Special Reports

Transition Rules: Learning to Live with Tax Reform

4 *Tax Notes* 7-13 (August 30, 1976)

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How can a congressman satisfy constituents who want him to vote for tax reform and remain at peace with supporters enjoying the benefits of a loophole or a special provision? If you answered "transition rules," you have the instincts of a good tax lobbyist, for it is in the design of transitional rules that the art of lobbying achieves its grandest moments.

Transition rules come in many forms and serve many purposes, some good and some bad. The bad ones can completely overturn the effects of a tax change, at least for certain well represented taxpayers. Or they may postpone for many years — in some cases, for generations — the effects of reform legislation.[1] On the other hand, good transitional rules can ease the economic dislocations otherwise resulting from sudden changes in tax policy and can permit Congress to maintain a budget target by phasing in or phasing out tax changes with substantial revenue impact.

Many Examples

Examples abound in the two major tax bills now before Congress of the use of transition rules to defeat or postpone reform. Two proposed transition mechanisms raise some of the most important issues in the design of rational transition rules. One such rule is the exclusion of existing trusts from the curbs on foreign trusts contained in the House and Senate versions of the Tax Reform Act (H.R.

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[1] The Estate and Gift Tax Reform Act (H.R. 14844), approved by the House Ways and Means Committee, has transition rules for its generation skipping provisions which put off the impact of the reforms for 40 to 50 years.

10612), currently before the conference committee. Another is a proposed exemption, rejected thus far, for capital [*8] gains accrued up to now from the carryover basis contained in the Estate and Gift Tax Reform Act (H.R. 14844). The arguments used to support these two proposals will be analyzed in order to illustrate the need for some revised thinking about transitional rules, an unfortunately obscure area of tax law.

Foreign Trusts

A notorious loophole in our tax laws is the treatment of so-called foreign trusts. Wealthy taxpayers will set up trusts in tax haven countries — the Bahamas is a favorite — and accumulate income for U.S. beneficiaries tax-free. Section 1013 of the Tax Reform Act ends this loophole for newly created trusts by taxing the grantor (the person creating the trust) on the trust income. The legislation is skillfully drafted, and is, overall, an important improvement in our tax structure. The legislation, however, does not apply to trusts created before the legislation was first approved by the Ways and Means Committee.[2]

Why should trusts established before the reform legislation continue to be exempt from tax on their future income? The reports of the tax committees of Congress do not answer, or even ask this question. The obvious effect of the limitation is to allow taxpayers clever enough to establish foreign trusts before the reform legislation to continue to enjoy their loophole. It appears, in fact, that these lucky taxpayers can continue to transfer assets to their trusts without the new grantor trust rules applying.

The argument sometimes advanced for similar effective date provisions is the alleged need to protect taxpayers from "hardship" when they relied "in good faith" on the tax laws then existing when they entered into binding legal agreements. In the case of foreign trusts, the argument would be that Mr. X would never have

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[2]For a discussion of a Senate Finance Committee proposal to move the effective date from May 21, 1974 to May 29, 1976, see *Tax Notes*, August 9, page 17. The Finance Committee amendment was prepared at the behest of a few taxpayers who wanted to sneak in under the wire. It was defeated on the Senate floor.

transferred his money to a Bahamian trust if he knew the law would be changed.

Congress again and again has responded to this argument by adopting a "grandfather" clause that preserves the special tax gimmick for those already enjoying it. The acceptance of this argument is a major cause of the complexity and inequity of most tax bills, and certainly of the ones now before Congress. [*9]

This "reliance" argument is so bizarre that there is really little you can say to anyone who does not intuitively see its unfairness. The argument seems to suggest that the government and the tax avoider have an implicit contract arrangement that the government is morally bound to honor. I asked some lawyer friends for example of what would happen if this "Reliance Fallacy" were adopted in other areas of the law. Although none of the analogies are perfect, I present a small sample:

o Anyone who owned a brewery at the time of the adoption of the 19th Amendment can continue to manufacture and sell liquor.[3]

o A state welfare regulation denies welfare benefits to anyone with assets over $3,000. A number of middle class individuals apply for welfare and avoid the assets limitations by holding their property in trust. The law is changed to block this abuse, but anyone who had established his trust before the change can continue to receive welfare payments.

o If a speculator corners the quinine supply in anticipation of a malaria epidemic, he is entitled to compensation if the government decides to spray for mosquitoes.

o Taxpayers who have used a loophole for three of the past eight years have a vested right not subject to divestiture; removal is a Fifth Amendment taking requiring fair compensation.[4]

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[3]An example based on the 13th Amendment, which abolished slavery, has been omitted from the list.

