Principles and Practice of Tax Reform Transition

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TAX FOUNDATION

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BACKGROUND PAPER NO. 23
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Introduction

The problems that have led Americans to turn thumbs down on the current income tax system are now well known. Taxpayers perceive it to be unfair. It is too complex for both tax payer and tax administrator. The complexities lead to unreasonable compliance costs and great uncertainties. The income tax hinders saving and investment and generally leads to an inefficient allocation of resources. Thus it stunts job and wage growth and ultimately weakens the ability of American companies to compete in world markets.

Likewise the principles that have guided the authors of most tax reform proposals are equally well established. The tax system should be simple. It should be fair according to some consistently applied standard of fairness. And it should be as economically neutral as possible so that the tax system does not diminish the economy's ability to yield as many benefits as possible.

While the principles underlying tax reform are well established, the principles underlying the transition from the existing tax system to a new system are not. The "transition issue" is often left as an afterthought to be handled later by technicians. Transition applies to the tax treatment of activities and arrangements entered into before a new tax system is adopted. It does not apply to activities undertaken after the adoption of the new tax system.

Whether politically appealing or not, tax reformers must eventually come to terms with a very long list of transition issues if tax reform is to evolve from campaign issue to reality. Rather than procrastinating, tax reformers ought to address these issues early and directly. Doing so could provide tax reform with extra momentum. Many concerns raised about fundamental tax reform have more to do with the tax treatment of existing economic arrangements than with how such arrangements would fare under the new tax regime.

Compared to the great issues of policy guiding tax reform, at first blush there seem to be no great principles of economic policy or ideology at stake in transition issues. They can be messy and complex. And their solutions are often expensive in that they shrink the tax base temporarily, possibly necessitating an unpopular higher tax rate to maintain a given level of tax collections.

There are, however, at least two great moral and economic principles involved in developing transition rules — the need to avoid the confiscation of wealth and income inherent in retroactive taxation and, conversely, the need to avoid through retroactive tax relief the creation of economic windfalls. Without proper transition rules, tax reform can become tax burden roulette, yielding tremendous windfalls to some and imposing significant, retroactive tax increases on others. Such consequences would violate the letter and spirit of tax reform and could ultimately doom it in a cloud of confusion and opposition even from those who would otherwise support it.

In addition, there is a vital economic imperative to developing a working transition regime. Simply put, without such a regime the economy could suffer severe economic disruptions in the year or two prior to the enactment of any new tax system. For example, suppose the new tax system were to allow businesses to deduct the full cost of their purchases of plant and equipment in the year in which they were purchased. Under current law, of course, businesses must generally deduct these costs over some specified number of years. Suppose tax reform included no transition rules for the costs of plant and equipment purchased in the years prior to tax reform's enactment. In this case, business investment would decline dramatically, beginning as soon as tax reform appeared likely, and would virtually cease in the months prior to tax reform's enactment.

Similarly, the sale of homes would come to a standstill as tax reform became more likely if homeowners were unable to continue to deduct their home mortgage interest on existing mortgages. Businesses would practically cease to borrow because
interest, deductible under current law, might not be deductible after tax reform. In short, the economic results of failing to provide transition could be calamitous. And, if the very prospect of tax reform absent transition rules would harm the economy, and if this is portrayed by its critics as a result of tax reform itself, then fundamental tax reform could not possibly proceed.

Transition Principle One

The principles of tax reform establish a clear framework for the new tax system. The process of establishing transition rules requires the development of a similar referential framework. A proper framework will guide the discovery of areas requiring transition rules and the formulation of those rules. The backbone of this framework for transition must be to protect taxpayers from financial harm and to avoid economic windfalls resulting from tax reform. While there are limits to the extent to which this principle can be practically applied, and there are surely other principles to add to this first principle, the ideal result of transition would be to impose the same amount of tax on a taxpayer's pre-existing arrangements as the taxpayer would pay had tax reform not occurred.

