

SUITABLE FOR FRAMING: BUSINESS DEDUCTIONS IN A
NET INCOME TAX SYSTEM

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ABSTRACT

The federal tax code includes numerous provisions disallowing or curtailing income tax deductions related to such disparate activities as business lobbying and providing non-performance-based compensation to senior corporate executives. The primary claim of this article is that a tendency to mentally frame business deductions as subsidies, often reinforced by rhetoric explicitly framing deductions as subsidies, helps explain these provisions. The traditional “public policy” disallowances directed at lobbying, fines and penalties paid by businesses, and antitrust treble damages respond to an appearance of a taxpayer subsidy that would follow from deduction, despite the fact that it is far from clear that these deductions, if allowed, would create an exception to taxation of net income. Disallowances directed at executive pay and other corporate governance matters also take advantage of an appearance of subsidy. In these cases, structuring an economic disincentive as a disallowed deduction (versus economically equivalent direct regulation) and explicitly framing the intervention as the elimination or curtailment of a subsidy create an illusion of lesser regulatory intervention that helps overcome opposition to the legislation. The normative implications of mental and rhetorical framing of deduction as subsidy are troubling. It is

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becoming increasingly clear that disallowed deductions generally are a poor means of implementing economic policy, and the power of subsidy framing and rhetoric provides another reason to be skeptical of corporate governance and similar business regulation incorporated in the tax code.

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INTRODUCTION

The federal tax code includes numerous provisions that discourage particular nontax behaviors. “Sin taxes” and other excise taxes do so, of course, but often disincentives take the form of curtailed or disallowed business tax deductions. Consider Internal Revenue Code (Code) section 162(f), which disallows deductions for fines or penalties paid to the government for violations of law,¹ or section 162(m), which limits the corporate tax deduction for non-performance-based compensation paid to certain senior executives.² The effect of both provisions is to raise the effective cost of—and to discourage—disfavored activity.

This Article asks why these disallowance provisions, which have been described as negative tax expenditures³ or tax penalties,⁴ appear in the Code. In the case of section 162(m) and other corporate governance-directed disallowances, the question is why tax instead of direct nontax regulation. In the case of section 162(f) and the other traditional “public policy” disallowances, the question is why there is any federal intervention at all. The primary claim of this Article is that a tendency to mentally frame business deductions as subsidies, often reinforced by rhetoric explicitly framing deductions as subsidies, helps to explain why one observes these disallowance provisions.

Public Policy Disallowances. This Article argues that the disallowance on “public policy” grounds of deductions for fines and penalties paid,⁵ bribery,⁶ a portion of antitrust treble damages,⁷ and

1. I.R.C. § 162(f) (2006).

2. *Id.* § 162(m).

3. For an explanation of tax expenditures, see STANLEY S. SURREY, PATHWAYS TO TAX REFORM: THE CONCEPT OF TAX EXPENDITURES 336 n.61 (1973) [hereinafter SURREY, PATHWAYS TO TAX REFORM]; STANLEY S. SURREY & PAUL R. MCDANIEL, TAX EXPENDITURES 28-30 (1985); Stanley S. Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 HARV. L. REV. 705 (1970) [hereinafter Surrey, *Tax Incentives*].

4. See Eric M. Zolt, *Deterrence via Taxation: A Critical Analysis of Tax Penalty Provisions*, 37 UCLA L. REV. 343, 344 (1989).

5. I.R.C. § 162(f).

6. *Id.* § 162(c).

7. *Id.* § 162(g).

lobbying and political activities⁸ is best understood as a response to an appearance of subsidy. Some legislators may honestly believe that the underlying deductions unfairly subsidize objectionable behavior and undermine public policy.⁹ Others may favor disallowance as a means of mitigating public outrage that would follow from the appearance of subsidy if the deductions were allowed.¹⁰ Still other legislators might harness, or even create, this outrage in order to advance their political prospects.¹¹

But are the underlying deductions subsidies? That depends on one's baseline. In a tax system directed at net income, some deductions properly define net income and are not subsidies, whereas other deductions represent exceptions to the tax on net income and constitute subsidies.¹² In order to distinguish between the two groups, however, one would need a normative net income baseline, and Congress has provided no such baseline.¹³ Moreover, even when theorists agree on a normative theory for defining the baseline, such as the Haig-Simons definition of income,¹⁴ they do not always agree on the proper classification of particular deductions.¹⁵

The result of this ambiguity is not random classification of deductions as subsidy or nonsubsidy. There appears to be a tendency to equate deduction—at least business deduction—with subsidy.¹⁶ There are several possible explanations for this phenomenon. First, the pre-deduction situation may be the instinctive mental baseline. In part, the use of the term “deduction” in other contexts to signify a discount may be imported into our thinking about tax.¹⁷ Second, in some cases, observers may fail to consider the entire transaction, ignoring the fact that gains are taxable, which suggests that costs are appropriately deducted.¹⁸ Third, and more perniciously, this

8. *Id.* § 162(e).

9. *See infra* Part III.B.

10. *See infra* note 188 and accompanying text.

11. *See infra* note 198.

12. *See infra* notes 83-91 and accompanying text.

13. *See infra* notes 83-85 and accompanying text.

14. *See infra* note 88 and accompanying text.

15. *See infra* Part II.A.2.

16. *See infra* Part II.A.2.

17. *See infra* note 79 and accompanying text.

18. *See infra* Part III.A.1.a.ii.

Article will suggest that political rhetoric that frames deductions as subsidies may shape popular perception.¹⁹

As a policy matter, nothing should turn on uncertain “subsidy” labels, but the appearance of subsidy has long figured into public policy disallowances. Tax administrators initially sought these disallowances, and the courts sustained them.²⁰ Determining whether the allowance of a deduction for fines, penalties, or damages actually undermines public policy requires an inquiry into the processes by which the sanction was set. The courts were ill-equipped to conduct this inquiry, and disallowance seems to have followed from an intuitive but often questionable syllogism: (1) deduction equals subsidy; (2) subsidization of proscribed behavior undermines public policy, therefore, (3) deduction undermines public policy.²¹

As reactive responses to an appearance of subsidy that is inherent in a tax scheme directed at net income, these interventions likely would vanish if the corporate income tax were to vanish. Although section 162(f) increases the cost of violations of law and provides revenue for the United States Treasury,²² it is unlikely that the provision would be replaced by a direct exaction levied on fines or penalties paid if the corporate income tax were repealed and not replaced with some other tax scheme levied on net corporate income.

Corporate Governance Disallowances. Section 162(m) and the other corporate governance disallowance provisions are different in this regard.²³ Section 162(m) was not a direct response to an appearance of subsidy but was a response to public outrage and a demand for action regarding executive pay generally.²⁴ This Article argues that the appearance of subsidy likely played a key role in the choice to structure the federal intervention as a disallowance instead of as direct regulation. But direct regulation was certainly a conceivable

19. See *infra* Part II.B.

20. See, e.g., *Rugel v. Comm’r*, 127 F.2d 393, 395 (8th Cir. 1942) (disallowing deduction for payments to “purchase ... political influence”); *Great N. Ry. Co. v. Comm’r*, 40 F.2d 372, 373 (8th Cir. 1930) (disallowing deduction for penalty payments).

21. See *infra* Part III.A.1.b.

22. See I.R.C. § 162(f) (2006).

23. *Id.* § 162(m).

24. See *infra* notes 103-04, 195 and accompanying text.

alternative and, absent a corporate income tax, direct regulation might have been enacted.²⁵

Of course, there is no inherent economic difference between direct regulation and tax disincentive, but even where substantively identical, form matters.²⁶ Given the propensity to conceptualize business deductions as subsidies, structuring a disincentive as a tax disallowance creates an illusion that is similar to the fiscal illusion created by tax subsidies.²⁷ It is well understood that the difference between tax subsidies and direct spending is illusory.²⁸ The government can influence the allocation and distribution of societal resources through either avenue, but the use of a tax subsidy instead of direct spending creates an illusion of smaller government from a fiscal perspective because the tax subsidy appears to reduce taxes and spending.²⁹ Although an illusion, the appearance affects reception and helps to explain the popularity of various tax programs.³⁰

Now consider tax disincentives and direct penalties that have the same allocational and distributional properties. Tax disincentives, such as section 162(m), suffer relative to direct penalties in terms of fiscal illusion because they appear to increase taxes and provide no direct revenue.³¹ But to the extent that a tax disincentive taking the form of a disallowed deduction is viewed as simply eliminating a tax subsidy, it creates an illusion of lesser regulatory interference. This Article will refer to this effect as “regulatory illusion.”³²

The regulatory illusion created by disallowed deductions such as section 162(m) is reinforced by political rhetoric that labels the underlying deduction a subsidy, whether the deduction is or is not

25. See *infra* Part III.B.3.

26. See *infra* Part III.B.3.

27. See *infra* Part III.B.3.

28. See David F. Bradford, *Tax Expenditures and the Problem of Accounting for Government*, in *TAX EXPENDITURES AND GOVERNMENT POLICY* 427, 428 (Neil Bruce ed., 1988); Daniel N. Shaviro, *Rethinking Tax Expenditures and Fiscal Language*, 57 *TAX L. REV.* 187, 191 (2004) (noting that the distinction “depends on pure form”).

29. See Bradford, *supra* note 28, at 429; Shaviro, *supra* note 28, at 189; Eric J. Toder, *Tax Cuts or Spending—Does It Make a Difference?*, 53 *NAT’L TAX J.* 361 (2000); see also *infra* Part III.B.3.

30. See *infra* note 222 and accompanying text.

31. I.R.C. § 162(m) (2006); see *infra* Part III.B.3.

32. See *infra* Part III.B.3.

an actual subsidy.³³ The inherent ambiguity in the character of income tax deductions allows virtually all deductions to be plausibly framed as subsidies and disallowances to be framed as subsidy curtailment or elimination.³⁴ It is much more difficult to plausibly frame direct penalties as subsidy curtailment.³⁵ This structural or rhetorical maneuver should be important when the subject is economic regulation that might be resisted by free-market-oriented legislators or constituents. Thus, just as fiscal illusion helps to explain the popularity of tax subsidies, regulatory illusion can help to explain disallowances directed at corporate governance and similar matters.³⁶

To test the impact of disincentive structure and framing on public perception, I conducted a student survey, the results of which are reported herein.³⁷ Several hundred law students were asked to rate the degree to which they would support hypothetical regulation of “excessive” executive pensions. Consistent with the suggestions above, the students were less inclined to support direct penalties on excess pensions than they were to support the elimination of a deduction, although the two interventions were structured to be economically equivalent.³⁸ Moreover, support for deduction curtailment was greater when the disallowance was explicitly framed as the elimination of a subsidy than when the change was presented in neutral language without any mention of subsidization.³⁹

Of course, regulatory illusion is only useful when there is an underlying deduction related to the disfavored activity that may be curtailed. By contrast, the enactment of an excise tax would not create an appearance of subsidy elimination and would not benefit from regulatory illusion. Also, this Article does not claim that subsidy confusion and regulatory illusion fully explain the existence

33. Recall that a business deduction represents a tax subsidy when it creates an exception to the tax on net income. Although straightforward conceptually, it will not always be clear whether a particular deduction is better thought of as subsidy or normatively correct adjustment to net income. *See infra* Part II.A.2.

34. *See infra* Part II.A.2.

35. *See infra* notes 212-16 and accompanying text.

36. *See infra* Part III.B.3.

37. *See infra* Part II.C; *see also infra* Appendix.

38. *See infra* Part II.C; *see also infra* Appendix.

39. *See infra* Part II.C; *see also infra* Appendix.

of all disallowance provisions directed at nontax behavior. Several commentators have remarked upon the administrative advantages of using the Code to regulate corporate governance and similar behavior.⁴⁰ These observations are not in conflict with this Article's argument. The key point here is that given the tendency of observers to broadly conceptualize business deductions as subsidies and the ease with which disallowance can be plausibly framed as subsidy curtailment, one should expect to see more public policy disallowances in the Code and more frequent resort to the Code as the venue of choice for governance and similar regulation than one otherwise would.

From a normative perspective, purposeful exploitation of mental framing of deduction as subsidy and overbroad rhetoric equating deduction to subsidy are troubling.⁴¹ Although rhetoric can be fought with rhetoric, to some extent framing effects may be unavoidable. As noted above, regulation structured as the disallowance of a subsidy is viewed differently than direct regulation, even when no overt reference is made to subsidies.⁴² It is becoming increasingly clear, however, that disallowed deductions are generally poor means of implementing economic policy, despite some administrative advantages.⁴³ Recognizing the power of subsidy framing provides yet another reason to be skeptical of business regulation incorporated in the Code.

This Article is organized as follows. Part I provides an overview of disallowance provisions aimed at business behavior. Part II argues that business deductions tend to be conceptualized, or mentally framed, as subsidies and that this tendency may be reinforced by rhetoric explicitly equating deduction with subsidy. The consequences of mental and rhetorical framing for judicial and legislative processes are discussed in Part III. Part IV outlines the implications of mental and rhetorical framing and is followed by a brief conclusion.

40. See, e.g., David A. Weisbach & Jacob Nussim, *The Integration of Tax and Spending Programs*, 113 YALE L.J. 955, 958 (2004).

41. See *infra* Part IV.

42. See *supra* notes 28-39 and accompanying text.

43. See *infra* Part III.B.3.a.

I. OVERVIEW AND BACKGROUND ON DISALLOWED DEDUCTIONS

This Article is concerned with disallowance provisions that are directed at nontax business behavior, ranging from political activities to executive compensation. The disallowances raise the effective cost of such behaviors relative to the alternative of allowing the otherwise ordinary and necessary business expense deductions.⁴⁴ As a result, these provisions often have been labeled tax penalties⁴⁵ or negative tax expenditures.⁴⁶ Reflecting the ambiguity that is discussed in Part II.A.2, this Article will refer to these provisions simply as “disallowances.”

This Part provides a brief overview of such disallowances. It provides examples, reviews the academic literature as it relates to disallowance, and briefly considers and contrasts substantively identical, nontax regulation.

A. Examples of Disallowances

A number of disallowance provisions are directed at corporate governance or other corporate behavior. Section 162(m) is one example.⁴⁷ Corporations normally are permitted to deduct the cost of employee compensation.⁴⁸ Section 162(m), however, disallows the deduction for non-performance-based pay provided to certain senior executives that exceeds \$1 million annually.⁴⁹ For example, former Bank of America CEO Kenneth Lewis received a salary of \$1.5 million for 2008.⁵⁰ Salary is not performance-based pay. Given section 162(m), Bank of America would have been permitted to deduct from its taxable income only \$1 million of that amount; the remaining \$500,000 would have been a nondeductible expense.⁵¹

44. Excise taxes also raise the effective cost of nontax behavior but do not share the ambiguity of disallowances.

45. Zolt, *supra* note 4, at 344.

46. See *supra* note 3 and accompanying text.

47. I.R.C. § 162(m) (2006).

48. *Id.* § 162(a)(1).

49. *Id.* § 162(m).

50. See *Executive Pay*, N.Y. TIMES, Apr. 5, 2009, at BU10.

51. The \$1 million limitation applies to all compensation received by the executive within

Similarly, sections 280G and 162(k) disallow corporate tax deductions for certain excessive “golden parachute” severance payments made to executives and for “greenmail” payments made to corporate raiders, respectively.⁵² Section 901(j) disallows credits for taxes paid to foreign countries that the United States does not recognize, with which the United States has severed diplomatic relations, or that have been designated as supporting international terrorism.⁵³

Moreover, during recent years, legislators have introduced numerous bills in Congress that would have disallowed deductions arising from various disfavored business practices. For example, in 2009, Senators Carl Levin and John McCain introduced the Ending Excessive Corporate Deductions for Stock Options Act, which would have limited corporate tax deductions for stock option compensation to the amount recognized as an expense in financial statements.⁵⁴ In the 109th Congress alone, at least fifteen bills were introduced that would have disallowed tax deductions in this manner.⁵⁵

Other disallowance provisions have a much longer pedigree. Many were first created by courts that disallowed certain deductions on “public policy” grounds.⁵⁶ Subsequently, Congress codified many of these provisions. Examples include disallowance of deductions for the payment of fines and penalties,⁵⁷ bribes and kickbacks,⁵⁸ and certain lobbying and political activities.⁵⁹ Along the same lines, Congress has disallowed deductions for the punitive portion of

the year. I.R.C. § 162(m). To simplify exposition, this calculation assumes that all other compensation received by Lewis qualified as performance-based.

52. *Id.* §§ 280G, 162(k). In these cases, Congress also subjects the receipts of these payments to excise taxes. *See id.* §§ 4999, 5881.

53. *Id.* § 901(j). Until 1993 this provision was also used to disallow tax credits for companies doing business in South Africa. *See* South African Democratic Transition Support Act of 1993, Pub. L. No. 103-149, § 4(b)(8), 107 Stat. 1503, 1505 (codified as amended at I.R.C. § 901(j)).