[4]My contributor will be surprised to learn of an article in the June, 1976, issue of *National Tax Journal*, which actually suggests compensation for "victims" of tax reform in a wide range of situations. Presumably loophole hunters would be

o Anyone who has customarily parked his car at a broken parking meter can continue to park there for free even after the meter has been repaired.

This list went on and on, and some of the suggestions. I'm afraid, were a little silly. But I think they make their point. The tax avoider is a speculator, not a contractor. He is not avoiding tax as a favor to the government, but just the opposite. Perhaps fairness prevents us from taking away special benefits he enjoyed in the past, but it does not prevent — it positively requires — our taking them away for the future. [*10]

Carryover Basis at Death

Under Section 6 of the Estate and Gift Tax Reform Act, now before the House, a person inheriting property will be required to take over the basis of the decedent for purposes of computing gain on any future sale. This carryover basis rule replaces the current stepped-up basis rule, which allows the heir to take a fair market value basis on inherited property. The effect of a step-up in basis is to completely exempt the decedent and his heirs from an income tax on the appreciation in value of his property. Many tax authorities feel that an income tax on the decedent would be a fairer and more economically sensible result. But the carryover rule, which preserves the possibility of tax on the gain, is acknowledged to be fairer than the current stepped- up basis rule.

An important issue in the Ways and Means Committee debate on this topic was whether gains accruing before the adoption of the new rule should be exempted from the carry-over rule. The committee voted not to include a start-up date. The minority view was that full carryover without a start-up date results in a "retroactive" tax. That characterization is seriously misleading, as the majority of the committee apparently understood.

The opponents of the carryover rule allege that it imposes a retroactive tax because it causes gains already earned, which are exempt under current law, to become taxable. That is, the rule retroactively reverses the current exemption.

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excluded from the compensation scheme.

What is a Retroactive Tax?

The initial fallacy of this argument is the assumption that accrued gains are "exempt" under a capital gains tax. Perhaps in an ideal personal income tax we would tax capital gains as they accrued, but we do not, nor do we pretend that we do. We have explicitly adopted a realization principle — tax is assessed only when gains are realized. Accrued but unrealized gains are not exempt. The taxable event which could trigger assessment simply has not occurred. It is only by incorrectly assuming that our capital gains tax is an accrual tax that the issue of retroactivity is raised.

When taxes are more clearly distinct, the Retroactivity Fallacy loses its force. No one seems to argue, for example, that a new sales tax (or an increase in the rate of an old one) is retroactive when it applies to purchases made from income already earned. Before enactment of the sales tax, however, unspent earnings were "exempt" from tax when used to make purchases. It is in much the same way that unrealized capital gains are exempt under a tax on realized gains. Following this analogy, a country which had traditionally exempted all capital gains, not simply [*11] gains accrued at death, could impose a tax on all gains realized in the future without that tax being retroactive. The tax is on realized gains, and it applies only to gains realized after the tax law is enacted.[5]

When Are Retroactive Taxes Bad?

The second fallacy in the argument is the implicit assumption that all retroactive tax laws are bad. Perhaps because of our legitimate objections to retroactive criminal laws, most of us start off disposed against a retroactive tax. But tax justice and criminal justice are not closely related.[6] First of all, in the criminal area, the meaning of

[5]When Canada adopted a capital gains tax for the first time in 1971, it utilized a start-up date, in large measure because of an acceptance of the Retroactivity Fallacy. One result was that the tax administrators were faced with the impossible task of determining the fair market value of all capital assets as of the effective date of the act. Even more importantly, the gross unfairness which prompted enactment of the capital gains tax was continued in large measure for several more decades.

[6]Unlike retroactive criminal laws, retroactive tax laws do not violate the Constitution. See, e.g., *Brushaber v. Union Pacific R.R. Co.*, 240 U.S. 1 (1916).

"retroactive" is reasonably well understood, the definitional problems arising only at the fringes (is a conspiracy statute retroactive if applied to a conspiracy which began before, but extended beyond, the enactment of the statute?). As suggested above, the definitional problems in the tax area are much more complex. How can we be so sure we don't like retroactive taxes if we are so uncertain as to what a retroactive tax really is?

Even in cases in which a tax change is clearly retroactive — an increase in the rates enacted in May but applicable from January — it is uncertain whether they are bad. Tax justice requires a serious attempt to be fair to everyone, which necessarily means compromises among competing claims for tax relief. Assuming a fixed revenue target, forgiveness of a tax on one person means a greater tax on someone else. It is simplistic to assume that a ban on all retroactive taxes will result in the fairest distribution of burdens in most cases.

In the carryover-basis-at-death issue, an exemption for accrued gains would mean that the wealthiest people in the society will continue for years to enjoy the benefits of a tax provision that is uniformly condemned as unfair. How does it promote tax [*12] justice for that group to enjoy its unfair tax relief at the expense of the rest of the taxpaying public? Perhaps there is a response to this question. The Retroactivity Fallacy, however, implicitly assumes that retroactive taxes are always bad and thus avoids facing this question.

