-9290. *Please mention the **Federal Bar Association Insurance Tax Seminar** to receive the conference rate.*

More information and registration materials on the seminar will be available in the Spring of 2009.

Questions? Contact the Federal Bar Association at (571) 481-9100 or fba@fedbar.org.

www.fedbar.org

Tax Free Profit for Federal Contractors: a Law Student Discovers a Loophole

Andrew Strelka

Before coming to law school, I worked for a large federal contractor, calculating the price we would bid to the government during contract negotiations. One item I was always directed to include in our price was a "cost" called Facilities Capital Cost of Money ("FCCOM," pronounced "fick-um.") Even though I was the one ultimately responsible for the price, I never quite understood what the FCCOM subsidy was or why we included it, I only knew that we could. It wasn't until several years later that I began to question its legitimacy.

After many hours of research, several FOIA requests, an administrative appeal, and an analysis of over a hundred annual reports, I can conclusively state that FCCOM provides federal contractors with a tax windfall that produces an enormous amount of forgone tax revenue. Through this loophole, contractors can effectively paint a certain amount of earned profit as FCCOM and receive a tax deduction. This article reveals how the FCCOM tax loophole was created, how it functions, and seeks to notify Congress and tax professionals of its existence.

Introduction

In the 1970's the United States was subject to double-digit inflation and 12% prime interest rates.[1] While consumers struggled with a deteriorating currency, the federal government began to have a hard time finding contractors. Several studies showed an outdated and shrinking defense industrial base because federal contractors were earning a lower return on invested capital from their government work than from their commercial work, drawing investment dollars away from defense oriented facilities.[2] As a result, in 1976 the government body that oversees federal contractor accounting, the Cost Accounting Standards Board ("CASB"), enacted Cost Accounting Standard 414 ("CAS 414") which introduced and established Facilities Capital Cost of Money as an allowable contract cost.[3]

FCCOM attempted to "even out" the supposed difference between the return on investing money in federal contracting facilities versus facilities for commercial business purposes. Through FCCOM, contractors could receive a payment from their government customers based on how much money they had invested in federal contracting facilities. This payment was supposed to represent the capital cost or time value of investing money in those federal contracting facilities.

To actually calculate time value of money for a given investment amount, the contractor would somehow need to forecast the difference in return between investing the amount in commercial facilities versus federal contracting facilities. This would no doubt be difficult without cumbersome data sets allowing analysts to forecast future returns with some certainty.

CAS 414 sidestepped such burdensome calculation methods by allowing the contractor to merely estimate the time value of money by multiplying the investment amount by a rate supplied by the Treasury.[4] Contractors would then receive the FCCOM subsidy by including this estimated time value of money in their total contract costs to the government.

The CASB defined FCCOM as a cost despite the look and feel of a subsidy. Keep in mind that dollars invested by the contractor in facilities are already included in overhead charges to the government. The actual cost of the facility is already paid for. FCCOM acted merely as an "incentive" to invest in such facilities. For example, assuming the December 2006 Treasury rate of 5.75%, a contractor who invested $100 in facilities for an ongoing federal contract and charged a 10% fee, would receive from the government a payment of $110. This payment is made up of $100 for facility overhead costs, $4.25 for profit, and $5.75 for FCCOM.[5] This

[1]*See* Howard W. Wright & James P. Bedingfield, Government Contract Accounting 248 (1979).

[2]*See* FAA, Pricing Handbook § 11.1, (Jan. 1, 2007), *available at* http://fast.faa.gov/pricing/98-30C11.htm. It's important to note that profit amounts are highly regulated in federal contracting. Whereas a commercial firm might respond to high inflation by increasing their profit margin on goods sold, a federal contractor is limited to the fee percentage they can charge the government. For example, 10 U.S.C. § 2306(d) (2000) allows a maximum fee of 15% on only the riskiest of experimental cost-plus contracts. Otherwise, a contractor's fee is generally capped at 10%.

[3]*See id.*; Wright & Bedingfield, *supra* note 1.

[4]How contractors calculate FCCOM is discussed further in this article. *See generally FAA, Pricing Handbook* § 11.1, (Jan. 1, 2007) (discussing the opportunity cost of facility investment).

[5]The profit amount and the FCCOM subsidy, when added

article focuses on the treatment of that $5.75.

Briefly stated, in a world without FCCOM, the contractor would have received $100 for facility overhead costs and $10 for profit. Under a 1997 amendment to the Federal Acquisition Regulations ("FAR"), for every dollar of FCCOM that is billed, the profit amount is reduced. Ceteris paribus, the contractor receives the same total payment regardless of whether FCCOM is billed or not. The contractor is rewarded for billing FCCOM however, as the $5.75 FCCOM subsidy, may be deducted as a business expense.

This article will show that allowing contractors to receive a tax windfall through FCCOM was never an expressed purpose of CAS 414 and no case or statute exists which specifically states that FCCOM is to be received tax-free. Despite this, each year millions of dollars in tax revenue are forgone. Through several Freedom of Information Act ("FOIA") requests with the Office of Management and Budget ("OMB") and the Defense Contract Audit Agency ("DCAA"), I have discovered that it is unlikely any record is being kept of how much money the government pays each year in FCCOM or how much is paid per contractor. A complete record of my FOIA history with DCAA and OMB is available at www.taxinglifeinsurance.com/FCCOM.

Because of this lack of accountability, I conducted a study to estimate the FCCOM subsidy received by 52 federal contractors in government fiscal year 2005 ("GFY 2005"). This article analyzes the results of this study and reveals that in GFY 2005, the sample firms could have billed over $246 million in FCCOM subsidy.

As previously mentioned, a 1997 amendment to the FAR has nullified any substantive benefit from the FCCOM subsidy. For every dollar of FCCOM received by the contractor, profit payments from the government are commensurately reduced. Unbelievably, after the adoption of this amendment, the tax loophole was not closed but seemingly bolstered by Treasury. Even though the contractor receives the same amount of revenue regardless of whether FCCOM is billed, if the contractor chooses to receive FCCOM instead of solely profit, a certain amount of profit dollars are treated as FCCOM and the contractor is allowed a tax deduction. Assuming a corporate tax rate of 35%, my study of 52 contractors produced a possible $86 million in forgone taxes in GFY 2005.

Because of the current tax loophole, the FCCOM subsidy allows contractors to receive a portion of their profit tax free.

together, equal 10% of the contract costs.

Background

I. The Origin of CAS 414

The enactment of the FCCOM subsidy was a reaction to the high inflation and prime interest rates of the 1970's. Under CAS 409, federal contractors were depreciating tangible assets based on historical costs.[6] Under the prevailing interest and inflation rates however, this policy led to ineffective results.[7] The CASB determined that payouts to contractors had to be increased if contractors were to remain financially sound, and since the CASB only has authority over the allowability of costs and cannot adjust profit levels, it decided to increase costs.[8]

The CASB maintains the Cost Accounting Standards, a subset of the FAR that govern uniformity and consistency in the measurement, assignment, and allocation of costs to government contracts.[9] In 1975, the CASB officially proposed the idea of a new cost accounting standard via publication in the *Federal Register*:

> Accounting for costs under inflationary conditions has been a matter of concern to the CASB for some time. The Board has determined that affirmative action should be taken now to recognize the impact of inflation on contract cost.[10]

The CASB proposed two solutions to combat inflation: (1) adjusting historical depreciation by indexing for inflation or (2) allowing a capital cost that covered the impact of inflation and the time value of money. The latter solution would later evolve into FCCOM:

> The Board has authorized a staff project for the devel-

[6]Wright & Bedingfield, *supra* note 1.

[7]*Id. See* Accounting Government Contracts - Cost Accounting (MB) 1-23, at § 23.01 (2006). ("Recovery of depreciation was not sufficient motivation for contractors to invest in new facilities, whether to bring in new technology or simply to replace the old with something new and better.").

[8]*Id.* The CASB's lack of authority to adjust profit levels is discussed further in this article.

[9]The FAR receives its statutory authority from the Office of Federal Procurement Policy Act of 1974, Pub. L. 93-400, 88 Stat. 796 (codified as amended at 41 U.S.C. § 433 (2000)). It is prepared, issued, and maintained by DOD, GSA, and NASA under their specific statutory authorities. The FAR is published under title 48 of the *Code of Federal Regulations* with chapter 99 being devoted to the Cost Accounting Standards. For example, the language "FAR part 9904" is indicative of 48 C.F.R. § 9904 (2007).

[10]CASB Historical Depreciation Costs for Inflation, 40 Fed. Reg. 47517 (Oct. 9, 1975).

> opment of a possible Cost Accounting Standard to deal with the imputed cost of capital. Such a Standard will, in all probability, involve identification of assets, including depreciable assets, related to the performance of negotiated contracts. The recognition of capital cost could be on the basis of asset acquisition costs, on the basis of the current purchasing power equivalent of those costs, or on the basis of replacement values. The interest rate used in recognizing the contract cost of capital employment could be designed to cover the impact of inflation as well as the time value of money. The Board could, in other words, include recognition of the impact of inflation in a provision for capital cost recognition.[11]

The CASB received over 90 comments regarding the two proposals, and in March 1976, revealed in the *Federal Register* that it was abandoning the proposal to adjust depreciation for inflation and instead would seek to enact FCCOM.[12] The announcement detailed the calculation methods and payment procedures for FCCOM and again asked for comments.

Finally, in June 1976, the CASB adopted FCCOM as a new cost accounting standard and published CAS 414 which has remained virtually unchanged since its original publication.[13] In its announcement, the CASB summarized the comments it received regarding FCCOM and succinctly stated the biggest argument against FCCOM: that if contractors need more money to remain solvent they should increase their profit margins.

> Commentators who represented contractors and the accounting profession tended to favor the proposal, while those who represented some Government agencies were opposed. Government representatives were joined by some other commentators who expressed the belief that the cost of money as an element of the cost of capital committed to facilities should remain, explicit or otherwise, a consideration in determining contract profit compensation, rather than be treated as an element of cost.[14]

The comments directing the CASB to keep cost of money as a consideration in negotiating profit echo the thesis of this article, that FCCOM is essentially another way for contractors to receive profit. The CASB seemed to ignore this argument and merely stated, "The cost to be measured, even though imputed, is real and is relevant for contract costing," and "contract costs currently do not include any measurement of the cost of money, which is undeniably a cost related to contract performance."[15]

Through these words, the CASB exercised their authority to make and promulgate cost accounting standards, essentially "inventing" a new and allowable cost.[16] In order to understand what it means for the CASB to designate FCCOM as an allowable cost, a brief overview of federal contract costs is necessary.

II. Allowability

Whether a cost element can be billed under a cost reimbursable contract or included in the price of a fixed-price contract depends on whether the cost is allowable. Generally, allowability is based on whether the cost is reasonable and allocable.[17] A cost is reasonable if, in its nature and amount, it does not exceed that which would be incurred by a prudent person in the conduct of competitive business.[18] To be allocable, a cost does not need to fall

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[11] *Id.*

[12] *See* CASB Cost of Money as an Element of the Cost of Facilities Capital, 41 Fed. Reg. 9562 (Mar. 5, 1976). The proposal to adjust depreciation for inflation was referred to as CAS 413. A FOIA request is currently pending with OMB concerning the details of the received comments and the decision to abandon CAS 413. *See* Wright & Bedingfield, *supra* note 1 ("CAS 413 would have applied the gross national product deflator to increase depreciation based on historical costs. CAS 413 was abandoned by the CASB before promulgation, primarily because of political opposition from Congress.").

[13] *Compare* CASB Cost of Accounting Standard – Cost of Money as an Element of the Cost of Facilities Capital, 41 Fed. Reg. 22241 (June 2, 1976), *with* CASB Cost of Accounting Standard – Cost of Money as an Element of the Cost of Facilities Capital 48 CFR § 9904.414 (2007).

[14] CASB Cost of Accounting Standard – Cost of Money as an Element of the Cost of Facilities Capital, 41 Fed. Reg. 22241 (June 2, 1976).

[15] *Id.*

[16] *See infra* note 40 and accompanying text for discussion on the CASB's authority to create cost accounting standards.

[17] *See* 48 C.F.R § 31.201-2 (2007); *Bill Strong Enterprises v. Shannon*, 49 F.3d 1541, 1549 (Fed. Cir. 1995) ("Benefit to the contract purpose, whether in its work performance or administration, is therefore a prerequisite for allowability."). Note that this case has been subsequently overruled by *Reflectone v. Dalton*, 60 F.3d 1572 (Fed. Cir. 1995) with regards to what constitutes a claim under the Contract Disputes Act. *See also* Charles Tiefer & William Shook, Government Contract Law 179 (2d ed. 2004).

[18] 48 C.F.R. § 31.201-3 (2007). *See* Tiefer & Shook, *supra* note 17, at 221 ("As a practical matter, the Government has had relatively little success in disallowing costs solely on the basis of

directly under the performance of a contract. It is allocable if it is incurred specifically for the contract, benefits both the contract and other work, or is merely necessary to the overall operation of the business although a direct relationship to any particular cost objective cannot be shown.[19]

Performing a grounds-up reasonability and allocability test on FCCOM is usually not necessary as the FAR, through the enactment of CAS 414, expressly directs contractors to its allowability:

> 52.215-16 Facilities Capital Cost of Money
> (a) Facilities capital cost of money will be an allowable cost under the contemplated contract, if the criteria for allowability in FAR 31.205-10(b) are met. One of the allowability criteria requires the prospective Contractor to propose facilities capital cost of money in its offer.
> (b) If the prospective Contractor does not propose this cost, the resulting contract will include the clause Waiver of Facilities Capital Cost of Money.[20]

Through the above provision, FCCOM actually receives less scrutiny regarding allowability than that of other cost elements.[21] FAR part 52.215-16 states that as long as FCCOM is allowable under FAR part 31.205-10, then a contractor simply needs to include it in their bid in order to bill for it later.