Taxpayers enter into economic arrangements assuming a whole panoply of conditions and factors ranging from the expected performance of the overall economy to developments in their personal situations. Included in these factors are the full range of government policies that may come to bear. Foremost of these for our purposes is the expected tax treatment of the transaction. All the economic activity, all the investments, and all the contracts entered into before a new tax system is adopted were predicated on the operation of the current income tax. A taxpayer buys a house assuming he will be able to deduct the interest on the mortgage. A business purchases new machinery assuming it will be able to deduct the cost of the machinery against future income according to a prescribed schedule. An investor purchases equities assuming she will owe tax on dividends and capital gains received. To be sure, in some cases the taxpayer may suffer some uncertainty as to the precise tax treatment, and in others the taxpayer's understanding may be inaccurate. Nevertheless, in the vast majority of cases the tax treatment is reasonably well known and certain, assuming no change in the tax system.

When any of the aforementioned activities are undertaken after tax reform, the tax consequences may be quite different from what they would have been under the income tax. Indeed, taxing each of these activities in a more economically neutral manner is a fundamental goal of tax reform. Taxpayers are sure to face altered markets and new incentives under a new tax system and they are sure to alter their choices based on this new information. The important point here is that taxpayers will have the opportunity to determine these consequences before entering into arrangements once tax reform is enacted.

In contrast, taxpayers who enter into contracts and other arrangements prior to tax reform do so on the basis of the existing tax system and its effects on prices and markets. Applying the new tax rules to the old arrangements can impose a much higher or a much lower tax burden on these arrangements. When the tax burden is much higher, it is a case of retroactive taxation. When the tax burden is lower, it is a windfall. Neither windfalls nor retroactivity are appropriate consequences of tax policy or tax reform. Thus, the first principle of tax reform transition:

• Transition rules should prevent insofar as possible instances of retroactive taxation or retroactive tax relief.

Avoiding retroactive taxation is a basic principle of sound tax policy. The Congress deemed it sufficiently important that it is now codified in Internal Revenue Service regulations. In 1996, as part of the Taxpayer Bill of Rights 2 (H.R. 2337), the Con-
gress established that the effective data of any temporary, proposed, or final regulation may not be earlier than the date the regulation is published in the Federal Register.¹

**Retroactivity and Tax Fairness**

Retroactive taxation is to be avoided under any sound tax system, but especially in the context of tax reform. An over-arching principle of tax reform is tax fairness.

Tax fairness is certainly a term of art defying universal definition. It is, however, hard to overstate its importance. When a tax system is perceived as unfair, tax compliance falls, tax revenues fall, and citizens who choose not to comply fully are knowingly breaking the law. As resentment toward a tax system increases, this resentment soon spills over to a general dislike and distrust for all government institutions.

Although a universally accepted general definition of tax fairness has yet to be found, certain aspects of tax fairness can be readily discerned. For example, it is fair that similarly situated taxpayers should pay similar amounts of tax. (Of course, defining what one means by “similarly situated” can get tricky.) Another, more certain, aspect of a fair tax system is that changes are applied on a prospective basis only. Tax changes applied retroactively are obviously unfair. Changing the tax rules retroactively is equivalent to changing the rules in the middle of the game. If tax fairness is a motivation for tax reform, then tax reform should not create a new dimension of unfairness through poorly designed transition rules.

Consider, for example, a family that buys a home expecting to be able to deduct the interest on the mortgage. Suppose the interest amounts to $1,000 a month and the family pays federal income tax at a 28 percent marginal rate. If the result of tax reform is to eliminate the mortgage interest deduction even for pre-existing mortgages, then this family would face a $280 per month increase in its housing costs. This would be unfair.

**Retroactivity and Uncertainty**

There is an important economic dimension to retroactivity as well. Due largely to its complexity, taxpayers are often uncertain about the operation and administration of the existing income tax. Sometimes this uncertainty is with respect to a specific aspect of the tax code and its application to a specific activity or investment. Sometimes this uncertainty relates to a general unease about the tax system. Virtually every economic activity carries with it a degree of risk of loss or unmet expectations. In general, riskier endeavors require higher expected rates of return. For example, for financial investments the market has developed rigorous means of evaluating the relative risks of different investment options and prices them accordingly. Higher risk investments require the expectation of higher returns. A greater sense of risk stemming from uncertainty about the possible tax consequences of an activity will usually mean the taxpayer will require a higher rate of return.

