Duke Law Journal

VOLUME 62 APRIL 2013 NUMBER 7

DELEGATING UP: STATE CONFORMITY WITH THE FEDERAL TAX BASE

RUTH MASON†

ABSTRACT

Congress uses the income tax to achieve policy goals. States import federal tax policies into their own tax systems when they incorporate by reference the federal income tax base as the starting point for assessment of state income taxes. But federal tax policies reflect national, not state, political choices. This Article calls attention to the practice of tax-base conformity and to its advantages and disadvantages. Conformity conserves legislative, administrative, and judicial resources, and it reduces taxpayers' compliance burdens. At the same time, however, conforming states cede tax autonomy to the federal government, thereby jeopardizing federalism values, such as regulatory diversity and diffusion of power. Conforming states also expose themselves to revenue volatility stemming from the ever-changing federal tax law. Despite these concerns, the administrative and compliance advantages of federal-state tax-base conformity are so significant that states are unlikely to abandon it. Thus, this Article

† Anthony J. Smits Professor of Global Commerce and Professor of Law, University of Connecticut School of Law. For their helpful comments, I am grateful to Anders Christiansen, Daniel Halperin, Wally Hellerstein, Daniel Hemel, Michael Knoll, Sarah Lawsky, Marty McMahon, Katie Pratt, Alex Raskolnikov, David Schizer, Rich Schragger, Ted Seto, Kirk Stark, Jeff Strnad, David Walker, Ethan Yale, George Yin, Larry Zelenak, faculty workshop participants at Cornell Law School, University of Connecticut School of Law, University of Florida College of Law, and University of Virginia School of Law, tax workshop participants at Columbia Law School, Duke University School of Law, Loyola Law School of Los Angeles, and participants at the *Yale Law Journal* Reading Group and the Yale Law Women Reading Group. Mike Aikins and Jarrod Shobe provided valuable research assistance.

makes only limited recommendations for reducing the adverse impacts of tax-base conformity.

TABLE OF CONTENTS

INTRODUCTION

Congress uses tax incentives to regulate by rewarding socially useful behavior with lower taxes and penalizing undesirable activities with higher taxes. Deductions, exemptions, and tax credits reward favored activities, such as charitable giving. Higher tax rates, acceleration of tax liability, and denials of deductions, exemptions, and tax credits penalize disfavored activities, such as early withdrawal of retirement savings. Thus, Congress uses its taxing power to influence behavior.

Whereas Congress uses tax incentives to affect the behavior of private taxpayers, this Article argues that federal tax incentives also affect the states because most states incorporate federal definitions of income into their own tax laws. For example, the starting point for calculating individual income taxes in almost all states is the taxpayer's *federal* "adjusted gross income" or "taxable income." As this Article explains, these federal income definitions reflect a variety of controversial tax policy decisions made at the federal level. When states incorporate by reference federal income definitions, states automatically import federal tax policies into state law. Although states set their own income tax rates, and although states deviate from federal tax law on some issues, all state income taxes closely track the federal tax base.

The usual reason given for federal-state tax-base conformity is administrability. Assessing state income taxes upon the federal tax base eases states' legislative and enforcement burdens, and it reduces taxpayers' compliance burdens. This Article provides a fuller account of the benefits of tax-base conformity. For example, state conformity with the federal tax base results in states using the same tax bases as each other—that is, federal-state tax-base conformity results in de facto state tax-base harmonization. Among other advantages, state tax-base harmonization facilitates interstate commerce by reducing transaction costs for taxpayers with economic activities in more than one state. Harmonization also reduces the risk to taxpayers of double state taxation, as well as the risk to states of tax-base erosion through tax arbitrage. Finally, state bases that conform with the federal base also likely contain fewer protectionist provisions or provisions that discriminate against residents of other states than would autonomously drafted state tax bases.

Although it generates many advantages, federal-state tax-base conformity also presents disadvantages. For example, conforming states cede tax autonomy to the federal government, thereby potentially reducing states' responsiveness to resident voters. Furthermore, conformity jeopardizes the values served by federalism, including regulatory diversity and diffusion of power. Finally, conforming states also expose themselves to the revenue volatility that stems from the ever-changing federal tax law.

Despite these disadvantages, federal-state tax-base conformity so far has generated little controversy, perhaps because tax scholars tend to focus on federal taxation to the exclusion of state taxation.[1] Although tax scholars have considered the fiscal federalism implications of particular federal tax provisions that affect state taxation, such as the federal deduction for state and local taxation, federal-state tax-base conformity has not played a significant role in fiscal federalism analysis.[2] One commentator, however, recently considered the democratic impact of federal-state tax-base

1. *See* Kirk J. Stark, *The Federal Role in State Tax Reform*, 30 VA. TAX REV. 407, 423 (2010) (calling base conformity "little discussed"). The last scholarly article that had tax-base conformity as its principal topic was published in 1977. Otto G. Stolz & George A. Purdy, *Federal Collection of State Individual Income Taxes*, 1977 DUKE L.J. 59. Stolz and Purdy's analysis is more limited than that provided in this Article because they focus on the now defunct Federal-State Tax Collection Act of 1972, 26 U.S.C. §§ 6361–65 (1988) (repealed 1990), under which the federal government would collect income taxes on behalf of the states, provided that the states substantially conformed their bases with the federal base. Stolz & Purdy, *supra*, at 61–66.

2. For articles discussing the federal deduction for state and local taxes, see generally, for example, Brian Galle, *Federal Fairness to State Taxpayers: Irrationality, Unfunded Mandates, and the "SALT" Deduction*, 106 MICH. L. REV. 805 (2008); Louis Kaplow, *Fiscal Federalism and the Deductibility of State and Local Taxes Under the Federal Income Tax*, 82 VA. L. REV. 413 (1996); Ruth Mason, *Federalism and the Taxing Power*, 99 CALIF. L. REV. 975 (2011); and Kirk J. Stark, *Fiscal Federalism and Tax Progressivity: Should the Federal Income Tax Encourage State and Local Redistribution?*, 51 UCLA L. REV. 1389 (2004).

conformity.[3] In an article primarily addressing international delegation, Professor Michael Dorf used the example of federal-state tax-base conformity to illustrate his argument that "upward delegation[]"[4] within a federal system raises fewer democratic concerns than does upward delegation from a nation to a supranational institution.[5] Though Professor Dorf is undoubtedly correct in this comparative analysis, at least three factors justify taking a closer look at federal-state tax-base conformity. First is the states' growing reliance on income taxation in the face of declining property tax revenues.[6] Second is Congress's growing tendency to use the federal tax law to regulate, rather than simply to raise revenue.[7] Both of these factors tend to increase the regulatory impact in the states of federal-state tax-base conformity. Finally, the current divisive political environment may mean that national policy preferences are more likely to diverge from state policy preferences.

After exploring the advantages and disadvantages of tax-base conformity, this Article argues that the most important tool for mitigating the adverse impact of federal-state tax-base conformity is states' ability to deviate from the federal tax base. Because no law obliges states to conform to the federal tax base, states may terminate conformity at any time. Moreover, states can deviate or "decouple"[8] from particular federal tax provisions on a case-by-case basis, which

---

3. Michael C. Dorf, *Dynamic Incorporation of Foreign Law*, 157 U. PA. L. REV. 103, 153–58 (2008).

4. *Id.* at 118.

5. *Id.* at 153–58.

6. *See* Kim Reuben & Carol Rosenberg, *State and Local Revenues*, 119 TAX NOTES 77, 78 (2008) (noting that from the 1970s to 2008, state personal income taxes as a share of all state and local revenue, including local taxes, grew from 9 to 12 percent); *see also* TAX POLICY CTR., THE TAX POLICY BRIEFING BOOK: A CITIZEN'S GUIDE FOR THE 2008 ELECTION AND BEYOND, at IV-1-4 (2008), *available at* http://www.taxpolicycenter.org/upload/Statelocal/IV-1STATEOFLOCALTAXPOLICY.final.pdf (providing detailed data and noting that state personal income tax collections totaled $305 billion in 2008).

7. *See generally* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-05-690, TAX EXPENDITURES REPRESENT A SUBSTANTIAL FEDERAL COMMITMENT AND NEED TO BE REEXAMINED 22–27 (2005), *available at* http://www.gao.gov/new.items/d05690.pdf (showing an increase over time in the number and dollar value of federal tax expenditures). The most dramatic recent example of regulation through the tax law is the enforcement through a tax penalty of the individual mandate of the Patient Protection and Affordable Care Act. *See* I.R.C. § 5000A (Supp. V 2012) (imposing a tax penalty on certain individuals who fail to maintain minimum essential health-care coverage).

8. JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, STATE TAXATION ¶ 7.02[1][a] (3d ed. Supp. 2007) (discussing states' decisions to deviate from or conform to federal bonus depreciation in 2001).

allows states to secure the principal advantages of base conformity while retaining significant control over their fiscal systems. This feature of tax-base conformity contrasts with other intergovernmental cooperative mechanisms, such as international delegations or conditional grants, which generally restrict deviations.[9]

Notwithstanding the formal option to deviate, certain factors tend to entrench federal tax law within the states. State deviations from the federal tax base face political, procedural, and administrative obstacles. One political obstacle is that after states incorporate federal tax preferences into the state tax base, state taxpayers come to rely on them, making them harder to repeal. In particular, if state taxpayers view state deviations from federal tax preferences as "tax increases," this framing would discourage deviations. In addition, deviations increase compliance and enforcement costs for states and taxpayers. Despite these costs and obstacles, all states have exercised their option to deviate (at least somewhat) from the federal tax base.

But not all federal tax laws are created equal from the perspective of states wishing to deviate. As a practical matter, some federal tax provisions cannot easily be severed from the rest of the federal tax base. Examples of nonseverable federal provisions include the annual reporting requirement and the realization rule.[10] It is not practical for conforming states to deviate from such federal provisions. Unfortunately, as this Article shows, because the degree of entrenchment of a federal tax provision is not necessarily related to its normative desirability, incorporating states will sometimes be unable to deviate from federal tax rules that do not work well for the state or that do not reflect the preferences of state voters.[11]

The primary aims of this Article are positive; it analyzes the practice of tax-base conformity with emphasis on its advantages and disadvantages, and it seeks to explain why base conformity is both widespread and entrenched. The first five parts of the Article tackle these issues. Part I provides background on state conformity with the federal individual income tax base. Although I focus on individual taxation because of its revenue significance,[12] many of my arguments

9. *See* Dorf, *supra* note 3, at 115–24.

10. For more on the realization rule, see *infra* Part III.A.1.

11. *See infra* Part V.C.

12. Excluding local taxes, in 2008, state individual income taxes accounted for 24 percent of total state tax revenues, whereas corporate taxes accounted for 4 percent. The remainder of

also apply to corporate taxes because many states also incorporate the federal corporate tax base.[13] Part II analyzes the advantages of tax-base conformity. Part III analyzes its disadvantages. Part IV considers the impact of base conformity on state tax competition. Part V considers the extent to which states' ability to decouple from particular provisions of the federal tax law mitigates the disadvantages of conformity, and it concludes that the entrenchment of certain federal tax provisions limits states' opportunities for deviation. Although the primary purpose of this Article is to shed light on the hidden impact of tax-base conformity, rather than to make normative claims about conformity, Part VI nevertheless makes limited policy recommendations for reducing some of the adverse impacts of base conformity identified in Part III. Part VI also points to avenues for future research that would expressly take base conformity into account as an important aspect of both state tax policy and fiscal federalism.

In making policy recommendations, Part VI assumes (realistically) that the administrative and other advantages of tax-base conformity are so substantial that states will not abandon conformity. Part VI therefore considers other steps states can take to mitigate the democracy and federalism concerns raised by conformity. For example, conforming states should publish tax expenditure budgets, which would alert voters and state officials to the costs of incorporating federal tax subsidies. Likewise, rather than conforming to the federal definition of "taxable income," states instead should conform to the federal definition of "adjusted gross income."[14] Making this simple change would prevent states from automatically incorporating federal itemized deductions that have clear regulatory goals.

An implication of the analysis in this Article is that federal-state fiscal interactions are more complex than is usually appreciated, and specifically, that commentators have underestimated the influence of the federal government on state tax policy. For example, although many commentators (including myself) have commented on the

---

state revenue was from other sources, such as sales and gross-receipts taxes and utility revenues. *See* TAX POLICY CTR., TAX FACTS: STATE AND LOCAL GENERAL REVENUE 2004–2010 (2012), *available at* http://www.taxpolicycenter.org/taxfacts/displayafact.cfm?Docid=507.

13. For more on state conformity to the federal corporate tax base, see generally HELLERSTEIN & HELLERSTEIN, *supra* note 8, ¶¶ 7.02–7.16 (Supp. 2007).

14. For a definition of "adjusted gross income," see *infra* note 24 and accompanying text.

absence of an active federal role in state taxation,[15] this Article reveals that the federal government wields substantial passive influence over state taxation by defining the tax base.

Base conformity therefore should play a meaningful role in federalism analysis and tax policy debates.[16] Part VI shows that explicit consideration of base conformity provides new insight into old tax policy questions. For example, it provides new justification for the federal deduction for state and local income taxes: the deduction encourages states to raise revenue via a method that indirectly bolsters federal policy. Base conformity considerations also reinforce the argument that the preferred form for federal tax incentives should be credits, rather than deductions or exemptions. Structuring federal tax incentives as credits not only would assure that low-bracket taxpayers receive the same benefits as high-bracket taxpayers, but it also would minimize the regulatory impact of federal tax incentives at the state level, given that the default under base conformity is that states do not incorporate federal credits. Part VI discusses the impact of base conformity on other important tax policies as well, including the use of legislative sunsets and the possibility of adopting a federal consumption tax. Finally, Part VI suggests specific avenues for empirical research that would afford us a better understanding of the role of base conformity in our fiscal federal system.

I. FEDERAL-STATE TAX-BASE CONFORMITY

To understand the regulatory impact of the federal tax base on the states, it is important first to understand some technical aspects of state tax bases. Forty-one states have broad-based individual income taxes; two tax only unearned income, and seven states have no

---

15. *See* Walter Hellerstein, Georg W. Kofler & Ruth Mason, *Constitutional Restraints on Corporate Tax Integration*, 62 TAX L. REV. 1, 57–58 (2008) ("Although . . . Congress has occasionally imposed national rules affecting direct taxation . . . , states have largely been left to their own devices . . . ."); *see also* Kathryn L. Moore, *State and Local Taxation: When Will Congress Intervene?*, 23 J. LEGIS. 171, 182–203 (1997) (studying empirically congressional intervention in state taxation, but not considering conformity as a method of intervention); Daniel Shaviro, *An Economic and Political Look at Federalism in Taxation*, 90 MICH. L. REV. 895, 952–54 (1992) (providing reasons as to why members of Congress are reluctant to intervene directly to limit state taxing powers, even if doing so would increase efficiency).

16. This is currently not the case. For example, in a lengthy recent article, Professor David Super only briefly considered tax-base conformity. David A. Super, *Rethinking Fiscal Federalism*, 118 HARV. L. REV. 2544, 2594–98 (2005).

individual income taxes at all.[17] The nine states without comprehensive income taxes are not the principal subject of this Article. But they demonstrate that it is possible for at least some states to fund their public programs without reliance on income taxation.[18] As discussed in Part V.A., that some states have forgone comprehensive income taxation shows that at least some states have a viable alternative to federal-state tax-base conformity.[19] This Part focuses on the forty-one states with comprehensive income taxes, and it describes how these states rely significantly on the federal tax base for purposes of determining their residents' income tax liability.

States conform their tax bases with that of the federal government in a variety of ways. In the past, for example, some states simply collected a fixed percentage of each resident's federal tax liability.[20] This method represented perfect state conformity with the federal base as well as its progressive rate structure. Today no state directly piggybacks on the federal tax; that is, no state calculates its income tax as a simple percentage of federal tax liability.[21]

Instead, states conform to the federal tax base by incorporating federal definitions of income into their own law. Thirty-five of the forty-one states with broad-based income taxes use federal definitions of income as the starting point for calculating residents' taxable income.[22] Twenty-nine states start with federal "adjusted gross income" (AGI).[23] Federal AGI is federal gross income after so-called above-the-line deductions for such items as contributions to self-employed retirement plans, alimony payments, individual retirement account (IRA) contributions, moving expenses, and certain

17. *See* RICK OLIN & SANDY SWAIN, WIS. LEGISLATIVE FISCAL BUREAU, INFORMATIONAL PAPER 4, INDIVIDUAL INCOME TAX PROVISIONS IN THE STATES 1–2 (2011), *available at* http://legis.wisconsin.gov/lfb/publications/Informational-Papers/Documents/2011/4_individual%20income%20tax%20provisions%20in%20the%20states.pdf.

18. Seven states—Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming—do not tax income at all, and another two states—New Hampshire and Tennessee—tax only unearned income. *Id.* Although the two states that tax only unearned income rely on federal tax laws, they do so to a much lesser extent than do states with comprehensive income taxes. *See generally id.* at 14–57 (providing an overview of each state's income tax provisions).

19. *See infra* Part V.A.

20. HELLERSTEIN & HELLERSTEIN, *supra* note 8, ¶ 20.02 (Supp. 2003).

21. *Id.*

22. *See* OLIN & SWAIN, *supra* note 17, at 14–57.

23. *Id.*

educational expenses, such as payments of student-loan interest.[24] In contrast with the majority of states that start with federal AGI, six states use as their starting point federal "taxable income," which is federal AGI less personal exemptions and either the standard deduction or itemized deductions.[25] Because states that begin their income calculations with federal taxable income automatically incorporate federal itemized deductions into their tax bases, they generally will conform more closely to the federal tax base than states using federal AGI as their starting point. Nevertheless, most states that use federal AGI as their starting point still permit taxpayers to take personal exemptions and to elect either a standard deduction or itemized deductions.[26] Most states, including those that use federal AGI as their starting point, at least partially conform their itemized deductions to the federal itemized deductions.[27]

States adopt federal definitions of income in either a static or dynamic fashion. States with static, or "fixed-date," incorporation adopt the federal tax base as it existed at a certain point in time,[28] whereas states with dynamic, or "rolling," incorporation use current federal tax law as the starting point for their determinations of

24. For a simple explanation of above-the-line deductions, see INTERNAL REVENUE SERV., PUB. 17, YOUR FEDERAL INCOME TAX: FOR INDIVIDUALS 123–42 (2011), *available at* http://www.irs.gov/pub/irs-pdf/p17.pdf.

25. *See* OLIN & SWAIN, *supra* note 17, at 14–57.

26. *See id.* at 5 (noting that thirty-four states had standard deductions in 2009).

27. Many states offer itemized deductions identical to the federal itemized deductions. *See id.* at 11 tbl.4 (detailing each state's degree of conformity with federal itemized deductions). Only eleven states with broad-based income taxes did not conform at least partially with federal itemized deductions. Of these eleven, ten did not have to specify autonomously the content of state itemized deductions because they completely disallowed itemized deductions. *Id.*

28. For example, South Carolina incorporates federal tax law statically. *See* S.C. CODE ANN. § 12-6-40(A)(1)(a) (2000 & Supp. 2012) ("Except as otherwise provided, 'Internal Revenue Code' means the Internal Revenue Code of 1986, as amended through December 31, 2011, and includes the effective date provisions contained in it.").

taxable income.[29] Fewer than half the states with income taxes incorporate federal law dynamically.[30]

Although states begin their income calculations with either federal AGI or federal taxable income, all states deviate, or decouple, from particular provisions of the federal tax law. For example, states typically require residents to add back the federal-level deduction for the payment of state and local income taxes.[31] Likewise, although the federal government allows taxpayers to exempt interest from all state and local bonds, most states require residents to add back interest earned on out-of-state bonds.[32]

In addition to making upward adjustments to residents' income, many states also provide deductions that are unavailable at the federal level. For example, several states allow residents to deduct their federal taxes.[33] Other common state adjustments include allowing state residents to subtract federally taxable Social Security benefits and retirement or pension income.[34] States use such special tax provisions to attract residents and to advance other policy goals and preferences. For example, in a provision that presumably aims to promote Mississippi casinos, Mississippi provides a special itemized deduction for gambling losses, but it limits the deduction to losses incurred at Mississippi-licensed gaming establishments.[35]

After calculating state-taxable income, a state determines a resident's state tax liability by applying its tax rates. Each state

---

29. For example, Massachusetts incorporates federal tax law dynamically. *See* MASS. ANN. LAWS ch. 63, § 1 (LexisNexis 2008 & Supp. 2012) (defining "gross income" for state tax purposes as "gross income as defined under the provisions of the Internal Revenue Code, as amended and in effect for the taxable year"). Ten states clearly forbid dynamic incorporation of federal law as a violation of state constitutional nondelegation principles. *See* Dorf, *supra* note 3, at 109 n.14. The constitutions of twelve states explicitly permit dynamic incorporation of federal tax law. *Id*. Courts in yet other states have approved dynamic incorporation of federal tax law even in the absence of express constitutional authorization. *Id.*

30. *See generally* OLIN & SWAIN, *supra* note 17 (compiling data indicating that, of the forty-one states with broad-based taxes, fifteen adopt the current tax code as their starting point, six do not officially use a federal starting point, and the remainder incorporate statically).

31. HELLERSTEIN & HELLERSTEIN, *supra* note 8, ¶ 20.02 (Supp. 2003).

32. *See, e.g.*, N.Y. TAX LAW § 612(b) (McKinney 2006 & Supp. 2013) ("There shall be added to federal adjusted gross income: . . . [i]nterest income on obligations of any state other than this state . . . to the extent not properly includible in federal adjusted gross income . . . .").

33. HELLERSTEIN & HELLERSTEIN, *supra* note 8, ¶ 20.02 & n.16 (Supp. 2003).

34. *See* RONALD K. SNELL, NAT'L CONFERENCE OF STATE LEGISLATURES, STATE PERSONAL INCOME TAXES ON PENSIONS AND RETIREMENT INCOME: TAX YEAR 2010, at 3 (2011), *available at* http://www.ncsl.org/documents/fiscal/TaxonPensions2011.pdf.

35. *See* MISS. CODE ANN. § 27-7-17(3)(a) (2010).

chooses its own tax rates. Tax credits provide another opportunity for states to tailor their tax base to local conditions and preferences. States provide tax credits for a wide variety of taxpayer expenditures, including spending on historic preservation, job training, investment in energy-saving technologies, organ donation, and adoption.[36] In addition, to prevent double state-level taxation, all states that tax income allow credits for taxes that their residents pay to other states.[37] Many states also incorporate federal tax credits. For example, like the federal government, many states offer an earned income tax credit.[38]

Of the forty-one states with comprehensive income taxes, six employ neither federal AGI nor federal taxable income as the starting point for their income calculations.[39] I refer to these states as "facially nonconforming." Although their income definitions are not formally tied to the federal definitions of income, these states nevertheless rely significantly on federal tax law and concepts. For example, instead of beginning their income calculations with a resident's federal AGI or federal taxable income, facially non-conforming states typically begin the calculation by requiring a taxpayer to list her wages as stated on her federal Form W-2, together with amounts reported on federal Forms 1099 and similar federal tax forms.[40] These states also typically require a taxpayer to report business income in the same way as she reported it on her federal Schedule C,[41] and they typically rely on the federal Schedule D for purposes of calculating capital gains and losses.[42] Since the amounts

36. For detailed descriptions of the tax incentives offered by each state, see generally OLIN & SWAIN, *supra* note 17.

37. *Id.* at 6.

38. *See id.* (noting that twenty-one states have an earned income tax credit).

39. *See id.* at 14, 16, 27, 36, 41, 49 (gathering data on the deviations between the federal tax base and the tax bases of the six facially nonconforming states—Alabama, Arkansas, Iowa, Mississippi, New Jersey, and Pennsylvania).

40. *E.g.*, ARKANSAS 2010 INDIVIDUAL INCOME TAX FORM AND INSTRUCTIONS 13–14 (2010), *available at* http://www.dfa.arkansas.gov/offices/incomeTax/individual/Documents/LongBooklet_2010.pdf.

41. *See, e.g.*, *id.* at 14 (requiring state taxpayers to report the amount reported on federal Schedule C for business and farm income); *see also* OLIN & SWAIN, *supra* note 17, at 14, 16, 27, 36, 41 (detailing the significant conformity between five of the six facially nonconforming states and the federal government in reporting of business income). Among facially nonconforming states, Pennsylvania is the exception. It has its own schedules for business, rental, and farm income. *See id.* at 49.