FAR part 31.205-10 is slightly more detailed in its requirements for allowability and states three requirements that must be met for FCCOM to be allowable.[22] The first requirement is that FCCOM must be calculated and allocated in accordance with FAR part 9904.414, which is detailed in the next section of this article.[23]

The second requirement provides limits on the capital asset's value for FCCOM calculation when business combinations are present.[24] A tangible capital asset's value, when the purchase method of accounting for a business combination is used, is limited to the purchase price of the asset and costs necessary to prepare the asset for use.[25] Intangible capital asset value is limited to the total of the amounts that would have been allowed had the business combination not taken place.[26]

The third and final requirement for allowability mirrors FAR part 52.215-16: the calculated FCCOM amount must be specifically identified and proposed in the contractor's cost proposal.[27] It follows then that aside from incorrectly computing it, the only bar to a federal contractor's privilege to receive FCCOM is if the contractor failed to include it in their offer to the government.[28]

III. Calculation and Billing

Through CAS 414, FCCOM is an allowable cost if the contractor identifies and correctly calculates it in its cost proposal. FAR part 9904.414 instructs contractors on how to calculate the subsidy.[29] Essentially, the contractor first computes the investment base from their accounting data.[30] This base would generally include fixed assets that give rise to depreciation, a warehouse for example, and also any costs of land.[31] The base should include assets that are "used in the contractor's regular business activities."[32] The *Contract Audit Manual*, an instructional guide for federal auditors published by DCAA, states that assets held for speculation, facilities considered idle, assets under construction for a contractor's own use, and assets that have not yet been put into service are not considered as being

unreasonableness.").

[19]48 C.F.R. § 31.201-4 (2007).

[20]48 C.F.R. § 52.215-16 (2007).

[21]Specific determinations of cost element allowability typically involve analysis of industry precedent and case law. FCCOM however enjoys the honor of being expressly allowable in the FAR.

[22]*See* 48 C.F.R. § 31.205-10(b) (2007).

[23]*See* 48 C.F.R. § 31.205-10(b)(1) (2007). FAR part 9904.414 is to be used in calculating and allocating the FCCOM base but if the capital asset is under construction, separate guidance is provided under part 9904.417.

[24]*See* 48 C.F.R. § 31.205-10(b)(2) (2007).

[25]*See* id. This section references FAR part 9904.404-50 which provides detailed guidance on tangible asset valuation when business combinations are present.

[26]*See id.*

[27]*See* 48 C.F.R. § 31.205-10(b)(3) (2007).

[28]*See* Timothy J. Pendolino et al., *1995 Contract Law Developments--The Year in Review*, 3 Army Law. 68 (Jan. 1996) ("Under the FAR, the board ruled that the requirement that a prospective contractor propose FCCOM to avoid waiving it is contingent on the applicability of cost principles for contracts with commercial organizations. If a prospective contractor fails to identify or propose FCCOM in a proposal for a contract that will be subject to the cost principles for contracts with commercial organizations, FCCOM will not be an allowable cost in any resulting contract.").

[29]*See* 48 C.F.R. § 9904.414 (2007).

[30]*See* 48 C.F.R. § 9904.414-50(a) (2007).

[31]*See* Accounting Government Contracts - Cost Accounting (MB) 1-23, at § 23.04 (2006).

[32]48 C.F.R. § 30.414 APPENDIX A (2007). *See* Accounting Government Contracts - Cost Accounting (MB) 1-23, at § 23.04 (2006).

"used in the contractor's regular business activities."[33]

	January-June Cost of Money Rate	July-December Cost of Money Rate
1997	6.38%	6.75%
1998	6.25%	6.00%
1999	5.00%	6.50%
2000	6.75%	7.25%
2001	6.38%	5.88%
2002	5.50%	5.25%
2003	4.25%	3.13%
2004	4.00%	4.50%
2005	4.25%	4.50%
2006	5.13%	5.75%

Fig. 1

After the investment base is calculated, it is multiplied by the cost of money rate as specified by Treasury to arrive at the contractor's FCCOM.[34] Treasury publishes its cost of money rate twice a year and *Fig. 1* shows the rates from the last ten years.[35] The rate is also referred to as the Renegotiation Board Rate or the Prompt Payment Rate.[36]

So far this may seem relatively simple, but in reality it can get complicated quickly. It would be rare for a large contractor to have one facility completely dedicated to one contract. Because a facility may be devoted to several contracts at one time, facility costs are allocated proportionally to different contracts. Since each contract requires its own FCCOM base for subsidy calculation purposes,[37] contractors need to keep track of exactly how much of a facility is devoted to each contract.

To accomplish this task, contractors generally include FCCOM in their allocated facility overhead rates and calculate the FCCOM base as a percentage of the amount of facility overhead dollars allocated to a specific contract.[38] Form CASB CMF (Cost Accounting Standards Board Cost of Money Factor), mentioned in FAR part 9904.414, is a worksheet that assists the contractor in calculating FCCOM given several different overhead pool allocations.[39]

Analysis

I. The Loophole

When FCCOM was enacted, a tax loophole and a mechanism to constructively increase profit sprung into existence. Apart from possible findings in pending FOIA requests to Treasury, IRS, and OMB, I can find no indication that the tax loophole was anticipated.

During the rampant inflation of the 1970's, the CASB set out to increase contractor returns on investment in federal contracting facilities. It did so by creating a cost for time value of money through CAS 414. Alternatively, the return on facilities could have been increased by allowing contractors to include more profit in their contracts, but due to a lack of authority, this was something the CASB could not directly do.

The CASB received its authority under a 1972 amendment to the Defense Production Act of 1950 which states that the "Board shall have the exclusive authority to make, promulgate, amend, and rescind cost accounting standards and interpretations thereof designed to achieve uniformity and consistency in the cost accounting standards governing measurement, assignment, and allocation of costs to contracts with the United States."[40] The CASB controls the world of costs but has no authority to adjust profit margins.

Lacking the authority to directly increase profit levels, the solution the CASB crafted to increase contractor returns involved moving something that was normally part of profit margins (time value of money) out of profit and into cost by separately identifying and declaring it a

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[33]DCAA, *Contract Audit Manual* § 8-414.2, (Aug. 26, 2006). *See* Accounting Government Contracts - Cost Accounting (MB) 1-23, at § 23.04 (2006). *But see* Appeal of Raytheon Company 88-3 B.C.A. (CCH) P20,899 (ASBCA 1988) (allowing contractor to include the costs for an unused and undeveloped tract of land in their FCCOM calculations); Appeal of Gould Defense Systems, Inc. 84-3 B.C.A. (CCH) P17,666 (ASBCA 1984) (allowing inclusion of goodwill in the investment base for purposes of calculating FCCOM, so long as the goodwill was correctly amortized under a legitimate amortization policy).

[34]*See* 48 C.F.R. § 9904.414-50(c)(3) (2007).

[35]This data subset comes from DCAA, *Contract Audit Manual* § 8-414.2(a), (Aug. 26, 2006) which lists the semiannual cost of money rates from years 1982 through 2006.

[36]*See* Wright & Bedingfield, *supra* note 1. Also, the rate is available from the Treasury's website at www.fms.treas.gov/prompt/rates.html.

[37]*See* 48 C.F.R. § 9904.414-50(c)(1) (2007).

[38]*See* DCAA, *Contract Audit Manual* § 8-414.1, (Aug. 26, 2006) ("The cost of money is an imputed cost which is identified with the total facilities capital associated with each indirect cost pool, and is allocated to contracts over the same base used to allocate the other expenses included in the cost pool.").

[39]*See* 48 C.F.R. § 9904.414-60 (2007); Form CASB CMF, fast.faa.gov/docs/forms/Temp32.doc (last visited Jan. 19, 2008).

[40]41 U.S.C. § 422(f)(1) (2000). The 1972 amendment to the Defense Production Act can be found at 91 P.L. 379, 84 Stat. 796.

cost. After the adoption of CAS 414 however, the limits on contactor profit margins remained the same[41] and a mechanism to constructively increase profit was born.

Until September 1997, contractors could constructively increase profit by billing the government for the FCCOM subsidy.[42] The contractor essentially received money for a non-incurred cost that was separate from the negotiated profit amount. This can be illustrated by looking at a contractor's effective profit before and after the adoption of CAS 414.

Consider a contractor that in January 1997 invested $100 in facilities for an ongoing federal contract and charged the maximum fee of 10%.[43] Before CAS 414, this contractor would have received from the government a payment of $110. Any return on the facility investment would have been a component of the $10 in profit received by the contractor. After the adoption of CAS 414 however, this contractor would have received $100 for the facility overhead costs, $10 in profit, and $6.38 in FCCOM subsidy (using the January 1997 Treasury rate of 6.38%). Even though the contractor only incurred $100 in costs and charged a 10% fee, the combination of applied fee and FCCOM produced an "effective fee" of 16.38%. Through FCCOM, the contractor received an effective fee that was higher than the actual fee allowed by law.

It is important to note that the above scenario involved a contractor only billing for facility overhead. This was done to show the pre-September 1997 impact FCCOM had on federal contracts that included charges for facilities. The impact of FCCOM to constructively increase profit diminished when the ratio of facility costs to other contract costs was reduced. For example, the effect of FCCOM on a contractor that charged 10% fee on a contract that consisted of $1,000,000 in labor and $1,000 in facilities would have been almost undetectable.[44]

For contracts composed of mostly facility costs however, without a commensurate reduction on the contractor's proposed fee percentage, contractors could turn a higher effective profit by billing for FCCOM. Despite the CASB's lack of authority to adjust profit levels, through CAS 414 a constructive increase in profit was enacted.

The tax loophole is slightly more complex and still remains a viable tax strategy.[45] During its publication in the *Federal Register*, no mention was made concerning the tax treatment of FCCOM. The tax code also does not specifically address FCCOM, but through the interplay of two sections of the code, contractors are free to deduct the FCCOM subsidy.

Section 162 allows businesses and individuals to deduct the ordinary and necessary business expenses incurred in a trade or business.[46] Even though the CASB has designated FCCOM as a cost, because of its subsidy-like nature it would seem almost overly aggressive for a contractor to deduct it under § 162 without the code specifically designating FCCOM as a cost or business expense as well.

Recognition of FCCOM as a business expense comes from § 460. This section, which lists special rules for long-term contracts and covers allocating costs to a contract, seems to let FCCOM slip through as a cost:

> (c) Allocation of costs to contract
> (1) Direct and certain indirect costs
> In the case of a long-term contract, all costs (including research and experimental costs) which directly benefit, or are incurred by reason of, the long-term contract activities of the taxpayer shall be allocated to such contract in the same manner as costs are allocated to extended period long-term contracts under section 451 and the regulations thereunder.
> (2) Costs identified under cost-plus and certain Federal contracts
> In the case of a cost-plus long-term contract or a Federal long-term contract, any cost not allocated to such contract under paragraph (1) shall be allo-

[41]*See supra* note 2.

[42]This profit expanding attribute of FCCOM was nullified by the agencies that manage the FAR in 1997. How this was accomplished is discussed in the next section.

[43]Generally, contractors are capped at charging a fee of 10% per 10 U.S.C. § 2306(d) (2000). The FAR allows higher fee percentages when the contractor assumes more contract risk. *See supra* note 2. Fee percentages are applied to total contract cost. For example, a contractor bidding a 10% fee on a contract with a total cost of $100 would bid a price of $110.

[44]Before CAS 414, the contractor in this example would earn $100,100 in fee (10% of total cost). After adoption of CAS 414 and assuming the January 1997 Treasury rate of 6.38%, FCCOM would have increased the effective fee from 10% to only 10.006374%. Because FCCOM only applies to facility costs, the less facility costs made up the total contract cost, the less impact FCCOM would have on total profit.

[45]How the tax loophole has remained intact is discussed further in this article.

[46]*See* I.R.C. § 162(a) (2000); Treas. Reg. § 1.162-1 (2007); Boris I. Bittker & James S. Eustice, Federal Income Taxation of Corporations and Shareholders P 5.03[1] (7th ed. 2006).

> cated to such contract if such cost is identified by the taxpayer (or a related person), pursuant to the contract **or Federal, State, or local law or regulation, as being attributable to such contract.**[47]

Paragraph (1) of this subsection directs taxpayers how to allocate certain incurred costs under a long-term contract.[48] Generally a long-term contract is any contract for the building, installation, or construction of property where the contract is not completed within the tax year in which it is entered into.[49] Paragraph (2) is more pertinent however as it pertains to federal contracts and its broad language provides contractors the means with which to deduct FCCOM.[50]

At first glance, this paragraph seems merely to provide accounting allocation instructions like paragraph (1). Of crucial significance is that the paragraph relies on federal, state, and local regulations to state what costs can and cannot be attributable to a contract. In the federal contracting world this is the FAR, and as previously mentioned, the FAR (through CAS 414) clearly states that the FCCOM subsidy is an allowable cost.[51] Through this paragraph, an amount representative of the time value of money invested in contracting facilities, a previous component of profit,[52] is free to be deducted under § 162 by federal contractors.

Notwithstanding the connection between §§ 162 and 460, I can offer no direct evidence that federal contractors are taking full advantage of this deduction. There is a dearth of case law or any other published sources on the matter which may be indicative of either contractors failing to take the deduction or IRS not challenging it. Despite the lack of judicial precedent, the next two sections of this article bring up the possibility that the deduction does indeed occur and Treasury has legitimized it.

II. GSA, NASA, and DOD Fix the Profit Loophole

In 1997, the agencies that manage the FAR (GSA, NASA, and DOD) ended FCCOM's ability to constructively increase profit by adopting an amendment that included a reduction in profit: "Before the allowability of facilities capital cost of money, this cost was included in profits or fees. Therefore, before applying profit or fee factors, the contracting officer shall exclude any facilities capital cost of money included in the cost objective amounts."[53]

The CASB, through CAS 414, had moved FCCOM from profit to cost. Through this simple and direct amendment to the FAR however, FCCOM would still be a cost but it would be at the expense of profit: the government official overseeing the bid negotiation would now simply subtract the contractor's proposed FCCOM amount from their proposed profit. The contractor that billed $6.38 in FCCOM and $10 in profit would now receive $6.38 in FCCOM subsidy and only $3.62 in profit, for a total payment of $10. In terms of profit, this is the same result as if FCCOM had never been proposed in the first place.

This amendment was adopted without change and effectively nullified the substantive benefit of FCCOM.[54] For reasons not expressed in the agencies' Federal Register publications, the agencies decided to sidestep the CASB and CAS 414 by making FCCOM a zero sum game. The only thing remaining to completely offset FCCOM was to update the tax law so that contractors would be unable to use §§ 162 and 460 to take a deduction.