I realize that this refutation of the Retroactivity Fallacy won't convert everyone to my side. The virulence of the fallacy stems from the fact that it is easy to invoke and complicated to refute. It sometimes merges with the Reliance Fallacy, drawing strength from it and making the refutation even more long-winded. So I may be forgiven perhaps for my rhetorical use of capital letters.

Conclusion

Whenever the tax law is changed, the question of transition rules is raised, for all amendments to the Internal Revenue Code upset some taxpayers' expectations. If an old tax incentive is removed, persons who had made investments on the basis of that incentive will suffer some loss. When a new incentive is added, taxpayers in competing industries will experience a relative disadvantage. Similarly, when a loophole is closed, people who had been taking advantage of the loophole will pay higher taxes. If a new loophole is opened, those not able to benefit pay relatively higher taxes.

To justify a transition rule for a particular group of taxpayers, therefore, it cannot be enough to simply show that a reasonable expectation is about to be frustrated. With that standard, no tax changes at all would be possible, for every taxpayer has some stake in the existing tax system. The frustration of some expectations is the price we must pay for reform. It is a price we would have to pay even if our tax code had started out without defects, for changes in the tax law would in any case have been required by changes in our economy and changes in our societal values.

The most common mistake in our current approach to transition rules is to feel an obligation to give some relief to any taxpayer whose expectations are being frustrated by the tax change and who can demonstrate that he has made some kind of “commitment” on the assumption that the old law would continue. Since it is impossible to adjust for all of these taxpayers, only those with the ear of Congress get relief. The transition rules, instead of being used as an instrument for easing into a new tax regime, become a jungle of special interest provisions.

On the basis of our bad experiences with transition rules in the past, I suggest that Congress adopt a set of policy guidelines for future transition rules. I present here some suggestions for inclusion in that set of guidelines: [*13]

1. When Congress amends the Code to correct what is generally regarded as an unintended defect in the statute, no special transition rules are justified. If you hunt for loopholes, you must assume the risk that the loophole will be closed.

2. When explicit tax incentives, such as the investment credit, are repealed, taxpayers who have made substantial irrevocable commitments should be protected from serious harm. The corollary to this rule is that taxpayers whose commitment or whose harm is not substantial will not be protected.

3. When the hardship of a tax change is broadly spread over a large class of taxpayers, transition rules are inappropriate. An increase in

the tax rates, for example, would normally be done without transition rules.

4. Administrative simplicity should be given much more importance than it now is. The pages of transition rules adopted when the investment credit was suspended in 1966 illustrate the danger in ignoring administrative considerations.

5. Congress should be required to explain its rationale for adopting a transition rule. To evoke the Reliance Fallacy or the Retroactivity Fallacy (or both) is not enough. The underlying policy objective must be set forth.

6. Congress should identify those taxpayers, by name when possible, who are expected to benefit from a transition rule. The billion-dollar transition rule business is public business and should be brought out into the sunshine. ▫

Letters to the Editor

Re: Transition Rules

4 *Tax Notes* 5-8 (September 27, 1976)

Letter to the Editor from Peter L. Faber

To the Editor:

Professor McIntyre's article on transition rules (*Tax Notes*, August 30, page 7) takes an overly simplistic view of the problem. While it is certainly true that in many cases transitional rules are unjustified, in other cases they serve a valid purpose and it is hard to develop a set of general principles that will cover all situations.

The foreign trust area is a good example. H.R. 10612 would, in general, tax the United States grantor of a foreign trust with United States beneficiaries on the trust's income. Professor McIntyre has no sympathy with the unlucky grantor who established a foreign trust before the enactment of tax reform legislation, arguing that he is a speculator in tax loopholes and deserves anything that happens to him.

Bermuda Trust Example

I know of one case where a person established a trust in Bermuda in order to remove assets from the reach of an estranged spouse. Substantially all of his assets were placed in the trust and tax avoidance was not considered in establishing it. Surely it would be unfair to tax a grantor in these circumstances on trust income that he never received and the tax on which no one was trying to avoid. He established the trust in reliance on provisions of existing law that held that he would not be taxed on the income, and it is hard to see why he should not be protected from later changes to the tax law that would reverse this result.

Professor McIntyre argues that when Congress amends the Code "to correct what is generally regarded as an unintended defect in the statute, no special transition rules are justified. If you [*6] hunt for loopholes, you must assume the risk that the loophole will be closed." One suspects that most people use the word "loophole" to describe anything in the tax law that they don't like. It is clear, for example, that, regardless of whether one considers the exemption from tax of the income of foreign trusts a “defect”, it certainly was not “unintended.” Whether it is a “loophole” can be argued both ways.