42. *See, e.g.*, ARKANSAS 2010 INDIVIDUAL INCOME TAX FORM AND INSTRUCTIONS, *supra* note 40, at 14; *see also* OLIN & SWAIN, *supra* note 17, at 14, 16, 27, 36, 41, 49 (noting certain deviations between the calculation of capital gains and losses between the federal government and facially nonconforming states, but also noting that in two of the six states, the federal and

stated on such federal tax forms are calculated by reference to federal tax rules, they reflect federal tax policies. Thus, although these states do not adopt federal income definitions formally, their tax bases substantially conform to the federal tax base, including by allowing state residents federal exemptions and other tax benefits.[43]

II. Advantages of Tax-Base Conformity

Federal-state tax-base conformity generates what might be called vertical harmonization benefits. By minimizing differences between the state and federal tax bases, conformity eases taxpayer compliance, enhances state enforcement efforts, and conserves state legislative resources.[44]

Similarly, by minimizing interstate tax base differences, tax-base conformity also secures what might be called horizontal harmonization benefits. Among other benefits, harmonization of state tax bases facilitates interstate commerce, and it may discourage states from enacting protectionist taxes. This Part discusses the vertical and horizontal benefits of tax-base conformity. Although this Part is primarily descriptive, the benefits it describes should also be understood to create pressure for states to conform.

A. Vertical Harmonization Benefits

Tax-base conformity generates benefits from vertical harmonization of the federal and state tax bases. These are advantages that arise from the states having the same tax base as the federal government. For example, by requiring state residents to report the same amount for state tax purposes as they report for federal tax purposes, states reduce taxpayers' compliance costs.[45]

---

state calculations are identical). Again, Pennsylvania is the exception. Although it calculates capital gains and losses in the same way as the federal government, it allows taxpayers to take all losses in the year incurred, as compared with the federal government, which allows taxpayers to offset at most $3000 annually of net capital losses against ordinary income. *Compare* 72 PA. STAT. ANN. § 3402-307(E) (West 1995) (providing unlimited deduction for losses on "any transaction entered into for profit, though not connected with the trade or business"), *with* I.R.C. § 1211 (2006) (limiting to $3000 the amount of net capital losses that may be applied to reduce ordinary income each year).

43. *See, e.g.*, N.J. STAT. ANN. § 54:8A-35 (West 2002) (allowing New Jersey taxpayers itemized deductions for charitable contributions and casualty losses but not for other federal itemized deductions).

44. *See, e.g.*, Stolz & Purdy, *supra* note 1, at 125–27.

45. State courts reviewing incorporations of federal law for consistency with state nondelegation doctrines have acknowledged the administrative gains from following federal

Although empirical studies have not specifically estimated the compliance cost savings from tax-base conformity,[46] conformity avoids the need for taxpayers to calculate their income twice or to keep two sets of records. Instead, state taxpayers calculate their federally taxable income, and then they use this amount to file both federal and state taxes. Electronic filing programs even allow taxpayers to file federal and state forms together.[47] By reducing tax complexity in this way, conformity promotes voluntary compliance.[48] Moreover, because federal tax definitions and concepts are subject to frequent judicial and regulatory interpretation, they possess a degree of legal certainty that reduces transaction and planning costs.[49]

Conformity also aids state tax enforcement goals by enabling states to free ride on the elaborate federal administrative mechanisms for enforcing federal tax laws. These mechanisms include federal withholding, auditing, and third-party reporting requirements.[50] Exchange-of-information agreements between the states and the federal government allow the states to learn of federal deficiency

---

rules and definitions. For example, in upholding the constitutionality of a state statute that incorporated the federal corporate tax base, the Connecticut Supreme Court noted the "convenience to the taxpayer and economy to the state." First Fed. Sav. & Loan Ass'n of New Haven v. Connelly, 115 A.2d 455, 460 (Conn. 1955). Similarly, in discussing Alaska's system of determining state tax liability by reference to federal liability, the Alaska Supreme Court noted that the system "was aimed at convenience to the taxpayer and simplicity of administration." Hickel v. Stevenson, 416 P.2d 236, 239 (Alaska 1966).

46. *Cf.* W. Bartley Hildreth, Matthew N. Murray & David L. Sioquist, *Interstate Tax Uniformity and the Multistate Tax Commission*, 58 NAT'L TAX J. 575, 580–88 (2005) (lamenting the "sparse and not comprehensive" empirical evidence of corporate compliance costs due to nonuniformity of tax bases across the states but hypothesizing that corporate compliance costs would be higher without federal base conformity).

47. *See* Harley Duncan & LeAnn Luna, *Lending a Helping Hand: Two Governments Can Work Together*, 60 NAT'L TAX J. 663, 672 (2007) (describing the FedState E-file program).

48. HARLEY T. DUNCAN, FED'N OF TAX ADMINS., RELATIONSHIPS BETWEEN FEDERAL AND STATE INCOME TAXES 6 (2005), *available at* http://www.taxadmin.org/fta/rate/taxreformpanel.pdf; *cf.* Richard D. Pomp, *Restructuring a State Income Tax in Response to the Tax Reform Act of 1986*, 36 TAX NOTES 1195, 1199–1200 (1986) (arguing that base conformity provides states an important opportunity for tax simplification).

49. *Cf.* Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (or "The Economics of Boilerplate")*, 83 VA. L. REV. 713, 719–29 (1997) (discussing network and learning effects in the context of standard forms and boilerplate; for example, frequent judicial interpretation of widely used contract terms reduces the legal uncertainty associated with those terms).

50. *See* Stolz & Purdy, *supra* note 1, at 70–72, 75 n.76 (detailing state-federal cooperation in enforcement, including, for example, cooperative audits, information-sharing agreements, and exchange of personnel).

determinations made against their residents.[51] The federal and state governments also exchange information about the amounts individuals file at each level to ensure that they match.[52] States can use this information to assess their own deficiencies or to begin an audit. By increasing the chances of detection, these shared enforcement mechanisms may make taxpayers less inclined to underreport their income to either level of government.

Additionally, by relying on the federal tax base, states avoid expending scarce legislative resources on devising and maintaining their own bases.[53] Similarly, state revenue departments can rely on tax liability determinations made by the Internal Revenue Service (IRS) and federal courts (including the specialized Tax Court),[54] and conformity enables states to avoid duplicating certain tasks handled by the Treasury Department, such as writing tax regulations. Because conforming states can rely on expert federal tax legislative drafting, regulatory interpretation, and adjudication, conformity allows states to reduce their investment in developing expertise in income taxation.[55] To the extent that state employees need income tax expertise, base conformity makes it useful for states to allow their employees to participate in IRS training sessions.[56] Finally, conformity may provide political cover to state lawmakers, who can shift the blame to Congress for unpopular state tax policies imported from the federal tax base.

B. Horizontal Harmonization Benefits

Federal-state tax-base conformity also results in significant tax harmonization among the states, which produces benefits of its own.[57]

---

51. *See* Duncan & Luna, *supra* note 47, at 668–72 (describing corporate tax information sharing in both directions: from the federal government to the states and vice versa).

52. *See id.* at 670 (discussing states' nascent participation in the State Reverse File Match Initiative).

53. *See* Dorf, *supra* note 3, at 133–35 (detailing legislative costs, including salaries, costs of attaining sufficient expertise to write effective legislation, and the costs of "adjusting the law to changing circumstances" at the federal level).

54. *See* HELLERSTEIN & HELLERSTEIN, *supra* note 8, ¶ 20.02[1] (Supp. 2003) (discussing the legal effect in various states of federal-level tax-deficiency determinations).

55. *See* Pomp, *supra* note 48, at 1199 ("[M]any state tax provisions require a higher order of administrative capacity than actually exists.").

56. *See* Duncan & Luna, *supra* note 47, at 673 (noting that the IRS allows state employees to participate in its training programs on a space-available basis).

57. The federal tax base serves as a Schelling point for the states—it is the base each state expects the others to use, even in the absence of express coordination among the states or

For example, it reduces the likelihood that cross-border taxpayers will experience unrelieved double state taxation, and it protects state tax bases by reducing opportunities for cross-border tax arbitrage. Finally, as compared to a situation in which each state autonomously devised its own tax base, adoption by the states of the federal tax base probably promotes tax subsidization of taxpayer activities whose positive benefits spill over to other states. Similarly, conformity also may reduce state tendencies to enact tax bases that either discriminate against residents of other states or otherwise impose negative externalities on other states.

1. *Facilitates Interstate Commerce.* Harmonization of tax bases across the states helps people anticipate how they will be taxed if they move or expand their business or investment into another state. By thus reducing learning costs associated with cross-border movements, federal-state tax-base conformity may facilitate interstate commerce and the growth of multistate enterprises.

2. *Reduces Double Taxation*. Double taxation occurs when multiple states claim to be the source of the same item of income or when the income is sourced in one state, but owned by a taxpayer who resides in another state. For example, when a law professor resides in Connecticut, but earns income in New York, both states have jurisdiction to tax him on that income.[58] If both states exercise their tax jurisdiction, and if Connecticut does not relieve the resulting double taxation by crediting New York's tax, the unrelieved double taxation will discourage cross-border work, raising both practical and constitutional problems.[59] Conformity may help reduce double state taxation because states' methods for avoiding double taxation, including apportionment and crediting, work best when all states use

between the states and the federal government. *See generally* THOMAS C. SCHELLING, THE STRATEGY OF CONFLICT 54–57 & n.1 (1960) (describing the idea that people tend to converge on "focal points," even in the absence of communication). One way Professor Schelling illustrated this idea was by asking a group of students what they would do if they arranged to meet a friend tomorrow in New York City, but they did not specify where or when; most students responded that they would go to the information booth at Grand Central Station at noon. *Id.*

58. *See* Zelinsky v. Tax Appeals Tribunal, 801 N.E.2d 840, 849 (N.Y. 2003) (involving a Connecticut-resident law professor with New York-source income).

59. Double taxation of individuals may violate the Privileges and Immunities Clause and the dormant Commerce Clause. *See generally* HELLERSTEIN & HELLERSTEIN, *supra* note 8, ¶¶ 4.14–4.16 (Supp. 2009); *see also id.* ¶ 20.06 (Supp. 2003 & Supp. 2012). If so, as the residence state, Connecticut would be obliged to credit the taxes assessed by New York. *See id.*

the same tax base. For example, when all states use the same rules for sourcing income, double state taxation is less likely to occur.[60]

3. *Prevents Tax Arbitrage.* Tax arbitrage encompasses tax-planning devices that exploit differences in the tax laws of two different jurisdictions.[61] Whereas differences in state tax bases create tax-planning opportunities for both individual[62] and corporate taxpayers,[63] federal-state tax-base conformity may reduce deadweight loss from tax arbitrage by minimizing differences in state tax bases.

---

60. *See, e.g.*, *Zelinsky*, 801 N.E.2d at 845 (noting that Professor Zelinsky would not have suffered unrelieved double state taxation if Connecticut adopted the same "convenience of the employer" test as New York; in other words, double taxation would not have arisen if Connecticut and New York had the same tax base, including the same sourcing rules); *see also* Shaviro, *supra* note 15, at 912 (discussing state tax relief for double taxation); *cf.* John F. Avery Jones, *Are Tax Treaties Necessary?*, 53 TAX L. REV. 1, 17–19 (1999) (describing so-called qualification conflicts, which arise under double tax treaties when two countries have different definitions of income or different national-law characterizations of the same item of income).

61. *See* H. David Rosenbloom, *International Tax Arbitrage and the "International Tax System*,*"* 53 TAX L. REV. 137, 142 (2000) (describing "international tax arbitrage" as "a lofty term that refers to taking advantage of differences among country tax systems, usually differences in addressing a common tax question" (internal quotation marks omitted)); *see also, e.g.*, Jeremy Edwards & Michael Keen, *Tax Competition and Leviathan*, 40 EUR. ECON. REV. 113, 117 (1996) (incorporating an arbitrage condition into an econometric model of tax coordination).

62. For example, although most states incorporate federal rules for determining capital gains and losses, some calculate capital income differently from the federal government. *See, e.g.*, ARK. CODE ANN. § 26-51-815(b) (2012) (excluding up to 30 percent of net long-term capital gains); MICH. COMP. LAWS § 206.30(1)(p) (West 2003 & Supp. 2012) (providing senior citizens an annual deduction—of $9,420 for single returns and $18,840 for joint returns—for interest, dividends, and capital gains); N.D. CENT. CODE § 57-38-30.3(2)(d) (2011) (excluding up to 30 percent of net long-term capital gains); S.C. CODE ANN. § 12-6-1150(A) (2000 & Supp. 2012) (excluding 44 percent of long-term capital gains). Several other states—including Colorado, Connecticut, Idaho, and Kansas—have capital-gains preferences only for certain in-state assets. *See* OLIN & SWAIN, *supra* note 17, at 18–19, 24, 28. Taxpayers can exploit these differences by manipulating where they reside or where they realize gains and losses.

63. For example, Delaware deviates from the federal corporate tax base by exempting certain income from intangible assets. *See* DEL. CODE ANN. tit. 30, § 1902(b)(8) (2009). In response, many multistate corporations transfer their valuable intangibles to holding companies that they establish in Delaware. *See* Lawrence Bajor, *The Slow Death of State Tax Arbitrage*, J. ST. TAX'N, July–Aug. 2007, at 35, 37 (2007) (evaluating the use of Delaware holding companies in state tax planning). This structure allows multistate companies to reduce their taxable income in other states (by paying deductible licensing fees to their Delaware intangibles holding company) while generating no taxable income in Delaware (because the licensing fees are exempt there). Delaware's deviation from the federal tax base succeeded in making it a destination for intangible assets held by multistate corporations, but it also generated significant litigation as well as defensive legislative responses from several other states attempting to shore up their eroded tax bases. *See* HELLERSTEIN & HELLERSTEIN, *supra* note 8, ¶¶ 6.11, 6.13 (Supp. 2006) (reviewing states' jurisdiction to tax out-of-state intangible property).

4. *Encourages Cross-Border Spillovers*. To the extent that federal tax law reflects the larger territorial scope of federal interests, federal tax provisions probably reward behaviors whose benefits spill over to other states more than would autonomously drafted state tax bases.[64] If this is so, then by adopting the federal tax base, states amplify the salutary effects of any federal tax laws that subsidize interjurisdictional spillovers. For example, the federal deduction for deposits to traditional IRAs aims to encourage taxpayers to save for retirement. The withdrawal in retirement of the earnings from traditional IRAs is federally taxable, which serves partially to mitigate the federal revenue loss associated with the deduction.[65] When transferred to the state level, this same tax incentive carries an additional risk for any state adopting it. The risk derives from the possibility that the saver will transfer his or her state of residence before withdrawing the earnings in the account. Should the saver migrate, the state that subsidized the deposit may lose the opportunity to tax the withdrawal because the taxpayer is no longer a resident. In this way, the subsidy funded by the state in which the taxpayer spends her working years may spill over to the state in which she retires.

Even though such interjurisdictional spillovers may be salutary from a national perspective, states presumably would be less likely to subsidize them if they constructed their tax bases from scratch. If they defined their tax bases from scratch, even states wanting to subsidize savings presumably would structure their savings incentives differently from the federal government. For example, instead of providing an up-front deduction for deposits to retirement accounts, states might structure their savings incentives as exemptions of withdrawals from such accounts.[66] By delaying the timing of the subsidy to the taxpayer's retirement years, the state thereby would

---

64. Examples of federal tax provisions that promote behaviors with national benefits include, among others, incentives for saving, education, investment in green technologies, the purchase of private health-insurance coverage, and special tax benefits available to military personnel.

65. *See* I.R.C. § 72(t) (2006 & Supp. V 2012) (imposing a 10 percent additional tax on early distributions).

66. Although most states conform with the federal treatment of IRAs, Pennsylvania, a facially nonconforming state, denies deductions or exclusions for contributions by account owners to their traditional and Roth IRAs, but it exempts qualified distributions from both traditional and Roth IRAs. *See* PENN. DEP'T OF REVENUE, REV-636 PO (02-12), RETIREMENT: TRADITIONAL IRAS AND ROTH IRAS (2012), *available at* http://www.portal.state.pa.us/portal/server.pt/gateway/PTARGS_0_2_818161_0_0_18/rev636.pdf.

avoid the risk of subsidizing savings of taxpayers who will retire elsewhere. If avoiding the spillover means that a state does not provide a tax subsidy at all, or that it provides a tax subsidy in a less effective manner, nonconformity may reduce national welfare. The federal tax law contains many incentives for behaviors that create positive externalities whose benefits are not limited to any particular state. These include incentives for education, military service, and reducing pollution and carbon emissions.[67] By incorporating these incentives into their own tax bases through conformity with the federal base, states provide additional incentives for interjurisdictional spillovers.[68]

For the same reasons, base conformity also may reduce states' use of "not-in-my-backyard" (NIMBY) taxes. That is, conformity may dampen states' urge to overtax socially productive, but noxious, activities, such as radioactive waste disposal.[69]

5. *Discourages Tax Exportation and Protectionist Taxation.* In the same vein, conformity may reduce the extent to which states use their tax laws to impose negative externalities on residents of other states.[70] For example, compared to conforming bases, autonomously drafted state tax bases presumably would contain more provisions aimed at exporting tax burdens to residents of other states. The goal to export taxes to nonresidents can be illustrated with an example from international tax. A country may collect what is arguably more than its fair share of tax from nonresidents who have minimal contacts with its territory. For example, instead of taxing them only on their winnings from tournaments in Britain, the United Kingdom taxes nonresident athletes on a share of their worldwide endorsement

67. *See, e.g.*, I.R.C. § 221 (providing a deduction for student-loan interest).

68. Whether such additional incentives are salutary depends on the elasticity of the behavior and the degree of the federal subsidy.

69. *Cf.* Robert P. Inman & Daniel L. Rubinfeld, *Designing Tax Policy in Federalist Economies: An Overview*, 60 J. PUB. ECON. 307, 314, 318–22 (1996) (noting that state tax autonomy provides room for NIMBY taxation and suggesting solutions).

70. *Cf.* Michael W. McConnell, *Federalism: Evaluating the Founders' Design*, 54 U. CHI. L. REV. 1484, 1499 (1987) (reviewing RAOUL BERGER, FEDERALISM: THE FOUNDERS' DESIGN (1987)) (arguing that allowing states discretion to set their own product-liability law "created a liability monster," where each state sought to benefit resident plaintiffs while imposing costs on nonresident defendants).

income, even if they only participate in a single competition in Britain.[71]

Other examples of attempts to export taxes can be drawn from state indirect taxation. For example, states may impose high hotel taxes or natural-resource severance taxes because they believe that the economic burden of such taxes will fall primarily on nonresidents who lack political representation in the taxing state.[72] Because residents of all states have representation in the federal government, however, federal law is less likely than state law to contain provisions that aim to shift tax burdens from residents of one state to residents of another.

As compared to a hypothetical state income tax devised autonomously by state legislators, the federal tax base also can be expected to contain fewer provisions that protect the residents of any particular state from competition from residents of other states. This is because the temptation to use the tax system to prefer one state over another is weaker at the national level than at the state level.[73] Although the Supreme Court has interpreted the dormant Commerce

71. Until 2012, the United Kingdom calculated its share of a nonresident's global endorsement income by a fractional method. The global income was multiplied by the number of days spent competing in British tournaments divided by the number of days spent competing globally. *See Usain Bolt's Tax Lesson*, WALL ST. J., Aug. 16, 2012, at A10. This calculation arguably overtaxed athletes whose activities in Britain were limited to competition. Since 2012, the United Kingdom has calculated its share of nonresidents' income by taking into consideration days of performance *or training* in the United Kingdom divided by global days of performance or training. Compared to the 2010 rule, this formula generally will result in more income being allocated to the athlete's country of residence, and less to the United Kingdom. *See* Tony Nitti, *One Reason the NFL Will Never Permanently Relocate a Team to London: The U.K.'s Tax Treatment of Nonresident Athletes*, FORBES (Oct. 29, 2012, 10:14 AM), http://www.forbes.com/sites/anthonynitti/2012/10/29/one-reason-the-nfl-will-never-permanently-relocate-a-team-to-london-the-u-k-s-tax-treatment-of-nonresident-athletes/.

72. *Cf.* Commonwealth Edison Co. v. Montana, 453 U.S. 609, 617–29 (1981) (rejecting a claim that Montana's coal-severance tax violated the Commerce Clause by exporting tax burdens to residents of other states). Whether taxes, such as severance taxes or hotel taxes, actually export tax burdens to nonresidents depends on their incidence, which is notoriously difficult to determine. *See* Charles E. McLure, Jr., *Incidence Analysis and the Supreme Court: An Examination of Four Cases from the 1980 Term*, 1 SUP. CT. ECON. REV. 69, 80 (1982) (noting that "any tax levied on a product that is sold primarily to non-residents" is not necessarily an exported tax, as it depends on who actually bears the economic burden of the tax). Even if not successful in exporting tax burdens, however, taxes that states intend to serve as export taxes can be harmful. *See* Shaviro, *supra* note 15, at 927–28 (noting that states with such taxes spend more than the national average, perhaps due to the belief that residents do not bear the incidence of such taxes).

73. The federal tax base may reflect population bias in congressional voting rules. *See infra* Part VI.C.

Clause to prohibit protectionist state taxation,[74] imperfect enforcement of that constitutional norm leaves room for gains from tax-base conformity.[75] Similarly, compared to autonomously drafted state tax bases, conforming bases probably contain fewer provisions designed to attract mobile residents from other states.[76]

6. *Helps Identify Unconstitutional Tax Discrimination*. A final benefit of tax-base conformity is that it could help taxpayers identify discriminatory state tax provisions that are ripe for constitutional challenge. For the reasons explained in the last subsection, discriminatory state tax provisions that violate the dormant Commerce Clause or the Privileges and Immunities Clause are likely to take the form of deviations from the federal tax base. State deviation from the federal base results in special reporting by the taxpayer on state tax forms, and this special reporting increases the political salience of the divergence of state and federal tax policy. For example, the itemized deduction that Mississippi grants for gambling losses distinguishes between gambling losses incurred in Mississippi gaming establishments and those incurred in other states.[77] This distinction may unconstitutionally discriminate against out-of-state gaming establishments.[78] As a deviation from the federal tax code, claiming the deduction for in-state gambling losses requires special

74. *See, e.g.*, Dep't of Revenue v. Davis, 553 U.S. 328, 337–38 (2008) ("The modern law of what has come to be called the dormant Commerce Clause is driven by concern about economic protectionism—that is, regulatory measures designed to benefit in-state economic interests by burdening out-of-state competitors." (quoting New Energy Co. of Ind. v. Limbach, 486 U.S. 269, 273–74 (1988)) (internal quotation marks omitted)).

75. Problems with enforcement stem from, inter alia, difficulties in identifying a party with standing to challenge such legislation. *See, e.g.*, DaimlerChrysler Corp. v. Cuno, 547 U.S. 332 (2006) (vacating, for lack of standing, the Sixth Circuit's judgment in *Cuno v. DaimlerChrysler, Inc.*, 386 F.3d 738 (6th Cir. 2004), which held that an Ohio business tax credit discriminated against interstate commerce); *see also* Peter D. Enrich, *Saving the States from Themselves: Commerce Clause Constraints on State Tax Incentives for Business*, 110 HARV. L. REV. 377, 405–22 (1996) (discussing judicial standing obstacles to dormant Commerce Clause challenges of state tax incentives that distort interstate commerce). Such state tax incentives take the form of deviations from the federal tax base. *See infra* Part IV.

76. *Cf.* Enrich, *supra* note 75, at 406, 467 (arguing that the Supreme Court should strike down as violations of the dormant Commerce Clause state tax incentives designed to poach business from other states). For the other side of the argument, see *infra* Part IV.

77. *See supra* note 35 and accompanying text.

78. The Supreme Court has given potentially discriminatory subsidies, like the Mississippi deduction, less scrutiny than potentially discriminatory taxes. *See, e.g.*, *New Energy*, 486 U.S. at 278 (distinguishing between discriminatory taxes and direct subsidies for domestic industry).

reporting on Mississippi tax forms,[79] which increases the salience of the deduction. Although not all state tax deviations are discriminatory, their high salience may increase the likelihood of a constitutional challenge to those that are discriminatory, which may, in turn, discourage states from enacting discriminatory deviations in the first place.