To the extent taxpayers require higher returns on their activities due to a general uncertainty about the tax consequences, the range of activities they are willing to undertake decreases. Heightened uncertainty about taxation reduces the amount of economic activity. This is an argument for tax reform (that taxpayers would have greater confidence in their understanding of the tax consequences) and for subsequent stability. To the extent taxpayers believe they may be subject to harsh and retroactive tax changes, this prospect further enhances the perceived riskiness of their activities and so further reduces the amount of economic activity. Every instance of retroactivity strengthens the prospect in investors' minds that the Congress may apply taxes retroactively in the future.

**Constitutionality**

In addition to the unfairness and bad economics of retroactive taxation, there is a serious question of the constitutionality of retroactive taxation resulting from fun-
damental tax reform. In recent years, the Supreme Court has indicated that it will only consider challenges to retroactivity on the basis of violating the Due Process Clause of the Fifth Amendment. The Due Process Clause simply states that no person shall “be deprived of life, liberty, or property without due process of law.” Since retroactive taxation clearly involves a deprivation of property, the issue is what constitutes “due process of the law.”

Whether the retroactive application of a statute violates due process depends on the finding as to whether the application was “arbitrary and irrational.” The test of whether the retroactive application was arbitrary depends on whether

"... the retroactive application of a statute is supported by a legitimate legislative purpose furthered by rational means, ...."  

Usury v. Turner Elkhorn Mining Co. (US 1976)

The more interesting parts of the test are the conditions under which enacting retroactive taxation is deemed irrational behavior on the part of the legislature. In the Supreme Court’s opinion in United States v. Carlton (1994), Justice Blackmun noted three cases from the late 1920s. The first two cases (Nichols v. Coolidge and Blodgett v. Holden) held the imposition of estate and gift taxes on transfers consummated before the tax provisions were proposed in Congress to be unconstitutional. The third case (Untermyer v. Anderson) involved the imposition of gift tax on a gift made while the statute was pending in Congress, but before its enactment. In this third case the Court held the imposition of the tax to be unconstitutional on the grounds that “the taxpayer may justly demand to know when and how he becomes liable for taxes — he cannot foresee and ought not to be required to guess the outcome of pending measures.” Justice Blackmun went on to point out that these cases apply solely in situations involving “the creation of a wholly new tax.” Thus, it would seem clear on this basis that additional taxes owed due to the imposition of a new tax resulting from tax reform could be unconstitutional.

Justice O’Connor, concurring in the Court’s judgement in Carlton, also emphasized the length of the retroactive reach in assessing whether the means employed were rational. She noted that, in previous rulings in which retroactive taxation was found to be constitutional, the retroactive reach was “confined to short and limited periods.” Specifically, she concluded:

A period of retroactivity longer than the year preceding the legislative session in which the law was enacted would raise, in my view, serious constitutional questions.

Justice O’Connor went on further to pose her own rationality test:

The government interest in revising the tax laws must at some point give way to the taxpayer’s interest in finality and repose.

Against this proposition she concluded that a “wholly new tax” could not be imposed retroactively because it would be “arbitrary to tax transactions that were not subject to taxation at the time the taxpayer entered into them.” Thus, tax reform that would otherwise increase the tax burden on existing transactions would appear to violate the Due Process Clause of the Fifth Amendment unless there were some material, mitigating circumstances.

Economic Windfalls

Retroactive taxation, the changing of the rules as they apply to pre-existing arrangements so as to increase the tax burden, is unfair and is equivalent in nature to the expropriation of income and wealth. The reverse of retroactive taxation, namely tax reform-created windfalls are also inappropriate and unfair, though obviously for different reasons. These windfalls arise
when certain activities or investments, subject to tax under current law would face a lower rate of tax or would be tax free under tax reform. A simple example of such a windfall arising with a taxable bond is presented in Example 1.