Is the allowance of accelerated depreciation a loophole? Some tax reformers would argue that it is, while other persons would say that it accurately reflects the rate at which physical wear and tear affects the value of property. Are the provisions that allow trust income to be taxed to beneficiaries rather than grantors of domestic trusts loopholes? How about the exemption for Social Security benefits? Here again, the point can be argued both ways.

Professor McIntyre’s point may have some validity if it were possible to categorize all users of tax deductions and exemptions as evil evaders of their fiscal responsibilities as citizens, but this just isn’t the case. People who rely on provisions of the Internal Revenue Code may frequently be entitled to some relief when those provisions are changed in a manner which affects commitments previously made. It is not dishonest to assume that the tax law means what it says, even if it can be argued that Congress should have drafted the law differently in the first place.

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Professor McIntyre Replies

In my article, I suggested that lobbyists achieve their “grandest moments” in the design of transition rules, and I discussed in some detail the types of arguments they present to Congress in defense of their client’s special tax position. In many cases, lobbyists convince Congress to perpetuate an admitted unfairness on the unanalyzed ground that some taxpayers “relied” on the old law “in good faith.” I understand that in some cases “reliance” may be an important factor in deciding whether to provide a transition rule. I suggested in my article, for example, that reliance would be relevant in the case of a repeal of the investment credit, since the government had encouraged the reliance in order to stimulate capital outlays. [*7]

In the case of unintended defects in the law, however, the government had not encouraged taxpayers to rely on the continued availability of the tax break. In such cases, "reliance" is generally irrelevant. It is certainly fallacious to invoke "reliance" without at least offering some argument for why it should be relevant. Finally, since an unintended defect necessarily involves unfairness to the majority of taxpayers, someone arguing for continuation of that unfairness must not only show that reliance is relevant but must also overcome the strong presumption that we should treat all taxpayers the same and not create special tax regimes for the well-connected.

As an example of what I termed the Reliance Fallacy, I looked at the provision of the current tax bill which cracks down on new foreign trusts but leaves the loophole wide open for old trusts. The legislative history of the change gave no serious analysis of the equity issues involved, but simply recited the truism that tax avoiders had relied on the old law. I provided many examples of how nonsensical this view of reliance would be if transported from the tax area to other areas of the law.

Faber's Critique

Counselor Faber feels that my approach is "overly simplistic" and goes on to give his own defense of the exemption for existing foreign trusts. His defense catches the flavor very nicely of the lobbying arguments I was complaining of. His defense has three parts. First of all, he presents a case of an "innocent victim" of the reform and suggests implicitly that this is just one of any number of such cases. He then invokes the leap in logic I call the Reliance Fallacy to claim without argument that the innocent victims deserve special tax relief. The final step is to conclude, again without argument, that all victims of the reform deserve preferential treatment.

Counselor Faber's innocent victim is a husband who created a foreign trust in order to deprive his estranged wife of whatever legal claims she had to his assets. The husband's innocence stems from the supposition that "tax avoidance was not considered" in establishing the trust. Such cases must be extraordinarily rare. I have no data on the number of wayward husbands fleeing U.S. jurisdiction, but I do know that it is nearly impossible for a U.S. taxpayer to establish a tax haven trust which qualifies as "foreign" without expert tax advice. Of the estimated $5 billion to $10 billion of assets transferred to tax haven foreign trusts, the transfers by persons without a tax avoidance motive must have been trivial.

Counselor Faber's invocation of the Reliance Fallacy follows the usual pattern, but with a humorous twist. The usual pattern is simply to posit reliance without any explanation of its relevance. [*8] The twist is that Counselor Faber's example is not a reliance situation. The husband, we are told, did not consider the tax break when he established the Bermuda trust. The favorable tax treatment was an unexpected bonus of his plan to shelter his assets from his wife.

Since Counselor Faber's "hardship" case is statistically trivial and the hardship by his own postulation is nonexistent, no arguments are available to him to justify the quantum jump to an exemption for all pre-reform trusts. I assume that is why he offered none.

Attack on "Strawmen"

Counselor Faber's third paragraph is an attack on strawmen of his own creation. He implies that I have used the word "loophole" too loosely when in fact I have given the term a very narrow and specific meaning. In my lexicon, a "loophole" is "an unintended defect in the statute." An unintended defect is a result which is widely acknowledged to be unfair, is not justified by competing economic or social objectives and was not desired by Congress. I consider preferential treatment of foreign trusts over domestic trusts a loophole under my usage since the result is patently unfair, and it is my view that it was not intended by Congress. Nothing I have found in the legislative history suggests that Congress desired to give a tax preference to foreign trusts, the result being an unreflected consequence of the tightening of the rules for domestic trusts in 1969.

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