54. S. 1491, 111th Cong. (2009).

55. For example, House Bill 575, the Say No to Drug Ads Act, would have disallowed deductions for certain prescription drug advertisements. H.R. 575, 109th Cong. (2005).

56. *See* *Comm’r v. Heininger*, 320 U.S. 467, 473-74 (1943) (discussing judicial disallowance).

57. I.R.C. § 162(f) (2006).

58. *Id.* § 162(c).

59. *Id.* § 162(e).

antitrust treble damages,⁶⁰ net gambling losses,⁶¹ and expenses incurred in the sale of illegal drugs.⁶² Congress has also limited depreciation deductions with respect to luxury automobiles.⁶³

B. The Literature on Disallowances

Although not featured as prominently as tax subsidies, disallowances have been discussed in the academic literature. In his 1973 book *Pathways to Tax Reform: The Concept of Tax Expenditures*, Stanley Surrey listed seven Code provisions that he labeled disincentives, including denials of deductions for the following: lobbying and political contributions, payments of fines and penalties, bribes and kickbacks, payment of treble damages in antitrust cases, and net gambling losses.⁶⁴ Surrey speculated that the reason there were not more tax penalties was that Congress was “wary of mixing morals and enforcement against nontax pursuits” into the Code.⁶⁵ The reticence seems to have diminished of late.

In a 1989 article, Eric Zolt applied the Surrey critique of tax subsidies in analyzing disallowances or tax penalties.⁶⁶ Zolt found tax penalties lacking. He concluded that they were “remarkably crude policy instruments” and difficult to defend on economic grounds.⁶⁷ Updated for current tax rates, Zolt’s chief criticisms were as follows: First, the denial of a deduction, the classic tax penalty, has the effect of imposing a 35 percent penalty on an offending individual or corporation paying tax at the highest marginal rate, but the penalty has lesser or even no effect on corporate taxpayers with large accumulated losses or on individual taxpayers in lower

60. *Id.* § 162(g).

61. *Id.* § 165(d).

62. *Id.* § 280E.

63. *Id.* § 280F.

64. See SURREY, *PATHWAYS TO TAX REFORM*, *supra* note 3, at 336-37. With the exception of the limitation on deductibility of gambling losses, each of these disallowances is directed at business activity, in the sense that only businesses would be entitled to the underlying deductions absent the disallowance provisions.

65. *Id.* at 337.

66. See generally Zolt, *supra* note 4. Zolt defined tax penalties more narrowly than I have. He “focuse[d] only on those provisions for which Congress’ motive is to penalize illegal or undesirable nontax activities.” *Id.* at 348.

67. *Id.* at 344-45.

tax brackets.⁶⁸ Thus, two taxpayers may face widely different penalties for engaging in the same disfavored behavior. Second, the denial of a deduction is a one-size-fits-all-offenses penalty.⁶⁹ For a corporation paying tax at the highest marginal rate, the tax penalty for paying executive salaries in excess of \$1 million or for lobbying federal officials is exactly the same—35 percent of the money spent. It seems unlikely that a 35 percent penalty provides optimal deterrence for such disparate activities. It is fair to say that these provisions are remarkably crude deterrents.

However, the crudeness of tax penalties should not lead to automatic condemnation. Zolt also noted that tax penalties entail low administrative costs and that these provisions may serve a symbolic function.⁷⁰ To some degree, these benefits offset the crudeness of the incentives provided. This view is reinforced in more recent work by David Weisbach and Jacob Nussim, who argue that institutional considerations, such as administrative costs, specialization, and coordination, should determine whether federal programs are implemented via the tax code or through other avenues.⁷¹ Aside from discussion of possible administrative or coordination benefits, there has been little consideration of why disincentives directed at nontax behavior appear in the Code at all.

C. Tax-Like Disincentives Outside the Tax Code

It was not inevitable that these disincentives would be incorporated within the tax code. One observes very similar tax-like disincentives in other regulatory schemes. Consider, for example, the federal Corporate Average Fuel Efficiency (CAFE) standards.⁷² Vehicle manufacturers that fail to meet the required sales-weighted average fuel economy standard for any model year are fined five dollars per vehicle for every tenth of a mile per gallon by which their

68. *See id.*

69. *See id.* at 345.

70. *See id.* Symbolic legislation addresses legislators' political need to appear to act rather than, or in addition to, instrumental objectives. *See infra* note 189 and accompanying text.

71. *See* Weisbach & Nussim, *supra* note 40, at 958-59.

72. *See* 49 U.S.C. §§ 32901-32919 (2006).

fleet falls short of the standard.⁷³ This is clearly a tax in an economic sense: it is a Pigouvian tax levied on an activity that generates negative externalities.⁷⁴ The disincentives created by the CAFE standards and fines are analogous to those created by the limit placed on the deduction for senior executive non-performance-based pay under section 162(m).⁷⁵ Note, however, that in the case of the CAFE standards, there was no closely associated tax deduction or credit that could have been curtailed. As a result, it was necessary to enact an excise tax to create the desired disincentive.

II. MENTAL AND RHETORICAL FRAMING OF DEDUCTION AS SUBSIDY

From an economic standpoint, the disallowance of a tax deduction may be indistinguishable from a direct penalty, such as that imposed under the CAFE regime.⁷⁶ But to observers, these forms of regulation appear to be different. Unlike direct penalties, the disallowance of a business tax deduction tends to be conceptualized as the elimination of a taxpayer subsidy. The inherent tendency to conceptualize deduction as subsidy, which this Article refers to as “mental framing,” may be reinforced by rhetoric explicitly framing deductions as subsidies and disallowance as subsidy curtailment.⁷⁷

73. See *id.* § 32912.

74. See ARTHUR CECIL PIGOU, *THE ECONOMICS OF WELFARE* 192-95 (Transaction Publishers 2002) (1952); see also William J. Baumol, *On Taxation and the Control of Externalities*, 62 AM. ECON. REV. 307, 307-08 (1972).

75. See I.R.C. § 162(m) (2006).

76. This is not to say that disallowances and direct sanctions always are viewed as equivalent from the point of view of the regulated party, even when economically equivalent. Some penalty regimes carry independent normative weight beyond the explicit sanction. In other words, a company may be more likely to suffer a tax disallowance than to commit an act deemed illegal, even if the economic sanctions are equivalent.

77. The term “framing effect” often is used to refer to the phenomenon in which reception of a proposal differs depending on how the proposal is described. See, e.g., James N. Druckman & Kjersten R. Nelson, *Framing and Deliberation: How Citizens’ Conversations Limit Elite Influence*, 47 AM. J. POL. SCI. 729, 730 (2004). For example, many observers believe that estate tax repeal advocates shifted public opinion against the tax by relentlessly applying the label “death tax.” See, e.g., MICHAEL J. GRAETZ & IAN SHAPIRO, *DEATH BY A THOUSAND CUTS: THE FIGHT OVER TAXING INHERITED WEALTH* 124-25 (2005) (noting the widespread perception, but also noting that some observers believe the rhetoric had less impact on public opinion than is generally claimed). This Article will refer to this phenomenon as “rhetorical framing.” But rhetoric aside, in considering any complex question, certainly any tax question, observers start with a mental baseline. These baselines or frames are not necessarily

The rhetoric is effective because it is plausible. It is plausible because although some business deductions almost surely do not constitute subsidies, there is no authoritative baseline and a wide range of ambiguity.

A. Mental Framing

1. Choice of Baseline—In General

The characterization of a deduction as a subsidy and disallowance as subsidy curtailment is economically irrelevant, but the perception matters. Characterization of a transfer as a subsidy simply reflects a choice of baseline. The instinctive baseline for thinking about a direct penalty, such as the CAFE penalties, is the pre-penalty situation. The imposition of a direct penalty makes the regulated party worse off relative to that baseline. Eliminating the penalty would make the regulated party better-off, but as a move back in the direction of the pre-penalty situation, elimination would not typically be characterized as granting a subsidy, but as removing the penalty.⁷⁸

Despite the fact that the U.S. income tax system is based on net, not gross, income, I believe that in thinking about any particular business deduction, observers tend to adopt a pre-deduction, gross income baseline. Given that baseline, these deductions appear to be pro-taxpayer deviations that observers tend to conceptualize as subsidies. This is not surprising. Outside of the tax context, to “deduct” means to reduce, subtract, or discount from some baseline.⁷⁹ The elimination of a deduction is a move back in the direction

consistent. Observers may apply a different mental baseline to economically equivalent, but technically different, regulatory interventions. This Article will refer to this choice of baseline as “mental framing.”

78. Seth Kreimer has suggested that history is a plausible baseline for distinguishing between penalties and nonsubsidies. See Seth F. Kreimer, *Allocational Sanctions: The Problem of Negative Rights in a Positive State*, 132 U. PA. L. REV. 1293, 1359-63 (1984). I do not think, however, that a direct penalty has to be new for this effect to hold. In other words, I do not think that direct penalties are characterized as penalties because of reliance on a pre-penalty status quo. The fact that a direct penalty is long-established does not tend to affect our conceptual baseline.

79. See, e.g., THE AMERICAN HERITAGE COLLEGE DICTIONARY 369 (4th ed. 2007); ROGET'S INTERNATIONAL THESAURUS 252.07, 255.09, 631.02 (6th ed. 2001).

of the gross income baseline, so observers tend to conceptualize that move as the elimination of a subsidy.⁸⁰

This is not the only way to frame a deduction. In *Commissioner v. Sullivan*, discussed below, the Supreme Court adopted a different baseline, which resulted in a different characterization.⁸¹ However, this Article argues that the general tendency is to select a baseline that results in business deductions being characterized as subsidies.

2. *Inherent Ambiguity*

The tendency to characterize business deductions as subsidies is facilitated by the inherent ambiguity of deductions in a tax scheme based on net income that lacks a clear baseline. The ambiguity of tax deductions and their disallowance can be traced back to the Sixteenth Amendment, which clarifies the power of Congress to tax incomes, but fails to define the term. The Amendment simply provides that “[t]he Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.”⁸² Commentators generally agree that the aim of the Sixteenth Amendment was to confirm Congress’s power to tax *net* income,⁸³ but the Amendment simply refers to “incomes,”⁸⁴ leaving open the possibility that a nonapportioned tax on gross income would be constitutional. This is an open question.⁸⁵ In any event,

80. Some nonbusiness deductions, such as the personal income tax deduction for home mortgage interest payments, may not be conceptualized by the average observer as a subsidy. However, nonsubsidy characterization of personal deductions, where it exists, may be a function of settled expectations rather than an economic intuition regarding the nature of the deduction. In any event, the focus of this Article is on business deductions, and in that context the tendency to conceptualize as subsidy appears to be pervasive.

81. 356 U.S. 27 (1958); *see also infra* notes 145-52 and accompanying text.

82. U.S. CONST. amend. XVI.

83. *See, e.g.*, ERIK M. JENSEN, *THE TAXING POWER: A REFERENCE GUIDE TO THE UNITED STATES CONSTITUTION* 118 (2005).

84. U.S. CONST. amend. XVI.

85. The open question is whether basis recovery is constitutionally protected. *See* Joseph M. Dodge, *The Constitutionality of Federal Taxes and Federal Tax Provisions* 20 (Fla. State Univ. Coll. of Law, Pub. Law Research Paper No. 226, 2006), available at <http://ssrn.com/abstract=943014> (arguing the minority position that basis recovery is not constitutionally protected and that for purposes of the Sixteenth Amendment “income” equals “gross income”). No one seriously argues that specific deductions for business expenses are constitutionally

perhaps as a result of this uncertainty, combined with a recognition that some deductions are needed to properly define the tax base, courts have long provided Congress with extremely broad discretion to create, revoke, or condition deductions from gross income. Deductions, it is often said, are a matter of “legislative grace.”⁸⁶ Or, as the Supreme Court stated in *Helvering v. Independent Life Insurance Co.*, “Unquestionably Congress has power to condition, limit or deny deductions from gross income in order to arrive at the net that it chooses to tax.”⁸⁷

One consequence of this state of affairs is that at one level deductions are inherently ambiguous. If gross income constituted the income tax baseline, all deductions allowed by Congress would represent subsidies. If the currently enacted Code constituted the baseline, no deduction would be a subsidy. A more reasonable view, however, is that Congress has enacted a tax on net income, that some deductions allowed by Congress define net income, and that others represent exceptions to the tax on net income, and thus are subsidies. Unfortunately, deductions do not come with handy labels, and individual members of Congress are as unlikely to agree on the appropriate characterization of particular deductions as are judges or commentators.

Adoption of a normative conception of net income does not fully resolve the ambiguity. The Haig-Simons definition of income—the sum of personal consumption and the change in wealth across the relevant period—is widely accepted by commentators as an appropriate measure of economic income,⁸⁸ but even within a

protected, although eliminating all deductions for ordinary and necessary business expenses would be problematic. See JENSEN, *supra* note 83, at 118.

86. *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934) (noting that the “power to tax income ... extends to the gross income”).

87. 292 U.S. 371, 381 (1934). As Erwin Griswold noted, this is a statement of congressional power, and the consequence is that denying a deduction is a particularly robust means of federal regulation. See Erwin N. Griswold, *An Argument Against the Doctrine that Deductions Should Be Narrowly Construed as a Matter of Legislative Grace*, 56 HARV. L. REV. 1142, 1143 n.8 (1943).

88. See HENRY C. SIMONS, *PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY* 50 (1938) (“Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question.”); MICHAEL J. GRAETZ & DEBORAH H. SCHENK, *FEDERAL INCOME TAXATION: PRINCIPLES AND*

Haig-Simons framework, vexing problems remain in properly characterizing deductions. The deduction for charitable contributions is necessary to properly define income in the eyes of some, but represents a subsidy for others.⁸⁹ Stanley Surrey and Paul McDaniel considered the failure to allow a deduction for all wagering losses to be a tax penalty.⁹⁰ Others view wagering losses as nondeductible consumption.⁹¹

Of course, the baseline problem and the ambiguity of deductions are quite familiar to those interested in tax policy. These difficulties have been at the center of the debate over the coherence of tax expenditure analysis since the 1960s. Tax expenditures, as Surrey and others defined them, are positive (that is, pro-taxpayer) deviations from a “normal” income tax.⁹² In other words, tax expenditures are subsidies.⁹³ Surrey argued that the Code was an inefficient means of delivering subsidies,⁹⁴ and advocated and ultimately achieved an annual accounting of tax expenditures comparable to the direct federal spending budget.⁹⁵ A fundamental problem with tax expenditure analysis, however, as Boris Bittker and others

POLICIES 97 (6th ed. 2009) (noting that the Simons definition “is the most widely accepted” and that it is considered to be a refinement of a definition provided by Robert Haig, hence the “Haig-Simons” definition).

Although the Haig-Simons definition of income is widely accepted in the context of the individual income tax, its application to the corporate income tax is less well established. See William D. Andrews, *Is Tax Exemption a Subsidy?* 12 (1992) (unpublished manuscript, on file with the William and Mary Law Review).

89. Compare William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309, 344-75 (1972) (arguing that the deduction for charitable contributions is consistent with an ideal income tax on personal consumption and accumulations), with SURREY & MCDANIEL, *supra* note 3, at 205 (arguing that charitable contributions represent consumption and are properly categorized as tax expenditures).

90. See SURREY & MCDANIEL, *supra* note 3, at 224.

91. See, e.g., Daniel Shaviro, *The Man Who Lost Too Much: Zarin v. Commissioner and the Measurement of Taxable Consumption*, 45 TAX L. REV. 215, 230-33 (1990) (analyzing the consumption aspects of gambling).

92. See, e.g., Surrey, *Tax Incentives*, *supra* note 3, at 706-07.

93. See *id.*

94. See *id.* at 734-35; see also SURREY, *PATHWAYS TO TAX REFORM*, *supra* note 3, at 140-41; SURREY & MCDANIEL, *supra* note 3, at 26-27.

95. See Edward A. Zelinsky, *The Tax Reform Act of 1986: A Response to Professor Yono and His Vision of the Future of the Internal Revenue Code*, 55 FORDHAM L. REV. 885, 893-94 (1987).

argued, is the arbitrariness of the baseline and the impossibility of nailing down the “normal” income tax.⁹⁶

One response to Bittker’s criticism is that although there may be a zone of ambiguity as a result of the lack of an authoritative net income baseline, the appropriate characterization of many deductions is uncontroversial within a broad range of competing conceptions of net income. For example, deductions for office rent and employee wages are clearly appropriate adjustments in determining net income, whereas allowing an immediate deduction of certain capital expenditures clearly represents a subsidy. Not all deductions are equally ambiguous.

Nonetheless, the fact that some deductions, exemptions, and tax credits clearly do constitute subsidies, combined with the lack of authoritative categorization of deductions, may contribute to the tendency to adopt a gross income baseline in conceptualizing deductions generally.