Example 1

Suppose a bond pays 10 percent interest for 20 years, was purchased for $1,000, and that its owner is subject to a combined federal and state tax rate of 30 percent. In after-tax terms, this bond yields its owner a 7.0 percent annual rate of return. In buying the bond the taxpayer figured his or her return on an after-tax basis and concluded that $1,000 was a fair and reasonable price given the bond’s risk characteristics. Now suppose, after purchasing the bond, that a new tax system is introduced and that the new system does not impose tax on interest income. The bondholder then receives an after-tax yield of 10 percent and the price of the bond would rise automatically to $1,318. Through the enactment of a new tax system, this bondholder has received a windfall of $318 on a $1,000 investment.

Taxes on capital income and principal greatly reduce the ability of the economy to create new jobs and higher wages. They do this by raising the cost of capital to investment. The cost of capital increases to cover the taxes and still yield investors a satisfactory after-tax return. Thus, capital income taxes, by increasing the cost of capital, reduce the desired stock of capital employed.

When a taxpayer evaluates a potential investment, the taxes that would be due play an important role in determining whether the investment is likely to yield a satisfactory after-tax return. If the taxpayer makes the investment, he or she has determined that the price of the asset is reasonable given the expected income streams and tax liabilities. At higher levels of tax, the price the taxpayer is willing to pay would be lower, and conversely at lower levels of tax the taxpayer would be willing to pay a higher price.

Consider again the case of the $1,000 20-year bond paying 10 percent interest. If the taxpayer purchases the bond for $1,000, he or she is saying that this is a fair and reasonable price for the bond. Suppose, as above, that the tax on the bond’s interest income is waived and that the price of the bond increases to $1,318. The entire amount of the $318 windfall becomes the property of the bondholder. A subsequent purchaser of the bond would pay the current going price of the bond, namely $1,318, which now yields him or her an annual rate of return of 7.0 percent. Thus, subsequent asset purchasers would be indifferent between buying the bond for $1,000 and paying 30 percent tax on the resulting interest income, or paying $1,318 and paying no tax. As this example demonstrates, the full amount of the windfall becomes the property of the asset holders at the time of the change in tax policy — subsequent owners receive none of the windfall.

Most tax reform proposals would eliminate the tax on capital assets. Thus they eliminate the taxes on dividends, interest, and capital gains, and they eliminate the estate and gift taxes. Every asset producing a taxable stream of receipts to its owner under current law would yield that owner a one-time windfall under tax reform. In total, this would amount to hundreds of billions of dollars of tax windfall.

Tax reform-created windfalls are inappropriate for a number of reasons. First, without appropriate transition rules tax reform would bestow these windfalls on some lucky citizens and not on others. If all citizens benefitted from these windfalls uniformly, then they would be far less troublesome.

The second problem with these windfalls is that they only accrue to taxpayers with wealth prior to tax reform. Indeed, the more wealth one has prior to tax reform, the more windfall one would receive. This is probably the greatest political difficulty for tax reform proposals lacking adequate transition rules: They would bestow enorm-
mous windfalls on the wealthy. The following example illustrates both dimensions of the windfall problem.

Example 2

Consider two individuals with like amounts of current and expected future incomes. In looking for a better future for herself, Ms. Jones reduces her personal consumption expenditures to pay for additional education specifically to increase the value of her labor services. Mr. Smith also reduces his consumption expenditures, but he uses the proceeds to buy shares in a mutual fund that invests in corporate equities. If Ms. Jones and Mr. Smith receive equal amounts of additional income from their investments, then under current law they would pay equivalent amounts of additional tax. Whether this treatment is correct or not on a theoretical basis, the relevant fact is that both of them made their decisions expecting a certain future tax treatment.

Many tax reform proposals would eliminate the multiple taxation of saving and would do so by shifting the tax burden ultimately on to labor income. At the individual level, for example, the Flat Tax taxes all labor income and excludes from the tax base all forms of capital income such as dividends and interest income, and excludes capital gains. Suppose the Flat Tax were enacted some time after Ms. Jones graduates. Under the Flat Tax, Ms. Jones would continue to see a rising tax burden as her education pays dividends in terms of higher wages. Mr. Smith, however, would reap a sure windfall as the taxes that would have been due on his investments under the income tax are eliminated. Thus, we have two similarly situated individuals, both of whom saved and invested based on the existing rules of the game. But the actual tax treatment of their investment is very different due entirely to tax reform.