III. Treasury Keeps the Tax Loophole Safe

In 1999, Treasury published proposed regulations concerning § 460 in the Federal Register and asked for

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[47] I.R.C. § 460(c) (2000) (emphasis added).

[48] This paragraph steers the taxpayer to § 451 which covers the general rules for taxable year of inclusion. For contracts entered into before March 1, 1986, accounting for long-term contracts was primarily governed by § 451, however Treas. Reg. § 1.451-3 which set forth the rules for such contracts, was removed on January 10, 2001 by T.D. 8929. Now, accounting for long-term contracts is primarily governed by Treas. Reg. § 1.460. *See* T.D. 8929, 2001-1 C.B. 756; 7 CCH Standard Federal Tax Reporter 21,009.47 (2003).

[49] *See* I.R.C. § 460(f) (2000); Treas. Reg. § 1.460-1(b)(1) (2007).

[50] A federal long-term contract is any long-term contract to which the United States (or any agency or instrumentality thereof) is a party. *See* I.R.C. § 460(d) (2000).

[51] *See supra* notes 20-28 and accompanying text.

[52] As previously mentioned, time value of money and return on facilities used to be components of a contractor's proposed profit figure. The agencies that manage the FAR have acknowledged this. *See* Federal Acquisition Regulation; Part 15 Rewrite: Contracting by Negotiation; Competitive Range Determinations, 62 Fed. Reg. 26640, 26659 (May 14, 1997) ("Before the allowability of facilities capital cost of money, this cost was included in profits or fees.").

[53] *Id.*

[54] *See* Federal Acquisition Regulation; Part 15 Rewrite: Contracting by Negotiation; Competitive Range Determinations, 62 Fed. Reg. 51224 (Sept. 30, 1997). The current regulation can be found at 48 C.F.R. § 15.404-4 (2007).

comments.[55] Included in the proposed regulations was a clause that gave special instructions for federal contracts. If Treasury was going to close the FCCOM tax loophole, this would have been a great place to do it.

> (iv) Costs identified under cost-plus long-term contracts and federal long-term contracts. To the extent not otherwise allocated to the contract under this paragraph (b), a taxpayer must allocate any identified costs to a cost-plus long-term contract or federal long-term contract (as defined in section 460(d)). Identified cost means any cost, including a charge representing the time-value of money, identified by the taxpayer or related person as being attributable to the taxpayer's cost-plus long-term contract or federal long-term contract under the terms of the contract itself or under federal, state, or local law or regulation.[56]

The language in this proposed regulation is astounding. It seems to reference FCCOM as being an actual cost through the use of the phrase "time-value of money." Keep in mind that the phrase "time-value of money" is the generic term for FCCOM used by the CASB when it originally proposed the subsidy.[57] Of all the myriad costs this regulation could have mentioned in its example of an identified cost (overhead, materials, labor, travel, general & administrative, etc.), the drafters, without explanation in the regulation, reinforced the tax loophole that had been operating for the last two decades.

After receiving eleven comments, none of which concerned FCCOM, the Treasury published the regulation as final in January of 2001.[58] The clause mentioning "time-value of money" remained unchanged.[59] Through this regulation, a non-Congressionally enacted subsidy (which no longer provided any substantive benefit) for federal contractors seems to have been expressly blessed as tax-free by the Treasury.

Although this regulation could definitely be used by a contractor arguing for a FCCOM deduction, other than the use of "time-value of money" by the CASB to refer to FCCOM, I have no direct evidence that Treasury's intention was to bolster the FCCOM tax loophole. Given that §§ 162 and 460 had not changed when this regulation was promulgated, there would seem to be no reason to bolster the still-active loophole unless it was a preemptive defensive maneuver to counter FCCOM's complete nullification after the FAR's 1997 amendment.

Regardless of Treasury's intention, the fact remains that since 1997, FCCOM has provided absolutely no benefit except a tax deduction. Currently, a contractor charging the government $100 in facility costs and 10% profit would receive $110. Under § 162 the facility costs would be deducted from income and the contractor would only pay taxes on the $10 profit figure. If the contractor decided to utilize FCCOM, the contractor would still receive $110 but would also receive a tax windfall. Assuming the December 2006 Treasury rate of 5.75%, the contractor would bill $5.75 in FCCOM which would then be deducted from the profit figure per the FAR's 1997 amendment, leaving $4.25 in profit. The facility costs of $100 would be deducted as before but in conjunction with § 460, the FCCOM amount of $5.75 could also be deducted, leaving a taxable income of only $4.25. The same amount of revenue is received by the contractor but the tax burden is decreased for every dollar of FCCOM billed.

IV. Finding FCCOM: The Worst Case Scenario

The amount of FCCOM the government has paid to contractors can be estimated firm by firm from annual report data. In order to illustrate FCCOM's possible impact, I selected a sample of 52 federal contractors to estimate a worst-case-scenario of forgone tax revenue from the FCCOM tax loophole. The sample was comprised of firms listed on *Washington Technology*'s 2005 Top 100 Federal Prime Contractors list.[60] Data was gathered from Form 10-K's and as a result, private firms, firms not first incorporated in the

LOOPHOLE *continued on page 31*

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[55]*See* Accounting for Long-Term Contracts, 64 Fed. Reg. 24096 (May 5, 1999).

[56]*Id.* at 24100 (emphasis added).

[57]*See supra* note 11 and accompanying text.

[58]*See* Accounting for Long-Term Contracts, 66 Fed. Reg. 2219 (Jan. 11, 2001). The final publication briefly addressed several comments received, but no mention was made of FCCOM or "time-value of money." This was verified through a FOIA request for the eleven comments. The current regulation can be found at Treas. Reg. § 1.460-5 (2007).

[59]*See* Treas. Reg. § 1.460-5(b)(2)(iv) (2007).

[60]*See* www.washingtontechnology.com/top-100/2005/. A prime contractor is a firm which has directly contracted, as opposed to subcontracting under another firm, with the federal government. *See generally Commissioner v. Aluminum Co. of*

Sunset Provisions in the Tax Code: A Critical Evaluation and Prescriptions for the Future

Manoj Viswanathan

In this Note I argue that sunset provisions associated with tax bills are, in their current form, the product of political maneuvering designed to bypass budgetary constraints, and serve as a façade covering attempts to enact permanent legislation. The use of sunsets in this manner has lead to considerable uncertainty regarding the future existence of their associated tax provisions. This uncertainty, in turn, has created opportunities for legislators to extract rents from lobbyists, generated inefficiencies for both taxpayers and the government, and increased overall tax code complexity. These problems can be minimized, however, if sunsets are used in a more principled manner. This note argues that sunset clauses in tax legislation can be made more efficient by limiting both the occasions in which sunsets are employed as well as the procedures used to implement them. First, sunsets should only be used in conjunction with certain kinds of tax incentives: the incentives should be simple, of limited duration, and provide diffuse rather than concentrated benefits. Second, sunsets should only be implemented thorough a limited set of Congressional budgetary procedures. Specifically, sunsets should only be included as part of the reconciliation process for enacting fiscal legislation if the underlying bill increases rather than decreases revenue, and if Congress enacts and adheres to a revenue-neutral, pay-as-you-go set of budgetary rules. These changes, both substantive and procedural, will increase overall efficiency in the use of sunset provisions in tax legislation.

Introduction

Sunset provisions, seldom used prior to 2000, have become increasingly frequent addendums to modern tax legislation. A "sunsetting" tax law is in effect for a specified period of time, most commonly ten years or less, after which the law simply expires. The majority of the tax cuts enacted in 2001, 2002, and 2003 will expire before 2011. Proponents of sunset clauses claim that their temporary nature forces legislatures to periodically consider the efficacy of their legislation, leading to increased governmental efficiency. Opponents argue that sunsets are merely a ruse used by the majority party to minimize the estimated costs of tax-reducing legislation. Although there has been some discussion about the George W. Bush administration's use of sunsets as applied to specific provisions of the 2001, 2002, and 2003 tax cuts,[1] there has been little discussion of the pros and cons of the use of sunsets generally. Other articles have discussed the historical development of sunset provisions as evidence of their shortcomings,[2] but have not discussed methods by which the advantages of sunsets can be maximized while minimizing the costs. This Note addresses this scholarly gap by providing this analysis.

In this Note, I argue that sunset provisions used in tax legislation are the product of political manuevering designed to bypass budgetary constraints, and are nothing more than a façade covering attempts to enact permanent legislation. As currently used, sunset provisions create great uncertainty as to the future existence or repeal of the associated tax provisions, providing opportunites for legislators to extract rents from lobbyists, generating inefficiencies for both taxpayers and the government, and increasing overall tax code complexity. I also argue that

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[1]William G. Gale & Peter R. Orszag, *An Economic Assessment of Tax Policy in the Bush Administration, 2001–2004*, 45 B.C. L. Rev. 1157 (2004) [hereinafter Gale & Orszag, *Economic Assessment*] (analyzing economic effects and repercussions of most recent tax cuts); William G. Gale & Peter R. Orszag, *Sunsets in the Tax Code*, 99 Tax Notes 1553 (2003) [hereinafter Gale & Orszag, *Sunsets*] (giving rough overview of estimated cost of current sunsets in tax code); *see generally* Cheryl D. Block, *Pathologies at the Intersection of the Budget and Tax Legislative Processes*, 43 B.C. L. Rev. 863 (2002) (evaluating political gimmickry associated with budget rules); Rebecca M. Kysar, *The Sun Also Rises: The Political Economy of Sunset Provisions in the Tax Code*, 40 Ga. L. Rev. 335 (2006) (evaluating sunset provisions through case studies rather than lens of effective tax policy).

[2]*See, e.g.*, Michael W. Evans, *The Budget Process and the "Sunset" Provision of the 2001 Tax Law*, 99 Tax Notes 405, 406–07 (2003) (detailing legislative history behind the use of sunsets in taxation legislation); Richard C. Kearney, *Sunset: A Survey and Analysis of the State Experience*, 50 Pub. Admin. Rev. 49, 50–51 (1999) (collecting data about efficiency of state-run sunset programs to increase agency oversight); Chris Mooney, *A Short History of Sunsets?*, Legal Aff., Feb. 2004, at 67 (describing shortcomings of George W. Bush's sunset legislation); Dan R. Price, *Sunset Legislation in the United States*, 30 Baylor L. Rev. 401, 403 (1978) (giving overview of early state-adopted sunset provisions).

it is possible to use sunset clauses to create temporary tax incentives that stimulate short-term economic growth. However, these tax incentives should be of limited duration, be simple enough not to significantly increase complexity with their short life, and provide diffuse rather than concentrated benefits. Lastly, I argue that sunsets will be used more efficiently if the reconciliation process for enacting fiscal legislation is only used for revenue increases rather than revenue decreases, and if Congress enacts and adheres to a revenue-netural, pay-as-you-go set of budgetary rules.

Part I of this Note begins with a brief history of the use of sunset clauses in legislation generally, and then describes the developments in legislative procedure that resulted in the recent proliferation of sunsetting tax provisions. The historical and legislative background of sunsets indicates that the recent proliferation of sunsets in tax legislation was not motivated by reasoned tax policy, but rather by a desire to finesse budget rules and mask the cost of extensive tax cuts. Part II analyzes whether sunsets can be used in conjunction with tax legislation to create sound tax policy. This analysis evaluates the efficiency and complexity of sunsets and concludes that sunset provisions attached to tax cuts, as opposed to tax increases, are more susceptible to interest group capture and economic inefficiency. Attaching sunset provisions to tax increases still raises compliance and complexity issues, but these concerns are not as severe as those associated with tax cuts. Sunsets in their current form, I argue, are an irresponsible form of tax legislation, and should be modified to minimize inefficiency and compliance costs. Part III considers how to ensure that sunset provisions are only used when their benefits outweigh the costs caused by their uncertainty and susceptibility to interest group capture.

I. Historical Background on Use of Sunset Provisions in Tax Legislation

The modern concept of sunsetting originated from the idealistic political reform movement of the 1970s, which sought to reform an American government considered bloated, inefficient, and beholden to special interests.[3] In order to catalyze legislative oversight, political theorist Theodore Lowi suggested in 1969 that every law creating federal agencies be subject to a time limit.[4] Lowi believed that federal agencies frequently catered to interests established as a result of extensive lobbying, thereby undermining the democratic process.[5] Lowi proposed a five- to ten-year limit on the life of all congressional acts, hypothesizing that as the sunset approached, the pressure of legislative review would diminish the effect of interest group politicking.[6]

The George W. Bush administration made extensive use of sunsets in enacting legislation subsequent to the September 11 attacks. Responding to national sentiment to combat terrorist activity, Congress passed the USA PATRIOT Act.[7] The provisions of the Patriot Act that increased government power to search, detain, and investigate possible terrorists, were scheduled to sunset after four years.[8] The explanation for the sunset was that the Patriot Act was emergency legislation, and therefore should be repealed when the danger was no longer imminent.[9] However, many academics doubted such a sunset would ever occur. As presciently stated in 2003 by scholar John Finn, few legislators would support the elimination of any previously enacted national security measures.[10] Finn's comments proved to be well-founded; the major provisions of the Patriot Act were overwhelmingly renewed by the Senate,[11] approved by more than a two-thirds majority of the House,[12] and affirmed by President Bush on March 09, 2006,[13] making several of measures permanent law.

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[3]Mooney, *supra* note 2, at 67–68.

[4]*See* Theodore J. Lowi, The End of Liberalism: Ideology, Policy, and the Crisis of Public Authority 309 (1969) (recommending use of sunset provisions); *see also* Melissa J. Mitchell, *Cleaning Out the Closet: Using Sunset Provisions to Clean Up Cluttered Criminal Codes*, 54 Emory L.J. 1671, 1696–97 (2005) (giving brief overview of history of sunset provisions in America).

[5]*See* Lowi, *supra* note 4, at 287.

[6]Kysar, *supra* note 1, at 351–52 (summarizing Lowi's key points).

[7]Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT) Act of 2001, Pub. L. No. 107-56, 115 Stat. 272.

[8]Sean D. Murphy, *Contemporary Practice of the United States Relating to International Law*, 96 Am. J. Int'l. L. 237, 253 (2002).

[9]Rosa Ehrenreich Brooks, *War Everywhere: Rights, National Security Law, and the Law of Armed Conflict in the Age of Terror*, 153 U. Pa. L. Rev. 675, 696 (2004).