3. Choice of Baseline—False Equality of Those Not Similarly Situated

A tendency to focus on the expense and deduction, to neglect the associated income inclusion, and thus to improperly compare business and nonbusiness taxpayers, may further contribute to the characterization of deductions as subsidies. In a related attempt to distinguish penalties from nonsubsidies, Seth Kreimer suggested that one appropriate baseline is equality of treatment of those similarly situated.⁹⁷ Given this intuitive baseline, a business that is allowed a deduction that is not allowed to nonbusiness taxpayers appears to receive a subsidy. For example, in *Cammarano v. United States*, the Supreme Court addressed a taxpayer challenge to a Treasury regulation that disallowed deduction of certain lobbying and political advocacy expenses.⁹⁸ The taxpayer argued, inter alia, that disallowance of an otherwise ordinary and necessary business expense deduction for amounts expended on publicity to influence

96. See, e.g., Boris I. Bittker, *Accounting for Federal “Tax Subsidies” in the National Budget*, 22 NAT’L TAX J. 244, 254-55, 260 (1969).

97. See Kreimer, *supra* note 78, at 1363-71.

98. 358 U.S. 498, 499-500 (1959).

the voting public on a ballot measure crucial to its business was tantamount to a penalty for engaging in protected First Amendment activity.⁹⁹ The Court disagreed. Adopting a baseline of nondeduction of political advocacy expenditures by nonbusiness taxpayers, the Court stated that the Cammaranos were “simply being required to pay for [their political] activities entirely out of their own pockets, as everyone else engaging in similar activities is required to do under the ... Code,” and that the likely intent behind the regulation was that “everyone in the community should stand on the same footing ... so far as the Treasury of the United States is concerned” with respect to the purchase of “publicity [that] can influence the fate of legislation which will affect [it].”¹⁰⁰

Presumably, the Court’s idea was that because private citizens who might favor the referendum would not be entitled to deduct their lobbying expenses, equality demanded that the Cammaranos not be allowed to deduct their lobbying expenses either. A statute that leveled the playing field in this way would not penalize the Cammaranos, but would simply deny them a potential subsidy. This seems logical enough, but arguably the Cammaranos and ordinary citizens were *not* similarly situated absent the deduction. Any benefit that ordinary citizens received from lobbying in favor of the referendum, ranging from psychic benefits to lower prices, would not be taxed. The benefits to the Cammaranos—the profits of a continued franchise—would be taxed. If this is right, the Treasury regulation did not serve to level the playing field, and equality was not a logical basis for concluding that the Treasury regulation merely eliminated a taxpayer subsidy.¹⁰¹

99. *Id.* at 512-13.

100. *Id.* at 513.

101. In the simplest case, suppose that a referendum is proposed that would result in a zero-sum economic transfer from businesses to consumers and that the referendum would have no other effect. In this zero-sum case, absent taxes, businesses should be willing to spend up to a dollar to avoid a transfer of a dollar and consumers would be willing to spend up to a dollar to achieve a transfer of a dollar. Now suppose, as is true under current law, that the additional business profit of a dollar is subject to tax, but that business lobbying is not deductible. If businesses are taxed at a 35 percent marginal rate, they would only be willing to spend 65 cents pre-tax to avoid a transfer of a dollar, because the incremental dollar profit pre-tax would only produce 65 cents after-tax. Meanwhile, consumers would continue to be willing to spend a dollar to gain a dollar because their benefit—say, lower prices—would not be taxed. The playing field in this case is not level, but permitting a deduction for business

B. Rhetorical Framing

The tendency to conceive of deductions as subsidies may be reinforced by political rhetoric explicitly framing deductions as subsidies. It is well established that “individuals react to the purely formal way in which a question is presented or ‘framed.’”¹⁰² And one of the arguments to be developed in Part III is that the rhetoric of subsidy can be a powerful force in overcoming laissez-faire opposition to regulation and perhaps even in attracting votes for a judicial opinion imposing regulation.

Thus, it should come as no surprise that this type of rhetoric is frequently employed. In 1993, for example, President Clinton proposed the legislation that would ultimately become section 162(m), limiting the deductibility of non-performance-based pay granted to top corporate executives.¹⁰³ Part II.A argued that deduction of employee compensation lies within the unambiguous core of deductions that properly define net income and are not subsidies. Nonetheless, Clinton adopted subsidy rhetoric, arguing that “the Tax Code should no longer subsidize excessive pay of chief executives and other high executives.”¹⁰⁴

lobbying would restore equilibrium. If business lobbying is deductible, businesses again would be willing to match consumer spending on lobbying, because a dollar spent by businesses to save a dollar would result in matched after-tax cost and produce a benefit of 65 cents.

Of course, the playing field may not be level for other reasons. Consumer interests may face a greater collective action problem in organizing to lobby than businesses. But apparently the Court in *Cammarano* was not thinking of such possibilities when it spoke of a congressional goal that all “stand on the same footing ... so far as the Treasury of the United States is concerned.” *Id.*

Finally, note that the foregoing analysis does not rely on the existence of a matching stream of includable income in characterizing a business expense as a normatively appropriate adjustment to taxable income. In some cases, there may be no income associated with an expense that lies at the unambiguous core of deductions that properly define net income, but deduction remains normatively correct because the expenditure does not represent consumption or capital investment. Business casualty losses might be one example.

102. Edward J. McCaffery, *Cognitive Theory and Tax*, 41 UCLA L. REV. 1861, 1905-16 (1994) (suggesting several examples of the importance of framing in individuals’ responses to tax incentives, including a preference for excludable “fringe benefits” over programs requiring inclusion and deduction).

103. See Center on Executive Compensation, Position on Section 162(m), http://www.execcomp.org/positions/positions_sec162m.aspx (last visited Jan. 27, 2011).

104. Remarks to Business Leaders, 1 PUB. PAPERS 89 (Feb. 11, 1993).

Rhetorical framing is effective because it is plausible, even if not convincing. If one thought hard about it, one would realize that allowing a deduction for compensation does not represent a tax subsidy, but is a normatively appropriate adjustment in determining net income. But if one focuses solely on the deduction, it appears that the government is contributing to senior executive pay. And, of course, the government is, in a way, but the contribution is no more a subsidy than taxing profits is a penalty.

To be sure, opponents of an intervention of this sort may attempt to fight rhetoric with rhetoric, arguing that deductions such as these are not subsidies. Making such a nuanced argument in a sound-bite-driven media environment is an uphill battle, however, and it seems likely that subsidy rhetoric generally would prevail over nonsubsidy rebuttal.

Explicit subsidy rhetoric such as this may have two effects. First, as elaborated in Part III, it likely helps overcome opposition to a specific proposed intervention. Second, the accumulation of sound-bite subsidy rhetoric may reinforce the tendency of observers to associate deduction with subsidy and to adopt the subsidy baseline when thinking about deduction and disallowance.

C. Experimental Evidence on Mental and Rhetorical Framing

Experimental evidence supports the claims that observers view economically equivalent direct penalties and tax disallowances differently and that explicit subsidy rhetoric positively influences public acceptance of regulation. Members of the Boston University School of Law Class of 2010 received several different versions of a survey question gauging their reaction to regulation of executive pensions. Each version of the survey began with an identical paragraph describing the purported problem: growth of executive pensions far outpacing inflation.¹⁰⁵ One version of the survey went on to propose a direct penalty of 35 percent on excess executive pension payments, defined as payments in excess of \$1 million per year. Respondents were asked to rate on a scale of 1 to 10 the degree to which they would oppose or support this proposal, with a rating

105. See *infra* Appendix for the full text of these surveys.

of 10 equating to the strongest support. The support ratings for this proposal averaged 4.6.¹⁰⁶

A second version of the survey replaced the direct penalty proposal with a proposal to disallow corporate tax deductions for pension payments in excess of \$1 million per year, explaining that for “typical” firms, the effect would be a 35 percent increase in the effective cost of the excess payments. Thus, as structured, the direct penalty and the tax penalty had equivalent economic effect. The word “subsidy” was not used in this version. The only difference in the two versions was the structure of the disincentive. The disallowance-based proposal received an average support rating of 6.2.¹⁰⁷ The 1.6 percentage point difference in the mean level of support between these two versions was statistically significant.

These data suggest that structuring a disincentive as a disallowed deduction affects acceptance. The subjects did not equate economically equivalent interventions. Of course, the experiment does not establish that the reason for the difference in attitude was a difference in baseline or a tendency to equate deduction with subsidy.

A third version of the survey tested the impact of explicit subsidy rhetoric. This version maintained the deduction disallowance proposal, but unlike the second version which stated that the “change in law would increase the effective cost to [the company] of providing a \$3 million pension by \$700,000,” the subsidy-framed version stated that “[e]liminating the tax subsidy ... would save taxpayers about \$700,000.”¹⁰⁸ Framed as the elimination of a taxpayer subsidy, the third version of the proposal received an average support rating of 7.2.¹⁰⁹ Again, the differences in the mean level of support between this version of the survey and the other versions were statistically significant.

These data suggest that structuring an intervention as a tax disallowance and rhetorically framing the disallowance as the elimination of a subsidy may be powerful in shaping public opinion

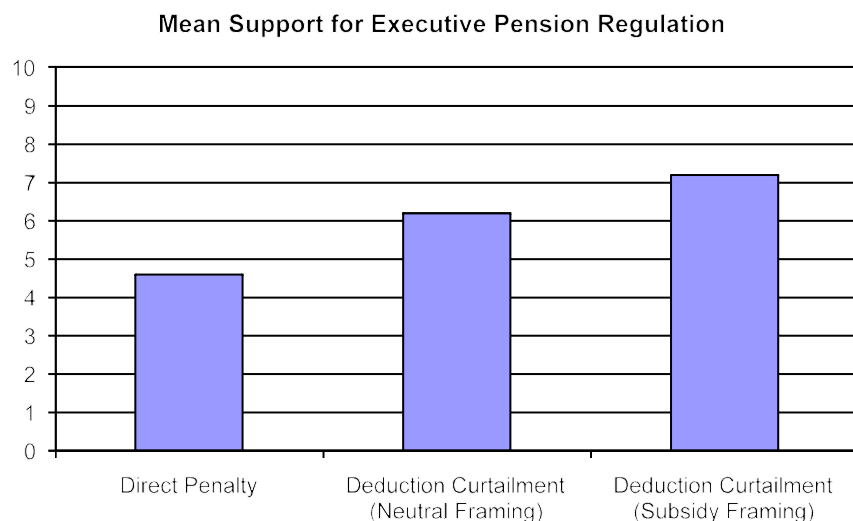
106. *See infra* Appendix (summarizing the statistics gathered from these surveys).

107. *See infra* Appendix.

108. *See infra* Appendix.

109. *See infra* Appendix.

in favor of the intervention. The mean support ratings for each version of the survey are portrayed in the following figure.



III. THE CONSEQUENCES OF FRAMING DEDUCTION AS SUBSIDY

Mental and rhetorical framing of deduction as subsidy has several important consequences. A court's choice of baseline may largely determine the outcome of a case. Explicit rhetorical framing of deduction as subsidy may yield sufficient votes to garner a majority on appeal or smooth reception. More concretely, subsidy framing may help explain judicial approval of the IRS's disallowance of a number of business deductions on public policy grounds. Mental and rhetorical framing may also have contributed to the codification by Congress of these and other public policy disallowances. Moreover, the regulatory illusion that flows from framing deduction as subsidy may help explain why a number of corporate governance provisions are found in the Code.

A. *Judicial Framing*

Judicial opinions routinely equate deduction with subsidy and adopt the corresponding baseline. These opinions certainly reflect framing. The difficulty lies in distinguishing between mental framing, in which the subconscious adoption of a baseline results in the characterization of a deduction as subsidy and thus contributes to a certain result, and rhetorical framing, in which the drafter decides on other grounds but adopts subsidy characterization as a purposeful rhetorical device in order to attract votes or to improve reception of the opinion. Either way, it is important to understand the role that deduction framing may be playing in tax cases.

1. *Tank Truck and Common Law Disallowance of Deductions on Public Policy Grounds*

Judicial disallowance of otherwise ordinary and necessary business expense deductions on public policy grounds goes back to the early days of the federal income tax. In *Commissioner v. Heininger*, the Supreme Court stated that the test for disallowance was whether allowing the deduction would “frustrate sharply defined national or state policies proscribing particular types of conduct.”¹¹⁰ Although the Court in *Heininger* held that deduction of legal fees incurred in an unsuccessful defense against charges of mail fraud was allowable, it provided several examples of situations in which courts had disallowed deductions on public policy grounds, including claimed deductions for fines or penalties incurred for violation of state or federal statute,¹¹¹ certain lobbying and political activities,¹¹² and bribery.¹¹³

Implicitly or explicitly, these disallowance cases adopt a gross income, pre-deduction baseline against which a deduction appears to subsidize the disfavored behavior and thus to frustrate public policy. For example, in an early case disallowing the deduction of unspecified penalties paid to the government by the Great Northern

110. 320 U.S. 467, 473 (1943).

111. *Id.* (citing, inter alia, *Great N. Ry. Co. v. Comm’r*, 40 F.2d 372 (1930)).

112. *Id.* (citing, inter alia, *Textile Mills Sec. Corp. v. Comm’r*, 314 U.S. 326 (1941)).

113. *Id.* at 473-74 (citing, inter alia, *Rugel v. Comm’r*, 127 F.2d 393 (1942)).

Railway, the Eighth Circuit Court of Appeals simply said that “[i]t cannot be that Congress intended the carrier should have any advantage, directly or indirectly, or any reduction, directly or indirectly, of these penalties.”¹¹⁴

Perhaps the most frequently cited example of common law disallowance of an otherwise ordinary and necessary business expense deduction is the Supreme Court’s 1958 opinion in *Tank Truck Rentals, Inc. v. Commissioner*.¹¹⁵ There, the taxpayer, an owner and operator of bulk liquid tankers, had paid fines for exceeding Pennsylvania’s maximum highway weight limit.¹¹⁶ As the Court explained, Pennsylvania restricted trucks to 45,000 pounds while the surrounding states allowed 60,000 pound cargos.¹¹⁷ Finding it “economically impossible” to do otherwise, trucking companies deliberately exceeded the Pennsylvania limitation, “in the hope, and at the calculated risk, of escaping the notice of the state and local police.”¹¹⁸

The IRS disallowed the deduction for the fines paid in Pennsylvania on public policy grounds, and the Tax Court agreed that allowing a deduction “would frustrate sharply defined state policy.”¹¹⁹ Before the Supreme Court, the taxpayer argued that the fines were equivalent to tolls for the use of the highways, and thus should be deductible.¹²⁰ The Court disagreed, finding it “clear” that the fines were punitive because they were assessed only when the offenders were apprehended.¹²¹ The Court went on to affirm the disallowance on public policy grounds. Although recognizing that Congress intended to tax net income as a general matter, the Court emphasized that an expense must be ordinary and necessary to be deductible under the Code and held that an expense is not “neces-

114. *Great N. Ry. Co.*, 40 F.2d at 373.

115. 356 U.S. 30 (1958).

116. *Id.* at 31-32.

117. *Id.* at 32.

118. *Id.* at 32-33.

119. *Id.* at 31.

120. *Id.* at 36.

121. *Id.* at 34. The Court did not explain why probabilistic assessment rendered the fines punitive measures instead of user fees. Elsewhere, the Court recited facts that suggested quite strongly that Pennsylvania’s system of load limits and enforcement worked as user fees; for example, the statute allowed for single-trip permit purchase by overweight truckers in lieu of removal of excess weight. *Id.* at 36.

sary” if deduction would thwart state policy.¹²² Writing for a unanimous Court, Justice Clark stated, “To allow the deduction sought here would but encourage continued violations of state law This could only tend to destroy the effectiveness of the State’s maximum weight laws.”¹²³

Although the word “subsidy” does not appear in the *Tank Truck* opinion, and the test is not overtly about subsidization, baselines and subsidy characterization lie at the root of the Court’s analysis in *Tank Truck*. The specific question before the Court was whether allowing the deduction would thwart state policy.¹²⁴ But to answer that question with confidence, the Court would have needed information on the Pennsylvania regulatory scheme that it lacked. If the fines were set by the Pennsylvania regulator under the assumption or expectation that they would not be deductible, deduction would have tended to thwart state policy. If expectations were that fines and penalties would be deductible as an ordinary business expense, deduction would not necessarily have thwarted state policy.

The *Tank Truck* opinion implicitly adopted the former baseline. Justice Clark stated that allowing these deductions would “encourage continued violations of state law” and “reduc[e] the ‘sting’ of the penalty,”¹²⁵ which is economically equivalent, but rhetorically distinct, from saying that denying the deduction would discourage violation or increase the sting of penalties. The baseline adopted by the Court suggests that the deductions were conceived of as subsidies, and, in fact, in an opinion issued three months later, Justice Clark cited *Tank Truck* as an example of the “accepted

122. *Id.* at 33.