III. DISADVANTAGES OF TAX-BASE CONFORMITY

By incorporating federal definitions of income into their own tax laws, states delegate to the federal government authority over important aspects of their fiscal systems. As a result, tax-base conformity has generated legal challenges under the nondelegation principles of many states' constitutions,[80] and several states have specific provisions in their constitutions to accommodate federal tax-base conformity.[81]

Rather than analyzing whether tax-base conformity violates state constitutions or other state laws, however, this Part assumes that state incorporation of the federal tax base is legal in order to analyze the disadvantages of tax-base conformity. Section A explains how tax-base conformity reduces state tax autonomy. Section B considers how the harmonization that results from tax-base conformity undermines

79. MISS. DEP'T OF REVENUE, FORM 80-108, ADJUSTMENTS & CONTRIBUTIONS 1 (2012) *available at* http://www.dor.ms.gov/docs/indiv_80108128.pdf.

80. *See* Dorf, *supra* note 3, at 108–11 (reviewing the status of tax-base conformity under state nondelegation doctrines). *Compare* Commonwealth v. Warner Bros. Theatres, Inc., 27 A.2d 62, 63–64 (Pa. 1942) (upholding dynamic incorporation of the federal definition of net income against nondelegation challenge), *with* Wallace v. Comm'r of Taxation, 184 N.W.2d 588, 593 (Minn. 1971) (holding that dynamic incorporation of federal tax law would violate the Minnesota Constitution's nondelegation principle). Static incorporation of federal tax law generally does not constitute a delegation of state legislative power, but dynamic incorporation may. Several state courts have held that even dynamic federal-state tax-base conformity does not represent a legislative delegation. For example, the Connecticut Supreme Court stated:

> This is not a delegation of legislative power but an incorporation by reference of the federal law into the state law. State law lays a tax on the franchise or privilege of a corporation to do business in this state. The state legislature and not the Congress has selected net earnings as the base for determining the amount of this tax and has fixed the rate to be paid on that tax base. As a matter of convenience to the taxpayer and economy to the state, the legislature has adopted some of the standards [including the definition of gross income] employed in the federal corporation net income tax law.

First Fed. Sav. & Loan Ass'n of New Haven v. Connelly, 115 A.2d 455, 459–60 (Conn. 1955) (citations omitted).

81. *See, e.g.*, HAW. CONST. art. VII, § 2 ("In enacting any law imposing a tax on or measured by income, the legislature may define income by reference to provisions of the laws of the United States as they may be or become effective at any time or from time to time, whether retrospective or prospective in their operation.").

federalism values, such as diffusion of power and regulatory diversity. Finally, Section C shows that the loss of state tax autonomy under base conformity causes fiscal volatility because states that dynamically incorporate federal tax law open themselves to revenue shocks from changes in federal law.

Two factors tend to mitigate the disadvantages of federal-state tax-base conformity. First, because the regulatory impact of taxation is a function of both the base and the rate, by retaining control over their tax rates, states retain an important fiscal policy tool. Second, states can (and do) deviate from federal tax provisions. Later, in Part V, I will argue that the ability of the states to deviate from federal tax law significantly mitigates the disadvantages of tax-base conformity. For purposes of identifying and describing those disadvantages, however, this Part assumes complete federal-state tax-base conformity.

A. State Tax Autonomy

When states conform to the federal tax base, they cede to the federal government at least three kinds of authority. First, they relinquish the ability to determine structural and definitional aspects of their income taxes, such as whether to tax imputed income and how to treat married taxpayers. Second, they cede authority to determine tax incentives. Finally, tax-base conformity allows the federal government to set the policy agenda for state income taxation.

1. *Structure and Definition of Income.* By conforming their tax bases to that of the federal government, states voluntarily cede control over decisions about the structure of their income taxes and about how to define income. Structural and income-defining decisions are those a government must make to assess income taxes, even if it does not intend to use tax incentives to regulate behavior. These decisions include who should be taxed, how often, and how to define income. If these questions had uncontroversial answers, then ceding structural and income-defining tax authority to the federal government would be unproblematic. In reality, these questions involve a large set of well-known and controversial issues.

For example, federal law does not tax imputed income. Imputed income includes the value of services a taxpayer provides for herself and the value of using capital assets that she owns.[82] For instance, when a taxpayer resides in a house that she owns, she has imputed rental income. Taxing all imputed income is impossible because we cannot accurately estimate the amount of each taxpayer's imputed income. But many have criticized the inequities caused by the failure to tax at least those sources of imputed income that could be taxed reasonably accurately, such as imputed rental income.[83] By adopting the federal tax base, states defer to federal choices, including the decision not to tax imputed rental income, even though the experiences of other countries have shown that taxing imputed rental income is administrable and can reduce tax inequities between otherwise similarly situated renters and homeowners.[84]

Likewise, the federal tax system generally does not tax appreciation until disposition of the appreciated asset.[85] Under this "realization rule," taxpayers accumulating wealth in the form of asset appreciation need not pay tax currently, whereas taxpayers who earn income from work cannot defer tax.[86] The realization rule thereby regressively shifts the tax burden away from those with asset appreciation. As with imputed income, the primary justifications for the realization rule are practical impediments, such as valuation and liquidity problems. Specifically, because we often do not know the exact value of an asset until its sale, we cannot accurately tax it until then. Likewise, if appreciation were taxed before disposition of the appreciated asset, taxpayers might not have the cash to pay the tax.

82. MICHAEL J. GRAETZ & DEBORAH H. SCHENK, FEDERAL INCOME TAXATION PRINCIPLES AND POLICIES 124 (5th ed. 2005).

83. Because federal law does not tax imputed rental income, for example, homeowners pay less tax than similarly situated renters, who must pay their rent with after-tax income. For historical analysis of this issue, see Dennis J. Ventry, Jr., *The Accidental Deduction: A History and Critique of the Tax Subsidy for Mortgage Interest*, 73 LAW & CONTEMP. PROBS. 233, 255–70 (2010).

84. *See, e.g.*, HUGH J. AULT & BRIAN J. ARNOLD, COMPARATIVE INCOME TAXATION: A STRUCTURAL ANALYSIS 181–83 (2010) (noting that although many countries have been moving away from taxing imputed rental income for administrative reasons, the Netherlands has retained its imputed rental tax); *see also* Paul E. Merz, *Foreign Income Tax Treatment of the Imputed Rental Value of Owner-Occupied Housing: Synopsis and Commentary*, 30 NAT'L TAX J. 435, 435 (1977) (noting that in the mid-1970s, forty-two countries taxed imputed rental income); *cf.* Ventry, *supra* note 83, at 256–57 (noting that acknowledgment of the regressive nature of the home mortgage deduction prompted federal lawmakers in the United States to consider taxing imputed rental income); *id.* at 257 (discussing solutions to the practical obstacles to taxing imputed rental income and noting that Wisconsin "experimented with taxing net [imputed] rental income under its income tax").

85. *See, e.g.*, I.R.C. § 1001 (2006).

86. GRAETZ & SCHENK, *supra* note 82, at 147.

Despite the fact that the realization rule arguably results in an unjust distribution of the tax burden, the federal government maintains it, even for assets—such as publicly traded securities—that can be easily and accurately valued and against which taxpayers could readily secure loans to provide the cash needed to pay any taxes due.[87] By adopting the federal tax base, the states adopt the same decision. Other classic base-defining conundrums (and how Congress resolves them) include whether to tax windfalls (yes),[88] how often to tax (annually),[89] whether to allow income averaging to mitigate income volatility (no),[90] whether to adjust tax basis for inflation (no),[91] and many more.

Decisions about the so-called taxable unit warrant lengthier treatment. The federal tax system permits four filing statuses: single, head-of-household, married-filing-jointly, and married-filing-separately. A large body of scholarship discusses the impact of this seemingly innocuous set of filing statuses.[92] In progressive tax systems, joint filing provides a tax "bonus" to married couples who earn income unevenly, because, by averaging their incomes, it allows such spouses to lower their joint tax burden compared to if they were single. However, married couples that earn income equally may pay a "marriage penalty"; they pay more tax as a married couple than the

87. *See, e.g.*, David A Weisbach, *A Partial Mark-to-Market Tax System*, 53 TAX L. REV. 95 (1999) (exploring mark-to-market taxation for assets that are liquid and easy to value). Experiences of other countries that maintain wealth taxes or imputed income taxes demonstrate that the administrative difficulties posed by the need for annual valuation of at least some kinds of assets are not insurmountable. *See generally* Moris Lehner, *The European Experience with a Wealth Tax: A Comparative Discussion*, 53 TAX L. REV. 615 (2000) (detailing the wealth taxes and imputed income taxes of eleven European countries).

88. *See* I.R.C. § 61 (2006); Comm'r v. Glenshaw Glass Co., 348 U.S. 426, 429–30 (1955) (holding that I.R.C. § 61 (1954) taxes windfalls).

89. I.R.C. § 441 (2006 & Supp. V 2012).

90. *See id.* §§ 441–483 (2006 & Supp. V 2012) (permitting only cash basis and accrual accounting, and requiring annual reporting); *see also* Neil H. Buchanan, *The Case Against Income Averaging*, 25 VA. TAX REV. 1151, 1155–56 (2006) ("[P]eople who temporarily earn very high incomes due to short-term success pay annual taxes at the same rates as do people whose high incomes are a permanent part of their lives.").

91. *See* GRAETZ & SCHENK, *supra* note 82, at 363–65.

92. *See generally, e.g.*, Lily Kahng, *One Is the Loneliest Number: The Single Taxpayer in a Joint Return World*, 61 HASTINGS L.J. 651 (2010); Marjorie E. Kornhauser, *Theory Versus Reality: The Partnership Model of Marriage in Family and Income Tax Law*, 69 TEMP. L. REV. 1413 (1996); Shari Motro, *A New "I Do": Towards a Marriage-Neutral Income Tax*, 91 IOWA L. REV. 1509 (2006); Lawrence Zelenak, *Marriage and the Income Tax*, 67 S. CAL. L. REV. 339 (1994).

sum of the taxes they would pay if they were single.[93] Commentators observe that, by providing tax bonuses to couples that earn income unevenly, the federal tax system favors traditional single-earner households.[94] In contrast with the filing status choices made by the federal government, many other countries either reject joint filing or provide married couples the option to file jointly or individually.[95] When states conform to federal filing statuses, they thereby import into their own law the biases inherent in those statuses.

These examples show that, even before considering whether to use taxes expressly to regulate, governments face a series of difficult base-defining and structural decisions. How governments resolve these issues influences taxpayer behavior and affects the distribution of the tax burden across members of society. When states adopt without deviation the federal tax base and filing rules, they import federal decisions on these matters into their own tax systems.

2. *Incentives*. When the states incorporate the federal tax base, they not only cede income-defining and structural tax authority, they also cede regulatory authority in a more traditional sense, given that the federal government uses tax incentives to regulate taxpayer behavior. Although the *primary* function of the federal tax base is to measure taxpayers' net income in order to apply progressive tax rates fairly, that is not its only function. The tax law contains many provisions designed to serve policy goals or voter preferences, rather than (or in addition to) defining income.[96] When such provisions take the form of tax subsidies—such as tax deductions, exemptions, and credits—tax experts call them "tax expenditures" to highlight the

93. This result would occur if, for example, the progressive tax brackets that apply to married couples are less than twice as large as those that apply to single taxpayers. *See, e.g.*, Kahng, *supra* note 92, at 656–59 (defining and discussing marriage penalties).

94. *See, e.g.*, Zelenak, *supra* note 92, at 371 ("The current joint-return system is not neutral. It favors the traditional family both in the behavioral sense that it discourages women from working, and in the distributive sense that it ignores the fact that a one-earner couple is really better off than a two-earner couple with the same taxable income.").

95. *See* Kornhauser, *supra* note 92, at 1437 n.56 (noting that most Organisation for Economic Co-operation and Development countries tax spouses separately).

96. Whether a tax deduction is needed to measure net income properly depends on whether the activity that generates the deduction is related to the production of taxable income. For example, business expenses (such as inventory costs) are expenses related to producing taxable income and therefore must be deducted in order to properly calculate net income. But the home mortgage-interest deduction is not necessary for measuring net taxable income because the United States does not tax the imputed rental income associated with a personal residence. *See supra* notes 82–84 and accompanying text.

revenue losses they generate.[97] In contrast, when such provisions take the form of new or increased taxes, acceleration of tax liabilities, or denials of exemptions, deductions or tax credits, they have been called "tax penalties" to highlight their purpose to discourage particular taxpayer behavior.[98]

By importing federal definitions of income, states thereby also import any federal tax incentives embedded in those definitions. As a result, states subsidize activities Congress has chosen to subsidize, and they penalize activities Congress has chosen to penalize. Among the many activities subsidized by federal tax incentives are home ownership,[99] employer provision of health insurance,[100] charity,[101] savings,[102] and family planning.[103] Congress also has used the federal tax law to penalize gambling,[104] failure to save,[105] failure to buy private health insurance,[106] and participation in the illegal drug trade.[107] The federal tax law also denies business deductions for certain disfavored activities, such as the payment of antitrust treble damages,[108] fines and penalties,[109] bribes and kickbacks,[110] and certain kinds of disfavored employee compensation.[111] A state that fully conformed its own tax

---

97. *See, e.g.*, U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 7, at 35–37.

98. *E.g.*, Mason, *supra* note 2, at 978; Eric Zolt, *Deterrence via Taxation: A Critical Analysis of Tax Penalty Provisions*, 37 UCLA L. REV. 343, 343–44 (1989).

99. *See* I.R.C. § 163(h)(3) (2006) (allowing deductions for home mortgage interest).

100. *See id.* § 106 (2006 & Supp. IV 2011) (excluding employer-paid health-insurance premiums from gross income).

101. *See id.* § 170 (allowing charitable-contribution deductions).

102. *See, e.g.*, *id.* § 219 (2006 & Supp. V 2012) (allowing deductions for contributions to retirement savings accounts).

103. *See id.* § 213 (2006) (allowing deductions for qualified medical expenses); INTERNAL REVENUE SERV., PUB. 502, MEDICAL AND DENTAL EXPENSES 5–6, 13–14 (2012), *available at* http://www.irs.gov/pub/irs-pdf/p502.pdf (explaining that deductions include expenses for birth-control pills, sterilization, vasectomies, abortions, and fertility treatments).

104. *See* I.R.C. § 165(d) (denying losses from wagering to the extent that they exceed the taxpayer's gains from wagering).

105. Congress provides both tax subsidies to encourage savings and tax penalties to discourage withdrawal of funds from tax-advantaged savings accounts. *See, e.g.*, *id.* § 72(m)(5)(B), (q), (t), (v) (2006 & Supp. V 2012) (taxing early withdrawals from retirement plans and IRAs).

106. *See id.* § 5000A (Supp. IV 2011) (making the tax effective in 2014).

107. *See id.* § 280E (2006) (denying expenses related to illegal drug-trade profits).

108. *Id.* § 162(g) (2006).

109. *Id.* § 162(f).

110. *Id.* § 162(c).

111. *See, e.g.*, *id.* § 162(m) (2006 & Supp. V 2012) (limiting public companies' deductions to $1 million for non-performance-based compensation paid to certain key employees); *id.* § 280G

base to the federal tax base likewise would incentivize and penalize these same activities. Already a signficant mode of federal regulation, federal tax incentives are on the rise,[112] and as federal use of tax incentives increases, so does state importation of federal policy preferences through tax-base conformity.

3. *Agenda-Setting and Other Authority*. Although as a formal matter states incorporating the federal tax base retain control over their income tax policy agendas, as a practical matter tax-base conformity results in the transfer of agenda-setting power from the states to the federal government. For states with dynamic incorporation of federal law, federal tax changes automatically take effect at the state level unless the state legislature acts to decouple from federal law. Likewise, states with static incorporation must pay careful attention to federal tax changes in order to minimize divergence between the state tax base and the federal tax base because divergence erodes the advantages of conformity. In either case, the states cede to the federal government significant influence over state income tax agendas.

States adopting the federal tax base also cede nonlegislative authority. For example, they cede regulatory and enforcement authority to the Treasury Department by accepting Treasury's tax regulations as authoritative and by relying on IRS auditing and enforcement. They also cede judicial authority when they accept the outcome of federal tax adjudications as determinative of state income tax liability.[113]

B. Harmonization Costs

The Framers of the U.S. Constitution created a government structure that ensured competition among governments: state governments would compete with one another, and the federal government would compete with those of the states. Through competition and diffusion of power, federalism would preserve individual liberty, discipline government, and make government

(2006 & Supp. V 2012) (disallowing employer deduction for certain golden-parachute payments).

112. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 7, at 25–28 (providing statistics on federal tax incentives).

113. *See supra* note 54.

representatives more responsive to voters.[114] Because tax-base conformity concentrates at the federal level what would otherwise be tax power "diffused" across the fifty states, it undermines one of the bulwarks against oppression inherent in our federal system.[115] The broad array of subject matters the federal government can and does reach with its taxing power makes federal-state tax-base conformity especially problematic. By conforming to the federal tax law, states mirror federal regulatory choices, even in areas, such as the family, that traditionally have been the province of the states.[116]

Moreover, by providing one-stop shopping for federal and state tax benefits, tax-base conformity also may facilitate lobbying and rent-seeking. Narrow and well-organized political interests may use lobbying at the federal level to secure benefits at both the federal and state levels.[117] Nor does base conformity necessarily reduce rent-seeking at the state level; interest groups unable to secure favorable federal tax legislation may take a second bite at the apple at the state level.

This Section explores how tax-base conformity impacts federalism values. It considers how the harmonization that results from states' incorporation of the federal tax base reduces policy diversity and may raise political accountability concerns. Tax-base conformity also undermines conforming states' ability to tailor tax incentives to local conditions, and it limits policy experimentation.[118]

---

114. *See* THE FEDERALIST NO. 51, at 265 (James Madison) (Ian Shapiro ed., 2009) (describing federalism as creating a "double security" of the "rights of the people" because the "different governments will control each other, at the same time that each will be controlled by itself"); *see also* Gregory v. Ashcroft, 501 U.S. 452, 458 (1991) (noting that federalism "makes government more responsive by putting the States in competition for a mobile citizenry").

115. *See* New York v. United States, 505 U.S. 144, 181 (1992) (noting that federalism secures liberty through the "diffusion of sovereign power" (quoting Coleman v. Thompson, 501 U.S. 722, 759 (1991) (Blackmun, J., dissenting)) (internal quotation mark omitted)). The Supreme Court invoked the liberty-securing function of federalism when it stated that "[p]erhaps the principal benefit of the federalist system is a check on abuses of government power" and that "a healthy balance of power between the States and the Federal Government will reduce the risk of tyranny and abuse from either front." *Gregory*, 501 U.S. at 458.

116. For examples of regulatory federal tax provisions, see *supra* Part III.A.1.

117. *See* Daniel Shaviro, *Beyond Public Choice and Public Interest: A Study of the Legislative Process as Illustrated by Tax Legislation in the 1980s*, 139 U. PA. L. REV. 1, 55–57, 71–125 (1990) (analyzing tax legislation under various theories, including public choice).

118. *See Gregory*, 501 U.S. at 458 (recounting federalism values, including "sensitiv[ity] to the diverse needs of a heterogeneous society" and "innovation and experimentation in government"); *see also* McConnell, *supra* note 70, at 1493–1500 (discussing advantages of federalism, including "that local laws can be adapted to local conditions and local tastes" and

1. *Voter Preferences*. As an initial matter, we might conclude that state delegation of taxing authority to Congress poses no democratic problem because state residents also have representation in the federal government.[119] Some might even argue that upward delegations from the states to the federal government are democracy-enhancing, because people pay more attention to federal politics than to state politics, and because state elections have lower participation levels than do national elections.[120] Even if we did not conclude that delegating up by the states was democracy-enhancing, most would agree with Professor Dorf's conclusion that such delegations sharply contrast with national delegations of authority to supranational bodies, such as the United Nations.[121] After all, with federal-state tax-base conformity, the "delegate" is Congress, a relatively transparent, well-monitored, democratically elected body. Indeed, in cases in which state and federal voters agree on substantive policy, state incorporation of federal law is unproblematic. For example, state and federal voters are likely to agree that business expenses should be deductible from gross income. As a result, state incorporation of § 162 of the Internal Revenue Code, which allows taxpayers to deduct "ordinary and necessary" business expenses,[122] is unlikely to generate controversy.

But federal-state tax-base conformity raises democratic concerns when the preferences of state voters differ from those of national voters. In a case interpreting Minnesota's nondelegation principle to permit only static, rather than dynamic, incorporation into state law of the federal definition of adjusted gross income, the Minnesota Supreme Court highlighted the problem when it observed that

---

"that state and local governmental units will have greater opportunity and incentive to pioneer useful changes").

119. *Cf.* Dorf, *supra* note 3, at 108–10, 135–36, 153–58 (comparing tax-base conformity with international delegation and considering whether representation within decisionmaking structures might ameliorate democratic losses).

120. *Cf.* Richard Briffault, *"What About the 'Ism'?" Normative and Formal Concerns in Contemporary Federalism*, 47 VAND. L. REV. 1303, 1326 (1994) ("For much of this century, the states were generally considered to be the least representative . . . and the least accountable of our three levels of government."); Edward L. Rubin & Malcolm Feeley, *Federalism: Some Notes on a National Neurosis*, 41 UCLA L. REV. 903, 915 (1994) ("[T]he story of participation in state and local government regularly features low voter turnouts, entrenched elites, and narrow-minded policies."); *id.* at 909, 936–51 (arguing that in the United States, "our real community is a national one").

121. *See* Dorf, *supra* note 3, at 112–13.

122. I.R.C. § 162(a) (2006).

> [t]he amounts which are to be included or excluded in the determination of [federal] adjusted gross income are numerous and are subject to change. Many of the exclusions are based on political and social rather than economic considerations. The same political and social considerations which are of significance to the Federal tax policy are not necessarily of significance to the state's tax collection scheme. . . . Any and all of these provisions, as well as others, may be changed at any time by the Congress of the United States—without consulting the Minnesota Legislature.[123]

Because Congress uses the tax law to pursue a large number of diverse regulatory programs, national and state preferences are likely to diverge in at least some cases. Two politically charged examples will demonstrate the point that by incorporating the federal tax base, states may end up substituting national preferences for state preferences.

The first example involves same-sex marriage. Several states recognize same-sex marriage, but the federal Defense of Marriage Act (DOMA)[124] provides that federal tax provisions that rely on a spousal relationship will not apply to same-sex married couples.[125] Whether DOMA increases or decreases the federal tax liability of same-sex married couples compared to similarly situated opposite-sex married couples depends on several factors, including whether the same-sex spouses earn their income equally or unequally.[126] In some cases, the effect of DOMA is to increase same-sex couples' tax liability compared to similarly situated opposite-sex couples.[127] For

---

123. Wallace v. Comm'r of Taxation, 184 N.W.2d 588, 591 (Minn. 1971).

124. Defense of Marriage Act, 1 U.S.C. § 7, 28 U.S.C. § 1738C (2006).

125. DOMA provides that:

> In determining the meaning of any Act of Congress, or of any ruling, regulation, or interpretation of the various administrative bureaus and agencies of the United States, the word "marriage" means only a legal union between one man and one woman as husband and wife, and the word "spouse" refers only to a person of the opposite sex who is a husband or a wife.

1 U.S.C. § 7. As a result, any federal tax benefits that depend on taxpayers' married status exclude same-sex married couples.

126. *See supra* notes 92–95 and accompanying text.

127. *See* Patricia A. Cain, *DOMA and the Internal Revenue Code*, 84 CHI.-KENT L. REV. 481, 498–99 (2009) (citing 2004 Congressional Budget Office estimates that repealing DOMA would increase federal tax collections because of imposition on same-sex couples of the "marriage tax penalty" and the disallowance of the option for members of same-sex married couples to elect "Head of Household" filing status). For a discussion of states' incorporation of federal filing statuses, see generally Heather Field, *Binding Choices: Tax Elections and Federal-State Conformity*, 32 VA. TAX REV. (forthcoming 2013), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2171339.

example, DOMA prevents same-sex couples from claiming marriage-related tax benefits, such as joint filing and the exclusion of fringe benefits provided by an employer to the employee's spouse.[128] In other cases, DOMA reduces same-sex couples' tax liability compared to similarly situated opposite-sex couples. For example, because same-sex married couples are not considered spouses for purposes of federal tax anti-abuse rules,[129] they have greater tax planning opportunities.[130]

States that incorporate without deviation federal tax filing statuses or the federal definitions of adjusted gross income or taxable income thereby import into their own tax systems differences in the treatment of same- and opposite-sex married couples. In states recognizing same-sex marriage, this incorporation may raise state constitutional questions,[131] and it also substitutes national for state preferences regarding marriage equality. Such substitution would be especially troubling from a democratic perspective in states where recognition of same-sex marriage was prompted by popular referendum.[132] Whereas states that recognize same-sex marriage have

---

128. For a brief summary of federal tax disadvantages to same-sex married couples under DOMA, see Cain, *supra* note 127, at 501–03, which provides a nonexhaustive list of such disadvantages, including the inability of one spouse to itemize deductions while the other takes the standard deduction.