[10]*See* Mooney, *supra* note 2, at 70.

[11]Sheryl Gay Stolberg, *Senate Passes Legislation to Renew Patriot Act*, N.Y. Times, Mar. 3, 2006, at A14. The Senate voted 89 to 10 in favor of renewal.

[12]Sheryl Gay Stolberg, *Patriot Act Revisions Pass House, Sending Measure to President*, N.Y. Times, Mar. 8, 2006, at A20. The bill passed 280 to 138.

[13]*Bush Celebrates a Victory, Though Not an Easy One*, N.Y. Times, Mar. 10, 2006, at A16.

Sunsets did not play a major role in tax legislation until 2001, when the Bush administration made extensive use of sunset provisions while drafting the Economic Growth and Tax Reconciliation Act of 2001[14] (commonly known as the EGTRRA). The history behind the inclusion of sunset provisions in the EGTRRA as well as the follow-up tax cuts in 2002[15] and 2003[16] is discussed in the following section.

A. *Previous Uses of Sunset Clauses in Tax Legislation*

Prior to the Bush administration, sunset clauses in the tax code applied to a relatively minor set of tax provisions known collectively as "the extenders." These ostensibly temporary provisions include the targeted jobs credit, the exclusion for employer provided educational assistance, and the orphan drug credit.[17] One of the most well-known extenders is the research and development credit, which reduces taxes by up to 20% of qualified research expenses.[18] Despite the bipartisan support for the majority of these provisions, they are periodically extended rather than made permanent.[19] Two reasons prevent the extender tax credits from becoming permanent provisions. First, calling the provisions temporary reduces revenue loss estimates for their enactment. In the 1990s, legislators were compelled to follow pay-as-you-go, or PAYGO, rules with respect to satisfying budget requirements.[20] These rules required revenue offsets, i.e., revenue neutrality, within the specified budget window for every new tax cut.[21] Tax cuts enacted for a short period of time demand less severe offsetting revenues,[22] making them easier to fit within a specified budget. Second, uncertainty in the extender renewal process creates uncertainty in the legislative process, benefiting both lobbyists whose clients retain their services and legislators who can use the uncertainty to extract rents. Given the presumption against permanent tax breaks created by the budget rules, interest groups are willing to engage in extensive lobbying to maximize the chances that their pet extender gets renewed.[23] Tax lobbyists "thrive on confusion and uncertainty"[24] and those benefits ultimately are shared with the lawmakers.

The narrow focus of extenders helps to explain why they continue to be temporary provisions continually renewed rather than permanent legislation. Since they affect specific niche areas, interest group efforts are likely to coalesce in support of their renewal. In 2001, with the passage of the EGTRRA, sunsets became an integral component of not just the extender provisions, but of general tax legislation. Many key provisions of EGTRRA are set to sunset in 2010, meaning that these tax laws will revert to pre-passage conditions in 2011.[25] The EGTRRA sunsets, however, serve different purposes than the sunsets in the extender provisions. The next section describes the unique procedural rules that govern most tax bills and concludes that sunset provisions are a response to those procedural rules.

B. *The Congressional Budget Act of 1974*

The Congressional Budget Act of 1974[26] created procedural restrictions on how Congress was to consider bills and amendments with fiscal consequences.[27] The Act established procedures for how Congress is to generate

[14] Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38 (codified as amended in scattered sections of 26 U.S.C.).

[15] Job Creation and Worker Assistance Act of 2002, Pub. L. No. 107-147, 116 Stat. 21 (codified as amended in scattered sections of 26 U.S.C.).

[16] Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, 117 Stat. 752 (codified as amended in scattered sections of 26 U.S.C.).

[17] Pat Jones, *Week in Review: New Day May Dawn for Sunset Tax*, 66 Tax Notes 1587, 1587 (1995).

[18] Kysar, *supra* note 1, at 358. *See also* I.R.C. § 41 (2000).

[19] Julie Hirschfield Davis, *"Temporary" Breaks Keep Tax Writers and Lobbyists in Perpetual Motion*, Cong. Q. Weekly, Feb. 2, 2002, at 293; *see* Gale & Orszag, *Sunsets*, *supra* note 1, at 1554 (stating that extenders were usually extended each time they were set to expire).

[20] PAYGO required revenue decreases to be offset by: (1) increases in revenues or (2) decreases in spending, so there would be no net increase in the deficit. John W. Lee, *Class Warfare 1988–2005 over Top Individual Income Tax Rates: Teeter-Totter from Soak-The-Rich to Robin-Hood-In-Reverse*, 2 Hastings Bus. Law. J. 47, 86 n.150 (2006) (quoting Elizabeth Garrett, *Harnessing Politics: The Dynamics of Offset Requirements in the Tax Legislative Process*, 65 U. Chi. L. Rev. 501, 514 (1998)).

[21] Stanley E. Collender, The Guide to the Federal Budget: Fiscal 1993, at 26 (1992).

[22] Kysar, *supra* note 1, at 360–61. *See also infra* notes 26–40 and accompanying text (discussing reconciliation process).

[23] *See* Jones, *supra* note 17, at 1587.

[24] *Id.* (calling uncertainty associated with extenders "music to the ears of Washington's tax lobbying community").

[25] Depending on the specific provision, some sunsets occur prior to 2010. *See, e.g.*, Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 431, 115 Stat. 38, 66 (codified as amended in scattered sections of 26 U.S.C.) ("This section shall not apply to taxable years beginning after December 31, 2005.").

[26] Pub. L. No. 93-344, 88 Stat. 297.

[27] Evans, *supra* note 2, at 406.

the framework from which substantive decisions on revenue and spending are made.[28] From this framework, known as a budget resolution, individual Senate committees make the changes in the law necessary to satisfy the specified budget. The process of making these changes is known as "reconciliation."[29]

The modern federal budget process consists of two budget "packages," one dealing with discretionary spending programs requiring annual appropriations, and another dealing with direct spending programs.[30] Tax legislation falls under the second category. Statutory rules require that the budget resolution set revenue and spending levels for the following fiscal year and at least the next four fiscal years.[31] Although Congress is required to use a budget window of at least five years, they are statutorily authorized to extend this window and have recently adopted a longer, ten-year budget.[32] This budget window takes into account total government revenues and spending. In deficit years, the budget resolution might call for an increase in revenues; in years of surplus, the resolution might authorize additional spending.[33]

The Budget Act of 1974 had a significant effect on how reconciliation legislation, the legislation implementing the budget resolution, was considered by the Senate. Typically, Senators have the right to limitlessly debate (filibuster) and amend any legislation under consideration, with debate ending only when sixty Senators are in favor of so doing.[34] As a result, for controversial measures to pass the Senate, a supermajority of sixty votes, rather than a simple majority of fifty-one votes, is required. This is especially significant when the Senate is equally or close to equally divided politically, and when discussions of partisan issues occur. If no party has a supermajority, the minority party can stifle a bill's enactment via filibuster. Additionally, Senators commonly attach unrelated amendments to bills, enabling passage of interest group legislation wholly irrelevant to the subject matter covered by the bill itself.[35] Prior to the Budget Act of 1974, Senators might include amendments to reconciliation legislation only to appease a legislator of the minority party.[36]

The Budget Act of 1974 imposed key restrictions on Senators' ability both to filibuster and to amend reconciliation legislation. First, the Act limited floor debate to twenty hours, preventing filibuster.[37] Because filibuster is not possible, a supermajority is not needed to pass reconciliation legislation, reducing the number of votes required to pass a controversial measure from sixty to fifty-one.[38] Second, the Budget Act limits fiscal legislation amendments to those that are germane.[39] Germaneness, although not specifically defined, has been characterized as imposing a more restrictive standard than simple relevancy.[40] Both of these restrictions were intended to expedite the budget-making process and improve governmental efficiency.

In the late 1970s and 1980s, the federal deficit grew at an alarming rate. The Budget Act of 1974 was enacted during what was at the time the largest deficit increase by percentage in American history.[41] Throughout the 1980s, the primary focus of the budget debate was on how to reduce the federal deficit through cutting spending and increasing taxes.[42] Most major tax bills enacted between 1980 and 1993 were reconciliation bills that increased taxes, and there was no serious criticism of using reconciliation as part of an overall strategy to reduce the deficit.[43] Given the economic climate in American politics prior to 1995, the question of whether or not legislation that was tax

[28] Block, *supra* note 1, at 872–74. Discretionary spending programs require annual appropriations which Congress debates and reauthorizes yearly, whereas direct spending programs (also known as mandatory spending) remain in effect until repealed, e.g. payments for social security. *Id* at 874.

[29] Allen Schick, Reconciliation and the Congressional Budget Process 1–8 (1981).

[30] Block, *supra* note 1, at 874.

[31] 2 U.S.C. § 632(a)(2000).

[32] Block, *supra* note 1, at 875; *see, e.g.*, H. R. Con. Res. 68, 106th Cong. (1999) (enacted).

[33] Block, *supra* note 1, at 875.

[34] *See* Standing Rules of the Senate, R. XXII, S. Doc. No. 106-15, at 16 (2000) (describing Senatorial procedural rules).

[35] Ellen Greenberg, The House and Senate Explained: The People's Guide to Congress 25 (1996) ("If the bill is about cows, the legislative rider can be about chickens.").

[36] Evans, *supra* note 2, at 406.

[37] *See* 2 U.S.C. § 641(e)(2) (2000).

[38] Evans, *supra* note 2, at 407.

[39] *See* 2 U.S.C. § 688(d)(2) (2000) ("No amendment that is not germane . . . shall be received.").

[40] Floyd M. Riddick & Alan S. Frumin, Riddick's Senate Procedure 854 (1992).

[41] According to the U.S. Treasury Department, United States debt on December 31 of 1975 was $577 billion, a 17% increase from the year before. The previous highest increase was from 1970–1971, when U.S. debt increased by 9%. U.S. Bureau of Pub. Debt, Historical Debt Outstanding – Annual 1950–2005, www.publicdebt.treas.gov/opd/opdhisto4.htm (last visited Jan. 12, 2007).

[42] Evans, *supra* note 2, at 407.

[43] *Id.*

cutting, as opposed to tax *increasing*, could be enacted via reconciliation procedures never arose.

In the mid-1990s, with the budget deficit replaced by a surplus, a sharp debate arose regarding the propriety of implementing tax cuts (as opposed to increases) via the reconciliation process.[44] In 1996, two years after gaining control of Congress, congressional Republicans created a budget resolution that cut taxes by $796 billion over ten years, offset by equivalent spending cuts.[45] The Democratic leader, Senator Tom Daschle, raised a point of order[46] objecting to the resolution on the grounds that "enforcing deficit *reduction* . . . is the sole reason for . . . [the] vehicle we call reconciliation."[47] Daschle argued that unless reconciliation bills were limited to those that reduced the deficit, the Congressional majority could characterize its top agenda items, regardless of content, as reconciliation bills, thereby stripping the minority of its rights of unlimited debate and amendment.[48] Daschle's appeal was overruled, with the presiding officer stating unequivocally that "[i]f [Senator Daschle's] question is, can the budget resolution direct the creation of a reconciliation bill which lowers revenues, the answer is yes."[49] Although the budgetary issues of this specific legislation were resolved via the Balanced Budget Act of 1997, procedural questions remained, triggering questions about the application of the Byrd rule.[50]

C. *The Byrd Rule*

It was increasingly common in the 1980s for Senators in committees drafting reconciliation bills to include individual, special-interest provisions.[51] Such provisions did not violate the germaneness provision of the Budget Act of 1974 since they were not amendments and were not subject to filibustering. The Senate responded to this by unanimously approving the Byrd rule,[52] a point of order against extraneous[53] provisions that could only be overruled by a supermajority of sixty votes.[54] The Byrd rule was intended to prevent special-interest provisions unrelated to the budget process from getting the benefit of the streamlined reconciliation process.[55] The Byrd rule had a significant impact on how the Senate considered reconciliation bills, with invocation of the rule occurring fifty-five times between 1985 and 2003, forty-two of which were successful.[56] In addition, it likely dissuaded many Senators from proposing what were probably extraneous provisions.[57]

In 1987, the Byrd rule was amended to include subsection (E), which would be of critical importance in the tax cuts passed during the George W. Bush administration. In response to worries that some provisions in reconciliation bills would have an effect outside of the period covered by the bill, subsection (E) added another definition of "extraneous." If a provision "increases . . . net outlays, or if it decreases . . . revenues during a fiscal year after the fiscal years covered by [the] reconciliation bill," the provision would be extraneous.[58] In other words, reconciliation bill provisions were only allowed to increase spending during the budget period covered by the reconciliation bill. Subsection (E) was

[44]*See id.*

[45]*Id.*

[46]A point of order is an objection made when a member of Congress believes a Senate rule is being violated. Another member may argue against the objection. GREENBERG, *supra* note 35, at 69. The presiding officer (for the Senate, the majority leader) rules on the point of order with the help of the Senate Parliamentarian, a non-elected, bipartisan expert on Senate procedure. *See id.* at 8.

[47]142 CONG. REC. 11,938 (1996) (emphasis added).

[48]Evans, *supra* note 2, at 408.

[49]142 CONG. REC. 11,940 (1996).

[50]Evans, *supra* note 2, at 408.

[51]*Id.*

[52]131 CONG. REC. 28,698–74 (1985).

[53]2 U.S.C. § 644(b)(1) (2000). "Extraneous" was defined as meeting any of the following standards:

(A) [the provision] does not produce a change in outlays or revenues . . . ;

(B) [in the case of a provision that increases outlays or decreases revenues] the net effect of provisions reported by the committee . . . is that the committee fails to achieve its reconciliation instructions;

(C) [the provision] is not in the jurisdiction of the committee with jurisdiction over [the] title . . . ;

(D) [the provision] produces changes in outlays or revenues which are merely incidental to the non-budgetary components of the provision. . . .

[54]Evans, *supra* note 2, at 409.

[55]Donald B. Tobin, *Less Is More: A Move Toward Sanity in the Budget Process*, 16 ST. LOUIS U. PUB. L. REV. 115, 132 (1996) ("In order to stop the abuse of the reconciliation process, the Senate passed the 'Byrd Rule,' which was designed to stop the Senate from considering extraneous matters on the reconciliation bill." (footnotes omitted)).