123. *Id.* at 35. The technical basis for the disallowance was that in order to be deductible, a business expense must be ordinary and necessary, and that “[a] finding of ‘necessity’ cannot be made ... if allowance of the deduction would frustrate sharply defined national or state policies proscribing particular types of conduct, evidenced by some government declaration thereof.” *Id.* at 33-34. This statement is somewhat odd, however, given the Court’s definition of “necessary” in this context as meaning “appropriate and helpful” “for the development of ... business,” which is considered a very low hurdle for deduction. *See Welch v. Helvering*, 290 U.S. 111, 113 (1933). Paying fines for regulatory violations would seem to be necessary in the *Welch* sense, and logically it makes more sense to think of the public policy disallowances as exceptions to the general rule that ordinary and necessary expenses are deductible rather than as defining “necessary.”

124. *See supra* notes 119-22 and accompanying text.

125. *Tank Truck*, 356 U.S. at 35-36.

practice” of disallowing deductions to avoid “subsidizing” behavior contrary to public policy.¹²⁶

a. The (Missing) Analysis of Tank Truck

Like Justice Clark, we do not know the basis on which the Pennsylvania regulator established fines for overweight trucks or whether the regulator explicitly considered deductibility under the federal income tax. My guess would be that the regulator did not consider deductibility at all. Luckily, the intention of this Section is not to resolve whether allowing the deductions sought by the company would have undermined public policy, but to demonstrate that it is plausible that allowing these deductions would have been consistent with public policy. Once that is established, it becomes clear that the Court’s untested assumption that deduction equals subsidy mattered to the outcome of the case, assuming, of course, that one can take the Court’s opinion at face value. Subsequently, this Article will consider the possibility that *Tank Truck* reflects rhetorical framing instead of, or in addition to, subconscious mental framing. The analysis will focus on two models of sanctions that are embraced by economists: optimal deterrence and complete deterrence.

i. Optimal Deterrence Model

Suppose, contrary to the Court’s conclusion, that the Pennsylvania fines were imposed as user fees and were calibrated (very roughly, no doubt) to reflect the wear and tear and other costs resulting from overweight trucks.¹²⁷ Taxes aside, that schedule of fines would lead to full compensation for road damage, and it would also result in optimal deterrence, which is the regulatory objective under

126. *Speiser v. Randall*, 357 U.S. 513, 543 (1958) (Clark, J., dissenting).

127. The regulator would also factor enforcement into the level of the fine. If, in other words, experience suggested that one out of every ten overweight truck trips resulted in apprehension and a fine, the fine set would be ten times the fine that would be assessed if enforcement were perfect. Of course, the government actually chooses the amount of resources it devotes to enforcement and the corresponding probability of detection. This choice affects the optimal fine. *See infra* note 129.

this approach.¹²⁸ As in the case of tolls, the regulator seeks not to eliminate the behavior that results in a fine, but to cause shippers to internalize the social costs. Shippers whose marginal gain from violating the load limit exceeded the expected fine would overload their trucks; others would not.

How would taxes figure into this equation? First, assume that the regulator ignored taxes in determining the fines for overweight trucking. In this case, deductibility would be consistent with achieving the state's objectives. The costs resulting from overweight trucks would be fully recovered because deductibility at the federal level would not affect the state's receipts. Moreover, potential violators would be optimally deterred. Suppose, for example, that the regulator had determined that the average social cost of overloaded trucks was \$1 per pound of excess weight per trip, and set its fines accordingly.¹²⁹ Absent taxes, a shipper would overload and pay the expected \$1 per pound per trip fine if its gain from overloading exceeded \$1 per pound per trip. Assuming the shipper's profits were taxable, however, \$1 per pound per trip gain pre-tax would leave only 65 cents after tax at a 35 percent marginal rate. Obviously, this after-tax rate of gain would not justify the payment of the fine, unless the fine was deductible. If the fine was deductible,

128. Setting the expected fine equal to the cost imposed results in optimal deterrence only if the offender is risk neutral. See A. MITCHELL POLINSKY, *AN INTRODUCTION TO LAW AND ECONOMICS* 79-90 (3d ed. 2003). If the potential offender is risk averse and enforcement is less than perfect, this level of fine may result in over-deterrence. See *id.* For a potential offender like Tank Truck Rentals—a business entity and a repeat player—risk neutrality is a reasonable assumption.

129. If the expected rate of apprehension was one out of ten, the nominal fine would be set at ten dollars per pound of excess weight. Gary Becker demonstrated that when potential offenders are risk neutral, the total cost of law enforcement, including the social cost of offenses committed, enforcement costs, and punishment costs (for the state and the offender), can be reduced by increasing punishments and reducing enforcement. See Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 *J. POL. ECON.* 169, 183 (1968). An implication is that in some situations, a regulator might seek to impose very high punishments on offenders. If penalties were deductible and the regulator failed to realize that, it might set a lower penalty than it otherwise would. Nonetheless, as demonstrated here, any combination of penalty and enforcement level that optimally deters potential offenders on a pre-tax basis would continue to optimally deter if gains from the offense are includable and penalties are deductible.

the expected after-tax cost of 65 cents per pound per trip would maintain the equilibrium and optimal deterrence.¹³⁰

Of course, if the fines were calibrated to recover costs and the regulator had assumed that they would be deductible for federal income tax purposes, the analysis is exactly the same. Deductibility would be consistent with the state's objectives. Disallowing the deduction for fines paid in either of these cases results in overdeterrence. The state fully recovers its costs, but because the gain from overloading is taxed, denying the deduction for fines paid results in some truckers *not* overloading in cases in which the benefit exceeds the harm.¹³¹

If the objective of the Pennsylvania regulator was to recover the costs imposed by overloaded trucks and deter truckers from overloading inefficiently by forcing them to internalize the costs of highway damage, deductibility would have been consistent with the state's objectives, unless the regulator assumed that the fine would *not* be deductible and reduced the nominal fine to maintain optimal deterrence. This seems unlikely, because the reduced fine would not fully compensate the state for the road damage, but it is possible.¹³²

130. See George G. Tyler, *Disallowance of Deductions on Public Policy Grounds*, 20 TAX L. REV. 665, 667-68 (1965) (arguing that neutrality is achieved in some cases by permitting the deduction (quoting Frank M. Keesling, *Illegal Transactions and the Income Tax*, 5 UCLA L. REV. 26, 36-37 (1958))); Zolt, *supra* note 4, at 364-67 (showing that if an expected penalty is set equal to the harm caused, disallowance of the tax deduction results in overdeterrence).

In this particular situation, a rational taxpayer would compare the after-tax cost of overloading against the after-tax benefit, taking into account the expected penalty if apprehended. In other scenarios, the comparison might be between an expected penalty and the alternative cost of precaution. Assuming that the cost of precaution would be deductible, allowing a deduction for the penalty would result in optimal deterrence. See A. Mitchell Polinsky & Steven Shavell, *Punitive Damages: An Economic Analysis*, 111 HARV. L. REV. 869, 928-29 (1998) (arguing that punitive damages that are calibrated to optimally deter disfavored behavior should be deductible in a business context). Of course, some costs incurred in precaution may be capital expenditures that are effectively deducted over time. In such a case, immediate deduction of fines and penalties could result in a certain amount of underdeterrence.

131. Suppose that the social costs of overweight trucking average \$1 per pound per trip and that the expected penalty is set at \$1 per pound per trip. If the gain from overloading is taxable, but fines are not deductible, a rational and risk neutral business would not risk incurring the fine unless the benefit from overloading was at least \$1.54 per pound per trip (assuming a 35 percent marginal tax rate). Firms that valued overloading between \$1 and \$1.54 per pound per trip would be inefficiently deterred in this case.

132. Suppose that the social costs of overweight trucking average \$1 per pound per trip.

ii. Complete Deterrence Model

Of course, the Court in *Tank Truck* rejected the idea that the Pennsylvania fines were akin to tolls or user fees, finding instead that they were punitive.¹³³ Apparently, the Court viewed the Pennsylvania regulation as being aimed at complete deterrence instead of optimal deterrence, that is, aimed at barring overloading and punishing violators. That Court and a number of others have treated this distinction as if it were critical in determining the normatively appropriate tax treatment of fines and penalties, but it is not obvious that it is.¹³⁴ The fact that behavior is illegal does not necessarily mean that associated expenses are nondeductible.¹³⁵ So the question remains whether allowing a deduction for a punitive fine aimed at complete deterrence would undermine public policy.

The answer, again, depends on how the fine was set. One approach to complete deterrence is to set penalties sufficiently high so as to offset the private benefit that would follow from participating in the proscribed activity, hence deterring participation even if the benefits to the potential violator exceed the social costs. For example, Environmental Protection Agency (EPA) civil penalties are based initially on the benefits achieved by avoiding or delaying

If the gain from overloading is taxable, but fines are not deductible, the optimally deterring penalty at a 35 percent marginal tax rate would be 65 cents per pound per trip. At this expected fine level, a shipper who valued overloading in excess of \$1 per pound per trip would overload; others would not.

133. See *Tank Truck Rentals, Inc. v. Comm'r*, 356 U.S. 30, 34 (1958).

134. See Comment, *Business Expenses, Disallowance, and Public Policy: Some Problems of Sanctioning with the Internal Revenue Code*, 72 YALE L.J. 108, 120-21 (1962) [hereinafter *Business Expenses*] (summarizing cases). To be sure, the distinction is important today as a matter of positive law. Under the regulations implementing section 162(c), compensatory damages paid to the government are not considered nondeductible fines or penalties. See Treas. Reg. § 1.162-21(b)(2) (2010); see also *Mason & Dixon Lines, Inc. v. United States*, 708 F.2d 1043, 1048 (6th Cir. 1983) (holding that liquidated damages paid in addition to fines for truck overloading were deductible).

135. This point was settled at the time the modern income tax was enacted. A proposal to limit deductions to those incurred in lawful trade was rejected by the Senate Committee drafting the 1913 income tax law. As Senator John Sharp Williams argued on the floor, "[T]he object of this bill is to tax a man's net income It is not to reform men's moral characters The law does not care where he got it from, so far as the tax is concerned, although the law may very properly care in another way." 50 CONG. REC. 3849 (1913).

compliance.¹³⁶ Of course, a regulator could ensure compliance by creating draconian punishments for even minor offenses, but excessive punishments create their own costs, such as error costs.¹³⁷ They may deter actors from engaging in legal activities that might erroneously be judged to be illegal. Thus, the idea behind penalty schemes of this type is to deter disfavored behavior but to do so without applying excessive penalties that can create their own costs.

Given the reportedly common practice of truckers exceeding the Pennsylvania weight restrictions, it seems unlikely that the Pennsylvania regulator was seeking complete deterrence, but assume for the sake of argument that the approach described above had been adopted. It turns out that the appropriate tax treatment under this regime is the same as it was under an optimal deterrence regime.

The only case in which deductibility of penalties would undermine public policy in this scenario would be one in which the regulator, in calculating the benefit of overloading, and hence the penalty, reduced the pre-tax benefit by the tax rate.¹³⁸ If the regulator did not consider taxation in calculating the benefits of overloading, or if the regulator assumed that the penalty would be deductible and hence based the penalty on the pre-tax benefit, allowing a deduction for fines paid would be the neutral tax treatment, because both the pre-tax cost and benefit of overloading would be reduced by the tax rate.

* * *

The previous two examples of how fines and penalties are set are quite stylized. It seems unlikely that this degree of analysis and precision is typical of the process of setting fines and penalties. As a general matter, however, as long as fines are limited based on

136. Willfulness and other factors determining the gravity of violations are factored in as well. See EPA, POLICY ON CIVIL PENALTIES: EPA GENERAL ENFORCEMENT POLICY #GM-21, at 5 (1984), available at <http://www.epa.gov/compliance/resources/policies/civil/penalty/epapolicy-civilpenalties021684.pdf>.

137. See, e.g., Keith N. Hylton & Vikramaditya Khanna, *A Public Choice Theory of Criminal Procedure*, 15 SUP. CT. ECON. REV. 61, 63 (2007).

138. If, for example, the estimated pre-tax benefit of overloading was \$1 per pound per trip, and the regulator set the expected fine equal to the after-tax benefit of 65 cents per pound per trip, allowing a violator to deduct the 65 cents per pound per trip penalty would undermine the regulatory scheme.

error costs or similar considerations, and assuming that federal income tax considerations are ignored in setting fines, which seems likely, it appears that allowing the deduction of fines preserves on an after-tax basis the balance sought on a pre-tax basis.¹³⁹

To be sure, if the Pennsylvania regulator had determined that the appropriate penalty was \$X per pound per trip for overloading, and consciously decided that violators should bear this level of punishment on an after-tax basis, deductibility obviously would thwart state policy. But what would be the rationale for imposing punishment on an after-tax basis?

One might think the rationale would arise from notions of equality, consistency, or fairness.¹⁴⁰ It might be felt unfair that companies would be allowed to deduct as business expenses fines for overloaded trucks, whereas ordinary taxpayers would be unable to deduct their speeding tickets. But the unfairness or inconsistency at the surface may fall away once one considers the entire transaction or series of transactions and realizes that any profits from overloading are taxed in the former case, but the benefits of speeding outside of a business context generally are not.

Finally, even if deductibility does not produce actual inequality, it may create an appearance of inequality, and that appearance may undermine norms encouraging voluntary compliance with traffic and other regulations. In this way, allowing businesses to deduct fines and penalties might undermine public policy, but there is no indication in the *Tank Truck* opinion that the Court had anything like this in mind.

139. As a final example, suppose that the Pennsylvania regulator sought complete deterrence but realized that if the fine for overloading was set too high, truckers would wastefully underload to avoid the risk of wrongful assessment, perhaps due to a risk of inaccurate scales. In this scenario, the regulator balances the risk and social costs imposed by the offenders most difficult to deter against the social cost of general underloading and arrives at some compromise fine. Assuming that the regulator's assessments were made ignoring federal income tax consequences, once taxes are taken into account the balance is preserved by allowing deduction for the fines.

140. For example, the EPA civil penalty guidelines stress that in addition to offsetting the benefits achieved by noncompliance, penalty programs should produce "fair and equitable treatment of the regulated community," displaying "both consistency and flexibility." EPA, *supra* note 136, at 4.

b. The Impact of Baseline Selection in Tank Truck

As the previous Section demonstrates, it is not obvious that allowing a deduction for overweight truck fines would have undermined Pennsylvania policy even if one accepts the Court's interpretation that these fines were punitive. As a result, if one takes the Court's opinion at face value, mental framing of deduction as subsidy was a critical factor in the outcome.

Why is this the case? First consider Justice Clark's emphatic assertion in the opinion that the fines paid were not tolls but were punitive assessments.¹⁴¹ It was necessary to make this distinction because highway tolls were clearly deductible as ordinary and necessary expenses.¹⁴² If the Court had been persuaded that the fines were essentially tolls, deductibility would have been all but assured.

It is important to understand that the different tax treatment of tolls and fines within the Court's framework is not the result of a view that the deduction for tolls does not represent a subsidy. Given the baseline adopted in *Tank Truck*, all deductions are subsidies.¹⁴³ Companies are allowed the subsidy of a deduction for tolls and similar expenses, however, because these deductions do not violate public policy.¹⁴⁴

In my view, the thought process in *Tank Truck* and similar cases reflects the following faulty syllogism: (1) deduction equals subsidy; (2) subsidization of disfavored activity undermines public policy; and therefore, (3) deduction undermines public policy. The syllogism is faulty because the initial premise is questionable at best. Not all deductions constitute subsidies, and deductions for fines and penalties paid, in particular, may be normatively appropriate adjustments in determining net income. If the Court had conceptualized the underlying deduction not as a subsidy, but as a normal adjustment to income, or had recognized the potential ambiguity, it

141. *Tank Truck Rentals, Inc. v. Comm'r*, 356 U.S. 30, 34, 36 (1958).

142. I.R.C. § 162(a) (2006).

143. Again, the *Tank Truck* opinion did not use the word "subsidy," but it adopted a pre-deduction baseline that would presumably apply equally to tolls and fines. *See Tank Truck*, 356 U.S. at 34, 36.

144. *See id.* at 33-34.

would not have been so obvious that allowing the deduction would have undermined Pennsylvania policy. At the least, it would seem that the Court would have had to consider the underlying basis for the penalty as sketched out above.

2. *Nonsubsidy Framing in Sullivan*

It is instructive to compare the framing in *Tank Truck* with that in *Commissioner v. Sullivan*, an opinion issued on the same day, in which the Court refused to disallow deductions for certain business expenses of an illegal bookmaker.¹⁴⁵ In contrast to the pre-deduction baseline adopted in *Tank Truck*, the *Sullivan* opinion adopted a net income baseline, a difference that may help explain the oft-noted inconsistency in the results.