129. *See* 1 U.S.C. § 7. Federal anti-abuse rules include provisions of the federal tax law designed to prevent related parties from securing tax benefits from transactions that lack economic substance. For example, a person cannot recognize a loss for tax purposes on property sold to his or her spouse. *See* I.R.C. § 1041 (2006) (treating as a nonrecognition event sales between spouses). For a broad and illuminating set of examples, see Theodore P. Seto, *The Unintended Tax Advantages of Gay Marriage*, 65 WASH. & LEE L. REV. 1529, 1548–93 (2008).

130. *See* Seto, *supra* note 129, at 1539–45 (arguing that same-sex couples should trigger tax anti-abuse rules that apply to related parties because if such rules do not apply, same-sex couples will be able to avoid tax more easily than similarly situated opposite-sex couples). Tax-planning opportunities available more to same-sex than opposite-sex couples under DOMA include income shifting, avoidance of marriage penalties, the ability to claim larger earned income tax credits despite larger family incomes, avoiding taxation of Social Security benefits, the ability for one spouse to claim the standard deduction while the other claims itemized deductions, and so on. *Id.* at 1559–80; *see also* Cain, *supra* note 127, at 501–03 (noting that, among other strategies, same-sex couples can more easily recognize capital losses while still maintaining control of the loss property).

131. *Cf., e.g.*, Varnum v. Brien, 763 N.W.2d 862, 906–07 (Iowa 2009) (holding that denying same-sex couples marriage licenses violated their equal-protection rights under the Iowa Constitution).

132. The law of New York, for example, provides that a "marriage that is otherwise valid shall be valid regardless of whether the parties to the marriage are of the same or different sex." N.Y. DOM. REL. LAW § 10-a(1) (McKinney 2010 & Supp. 2012); *see also* Rebecca DiLeonardo, *Washington Governor Certifies Same-Sex Marriage Referendum*, JURIST (Dec. 6, 2012, 12:46 PM), http://jurist.org/paperchase/2012/12/washington-governor-certifies-same-sex-marriage-

deviated from some of the federal tax provisions that treat same-sex married taxpayers as unmarried, Part V shows why conforming states cannot—as a practical matter—eliminate all differences of tax treatment under DOMA between same- and opposite-sex married couples.[133]

The second politically charged example involves the large set of federal tax preferences claimable by taxpayers who are not U.S. citizens. With very few exceptions, the same federal tax laws apply to all individuals who are tax residents of the United States, regardless of their citizenship or immigration status.[134] Noncitizens qualify as U.S. residents for tax purposes if they are green card holders[135] or if (to simplify greatly) they are physically present in the United States for more than half the tax year.[136] Although qualification as a U.S. tax resident triggers disadvantageous worldwide income taxation, it also brings advantages. All U.S. tax residents, including those who hold neither citizenship nor green cards, may claim most federal tax benefits, including charitable deductions, mortgage deductions, state and local tax deductions, exemptions for employer-provided health care, deductions for contributions to savings plans, and so on.[137]

referendum.php (noting that same-sex marriage was approved by popular referendums in 2012 in Maine, Maryland, and Washington, and that same-sex legislation has passed in five other states: Connecticut, Massachusetts, New Hampshire, New York, and Vermont).

133. *See infra* notes 265–267 and accompanying text.

134. Sections 1 and 61 of the Internal Revenue Code assess taxes against all "individuals" without exception. These provisions would seem to include citizens as well as all aliens, resident and nonresident. Sections 2(d) and 871, however, provide for a special regime applicable to "nonresident aliens." *Compare* I.R.C. §§ 1(a)–(d), 61 (2006) (assessing taxes against all "individuals"), *with id.* §§ 2(d), 871 (2006 & Supp. V 2012) (providing special tax rules for "nonresident alien[s]").

135. Lawful permanent residents of the United States are commonly called green card holders. *See, e.g.*, *Green Card (Permanent Residence)*, U.S. CITIZENSHIP & IMMIGRATION SERVS., http://www.uscis.gov/greencard (last updated May 13, 2011).

136. *See id.* § 7701(b)(1)(A)(i) (2006) (defining tax resident to include "lawful permanent resident[s] of the United States"); *see also id.* § 7701(b)(1)(A)(ii) (defining tax resident to include aliens meeting a substantial physical presence test, regardless of their immigration status). Anyone who is neither a U.S. resident as defined in § 7701(b)(1) nor a U.S. citizen is a "nonresident alien." *id.* § 7701(b)(1)(B). A separate tax regime denies nonresident aliens almost all federal tax expenditures. *See id.* § 873 (denying nonresident aliens most personal deductions).

137. *See generally* INTERNAL REVENUE SERV., PUB. 519, U.S. TAX GUIDE FOR ALIENS 8, 28 (2011), *available at* http://www.irs.gov/pub/irs-prior/p519--2010.pdf. Congress has imposed immigration-status restrictions on a few tax expenditures, including the earned income tax credit. To claim a dependent child under the earned income tax credit, the taxpayer, her spouse, and her qualifying child(ren) all must possess Social Security numbers (SSNs). I.R.C. § 32(m) (2006). Since 1996, only citizens, green card holders, and other resident aliens authorized to

Rather than constituting evidence of Congress's special solicitude for immigrants or its desire to make the United States an attractive labor market for foreigners, the advantageous treatment of tax-resident aliens may be simply an unintended artifact of the federal tax law's division of the world of taxpayers into only two categories: residents and nonresidents. Whatever the reasons, the federal tax law generally does not distinguish among U.S. citizens, green card holders, and others who reside for long periods in the United States. Indeed, a person may be a U.S. resident for tax purposes even if she was not legally admitted to the United States.[138] States that incorporate the federal tax base will inadvertently channel similar tax benefits to immigrants, including undocumented immigrants.[139] Extension at the state level of these federal tax preferences may undermine other state policies that aim to discourage inward migration by non-citizens.[140]

---

work in the United States are entitled to SSNs. INTERNAL REVENUE SERV., *supra*, at 32. As a result, aliens residing in the United States who are not authorized to work in the United States and who did not obtain an SSN under more liberal regulations applicable before 1996 cannot claim the earned income tax credit.

The child tax credit (CTC) also contains restrictions based on the citizenship status of the children being claimed. U.S. resident taxpayers (citizen and noncitizen, documented and undocumented) may claim the CTC for children who are U.S. citizens, U.S. nationals, or aliens resident (for tax purposes) in the United States. No one may claim the CTC for alien children who reside outside the United States. *See* I.R.C. § 24(c)(2) (2006) (denying CTCs to those whose dependents are not "resident[s] of the United States"); *id.* § 152(b)(3)(A) (defining dependents); *see also* INTERNAL REVENUE SERV., PUB. 972, CHILD TAX CREDIT 2 (2013), *available at* http://www.irs.gov/pub/irs-pdf/p972.pdf (defining "[a] qualifying child for purposes of the child tax credit").

This Article discusses only the *eligibility* of undocumented aliens who are U.S. tax residents for federal tax benefits, and it makes no claim regarding such taxpayers' actual use of those benefits.

138. *See* I.R.C. § 7701(b)(1)(A)(ii), (b)(3) (determining the tax residence of aliens who are not permanent residents by reference to the number of days physically present in the United States, without respect to whether the aliens were admitted legally or not).

139. *Cf.* TREASURY INSPECTOR GEN. FOR TAX ADMIN., INDIVIDUALS WHO ARE NOT AUTHORIZED IN THE UNITED STATES WERE PAID $4.2 BILLION IN REFUNDABLE CREDITS 4 (2011), *available at* http://www.treasury.gov/tigta/auditreports/2011reports/201141061fr.pdf (discussing refunds of the CTC paid in 2010 to taxpayers who filed their taxes with Individual Taxpayer Identification Numbers, rather than SSNs); *id.* at 6 (noting that the refundable CTC "appears to provide an additional incentive for aliens to enter, reside, and work in the United States without authorization").

140. For example, Arizona's controversial Support Our Law Enforcement and Safe Neighborhoods Act requires state police to verify the immigration status of anyone they stop or arrest, and the Act makes it a crime for immigrants to seek or obtain work without authorization or to fail to carry federal immigration documents. *See* Support Our Law Enforcement and Safe Neighborhoods Act, ch. 313, 2010 Ariz. Sess. Laws 450, *invalidated in part by* Arizona v. United States, 132 S. Ct. 2492, 2511 (2012); *see also* NAT'L EMP'T LAW PROJECT, MORE HARM THAN GOOD: RESPONDING TO STATES' MISGUIDED EFFORTS TO

I have used charged political issues to highlight the regulatory impact of federal-state tax-base conformity, but tax-base conformity does not represent a commitment to adopt any particular political viewpoint (for example, anti-marriage-equality or pro-immigration). Rather, under conformity, states adopt the same tax policies as Congress, no matter what the content of those policies. Although all states deviate at least somewhat from the federal tax base, the advantages of conformity appear to be compelling enough that the overwhelming majority of states conform closely to the federal tax base. The transfer of control over the content of tax policy from the states to the federal government represents a democratic loss for state residents. It results in the imposition on state residents of a tax regime that diverges from the tax regime they would impose on themselves through state-level democratic processes, at least under the reasonable assumption that state preferences will sometimes differ from national preferences.

2. *Political Accountability*. A related criticism about the democratic threat posed by federal-state tax-base conformity might be that by causing confusion as to whether state or federal legislators are responsible for state tax policies, conformity undermines the ability of state voters to hold their representatives accountable for unwanted tax policies. This argument can be drawn by analogy to arguments made in the unfunded-mandates and conditional-grants contexts. In holding that Congress could not simply commandeer the states to implement federal goals, the Supreme Court in *New York v. United States*[141] warned that "where the Federal Government directs the States to regulate, it may be state officials who will bear the brunt of public disapproval, while federal officials who devised the regulatory program may remain insulated from the electoral ramifications of their decision."[142] Similarly, commentators have reasoned that even though states have the opportunity to opt out of conditional federal grants, such grants may cause confusion among

REGULATE IMMIGRATION 11–13, 15–16 (2007), *available at* http://nelp.3cdn.net/b5b735db8dc21687d0_llm6bx88t.pdf (reviewing proposed state legislation designed to combat undocumented labor).

141. New York v. United States, 505 U.S. 144, 188 (1992) (striking down the Low-Level Radioactive Waste Policy Amendments Act of 1985, Pub. L. No. 99-240, tit. I, 99 Stat. 1842 (1986), which required states to dispose of or take title of radioactive waste created in their borders).

142. *Id.* at 169.

voters as to whether to hold state or federal legislators (or both) to account for the conditions attached to grants.[143] The argument that federal, rather than state, legislators should be held to account for grant conditions seems to rest on the notion that although grants are putatively conditional, states' financial dependence on federal aid makes states' ability to refuse federal grants illusory.[144] Thus, some commentators see conditional grants as functionally equivalent to mandates.

A similar argument could be made about tax-base conformity. Specifically, because the administrative benefits of base conformity are so significant—or, put negatively, because the costs associated with fully autonomous operation of a state income tax are so high—states that need to tax income lack a meaningful choice between conformity and an autonomous tax base. In short, the argument would run, states that seek to tax income *must* conform to the federal tax base, and as a result, state lawmakers should not be held politically accountable for the content of the tax base. Or, at a minimum, conformity confuses voters as to which level of government to hold responsible for the content of the state tax base. Although the Supreme Court usually has rejected constitutional challenges to conditional grants,[145] if conditional grants and base conformity actually create voter confusion, that confusion would be undesirable as a policy matter. Whether base conformity causes voter confusion poses theoretical as well as empirical questions. First is the theoretical question of which level (or levels) of government *ought* to be held accountable for the substance of the state tax base, and second is the empirical question of how voters actually assign political accountability for the content of the state tax base.

---

143. *Cf.* Ilya Somin, *Closing the Pandora's Box of Federalism: The Case for Judicial Restriction of Federal Subsidies to State Governments*, 90 GEO. L.J. 461, 486 (2002) (describing a political win-win for state and federal officials in which both are likely to welcome grants to promote local benefits and improve their standing with the electorate).

144. *See, e.g.*, Lynn A. Baker, *Conditional Federal Spending After* Lopez, 95 COLUM. L. REV. 1911, 1933–39 (1995) (explaining different reasons why conditional grants rarely present a real choice to states).

145. *See New York*, 505 U.S. at 166–77 (contrasting constitutionally permissible conditional grants with unconstitutional commandeering). *But see* Nat'l Fed'n of Indep. Bus. v. Sebelius, 132 S. Ct. 2566, 2603–07 (2012) (Roberts, C.J., Breyer & Kagan, J.J.) (holding unconstitutionally coercive the discretion given under the Patient Protection and Affordable Care Act to Secretary of Health and Human Services to withhold all existing Medicaid funds from states that chose not to participate in the act's Medicaid expansion if those states did not comply with any Medicaid requirement).

3. *Tailoring Tax Incentives*. In addition to reducing states' abilities to respond to voter preferences and potentially undermining political accountability, tax-base conformity also reduces the ability of states to tailor tax incentives to local conditions. Regional differences in elasticities of supply and demand can result in the same tax incentive having different effects in different states. Consider the federal deduction for home mortgage-interest payments.[146] The effectiveness of the subsidy in encouraging homeownership depends in part on the elasticity of the supply of housing. If housing supply is inelastic, such that no new houses will be built in response to the subsidy, then over time the effect of the subsidy will be to increase house prices.[147] If the subsidy becomes fully capitalized into higher house prices, it will no longer encourage taxpayers to buy homes.[148] Housing supply is more elastic in the Midwest than on the coasts, because density is already high on the coasts.[149] As a result, it could be efficient to selectively subsidize homeownership in the Midwest, but not on the coasts. Because federal taxes generally are nationally uniform, however, it is difficult for Congress to take advantage of such differences in regional elasticities. By incorporating one-size-fits-all federal tax incentives, states miss the opportunity to tailor their tax incentives to local conditions.

Information asymmetry also can cause tax incentives to be inefficient. For example, any time the government tries to encourage an activity by subsidizing it, it risks wasting some of the subsidy on people who would have engaged in the behavior even without the subsidy. The government cannot set the subsidy efficiently because it does not know how much subsidy each taxpayer requires to engage in the desired behavior, and it is in the taxpayer's interest to exaggerate the amount she requires in the hopes of increasing the subsidy.[150] If an imaginary creature—call it Pigou's Demon—could reveal each taxpayer's elasticity, the government could get subsidies exactly right. But without Pigou's Demon, preferences stay hidden and the government cannot provide perfect subsidies. Such information

146. I.R.C. § 163(h)(2)(D) (2006).

147. William G. Gale, Jonathan Gruber & Seth Stephens-Davidowitz, *Encouraging Homeownership Through the Tax Code*, 115 TAX NOTES 1171, 1179 (2007).

148. For an explanation of capitalization using numerical examples, see Deborah M. Weiss, *Tax Incentives Without Inequity*, 41 UCLA L. REV. 1949, 1955–62 (1994).

149. Gale et al., *supra* note 147, at 1179.

150. Edward A. Zelinsky, *Efficiency and Income Taxes: The Rehabilitation of Tax Incentives*, 64 TEX. L. REV. 973, 1009–10 (1986).

asymmetries are thought to be smaller between taxpayers and states than between taxpayers and the federal government because states are closer to the people and presumably have better access than does the federal government to information about them.[151] If this is so, then it would be more effective for states to use their superior information to set their own tax incentives than for states simply to copy federal incentives.[152] Data maintained by the federal government show that claims for federal tax incentives vary widely by state,[153] reflecting differences in the attributes of state residents and suggesting potential efficiency gains from greater tailoring of tax incentives to state attributes.

4. *Policy Experimentation*. Federal-state tax-base conformity erodes another traditional benefit of federalism: that federalism allows the states to conduct regulatory experiments.[154] Even when residents of all states agree on a particular policy goal, there may be different ways of achieving it. Similarly, if a problem shared by all the states has different causes in different locations, then the most effective strategy for combating that problem will differ regionally. For example, although residents of many states may share the goal of reducing reliance on fossil fuels, each state's tax incentives should promote the use of alternative energy resources appropriate to that state's particular climate and energy consumption profile. By adopting broadly targeted federal tax incentives for green

151. Kelo v. City of New London, 545 U.S. 469, 482 (2005) ("Viewed as a whole, our jurisprudence has recognized that the needs of society have varied between different parts of the Nation, just as they have evolved over time in response to changed circumstances. Our earliest cases in particular embodied a strong theme of federalism, emphasizing the 'great respect' that we owe to state legislatures and state courts in discerning local public needs." (quoting Hairston v. Danville & W. Ry. Co., 208 U.S. 598, 607 (1908))); Wallace E. Oates, *An Essay on Fiscal Federalism*, 37 J. ECON. LITERATURE 1120, 1121–22 (1999) (noting that fiscal federalism combines the federal government's financial power and stability with the states' abilities to know what the public needs).

152. Because state tax rates are lower than federal tax rates, state tax subsidies that take the form of deductions or exemptions have a smaller incentive effect than their federal equivalents. Nevertheless, if states go to the trouble (and revenue expense) of providing tax subsidies at all, they have an interest in ensuring that those subsidies are as efficient as possible.

153. *See generally* TAQUESHA CAIN, INTERNAL REVENUE SERV., INDIVIDUAL INCOME TAX RETURNS, BY STATE, 2007 (2011), *available at* http://www.irs.gov/pub/irs-soi/11inbystatesprbul.pdf (analyzing and reproducing data from the IRS's *Statistics of Income Bulletin* showing differences across states in taxpayers' claims for tax expenditures).

154. *See* New State Ice Co. v. Liebmann, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting) (reasoning that states may devise different ways to pursue similar policy goals, thus serving as "laborator[ies]" for "social and economic experiments").

technologies through incorporating the federal tax base, however, states miss the opportunity to incentivize technologies that are particularly effective for their state. Many states have enacted their own energy tax incentives in addition to those they incorporate from the federal government.[155] For example, Arizona subsidizes solar energy,[156] and Montana subsidizes geothermal energy.[157] But to the extent that states use these tailored credits in addition to, rather than as a substitute for, federal one-size-fits-all solutions, they risk wasting revenue on inefficient subsidies.[158] Moreover, state-level tax policies may conflict with federal tax policies imported into state law by incorporation. For example, Georgia's deviating tax incentive for low- and zero-emission vehicles coexists with its federally derived "SUV loophole," which allows expensing of a significant portion of the cost of heavy, low-mileage vehicles used in a trade or business.[159] Georgia imported the federal SUV loophole by incorporating (without deviation) the federal calculation of business income.[160]

155. *See* OLIN & SWAIN, *supra* note 17, at 6 (noting that thirty-eight states provide energy or environmental credits).

156. ARIZ. REV. STAT. ANN. § 43-1085 (2006 & Supp. 2012) (providing a tax credit for installing a solar energy device in a residence).

157. MONT. CODE ANN. § 15-32-115 (2012) (providing a tax credit for installation of a geothermal heating or cooling system in a principal dwelling).

158. Generally, states enact their own green credits in addition to the green tax incentives that they import from the federal tax base. Individuals can take advantages of federal energy credits covering a wide variety of technologies, including biomass stoves, insulation, geothermal pumps, wind turbines, solar and fuel cells, energy-efficient HVAC units and water heaters, and energy-efficient cars, such as fuel cell, hybrid, and electric cars. *See* JOINT COMM. ON TAXATION, TAX EXPENDITURES FOR ENERGY PRODUCTION AND CONSERVATION 5–9 (2009) (listing federal credits for energy efficiency available to individuals). *But see* Roberta F. Mann, *Federal, State, and Local Tax Policies for Climate Change: Coordination or Cross-Purpose?*, 15 LEWIS & CLARK L. REV. 369, 386–91 (2011) (arguing that the failure of federal and state governments to coordinate their responses to climate change results in inefficiencies and conflicts).

159. *Compare* GA. CODE ANN. § 48-7-40.16 (2009) (providing Georgia taxpayers with tax credits for zero- and low-emission vehicles), *with* I.R.C. § 179 (2006) (allowing immediate expensing of up to $25,000 for the costs of SUVs weighing 14,000 pounds or less and not covered by § 280F), *and id.* § 280F (restricting depreciation deductions for "luxury automobiles" weighing 6,000 pounds or less). *See generally* Lawrence Zelenak, *The Loophole That Would Not Die: A Case Study in the Difficulty of Greening the Internal Revenue Code*, 15 LEWIS & CLARK L. REV. 469, 473–79 (2011) (giving the history of the federal SUV loophole). Professor Zelenak remarks that "[a]lthough the SUV loophole is neither the most economically significant nor the most environmentally damaging of the Internal Revenue Code's offenses against the environment, it is among the most transparent and the most outrageous." *Id.*

160. *See* OLIN & SWAIN, *supra* note 17, at 22 (indicating that Georgia does not deviate from the federal calculation of business, rent, or farming income); *see also* GA. DEP'T OF REVENUE, FORM 500, INDIVIDUAL INCOME TAX RETURN 5 l. 3 (2010), *available at* https://etax.dor.ga.gov/

C. Fiscal Stability

Another disadvantage of tax-base conformity is that it injects uncertainty into state fiscal systems by increasing the volatility of state tax revenues. This volatility makes it more difficult for states to meet their financial obligations. One source of volatility is the income tax itself—income taxes are more volatile than other kinds of taxes, such as property or sales taxes. The second source of volatility stems from changes in federal law.

Professor Kirk Stark has argued that the ability to conform with the federal tax base, as well as the other administrative advantages of conformity, make it easy for states to assess income taxes. Conformity may even make it easier for states to use income taxes than to use property or sales taxes. According to Professor Stark, the "gravitational pull in favor of base conformity" results in states' overreliance on the income tax base instead of other tax bases.[161] The problem with state overreliance on income taxation, in Professor Stark's view, is that compared to other kinds of taxes, income taxes generate revenue volatility for states.[162] Other tax bases, such as property and sales, are more stable than the income tax because they are not as closely tied to the business cycle.[163]

Professor Stark acknowledges, however, that one virtue of state reliance on income taxes is that income taxes automatically stabilize the economy more than do taxes on other bases, such as property and sales taxes.[164] Income taxes function as automatic stabilizers because when incomes rise, tax payments automatically increase, leaving taxpayers with less to spend. On the other hand, when the economy contracts and incomes fall, people owe less in taxes as a percentage of their income, which dampens the effect of the loss of income on their

inctax/2011_forms/TSD_Individual_Income_Tax_Return_500-2011_Fillable.pdf (listing low- and zero-emission-vehicle tax credits).

161. Stark, *supra* note 1, at 432.

162. *Id.*

163. *Id.* at 422.

164. *Id.* at 417. For an empirical study on the extent to which federal taxes automatically stabilize economic fluctuations, see generally Alan J. Auerbach & Daniel Feenberg, *The Significance of Federal Taxes as Automatic Stabilizers*, 14 J. ECON. PERSPECTIVES, Summer 2000, at 37.

ability to consume. The more progressive the tax system is, the more it automatically stabilizes the economy.[165]

Although income taxes have salutary macroeconomic stabilizing effects, federal-state tax-base conformity generates revenue volatility unrelated to the business cycle. Specifically, conforming states experience revenue volatility stemming from changes in federal tax law. Such changes can dramatically increase or decrease state tax revenues, and they do not necessarily serve macroeconomic stabilizing goals. For example, in 1986 Congress substantially broadened the tax base by eliminating many tax preferences. To compensate for the broader base, the federal government also increased exemptions and the standard deduction, and it lowered tax rates.[166] Incorporating states that did not amend their exemptions, standard deductions, or rates experienced large revenue windfalls.[167] Although some states returned at least some of this windfall to their residents,[168] such unanticipated revenue windfalls are wasteful; they tend to lead to greater government spending,[169] which may be unsustainable.