[56]ROBERT KEITH, CONG. RESEARCH SERV., THE BUDGET RECONCILIATION PROCESS: THE SENATE'S "BYRD RULE" 9 (2004), *available at* www.rules.house.gov/archives/RL30862.pdf.

[57]Evans, *supra* note 2, at 410.

[58]2 U.S.C. § 644(b)(1)(E).

seldom used, but as the economy improved and the budget deficit turned into a surplus, questions arose regarding the applicability of subsection (E) to tax cuts.

The first successful invocation of subsection (E) with respect to a tax law occurred in 1999.[59] Despite Democratic objections, the Republican Congress passed a budget resolution asking for a tax cut and instructing the House Ways and Means and Senate Finance Committees to report reconciliation legislation to effectuate its implementation.[60] The Finance Committee anticipated a Byrd rule objection, and thus added two provisions to the reconciliation bill: the first, §1501, called for sunset on the last day covered by the bill (December 31, 2009); the second, §1502, restored all the tax cuts one day later.[61] The debate regarding the applicability of the Byrd rule therefore focused on §1502. Democrats argued a literal violation, since §1502 necessarily decreased revenues outside of the budget windows.[62] Republicans, on the other hand, argued that refusal to waive the Byrd rule in this instance would create instability in the tax code.[63] Calling the provisions of the Budget Act "antiquated" and "drawn to function in an era of deficits" rather than surpluses, Republican Senator William Roth moved to waive the Byrd rule.[64] Voting occurred mostly along party lines, with three Republicans voting with forty-five Democrats, resulting in a final tally of fifty-one in favor of waiving, and forty-eight against.[65] Since sixty votes were required to waive the Byrd rule, § 1502 was stricken. Although the 1999 tax bill was eventually vetoed,[66] the precedent establishing the Byrd rule's application to tax cutting reconciliation legislation had been set, and the use of sunsets with general tax cutting legislation emerged.

In summary, the 1995 combination of a deficit surplus and a politically divided Congress catalyzed Senate Republicans to propose promulgating tax-cutting legislation via reconciliation procedures. As a result, the Senate was forced to rule on the validity of this approach, and concluded that although the reconciliation process was an appropriate mechanism by which to enact tax cuts, subsection (E)—which renders provisions extraneous if they decrease revenues outside of the fiscal years covered by the reconciliation bill—also applied.[67] Therefore any tax cut passed through the reconciliation process must necessarily expire at the end of the fiscal period in question.

D. Putting Theory Into Practice: Sunsets in the 2001 Tax Cut

Cutting taxes was at the forefront of George W. Bush's legislative agenda.[68] However, there were still considerable objections from Democrats about the characterization of tax cuts as reconciliation legislation.[69] Such objections became even more pronounced given that the Senate was deadlocked with fifty Democrats and fifty Republicans, with Vice President Cheney breaking ties. The procedural debate over including tax cuts in reconciliation legislation escalated when Republican Senator Pete Domenici proposed an amendment instructing the Finance Committee to report a reconciliation bill that reduced the total level of revenues between fiscal years 2001 and 2011 by $1.6 trillion.[70] Against Democratic objections, including Senator Byrd's, that reconciliation legislation was not the appropriate vehicle through which to enact such major tax cuts, the Domenici amendment was approved fifty-one to forty-nine, with one Democratic defector.[71]

By that vote, the Senate had not only reaffirmed that the reconciliation process could be used to protect tax cutting legislation but, by including a sunset provision, had also implicitly acknowledged that, as a reconciliation bill, the tax cut would be subject to the Byrd rule.[72] As such, to satisfy subsection (E), proponents of the tax cut opted to sunset the bill's provisions at the end of 2010 rather than attempt to collect sixty votes to waive the Byrd rule.[73] The majority party grasped the infeasibility of garnering sixty votes for such a contentious tax cut in the politically divided Senate.

[59]The first time subsection (E) was successfully invoked in *any* legislation was in an amendment to reduce the cost of student loans, an amendment proposed by Senator Ted Kennedy. *See* 143 Cong. Rec. 12,555 (1997).

[60]H. R. Con. Res. 68, 106th Cong. §§ 104, 105 (1999) (enacted).

[61]Evans, *supra* note 2, at 411.

[62]*Id.*

[63]*See* 145 Cong. Rec. 18,172–73 (1999) (asserting that no tax relief could ever be permanent without waiver).

[64]*Id.* at 18,173.

[65]*Id.* at 18,178.

[66]Evans, *supra* note 2, at 411.

[67]*Id.* at 412.

[68]Rick Lyman, *Bush Legacy Rides on Tax Cut and School Funds*, N.Y. Times, May 23, 1999, §1, at 18.

[69]Evans, *supra* note 2, at 412.

[70]*Id.* at 412.

[71]147 Cong. Rec. 5663 (2001). The democratic defector was Senator Zell Miller.

[72]Evans, *supra* note 2, at 414.

[73]*Id.*

Several of the protections given to the 2001 tax cut because of its status as reconciliation legislation had significant impact. Although conjectures about a counterfactual world can be misleading, it is worthwhile to note how EGTRRA's characterization as a reconciliation bill affected its passage. Given that the time for debate was fixed, it is not surprising that the twenty hours allotted expired long before all the amendments had been discussed.[74] Interestingly, many amendments, including Senator Daschle's alternative tax cut bill, received more than forty votes, demonstrating that the bill's opponents might have been able to garner the votes necessary to sustain a filibuster had they been given the procedural opportunity to do so.[75] It is likely that congressional Republicans were only able to enact EGTRRA because it was passed as reconciliation legislation.

It is important to note that the sunset provisions that feature so prominently in the 2001 and subsequent tax cuts were not enacted as a consequence of reasoned tax policy principles, but were appended only to satisfy procedural requirements. Republicans desired to use the reconciliation process to protect tax cuts from the ordinary rules of limitless Senate debate. Democrats objected, arguing that if tax cuts could be characterized as reconciliation, the limitations associated with the Byrd rule applied. As a consequence, Republicans favoring the use of the reconciliation process did so knowing the tax laws must necessarily sunset for the laws to be Byrd rule-compliant. Whether or not sunsetting tax laws are or can be sound tax policy is the major focus of this Note, and is discussed at length in Part II.

II. Evaluating Sunset Provisions in Tax Legislation

The three traditional criteria for evaluating tax laws are equity, efficiency, and simplicity.[76] These factors are not independent criteria and have some level of interconnectedness; however, it is still helpful to consider each criterion individually. Equity refers to the general principle that those with a greater ability to pay should pay more, and those with identical abilities to pay should pay equally.[77] If two taxpayers are identically situated except for the fact that taxpayer A has twice the income of taxpayer B, equity demands that taxpayer B should not pay more taxes than taxpayer A. But how much more taxpayer A should pay is informed by personal philosophies of fairness, personhood rights, and economic autonomy. Although equity is an important consideration, especially for evaluating distributional effects and consequences of a particular tax, it is better suited to analyzing specific provisions of tax laws rather than the general forms that these tax laws might take. Since a sunset is the latter, this Note will focus on evaluating sunsets vis-à-vis efficiency and simplicity.

In its simplest form, the efficiency criterion requires that a tax interfere with economic behavior as little as possible.[78] Thus, under a completely efficient system of taxation a taxpayer's behavior would be identical to that of a perfectly functioning market. Many taxes are enacted with the express purpose of changing behavior;[79] however, this is arguably done to correct for an imperfectly functioning market. For example, a tax on cigarettes might lower cigarette consumption to its socially optimal level, given that detriment to public health, dangers of second-hand smoke, and other negative externalities are not being taken into account.

Evaluating the simplicity of a tax provision is equivalent to evaluating its complexity. This is not necessarily separate from equity and efficiency concerns.[80] If a tax law is difficult to understand, it will require spending time and money to ensure compliance. This raises equity concerns due to the increased ability of those with money to manage their assets to minimize tax liability. Generally, complexity is divided into three categories: rule, compliance, and transactional complexity.[81] Rule complexity refers to the problems of understanding and interpreting the law, including statutes, administrative

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[74] *Id.*

[75] *Id.*

[76] *See* Michael J. Graetz & Deborah H. Schenk, Federal Income Taxation 27–31 (5th ed. 2005).

[77] Susan Pace Hamill, *An Argument for Tax Reform Based on Judeo-Christian Ethics*, 54 Ala. L. Rev. 1, 7 (2002) (defining vertical and horizontal equity in reference to tax policy).

[78] Graetz & Schenk, *supra* note 76, at 27. Graetz and Schenk note that this definition is somewhat nonsensical, since society needs government to function, and government must somehow be funded. However, "under certain idealized circumstances, a market allocation yields maximum total consumer satisfaction, given a distribution of wealth." *Id.*

[79] *See, e.g.*, David J. DePippo, *I'll Take My Sin Taxes Unwrapped and Maximized, with a Side of Inelasticity, Please*, 36 U. Rich. L. Rev. 543, 545–49 (2002) (discussing history of "sin taxes").

[80] James Alm, *What Is an Optimal Tax System?*, *in* Tax Policy in the Real World 371 (Joel Slemrod ed., 1999).

[81] Graetz & Schenk, *supra* note 76, at 30–31.

rulings, and case law.[82] Compliance complexity refers to the complexity involved with complying with the law: keeping records, filling out forms, and the government expenditure required to administer the law.[83] Transactional complexity deals with the difficulty arising from taxpayers structuring their transactions to minimize tax liability.[84] To the extent that these transactions are performed merely to reduce tax burdens, they are also inefficient, since resources expended on conducting those transactions could be put to more socially beneficial uses.

The uncertainty associated with sunset provisions make them susceptible to criticisms on both efficiency and simplicity grounds, regardless of the tax law they happen to be sunsetting. A discussion of the specific characteristics of sunset provisions that create inefficiency and complexity follows.

A. *Efficiency Concerns with Uncertainty in the Continued Existence of a Sunsetting Provision*

Any law enacted by Congress has some probability of getting overturned; however, this baseline probability of statute repeal is fairly low.[85] This is especially true of tax cuts. Many of today's costliest tax breaks were relatively insignificant when first enacted. For example, current law excludes employer provided health care from an employee's gross income.[86] This exclusion is estimated to cost the United States government $90.6 billion in lost revenue in 2006;[87] in 1967 the exclusion cost $6.64 billion in inflation adjusted dollars.[88] The deduction for interest paid on home mortgages is similar: The corresponding revenue lost in 1967 was $12.62 billion in inflation adjusted dollars;[89] in 2006, $69.4 billion.[90] Given the enormous cost of these provisions, one would expect Congress to reassess whether or not they are sound tax policy. But because American taxpayers consider these tax cuts to be entitlements,[91] Congress doesn't dare. Therefore, it is reasonable to assume that any tax cut in existence for more than a few years, especially one benefiting many taxpayers, becomes exceedingly difficult to revise.

Tax cuts without sunset provisions attached are likely to live on untouched, as Calabresi noted,[92] whereas there is less certainty associated with the continued existence of sunsetting provisions. As illustrated from the continual renewal of the extender tax provisions,[93] these laws are frequently the subject of interest group politicking and therefore get revised much more frequently. The 2001 and 2003 tax cuts were sunsetted to ensure passage of the tax cut—the sunsets were a "means to an end."[94] Indeed, soon after each tax cut was enacted, Republican leaders, along with President Bush, began clamoring to repeal the sunsets.[95]

Sunsets in tax legislation are frequently repealed, i.e., the provision never sunsets, making it difficult for taxpayers to arrange their financial affairs. A simplified example illustrates this point.[96] Assume a recently enacted tax cut decreases the top marginal tax rate from 60% to 40% in year 1, but at the end of year 10, sunsets back to the original rate of 60%. Let Annie be a New York City resident with an adjusted gross income of $100,000 who, after spending annual fixed costs on food, housing, et cetera, derives maximal utility from her post-tax dollars by funding her

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[82]*Id.* at 30 (quoting Adam Smith: "The tax which each individual is bound to pay ought to be certain, and not arbitrary. The time of payment, the manner of payment, and the quantity to be paid ought to be clear and plain to the contributor, and to every other person.").

[83]*Id.*

[84]*Id.* at 31.

[85]As stated by Judge Guido Calabresi, "getting a statute enacted is much easier than getting it revised." Guido Calabresi, A Common Law for the Age of Statutes 6 (1982).

[86]I.R.C. § 106 (2000 & Supp. III 2003).

[87]Joint Comm. on Taxation, 109th Cong., Estimates of Federal Tax Expenditures for Fiscal Years 2006–2010, at 39 tbl.1 (2006) [hereinafter Federal Tax Expenditures].

[88]Cong. Budget Office, Tax Expenditures: Current Issues and Five-Year Budget Projections for Fiscal Years 1982–1987, at 26 (1981). These numbers are in inflation-adjusted 2006 dollars. The number cited by the census is $1.1 billion, which equates to $6.64 billion today. *See* Bureau of Labor Statistics, U.S. Dep't of Labor, Consumer Price Index, ftp://ftp.bls.gov/pub/special.requests/cpi/cpiai.txt (last visited Jan. 30, 2007) (noting that by comparing average CPI indexes, $1 in 1967 is worth $6.04 today).

[89]Cong. Budget Office, *supra* note 88, at 18. $1.9 billion in 1967 dollars equates to $12.62 billion today. *See* U.S. Dep't of Labor, *supra* note 88.

[90]Federal Tax Expenditures, *supra* note 87, at 33 tbl.1.

[91]For a discussion of how tax benefits transition from windfalls to entitlements, *see infra* notes 120–126 and accompanying text.

[92]*See supra* note 85 and accompanying text.

[93]*See supra* notes 17–25 and accompanying text.

[94]Mooney, *supra* note 2, at 71.

[95]*Id.* ("Before the ink was dry, the supporters of the bill were calling for [the tax cuts] to be made permanent.").