The specific question in *Sullivan* was whether an illegal bookmaking business could deduct expenses for wages and rental payments.¹⁴⁶ Significantly, the payment of rent for bookmaking operations was also illegal under state law.¹⁴⁷ A unanimous Court held the payments deductible.¹⁴⁸ Writing for the Court, Justice Douglas noted that wages and rental payments were ordinary and necessary expenses.¹⁴⁹ He argued that Treasury regulations specifying that the federal excise tax on gambling was deductible suggested that rent and wages should be deductible as well.¹⁵⁰ The Court held that, given these circumstances, it was up to Congress to make the decision to disallow these deductions and impose tax on the basis of gross income.¹⁵¹ Judicial disallowance of the deductions sought for fines and penalties in *Tank Truck* was distinguishable, according to Justice Douglas, because “allowance [would be] a device to avoid the consequence of violations of a law.”¹⁵²

145. 356 U.S. 27, 29 (1958).

146. *Id.* at 27.

147. *Id.* at 28.

148. *Id.* at 28-29.

149. *Id.*

150. *Id.* at 28-29.

151. *Id.* at 29.

152. *Id.*

Commentators have had difficulty squaring *Tank Truck* and *Sullivan*.¹⁵³ First, the Court in *Tank Truck* held that a finding of “necessity” supporting an ordinary and necessary deduction could not be made if allowance would frustrate sharply defined state policy and that “frustration of state policy is most complete and direct when the expenditure for which deduction is sought is itself prohibited by statute.”¹⁵⁴ In *Sullivan*, the Court did not explain why expenses for rent remained “necessary” when made in express violation of state law.¹⁵⁵ Second, the existence of a Treasury regulation supporting deduction of federal excise taxes on gambling seemed to have no bearing on the question whether deduction of illegal rental payments would frustrate *state* policy.¹⁵⁶ Third, although allowance of a deduction for fines and penalties would mitigate the consequences of a violation of law, and is distinguishable from allowance of deductions for rent and wages, the latter are analogous to other deductions that had previously been disallowed as violating public policy, such as for amounts expended in lobbying and bribery. And yet there was nothing in the Court’s opinion to indicate that these holdings were overruled or to explain why the distinction mattered.¹⁵⁷

So what does account for the inconsistent outcomes of these two cases? Bernard Wolfman has suggested that “Douglas did not devote as much attention to tax cases in this period as he had previously”¹⁵⁸ and that read in light of *Tank Truck*, Justice Douglas’s *Sullivan* opinion “simply fails to illuminate the crucial issues.”¹⁵⁹ On the

153. See, e.g., Bernard Wolfman et al., *The Behavior of Justice Douglas in Federal Tax Cases*, 122 U. PA. L. REV. 235, 260-62 (1973); *Business Expenses*, supra note 134, at 126, 137-41; see also James W. Colliton, *The Tax Treatment of Criminal and Disapproved Payments*, 9 VA. TAX REV. 273, 275-76 (1989); Cathryn V. Deal, *Reining in the Unruly Horse: The Public Policy Test for Disallowing Tax Deductions*, 9 VT. L. REV. 11, 31 (1984); Jacob L. Todres, *Internal Revenue Code Section 162(f): An Analysis and Its Application to Restitution Payments and Environmental Fines*, 99 DICK. L. REV. 645, 655-56, 660-61 (1995).

154. *Tank Truck Rentals, Inc. v. Comm’r*, 356 U.S. 30, 35 (1958).

155. See Wolfman et al., supra note 153, at 262; *Business Expenses*, supra note 134, at 138.

156. See Wolfman et al., supra note 153, at 262; *Business Expenses*, supra note 134, at 139.

157. See *Business Expenses*, supra note 134, at 138-39.

158. Wolfman et al., supra note 153, at 260.

159. *Id.* at 261.

other hand, the judgments in both *Tank Truck* and *Sullivan* were unanimous.¹⁶⁰

A striking difference between *Tank Truck* and *Sullivan* lies in the choice of baseline and the framing of the opinions, which are 180 degrees apart. In *Tank Truck*, Justice Clark's selection of a pre-deduction baseline caused deduction of fines to look like a subsidy for bad behavior, reducing the "sting" of the penalties. Justice Douglas's baseline in *Sullivan* was allowance of "the normal deductions of ... rent and wages."¹⁶¹ Justice Douglas emphasized that the disallowance in *Sullivan* "would come close to making this type of business taxable on the basis of its gross receipts, while all other business would be taxable on the basis of net income."¹⁶² Instead of comparing business and nonbusiness taxpayers, which is typical in public policy disallowance cases, Justice Douglas compared a group of taxpayers engaged in legal business with a group involved in illegal business. This approach is not surprising. The IRS's position in *Sullivan* was that a subset of business taxpayers should be denied certain deductions on public policy grounds, whereas its position in *Cammarano* was that no taxpayer should be allowed a deduction for lobbying or political activities.¹⁶³ Nonetheless, emphasis in *Sullivan* on the norm of deduction of rent and wages for the typical business highlights the nonsubsidy nature of these deductions. Given this baseline, disallowance looks like a penalty, and perhaps helps explain the conclusion that if this choice is to be made, "Congress should do it."¹⁶⁴

3. Rhetorical Versus Mental Framing in Case Law

It is impossible to determine the extent to which subconscious framing of deductions as subsidies or nonsubsidies contributed to the results in *Tank Truck* and *Sullivan*. Another possibility is that

160. See *supra* notes 123, 148 and accompanying text.

161. *Comm'r v. Sullivan*, 356 U.S. 27, 29 (1958).

162. *Id.*

163. *Cammarano v. United States*, 358 U.S. 498, 507-08 (1959). In this respect, the situation in *Sullivan* was analogous to that of *Commissioner v. Heininger*, 320 U.S. 467 (1943), in which the Court refused to disallow deduction for legal fees in unsuccessful defense.

164. *Sullivan*, 356 U.S. at 29.

other factors decided the vote of one or more of the Justices and that the framing of the opinions was selected ex post as a rhetorical device. It is well established that judges care about the reception of their opinions by the public and the other political branches, and appellate judges sitting on panels would certainly care about achieving a majority or perhaps unanimity.¹⁶⁵ Thus, a judge might understand that the subsidy question is nuanced or even that the subsidy label is inapposite, but still adopt explicit subsidy framing in an attempt to court votes or soften reception.

So, although the differing choice of baseline in *Tank Truck* and *Sullivan* may have influenced the disparate outcomes, the Court might have adopted the baselines ex post to help rationalize the conflicting outcomes. Perhaps the conflicting outcomes actually reflected a view that deductions for wages and rental payments lay nearer to the core of adjustments needed to properly determine net income than did deductions for fines and penalties, and thus greater deference to Congress was warranted in the former case. Or perhaps the difference reflected a view that disallowance of a particular set of deductions to all business taxpayers was less objectionable and more appropriately the subject of administrative or judicial action than disallowance for a subset of taxpayers, even if that subset consisted of illegal businesses. One cannot know.

Given the fact that the word “subsidy” does not appear in the *Tank Truck* opinion, it seems likely that subconscious mental framing had more to do with the outcome there than conscious rhetorical framing. The same cannot be said for the 1983 majority opinion in *Regan v. Taxation with Representation of Washington*, in which the Supreme Court upheld restrictions against substantial lobbying by tax-exempt, nonprofit organizations eligible to receive tax deductible contributions against First and Fifth Amendment challenges.¹⁶⁶ In that opinion, Justice Rehnquist explicitly equated

165. See generally LEE EPSTEIN & JACK KNIGHT, *THE CHOICES JUSTICES MAKE* (1998) (explaining that Justices concerned with legitimacy, compliance, and a potential legislative override would consider preferences of the public and other political branches and providing evidence that Justices make substantive sacrifices to gain majority support); Kevin T. McGuire & James A. Stimson, *The Least Dangerous Branch Revisited: New Evidence on Supreme Court Responsiveness to Public Preferences*, 66 J. POL. 1018, 1019 (2004) (providing evidence that Justices are highly responsive to public opinion).

166. 461 U.S. 540, 542, 551 (1983).

tax deductions and exemptions to cash grants, stating that both “are a form of subsidy that is administered through the tax system.”¹⁶⁷

This is certainly an overbroad statement. Only by adopting a gross income baseline would all deductions constitute subsidies without exception. And the overbroad generalization was accompanied by particularly intense subsidy rhetoric. Justice Rehnquist used the term “subsidy,” or a variation thereof, twenty-five times in seven pages of analysis.¹⁶⁸

The substantive questions raised in the *Taxation with Representation* case fall within the Supreme Court’s notoriously difficult “unconstitutional conditions” jurisprudence,¹⁶⁹ and this Article will not attempt to analyze them. The gist of Justice Rehnquist’s argument, however, was that restrictions on lobbying by public charities did not infringe on First Amendment rights because Congress had simply chosen not to subsidize their lobbying with taxpayer funds.¹⁷⁰ Given the slipperiness of the doctrine in this area, strong rhetorical framing of the deductions and exemptions at issue as subsidies quite possibly could have contributed to the production of a unanimous decision in the case.¹⁷¹

B. Political Framing

As in the case of common law disallowance, codification of various “public policy” exceptions to the deductibility of otherwise ordinary and necessary business expenses may reflect mental framing—an unexamined baseline assumption on the part of legislators that permitting a deduction for penalties, antitrust treble damages, government settlements, and the like, subsidizes the underlying disfavored activity. But legislators have an additional incentive to favor disallowance of these deductions. Even if a legislator believed that allowing a deduction was the neutral tax response, the ap-

167. *Id.* at 544.

168. *Id.* at 544-50.

169. *See, e.g.*, Kathleen M. Sullivan, *Unconstitutional Conditions*, 102 HARV. L. REV. 1413, 1415-16 (1989) (“[R]ecent Supreme Court decisions on challenges to unconstitutional conditions seem a minefield to be traversed gingerly.”).

170. *Taxation with Representation*, 461 U.S. at 546.

171. The only separate opinion was a concurrence filed by Justice Blackmun that was joined by Justices Brennan and Marshall. *Id.* at 551.

pearance of subsidy and the attendant public outrage might encourage her to support disallowance nonetheless. As a result, one might expect Congress to be more energetic than the courts in reacting to apparent tax subsidies and disallowing various deductions as a matter of “public policy.”

In addition, when a business deduction or exemption is associated with a disfavored activity, politicians may choose to structure regulation as a disallowance rather than as a direct mandate or some other nontax disincentive in order to take advantage of the appearance of subsidy. This structural choice may disarm laissez-faire opposition to—and improve public reception of—government intervention that might appear to be punitive if introduced outside of the tax code. Reception can be further improved by explicitly framing the underlying deduction in subsidy terms. These framing effects may help explain why corporate governance and similar nontax regulation is sometimes incorporated in the Code.

1. Mental Framing and Codification of Public Policy Disallowances

In 1969, Congress codified a number of the “public policy” exceptions to the generally permissive “ordinary and necessary” business expense deduction standard.¹⁷² These provisions include section 162(c), which disallows deductions for illegal bribes, kickbacks, and other illegal payments,¹⁷³ section 162(f), which disallows deductions for “fine[s] or similar penal[t]ies paid to a government for the violation of any law,”¹⁷⁴ and section 162(g), which disallows deductions for two-thirds of antitrust treble damages payments when associated with a criminal conviction.¹⁷⁵ Section 162(e), which disallows deductions for certain lobbying expenses, was enacted in 1962.¹⁷⁶ Subsequently, Congress has enacted other disallowance

172. Tax Reform Act of 1969, Pub. L. No. 91-172, § 902(b), 83 Stat. 487, 710-11.

173. I.R.C. § 162(c) (2006).

174. *Id.* § 162(f).

175. *Id.* § 162(g). Unlike deductions for bribes, fines, and penalties, deductions for antitrust treble damages had not been disallowed by the courts prior to the enactment of section 162(g). See Rev. Rul. 64-224, 1964-2 C.B. 52 (permitting full deduction of antitrust treble damage awards).

176. Section 162(e) was amended in 1993 to further curtail deductions for lobbying and

provisions that might constitute reaction to an appearance of subsidy, including section 280E, which disallows deduction of certain expenses incurred in illegal drug trafficking,¹⁷⁷ and section 162(m), which limits the deductibility of senior executive compensation that is not performance-based.¹⁷⁸

To some extent, the codified public policy disallowances probably reflect the same inclination to equate deduction with subsidy that led the courts to disallow some of these deductions. The only analysis in the Senate Report that recommended enactment of the rules that would become sections 162(c), 162(f), and 162(g) addressed antitrust treble damage payments and stated that the issue was whether the impact of the penalties “should be reduced by permitting them to reduce taxes which otherwise would have to be paid.”¹⁷⁹ That is a fair description of the issue, but the implication of the statement was that such a reduction would be bad policy. That implication was made clear in the contrast drawn in the Senate Report between antitrust policy and tax policy. Tax policy, the report stated, disfavors deviations “from the concept of a tax imposed on actual net business income.”¹⁸⁰

However, given the fact that profits from anticompetitive behavior would be taxed, it is not obvious that antitrust penalties

political advocacy. Under the current rule, lobbying of state and federal legislative and executive officials is generally nondeductible as are amounts expended in attempting to influence the public with regard to political matters. See I.R.C. § 162(e).

177. *Id.* § 280E.

178. *Id.* § 162(m). In my view, section 162(m) is better thought of as a proactive use of subsidy framing than as a reaction to an appearance of subsidy and, thus, this section will be addressed more thoroughly in Part III.B.2.

179. S. REP. NO. 91-552, at 261 (1969), *reprinted in* 1969 U.S.C.C.A.N. 2027, 2311. As another possible example of subsidy confusion, consider the legislative history behind section 280E, which disallows deductions or credits for expenses arising in connection with trafficking in controlled substances. As stated in Senate Report 494, “To allow drug dealers the benefit of business expense deductions at the same time that the U.S. and its citizens are losing billions of dollars per year to such persons is not compelled by the fact that such deductions are allowed to other, legal, enterprises.” S. REP. NO. 97-494, pt. 1, at 309 (1982), *reprinted in* 1982 U.S.C.C.A.N. 781, 1050. If these deductions constitute benefits, all deductions must constitute benefits. Of course, the drafters of this report may not have actually believed that the allowance of ordinary business deductions subsidized illegal drug trafficking. Instead, they may have adopted this rhetorical approach in order to appeal to the public or to other legislators.

180. S. REP. NO. 91-552, at 261.

should be nondeductible even as a matter of antitrust policy. The analysis is similar to and perhaps clearer than the analysis of fines and penalties outlined in Part III.A.1. Deduction would be inconsistent with antitrust policy only if the drafters of the treble damages provision based the penalty on nondeductibility. But in 1890, when the treble damages provision was adopted, there was no corporate income tax. Presumably the drafters of the provision selected treble damages (versus double or quadruple damages) as the appropriate penalty on a no-tax basis after considering deterrence, compensation, error costs, and similar factors. The balance between effective penalty and effective gain from anticompetitive behavior would have been maintained with the introduction and ramp-up of the income tax in the first half of the twentieth century. In 1969, however, the effect of disallowing deductions for two-thirds of antitrust damage payments was to disrupt this symmetry and increase the effective level of deterrence relative to that put in place by the drafters of the Sherman and Clayton Acts.¹⁸¹

Nonetheless, the legislative history suggests that the drafters of section 162(g) adopted a pre-deduction baseline that effectively

181. The antitrust treble damages provision was first enacted in 1890 as section 7 of the Sherman Act, ch. 647, 26 Stat. 209 (1890), and reenacted in 1914 within section 4 of the Clayton Act, ch. 323, 38 Stat. 731 (1914). The Civil War era income tax expired in 1872. A national income tax was reintroduced in 1913 following the ratification of the Sixteenth Amendment, but between 1913 and 1915, corporate income was taxed at a rate of only 1 percent. See THOMAS L. HUNGERFORD, CONG. RESEARCH SERV., TAX EXPENDITURES AND THE FEDERAL BUDGET 8 n.17 (2008); JACK TAYLOR, INTERNAL REVENUE SERV., STATISTICS OF INCOME BULLETIN: CORPORATION INCOME TAX BRACKETS AND RATES, 1909-2002 at 287 (2003).

To be clear, the effective level of deterrence increased following the introduction of I.R.C. section 162(g) because the financial gain from violations was taxable both before and after 1969, whereas the entire trebled penalty was deductible before and only one-third remained deductible after. Of course, it is possible that public policy is better served under the current tax law. The effect of section 162(g) is to “decouple” damage payments (two-thirds nondeductible) from damage receipts (fully taxable). As a result, the effective cost to violators exceeds the effective gain of successful plaintiffs assuming each is taxable at the highest corporate rate. If, prior to the adoption of section 162(g), deterrence of potential violators was inadequate, but incentives to sue were adequate, disallowing the deduction was a move in the right direction. There is no indication in the legislative history, however, that the proposal to enact section 162(g) developed from this sort of calculus. Moreover, as Mitchell Polinsky has argued, although there is a sound case for decoupling antitrust damage payments and receipts, the optimal system may involve plaintiffs receiving more after-tax than violators pay. See A. Mitchell Polinsky, *Detrebling versus Decoupling Antitrust Damages: Lessons from the Theory of Enforcement*, 74 GEO. L.J. 1231, 1231-32 (1986).

categorized the existing deduction of treble damages as a subsidy.¹⁸² As we have seen, “subsidization” of illegal behavior appears contrary to public policy. Absent a more thorough analysis of the situation, the subsidy characterization may well have led to the disallowance.