Tax reform that results in widespread tax windfalls would surely be welcomed by those receiving the windfalls. But all other taxpayers would just as surely find the windfalls to be unfair. This sense of resentment toward the new system by those left out of the windfall lottery would be enhanced by the higher taxes that they would have to pay to underwrite these windfalls. Even if tax reform provides every taxpayer a tax cut, those receiving windfalls would receive greater tax relief and those not receiving windfalls would receive less tax relief. This disparity is likely to be intolerable, especially since the wealthy would reap the greatest share of the benefit.

Tax windfalls could be justified if they produced some salutary economic effect. As a rule, no such effect exists. Consider once again Mr. Smith’s windfall that resulted from the elimination of the tax on capital income and capital gains. This capital income and gains result from pre-tax reform saving. Changes in tax law affecting the taxation of saving will obviously affect saving behavior going forward, but just as obviously such changes cannot affect decisions made prior to the changes.

Second Principle of Transition: Simplification

A chief goal of tax reform is to simplify the tax system dramatically. This goal should apply with equal weight to the design of transitional rules. The simplest transition system would be to have no transition rules at all. This would obviously maximize the gain in simplicity, but it would also maximize the violation of the proscription against retroactive taxation and the creation of windfalls. Thus, there is often an inherent tension between the need to avoid retroactive taxation and the need to preserve the benefits of tax reform’s simplification. The tension can often be relieved if we remember that simplification ought not be a standard applied in a vacuum. Hence the second principle of transition:

- Tax reform transition rules should be as simple as possible, recognizing that simplicity must be considered given the ar-
rangements the taxpayer has already undertaken to comply with the income tax.

No transition system can be simpler than allowing the taxpayer to continue to use existing compliance systems for their pre-tax reform arrangements. However, some tax reform proposals containing transition rules would require the taxpayer to adopt a new set of tax rules on a going-forward basis and a second new set of rules for transition, jettisoning all the previous tax rules. A good example is the case of depreciation allowances.

Businesses generally deduct the cost of their plant and equipment from taxable income over many years according to schedules prescribed by law. Thus, a business may have hundreds of millions of dollars in assets the costs of which have not yet been deducted in calculating taxable income. For a given company, the total of the amount not yet deducted is sometimes called the aggregate remaining basis. Under tax reform proposals adopting some form of cash flow tax or transfer tax at the business level, plant and equipment purchased after tax reform may be expensed. That is, when a company buys a new machine following tax reform, the company will be allowed to deduct the full price of the asset from taxable income in the year the machine is purchased. The question then is what to do with the remaining basis from prior purchases of plant and equipment.

One answer is to disallow any deduction for the remaining basis of these assets. While simple enough, this approach would violate the first principle of transition, which is to avoid retroactive taxation. The amount and type of investments businesses are willing to undertake are often heavily influenced by the applicable depreciation rules. Eliminating the deduction for depreciation retroactively would directly increase the tax on income produced by the underlying assets.

A second solution would be to allow businesses to deduct immediately the full amount of their remaining basis on prior years' investments. But there are two problems with this approach: It would dramatically reduce the size of the tax base, reducing tax revenues and presumably necessitating a higher tax rate, and it would produce an economic windfall because the current value of the deduction would exceed the present value of the deductions the business would have taken under current law.

Without question, the current depreciation allowance system is complex and compels taxpayers to develop sophisticated accounting systems to track assets for tax purposes. Recognizing this complexity and the need for transition rules, some tax proposals have suggested applying alternate, simpler depreciation rules to remaining basis. While well intended, these transition rules would actually exacerbate the existing complexity. Taxpayers spend large sums developing accounting systems to record and track depreciation on their assets. While wasteful and unfortunate, businesses have already incurred these expenses and the systems are already in place. No transition system could be simpler, then, than to allow the taxpayer to continue to apply the old depreciation rules to the old assets. Thus, to a first approximation at least, simplification and a proper transition rule go hand-in-hand when the existing depreciation is "grandfathered" in this way.