[96]For the purposes of this example, assume that the top marginal tax rate applies to all of Annie's adjusted gross income (AGI), inflation is negligible, money borrowed can be repaid in year 12 with no interest, tuition costs are time invariant, and that once enrolled Annie's daughter cannot transfer schools.

daughter's private education. In year 1, her daughter is to enroll in first grade. Letting Annie's annual fixed costs be $30,000, in years 1 through 10, when the lower marginal tax rate is in effect, Annie will have $30,000 to spend on her daughter's tuition.[97] In years 11 and 12, when the tax rate will revert to 60%, Annie will have only $10,000 to spend.[98] In total, Annie will then have $320,000 to spend on twelve years of tuition,[99] allowing her to afford a school charging approximately $26,700 in annual tuition.[100]

The preceding calculations assume that the tax cut will indeed be repealed at the end of year 10. On the other hand, if Annie knows with certainty that the tax cut will be extended, i.e., a repeal of the sunset, her tax rate will not change between years 10 and 11, and she will have $360,000 total, or $30,000 a year, to spend on her daughter's tuition.[101] However, taxpayers are unlikely to know the probability of the sunset occurring. While an extension of the tax cut is possible, it is by no means a certainty. Similarly, it is not certain that the tax cut will indeed sunset. This uncertainty has the consequence of creating inefficient outcomes. If Annie is risk averse and assumes that the tax cut will indeed sunset at the end of year 10, she will have $40,000[102] that she wishes she could have spent on her daughter's education that will be inefficiently allocated.

It is worthwhile to note that the inefficiency illustrated in the preceding example of a sunsetting tax provision is independent of the change in law affected by the sunset. This inefficiency is not created by the law itself, but rather by the uncertainty in the future existence of the law. If Annie knew with 100% certainty that the sunset would go into effect as enacted, the result would be an efficient allocation of all her $320,000 in available money. If Annie knew with 100% certainty that the sunset would be repealed, the result would still be an efficient allocation of all her available money (in this scenario, $360,000). When the future of the law is uncertain, however, there exists the possibility that Annie will either allocate too little or too much for her daughter's tuition.

B. The Transitory Nature of Sunsetting Tax Laws

The previous section dealt with the inefficiencies associated with enacting an ostensibly temporary tax provision whose renewal was uncertain. That analysis focused on the uncertainty of renewal as opposed to the temporary nature of the provision itself. Although uncertainty in the status of renewal is problematic, so too are provisions intended to be in effect for a limited duration. This section considers problems linked to temporary tax provisions generally, independent of the uncertainty accompanying the provision's renewal or repeal.

Even if a tax cut is intended to be in effect for only a short period of time, it is politically challenging to allow the cut to expire. Although a temporary measure might be justified, e.g., as catalyzing economic growth in a particular area, such a provision will invariably result in disgruntled taxpayers lamenting the end of the tax cut from which they benefited. A tax cut that was originally perceived as a windfall becomes an entitlement.[103] Although the tax cut might have outlived its usefulness, in the minds of taxpayers its repeal becomes a tax increase rather than a return to the status quo. Politicians will therefore be wary of repealing the tax cut, even though that might be optimal tax policy. As a result, inefficiencies are created.

Many factors contribute to the transformation of tax cuts from government conferred benefits to personal entitlements. It is understandable how some government benefits became perceived more as rights than privileges.[104] But some government benefits, such as the home mortgage interest deduction, are perceived as fundamental rights for no reason other than that they have been benefits for long periods of time.[105] The reason for this is that people do not treat out of pocket costs and opportunity costs equivalently.[106] People are especially averse to losses,

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[97] An AGI of $100,000 with a tax rate of 40% leaves $60,000 in post-tax dollars. Since Annie has $30,000 in annual fixed costs, she has $60,000 – $30,000 = $30,000 left to spend on her daughter's tuition.

[98] An AGI of $100,000 with a tax rate of 60% leaves $40,000 in post-tax dollars. Since Annie has $30,000 in annual fixed costs, she has $40,000 – $30,000 = $10,000 left to spend on her daughter's tuition.

[99] (10 × $30,000) + (2 × $10,000) = $320,000.

[100] $320,000 ÷ 12 ≈ $26,700.

[101] $360,000 ÷ 12 = $30,000.

[102] Her tax rate will remain at 40%, giving her $30,000 instead of $10,000 in after tax dollars. Since she will have this rate for two years, she will have ($30,000 – $10,000) × 2 = $40,000 inefficiently allocated.

[103] *See infra* notes 120–126 and accompanying text.

[104] *See Goldberg v. Kelly*, 397 U.S. 254, 261 (1970) (holding that in order to satisfy due process requirements, fair hearing must be given prior to termination of welfare benefits). *But see Mathews v. Eldridge*, 424 U.S. 319, 349 (1976) (holding that fair hearing need not be given in terminating disability payments).

[105] *See infra* notes 120–126 and accompanying text.

[106] Cass R. Sunstein, *Behavioral Analysis of Law*, 64 U. Chi. L.

meaning they value items already in their possession more than they would value an equivalent item *not* in their possession. According to research by Kahneman, et al., people are twice as bothered by economic loss as they are pleased with an equivalent economic gain.[107] A taxpayer is not necessarily a rational actor when appraising the value of certain tax benefits. As a result, the public might exert unjustified pressure on legislators to maintain wasteful tax breaks where that benefit could potentially be conferred in more efficient ways.

The impact of treating a tax cut as an entitlement rather than as a windfall is apparent when considering the dramatic increase of revenues lost due to tax expenditures. Tax expenditures are tax breaks enacted to encourage specific activities that the government has, for one reason or another, seen fit to subsidize.[108] Some well known tax expenditures have already been mentioned, including the exclusion of employer provided health care and the deduction for interest paid on home mortgages.[109] Although most tax expenditures are not enacted to be temporary measures, the growth in cost from inception far exceeds original estimates and should, one might expect, invite reconsideration of their existence. The deductions for employer-provided health care and interest paid on home mortgages have grown increasingly costly,[110] but there have been no serious attempts to repeal them. This is because once the tax expenditure begins to benefit more taxpayers, it becomes more difficult to repeal. The largest tax expenditures have experienced the most rapid growth, implying that once they "reach some threshold size they become less vulnerable to cutbacks."[111] Temporary tax cuts are susceptible to the same ossification into entitlements[112] that plague tax expenditures. In a sense, a positive feedback system results: the more costly a tax expenditure becomes, the more difficult it becomes politically to advocate for its repeal. Rather than *more* scrutiny, the most expensive tax cuts receive less.

This is in contrast to direct spending institutions, where increased expenditures result in increased scrutiny from the public.[113] Usually there exists one or more governmental institutions which have the same general goal as the one supported by the tax expenditure. For example, the Department of Housing and Urban Development (HUD) promotes goals similar to the home mortgage interest deduction,[114] and the Department of Health and Human Services (DHHS) promotes goals similar to the exclusion of employer provided health benefits.[115] HUD's 2007 budget is $33.5 billion,[116] roughly one-third the total of the cost of the home mortgage interest deduction. These institutions and their programs, funded by direct allocation of funds from the federal budget, employ inspectors general who investigate allegations of wrongdoing, provide regular audits even in the absence of wrongdoing, and make recommendations to agency heads on how to restructure government programs to increase efficiency and accountability.[117] In addition, government institutions are frequently discussed in the popular media, giving them an additional level of public scrutiny.[118] In

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Rev. 1175, 1179 (1997).

[107]Daniel Kahneman et al., *Experimental Tests of the Endowment Effect and the Coase Theorem*, 98 J. Pol. Econ, 1325, 1338–39 (1990).

[108]*See* Stanley S. Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 Harv. L. Rev. 705, 706 (1970) (defining tax expenditures as "provisions of the federal income tax system which represent government expenditures made . . . to achieve various social and economic objectives").

[109]*See supra* notes 86–90 and accompanying text. Tax expenditures are not limited to individuals. Many expenditures, such as the R&D credit and the tax credit for orphan drug research, are directed at corporations. *See* Federal Tax Expenditures, *supra* note 87, at 30 tbl.1 & 39 tbl.1.

[110]*See supra* notes 86–90 and accompanying text.

[111]Christopher Howard, The Hidden Welfare State 36 (1995).

[112]*See supra* notes 104–107 and accompanying text.

[113]In light of growing criticism of the Aid to Families with Dependent Children (AFDC) program, President Clinton, in his 1995 State of the Union address, promised to "end welfare as we know it." President William J. Clinton, State of the Union Address, 1 Pub. Papers 80 (Jan. 24, 1995).

[114]"HUD's mission is to increase homeownership, support community development and increase access to affordable housing free from discrimination." U.S. Dep't of Hous. & Urban Dev., HUD's Mission, www.hud.gov/library/bookshelf12/hudmission.cfm (last visited Jan. 12, 2007).

[115]DHHS "is the United States government's principal agency for protecting the health of all Americans and providing essential human services, especially for those who are least able to help themselves." U.S. Dep't of Health & Human Serv., HHS: What We Do, www.hhs.gov/about/whatwedo.html (last visited Jan. 12, 2007).

[116]U.S. Dep't of Hous. & Urban Dev., Fiscal Year 2007 Budget Summary app. A at 16 (2006), available at www.hud.gov/about/budget/fy07/fy07budget.pdf.

[117]*See* Kathleen Clark, *Toward More Ethical Government: An Inspector General for the White House*, 49 Mercer L. Rev. 553, 560 (1998) (detailing powers of inspectors general).

[118]Between December 31, 2005 and January 20, 2006, the New York Times ran 213 articles discussing either HUD or

contrast, the corresponding tax expenditure provisions, save for an annual estimate of revenue lost and a minimal amount of auditing done by the Internal Revenue Service,[119] are subject to virtually no oversight.

The factors previously discussed behind the lasting nature of popular tax expenditures imply that that temporary tax provisions have the same potential for permanence. Even though a particular tax cut might be enacted as a temporary provision, ending the benefit will become hugely unpopular politically. For example, the home mortgage interest deduction was included as part of the original 1913 income tax, but Congress did not intend the deduction to encourage home ownership,[120] but rather allowed deductions for all interest payments. By 1986, however, when the deduction for other forms of interest was disallowed via the Tax Reform Act, the home interest deduction survived.[121] Although supporters of the deduction claim owning a home is part of the American dream,[122] the rates of homeownership have changed marginally over the past forty years while the revenue loss due to the deduction has skyrocketed. In 1965 the home ownership rate was 63.4%; in 2006 it was 69%.[123] During that same time period the revenue lost due to the home mortgage interest deduction grew by a factor of 6.5.[124] Although limiting the home interest deduction makes fiscal sense,[125] few politicians would support such a repeal.[126]

C. Complexity Costs Associated with Temporary Provisions

According to Judge Learned Hand, a taxpayer has the right to "arrange his affairs [such] that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes."[127] Incorporating sunsets in tax provisions not only makes it difficult for taxpayers to structure their economic affairs to minimize liability, but increases the cost of compliance as well. President George W. Bush's Advisory Panel on Tax Reform stated that "[f]requent changes in the tax code, which often add to or undo previous policies, as well as the enactment of temporary provisions, result in uncertainty for businesses and families. This volatility is harmful to the economy and creates additional compliance costs."[128] Sunset provisions may cause rule, compliance, and transactional complexity.

Rule complexity refers to the difficulty associated

DHHS (94 and 109, respectively). I gathered this information through a Westlaw search for the following terms/phrases: (HUD or "Department of Housing and Urban Development") and (DHHS or "Department of Health and Human Services") (on file with author). During that same time period, the corresponding tax expenditures were mentioned 40 times (16 and 24, respectively). I gathered this information through a Westlaw search for the following terms/phrases: (("Home Mortgage Interest" w/4 Deduction) or (Mortgage /4 Tax /4 Expenditure) or (Mortgage /3 Deduction)) and ((Employer! /5 "Health Insurance" /5 Exclusion) or (Employer! /5 "Health Insurance" /5 Deduction)) (on file with author).

[119]In 2003, the percentage of individual tax returns audited was 0.54%. GRAETZ & SCHENK, *supra* note 76, at 73.

[120]Roberta F. Mann, *The (Not So) Little House on the Prairie: The Hidden Costs of the Home Mortgage Interest Deduction*, 32 ARIZ. ST. L.J. 1347, 1351–52 (2000).

[121]*See* I.R.C. § 163(h)(1)–(3) (2000).

[122]*See* President William J. Clinton, Radio Address to the Nation, 1 PUB. PAPERS 216 (Feb. 27, 1993) (stating that home ownership is "an essential part of the American dream we're working hard to restore"); President George Bush, 2 PUB. PAPERS 1188 (July 27, 1992) ("I believe that those on welfare, what they really want is a piece of the American dream: homeownership, a good job, opportunities for their children, and strong, loving families.").

[123]HOUS. & HOUSEHOLD ECON. STATISTICS DIV., U.S. CENSUS BUREAU, HOUSING VACANCIES AND HOMEOWNERSHIP tbl.14, www.census.gov/hhes/www/housing/hvs/historic/index.html (last visited Jan. 16, 2007). Although increasing, the rate of home ownership is not attributable to the home mortgage interest deduction more than it is to any other factor, e.g., the changing demographics of America. William T. Mathias, *Curtailing the Economic Distortions of the Mortgage Interest Deduction*, 30 U. MICH. J.L. REFORM 43, 60 (1996).

[124]*See supra* notes 89–90 and accompanying text.

[125]See PRESIDENT'S ADVISORY PANEL ON FED. TAX REFORM, SIMPLE, FAIR, AND PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM 72 (2005) [hereinafter PRESIDENT'S ADVISORY PANEL], *available at* www.taxreformpanel.gov/final-report/ (showing that more than 70% of tax filers do not benefit from deduction and that home ownership rates in United States are comparable to countries that do not utilize deduction).

[126]*See, e.g.*, Update from Congressman Neil Abercrombie, Congressman Neil Abercrombie: Fighting To Save the Home Mortgage Interest Deduction, www.house.gov/abercrombie/pdf/Home%20Mortgage%20Rate%20Interest%20Deduction%20e-neil.pdf (last visited Jan. 16, 2007) (claiming home interest mortgage deduction is "one of the most important factors" allowing families to buy homes, and predicting "an economic tsunami" if deduction is repealed).