Although most states experienced revenue windfalls due to the 1986 tax reform, because its overall effect was to lower federal taxes, states that assessed taxes as a percentage of residents' federal tax liability experienced significant revenue shortfalls to the extent that they did not increase their rates.[170] More generally, changes to the federal tax law that narrow the tax base or provide new tax subsidies

---

165. *Cf.* Thomas J. Kniesner & James P. Ziliak, *Tax Reform and Automatic Stabilization*, 92 AM. ECON. REV. 590, 590 (2002) (finding that lowering tax rates as part of the 1986 tax reform reduced the automatic stabilizing effect of the income tax).

166. HELLERSTEIN & HELLERSTEIN, *supra* note 8, ¶ 20.02 (Supp. 2003).

167. *Id.*; *see also* ADVISORY COMM'N ON INTERGOVERNMENTAL RELATIONS, SR-8, THE TAX REFORM ACT OF 1986—ITS EFFECT ON BOTH FEDERAL AND STATE PERSONAL INCOME TAX LIABILITIES 26 (1988) (estimating average percentage increases in state tax revenue due to the federal tax changes to be 7.4 percent, ranging from 0.7 percent in New England to 18.9 percent in the Southwest); *id.* at 4, 26 (noting that the lowest income quintile of state taxpayers faced the largest increases in their state tax liability).

168. HELLERSTEIN & HELLERSTEIN, *supra* note 8, ¶ 20.02 (Supp. 2003).

169. *See generally* Helen F. Ladd, *State Responses to the TRA86 Revenue Windfalls: A New Test of the Flypaper Effect*, 12 J. POL. ANALYSIS & MGMT. 82 (1993) (finding that states spent the windfalls from the 1986 act).

170. *See* Pomp, *supra* note 48, at 1195 n.1 (noting that in 1986 Nebraska, North Dakota, Rhode Island, and Vermont calculated their taxes as a percentage of federal tax); *see also* ADVISORY COMM'N ON INTERGOVERNMENTAL RELATIONS, *supra* note 167, at 13 (estimating revenue losses in those states respectively at 8.6 percent, 10.2 percent, 11.5 percent, and 9.9 percent). For a discussion of the state tax consequences of the recent repeal and reinstatement of the federal estate tax, see *infra* note 315 and accompanying text.

precipitate state revenue shortfalls. If states fail to either raise their tax rates or decouple from revenue-reducing federal legislation, they may have trouble meeting their spending obligations.

Making matters worse, Congress frequently amends federal tax law late in the year, or at times when state legislatures are not in session.[171] Congress also often enacts tax legislation with retroactive effect. Such revenue shocks are hard for conforming states to absorb because, unlike the federal government, most states' constitutions or statutes limit their ability to issue debt and require them to balance their budgets annually, which prevents them from relying on deficit spending.[172] Thus, revenue volatility is worse for the states than for the federal government.

State revenue volatility from changes in federal law also may combine with volatility from the business cycle. Congress may narrow the federal tax base during a recession, relying on deficit spending to meet its expenses and pay for public programs. For example, federal bonus depreciation rules enacted as stimulus in 2002 resulted in revenue shortfalls for states that did not decouple from the federal rules.[173] Although most states have rainy-day funds to help them navigate economic downturns, these funds are often insufficient to cover gaps.[174] Because they cannot deficit spend, to maintain revenue when the federal government narrows the tax base, incorporating states must take the politically difficult step of increasing tax rates. If a state is unable to raise taxes to maintain revenue, it must cut spending. Empirical research shows that states exhibit "fiscal perversity" in response to recessions.[175] Specifically, states raise taxes

---

171. *See, e.g.*, Shaviro, *supra* note 15, at 980 (noting that the landmark Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (codified as amended in scattered sections of 26 U.S.C. (2006 & Supp. V 2012)), was made effective for the 1986 tax year, but was not enacted by Congress "until late October of that year, by which time many state legislatures were no longer in session").

172. All states except Vermont and Wyoming have balanced-budget requirements, and in addition, states have "the expectation and tradition of balanced budgets and the concern that state bond ratings may be lowered if the state's budget does not balance." U.S. GEN. ACCOUNTING OFFICE, GAO/AFMD-93-58BR, BALANCED BUDGET REQUIREMENTS: STATE EXPERIENCES AND IMPLICATIONS FOR THE FEDERAL GOVERNMENT 3–4 (1993).

173. HELLERSTEIN & HELLERSTEIN, *supra* note 8, ¶ 7.02[1][a] (Supp. 2007); *see also* I.R.C. § 168(k) (2006 & Supp. V 2012) (permitting 50 percent of the basis of qualified property to be deducted in the first year).

174. Forty-five states have rainy-day funds. Michaele Morrow & Robert Ricketts, *State Conformity with Federal Tax Changes*, 32 J. AM. TAX'N ASS'N, Fall 2010, at 27, 28 n.2.

175. *See* ALVIN H. HANSEN & HARVEY S. PERLOFF, STATE AND LOCAL FINANCE IN THE NATIONAL ECONOMY 48 (1944) (coining the term "fiscal perversity").

and cut benefits in bad economic times, even though such procyclical responses tend to deepen recessions.[176] Welfare programs especially suffer from states' procyclical responses to recessions.[177]

IV. TAX-BASE CONFORMITY AND STATE TAX COMPETITION

The impact of tax-base conformity on state tax competition warrants separate analysis. From the perspective of state tax competition, the most important effect of conformity is horizontal harmonization. When the states incorporate by reference the federal tax base, the states end up using the same tax base—or nearly the same tax base—as each other. As a result, it is easier for mobile residents to compare tax burdens across states than if each state used a completely different base. Perfect base harmonization would allow taxpayers to compare state tax burdens by simply comparing nominal rates across states. At the other extreme, if every state constructed its tax base from scratch, comparing nominal state tax rates would tell residents nothing about effective tax burdens. Instead, to understand effective tax burdens, taxpayers would have to invest in learning about and comparing state tax bases. Whether facilitating the comparison of state tax burdens is salutary depends on whether state tax competition is productive or destructive.[178]

Commentators have argued that tax competition promotes welfare by constraining self-interested politicians who, without regard to voter preferences, seek to maximize tax revenue and the size of the public sector.[179] Under this view, residents "tame Leviathan" by

---

176. *See* Super, *supra* note 16, at 2559.

177. *See id.* at 2613–14 (explaining that during the recessions in 1990–1991 and 2001, state spending cuts fell heavily on programs providing cash assistance to the poor).

178. *Compare* Enrich, *supra* note 75, at 380–405 (arguing that state competition to provide business tax incentives creates a lamentable race to the bottom), *with* Clayton P. Gillette, *Business Incentives, Interstate Competition, and the Commerce Clause*, 82 MINN. L. REV. 447, 453–57 (1997) (arguing that the salutary effects of state business tax competition have been undervalued).

179. *See* GEOFFREY BRENNAN & JAMES M. BUCHANAN, THE POWER TO TAX: ANALYTICAL FOUNDATIONS OF A FISCAL CONSTITUTION 186 (1980) (arguing that despite the spillovers between different units in a federal system, tax competition is "an objective to be sought in its own right" because of its constraining effect on tax rates and revenue-seeking politicians). Professor Wallace Oates's review of empirical research on decentralization and the size of the public sector led him to conclude that the evidence was mixed, but that the strongest support for the Leviathan theory could be found on a local level, rather than the state or national level. He attributed this outcome to the lower costs of movement between localities than between states or nations. *See generally* Wallace E. Oates, *Searching for Leviathan: A Reply and Some Further Reflections*, 79 AM. ECON. REV. 578 (1989). For an analysis of yardstick

exiting—or threatening to exit—the jurisdiction or by politically punishing lawmakers for imposing higher taxes than those applicable in neighboring states. Proponents of the Leviathan view would regard tax-base conformity as salutary because, by making it easier for taxpayers to compare tax burdens across states, conformity facilitates tax competition, thereby disciplining state taxing and spending.

On the other hand, if, instead of disciplining government officials, state tax competition sparks a destructive race to the bottom in which states compete for residents by lowering tax burdens until states cannot adequately fund public goods, then tax-base conformity is undesirable precisely because it facilitates easy comparison of competing tax rates. Using theoretical models, economists have shown that tax competition between the states may result in inefficiently low tax rates and, consequently, public sectors that are too small.[180] Empirical evidence provides some support for this view.[181] By obscuring effective tax burdens and thereby dampening competition, nonconformity therefore could shore up state tax revenues.

Notice, however, that regardless of whether the dominant effect of state tax base competition is to "tame Leviathan" or "beggar thy neighbor," federal-state tax-base conformity does not prevent robust tax competition. First, as long as conformity is only partial, states can compete with respect to deviations from the federal tax base. Additionally, even if all states have identical tax bases, they can still compete by offering different tax rates and menus of public goods. As long as states can distinguish themselves from each other via tax rates and public benefits, state competition can occur. Of course, uniform state tax bases would enhance tax competition by making it easier for mobile residents to compare state tax burdens. Even in the absence of perfect base conformity, however, empirical evidence shows that taxpayers discern and respond to differences in overall tax burdens

---

competition, see generally Timothy Besley & Anne Case, *Incumbent Behavior: Vote-Seeking, Tax-Setting, and Yardstick Competition*, 85 AM. ECON. REV. 25 (1995).

180. John D. Wilson & David E. Wildasin, *Capital Tax Competition: Bane or Boon*, 88 J. PUB. ECON. 1065, 1065 (2004).

181. *See id.* at 1069–72 (discussing several models developed to measure the effect of tax competition on the size of local governments). *But see* Wallace E. Oates, *Fiscal Competition and the European Union: Contrasting Perspectives*, 31 REGIONAL SCI. & URB. ECON. 133, 137 (2001) (surveying available empirical evidence and concluding that it shows that tax competition results in suboptimal tax levels, but not a "race to bottom" or a "downward spiral in public sector activities").

across states.[182] Because tax burden competition can take place in the absence or presence of federal-state tax-base conformity, knowing whether such competition is destructive or salutary does not provide a complete answer to the question of whether states should conform to the federal tax base.

Nevertheless, conformity generates certain advantages that do not depend on answering the larger question about whether state tax competition is net beneficial or destructive. First, conformity aids Tieboutian sorting at the state level. Using what he characterized as an "extreme"[183] theoretical model that included unrealistic assumptions,[184] economist Charles Tiebout showed that competition among localities for mobile residents would lead to efficient provision of local public goods because it would reveal taxpayers' hidden preferences for public goods and levels of taxation. In Tiebout's model, taxpayers would reveal these hidden preferences by "voting with their feet."[185] Although Tiebout's work involved local governments, rather than states, scholars have applied the same logic to mobility among states.[186] To the extent that conformity aids in revealing taxpayers' hidden preferences—thereby making the provision of public goods more efficient—it is beneficial.

Another potential benefit of conformity involves the tax incentives states offer to attract mobile businesses.[187] States compete

---

182. *See, e.g.*, James R. Hines, Jr., *Altered States: Taxes and the Location of Foreign Direct Investment in Americ*a, 86 AM. ECON. REV. 1076, 1080–92 (1996) (finding that corporations from countries that exempt foreign-source income are more likely to invest in low-tax U.S. states than high-tax U.S. states).

183. Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416, 419–20 (1956).

184. Among the other assumptions in Tiebout's model were that human mobility was costless and motivated only by taxes and the availability of locally provided public goods, that people's preferences for taxes and public goods were fixed, that taxpayers had accurate information about the tax and benefit profiles of all the jurisdictions, that all the costs of local public goods would be borne exclusively by residents (no tax exportation), and that all benefits of local expenditures would accrue only to residents (no spillovers). *See id.* at 419.

185. *See id.* at 420.

186. *See, e.g.*, Robert P. Inman & Daniel L. Rubinfeld, *Fiscal Federalism in Europe: Lessons from the United States Experience*, 36 EUR. ECON. REV. 654, 656 (1992) (arguing that centralized fiscal policies may counteract "free mobility of labor across the members of an economic union"); *cf.* Wilson & Wildasin, *supra* note 180 (reviewing the literature on interjurisdictional capital tax competition).

187. In some cases, business tax incentives are designed to aid in-state business, and are not specifically designed to affect locational decisions. In other cases, state tax incentives are designed to poach business from neighboring states. *See* Louise Story, *As Companies Seek Tax Deals, Governments Pay High Price*, N.Y. TIMES, Dec. 1, 2012, at A1 (noting that "corporations

to attract mobile businesses not only by lowering their tax rates, but also by offering tax incentives. Although many have argued that tax *burden* competition has the beneficial effect of disciplining lawmakers, business-tax *incentive* competition has been harshly criticized as a zero-sum game among the states that erodes state tax revenues without increasing national welfare.[188] To be effective at luring business from other states, such incentives must offer benefits that cannot be secured elsewhere. Thus, they take the form of deviations from the federal tax base. Examples of business-tax deviations include tax credits for new equipment put into service within the state.[189] Because state business-tax incentives represent deviations from the federal tax base, they require special reporting on state tax forms. As a result, they are more salient to taxpayers, voters, and lawmakers than would be business-tax incentives that were part of an autonomous state tax base. Deviating state business-tax incentives require special reporting on state tax forms. This increased salience could help the incentives be more effective as incentives. Additionally, it could make such incentives more politically accountable, which would be especially important if state business-tax incentives represent a destructive race to the bottom among states.

V. DECOUPLING STATE AND FEDERAL TAX BASES

Although the disadvantages of tax-base conformity are significant, the fact that all states with income taxes significantly conform their tax bases to the federal base suggests that the advantages of conformity outweigh the disadvantages. Nevertheless, states have been reluctant to maintain strict conformity with the federal tax base. For example, in 1972, to ease state administrative costs associated with state income taxation, Congress passed the

---

have. . . creat[ed] a high-stakes bazaar where they pit local officials against one another to get the most lucrative package").

188. *See, e.g.*, Enrich, *supra* note 75, at 390–97 (summarizing empirical evidence on the effectiveness of state tax incentives and finding that the evidence is inconclusive as to whether such incentives affect location of business, though they clearly undermine state finances); *cf.* Richard C. Schragger, *Rethinking the Theory and Practice of Local Economic Development*, 77 U. CHI. L. REV. 311, 332 (2010) ("[T]here is some evidence that subsidies do not ultimately alter the location decisions of firms. And even if location subsidies do enhance local welfare, they do not improve overall welfare—one city loses what another city gains." (footnote omitted)). State and local business tax incentives do not have a more a significant impact on locational decisions because the value of those incentives is small compared to other factors, such as labor, supply, and transportation costs. Enrich, *supra* note 75, at 391.

189. *See* Enrich, *supra* note 75, at 382–89 (describing state business tax incentives).

Federal-State Tax Collection Act,[190] which provided states the ability to opt into a program under which the federal government would collect state income taxes and remit those taxes to the states. The act required nearly complete state conformity with the federal tax base.[191] As a result, the only significant income tax policy choice that would remain with states opting into the program was how high to set their tax rates.[192] Even though the states already substantially conformed their tax bases with that of the federal government, no state opted into the collection system, despite the significant administrative savings at stake.[193] The act was repealed in 1990.[194] Commentators offered a variety of observations to explain the utter failure of the legislation,[195] but one clear drawback was the act's requirement of complete conformity with the federal tax base.[196]

This Part argues that the ability of the states to decouple their tax regimes from particular federal tax provisions crucially safeguards state tax autonomy and significantly mitigates the other disadvantages of tax-base conformity identified in Part III, while at the same time allowing states to secure most of the administrative benefits of conformity.

Although the ability to decouple from the federal tax law preserves state tax autonomy, this Part explains that incorporating states do not have complete flexibility to deviate from the federal tax law. First, the costs of deviation—including administrative and political costs—limit the extent to which the states can deviate from federal law. In addition, as a practical matter, certain federal tax rules are not subject to deviation. For example, although it may be

---

190. Federal-State Tax Collection Act, Pub. L. No. 92-512, tit. II, 86 Stat. 936 (1972), *repealed by* Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, tit. XI, § 11801(a)(45), 104 Stat. 1388 (1990). For a discussion of the history, advantages, and disadvantages of the act, see generally Stolz & Purdy, *supra* note 1.

191. *See* Stolz & Purdy, *supra* note 1, at 75–92 (describing conformity requirements and limited exceptions).

192. *See id.* at 77.

193. HELLERSTEIN & HELLERSTEIN, *supra* note 8, ¶ 20.02[2] (Supp. 2003).

194. Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, tit. XI, subtit. H, pt. I, subpt. A, § 11801(a)(45), 104 Stat. 1388, 1388–522 (1990); *see also* HELLERSTEIN & HELLERSTEIN, *supra* note 8, ¶ 20.02 (Supp. 2003).

195. The law required states to allow the IRS to represent them in all tax enforcement disputes, civil and criminal, so another concern among states was that the federal government would be insufficiently zealous in pursuing state revenue claims. Stolz & Purdy, *supra* note 1, at 89.

196. *Id.* at 113–25 (discussing loss of state autonomy as an "oft-stated objection to the federal collection system").

practical for states to deviate from the federal home mortgage deduction, it is not practical to deviate from the federal realization rule, because the realization rule cannot easily be severed from the rest of the federal tax base. Because whether a federal rule is severable is determined by its degree of entrenchment in federal law, rather than by normative criteria, it is reasonable to conclude that at least some nonseverable federal tax rules are undesirable from the perspective of state taxation. As a result, conforming states incorporate at least some federal tax policies that do not work well for them and that state voters would not choose for themselves. Thus, although the ability of states to decouple from federal tax provisions constitutes a powerful federalism safeguard, it does not fully mitigate the disadvantages of conformity.

A. Full and Partial Decoupling

No law requires states to conform to the federal tax base. Nor must a state that rejects conformity necessarily take on the legislative and administrative burden of autonomously enacting and maintaining an income tax. Instead, states can raise tax revenue from other sources, such as property and sales taxes.[197] That nine states have no comprehensive personal income tax shows that it is possible for at least some states to function without significant income taxation.[198] Over time, however, states' reliance on income taxation has grown as a percentage of overall state and local tax receipts, which suggests that states will find it increasingly difficult to raise all the revenue they need from other tax bases.[199]

In addition to the nine states without comprehensive income taxes, another six states assess comprehensive income taxes but do not use federal AGI or federal taxable income as their starting point for calculating income.[200] As discussed earlier, however, these facially

197. Exclusive of local taxation, in fiscal year 2008, states raised 28 percent of their revenue from income taxes, including both individual and corporate taxes. *See* TAX POLICY CTR., *supra* note 12, at 3. Income taxes do not represent a significant source of revenue for most localities. *See* JEFFREY L. BARNETT & PHILLIP M. VIDAL, U.S. CENSUS BUREAU, STATE AND LOCAL GOVERNMENT FINANCES SUMMARY: 2010, at 6 tbl.A-1 (2012), *available at* http://www2.census.gov/govs/estimate/summary_report.pdf (displaying data showing that the substantial majority of local revenue derives from entities such as higher education institutions and hospitals, property taxes, and sales and gross receipts taxes).

198. *See supra* note 18.

199. *See supra* note 6.

200. The six states are Alabama, Arkansas, Iowa, Mississippi, New Jersey, and Pennsylvania. OLIN & SWAIN, *supra* note 17, at 14, 16, 27, 36, 41, 49.

nonconforming states substantially conform to the federal tax base.[201] The use by even facially nonconforming states of federal income tax concepts reflects the prohibitive costs of devising a fully autonomous income tax base.[202] This should not be surprising when we consider that the federal Internal Revenue Code is two thick volumes containing over 3.7 million words,[203] and the Treasury regulations that interpret them fill an additional six volumes.

States that judge it infeasible to decouple fully from the federal tax base nevertheless can—and do—deviate from particular provisions of the federal tax law.[204] States can accomplish this deviation at any time by a simple act of the state legislature. Deviations take a variety of forms. "Additions," or "add-backs," enlarge the state tax base compared to the federal tax base because they require that the taxpayer add back an item of income that she excluded or deducted at the federal level. If the addition is an item separately stated on the federal tax form, such as the deduction for IRA contributions or the deduction for student-loan interest payments,[205] then the state deviation will not significantly increase taxpayer compliance burdens.[206] In contrast, when states add back items that are not separately stated on federal forms,[207] compliance and enforcement costs increase. Deviations also may reduce state-taxable income as compared to federally taxable income. Like additions, such "subtractions" can be items separately stated on

201. *See supra* notes 39–43 and accompanying text; *see also* HELLERSTEIN & HELLERSTEIN, *supra* note 8, ¶ 7.02[3] (Supp. 2007) (explaining that such states also "largely follow the federal provisions" for corporate taxation).

202. Such costs include the expectations by state taxpayers that the state income tax base will (substantially) match the federal base.

203. NAT'L TAXPAYER ADVOCATE, ANNUAL REPORT TO CONGRESS 4 n.6 (2008), *available at* http://www.irs.gov/pub/irs-utl/08_tas_exec_summ0108v2.pdf.

204. *See, e.g.*, Mark A. Muntean, *California's Nonconforming Conformity Legislation*, 39 ST. TAX NOTES 259, 259 (2006) (noting that California's tax law "includes nearly 50 pages of nonconforming provisions in the form of exceptions to the IRC").

205. *See* INTERNAL REVENUE SERV., FORM 1040, at 1 l. 32 (2012), *available at* http://www.irs.gov/pub/irs-pdf/f1040.pdf (providing for IRA contribution deduction); *id.* at 1 l. 33 (providing for student-loan interest deduction).

206. *Cf.* Pomp, *supra* note 48, at 1201 (labeling the state practice of requiring the same information as federal tax returns as "facial/recordkeeping conformity"); *id.* at 1205 (arguing that "provisions that violate facial/recordkeeping conformity should be suspect . . . and can be justified only if their resulting benefits are clear and substantial").

207. For example, although interest on state and local bonds is federally exempt, most states require residents to add back interest earned on out-of-state bonds, a figure that appears nowhere on the federal tax form. *See supra* note 32 and accompanying text.

federal forms,[208] or not.[209] Tax credits provide another mechanism for deviation. Although many states conform at least partially with federal tax credits,[210] most states offer tax credits of their own design.[211]

B. Mitigating Role of Decoupling

A few state tax deviations are constitutionally required,[212] but most deviations reflect state preferences and policy goals. The ability of states to deviate from individual provisions of the federal tax law distinguishes federal-state tax-base conformity from other intergovernmental cooperative mechanisms that raise more serious democratic accountability concerns, such as conditional grants or delegations of authority to supranational organizations.[213] As this Section explains, deviations represent an important safeguard that

---

208. For example, many states allow residents to subtract pensions from their state-taxable incomes. *See* OLIN & SWAIN, *supra* note 17, at 5. Such pensions are federally taxable and separately stated on Form 1040, page 1, line 16. *See* INTERNAL REVENUE SERV., *supra* note 205, at l l. 16.

209. For example, some states offer tax preferences for qualified college-savings programs other than (or in addition to) federal I.R.C. § 529 college-savings plans. *See, e.g.*, 35 ILL. COMP. STAT. ANN. 5/203(a)(2)(D-20) (West 2012) (excluding distributions from the Illinois Prepaid Tuition Trust Fund, while requiring taxpayers to add back into income the return on federal § 529 plans); N.Y. TAX LAW § 612(c)(32) (McKinney 2006 & Supp. 2013) (providing exclusion under New York tax law of distributions from qualified New York college-savings plans). Because these amounts are not federally deductible (or excludable), they involve separate record-keeping obligations for state taxpayers.

210. When states conform to a federal tax credit, they typically do so by offering state taxpayers a percentage of the federal credit. *See, e.g.*, MASS. ANN. LAWS ch. 62, § 6(h) (LexisNexis 2008 & Supp. 2012) (providing against Massachusetts tax due a credit of 15 percent of the taxpayer's federally calculated earned income tax credit).

211. *See* OLIN & SWAIN, *supra* note 17, at 6 (noting that the most common state tax credits include credits for taxes paid to other states, energy and environmental credits, jobs and business credits, child- and dependent-care credits, low-income credits, elderly and disabled credits, earned income tax credits, and credits for property taxes, rent payments or homesteads).

212. For example, states cannot tax federal obligations without congressional permission. *See* Pomp, *supra* note 48, at 1207 n.24. Likewise, the Supreme Court has interpreted the dormant foreign Commerce Clause to prevent states from using their tax systems to discriminate against foreign commerce, even if the discriminatory provision was incorporated from federal law. *See* Kraft Gen. Foods, Inc. v. Iowa Dep't of Revenue & Fin., 505 U.S. 71, 74, 82 (1992) (holding that Iowa's method of calculating corporate dividends-received-deductions (DRDs) violated the dormant Commerce Clause because, like the federal DRD, it denied the deduction to dividends received from non-U.S. corporations).