**Specific Issues in Transition**

If addressed on an item-by-item basis and if taken to the extreme, the number of issues requiring a transition rule could run into the hundreds, if not the thousands. The issues present a natural taxonomy, however, which may greatly simplify the process. Under this taxonomy, the issues may be grouped according to whether:

1) A correct and simple solution is to grandfather the existing tax treatment for those economic arrangements and activities undertaken before tax reform.

2) The existing tax code has created tax assets such as excess Foreign Tax Credits for which there is no natural analog in
the new tax system and so grandfathering would be ineffective.

3) The taxpayer has a claim on future income from currently owned assets and the income would be taxed more lightly or not at all under the new tax system.

We shall next consider examples of each of these issues in turn. This discussion is intended solely to be illustrative of the issues involved and how certain solutions may or may not be appropriate.

**Grandfathering Existing Treatment**

The discussion above regarding depreciation of existing assets under transition demonstrated how grandfathering of prior tax treatment might be an appropriate transition rule in some circumstances. Depreciation, however, is just one item on a long list of provisions relating to costs incurred by a taxpayer that must be capitalized and deducted over a period of years under current law. There are many such expenses, including those associated with inventory and research and experimentation.

Perhaps the most important expense for which grandfathering of previous treatment may be appropriate is interest expense that is currently deductible. Recall the example above of the homeowner expecting to deduct home mortgage interest expense. As the example showed, the loss of the deduction would dramatically increase this borrower's costs.

Some commentators have noted that borrowers would receive some relief from a general decline in interest rates following tax reform. The implication they draw is that transition relief for pre-existing debt may not be needed. There are, in fact, sound reasons to assume that the elimination of tax on interest income would cause interest rates on currently taxable debt instruments to decline (the price of the debt instrument would increase) after tax reform solely because of the elimination of the tax on interest income. It is important to note that this change in interest rates is virtually automatic and is not dependent on any change in saving or investment behavior. It results simply because an asset was priced assuming the income from the asset was taxable and it would no longer be taxable after tax reform. For example, a bond that would pay 8 percent interest on a pre-tax basis currently where the marginal effective tax rate facing bondholders is 25 percent would, if issued after tax reform, pay 6 percent interest.

While the decline in interest rates following tax reform is important for future debt issuers, it offers existing debtors no relief unless they are able to refinance their debt at the new interest rates immediately and costlessly. Instead, as with the example of the family with a home mortgage discussed above, the loss of the interest deduction for pre-existing debt would impose a severe financial hardship and would be unfair. It is therefore essential that any tax reform eliminating the interest expense deduction for businesses or individuals prospectively also grandfather the deduction for pre-existing debt.

Fortunately, unlike those instances such as depreciation where grandfathering prior tax treatment results in a temporarily reduced tax base, grandfathering interest expense is roughly revenue neutral. This is because the tax on the interest income accruing to the holder of the debt must also be grandfathered to prevent a windfall accruing to creditors. Unfortunately, some simplicity preserved through grandfathering is offset by additional complexity because creditors holding debt issued prior to tax reform must continue to report and pay tax on interest income from this debt. These issues are demonstrated in Example 3 below.

**Example 3**

Suppose a bank has lent a business $100,000 to upgrade its machinery and charged 8 percent interest on the loan. The business purchased the machinery expecting to be able to deduct the interest expense while the bank expects to pay tax on its interest income. For simplicity, suppose both the business and the bank face a mar
ginal tax rate of 25 percent, so that the business is paying 6 percent interest and the bank is earning 6 percent, each on an after-tax basis. Now suppose Congress enacts tax reform, eliminating the interest deduction and the tax on interest income. The business's after-tax interest expense and the bank's after-tax income then each increase to 8 percent. In effect, tax reform has effected a one-time transfer of wealth from the business to the bank. If, however, both the business's interest deduction and the bank's interest income from this pre-existing debt are grandfathered, then the business is held harmless and the bank receives no windfall — all with no net effect on federal tax collections.