[127]*Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934). Judge Hand also stated that "a transaction, otherwise within an exception of the tax law, does not lose its immunity, because it is actuated by a desire to avoid, or, if one choose, to evade, taxation." *Id.*

[128]PRESIDENT'S ADVISORY PANEL, *supra* note 125, at xiii.

with following the law.[129] This is especially important since American taxation is a system of self-assessment, where taxpayers are responsible for paying the taxes they owe and the government performs random audits of these individual assessments.[130] Sunset provisions by definition involve a change in the tax law. Any change in the law requires additional resources to be spent on understanding how to file one's taxes. If the law changes drastically from one year to the next, as it supposedly will from 2010 and 2011, taxpayers will be required to relearn how to file their taxes. This concern is distinct from the concept illustrated previously with Annie and her private school-bound daughter.[131] In that example, Annie was assumed to have complete knowledge of the details of the tax law, which were, in that stylized example, quite simple. But tax provisions are not always as straightforward as a simple change in the marginal rate of taxation. For example, the 2001 tax cut increased the exemption level of the Alternative Minimum Tax (AMT) for both married couples and individuals,[132] but these exemptions sunsetted on December 31, 2005.[133] Although a taxpayer's income or structure of assets might not change from 2005 to 2006, it is possible that they will be subject to an entirely separate method of taxation. Additionally, the AMT is "one of the most complicated tax provisions to comply with and administer."[134]

Sunset provisions may also affect the costs of compliance. Compliance complexity refers to the ease with which the law can be followed once it is understood.[135] With sunset provisions the status of the law is in limbo, meaning that taxpayers, being risk-averse, will likely maintain the forms and records required for both the pre- and post-sunset law. For example, the research and development credit was officially off the books between October 1, 2000 and October 1, 2001, preventing taxpayers from claiming the credit for any research done during that time.[136] Yet taxpayers later were allowed to file amended returns to retroactively receive refunds for the credit.[137] If the status of a law is prone to frequent changes, taxpayers are likely to maintain extraneous documentation. An additional cost of compliance is the administrative cost of running the Internal Revenue Service. Every change in the law requires retraining revenue agents so that they can effectively perform their duties of oversight. Although this cost is difficult to quantify, it is clear that the expense increases the more the law changes.

Transactional complexity is the expense associated with taxpayers' arranging their assets and transactions to minimize overall tax liability.[138] Sunsets make such arrangement problematic, for much of the planning that goes into effective portfolio management occurs over a period of years, rather than months. For example, before the 2001 tax cut was enacted, the estate tax had an exemption of $675,000, with the value of the estate above that amount taxed at a rate of 60%.[139] The 2001 tax cut increased the exemption to $1 million and decreased the rate of taxation to 50% in 2002.[140] Over the next seven years, the tax cut implemented a gradually increasing exemption amount up to $3.5 million and a gradually decreasing rate of taxation down to 45%.[141] In 2010, the entire tax cut will be repealed.[142] Minimizing potential estate tax liability is done through methods such as the marital deduction, outright gifts, and trust funds,[143] all used over several years. A sunset of the tax cut would require additional asset shifting, whereas a repeal of the sunset would obviate the need for such preparation. As a result, tax planning becomes excessively complicated.

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[129] *See supra* note 82 and accompanying text.

[130] Michael J. Stepek, *The Tax Reform Act of 1986: Simplification and the Future Viability of Accrual Taxation*, 62 Notre Dame L. Rev. 779, 791–92 (1987).

[131] *See supra* notes 96–102 and accompanying text.

[132] Gale & Orszag, Economic Assessment, *supra* note 1, at 1233 tbl.1A (Pre-EGTRRA exemption level was $33,750 and $45,000 for singles and married couples, respectively; post-EGTRRA exemption level was $35,750 and $49,000).

[133] David Cay Johnston & Carl Hulse , *With Tax Break Expired, Middle Class Faces a Greater Burden for 2006*, N.Y. Times, Apr. 16, 2006, §1, at 24.

[134] Leonard E. Burman, William G. Gale, Jeffrey Rohaly & Matthew Hall , *Key Points on the Alternative Minimum Tax*, Urban-Brookings Tax Policy Center, Jan. 21, 2004, www.brookings.edu/views/op-ed/gale/20040121amt.htm (calling AMT "notoriously and pointlessly complex," creating "complicated interactions with the regular income tax")

[135] *See supra* note 83 and accompanying text.

[136] Kysar, *supra* note 1, at 361–62.

[137] *Id.*

[138] *See supra* note 84 and accompanying text.

[139] *See* Gale & Orszag, *Economic Assessment*, *supra* note 1, at 1233 tbl.1A.

[140] *Id.*

[141] *Id.*

[142] *Id.*

[143] *See generally* Martin M. Shenkman, Estate Planning After the 2001 Tax Act: Guiding Your Clients Through the Changes (2002) (describing tax-planning techniques that take 2001 tax cuts into account).

D. Societal Cost of Interest Group Politicking

Sunset provisions adversely affect the democratic process by encouraging interest group politicking and legislative capture. Since sunsets are attached to specific provisions, uncertainty in their repeal encourages the formation of focused interest groups dedicated to the promotion of their specific agendas. Interest groups are most likely to form when the consequences yield concentrated benefits and diffuse costs.[144] Because the benefited group is relatively small, it is able to overcome the usually prohibitive transaction costs associated with group organization and can effectively lobby for the action they desire.[145] The diffuse costs, however, are passed to the rest of the public.

These concepts are illustrated by the lobbying efforts involved with the research that qualifies for the research and experimentation credit. The nature of the credit makes it a perfect candidate for rent extraction[146] by Congress through interest group politicking. It is an extremely valuable credit, yet only applies to a few large corporations capable of conducting the qualifying research. Although the credit is valued at over $2 billion,[147] its narrow applicability keeps it out of the public's eye. In addition, the corporations involved have disposable income to spend on influencing politicians. Since the credit is eternally scheduled to sunset, members of the tax-writing committee who must reconsider the credit solicit contributions from coalitions, lobbyists, and large corporations.[148] The technical details of the structure of the credit are written in consultation with experts paid for by the credit's beneficiaries.[149] Because the credit benefits a concentrated group (the research corporations) with the cost of the credit distributed over the public, politicians have an incentive to renew the research credit rather than make it permanent. The money is in the treatment, not in the cure.

The estate tax has characteristics similar to those of the research and development credit. The EGTRRA gradually increases the exemption amount and decreases the taxation rate until 2010, when the exemption amount and tax rate revert to their pre-2001 values.[150] The estate tax affects only the richest 1–2% of citizens.[151] Graetz and Shapiro argue that the diminishing popularity of the estate tax was the result of lobbyists focusing on the American public rather than on Washington legislators.[152] However, independent of the machinations that led to reduction of the estate tax in the 2001 tax bill, the legislative climate post tax cut created a fertile environment for rent extraction. Indeed, soon after EGTRRA was enacted, a proposal to eliminate the estate tax altogether was supported by a majority of the Senate.[153] But since a supermajority of sixty votes was required to waive the provisions of the Byrd rule affecting revenues outside of the budget window,[154] the proposal failed. Yet it is the *chance* of repeal which catalyzes interest groups to contribute to politicians. If the mission had no chance of success, interest groups would not bother to expend lobbying money. As long as uncertainty exists, politicians have the ability to extract rents.[155]

To be sure, even in a world devoid of sunsets, interest group lobbying still occurs. It is possible that the money spent by interest groups on lobbying for occasional, permanent changes in the tax law is roughly equivalent to the money spent on the frequent extensions of the continually expiring sunsetted provisions. However, there are two reasons why sunsets enable more rent extraction than would otherwise occur. First, lobbying groups will pay a premium for short-term influence, given that the politicians to whom they are contributing may not be in

[144]*See* Mancur Olson , The Logic of Collective Action: Public Goods and the Theory of Groups 44 (1965) (detailing relationship between concentration of benefits and costs in provoking groups to act in their common interest).

[145]*See id.* at 46.

[146]The term "rent extraction" refers to the ability of legislators to extract payments ("rents"), in some form or another, in exchange for favorable legislation. Fred S. McChesney, *Rent Extraction and Rent Creation in the Economic Theory of Regulation*, 16 J. Legal Stud. 101, 102–03 (1987).

[147]Federal Tax Expenditures, *supra* note 87, at 30 tbl. 1 (figure cited is estimated revenue lost for 2006).

[148]Martin A. Sullivan, *The Research Credit: A Perfect Example of an Imperfect Code*, 85 Tax Notes 128, 135 (1999).

[149]*Id.*

[150]*See supra* notes 139–142 and accompanying text.

[151]Michael J. Graetz & Ian Shapiro , Death by a Thousand Cuts: The Fight over Taxing Inherited Wealth 3 (2005).

[152]*Id.* at 3–4.

[153]Carl Hulse, *Effort to Repeal Estate Tax Ends in Senate Defeat*, N.Y. Times, June 13, 2002, at A1. The voting was 54 in favor of abolishing the estate tax and 44 opposed.

[154]*See supra* notes 51–67 and accompanying text.

[155]For a particularly cynical view on the estate tax provision, see Edward J. McCaffery & Linda R. Cohen, *Shakedown at Gucci Gulch: The New Logic of Collective Action*, 84 N.C. L. Rev 1159, 1172–79 (2006). The authors state that Congress intentionally failed to resolve the estate tax situation in order to create the possibility of rent extraction.

a position of influence in the future.[156] Any long-term "contract" for political favor will necessarily be discounted to the extent that the legislator might, in the future, lack power to advocate for the lobbying group's agenda.[157] Second, new campaign finance legislation limits the annual contribution amount that politicians are allowed to receive, making it preferable for politicians to receive smaller annual payments than larger, occasional ones.[158]

The preceding examples of the estate tax and research and development credit illustrate the rent-extracting issues associated with sunsets generally. Their temporary nature creates uncertainty, and with this uncertainty comes interested parties who have much to gain from the sunset's repeal. In a perfect world, advocates who lobby on behalf of the public would oppose the lobbying efforts of the concentrated few who benefit from sunset clauses being repealed or delayed. However, the concentrated few invariably have more resources at their disposal. This fact, combined with the collective action problem of getting a disinterested public to care about laws that have minor direct effects on their personal tax liability, results in both transactional waste and Congressional capture. Legislators are able to extract rents from sunset date to sunset date, without regard to what is the optimal policy choice.[159]

III. *Towards Improved Usage of Sunsets in Tax Legislation*

The preceding section focused on the negative consequences associated with attaching sunset provisions to tax legislation. These inefficiencies manifested themselves in a variety of settings. Interest group politicking caused by uncertainty over renewal leads to suboptimal tax policy and undermines the democratic process in Congress.[160] Even sunsetting tax cuts with a broad beneficiary base can be problematic since popular support in favor of the tax cut will grow the longer the cut is in existence.[161] Ostensibly temporary provisions, therefore, may be in effect longer than is optimal due to public outcry at letting the sunset take effect. Additionally, the uncertainty of sunset provisions leads to inefficiency as taxpayers are unable to plan their financial affairs around the existence (or non-existence) of tax laws with sunset provisions attached.[162] Lastly, changes in laws create complexity through the increased cost of compliance by taxpayers and increased cost of administration by the government.[163] From this discussion follows the inevitable question: Can sunsets ever be sound tax policy?

A. *Using Sunsets With Tax Increases*

Because sunsets did not come into prominence until 2001, the discussion of the ills of sunsets, although general, has been based upon specific examples enacted during the Bush administration.[164] The sunsets included in those provisions were largely attached to tax *cuts*, as opposed to increases. Indeed, much of the criticism leveled heretofore against sunset provisions is exacerbated by their being attached to provisions reducing a taxpayer's tax burden rather than increasing it. A sunset clause attached to a provision *increasing* taxes would not suffer from becoming an entitlement; therefore, the provision is unlikely to develop a broad base of support during the time it is in effect. As a result, when the date of the sunset approaches there will likely be little fuss, with the statute expiring with a whimper rather than a bang.

One potential benefit of attaching a sunset clause to a provision increasing taxes would be the greater ease with which such legislation could get enacted. Stipulating that a tax hike is merely temporary might be the metaphorical spoonful of sugar needed to help assuage public animosity towards the legislation. It is also possible that taxpayers might, after a few years of being encumbered with the increased tax burden, accept the provision as any other displeasing aspect of life, thereby negating the need for the sunset at all. Rather than be included only because of budget rules and procedural requirements, sunset clauses might be used for the purpose Lowi envisioned: periodically evaluating the efficacy of a provision.[165]

With respect to interest group politicking, a sunset provision attached to a tax increase that affected a small number of taxpayers would still catalyze lobbying. Since the costs would be concentrated, the affected group would coalesce, overcome transaction costs, and lobby, enabling

[156] Richard L. Doernberg & Fred S. McChesney, *On the Accelerating Rate and Decreasing Durability of Tax Reform*, 71 Minn. L. Rev. 913, 947–49 (1987).

[157] *Id.*

[158] Kysar, *supra* note 1, at 394–95.

[159] *See* McCaffery & Cohen, *supra* note 155, at 1226.

[160] *See supra* notes 85–91 and accompanying text.

[161] *See supra* notes 104–112 and accompanying text.

[162] *See supra* notes 96–102 and accompanying text.

[163] *See supra* notes 127–143 and accompanying text.

[164] *See, e.g.*, Kysar, *supra* note 1; Mooney, *supra* note 2.

[165] *See supra* notes 4–6 and accompanying text (describing Lowi's philosophy on sunsets).

legislators to extract rents.[166] However, with an end date of the sunset in place, it is possible that the lobbying efforts would not be as costly as in the concentrated benefit situation. The lobbyists would advocate only that Congress follow its own law in letting the tax increase expire. In other words, since the tax increase as enacted would only be temporary, it is unlikely that legislators will be able to indefinitely extract rents. Legislators could threaten to push back the expiration date for a tax hike, but doing so would implicate notions of fairness that might be politically infeasible.

Although sunset provisions could be successfully incorporated into legislation increasing taxes, it is unclear what would catalyze their existence. The budget rules that inspired the current plethora of sunsets were the consequence of congressional Republicans using the reconciliation process to enact legislation that sharply divided the Senate. The Byrd rule prevented changing net revenues outside of the fiscal period in question and as a consequence, the majority of provisions were given expiration dates. With a tax *increase*, there would be no analogous Byrd rule problem. A bill enacted via reconciliation will be barred if it "increases . . . net outlays, or . . . decreases . . . revenues during a fiscal year."[167] A tax increase would not invoke subsection (E) and therefore a sunset need not be invoked.