213. *See* Dorf, *supra* note 3, at 123 (concluding that some delegations to supranational organizations are de facto irrevocable because "the only way to opt out of one of [the supranational body's] enactments is to opt out of the entire apparatus, with potentially disastrous economic and diplomatic consequences").

mitigates some of the disadvantages of conformity raised in Part III. Specifically, the ability of states to deviate from federal tax provisions helps preserve state autonomy and regulatory diversity, may improve political accountability, allows states to tailor tax incentives to local conditions, and provides states a method to reduce the revenue volatility associated with conforming to the ever-changing federal tax base. Although deviations from the federal tax base (or from federal filing statuses) increase state taxpayers' compliance costs and states' administrative and enforcement costs, every state deviates somewhat from the federal tax base.

1. *State Autonomy and Regulatory Diversity*. Decoupling helps preserve state autonomy and regulatory diversity. A state's ability to remove particular federal tax provisions from its own tax base does much to assuage the concern that federal-state tax-base conformity substitutes national for state political preferences regarding the content of the tax base. For example, earlier I recounted some of the objections to the federal exemption of imputed income from homeownership, including that it inequitably favors homeowners over renters.[214] Several states provide a renters' credit that attempts to balance the federal tax preference for owner-occupied housing.[215] Similarly, many states provide credits that expand or alter other federal tax preferences. For example, by granting tax credits (rather than itemized deductions) for charitable contributions, North Carolina avoids the unfairness attributed to the federal deduction for charitable contributions, which benefits only itemizers.[216]

State tax deviations also reflect diversity in preferences among the voters of different states. For example, many states use tax credits to encourage parents to work outside the home, including by allowing employers to credit expenses related to providing child-care facilities to their employees,[217] allowing parents and guardians to credit child-care costs incurred while at work,[218] and providing credits to two-

214. *See supra* notes 83–84 and accompanying text.

215. *See e.g.*, CAL. REV. & TAX CODE § 17053.5(a)(1) (West 2010); HAW. REV. STAT. ANN. § 235-55.7(b) (LexisNexis 2011).

216. *See* N.C. GEN. STAT. ANN. § 105-151.26 (West 2011).

217. *See* OLIN & SWAIN, *supra* note 17, at 14–57 (showing that fourteen states credited employers' child-care expenses in 2008).

218. *See id.* (showing that twenty-two states credited parents' and guardians' child-care expenses in 2008).

earner households.[219] In contrast, Utah provides a tax credit for stay-at-home parenting.[220] The content of these tax incentives reflect differences in the values of the residents of different states.

States even deviate from structural provisions of the federal tax law when those structural provisions clash with the values of state residents. For example, states that recognize same-sex marriages or same-sex domestic partnerships deviate from the federal practice of denying same-sex couples the ability to file joint tax returns.[221]

2. *Accountability*. The option to decouple from the federal tax base also mitigates the concern that tax-base conformity undermines political accountability by causing voters improperly to blame state legislators for federal-level tax policy choices. When individual provisions of the federal tax law can be incorporated—or not—into the state tax base on an item-by-item basis, it is appropriate for state voters to hold state legislators to account for the items that state legislators choose to incorporate, as well as those they choose to leave out. In this respect, we can distinguish tax-base conformity from conditional grants, which may be offered on a take-it-or-leave-it basis, and from federal commandeering, which gives states no choice whatsoever.[222]

The requirement that state residents calculate their state-taxable income using separate tax forms also lessens accountability problems

219. *See id.* at 46–57 (showing that four states credited two-earner households in 2008).

220. *See* UTAH CODE ANN. § 59-10-1005 (LexisNexis 2011) (providing tax credit for "[a]t-home parent[s]" who care for their own infant in their own home, and stating that the "[a]t-home" parent's earned income must not exceed $3000 for the year).

221. Kevin McCormally, *Tax Savings for Domestic Partners: Seven States and the District of Columbia Now Allow Same-Sex Couples To File Joint Returns*, KIPLINGER (Jan. 2009), http://www.kiplinger.com/features/archives/2008/01/domestic-partner-joint-tax-returns.html; *see also* OLIN & SWAIN, *supra* note 17, at 2 (noting that in 2009, six states allowed registered domestic partners or civil-union partners to elect whether to file jointly or separately).

222. *See supra* note 142 and accompanying text. Some commentators argue that it is perfectly appropriate for state voters to hold state representatives accountable for the terms of conditional grants because state legislators accept the conditions attached to grants. These commentators presumably also would conclude that state legislators should be held to account for the decision to conform the state tax base with the federal tax base. *See, e.g.*, Roderick M. Hills, Jr., *The Political Economy of Cooperative Federalism: Why State Autonomy Makes Sense and "Dual-Sovereignty" Doesn't*, 96 MICH. L. REV. 813, 825–27, 860 (1998) (noting that it is difficult for voters to determine whether federal or state legislators are responsible for grant conditions, but that "individual states decide whether to accept the conditions and apply for the funds" (emphasis omitted)).

arising from federal-state tax-base conformity.[223] The presence of two separate sovereigns, each assessing taxes separately using its own forms, helps to alert taxpayers to the fact that federal officials are responsible for the federal tax base, while state officials are responsible for the state tax base.

3. *Targeting Tax Incentives*. When national tax measures are not suitable to local conditions, states can deviate from the federal tax base by removing a federal tax provision or adding a new state provision. For example, as noted above, most states provide energy or environmental tax incentives tailored to local conditions.[224] Tailored tax incentives include Arizona's tax credits for water conservation and installation of certain solar energy devices.[225] These credits reflect Arizona's specific climate and geology. By providing tax incentives for solar energy, Arizona can target its subsidy to an alternative energy source likely to be especially effective in Arizona, whereas because federal alternative energy incentives must be targeted more broadly, they may subsidize Arizonans' expenditures on alternative energy solutions that are less effective than solar energy in Arizona.

States also can use deviations to meet state public health and safety concerns. For example, beginning in 2000, Oklahoma allowed a tax credit to restaurants that provided hepatitis A vaccinations to their employees.[226] The vaccination credit was one strategy in a public-health campaign that helped move Oklahoma from having one of the highest incidences of hepatitis A in the nation to having an incidence below the national average.[227] Similarly, tax credits in Massachusetts

---

223. The separate reporting approach taken in the United States could be contrasted with the approach taken by other federal systems, such as Canada, Norway, Sweden, and Denmark, in which the federal government collects the state income tax and remits it to the subnational government units. *See* Stolz & Purdy, *supra* note 1, at 70 (noting that the Canadian collection system requires strict provincial conformity with the federal tax, but that provinces can opt out of the federal collection scheme). Under such an assessment regime, state residents would presumably be more likely to blame or reward federal lawmakers for the content of the tax base.

224. *See supra* Part III.B.4; *see also* Evelyn Kim, *Are State Green Tax Incentives Good Environmental and Tax Policy?*, 45 ST. TAX NOTES 29 (2007) (noting that thirty-eight states provide energy or environmental credits).

225. ARIZ. REV. STAT. ANN. § 43-1090.01 (2006 & Supp. 2012) (providing tax credits for the installation of water-conservation systems); *see also supra* note 156.

226. OKLA. STAT. ANN. tit. 68, § 2357.33 (West 2008 & Supp. 2013).

227. From 1995 to 2000 Oklahoma had a very high incidence of hepatitis A, usually either the highest or in the top five of U.S. states. *See* DANNI DANIELS, SCOTT GRYTDAL & ANNEMARIE WASLEY, CTR. FOR DISEASE CONTROL, SURVEILLANCE FOR ACUTE VIRAL

and Rhode Island for residential lead-paint abatement reflect special public health concerns that arise from older housing stock.[228] Thus, state tax deviations enable states to tailor tax incentives or tax relief to local conditions.[229]

4. *Fiscal Stability*. Decoupling also allows states to minimize revenue shocks associated with substantive changes in the federal tax law. It is not uncommon for states to deviate from new federal legislation that narrows the tax base (as opposed to new federal legislation that expands the tax base). For example, in the period from 2002 to 2008 when states faced serious budget shortfalls, they were significantly less likely to incorporate new federal corporate tax expenditures.[230] State deviations from federal tax cuts and federal tax expenditures allow states to increase or maintain revenue levels without having to raise tax rates explicitly. That state deviation from the federal tax base may also increase (rather than only decrease) state revenue also serves to distinguish tax-base conformity from other intergovernmental fiscal arrangements that raise federalism concerns, such as conditional grants, under which a state's failure to accede to federal conditions results in revenue losses for that state.

C. Entrenchment

This Section identifies some of the principal barriers to federal tax base deviation, including procedural obstacles, increased administrative and compliance costs, and political risks associated with the high political salience of deviations. These and other factors raise the costs of deviation, including for provisions that a state easily can sever from the rest of the federal tax base. Additionally, some aspects of the federal tax law are what I call nonseverable; they are so

HEPATITIS—UNITED STATES, 2007, at 12 (2009), *available at* http://www.cdc.gov/mmwr/PDF/ss/ss5803.pdf.

228. *See* MASS. ANN. LAWS ch. 62, § 6(e) (LexisNexis 2008 & Supp. 2012); R.I. GEN. LAWS § 44-30.3-1 (2010).

229. Likewise, the tax incentives provided by many states for specific kinds of disaster relief and assistance reflect the greater incidence in these states of those natural disasters. *See, e.g.*, OKLA. STAT. ANN. tit. 68, § 2357.29 (West 2008) (providing credit for property damaged by a tornado occurring on May 8 or 9, 2003).

230. Morrow & Ricketts, *supra* note 174, at 29–33; *see also* LeAnn Luna & Ann B. Watts, *Federal Tax Legislative Changes and State Conformity*, 47 ST. TAX NOTES 619, 624 (2008) (finding that as state unemployment rises, so do state deviations from the federal corporate tax base); *id.* (explaining states' goal to "protect their ever eroding tax bases" by decoupling from federal corporate tax preferences).

entrenched that it is impractical for states to deviate from them, even if states would be willing to bear the other associated costs of deviation. For example, because the realization requirement informs so much of the federal income calculation, incorporating states cannot sever it from the rest of the federal tax base.[231] As this Section explains, there is no necessary connection between the normative desirability of a federal tax provision and its severability from the federal income tax base. Thus, it is reasonable to assume that states incorporate some nonseverable federal tax provisions from which they would prefer to deviate.

1. *Stickiness of the Federal Tax Base.* This subsection identifies factors, such as increased compliance costs and political obstacles, that might discourage a state from deviating from federal income tax rules, even when it is in the state's interest to deviate. These factors tend to make federal tax provisions "stick" at the state level, notwithstanding states' formal ability to deviate from them.

Disharmony Costs. Fear of eroding the benefits of vertical harmonization discussed in Part II may discourage a state from deviating from federal tax provisions. For example, deviations between the federal and state tax bases generate compliance costs for taxpayers. Although taxpayer return-preparation software lowers compliance costs associated with deviations, such software does not alleviate duplicative record-keeping requirements or planning burdens. Deviation also imposes costs on the deviating state. Devising and enforcing deviations requires the expenditure of scarce state legislative resources, and it increases state tax enforcement costs by reducing states' ability to free ride on federal administration and enforcement. Deviation also increases administrative and judicial costs because states must interpret and enforce any deviations and adjudicate taxpayer disputes without the opportunity to rely on federal interpretations and adjudications. Notice also that a state's ease of deviation varies with its resources. California may have the resources to administer a deviation that North Dakota could not.

Deviations also compromise the horizontal harmonization benefits of tax-base conformity. For example, deviations could trigger a competitive race to the bottom in which each state tries to attract mobile residents by offering them expensive tax benefits. Deviations

231. For discussion of the realization rule, see *supra* notes 86–87.

also promote tax arbitrage while at the same time impeding interstate commerce by increasing tax compliance costs and the risk of unrelieved double taxation for multistate taxpayers.

Information Gaps. Information gaps contribute to the costs of deviation. For example, state legislators and voters simply may not be aware of or understand the impact on their state of each incorporated federal tax provision. Despite the implementation of heuristics (including the federal tax expenditure budget) that seek to highlight the regulatory impact of federal tax subsidies,[232] the federal tax code is voluminous and complicated, and no state legislator or voter can be expected to understand all impacts of conforming to the federal tax base. As the rate of change to the federal tax law accelerates, these information problems become more acute.[233] Overwhelmed with information about federal law, state legislators and voters simply may prefer to continue to conform, rather than conduct a detailed cost-benefit analysis to determine which federal tax provisions harm the state.

Signaling. State deviations from the federal tax base send signals to taxpayers and others. In some cases, states send strategic signals through tax-base deviation. For example, when a state deviates from the federal tax base by exempting pension, retirement, and Social Security income, it sends the message that it is an attractive place to retire.[234] Likewise, when states deviate from federal tax rules by

232. The Congressional Budget Act of 1974, 2 U.S.C. § 622(3) (2006), requires annual publication of a list of federal tax expenditures, defined by the Act as "provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability." The purpose of the tax expenditure budget is to identify, estimate, and highlight spending through the tax law. For more on the tax expenditure budget, see JOINT COMM. ON TAXATION, BACKGROUND INFORMATION ON TAX EXPENDITURE ANALYSIS AND HISTORICAL SURVEY OF TAX EXPENDITURE ESTIMATES 2–3 (2011) (providing explanation and history of tax expenditure analysis).

233. Richard L. Doernberg & Fred S. McChesney, *On the Accelerating Rate and Decreasing Durability of Tax Reform*, 71 MINN. L. REV. 913, 914–23 (1987) (describing historical work by Professor Jon Witte that shows that changes to the federal tax law have consistently accelerated since the introduction of the income tax in the early twentieth century); *see also id.* at 945–53 (attributing the increasing rate of tax change to changes in the federal legislative landscape, such as lower incumbency rates both in Congress generally and on tax-writing committees).

234. In contrast with the federal practice of taxing up to 85 percent of Social Security benefits, most states have deviating tax laws that completely exempt Social Security payments. *See* SNELL, *supra* note 34, at 2–3 (showing that most states completely exempt Social Security

allowing same-sex couples to file joint returns, they signal their commitment to marriage equality.

In addition to sending positive signals, state tax deviations also may send negative signals. An analogy with contract default rules will illustrate. In a 2006 article, Professors Omri Ben-Shahar and John Pottow analyzed instances in which different jurisdictions have mutually exclusive contract default rules.[235] They hypothesized that if one of the defaults were more efficient than the other, then contracting parties in the jurisdiction with the less efficient default should systematically contract around it.[236] Instead, when they studied actual contracts, Professors Ben-Shahar and Pottow found that parties in each jurisdiction tended to stick to that jurisdiction's default.[237] To explain this puzzle, Professors Ben-Shahar and Pottow argued that a party to a contract might not suggest deviating from the default rule, even when the deviation would be favorable to both parties, because the very act of suggesting a deviation might "dissuade his potential counterparty from entering into the agreement."[238] In short, the party would avoid even efficient deviations for fear of signaling that he was trying to trick his counterparty by using a nonstandard term.[239]

Professor Kathryn Spier also suggests that contracting parties may stick to default rules or boilerplate contract terms to avoid sending negative signals.[240] She argues that if, for example, professional sports employment contracts typically do not contain injury clauses, a player would not suggest including one in exchange for a wage reduction for fear of signaling to the team that he has a higher-than-average risk of injury.[241] Professors Ben-Shahar and Pottow go further and argue that if the default flipped, so that sports

---

income, while of the fifteen that tax it, only seven follow the federal practice of taxing as much as 85 percent of it).

235. *See* Omri Ben-Shahar & John A.E. Pottow, *On the Stickiness of Default Rules*, 33 FLA. ST. U. L. REV. 651, 675–78 (2006) (considering several default rules, including at-will versus for-cause employment).

236. *Id.* at 672.

237. *See id.* at 675–78.

238. *Id.* at 652.

239. *See id.* ("The fear is that the counterparty will suspect that the proposer's decision to deviate from the norm and use an unfamiliar provision hides some unknown problem: in short, that it is a 'trick.'").

240. *Id.* at 657 (citing Kathryn E. Spier, *Incomplete Contracts and Signaling*, 23 RAND J. ECON. 432 (1992)).

241. *Id.* (citing Spier, *supra* note 240).

employment contracts typically included an injury clause, the player still would not suggest that the clause should be dropped in exchange for a wage increase, lest he signal to the team that he intends to avoid risks and therefore will not truly be committed to winning.[242] Thus, Professors Ben-Shahar and Pottow conclude that default rules might stick—regardless of their content—because contracting parties draw adverse inferences from requests to deviate.[243]

Because state income tax bases are very complicated, most taxpayers rationally avoid analyzing them closely. Thus, state residents might not have a clear idea of the content of or motivation behind state tax-base deviations. But the very fact of state deviation may signal to residents and potential residents that the state is hiding something. Indeed, state deviations make it difficult for residents and potential residents to use the state's tax rates in conjunction with their knowledge of the federal tax base to estimate their state tax liability. This asymmetry of information between the state and taxpayers may heighten taxpayers' fear of exploitation or surprise, discouraging them from migrating to a state with a high incidence of deviations from the federal tax base.[244] State tax deviations also might send negative signals about the characteristics of state government.[245] For example, a high incidence of deviation might signal state officials' disregard for added taxpayer compliance costs generated by deviation.[246] Thus, to avoid situations in which taxpayers draw negative inferences from tax-base deviations, states may avoid or minimize such deviations.[247]

---

242. *Id.* at 662.

243. *Id.* at 682.

244. *Cf. id.* at 664 ("[D]isinclinations toward deviance stem from a rudimentary fear of the unknown."); *id.* at 666 (noting that in experiments in which "adversaries (or even experimenters) are perceived to have more knowledge or competence in assessing the underlying risk probability," decisionmakers "tend to feel more anxious" and seek to avoid such situations).

245. Lisa Bernstein and Alan Schwartz have separately suggested that deviation from standard contract terms may signal litigiousness to counterparties. Lisa Bernstein, *Social Norms and Default Rules Analysis*, 3. S. CAL. INTERDISC. L.J. 59, 71–72 (1993); Alan Schwartz, *The Myth That Promisees Prefer Supracompensatory Remedies: An Analysis of Contracting for Damage Measures*, 100 YALE L.J. 369, 397 (1990).

246. *Cf.* L.L. Ecker-Racz, *Tax Simplification in This Federal System*, 34 LAW & CONTEMP. PROBS. 769, 774 (1969) (concluding in the late 1960s that "compassion for taxpayers" was overcoming states' "reluctance" to conform to the federal tax base).

247. States may acquiesce to a large number of low-dollar-value federal tax expenditures if the cost of deviating from any one such expenditure is not worth sending the adverse signal. Collectively, such provisions may amount to significant revenue losses and have significant

States also might want to avoid deviations that would reveal hidden information to other relevant parties, such as members of Congress. For example, if a state's congressional delegation supported a federal-level tax benefit, the state's failure to incorporate that benefit into the state tax base may reveal to other members of Congress that the benefit was less important to the state than its federal representatives claimed. For example, federal law provides tax incentives to the film industry, incentives that California's federal congressional representatives presumably favored. However, when assessing its income tax, California deviates from those film-industry tax incentives.[248] California's nonconformity with federal tax incentives that disproportionately benefit California may undermine claims made by the state's federal representatives that such incentives are needed in the federal tax base to support the film industry.

Political Obstacles. Political obstacles may make it difficult for incorporating states to deviate from the federal tax base. Some of these obstacles are structural. For example, states that dynamically incorporate federal law have no opportunity to deviate from new federal laws until the state legislature is in session, which may result in considerable time lags before deviation. Likewise, because some states require supermajority votes to raise taxes, once they incorporate federal tax preferences into state law, it may be difficult for states to deviate from them.[249]

The endowment effect also may increase the political costs associated with state tax-base deviations. The endowment effect is the tendency of people to ascribe more value to objects or entitlements

---

regulatory impacts. But deviating from many federal provisions probably sends a worse signal than deviating from just a few.

248. *See, e.g.*, Muntean, *supra* note 204, at 260 (expressing surprise that California did not conform to federal-level tax preferences for the movie industry). California's nonconformity with federal legislation is less surprising considering that such federal legislation accomplishes a wealth transfer from residents of all the other states to the movie industry of California. Although California's federal representatives would clearly favor such a transfer, it is not clear that California's state representatives would want to replicate that national transfer of wealth *within* California, because at the state level, the transfer would be from all California residents to California residents who are part of the movie industry.

249. *See* David Gamage & Jeremy Bearer-Friend, *Managing Fiscal Volatility by Redefining Tax Cuts and Tax Hikes*, 58 ST. TAX NOTES 113, 122–23 (2010) (discussing supermajority requirements); *id.* at 122 (noting that, due to the need for legislation to pass both legislative chambers and avoid veto by the governor, state law proposals "typically require the support of more than a mere 51 percent majority to become law"). This point suggests that once incorporated, provisions of the federal tax law will "stick" in the states.

that they possess than those that they do not possess.[250] Experiments have confirmed that the endowment effect attaches not only to physical assets, but also to intangible entitlements.[251] The federal tax base may generate endowment effects.[252] For example, taxpayers who receive a federal tax benefit, such as the deduction for charitable donations, may come to feel entitled to that tax benefit, such that they value it more than the dollar amount of tax savings that it generates. This sense of entitlement would make the deduction difficult to repeal at the federal level. Similarly, if taxpayers regard the federal tax base as embodying a set of good practices to which most states conform, it could create the expectation that the same tax benefits should be available at the state level.[253]

Even if state residents do not regard the federal tax base as embodying a set of good practices, such that they did not initially expect the state tax base to match the federal tax base, once states incorporate federal tax benefits, the endowment effect would make it more difficult politically for state legislators to drop those benefits in the future. The endowment effect therefore could make federal tax preferences sticky for incorporating states, even if the application of a federal tax benefit in a particular state is inefficient or poorly tailored, and even if its initial incorporation was by chance, for convenience, or because the state failed to conduct a thorough cost-benefits analysis of the federal tax benefit before incorporating it. Thus, once incorporated, federal tax benefits might stick without respect to whether they are efficient at the state level. Moreover, the

250. Daniel Kahneman and fellow researchers conducted a famous experiment in which college students who were given a mug demanded a higher price to sell it, on average, than did college students who were given six dollars instead of a mug and asked how much they would pay for the mug. The difference in the selling price for mug owners compared to the buying price for mug non-owners provides evidence of the endowment effect. *See* Daniel Kahneman, Jack L. Knetsch & Richard H. Thaler, *Experimental Tests of the Endowment Effect and the Coase Theorem*, 98 J. POL. ECON. 1325, 1329–34 (1990).

251. *See* Russell Korobkin, *The Status Quo Bias and Contract Default Rules*, 83 CORNELL L. REV. 608, 625–47 (1998) (conducting experiments involving contract default rules and reviewing evidence from experiments involving investment-portfolio allocations, job benefits, and electricity service); *see also* Cass R. Sunstein, *Switching the Default Rule*, 77 N.Y.U. L. REV. 106, 113–14 (2002) (summarizing his experiment showing that the endowment effect attaches to vacation time).

252. *See* Rebecca M. Kysar, *Lasting Legislation*, 159 U. PA. L. REV. 1007, 1035 (2011) (positing that the endowment effect applies to current tax benefits).

253. *Cf.* Sunstein, *supra* note 251, at 109 n.11 (noting in the default rules context that "[s]ocial scientists have yet to sort out the relationship between this legitimating effect and the endowment effect").

endowment effect might help explain why states like Arizona and Georgia have adopted their own tailored environmental tax credits in addition to, rather than as a substitute for, federal green tax preferences.[254]

Another reason state legislators may avoid deviating from federal tax benefits is that the high political salience of such deviations makes them politically risky. Most state taxpayers probably learn about the content of their state's deviations from the federal tax base through their experience filling out state tax forms. To undo a federal tax benefit, such as an exemption or deduction, a state must employ an add-back, or addition. Specifically, the state must instruct the taxpayer to increase her state tax or taxable income by the amount of the federal benefit. This procedure calls taxpayers' attention to precisely what they are losing through the state deviation. Even taxpayers who do not suffer an increase in state-taxable income due to the add-back (for example, because they did not qualify for the federal benefit) may perceive the state to be taking away upside potential.[255] Deviation from a federal tax benefit therefore may be framed as a tax increase, even if the state never adopted the federal tax benefit in the first place. In contrast, if state legislators devised the state income tax base from a blank slate, taxpayers would be unlikely to consider all of the possible exemptions and deductions that their state *could* grant, but does not. That is, if states worked from a blank slate, inconsistencies between the state and federal tax bases would not be framed as state tax increases.