Orphaned Tax Assets

Taxpayers accrue many tax deductions and credits other than those listed above, and for some of these items grandfathering may not be a viable or sensible solution. Such items might well be termed orphaned tax assets. They are assets because to the taxpayer they represent expected reductions in future tax liability, which is financially equivalent to an increase in after-tax revenue. They are orphans because there may be no simple, practical rule-of-thumb for developing transition rules for such provisions.

A good example of a potential orphan is accrued foreign tax credits. Under current law, the United States imposes tax on the worldwide income of its citizens. This means, for example, when a U.S. company earns income abroad the U.S. taxes that income as though it were earned in the United States. Generally, foreign-source income is subject to a variety of foreign taxes, including foreign income taxes. To avoid double income taxation the United States employs a foreign tax credit. This credit allows taxpayers to use foreign income taxes paid as a credit against their U.S. tax liability arising from foreign income. To prevent the taxpayer from using the foreign tax credit to offset U.S.-source income, the credit is limited to the amount of tax the taxpayer would owe if the income was U.S. source. An example of the taxation of foreign income and the Foreign Tax Credit is presented below.

Example 4

Suppose a U.S.-owned foreign company earns $2 million in manufacturing income in Germany and pays $1 million in German income tax. The German income tax liability creates a potential $1 million U.S. foreign tax credit. Suppose the foreign company repatriates the income to the U.S. parent company, thereby creating a $750,000 U.S. income tax liability. The U.S. parent company would then apply $750,000 of its $1 million foreign tax credit against the U.S. income tax liability, fully offsetting the U.S. tax liability. At the same time the U.S. parent would lose the amount of the excess credit, namely $250,000.

U.S. corporations frequently use partially- or wholly-owned foreign subsidiaries to carry out their international operations. Just as United States incorporated entities are considered U.S. citizens for U.S. federal income tax purposes, U.S.-owned foreign subsidiaries are considered to be foreign citizens for purposes of foreign and U.S. tax purposes. Consequently, as a general rule the United States has no direct claim on any income earned by these subsidiaries until a U.S. taxpayer becomes involved, normally when the foreign earnings are repatriated to the U.S. parent. Until such time as the earnings are repatriated, the recognition of the foreign income and associated foreign tax credits is generally “deferred” for U.S. tax purposes.

One of the advances in tax policy offered by tax reform is that most proposals would, in most cases, eliminate the U.S. tax on foreign-source income and the foreign tax credit. This change would dramatically reduce the complexity of the tax code and the uncertainty about how many transactions would be treated. It would also improve the ability of U.S. companies to com-
pete abroad. Unfortunately, eliminating the tax on foreign-source income also creates some particularly difficult transition issues. For example, eliminating the tax effectively extinguishes accrued foreign tax credits for some companies while simultaneously providing significant tax windfalls for other companies.

When a company is in a net excess foreign tax credit position, the value of its excess credits is recorded as an asset on the company's balance sheet. They are properly treated as an asset because they reflect a reduced future income tax liability. If tax reform eliminated the foreign tax credit without some appropriate transition with respect to accrued excess foreign tax credits, these assets would disappear. While the federal government would not receive the resources, from the company's perspective tax reform would have extinguished some of its shareholders' wealth. Obviously, this is just the sort of tax reform result demanding transition relief.

It is not immediately obvious what form that relief might take. One option would be for the Federal government to pay taxpayers for their lost foreign tax credits as though the taxpayers' loss was effectively a "taking" resulting from tax reform. Just about the same result could be achieved more easily if companies with excess foreign tax credits were allowed to apply those credits against the U.S. domestic income tax liability. It is hard to imagine, however, having the U.S. government make direct payments to U.S. international companies to compensate them for the fact that they paid high taxes to foreign governments. And it is equally difficult to imagine allowing these same companies to use foreign tax credits to reduce their U.S. income tax liability arising from U.S. domestic income. Nevertheless, some solution to this transition problem must be found to avoid violating the first principle of transition relating to retroactive tax increases.

**Past Investments, Future Income**

The taxation of foreign-source income provides an excellent example of another difficult transition problem, aside from what to do with earned excess foreign tax credits. Taxpayers, whether individuals or businesses, have made an entire economy's worth of investments all with the expectation that they would have to pay some tax, and in some cases a great deal of tax on the income and capital gains from these investments. In some cases, the effect of tax reform is to eliminate entirely the income tax burden on the streams of future income resulting from these investments.