It is likely that appearance of subsidy also lies behind an ongoing debate regarding the deductibility of corporate settlements with the Securities and Exchange Commission (SEC) and other regulators. Under current law, the disallowance of deductions for fines and penalties extends to amounts paid to settle “actual or potential liability for a fine or penalty.”¹⁸³ However, many settlements remain deductible under this formulation, including settlements that involve no admission of guilt or that are made early in the process to forestall further investigation.¹⁸⁴ The Government Settlement Transparency Act, introduced in 2003, would have broadened the disallowance of deductions for settlements, but this legislation was not enacted,¹⁸⁵ and some members of Congress remain dissatisfied with the status quo. For example, in 2006, Senators Chuck Grassley, John McCain, and John Warner wrote a letter to the Justice Department protesting a government settlement with Boeing that did not specify the tax treatment of the deal. Deductibility, the senators argued, would result in “leaving the American taxpayer to effectively subsidize [the] misconduct.”¹⁸⁶

182. See S. REP. NO. 91-552, at 262. One can only speculate as to why that baseline was selected. Most likely, the drafters simply analogized the “punitive” two-thirds portion of treble damages to fines and penalties, which the courts had long held nondeductible on public policy grounds. Perhaps if the drafters of section 162(g) had considered the entire transaction and the fact that added profits from anticompetitive behavior would be taxed, they might have reached a different conclusion. But if they focused solely on the payment of damages, the deduction would have produced an appearance of subsidy.

183. Treas. Reg. § 1.162-21(b)(1)(iii) (as amended in 1975).

184. See Press Release, Sen. Chuck Grassley, Grassley, Baucus Introduce Bill To Toughen Corporate Settlements (Apr. 28, 2003), available at <http://grassley.senate.gov/releases/2003/p03r04-28.htm> [hereinafter Grassley Press Release]. For examples of settlements, see cases discussed in Robert W. Wood, *Cleaning Up: Tax Deductions for Restitution, Fines, and Penalties*, TAX NOTES, Jan. 26, 2009, at 490.

185. S. 936, 108th Cong. (2003); see Grassley Press Release, *supra* note 184 (explaining that the proposed legislation would reach settlement amounts that are deductible under current law).

186. Leslie Wayne, *3 Senators Protest Possible Tax Deduction for Boeing in Settling U.S. Case*, N.Y. TIMES, July 7, 2006, at C3.

Of course, the analysis of the neutral tax treatment of settlements reached with respect to alleged violation of law is the same as that of fines and penalties incurred for violation, and I will not repeat it here.¹⁸⁷ The bottom line is that as long as gains from the disfavored activity are included in taxable income, it is not at all clear that deduction of settlements in lieu of fines or penalties would undermine public policy or constitute a subsidy. Taken in isolation, however, these deductions create an appearance of subsidy, which likely contributes to legislation such as the Government Settlement Transparency Act.

2. Subsidy Appearance and Response to Public Outrage

The public policy disallowance provisions, particularly the more recently enacted or proposed provisions, including the above mentioned Government Settlement Transparency Act, may have been put forward partly in response to an appearance of subsidizing illegal or otherwise undesirable activity and the attendant public outrage that would follow if fines, penalties, settlements, and the like were deductible as ordinary and necessary business expenses. Imagine that every time a business paid a large fine it was reported that 35 percent of that fine would be “subsidized” by the federal government through a tax deduction. Voters, not understanding that deductibility might very well be the neutral response, would be outraged. And this is not merely a speculative conjecture. Public outcry was considerable when it was learned that Exxon would be permitted to deduct the \$1.1 billion settlement it reached with state and federal government relating to the Exxon Valdez oil spill.¹⁸⁸ It is not surprising that a legislative response to such outrage ultimately was offered.

To the extent that disallowance provisions are enacted for the purpose of appealing to, and perhaps placating, outraged voters,

187. See *supra* Part III.A.1.

188. See, e.g., William P. Coughlin, *Exxon Reportedly Gets Years To Pay Damages*, BOSTON GLOBE, Feb. 14, 1991 (reporting comments of an Alaskan environmental lawyer that “[i]f it is true that they can write this off, it is a total outrage”); John D. McKinnon, *Wages of Corporate Sin: Tax Breaks—Companies Facing Claims for Sleazy Behavior Could Get Windfall from the IRS*, WALL ST. J., Sept. 3, 2002, at A4.

rather than for the purpose of actually influencing the behavior of those regulated, these provisions should be understood as symbolic legislation. As political scientist Murray Edelman described, the mass of uninformed voters may be satisfied with rhetoric and regulation that on its face appears to address public concerns—satisfied, in other words, with political symbols—even if tangible resource allocation remains unaffected.¹⁸⁹ Edelman highlighted the use of symbolic legislation to reassure voters feeling threatened by powerful economic forces.¹⁹⁰ Eliminating “subsidies” for fines and penalties and lobbying expenses incurred by business interests would appeal to exactly those concerns. Note that this is still a story about subconscious mental framing of deduction as subsidy, but the response is driven by framing on the part of constituents rather than politicians. Even a politician who believes that deductibility of settlements is the neutral tax response might be inclined to support disallowance to curry favor with voters.

An appearance of subsidy and the risk of voter outrage, which are addressed by disallowance provisions such as sections 162(c), 162(f), and 162(g), exist only as long as section 162 exists. The appearance of subsidy is essentially an unintended consequence of raising revenue through a tax on net business income. If the corporate income

189. See MURRAY EDELMAN, *THE SYMBOLIC USES OF POLITICS* 22-27 (1964). Legislation is generally viewed as serving direct instrumental purposes or fulfilling a symbolic or expressive function. See Mark Tushnet & Larry Yackle, *Symbolic Statutes and Real Laws: The Pathologies of the Antiterrorism and Effective Death Penalty Act and the Prison Litigation Reform Act*, 47 DUKE L.J. 1, 74-76 (1997). Unlike symbolic legislation, which is not directed at the behavior of the regulated party, expressive legislation is meant to adjust behavior by establishing or reinforcing social norms to which the regulated party responds. See *id.* at 75; see also Michael S. Kirsch, *Alternative Sanctions and the Federal Tax Law: Symbols, Shaming, and Social Norm Management as a Substitute for Effective Tax Policy*, 89 IOWA L. REV. 863, 913-16 (2004) (evaluating alternative sanctions applied to tax avoiders under this framework). It is conceivable that provisions such as sections 162(c) and 162(f) serve an expressive function, but it seems more likely that these provisions are largely symbolic. See also 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, 8-10 (1990) (discussing symbolic aspects of 1980s tax legislation and the effects).

Of course, provisions such as section 162(f) have an effect on resource allocation. Compared with a regime in which fines and penalties were fully deductible, section 162(f) increases funds available to the fisc for redistribution and influences decision making by some potential offenders. In my view, however, the primary purpose of these provisions, however has less to do with resource allocation than with overcoming an appearance of subsidy.

190. See EDELMAN, *supra* note 189, at 37.

tax were replaced by a national sales tax, for example, the problem would vanish. It is obvious that, but for the income tax, the courts never would have been asked to consider whether deductions for fines or lobbying activities were ordinary and necessary. But more importantly, to the extent that these public policy disallowances were reactions to an appearance of subsidy, Congress would have no incentive, in the absence of an income-based tax scheme, to enact nontax economic disincentives aimed at, for example, lobbying or behavior illegal under state law.

Under this view, these disallowances do not reflect an attitude in Congress that punishments of offenders are insufficient and need a federal tax “kicker” or that further economic disincentives need to be placed in front of lobbyists.¹⁹¹ Thus, we would not expect Congress to replace these disallowances even though their elimination as part of a broader elimination of the income tax would reduce the deterrence of businesses engaged in these activities.

3. Mental and Rhetorical Framing and the Choice To Structure Regulation as Tax Disallowance

In my view, when Congress codified the public policy disallowances directed at the payment of fines and penalties, bribes, and antitrust treble damages, it was essentially responding to a *tax* problem—an appearance of subsidy inherent in a tax scheme based on net income. There would have been no thought of looking outside the tax code for a response to this problem. The limitations on deductions for nonperformance-based senior executive pay, for excessive “golden parachute” payments, and, as proposed, for stock option compensation that is not expensed for financial reporting purposes, are different. These limitations respond to nontax concerns. The responses easily could have been structured as mandates (pay no more than \$1 million per year in salary, limit golden parachutes to three times average compensation, expense stock options) or as economically equivalent tax-like penalties adminis-

191. *But see infra* note 195 and accompanying text (suggesting an alternative view under which the public policy disallowances were enacted to increase disincentives).

tered outside of the tax code.¹⁹² In fact, before proposing to disallow deductions for stock option compensation not recognized as an expense for accounting purposes, Senator Carl Levin had introduced a bill in the Senate that would have directed the SEC to mandate stock-option expensing.¹⁹³

From an economic perspective, there is no real difference between a disallowed deduction and a direct penalty.¹⁹⁴ So why would Congress opt for the former? Of course, many considerations would come into play, but the primary argument of this Section is that structuring a disincentive as a disallowed deduction and rhetorically framing the disallowance as the elimination or curtailment of a taxpayer subsidy reduces the appearance of regulatory intervention, thereby disarming laissez-faire opposition and increasing public support generally. This illusion of minimal regulatory intervention helps explain the choice to structure intervention as disallowance in cases in which a preexisting deduction or exemption is associated with a regulatory objective.

Although this Article has argued that the codification of the public policy disallowances was largely a reaction to an appearance of subsidy, it is possible that regulatory illusion also played a role. Suppose a legislator in the mid-1960s believed that the deterrence offered by the antitrust treble damages provision of the Clayton Act was inadequate. The legislator might have proposed an increase in damages to, say, four times the loss, but he also might have recognized that it would be easier to convince his colleagues in Congress that the deduction for treble damages allowed by the courts was an inappropriate subsidy. More generally, a view that penalties imposed on businesses for misbehavior tend to be low and that disallowance of deductions is a more palatable alternative than increased nontax disincentives might help explain the push to render government settlements nondeductible—and perhaps some other “traditional” public policy disallowances as well.

However, I believe that the most compelling case for the power of structuring and rhetorically framing regulation as tax disallowance,

192. *See also* I.R.C. § 162(k) (2006) (disallowing deductions related to greenmail payments).

193. Corporate Executives' Stock Option Accountability Act, S. 259, 103d Cong. (1993).

194. *See supra* note 76 and accompanying text.

and for an explanatory relationship between regulatory illusion and regulatory structure, can be made in the context of corporate governance and similar regulations that appear in the Code.¹⁹⁵ Regulation of this nature is the focus of this Section.

a. Regulatory Options and Considerations

In exploring the effect of mental and rhetorical framing on the structure of legislation, it may be helpful to consider the hypothetical problem that formed the basis of the student survey discussed in Part II.C. Suppose an influential senator decided to propose legislation regulating executive pensions. The senator might consider proposing a ban on executive pensions, a cap on pension payments, an SEC-imposed penalty on excessive pension payments, or a limitation on the corporate tax deduction for executive pension payments. Presumably, Congress has the power to enact any of these measures. How would the senator go about selecting the best regulatory option?

One can imagine many considerations that would factor into this decision, including, of course, the substantive efficacy of the regulation in each potential form and venue,¹⁹⁶ the administrative costs and benefits,¹⁹⁷ and the impact of the choice of venue on the

195. *See, e.g.*, I.R.C. § 162(m). Of course, it is possible that the corporate governance disallowances were driven by the kind of public policy considerations addressed in the previous Sections of this Article, that is, by an honest belief that the underlying deductions undermine public policy or response to constituent outrage arising from an appearance of subsidy. But managing public perception of subsidization seems to be a better explanation for the disallowance of deductions for fines and penalties, for example, than it does for disallowance of deductions for non-performance-based executive compensation or for stock options that are not expensed on a firm's financial books. It seems unlikely that the public would be any more outraged by a deduction for \$100 million cash compensation than for a stock option worth \$100 million, or by a deduction for nonexpensed as opposed to expensed stock option pay. This is not to say that section 162(m) was not a response to voter outrage over excessive executive pay. The difference between section 162(m) and section 162(f) is that the deduction of the pay did not create the outrage. The outrage existed independently of the deduction. Under this view, disallowance was simply the means selected to respond to the outrage.

196. One result of incorporating corporate governance regulation into the Code is that the Treasury and IRS are left to interpret and administer the legislation instead of, say, the SEC, which presumably has greater expertise in these matters.

197. Weisbach and Nussim argue that institutional considerations, such as administrative

likelihood of enactment and the ease of enforcement. Moreover, the attractiveness of potential venues would vary with the motivations of the sponsoring legislators and would involve tradeoffs.¹⁹⁸ This Article argues that prospects for the enactment of corporate governance regulation are likely enhanced by structuring the regulation as a disallowance, but that doing so may come at a cost of reduced effectiveness.

Enactment, of course, would be an important consideration whether the goal of the effort was instrumental or symbolic, but by definition, substantive efficacy would be of little or no importance with respect to symbolic legislation. Although we cannot peer into the minds of our legislators, my suspicion is that the regulation of executive pay, severance arrangements, and other corporate governance matters that appear in the Code is to a large extent symbolic.

costs, specialization, and coordination, should determine whether federal programs are implemented via the tax code or through other avenues. They focus on tax subsidies, but their approach is equally applicable to the disincentives considered here. David A. Weisbach & Jacob Nussim, *The Integration of Tax and Spending Programs*, 113 YALE L.J. 955, 957-58, 993-94 (2004).

198. There is vast literature addressing the motives of the various players in the political process. Broadly, politicians are viewed as being motivated by self-interest and the public interest. See, e.g., Jonathan R. Macey, *Public Choice and the Law*, in 3 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 171, 177 (Peter Newman ed., 1998) (discussing the public choice model); Shaviro, *supra* note 189, at 6-8 (describing and critiquing both the public interest and public choice models). Self-interested motivations include not just a desire for reelection, but for power and prestige, and possibly for attractive opportunities following a career in public service. See RICHARD F. FENNO, JR., CONGRESSMEN IN COMMITTEES 1 (1973) (listing these goals as well as the goals of making good public policy and explicit personal gain); Shaviro, *supra* note 189, at 81-87 (discussing personal motivations of members of Congress beyond "narrow monetary self-interest"); see also R. DOUGLAS ARNOLD, THE LOGIC OF CONGRESSIONAL ACTION 5-6 (1990) (arguing that reelection is the dominant motivation of members of Congress, but that the quest for reelection can lead members to support both particular and general interests). Although some commentators use the phrase "public choice theory" to refer to the idea of legislation as a product that is sold to the highest bidder, the phrase also can be used to encompass other self-interested motivations of politicians.

Undoubtedly, all of these motivations play a role in legislative strategy. This is not the place to engage that debate, but this Article assumes that pure public interest is not the sole criterion. See Daniel A. Farber & Philip P. Frickey, *The Jurisprudence of Public Choice*, 65 TEX. L. REV. 873, 924-25 (1987) (concluding from the empirical evidence that many members of Congress act in the public interest, but that interest groups also exert significant influence over legislation).

b. Overcoming Resistance to Interference with Private Contracting

Our hypothetical senator might prefer an outright ban as both the most effective way of dealing with stealth compensation via pensions and the means of making the highest-impact statement. But, being a realist, the senator knows that he must deal with a Congress composed of laissez-faire capitalists who take freedom of private contracting very seriously, complete market skeptics who would not be opposed to aggressive regulation, and members with a range of views in between. Enacting federal legislation is never easy,¹⁹⁹ and, assuming that the senator values enactment as well as the ultimate effect of the legislation enacted in reforming corporate practices, he would be sensitive to the likely resistance by some of his colleagues.²⁰⁰

How will these alternative regulatory schemes be viewed? The first two options—the ban on executive pensions and the cap on payments—represent substantial interferences with private contracting and are least likely to receive broad support in Washington.²⁰¹ The effect of a ban is fairly straightforward and transparent. A cap on executive pension payments may appear to allow slightly more freedom for private contracting than an outright prohibition, but a cap is simply a ban above a threshold, and is unlikely to be perceived much more favorably.²⁰²

Experience suggests that strongly coercive regulation of this type is difficult to enact even in an environment in which few legislators are willing to defend corporate interests. From a public relations point of view, it is hard to imagine a worse decade for U.S. corporate

199. McNollgast, *Legislative Intent: The Use of Positive Political Theory in Statutory Interpretation*, 57 LAW & CONTEMP. PROBS. 3, 11 (1994) (“[I]t is difficult and time-consuming to change most prior legislative bargains.”).