The inability to deviate quietly from the federal tax base could explain why some states have chosen not to incorporate federal law. For example, Pennsylvania is a facially nonconforming state; it does not expressly incorporate either federal AGI or federal taxable

254. Arizona has deviating tax credits to support solar energy and Georgia has deviating credits to reduce air pollution. *See* OLIN & SWAIN, *supra* note 17, at 15 (indicating no Arizona deviations from federal environmental tax incentives, but noting credits for business investment in solar energy, water conservation, and electric-vehicle-recharge outlets); *id.* at 22 (indicating no Georgia deviations from federal environmental tax incentives, but noting state-level environmental tax credits for, inter alia, diesel-particulate emission-reduction equipment, electric-vehicle chargers, and low-emission vehicles).

255. Arguably, a state taxpayer should be glad that her state does not incorporate federal tax preferences for which she does not qualify, given that state deviation from the benefit will tend to shift the state tax burden away from her and toward fellow state residents who qualified for the benefit at the federal level. Nevertheless, it is not unreasonable to conclude that instead such a voter would feel regret that she will not be able to take advantage of the deduction at the state level in a later year.

income as the starting point for its income calculations.[256] However, its taxable base ends up looking like federal AGI minus federal above-the-line deductions, such as those for IRA contributions, self-employed health-insurance premiums, higher education expenses, teacher's expenses, and student-loan interest.[257] If, instead of enacting a facially nonconforming tax base, Pennsylvania used federal AGI and then required state taxpayers to add back the federal above-the-line deductions, it would draw more attention to the fact that Pennsylvania disallows these benefits. Thus, the desire to obscure its broad income tax base may have motivated Pennsylvania's legislature to reject explicit federal-state tax-base conformity.[258] For states that do conform explicitly, however, the desire to avoid what might be called "noisy withdrawals" from federal tax benefits may reduce the incidence of deviation.

In addition to making state tax deviations that claw back federal-level tax benefits politically riskier, the heightened salience associated with state tax deviations may result in greater political rewards for deviations that taxpayers approve of. Thus, the high salience of deviating state tax benefits may explain why so many state deviations from the federal tax base take the form of tax benefits unavailable at the federal level.[259] More generally, state voters may hold state legislators to account more for tax provisions that the state legislators specifically choose than for those they simply incorporate from the federal government.[260]

2. *Nonseverable Default Rules*. Even when state legislators and residents are willing to pay the political, administrative, financial, and

---

256. *See supra* notes 39–43 and accompanying text.

257. *See* PA. DEP'T OF REVENUE, FORM PA-40, PENNSYLVANIA INCOME TAX RETURN FORM AND INSTRUCTIONS 1–2 (2010); *see also* OLIN & SWAIN, *supra* note 17, at 49 (describing the major differences between the federal tax base and the Pennsylvania tax base).

258. The text should not be understood as making an argument against broad income tax bases; on the contrary, most commentators advocate broadening the federal tax base. *See generally* Stanley S. Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 HARV. L. REV. 705 (1970) (advocating a broad tax base shorn of policy-motivated tax incentives).

259. *See generally* OLIN & SWAIN, *supra* note 17.

260. Behavioral research finds support for the notion that people perceive action differently than inaction. *See* Korobkin, *supra* note 251, at 625 & nn.53–56 (citing behavioral experiments supporting the existence of the "status quo bias," which is the notion that "people systematically favor maintaining a state of affairs that they perceive as being the status quo rather than switching to an alternative state, all else being equal"); *id.* at 657–60 (summarizing experiments suggesting that people perceive it to be easier to control actions than inactions).

other costs associated with deviations from the federal tax base described above, they still may not, as a practical matter, be able to deviate from certain federal tax policies. Some federal tax laws simply do not come à la carte; they are not severable from the rest of the federal tax base. I label these provisions "practically nonseverable." They include many structural aspects of the federal tax law, such as annual reporting without income averaging,[261] the realization rule, and the exclusion of imputed income.[262] As discussed earlier, such structural aspects of the tax law may substantially impact efficiency and equity, but it would be difficult or impossible for states to benefit from federal tax-base conformity if they wanted to change such fundamental elements of the income tax calculation. Although nothing prohibits states from deviating from practically nonseverable provisions, the state tax base that would result from such deviations would be so different from the federal tax base that the state would substantially cede the benefits it derives from conformity. For example, if a state moved from the federal realization rule to even a partial mark-to-market tax regime—under which the requirement to mark-to-market could be limited to readily marketable assets whose value is easy to determine—the state would have to change significant aspects of its tax base as compared to the federal tax base.[263] Moreover, as the calculation of taxable income at the state level diverges from its calculation at the federal level, the state is able to rely less and less upon federal resources, including federal tax legislative drafting expertise, federal tax information collection, federal enforcement, and so on.

Other elements of the federal tax law may be severable, but only at great administrative cost. For example, state deviation from federal

261. *See supra* note 90 and accompanying text.

262. *See supra* notes 82–84 and accompanying text. States could tax some, but not all, kinds of imputed income that presently go untaxed at the federal level. Whether states could effectively tax a particular item of imputed income depends on a variety of issues, including whether the state could easily determine the value of the imputed income.

263. *Cf.* Weisbach, *supra* note 87, at 103–21 (exploring some of the complexities that would be involved in moving to a partial mark-to-market (MTM) tax base at the federal level, including deciding which assets to subject to the MTM regime, addressing tax-avoidance opportunities created by subjecting some assets to an MTM rule while others remain subject to a realization rule, and deciding how to handle taxation of corporate profits). Any state seeking to move to an MTM regime would face the same challenges. These challenges would become more acute for a more complete MTM regime. *See, e.g.*, Fred B. Brown, *"Complete" Accrual Taxation*, 33 SAN DIEGO L. REV. 1559, 1618–72 (1996) (considering MTM tax-base design issues).

depreciation rules will result in taxpayers having a different basis in the same asset for state and federal tax purposes, thereby increasing record-keeping costs and making enforcement more difficult.[264] Likewise, recall the same-sex marriage and immigration examples discussed earlier. The disparate federal treatment of same- and opposite-sex married couples is not limited to filing statuses.[265] Rather, much of the federal tax law depends on taxpayers' marital status. For example, a word search of the Internal Revenue Code reveals that over two hundred Internal Revenue Code sections contain at least one of the following words: "spouse," "husband," "wife," "married," or "marriage."[266] DOMA affects federal income tax calculations by requiring such terms to be inapplicable to same-sex married couples. Thus, to equalize treatment of same- and opposite-sex married couples, states would have to reinterpret federal tax code provisions to include same-sex couples and then recalculate same-sex couples' income based on those reinterpretations. To excise every instance in the federal tax base of different treatment of same- and opposite-sex married couples would significantly increase compliance costs for same-sex married couples and substantially erode the administrative benefits of conformity.[267]

Similarly, the favorable federal treatment of tax-resident aliens permeates the federal tax law.[268] As discussed above, federal tax law recognizes only two categories of taxpayers: U.S. tax residents and U.S. tax nonresidents.[269] The definition of U.S. tax resident includes not only all U.S. citizens and green card holders, but also any aliens who satisfy a physical presence test. As a result, citizens, green card holders, and other tax-resident aliens (whether documented or undocumented) receive nearly identical treatment under the federal tax law. To avoid incorporating tax advantages for undocumented immigrants into their own tax bases, states would either have to add

---

264. *See* DUNCAN, *supra* note 48, para. 7.4 (arguing that states find it "effectively impossible" not to conform to federal timing rules).

265. *See supra* notes 124–133 and accompanying text.

266. This search was performed on Title 26 of the U.S. Code in Westlaw.

267. *See* Tara Siegel Bernard, *Some Tax Breaks Unavailable to Same-Sex Couples*, N.Y. TIMES BUCKS BLOG, (Apr. 16, 2012 10:30 AM), http://bucks.blogs.nytimes.com/2012/04/16/some-tax-breaks-unavailable-to-same-sex-couples (describing burdens on same-sex married couples to create "dummy" joint federal tax returns to calculate their state income tax liability).

268. A word search of Title 26 of the U.S. Code on Westlaw reveals that over 250 Internal Revenue Code sections contain at least one of the following words: "alien," "resident," or "nonresident."

269. *See supra* notes 134–140 and accompanying text.

exceptions for each federal tax expenditure provision they incorporate, or they would have to subdivide the "U.S. tax resident" category of federal taxpayers. Not only might such deviations raise federal preemption questions,[270] but they also would seriously jeopardize the state's ability to free ride on federal enforcement and interpretive efforts.

As scholars have long recognized in the contracts context, immutable rules—those the parties cannot contract around—should have strong normative justifications.[271] For example, immutable contract rules may be designed to protect third parties from the adverse effects of contracts. Immutable tax rules also should have strong normative justifications. Some nonseverable aspects of the federal tax law have a strong normative basis. For example, the federal tax law generally does not draw distinctions between taxpayers on the basis of race, sex, or national origin. But other nonseverable federal tax provisions have weaker normative support. For example, federal reliance on realization and annual filing without income averaging reflect administrative convenience,[272] but they compromise the distributional fairness of the tax system. Unfortunately, the degree of severability of federal tax rules bears no necessary connection to their normative desirability. As a result, there is no reason to think that the nonseverable provisions of federal tax law are generally salutary or ones that the states *ought* to incorporate. For good or for ill, they simply come with conformity.

VI. EVALUATION AND RECOMMENDATIONS

Despite the disadvantages of tax-base conformity identified in Part III, it is unlikely that states will fully decouple their tax bases from that of the federal government. Indeed, several states consider dynamic conformity with federal tax law to be so important that their

---

270. An argument could be made that the federal government's plenary power over immigration preempts state deviation from the federal tax treatment of tax-resident aliens. *Cf.* Arizona v. United States, 132 S. Ct. 2492 (2012) (invalidating on preemption grounds an Arizona statute that sought to discourage illegal immigration).

271. *See, e.g.*, Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 88 (1989) (noting the scholarly consensus that immutable rules are those whose violation would be "socially deleterious").

272. *See, e.g.*, Deborah H. Schenk, *A Positive Account of the Realization Rule*, 57 TAX L. REV. 355, 355 (2004) ("There is a strong consensus [that] . . . a realization requirement is . . . necessary due to the liquidity and valuation constraints of accrual taxation."); *see also* BRENNAN & BUCHANAN, *supra* note 179, at 1205 ("[A]n income averaging system would likely be very complicated . . . .").

constitutions specifically permit it.[273] And over time, more and more states have adopted conforming tax bases.[274] That only six states with comprehensive income taxes do not practice explicit federal base conformity reflects the judgment by state legislators that the benefits of base conformity outweigh its costs. Only one state, Alaska, abandoned conformity after adopting it, and that state completely repealed its income tax.[275] Assuming that federal-state tax-base conformity is here to stay, this Part has three goals. It recommends steps that the state and federal governments can take to reduce the adverse impact of conformity, it considers the implications of tax-base conformity for controversial tax policy issues, and it suggests avenues for future research that would take account of tax-base conformity.

A. *Policy Recommendations*

This Section makes policy recommendations to the states and the federal government for minimizing the disadvantages of federal-state tax-base conformity.

1. *State Governments.*

Publish Tax Expenditure Budgets. To increase awareness among state voters and legislators of the regulatory impact of tax-base conformity, states should publish annual tax expenditure budgets. By drawing attention to the existence and cost of tax expenditures, such budgets would increase the accountability of all state tax expenditures, including those that the state imports from the federal government via base conformity. At present, data on the magnitude of state tax expenditures are difficult to obtain because not all states maintain reliable tax expenditure budgets, and some states do not maintain tax expenditure budgets at all.[276] States cannot rely on

---

273. Without such provisions, dynamic incorporation of federal tax law could violate state constitutional prohibitions on delegation of legislative authority. *See supra* note 80. The constitutions of twelve states provide for dynamic incorporation of federal tax law. Dorf, *supra* note 3, at 110 n.14.

274. *Cf*. Hildreth et al., *supra* note 46, at 583–84 (finding that state corporate tax systems increased in conformity over the period spanning 1929 to 1989).

275. HELLERSTEIN & HELLERSTEIN, *supra* note 8, ¶ 20.02 n.7 (Supp. 2003); Stolz & Purdy, *supra* note 1, at 116 & n.289; *cf.* Ecker-Racz, *supra* note 246, at 775 ("[N]o state that has once conformed its income tax base to the federal has subsequently abandoned it.").

276. Several states with individual income taxes do not publish tax expenditure budgets, including Alabama, Alaska, Georgia, Indiana, Nevada, New Jersey, New Mexico, South Dakota, and Wyoming. JASON LEVITIS, NICHOLAS JOHNSON & JEREMY KOULISH, CTR. ON

estimates of federal tax expenditures alone because states also implement their own tax expenditures and because the impact of federal tax expenditures is not geographically uniform.

Prefer Static (or Lagged) Incorporation to Dynamic Incorporation. The choice between dynamic and static incorporation represents a trade-off between administrative convenience and control over the state tax base. Although nearly half of conforming states have already chosen static incorporation,[277] the analysis presented in this Article suggests that more states should consider doing so. Through static incorporation, states can secure many of the advantages of tax-base conformity while avoiding the more serious revenue shocks and democratic losses caused by dynamic incorporation. Incorporating the federal tax base as it existed at a fixed point in time allows state officials the opportunity to analyze and debate the merits of new federal law before it becomes the law of the state. Likewise, tax revenues are more predictable when states elect to have a static tax base.

States' inability to deficit spend, coupled with their inability to adjust rates quickly to account for late-year federal tax changes, may explain why so many states eschew dynamic incorporation of federal tax law in favor of static incorporation, even though static incorporation increases compliance costs.[278] In addition to increasing compliance costs, another drawback to static conformity is that statically conforming states must regularly amend their tax law to keep it aligned with federal law.[279] Failure to do so would result in divergence between the state and federal tax base that would erode

---

BUDGET & POLICY PRIORITIES, PROMOTING STATE BUDGET ACCOUNTABILITY THROUGH TAX EXPENDITURE REPORTING 5 (2009), *available at* http://www.cbpp.org/files/4-9-09sfp.pdf (estimating that state tax expenditures "cost states tens, perhaps hundreds, of billions of dollars per year in forgone revenue"). Most states with individual income taxes publish tax expenditure budgets, although the data they provide is often incomplete. *See id.* at 1.

277. *See* DUNCAN, *supra* note 48, para. 3.4.3 (reporting that seventeen states have "fixed-date" conformity).

278. *See, e.g.*, Stolz & Purdy, *supra* note 1, at 120 & n.307 (describing how Oregon switched to static incorporation after federal base changes under the Tax Reform Act of 1969, Pub. L. No. 1972, 83 Stat. 487 (codified as amended in scattered sections of 26 U.S.C.), left it with a $30 million revenue shortfall).

279. *See* Morrow & Ricketts, *supra* note 174, at 29 (summarizing a study of states' decisions to conform or not with eleven major federal tax initiatives enacted from 2002 to 2008 and finding—to their surprise—"no differences between states whose tax systems require affirmative legislative action to decouple from tax changes implemented by the federal government and those that do not").

the gains associated with conformity. As the New Jersey Supreme Court observed, "unless the Legislature may . . . provide suitably for the State's immediate adoption of amendments to the federal laws and regulations, the State's policy of uniformity would, as a practical matter, soon be defeated."[280]

To prevent significant divergence of state and federal tax bases over time, states could adopt lagged conformity, with a period of delay of one or two years to reflect state legislative rules, practices, and session schedules. Such lagged conformity would allow states to anticipate and plan for revenue volatility. It also would allow them to observe new federal tax policies in action before deciding whether to incorporate them. If newly incorporated federal tax incentives become entrenched due to loss aversion, then giving state legislatures more time to evaluate new federal tax incentives before incorporation could represent an important improvement in state fiscal responsibility. Of course, compared to dynamic incorporation, both lagged and static incorporation would increase state administrative costs and taxpayer compliance costs.

Incorporate Federal AGI, Not Federal Taxable Income. A federal taxpayer calculates her federal income tax liability by beginning with what might be called her "gross income less exclusions."[281] This figure represents the taxpayer's "gross income" includable under § 61 of the Internal Revenue Code,[282] less any excluded income. Items of gross income may be expressly excluded by federal statute or implicitly excluded by long-standing federal practice. For example, gifts and qualifying employer-paid health-insurance premiums are excluded by federal statute, while federal practice has been to exclude imputed income. From the figure representing her gross income less exclusions, the taxpayer then subtracts her above-the-line deductions to arrive at AGI. From AGI, the taxpayer subtracts personal exemptions and standard or itemized deductions to arrive at her taxable income.[283] Finally, she applies the

---

280. State v. Hotel Bar Foods, 112 A.2d 726, 732 (N.J. 1955).

281. The Form 1040 labels this figure "total income" on line 22, but the term "total income" does not appear in the Internal Revenue Code and therefore does not represent a term that states could incorporate into their own tax law. *See* INTERNAL REVENUE SERV., *supra* note 205, at 1 l. 22.

282. That is, her "gross income from whatever source derived." I.R.C. § 61 (2006).

283. *See* INTERNAL REVENUE SERV., *supra* note 205, at 2 ll. 40–42.

federal tax rates to her taxable income to calculate her federal tax liability. Only then does she apply any available federal tax credits.[284]

When states conform earlier in the federal income tax calculation, they tend to incorporate fewer regulatory federal tax provisions, whereas when states conform later in the calculation, they tend to incorporate more regulatory federal tax provisions. Thus, the point at which states conform to the federal income tax calculation matters. For example, states that conform with the federal definition of AGI import into state law federal exclusions and above-the-line deductions, but not federal itemized deductions. In contrast, states that conform with the federal definition of taxable income incorporate not only federal exclusions and above-the-line deductions, but also federal itemized deductions, many of which have regulatory goals.[285] Thus, to minimize the disadvantages of tax-base conformity, states should incorporate the federal definition of AGI, rather than the federal definition of taxable income.

Notice, however, that even if states conform with AGI, rather than taxable income, they cannot entirely avoid importing federal tax policies into their own tax bases because federal AGI reflects federal exclusions that may have regulatory effects.[286] Excluded items of income, such as gifts or employer-paid health-insurance premiums, appear nowhere on a taxpayer's federal Form 1040. The taxpayer simply omits reporting such income. Some of the most expensive

---

284. *See supra* notes 36–38 and accompanying text.

285. Above-the-line deductions include, inter alia, deductions for qualified payments of educator expenses, moving expenses, self-employment taxes, self-employed health-insurance premiums, alimony, IRA contributions, student-loan interest, tuition and fees. *See* INTERNAL REVENUE SERV., *supra* note 205, at 1 ll. 23–37 (listing deductions from gross income whose subtraction yields "adjusted gross income" on line 37). Itemized deductions include, inter alia, qualified medical and dental expenses, state and local taxes, home mortgage interest, and gifts to charity. *See generally* INTERNAL REVENUE SERV., SCHEDULE A (FORM 1040) (2012), *available at* http://www.irs.gov/pub/irs-pdf/f1040sa.pdf (requiring itemization of these deductions for reporting purposes).

286. There is no administrable point earlier than AGI at which states could conform with the federal calculation of income. Although the federal Form 1040 labels as "total income" the figure that I refer to as "gross income less exclusions," the term "total income" is not defined by the Internal Revenue Code, and therefore it cannot easily be incorporated by reference into state law. Whereas the term "gross income" appears in § 61 of the Internal Revenue Code, that amount appears nowhere on the federal tax form, and therefore it would not be an administratively convenient point of conformity.

federal tax expenditures are structured as exclusions, but it is difficult for incorporating states to deviate from them.[287]

To reverse the effect of exclusions, states would have to direct taxpayers to add back excluded items of income. How difficult a task this would be for state taxpayers depends on federal (or other regulatory) reporting requirements for excluded items of income. Whereas certain items of excluded income, including employer-paid health-insurance premiums, may appear on taxpayers' W-2 forms, other excluded items, such as gifts, may not be subject to any federal record-keeping requirements. It would be particularly difficult for states to use add-backs to include items of income that are federally excluded but not subject to federal reporting requirements.

In contrast, because states conform with federal tax law by incorporating either federal AGI or federal taxable income, states do not automatically incorporate any federal tax credits. As a result, the default rule for federal tax credits is nonincorporation. This default is good from the perspective of preserving state autonomy, because tax credits, like above-the-line and itemized deductions, tend to be regulatory.

Invoke the Political Safeguards of Federalism. Defenders of conditional federal spending have argued that the "political safeguards of federalism" adequately protect state autonomy from federal encroachment, obviating the need for courts to review federal legislation to ensure that such legislation complies with the strictures of federalism. Under the political-safeguards theory, famously championed by Professor Herbert Wechsler, judicial enforcement of federalism is unnecessary because the states are fully capable of looking after their own interests in the political arena.[288] Modern proponents of the political-safeguards theory argue that even though popular election of Senators has eroded the traditional political safeguards of federalism, new safeguards have arisen to replace them. For example, Professor Larry Kramer argues that political parties

287. Of the top ten federal tax expenditures by value, six are exclusions. *See* JOINT COMM. ON TAXATION, *supra* note 232, at 18 (listing among the top ten tax expenditures the exclusions for: capital gains at death, qualified pension contributions and earnings, employer contributions to medical insurance, Social Security Old-Age and Survivors Insurance benefits, unemployment benefits, and interest on life-insurance savings).

288. *See generally* Herbert Wechsler, *The Political Safeguards of Federalism: The Role of the States in the Composition and Selection of the National Government*, 54 COLUM. L. REV. 543 (1954).

protect states from federal encroachment by tying the fates of state and national politicians.[289]

Experience has shown that states can be effective at protecting their interests in the national political arena when it comes to taxation. For example, during the negotiations over what became the base-broadening federal Tax Reform Act of 1986,[290] proposals were made to eliminate the federal deduction for payments of state and local taxes.[291] The states successfully defeated the most aggressive version of the proposal, thereby ensuring that state and local income and property taxes would remain federally deductible.[292] Likewise, when British tax-treaty negotiators secured a concession from U.S. treaty negotiators that would have limited states' ability to impose worldwide unitary taxation against British companies with operations in the United States, states successfully lobbied the Senate to condition ratification of the treaty upon the requirement that the offending clause be read out of the treaty.[293] States also can use preexisting organizations, such as the Multistate Tax Commission, to help formulate their responses to federal tax policies.[294] The Multistate Tax Commission is an intergovernmental state tax agency charged with, among other tasks, facilitating assessment and collection of state taxes and promoting compatibility among the states' tax systems.[295] States also might arrange through the Multistate Tax Commission for collective deviation from federal tax provisions. Such collective action would counteract the risk that any particular state, by failing to conform, would send negative signals to state taxpayers.

---

289. *See generally* Larry D. Kramer, *Putting the Politics Back into the Political Safeguards of Federalism*, 100 COLUM. L. REV. 215 (2000).

290. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (codified as amended in scattered sections of 26 U.S.C. (2006 & Supp. V 2012)).

291. *See* Jane G. Gravelle & Jennifer Gravelle, *How Federal Policymakers Account for the Concerns of State and Local Governments in the Formulation of Federal Tax Policy*, 60 NAT'L TAX J. 631, 631 (2007).

292. *See id.*

293. RICHARD E. ANDERSEN, ANALYSIS OF UNITED STATES INCOME TAX TREATIES ¶ 7.01[2][g] & n.49 (2011).

294. *See* Hildreth et al., *supra* note 46, at 577–78 ("The preservation of state sovereignty [was] not mentioned explicitly in the [Multistate Tax] Compact itself though it does appear in statements made by Commission members and in Commission publications . . . .").

295. *See* MULTISTATE TAX COMM'N, THE MULTISTATE TAX COMPACT art. I (1967).

2. *Federal Government*. The discussion of the advantages and disadvantages of tax-base conformity in this Article generates policy implications for the federal government as well as state governments.

Calculate State Costs in Federal Tax Expenditure Budget. One implication of the analysis in this Article is that the federal tax expenditure budget underestimates the total revenue losses associated with federal tax expenditures because the budget estimates only *federal* revenue losses.[296] A more accurate tax expenditure budget also would estimate the revenue losses for conforming states. If the federal government undertook such estimates, it would relieve states of the burden of tax expenditure estimation, at least for tax expenditures incorporated from the federal tax base.