In the international arena, U.S. taxpayers have made billions of dollars of foreign investments in the expectation that they would eventually owe some residual U.S. income tax. As discussed above, most tax reform proposals would eliminate this tax on foreign-source income. This obviously creates an economic windfall to these companies entirely outside the normal forces of economics.

The problem of past taxable investments yielding income that is not taxable due to tax reform extends across the economy from complex areas such as international taxation to as simple a matter as the interest income earned by an individual on a bank Certificate of Deposit. Every instance in which tax reform would eliminate the tax owed on the income or capital gain from a past investment creates a windfall to the asset's owner. This applies to every share of stock, every parcel of capital gains tax-yielding real estate, and every bond held by a U.S. taxpayer. And, as demonstrated in Example 1, the amount of the windfall can be sizable. In that example, a holder of a $1,000 bond yielding 10 percent annual interest would enjoy a $318 windfall under tax reform. Such windfalls must be avoided if fairness is to remain a goal of tax policy and tax reform.
Conclusion

As tax reform moves forward it is imperative that tax reformers give due and early attention to the problems of transitioning from the existing income tax to the new tax system. The more fundamental the reform, the greater will be the need to attend to transition issues.

At the heart of the need for proper transition rules is the need to avoid insofar as possible retroactive tax changes, whether those changes are in the form of tax increases or tax relief. Retroactive tax increases constitute a confiscation of wealth and income. Retroactive tax relief, or windfalls, would be wonderful for those receiving the windfalls but are harmful to all other taxpayers because the cost of these windfalls is a higher tax rate. Either way, the need for even-handedness in the imposition of the tax burden is clearly violated.

Compared to the apparent simplicity of most tax reform plans, transition issues can be quite complex. Often, however, this complexity is due to the complexity of the existing system and of economic activity generally. In many cases, the complexity can be minimized with due care and by maximizing the use of the grandfather principle.

Finally, many transition rules would be quite costly in terms of reducing, albeit temporarily, the tax base. However, there would be offsetting transitional revenues to the extent tax reform transition adequately recaptures the many economic windfalls that would otherwise occur. These windfalls occur when the tax base under the new tax system excludes income currently taxed under the income tax. The extent to which the transition regime addresses retroactive tax increases and these tax reform-generated windfalls will determine the net effect the transition regime will have on federal revenues and thus on the initial tax rate. The ability and willingness of tax reformers to address these issues directly will affect the pace at which tax reform moves from dream to reality.

Endnotes

1 For a more complete discussion of retroactive tax policy, see “Sound Tax Policy vs. Retroactivity,” by J.D. Foster, published as an Extra Point, July 1997, Tax Foundation.

2 This section draws extensively from, “The Post-Carlton World: Just When is a Retroactive Tax Unconstitutional,” by Richard Belas which appeared in Tax Notes, October 30, 1995.

3 Allowing taxpayers with remaining basis to continue to deduct the costs of their previous investments provides a good approximation to a transition rule that is consistent with tax neutrality. It is only an approximation, however, because the value of the tax deduction changes according to whether the tax rate in the new tax system is higher or lower than was the tax rate in the previous system. The value of a deduction to a firm is equal to the tax rate times the amount deducted. Thus, if the marginal tax rate is 35 percent, then the value of a deduction is 35 cents on the dollar. If the tax rate in the reformed tax system is 25 percent, then the value of the deduction drops by 10 cents per dollar of depreciable basis. This loss due to the decline in the value of depreciable basis due to a lower tax rate is roughly offset by the lower tax rate applied to the income produced by these assets.

4 For a more complete explanation of U.S. international tax policy, see “Promoting Trade, Shackling our Traders”, by J.D. Foster, Tax Foundation Background Paper No. 21, November, 1997.

5 In an ideal world, companies with excess foreign tax credits made worthless by tax reform would also be the companies with like amounts of expected residual U.S. tax from foreign investments. This, however, would be the rare exception, rather than the rule, and so separate solutions to the excess credit and future residual tax problems will be needed.