200. See ARNOLD, *supra* note 198, at 8 (arguing that legislative sponsors design proposals to appeal to member preferences, which in Arnold’s view are dominated by constituent preferences and the quest for reelection).

201. See, e.g., Nicholas P. Dickerson, Comment, *What Makes the Internet So Special? And Why, Where, How, and by Whom Should Its Content Be Regulated?*, 46 HOUS. L. REV. 61, 89 n.157 (2009).

202. Imagine replacing section 162(m) with a nontax fine meant to preclude delivery of non-performance-based pay in excess of the \$1 million limitation, for example, a fine equal to some multiple of the excess non-performance-based pay.

executives than the last. The decade began with the Enron and WorldCom fiascos.²⁰³ The stock option backdating scandal soon followed.²⁰⁴ And we finished the decade still reeling from a financial collapse that is widely attributed to executive greed and incompetence, at least in the financial sector.²⁰⁵ Despite all of this, new direct, substantive federal regulation of corporate governance has been extremely limited, and significant coercive regulation in the form of mandates or caps even more so. To be sure, with the Sarbanes-Oxley Act, Congress increased disclosure requirements, strengthened board and auditor independence requirements, and actually banned corporate loans to executives.²⁰⁶ Moreover, pay czar

203. Enron filed the largest corporate bankruptcy in U.S. history on December 2, 2001. Richard A. Oppel, Jr. & Andrew Ross Sorkin, *Enron Corp. Files Largest U.S. Claim for Bankruptcy*, N.Y. TIMES, Dec. 3, 2001, at A1. WorldCom's filing on July 21, 2002, was precipitated by an accounting scandal, and was over \$40 billion larger than Enron's filing. Simon Romero & Riva D. Atlas, *WorldCom Files for Bankruptcy; Largest U.S. Case*, N.Y. TIMES, July, 22, 2002, at A1.

204. See, e.g., Charles Forelle & James Bandler, *The Perfect Payday: Some CEOs Reap Millions by Landing Stock Options When They Are Most Valuable*, WALL ST. J., Mar. 18-19, 2006, at A1.

205. See, e.g., PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, POLICY STATEMENT ON FINANCIAL MARKET DEVELOPMENTS 1 (2008) (listing the following as the underlying causes of the 2007 financial crisis: "(1) a breakdown in underwriting standards for subprime mortgages; (2) a significant erosion of market discipline by those involved in the securitization process, including originators, underwriters, [and] credit rating agencies ...; (3) flaws in credit rating agencies' assessments of subprime residential mortgage-backed securities and other complex structured credit products ...; (4) risk management weaknesses at some large U.S. and European financial institutions; and (5) regulatory policies, including capital and disclosure requirements, that failed to mitigate risk management weaknesses").

206. Revelations of significant abuse prompted the loan ban. See generally PERMANENT SUBCOMM. ON INVESTIGATIONS, COMM. ON GOVERNMENTAL AFFAIRS, THE ROLE OF THE BOARD OF DIRECTORS IN ENRON'S COLLAPSE, S. REP. NO. 107-70, at 53 (2002) [hereinafter THE ROLE OF THE BOARD]; 149 CONG. REC. 2823 (2003) (statement of Sen. Levin) [hereinafter Levin Statement]. At Enron, former CEO Ken Lay had borrowed \$81 million from the company through a series of loans and repaid all but \$7 million with stock received from option exercise. See THE ROLE OF THE BOARD, *supra*, at 53. Through these loans, Lay effectively sold \$74 million of stock back to the company without disclosing the sales to shareholders, at a time when Lay was continuing to publicly claim that all was well at Enron. See *id.* At Tyco, CEO Dennis Kozlowski and general counsel Mark Belnick received a combined \$30.5 million in loans to purchase real estate, and Kozlowski allegedly used millions in company loans intended to pay taxes on stock option gains to purchase artwork. See Levin Statement, *supra*, at 2824; Mark Maremont et al., *Probe of Ex-Tyco Chief Focuses on Improper Use of Company Funds*, WALL ST. J., June 6, 2002, at A1. WorldCom loaned its CEO hundreds of millions of dollars at low interest rates, and Adelphia loaned over \$260 million to members of the controlling Rigas family. See Levin Statement, *supra*, at 2825 (citing a proprietary report on

Kenneth Feinberg managed to curtail and mandate the form of executive pay at companies participating in the federal bailout.²⁰⁷ But it appears that generally applicable corporate governance regulation coming out of the financial crisis will be “relatively modest.”²⁰⁸

Of course, there are good reasons for legislators to hesitate before adopting strongly coercive regulation of corporate governance matters, even when reform is clearly needed. This is not the place to explore the problems with such regulation.²⁰⁹ For present purposes, the point is that, given the track record, it is not surprising that reform-minded legislators often would abstain from

Adelphia issued by the Corporate Library); Joann S. Lublin & Shawn Young, *WorldCom Loan to CEO of \$341 Million Is the Most Generous in Recent Memory*, WALL ST. J., Mar. 15, 2002, at A3 (reporting that loans to CEO Bernard Ebbers carried interest rates of 2.14 to 2.18 percent). In many cases, the interest and sometimes the principal of executive loans were forgiven by boards of directors with little apparent deliberation. Levin Statement, *supra*, at 2825. Moreover, the cost of forbidding such loans might appear to be modest. Unlike executive pensions, which are ubiquitous, most companies and executives managed just fine without such loans. Nonetheless, the Sarbanes-Oxley Act's ban on loans to corporate executives has received harsh criticism as heavy-handed congressional interference with private contracting. See Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1538-40 (2005).

207. See, e.g., Deborah Solomon & Dan Fitzpatrick, *Pay Slashed at Bailout Firms*, WALL ST. J., Oct. 22, 2009, at A1 (detailing limits on cash salary for senior executives and shift of compensation into “salary stock”); Deborah Solomon & Jessica Holzer, *Treasury Restricts Pay at Four Firms*, WALL ST. J., Dec. 14, 2009, at A7 (describing pay limits placed on the next most highly compensated group of employees).

208. Stephen M. Bainbridge, *The Corporate Governance Provisions of Dodd-Frank* (UCLA Sch. of Law, Law-Econ. Research Paper No. 10-14, 2010), available at http://ssrn.com/abstract_id=1698898; see Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 951, 952, 954, 124 Stat. 1376 (2010) (requiring a nonbinding shareholder vote on executive pay no less frequently than once every three years, directing the SEC to impose independence requirements on the compensation committees of exchange listed companies, and directing the SEC to require the national securities exchanges to include erroneous pay “clawback” provisions as a listing requirement). The Act also addresses compensation disclosure and compensation committee independence. See *id.* §§ 952-53.

209. For scholarship that addresses such problems, see Jeffrey N. Gordon, “Say on Pay”: *Cautionary Notes on the U.K. Experience and the Case for Shareholder Opt-In*, 46 HARV. J. ON LEGIS. 323, 325-26 (2009) (criticizing mandatory “say on pay” proposals); David I. Walker, *The Challenge of Improving the Long-Term Focus of Executive Pay*, 51 B.C. L. REV. 435, 444-55 (2010) (criticizing proposals aimed at restricting the form and term of executive compensation).

proposing bans or inviolable caps and would focus instead on less coercive tax and nontax disincentives.²¹⁰

c. Regulatory Illusion of Deduction Disallowance Compared with Economically Equivalent Nontax Disincentives

Administrative costs aside, tax and nontax penalties can be designed to be economically equivalent. Consider an SEC penalty applied to excessive pension payments, however defined, that is analogous to the penalties applied to automakers that fail to comply with the CAFE standards discussed in Part I.C. At a 35 percent marginal tax rate, a 35 percent fine imposed by the SEC on excess pension payments would be equivalent to denial of a corporate tax deduction for the same payments.²¹¹

Although economically equivalent, perception of tax and nontax penalties would differ.²¹² There is little doubt that the hypothetical SEC fine would be viewed as a penalty. Businesses that chose to ignore the limitation would be required to remit a payment to the government. Such a scheme should be viewed as less coercive than a ban or hard cap, but the natural mental framing would be that of a penalty, and it would be difficult to effectively shift the rhetoric to revocation of a subsidy.²¹³

Observers, however, tend not to equate disallowed deductions and direct penalties. As a result of mental framing, the disallowance likely would be viewed as the elimination of a subsidy.²¹⁴ Moreover, this mental framing can be augmented through rhetoric, such as that employed by former President Clinton in arguing for the

210. Robert Cooter divides disincentives into prices and sanctions. *See* Robert Cooter, *Prices and Sanctions*, 84 COLUM. L. REV. 1523, 1552 (1984). In his terminology, a sanction is a disincentive that results in an abrupt jump in cost when a violation occurs, whereas prices result in smooth, continuous costs. *See id.* The ban and hard cap discussed in the text above are examples of sanctions in Cooter's terminology. The tax and nontax disincentives discussed below would be prices.

211. To be sure, not all corporations pay tax at the 35 percent statutory marginal rate. Many firms face a lower marginal rate of tax as a result of losses incurred in previous years.

212. *See supra* Part II.

213. Again consider fines levied for violation of the CAFE standards. *See supra* Part I.C. Although economically equivalent to curtailed deductions, they are difficult to frame as the revocation of a subsidy. *See supra* Part I.C.

214. *See supra* note 80 and accompanying text; Part II.C.

curtailment of the “subsidy” provided by corporate tax deductions for senior executive pay.²¹⁵

In this context, whether section 162(m) or a limitation on deductions for executive pension payments is, in fact, better viewed as a penalty or as revocation of a subsidy is immaterial. The key is that tax disallowances tend to be viewed, and can be persuasively portrayed, as revocation or limitation of subsidies, whereas economically equivalent SEC penalties will be viewed as penalties. As a result, the choice to structure a corporate governance or similar regulation as a tax disallowance instead of as an economically equivalent direct penalty should mitigate public and legislative opposition, both directly and indirectly as a consequence of lessening public opposition, and facilitate enactment.²¹⁶

d. Does Framing Impact Structure?

Do these framing advantages help explain the existence of corporate governance and similar regulation in the tax code? There is no “smoking gun” committee report establishing the connection, but common sense suggests that one exists. Within a model of the political process in which politicians value enactment in addition to, or in lieu of, efficacy, regulatory illusion should affect the choice of regulatory method.

Hints of purposeful exploitation of disallowance do exist. It is noteworthy, for example, that Senator Carl Levin’s crusade to force companies to record stock option compensation as an expense for financial accounting purposes began with a proposed mandate and evolved into a proposed tax disallowance.²¹⁷ A reasonable interpretation would be that the senator first advocated the regulatory

215. *See supra* notes 103-04 and accompanying text.

216. This is not to suggest that disallowance proposals always skate through the legislative process. Indeed, most disallowance proposals are never enacted. None of the fifteen disallowance proposals introduced in the 109th Congress has been enacted to date. *See supra* note 55 and accompanying text. The argument is simply that regulation structured as disallowance should face better prospects of enactment than equivalent nontax regulation.

217. *See* Corporate Executives’ Stock Option Accountability Act, S. 259, 103d Cong. (1993) (mandating expensing of stock options); Ending Excessive Corporate Deductions for Stock Options Act, S. 1491, 111th Cong. (2009) (barring corporate tax deductions for option compensation not recognized as an accounting expense).

approach he felt would be most efficacious and subsequently traded efficacy for improved prospects of enactment, although, to be sure, even the disallowance has not been enacted.

Moreover, there is evidence of purposeful exploitation of disallowance in a very similar situation: the 1988 amendments to section 527. This section addresses the taxation of political organizations and generally exempts these organizations from federal income tax, although, unlike public charities, political organizations are not eligible to receive tax deductible contributions.²¹⁸ Dissatisfied with the proliferation of “stealth” political action committees (PACs) that were not regulated under the Federal Election Commission Act as a result of the Supreme Court’s decision in *Buckley v. Valeo* and thus not required to disclose the identity of their contributors, Congress amended section 527 in 1988 to tax independent political organizations on undisclosed receipts and expenditures.²¹⁹ The amendments were challenged on First Amendment grounds, but the challenge failed.²²⁰

Most relevant for our purposes, however, is the fact that this regulatory intervention was openly structured as a tax disallowance to minimize the chances of invalidation. As Senator John McCain claimed on the Senate floor, “Making these [disclosure] requirements a contingency for certain tax credit [sic] status ensures that these requirements are clearly constitutional. The Constitution guarantees freedom of speech and association, not an entitlement to tax-exempt status.”²²¹ Although the hurdle in this case—

218. I.R.C. § 527 (2006).

219. See Pub. L. No. 100-647, § 1001(b)(3)(B), 102 Stat. 3342 (amending I.R.C. § 527). In the early 1970s, Congress established the Federal Election Commission and required entities organized to influence elections to disclose the identities of their major contributors. *Buckley v. Valeo*, 424 U.S. 1, 1 (1976). However, in *Buckley*, the Supreme Court held that independent political organizations that refrained from directly advocating the election or defeat of particular candidates were not subject to regulation by the FEC. See *id.* at 143; Gregg D. Polsky & Guy-Uriel E. Charles, *Regulating Section 527 Organizations*, 73 GEO. WASH. L. REV. 1000, 1004 (2005); Donald B. Tobin, *Anonymous Speech and Section 527 of the Internal Revenue Code*, 37 GA. L. REV. 611, 624 (2003). After *Buckley*, PACs and political parties faced disclosure mandates, but independent, issue advocacy groups could remain anonymous. Tobin, *supra*, at 625 & n.71.

220. *Mobile Republican Assemblies v. United States*, 353 F.3d 1357, 1361 (11th Cir. 2003).

221. 146 CONG. REC. 12850 (2000) (statement of Sen. McCain); see also Polsky & Charles, *supra* note 219, at 1023-24 (arguing that incorporating disclosure regulation within

constitutional scrutiny—is different than the hurdle faced by the sponsors of most corporate governance regulation—overcoming laissez-faire opposition and achieving enactment—the section 527 episode demonstrates the attention paid to structuring and rhetorical framing. It seems likely that legislative sponsors would recognize and exploit the framing advantages of tax disallowance in cases in which no constitutional shadow is cast on direct regulation.

e. Regulatory Illusion Versus Fiscal Illusion

The claims of this Article regarding the relationship between regulatory illusion and the existence of tax disallowance aimed at corporate governance and similar matters parallels a similar claim regarding the relationship between fiscal illusion and the existence of tax subsidies. The fiscal illusion claim is that the creation of tax subsidies is an attractive means of advancing popular programs, such as those encouraging home ownership or employer-provided health insurance, because tax subsidies appear to limit or reduce the size of government, where the size of government is naively judged by the level of taxes and direct spending.²²² From an allocational and distributional perspective, which is all we should care about, tax subsidies and direct spending programs may be

section 527 “was, at least in part, designed to bolster the chances that this regulation would survive a First Amendment challenge”).

222. SURREY & MCDANIEL, *supra* note 3, at 104 (“[L]egislators or presidents who do not want to appear to be ‘big spenders’ can comfortably approve tax expenditures without damaging their image of fiscal conservatism.”); Shaviro, *supra* note 28, at 190-91 (explaining that “big government” is characterized by high taxes and spending, and arguing that political actors manipulate this label); Toder, *supra* note 29, at 361 (“Tax incentives serve the needs of political leaders by enabling them to appear to reduce spending and taxes, while at the same time pursuing an activist policy that promotes popular programs.”). The late David Bradford provided the classic example of the reach of fiscal illusion in this context by facetiously proposing that the federal defense budget be replaced with a weapons supply tax credit. *See* Bradford, *supra* note 28, at 432.

The fiscal illusion created by tax subsidies is one example of a larger phenomenon of obscuring the real cost of publicly provided goods and services in order to assuage public opposition and facilitate larger government. *See* JAMES M. BUCHANAN, PUBLIC FINANCE IN DEMOCRATIC PROCESS: FISCAL INSTITUTIONS AND INDIVIDUAL CHOICE 139-43 (1967) (describing ways in which tax systems can create fiscal illusions); Shaviro, *supra* note 189, at 59 (discussing means by which government can “impos[e] costs indirectly and otherwise camouflag[e] them in order to avoid public scrutiny”).

identical, but formally, tax subsidies reduce taxes and add nothing to direct expenditures.²²³ The “small government” preferring public is susceptible to this fiscal illusion, and, as a result, the demand and provision of public goods and services depends on how they are financed.²²⁴

The fiscal illusion of tax subsidies is, of course, the result of a tendency to frame tax cuts and direct spending differently.²²⁵ Daniel Shaviro has attributed the difference in public perception “to the fact that people are simply more willing to allow others to take advantage of tax breaks than they are to give them payouts,”²²⁶ and Edward Zelinsky has shown that individuals react differently to paying “volunteer” firefighters directly as compared with providing firefighters with economically equivalent property tax exemptions.²²⁷

My sense is that framing and illusion are equally important for the enactment of tax disincentives, but for very different reasons. Disallowances of otherwise ordinary and necessary business expense deductions suffer in terms of fiscal illusion. They appear to raise taxes and they provide no direct revenue. But surely placing disincentives in the Code has little to do with revenue. If the disincentives are successful in altering behavior, there will be no revenue effects at all, and if unsuccessful, wouldn't Congress have preferred to more directly and visibly raise revenue from wrongdoers? Rather, the benefit of placing disincentives in the Code is the ability to shift the rhetoric from “penalty” to “no subsidy,” which defuses critics of regulatory intervention.