In summary, sunsets used in conjunction with tax increases are likely to have less inefficiencies and be less vulnerable to criticism than sunset provisions attached to tax cuts. Because the Byrd rule does not require a sunset in the case of tax increases, sunset provisions associated with a tax increase are more likely to be a part of clearly planned tax policy. However, sunsets associated with tax increases should be employed to create as little uncertainty as possible so that taxpayers will be able to effectively manage their assets and the government will be able to effectively administer the provision.

B. Using Sunsets With Tax Cuts

As the preceding section illustrates, a sunset provision attached to a tax cut has a greater chance of being bad tax policy. The presumption towards suboptimal tax policy is created by the fact that when associated with tax legislation, sunsets are created for two main purposes. One, to create opportunities for legislators to extract rents, as illustrated by the extenders; two, as a consequence of the Byrd rule, to prohibit tax cuts from becoming permanent. In either situation, tax policy is not the motivating factor behind the creation of the sunset, and it is therefore unlikely that the sunset clause is worth the additional inefficiencies and complexities created. However, it is possible that sunsets could be used in conjunction with tax-reducing legislation to advance sound fiscal planning. Rather than being the consequence of legislative gimmickry, temporary tax provisions could be used to implement short-term policy that is tailored to remedy pressing and immediate concerns. However, any such sunsetted tax cut must necessarily balance the harms caused by the increased uncertainty and complexity with the benefits of having such legislation only be temporary.

Tax reducing legislation with a sunset provision attached should not have an excessively long period for which the legislation is in effect. Tax cuts that sunset after ten years, for example, have a much lower probability of actually sunsetting. Because Congressional elections occur on a much shorter schedule,[168] the composition of Congress can change drastically over a ten-year period. Any law enacted by the current Congress can be repealed by a future Congress, meaning that changing the composition of Congressional members creates uncertainty in a law's existence. Therefore, the most effective sunset clauses should be attached to legislation intended to be in effect for one or two years at most. Since the composition of Congress is unlikely to change appreciably over this short period of time, it is more likely that the enacted legislation will exist unaltered. Having a tax cut enacted for a short period of time would also reduce the chance that the tax cut becomes an entitlement in the mind of the public. A benefit only given in one tax year is likely to be perceived as merely a windfall rather than a privilege. This would allow for expiration of the tax cut in question to occur with less political fallout. Additionally, since the tax cut would not affect net outlays or revenues outside of the fiscal period in question, this sunset would not have been created by Byrd rule issues. This would give the sunset

[166] James Q. Wilson, Political Organizations 334 (1995). Wilson divides political activity into four categories: distributed costs and distributed benefits, concentrated costs and concentrated benefits, concentrated costs and distributed benefits, and distributed costs and concentrated benefits. *Id.* at 332–37.

[167] 2 U.S.C. § 644(b)(1)(E) (2000).

[168] David Heath, Elections in the United States 23 (1999). Senators are elected to six year terms, with one-third of the Senate up for reelection every two years. Representatives serve two-year terms.

provision legitimacy, with sound tax policy being the reason for its enactment rather than political jousting.

In order to mitigate against interest group lobbying, sunsets should be applied to tax cuts that provide diffuse, rather than concentrated, benefits. Temporary tax legislation with concentrated benefits will invariably spawn interest groups lobbying to either extend the tax cuts or make them permanent. With diffuse benefits there is a greater chance that legislators will do what makes the most economic sense, rather than what is in their own self interest. However, if the tax cut in question does provide concentrated benefits, renewal of these provisions should be subject to a higher level of scrutiny than that to which ordinary legislation is subjected. This will mitigate against the effect of interest group lobbying when the temporary tax provision provides concentrated rather than diffuse benefits. In other words, the presumption should be heavily on the side of the temporary tax cuts being just that—temporary. This is especially true if the purpose of the temporary provision is to provide incentives for behavior that might not otherwise be economically sound. If businesses know that the "temporary" provision is likely to be renewed, they will invest less now than they would have if they knew the provision would not get extended. As a result, temporary tax cuts which aim to catalyze certain behavior undercut this goal by being continually extended.

Finally, any sunset provision must not create an excessive amount of complexity in the code. Drastic changes to how taxpayers assess their liabilities create economic inefficiencies.[169] Since sunset clauses involve modifying laws after a set period of time, there is an increased chance of creating confusion for the public as to what is the applicable law. Consequently, laws with sunsetting provisions should be as simple as possible. This is even more important when enacting a short-term provision, since there might only be one or two years for taxpayers to learn how to deal with the new provisions.

In short, there is potential for sunsets to be beneficial components of tax cutting legislation, provided that the associated tax provisions are enacted for short periods of time and are the result of reasoned tax policy rather than partisan maneuvering. Additionally, the tax provision being sunsetted should be simple enough to withstand being changed rapidly.

[169]*See supra* Part II.

An example of a sunset clause that was implemented successfully is the bonus depreciation schedule. In an effort to stimulate business in the aftermath of the terrorist attacks of September 11, 2001, Congress allowed taxpayers to deduct 30% of the value of equipment used in a business in the first year that the equipment was purchased.[170] This was later increased to 50% in 2003.[171] Although the goal of the provision can be debated, the provision successfully encouraged businesses to make capital investments.[172] This provision was scheduled to, and did, sunset at the end of 2004. Congress recognized that as the economy recovered, there was less of a need for the bonus depreciation schedule. Similarly, tax credits for those affected by natural disasters could be successfully implemented via a sunset provision. Natural disasters create the need for short-term economic stimulus in the regions affected, something that a sunsetted tax credit could provide. Indeed, Congress enacted such legislation in response to Hurricane Katrina in September of 2005.[173]

C. *Budgetary Rules and the Reconciliation Process*

The key problem afflicting the recent use of sunsets is using their temporary nature to mask the costs of tax legislation that the proposing Senators intend to make permanent. As long as sunset clauses exist only as a concession to an opposing minority, the desire to repeal the sunset will continue to exist. With this desire comes the associated uncertainty in the life of the provision—even if the minority party can prevent a total repeal of the sunset due to Byrd rule constraints, the majority party can still continually extend the tax provision.

The simplest way to eradicate this disingenuous behavior would be to prohibit using reconciliation procedures to enact legislation that results in an increased deficit. This, of course, was the argument the Democrats unsuccessfully presented in 1996 when Republicans first attempted to pass deficit-increasing legislation via reconciliation measures.[174] However, had Republicans been unable to use reconciliation legislation to pass the desired tax cuts, the revenue outlays for the cuts would necessarily have been much less, and as a result

[170]I.R.C. § 168(k)(1)–(2) (Supp. III 2003).

[171]*Id.* § 168(k)(4).

[172]Kathleen Pender, *Capitalize on Asset Tax Breaks by 2005*, S.F. Chron., Jul. 18, 2004, at J1.

[173]*See* Katrina Emergency Tax Relief Act of 2005, Pub. L. No. 109-73, 119 Stat. 2016. The Act created generous rules for deducting casualty losses and gave bonus depreciation deductions.

[174]*See supra* notes 44–50 and accompanying text.

would have been more fiscally sustainable.[175] Republicans did not take into account how uncertainty reduces the incentive effects of a tax cut by increasing transactional and compliance costs.[176] Allowing the majority party to use the reconciliation process to push through any fiscal legislation, no matter how costly, provided only that the laws sunset at the end of the budget window, is irresponsible.

Congress would also be better served by readopting and actually adhering to the pay-as-you-go (PAYGO) rules that were first codified in 1990.[177] The PAYGO rules required that any new tax legislation enacted by Congress be revenue neutral, that is, could not lose more money than it raised.[178] The PAYGO rules were in effect from 1990 and periodically extended until 2002.[179] Even when these rules were in effect, however, Congress was able to manipulate them as needed. In 1999 Congress eliminated installment sale reporting,[180] a taxpayer-friendly method of accounting, for certain taxpayers and used the increased revenues to fund, under PAYGO rules, extensions of various expired and expiring tax cuts.[181] However, soon after Congress modified the applicability of installment sale reporting, Congress introduced legislation to repeal it.[182] As stated by Block:

> Under PAYGO rules, the retroactive repeal of the installment sale provision lost federal revenue and, absent an offsetting revenue increase, should have triggered a mandatory sequester of government funds. No problem. Congress simply directed the OMB, responsible for the sequester, to change the sequester balance to zero. When the dust settled, Congress had agreed to use the repeal of installment reporting for accrual method taxpayers to pay for the cost of other tax cuts, but when the invoice arrived to pay for the tax cuts, Congress never paid the bill.[183] Since Congress enacted PAYGO, they were empowered to violate it. Having PAYGO rules that are actually followed would force Congress to make decisions about difficult budget questions without passing the buck to future legislative sessions.

Prohibiting tax cuts to be enacted via reconciliation legislation and requiring PAYGO rules to be followed by Congress would reduce the amount of budgetary handwaving that Senators engage in when enacting fiscal legislation. As a result, the budget-making process would be more transparent, with more reliable estimates of revenue generated and lost and, consequently, more certainty in the tax code. Using these procedures to check Congressional discretion would be fiscally sound and would in many instances obviate the need for attaching sunset provisions to tax legislation.

Conclusion

This Note offers an overview of what led to the proliferation of sunsets in recent tax legislation, the factors behind their inefficiencies, and prescriptions for how Congress can better implement sunset provisions to create more effective tax policy. However, as long as Congress remains nearly evenly divided, the majority party will continue to use the reconciliation process to enact tax cuts. These tax cuts will necessarily be of limited duration in order to circumvent Byrd rule constraints prohibiting alteration of net revenues outside of the fiscal window under consideration. If the status quo remains, America will not only continue to have uncertainty with respect to its tax laws, but will grossly underestimate the revenue loss resulting from the sunsetted tax cuts. Consequently, legislators will continue to use this uncertainty to extract rents, while spreading the diffuse cost of this legislation to the indifferent public. In addition, Congressional gimmickry in altering and enacting budgetary legislation is likely to undermine public faith in our governmental institutions. In short, sunsets will continue to be inefficient mechanisms by which Congress implements tax legislation.

Congress should limit the use of the reconciliation

[175]Kysar, *supra* note 1, at 396.

[176]*See* Gale & Orszag, *Economic Assessment*, *supra* note 1, at 1184 (arguing that justifications for use of sunsets do not apply to 2001 and 2003 tax cuts).

[177]Omnibus Budget Reconciliation Act of 1990, Pub. L. No 101-508, § 13204, 104 Stat. 1388, 1388-616 (codified as amended at 2 U.S.C. § 632(b) (2000)).

[178]*Id.*

[179]*See* Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, §§ 14001–03, 107 Stat. 312, 683–85 (extending PAYGO rules until 1998); Balanced Budget Act of 1997, Pub. L. No. 105-33, § 10205, 111 Stat. 251, 702–04 (extending PAYGO rules until 2002).

[180]Ticket to Work and Work Incentives Improvement Act of 1999, Pub. L. No. 106-170, § 536, 113 Stat. 1860, 1936 (disallowing installment reporting for most accrual basis taxpayers).

[181]Block, *supra* note 1, at 866–67.

[182]*Id* at 866.

[183]*Id.*

process to legislation which reduces the deficit, and prohibit reconciliation bills that call for a deficit increase. With that limitation in place, and the existence of a clearly defined and adhered to set of pay-as-you-go rules, sunsets might possibly live up to the potential hoped for by political theorists in the 1970s. In order to use sunsets effectively with respect to tax cuts, the cuts should be simple, of short duration, and provide diffuse rather than concentrated benefits to reduce the opportunities legislators have to extract rents. With these safeguards in place, a new day may eventually dawn on the world of sunset clauses and tax legislation.

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LOOPHOLE *continued from page 9*

United States, and firms that have been subsequently acquired since the date of this writing were removed from the sample to allow for more uniformity. The complete results, including all data used, are available at www.taxinglifeinsurance.com/FCCOM.

The results of the study are staggering. In total, the sample was able to charge the government $246 million in FCCOM in GFY 2005. The average subsidy was $4.74 million and the median subsidy was $1.15 million. Assuming a corporate tax rate of 35%, by paying the sample's 52 firms $246 million in FCCOM instead of profit, the firms collectively received a tax benefit of $86 million.

Conclusion

In the 1970's, soaring inflation and interest rates had diminished the benefit to federal contractors of depreciating assets at historical costs. Because of statutory caps on fee, contractors could not make up the difference by increasing profits. Lacking the authority to directly expand profit caps, the CASB found a way to indirectly increase contractor profits by inventing a cost that represented the time value of money invested in facilities. The FCCOM subsidy sprung to life as an allowable cost, and a tax loophole was created.

Contractor profit could be constructively increased over the maximum allowed fee percentages by allowing contractors to bill for a cost they never actually had to pay. This lasted until 1997 when an amendment to the FAR forced a reduction in contractor profit for every dollar of FCCOM subsidy received. Any substantive benefit from CAS 414 was essentially nullified yet the tax loophole remained.

Even though the 1997 amendment caused contractor revenue to remain the same whether or not FCCOM was billed, because the tax code relies on the FAR to determine what is and is not a cost, the tax loophole provides a deduction for every dollar deemed a part of the FCCOM subsidy. Contractors can effectively move dollars from their proposed profit amount to their FCCOM subsidy which can then be deducted from their taxes. Through Treas. Reg. § 1.460-5 (2007) the Treasury seemingly bolstered the loophole which is puzzling considering the agencies that oversee the FAR decided to render the subsidy moot two years prior. Currently the only benefit provided by the FCCOM subsidy is a tax benefit.

Through my own study, 52 firms could have charged the government an estimated $246 million in FCCOM in GFY 2005. If these firms also utilized the tax loophole, over $86 million in deductions could have been taken. With the study showing an average tax windfall of over $1.6 million per contractor, if the entire industry utilized the tax loophole to the fullest degree the impact on the Treasury would be enormous.

Then again, these numbers are all estimates and I have no evidence to show that contractors are even taking the deduction under §§ 162 and 460. Due to an apparent lack of federal oversight, the true impact of the tax loophole seems to be unknown. Consider though that even if the numbers in this study were incorrect by a factor of ten, millions of tax dollars would still be deducted in the aggregate.

If this article illustrates anything it is that the government needs to take account of how much FCCOM is being paid to federal contractors. This will also shed light on how much tax revenue is lost through the tax loophole. Without further investigation of this subsidy, FCCOM will continue to be tax free profit for federal contractors.

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