Produce a Federal Tax Code Pocket Part. The federal government also could generate a simple list of changes in the federal tax law each year, including both new tax provisions and repeals or expirations of existing provisions.[297] The current tax expenditure budget could be used as the model for the list of changes.[298] By identifying the changes in federal tax law from year to year, the federal government would assist state legislators and voters by focusing attention on whether the state should deviate from changes in federal tax policies. Thus, state legislators and state voters would read the list of changes in conjunction with the federal tax expenditure budget to help predict both the regulatory and revenue effects of tax-base conformity. These steps would not only aid state legislators, but they would also help federal legislators understand the impact of federal policies on the states.

Consider the Impact of Federal Taxes on the States. Congress also should explicitly consider the effect of proposed federal tax law changes on the states. For example, the expectation that states will, through incorporation, implement tax incentives identical to those

296. Likewise, federal outlay equivalent estimates for tax expenditures, which estimate how much the federal government would have to spend to convert federal tax expenditures to direct spending programs, also are inaccurate because they ignore the loss of matching state subsidies through conformity.

297. Of course, changes to federal tax law are already publicly available, but reducing such changes to a simple list, modeled on the federal tax expenditure budget, would make those changes more salient.

298. *See supra* note 232 and accompanying text.

provided at the federal level should factor into the size of federal subsidies.

Additionally, Congress should adopt policies that seek to minimize the impact of federal tax law changes upon state revenues. For example, instead of narrowing the tax base to provide fiscal relief during recessions, Congress should prefer rate reductions. Under tax-base conformity, federal base narrowing (but not federal rate reduction) impacts state tax revenues.[299] States generally will find it politically easier to simply maintain their rates in the face of federal rate cuts than to raise their rates in response to narrowing of the federal tax base. In this way, Congress could help the states avoid fiscal crises.[300]

Congressional contemplation of the impact of its income tax policy on the states in these ways would mark a clear change from current practice, under which "Congress regularly adopts changes to the Internal Revenue Code . . . with little or no consideration of the fiscal consequences for state and local governments."[301]

Consider Stealth Commandeering. Alternatively, in some cases, federal lawmakers may consciously seek to exploit base conformity as a low-cost way of implementing federal policy at the state level. Because states incorporate most changes to the federal tax base, incorporation represents a cheap way for the federal government to influence state tax policy and to supplement the subsidies Congress offers through the federal tax system. It is also worth observing that, unlike conditional grants, changes to the federal tax base do not

299. In a written submission to President Bush's Tax Advisory Panel on Federal Tax Reform, Harley Duncan of the Federation of Tax Administrators explained that although Bush administration changes to the federal corporate tax base provoked significant state deviations, federal changes to the individual tax base did not have as profound an effect because "the bulk of the federal revenue impacts were associated with the marginal tax rate reductions and the child tax credit, neither of which have an impact on states from a conformity standpoint." DUNCAN, *supra* note 48, ¶ 3.5.4.

300. *See* Stark, *supra* note 1, at 408 (arguing that the federal government has an "interest in minimizing state fiscal crises"). Economists' findings that failure of either level of government to consider the effect of its fiscal policies on the other level may lead to inefficiently high taxation provides further support for such a deliberative prescription. *See* Álex Esteller-Moré and Albert Solé-Ollé, *Vertical Income Tax Externalities and Fiscal Interdependence: Evidence from the US*, 31 REG. SCI. & URB. ECON. 247, 250 (2001).

301. Stark, *supra* note 1, at 410; *see also* Luna & Watts, *supra* note 230, at 619 ("[T]he state budgetary impact of a federal change is seldom taken into account by Congress.").

require Congress to transfer funds to the states,[302] and because states retain the formal option to decouple from the federal tax base, congressional exploitation of tax-base conformity probably would not violate constitutional prohibitions on commandeering.[303]

B. Implications for Perennial Tax Policy Debates

This Section considers the implications of tax-base conformity for controversial tax policy issues, such as the appropriate structure and content of federal tax expenditures, the role of the federal deduction for state and local income taxes, whether Congress should employ legislative sunsets, and the desirability of federal consumption taxation. Rather than disposing of these debates, tax-base conformity considerations may further complicate them.

1. *Tax Expenditures Generally*. Commentators have long criticized the federal use of tax expenditures—especially those structured as deductions and exemptions—on the grounds that such tax expenditures are inequitable, inefficient, politically unaccountable, and add to the complexity of the tax law.[304] The fact that federal-state tax-base conformity duplicates those disadvantages at the state level provides a new argument against using such tax expenditures to incentivize behavior. Moreover, incorporation of federal exemptions and deductions at the state level may introduce new inefficiencies. Under conformity with AGI or taxable income, the states effectively match federal subsidies structured as deductions or exemptions, but the amount of each state's match varies with the state's tax rate. For example, consider two taxpayers who each spend $100 in federally deductible home mortgage interest and who are both taxable at the highest marginal rate in their states. If one lives in

302. Through the federal deduction for state and local taxation, a portion of the cost of the state-level match of federal-level tax subsidies effectively would be charged back to the federal government.

303. *See supra* note 145. Under constitutionally permissible conditional grants, "[i]f a State's citizens view federal policy as sufficiently contrary to local interests, they may elect to decline a federal grant," New York v. United States, 505 U.S. 144, 168 (1992), whereas under unconstitutional commandeering, "[a] State may not decline to administer the federal program. No matter which path the State chooses, it must follow the direction of Congress." *Id.* at 176–77.

304. *See, e.g.*, Surrey, *supra* note 258, at 705 (criticizing Congress for using the tax law to achieve nontax regulatory goals); *see also* Eric Toder, *Tax Cuts or Spending—Does It Make a Difference?*, TAX POLICY CTR. (June 8, 2000), http://www.taxpolicycenter.org/publications/urlprint.cfm?ID=410261 ("By the usual standards of tax policy analysis, tax expenditures make the tax system worse according to the goals of fairness, efficiency, and simplicity.").

California, a state that conforms to the federal mortgage-interest deduction, her state-level mortgage-interest deduction will be worth $10.30. In contrast, if the other lives just across the Colorado River in Arizona, which also conforms to the federal mortgage-interest deduction, her $100 deduction will be worth only $4.54.[305] Varying subsidies by state tax rates only makes sense if elasticities also similarly vary with those rates.

The federalism concerns raised by tax-base conformity also provide new arguments to support the position that, if the federal government will use tax expenditures at all, the preferred form of tax expenditures should be tax credits.[306] First, unlike exemptions and deductions, whose value varies with state tax rates, tax credits have the same dollar value for all taxpayers. Second, because they come later in the tax-liability calculation than do exemptions or deductions, it is easier for incorporating states to sever federal tax credits than it is for states to sever federal exemptions or deductions. Indeed, because states conform to the federal definition of either AGI or taxable income, by default states do not incorporate any federal tax credits. Instead, incorporating a federal tax credit requires a special act of the state legislature. Congress therefore could improve the equity, efficiency, and autonomy of state tax systems by favoring tax credits over deductions and exemptions. Federal tax credits would be particularly appropriate when there are likely to be regional differences in relevant conditions, such that it would be efficient for some states to incorporate the federal tax incentive, but for others to reject it.

2. The SALT Deduction in Particular. Analysis of federal-state tax-base conformity also provides new insight into the justification for

---

305. The highest marginal tax rate in California in 2012 was 10.3 percent, whereas in Arizona it was 4.54 percent. *See* Nick Kasprak, *Monday Map: Top State Marginal Income Tax Rates, as of January 1st, 2012*, TAX FOUND. (Feb. 27, 2012), http://taxfoundation.org/blog/monday-map-top-state-marginal-income-tax-rates-january-1st-2012.

306. *See, e.g.*, Lily L. Batchelder, Fred. T. Goldberg, Jr. & Peter R. Orszag, *Efficiency and Tax Incentives: The Case for Refundable Tax Credits*, 59 STAN. L. REV. 23, 49 (2006) (arguing that tax credits are more equitable and efficient than deductions and exemptions); *see also* ORG. FOR ECON. CO-OPERATION & DEV., TAX POLICY STUDY NO. 13, FUNDAMENTAL REFORM OF PERSONAL INCOME TAX 62 (2006) (noting that in many countries, conversion to refundable or "non-wastable" credits has been motivated by the concern of equitable treatment for taxpayers with no taxable income).

the federal deduction for state and local income taxes (SALT).[307] One effect of the SALT deduction is that it encourages states to impose income taxes, or to prefer income taxes to property, sales, and other taxes that are not federally deductable.[308] Commentators have had a hard time understanding why the federal government would be interested in subsidizing state-level income taxation.[309] But the subsidy makes more sense once we account for tax-base conformity because through conformity, states bolster federal policies implemented through the federal income tax. This post hoc justification for the SALT deduction, although not without its problems,[310] seems more persuasive than previously advanced justifications.[311]

3. *Legislative Sunsets*. Whether federal-state tax-base conformity strengthens or weakens the argument for federal legislative sunsets depends on how those sunsets operate in practice. The federal government has long employed expiration dates in tax legislation, but it has only recently engaged in the controversial practice of using sunsets to expire significant tax laws with large revenue effects.[312] For

---

307. *See* I.R.C. § 164(a) (2006) (providing deductions for, inter alia, state and local real property, personal property, and income taxes).

308. *See* Martin S. Feldstein & Gilbert E. Metcalf, *The Effect of Federal Tax Deductibility on State and Local Taxes and Spending*, 95 J. POL. ECON. 710, 731 (1987) (arguing that the SALT deduction provides an incentive for state governments to rely more heavily on federally deductible taxes than on other sources of revenue); Kaplow, *supra* note 2, at 486 (noting that because of the state and local tax deduction, "taxpayers will favor higher taxes (or be less aggressive in demanding lower taxes)").

309. For example, Professor Kaplow notes that the notion that the SALT deduction is needed to compensate states for interjurisdictional spillovers is unsatisfying because the deduction is not limited to taxes that fund state programs with interjurisdictional spillovers. *See* Kaplow, *supra* note 2, at 480–84.

310. In addition to subsidizing conforming state tax provisions, the SALT deduction also subsidizes deviating provisions. Thus, the SALT deduction does not discriminate between state tax laws that bolster federal tax policies and those that do not. Indeed, in addition to subsidizing state (and local) income taxes, the SALT deduction subsidizes, inter alia, state and local real and personal property taxes. I.R.C. § 164(a) (2006). Taxpayers can also elect to deduct state and local sales taxes in lieu of income taxes. *Id.* § 164(b)(5). State and local real property, personal property, and sales tax bases do not derive from the federal government; thus, the federal deduction for them cannot be explained by the theory that those taxes bolster other federal tax incentives.

311. In addition to Kaplow's criticism of the spillover argument, *see supra* note 309, justifications of the SALT deduction based on equity have also been criticized, *see, e.g.*, Galle, *supra* note 2, at 807–15 (summarizing criticisms of equity justifications proffered for the SALT deduction).

312. For analysis of sunsetting legislation, compare George K. Yin, *Temporary-Effect Legislation, Political Accountability, and Fiscal Restraint*, 84 N.Y.U. L. REV. 174, 237–39 (2009), which argues that legislative sunsets promote fiscal responsibility by reflecting the true costs of

example, Congress enacted some of the largest tax cuts in U.S. history during the Bush administration, and those tax cuts were originally set to expire at the end of 2010.[313] If our growing experience with sunsets reveals that the application of clear expiration dates tends to coalesce legislative changes into a particular year (that is, the year when tax legislation is set to expire), and that sunsets thereby lead to greater predictability and stability in the federal tax law, then sunsets would make tax-base conformity easier for the states, in part by giving states advance notice of federal legislative changes.[314] States with dynamic incorporation of federal law would face fewer revenue shocks because sudden changes in federal tax law would be less frequent and more predictable, and state legislators could be better prepared for them. Likewise, if sunsets lead to greater stability in the federal tax law, states with static or lagged incorporation would see less divergence over time between the state tax base and the federal tax base. Minimization of such divergence would help maintain the administrative and compliance cost savings of base conformity. In contrast, if as a practical matter sunsets lead to greater uncertainty about the content of federal tax law or to more substantive changes in the federal tax law, then sunsets would increase the costs of tax-base conformity.[315] Our growing experience with sunsets will help answer these questions.

---

legislation, with Kysar, *supra* note 252, at 1014, which argues that sunsets do not enhance fiscal responsibility but do increase rent-seeking and the influence of interest groups.

313. *See* Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, §§ 107, 303, 117 Stat. 752, 755–56, 764 (codified as amended at I.R.C. § 1 (2006 & Supp. IV 2011)) (providing a December 31, 2010 sunset); Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), Pub. L. No. 107-16, § 901(a), 115 Stat. 38, 150 (codified as amended at I.R.C. § 1 (2006 & Supp. IV 2011)) (same); *see also* Kysar, *supra* note 252, at 1017 (noting the size of these tax cuts). Most of these tax cuts were extended in 2010 and again at the end of 2012. *See* Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, § 101(a), 124 Stat. 3296, 3298 (codified as amended at I.R.C. § 1 (2006 & Supp. IV 2011)) (extending for two years the sunset of Section 901 of EGTRRA); *see also* American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, §§ 101–102 (2013) (making permanent the tax cuts for most taxpayers, while letting rates revert for some taxpayers).

314. *See* Yin, *supra* note 312, at 232–33 (acknowledging the high rate of change in the federal tax law but arguing that by extending sunsetting legislation before its expiration date, Congress could "provide considerable stability and predictability"). *But see* Kysar, *supra* note 252, at 1063–65 (arguing that sunsets lead to more legislative volatility).

315. The temporary repeal of the federal estate tax provides a recent example. In 2001, as part of the EGTRRA, Congress enacted legislation that phased out and then completely repealed the federal estate tax. EGTRRA §§ 501, 901(a), 115 Stat. at 69, 150 (codified as amended at I.R.C. § 2210 (2006 & Supp. V 2012)). EGTRRA also gradually eliminated the federal credit for state-level estate taxes. The impact on the states of the elimination of this credit depended on how their estate taxes were structured. For states that had autonomous

4. *Consumption Taxes*. As discussed in Part II, tax-base conformity generates significant administrative, legislative, and judicial cost savings. Indeed, the ease of collecting revenue on a base largely determined, administered, and enforced by the federal government may have led many states to adopt income taxes in the first place.[316] If the federal government adopted a value-added tax or any other broad-based consumption tax, the administrative advantages of state conformity with federal consumption taxation might lead states to abandon their own consumption taxes in favor of federal conformity. By (mostly) refraining from assessing consumption taxes, the federal government preserves this base for the states, thereby ensuring that states have a platform for autonomous tax policymaking. The notion that a federal consumption tax would erode state tax autonomy probably does not constitute a decisive factor in the debate over whether the federal government should introduce a broad-based consumption tax. However, the potential impact of federal consumption taxes on state tax autonomy helps explain state opposition to federal consumption taxation.[317]

estate taxes, elimination of the federal credit meant that state residents suddenly felt the economic burden of the state estate tax. For states that designed their estate taxes simply to "pick up," or "soak-up," the federal estate tax credit, the gradual elimination of the federal credit also automatically eliminated state-level estate taxes. *See* HELLERSTEIN & HELLERSTEIN, *supra* note 8, ¶ 21.01[2] (Supp. 2002). Even though EGTRRA changes were phased in over time, only a few states amended their estate taxes to account for the federal changes. *See* Duncan & Luna, *supra* note 47, at 667–69. This response could signal that the amount of revenue from state-level estate taxes was not worth its administrative costs to the states, or that states were waiting to see whether the federal credit for state-level estate taxes would return at the end of 2010 when EGTRRA was set to expire. At the expiration of EGTRRA in 2010, Congress reinstated the federal estate tax for two years, but it provided only a deduction, rather than a credit, for state estate taxes. *See* HELLERSTEIN & HELLERSTEIN, *supra* note 8, ¶ 21.01[2] (Supp. 2002) (discussing state tax consequences of the federal legislation). As a result, for states with "soak-up" estate taxes, the state-level estate tax was not automatically reinstated when the federal estate tax was reinstated.

316. Stark, *supra* note 1, at 432.

317. *See, e.g.*, Kathryn James, *An Examination of Convergence and Resistance in Global Tax Reform Trends*, 11 THEORETICAL INQUIRIES L. 475, 484 (2010) ("Each [value-added tax] reform proposal from Nixon to Bush Junior has met with a similar chorus of opposition: . . . state and local government representatives were concerned about the balance of federal taxing power and feared any intrusion into the sales tax area . . . ."). The states also have revenue concerns about the federal government intruding upon a base previously tapped exclusively by the states and localities.

C. Avenues for Future Research

This Article's introduction to the problems posed by the pervasive practice of federal-state tax-base conformity suggests directions for future empirical study. So far empirical research on tax-base conformity and deviation has been "sparse,"[318] and it has mostly focused on corporate taxation.[319] There exists little empirical research on individual state taxation, and what little research there is tends to analyze differences among states' effective tax rates, or the impact of federal tax rates on state tax rates, rather than analyzing differences in tax bases.[320] But the analysis in this Article suggests that studying state tax bases would enrich our understanding of state taxation.

For example, if federal tax laws function as sticky defaults, in part because of state legislators' concerns about yardstick competition or signaling, then deviation by a pioneer state could pave the way for deviations by other states. Likewise, researchers should be able to observe other patterns in deviations from federal tax law, particularly among neighboring states that compete for residents. Interestingly, except for Iowa, the states that tax income but do not expressly incorporate a federal definition of income—states I have referred to as facially nonconforming—fall into two contiguous regions.[321] This contiguity raises the question of whether competition for residents among neighbors drives nonconformity.[322] Likewise, the federal tax law may contain regional biases due to the voting rules in Congress. Because each state has two senators, regardless of its population, sparsely populated states possess influence in Congress disproportionate to their populations.[323] As a result, populous states

---

318. Luna & Watts, *supra* note 230, at 624.

319. *See, e.g.*, Gravelle & Gravelle, *supra* note 291; Hildreth et al., *supra* note 46; Luna & Watts, *supra* note 230.

320. *See, e.g.*, Esteller-Moré & Solé-Ollé, *supra* note 300, at 257 (estimating the effect of increases of federal personal tax rates on state tax rates but ignoring issues of base deviation by assuming a hypothetical common base).

321. The facially nonconforming states are Alabama, Arkansas, Iowa, Mississippi, New Jersey, and Pennsylvania. *See supra* note 39.

322. Pennsylvania and New Jersey share a border, and Alabama, Arkansas, and Mississippi form another continuous region of facial nonconformity.

323. *See* Lynn A. Baker, *Constitutional Ambiguities and Originalism: Lessons from the Spending Power*, 103 NW. U. L. REV. 495, 528–29 (2009) (noting that although the population of California is 32.3 times that of Rhode Island, its ability to form winning coalitions in Congress is only 5.5 times greater). Professor Baker argues that "allocation of coalition-building power in the Senate will importantly affect the distribution of special legislation—'pork'—that Congress enacts under the Spending Clause." *Id.* at 530. She confirms this hypothesis with empirical

may have more reason to decouple from certain federal tax laws than do sparsely populated states. Populous states also tend to have more resources and larger tax bureaucracies; these resources facilitate deviation.

Patterns of state conformity and deviation also may reflect differences in state politics and political processes. For example, if states deviate from federal tax law when state preferences fail to match national preferences, then we would expect to see more deviations from the federal base when different political parties control the state and federal governments.[324] Likewise, if states' ability to respond quickly to changes in federal law affects their choice of method of incorporation of federal law (whether dynamic or static, AGI or taxable income), then methods of incorporation should vary with characteristics of state legislatures. For example, state legislatures that meet only biennially, or that have significant limitations on their ability to pass tax legislation, may be more likely to incorporate federal tax law statically.[325] More generally, empirical research could be expected to reveal links between a state's degree of conformity with the federal tax base and its other attributes, such as its overall income levels, demography, geography, climate, and culture.

In addition to empirical research on patterns of state deviation and conformity, reliable estimates of the costs of deviation also would

---

evidence of each state's "balance of payments," that is, its contributions to the federal fisc compared to federal outlays it receives. *See id.* at 534–36. This effect presumably would also carry over to tax expenditures, as well as other tax provisions. For example, the federal alternative minimum tax (which itself disproportionately disadvantages taxpayers in populous states) takes away the federal deduction for the payment of state and local taxes, a deduction for which taxpayers in populous states are disproportionately eligible. *See* I.R.C. § 56(b)(1)(A)(ii) (2006) (denying SALT deductions under the alternative minimum tax).

Differences in the extent to which state and federal legislative processes are subject to counter-majoritarian pressures—from, for example, misapportionment or gerrymandering—could also result in federal preferences that diverge from state preferences. In such cases, one would predict a higher incidence of state deviation.

324. *See, e.g.*, Morrow & Ricketts, *supra* note 174, at 28 (finding for corporate taxes "that the political affiliation of the state legislature, but not that of the majority of the state's voters (as exhibited by the support of those voters for the president) is a significant predictor of the likelihood the state will conform to income-decreasing tax changes implemented at the federal level").

325. *See* RONALD K. SNELL, NAT'L CONFERENCE OF STATE LEGISLATURES, STATE EXPERIENCES WITH ANNUAL AND BIENNIAL BUDGETING 1 (2011), *available at* http://www.ncsl.org/documents/fiscal/BiennialBudgeting_May2011.pdf (noting that nineteen states employ biennial budgeting); *id.* (noting that four states hold legislative sessions biennially, rather than annually).

help elucidate the degree of entrenchment of federal law. Although researchers have estimated overall state tax-compliance costs for multistate corporations, they have not estimated state tax-compliance costs for individuals or the cost savings for any taxpayers of state conformity to the federal tax base.[326] Without a clear measure of these amounts, and without estimates of the incremental costs for deviating from particular provisions, it is hard for states and state voters to evaluate when their state could benefit from deviating from a particular federal tax provision. Thus, more empirical evidence could help quantify the costs and benefits of tax-base conformity, thereby aiding states in determining whether, and to what extent, they should conform to the federal base.

CONCLUSION

It has long been understood that by conforming to the federal tax base, states conserve legislative resources and take advantage of federal tax enforcement measures and other administrative benefits, such as tax information sharing. This Article offers new insights into the advantages of tax-base conformity: in addition to reducing administrative costs, base conformity also facilitates interstate commerce, reduces tax arbitrage, promotes interstate spillovers, and discourages discriminatory state taxation. Moreover, because it results in the states using very similar tax bases, conformity may productively channel tax competition to competition over tax rates, rather than tax bases.

But tax-base conformity comes at a price. By homogenizing tax bases across the states, base conformity undermines both horizontal competition between the states and vertical competition between the states and the federal government. A consequence of this homogenization is that state tax bases may fail to reflect differences in the values and preferences of voters of different states. Moreover, when states use the federal tax base as the starting point for assessing state income taxes, they inevitably incorporate federal regulatory policy into their own tax bases. By delegating tax authority to the federal government in this way, states relinquish control over an important policy tool. Thus, the impact of tax-base conformity is

326. *See* Duncan & Luna, *supra* note 47, at 667 (observing the lack of empirical studies on the compliance cost savings due to base conformity).

similar to other intergovernmental interactions, such as conditional grants, that raise federalism concerns.

Of course, there are crucial differences between federal-state tax-base conformity and conditional grants. First, states have greater freedom to deviate from particular federal tax provisions than from particular provisions of conditional federal grants. However, as this Article argues, because tax-base deviations impose costs and because not all federal tax provisions come à la carte, it is reasonable to assume that incorporating states adopt at least some federal tax laws that serve neither state interests nor state voter preferences. The federal government's accomplishment of ever more regulation through the tax system exacerbates this problem. Another difference between tax-base conformity and conditional grants is that the pressure states feel to conform their tax bases to that of the federal government does not emanate primarily from the federal government. Instead, it derives from the need to compete with other states for mobile residents who want to minimize their compliance burdens. Likewise, states feel pressure to raise income taxes at the lowest possible administrative and legislative cost.

The pressures to conform, and the benefits conformity brings, suggest that federal-state tax-base conformity is here to stay. The growth and persistence of base conformity reveals that the federal government has far more influence on state taxes than is usually acknowledged. Although scholars have long neglected tax-base conformity, this Article shows that to fully understand our fiscal federalism requires consideration of base conformity.