223. Shaviro, *supra* note 28, at 191.

224. Shaviro, *supra* note 189, at 59.

225. Edward A. Zelinsky, *Do Tax Expenditures Create Framing Effects? Volunteer Firefighters, Property Tax Exemptions, and the Paradox of Tax Expenditure Analysis*, 24 VA. TAX REV. 797, 800 (2005).

226. Shaviro, *supra* note 189, at 63. Shaviro also suggests that the difference follows from a failure to understand that tax subsidies and direct spending are “functionally equivalent.” *Id.* at 62.

227. Zelinsky, *supra* note 225, at 797 (providing survey evidence suggesting that direct payments were more likely to be viewed as vitiating volunteer status than economically equivalent tax exemptions, and suggesting that framing effects help explain the persistence of tax expenditures despite the promulgation of tax expenditure budgets); *see also* ARNOLD, *supra* note 198, at 200 (arguing that tax preferences have a “dual advantage” over direct spending of being equally salient to beneficiaries, but largely invisible otherwise).

To be sure, merely placing a disincentive in the Code is not sufficient to create the appearance of revoking a subsidy. It would be no easier to frame an excise tax imposed on excessive executive pensions as the revocation of a subsidy than it would be to frame an SEC fine as removing a subsidy. The key to subsidy framing, in this context at least, is the existence of an associated deduction that can be curtailed on the basis of noncompliant behavior.

IV. IMPLICATIONS OF MENTAL AND RHETORICAL FRAMING OF DEDUCTION AS SUBSIDY

Mental framing is an unavoidable aspect of human cognition. However, baselines can change over time as we acquire experience and information. Self-serving rhetorical framing is inevitable in open democratic debate, but to some extent the force of rhetoric may be tempered through reflection and analysis. Structuring business regulation as tax disallowance leads to predictable mental framing biases and facilitates rhetorical framing that likely produces more regulation than we would otherwise observe. This Part briefly explores these implications.

A. *Mental Framing*

Mental baselines are necessary and useful tools for categorizing information and solving problems. However, this Article has argued that there is a tendency among judges, policymakers, and the public towards overbroad framing of business deductions as subsidies.²²⁸ Moreover, repeated use of explicit subsidy rhetoric by policymakers may reinforce the false perception both inside and outside Washington that all business tax deductions, exemptions, and credits are subsidies.²²⁹

228. *See supra* Part III.

229. Murray Edelman has described how verbal cues become laden with meaning over time and how political rhetoric “becomes a sequence of Pavlovian cues rather than an instrument for reasoning and analysis if situation and appropriate cue occur together.” EDELMAN, *supra* note 189, at 116. His example from the 1960s is the reaction of physicians to the phrase “compulsory health insurance,” but he could as easily have been talking about the reaction of voters to “subsidies” attributed to various tax deductions. *See id.*

Although mental framing is to some extent unavoidable, judges and policymakers should be alert to the tendency to conceptualize business deductions as subsidies and resist the tendency to let the appearance of subsidy alone influence outcomes. They should question the subsidy characterization and its significance. Perhaps the underlying deduction represents an actual subsidy; perhaps it does not. One way policymakers may be able to overcome their subconscious mental framing of deduction as subsidy is by consciously considering not just the ex post effect of deduction or disallowance, but the entire transaction, including the tax treatment of any benefit arising from the disfavored behavior. Doing so may reveal that business and nonbusiness taxpayers are not similarly situated, and that deduction is not necessarily equivalent to subsidy.

More importantly, judges and policymakers should ask whether the subsidy characterization matters at all. Perhaps subsidy characterization is irrelevant, and the appropriate question is simply whether the underlying policy issue at stake is advanced or hindered by the proposed disallowance. Policymakers considering disallowance on public policy grounds should ask whether the optimal policy response is to squelch the disfavored behavior entirely or to cause participants to internalize the full social cost. They should also ask whether deduction really does undermine the policy or simply maintains, on an after-tax basis, the balance of deterrence, error costs, and the like, that was desired on a pre-tax basis. Policymakers faced with corporate governance and similar regulation proposed as disallowance should consider whether they would support equivalent nontax regulation. This is not to suggest that policymakers should ignore administrative or other differences between tax and nontax regulation, but a red light should go off if a policymaker who supports a disallowance proposal would strongly resist equivalent nontax regulation.

B. Rhetorical Framing

Self-serving and even disingenuous characterization of business deductions as subsidies by policymakers seeking a legislative result is regrettable, perhaps, but certainly unavoidable. Some business deductions do represent subsidies within our net income tax system;

others are debatable.²³⁰ Moreover, even if we could reach consensus on the proper characterization of each deduction, it is inconceivable that such rhetoric could or would be restricted in open, democratic debate.

Nonetheless, disingenuous subsidy rhetoric is particularly troubling because there may be a negative externality. The rhetoric may reinforce the already overbroad view amongst the public, jurists, and policymakers that business deductions are subsidies.²³¹ In other words, the rhetoric is effective both in the current debate and in shaping perception over time. There is, however, no apparent supply side solution to this problem.

C. Structural Choice or Framing

Although overbroad mental framing of business deduction as subsidy and self-serving rhetoric equating deduction with subsidy are inevitable and largely unavoidable, the choice to structure business regulation as a disallowance is not. This Article has argued that business deductions are particularly susceptible to mental framing as subsidy and that rhetoric equating deduction with subsidy can be a powerful tool in achieving enactment of disallowances. Of course, disallowance proposals are not always successful. They may succeed only rarely. But if the foregoing analysis is correct, an implication of the framing effects is that there will be more business regulation than there would be if the tax code were not a viable regulatory venue.

Moreover, experience suggests that such regulation can be ineffective and even counterproductive. Consider corporate governance regulation enacted in the form of disallowed deductions, such as section 162(m), which caps the deductibility of non-performance-

230. See *supra* Part II.A.2.

231. For example, in July 2010, BP announced its intention to deduct damage payments and other costs associated with the Gulf of Mexico oil spill. President Obama's press secretary called on the company to voluntarily forgo the deduction which could reduce its taxes by up to \$10 billion. As tax commentator Lee Sheppard noted, several companies have voluntarily forgone deductions in the face of political pressure. She went on to note, consistent with the idea expressed in this Article, that "[d]oing so makes for a better headline, but it also convinces the populace that all deductions are tax preferences." Lee A. Sheppard, *Cash on the Barrelhead: BP and Taxes*, TAX NOTES, Aug. 9, 2010, at 571.

based senior executive pay,²³² and section 280G, which limits the deductibility of excessive severance payments.²³³ These are “remarkably crude policy instruments”²³⁴ that impose a one-size-fits-all-offenses penalty on a range of disfavored behaviors engaged in by particular firms, and that from firm to firm impose varying disincentives depending on effective marginal tax rates.

The bluntness of the tax instrument, combined with a loss of expertise that occurs when regulation that would logically be administered by the SEC is administered by the Treasury instead,²³⁵ may help explain why tax-based corporate governance regulation has met with such little success and, indeed, may have been counterproductive. Of course, if one believes that corporate governance legislation is largely symbolic, one would not be surprised to learn that sections 162(m) and 280G have failed to reduce the value or improve the structure of executive pay arrangements. But the situation is worse than that. In all likelihood, these provisions have skewed compensation away from the efficient mix of stock, options, and cash; provided camouflage for boosting executive pay; and shifted costs of noncompliance onto shareholders.²³⁶

Section 162(m) is widely believed to have contributed to the explosion in stock option compensation in the 1990s.²³⁷ The rule provided a reason or pretext for firms to replace salary with options, and given the riskiness of options, firms could justify replacing a dollar of salary with much more than a dollar of option compensa-

232. I.R.C. § 162(m) (2006).

233. *Id.* § 280G.

234. See Zolt, *supra* note 4, at 344.

235. See Weisbach & Nussim, *supra* note 40, at 958-59.

236. See, e.g., Gregg D. Polsky, *Controlling Executive Compensation Through the Tax Code*, 64 WASH. & LEE L. REV. 877, 925-26 (2007) (arguing that section 162(m) should not have been expected to benefit shareholders under either of the prevailing theories of the executive compensation setting process and concluding that the empirical evidence supports the view that it was not); James R. Repetti, *The Misuse of Tax Incentives To Align Management-Shareholder Interests*, 19 CARDOZO L. REV. 697, 699 (1997) (arguing that tax incentives aimed at corporate governance are ineffective because “they fail to address the complexities of stockholder-management relations”).

237. See Polsky, *supra* note 236, at 906 (documenting the widespread belief among informed observers that section 162(m) contributed to the options explosion, but also noting the lack of clear-cut empirical evidence).

tion.²³⁸ Moreover, given the complexity of options, executive pay became much less transparent, which may have facilitated increases in total compensation.²³⁹ Add in the 1990s bull market and the result was a tremendous transfer of wealth from stockholders to executives.²⁴⁰ Today, of course, option compensation is under attack in Washington as having encouraged excess risk-taking that contributed to the recent financial meltdown (an ironic situation, given the history),²⁴¹ and firms are responding by switching away from options to restricted stock and short-term incentives.²⁴²

Section 280G has not had such disastrous social consequences, but it has been no more successful. Initially, some firms responded by capping golden parachute severance payments at a level that would ensure full deductibility at the corporate level and avoid excise taxes for executives.²⁴³ As time went on, however, more and more firms exceeded the caps and adopted “gross up” policies that caused shareholders to bear the cost of both the foregone tax deduction and the executive’s excise tax.²⁴⁴

Would direct regulation have been more successful? It is hard to say. The agency problems are substantial and undermine attempts

238. See Brian J. Hall & Jeffrey B. Liebman, *The Taxation of Executive Compensation*, in 14 TAX POLICY AND THE ECONOMY 1, 36 (James M. Poterba ed., 2000) (finding that salary reductions post-1993 were more than offset by additional stock option grants).

239. Lucian A. Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 756, 817 (2002) (proposing a managerial power theory of the executive pay setting process in which compensation opacity minimizes outrage and facilitates increased pay).

240. See Lucian Bebchuk & Yaniv Grinstein, *The Growth of Executive Pay*, 21 OXFORD REV. ECON. POL’Y 283, 302 (2005) (finding an increase in senior executive pay between 1993 and 2003 at U.S. firms that far exceeded the growth that could be explained by increases in stock prices alone, and finding that the aggregate compensation of the top five executives of these firms from 2001 to 2003 exceeded 10 percent of aggregate corporate earnings).

241. See Walker, *supra* note 209, at 444 (explaining that section 162(m) encouraged firms to compensate executives with stock options).

242. See JAMES F. REDA & ASSOCS., EXECUTIVE COMPENSATION TRENDS FOR 2009: BALANCING RISK, PERFORMANCE AND PAY (2009), available at <http://www.cii.org/resources/KeyGovernanceIssues/ExecutiveCompensation> (reviewing 2009 proxy statements of 200 large companies).

243. See Bruce A. Wolk, *The Golden Parachute Provisions: Time for Repeal?*, 21 VA. TAX REV. 125, 136 (2001).

244. See *id.* at 181 (discussing the gross up provisions used to reallocate the tax burden of sections 280G and 4999 from company executives to shareholders).

to control executive pay through substantive regulation.²⁴⁵ However, in these cases, shareholders, and indeed society, may have been better off if Congress had not regulated at all, instead of targeting these deductions. In these cases, subsidy framing may have made it too easy to enact legislation that would have better lain dormant.

To be sure, it is also possible that alternative nontax corporate governance legislation might have been worse. Suppose there was no corporate income tax or similar tax that could serve as the basis for tax penalties. A Congress that was determined to regulate executive pay might have devised penalties that were equivalent economically to sections 162(m) and 280G. On the other hand, nontax intervention might have taken the form of a ban or cap on non-performance-based pay or golden parachute payments along the lines of the Sarbanes-Oxley ban on executive loans. If enacted, legislation of this nature might have had greater impact than sections 162(m) and 280G, but also could have created much greater inefficiencies.²⁴⁶ However, the fact that alternative regulation possibly could have been worse does not justify the ineffective and counterproductive business regulation that is found in the tax code today.

CONCLUSION

Framing is an unavoidable aspect of human cognition. Everyone is aware that survey responses are affected by how questions are framed. Tax deductions, however, seem particularly susceptible to mental and rhetorical framing as subsidy. This Article has argued

245. See Walker, *supra* note 209, at 445-46.

246. Suppose, for example, that as a result of risk aversion or other factors, it would be efficient for a firm to provide non-performance-based pay to an executive in excess of the \$1 million "cap" provided under section 162(m). I.R.C. § 162(m) (2006). The cost to shareholders of managers electing to ignore the current deduction disallowance is simply the forgone tax benefit. So, for example, if the firm continued to provide \$2 million of non-performance-based pay to an executive after the enactment of section 162(m), instead of restructuring the pay as \$1 million non-performance and \$1 million performance-based pay, it would incur a cost of \$350,000 at a 35 percent tax rate. This alternative would not exist under a system that placed a hard cap of \$1 million on non-performance-based pay. Firms would be strictly constrained in their compensation decisions no matter how inefficient, and social welfare could well be reduced by a regulatory approach that imposed greater inefficiencies on firms, particularly if the regulation was largely symbolic in the first place.

that mental framing of deduction as subsidy contributed to disallowance of various business deductions on “public policy” grounds in the courts and to the codification of these disallowances by Congress. It has also suggested that mental and rhetorical framing contributed to the choice to structure various corporate governance measures as tax disallowances and to the ultimate enactment of these measures. The normative implications of framing are troubling and provide another reason to be skeptical of corporate governance and similar business regulation incorporated in the tax code.

APPENDIX

Student Attitude Surveys—Executive Pensions

Each of approximately 250 first-year law students at Boston University received 1 of 3 versions of a survey question. 241 responses were received. Summary statistics and the 3 versions of the survey question follow:

Regulatory Approach	N	Mean Support Rating	Standard Deviation	2 sample t tests One-tail P value
Direct Penalty	83	4.6	2.8	.0001
Deduction Curtailment (subsidy framing)	82	6.2	2.7	
Deduction Curtailment (subsidy framing)	76	7.2	2.5	.0103

[Version #1: Direct Penalty]
Student Attitude Survey—Executive Pensions

This ANONYMOUS survey is being administered by Professor [] and will provide data for his research. Your participation is entirely VOLUNTARY. There will be no repercussions if you decide not to participate. If you have any questions about this survey or the research, you may contact Professor [] at [], at [], or by stopping by his office. Thank you for your assistance.

Please consider the following:

Many observers feel that corporate executive retirement packages have grown too large. At the same time that businesses have been cutting back on pensions offered to rank and file employees, pensions received by chief executive officers (CEOs) and other corporate executives have mushroomed. A recent study of CEOs nearing retirement found that, on average, the executives were promised pension payments in excess of \$1.5 million/year, with some executives being promised over \$5 million/year.* While some observers consider these large pensions to be unfair and a matter of public concern, others argue that as long as pension payments are fully disclosed to investors, this private market should be allowed to operate freely without government interference.

Governments employ various tools to discourage behavior considered socially undesirable or to correct for market failure, including penalties, user fees, and excise taxes. Suppose Congress were to consider imposing penalties on executive pension payments beyond a certain level. For example, Congress might allow pension payments of up to \$1 million/year for each former executive without penalty. However, pension payments in excess of this amount would result in a penalty of, say, 35 percent of the excess payment. The penalty would be paid by the corporation that made the excess pension payment. Thus, for example, if Acme Corp. paid its former

* See Lucian A. Bebchuk & Robert J. Jackson, Jr., *Executive Pensions*, 30 J. CORP. L. 823, 843 (2005).

CEO a pension of \$3 million in 2008, the penalty would be 35 percent of the excess \$2 million, or \$700,000.

Would you be in favor of Congress imposing a penalty on excess pension payments as described above? Please rate your view on a scale of 1 (strongly object to imposing a penalty on excess executive pensions) to 10 (strongly support imposing a penalty) and enter the figure in the box below.

[Version #2: Deduction Curtailment, Neutral Framing]
Student Attitude Survey—Executive Pensions

This ANONYMOUS survey is being administered by Professor [] and will provide data for his research. Your participation is entirely VOLUNTARY. There will be no repercussions if you decide not to participate. If you have any questions about this survey or the research, you may contact Professor [] at [], at [], or by stopping by his office. Thank you for your assistance.

Please consider the following:

Many observers feel that corporate executive retirement packages have grown too large. At the same time that businesses have been cutting back on pensions offered to rank and file employees, pensions received by chief executive officers (CEOs) and other corporate executives have mushroomed. A recent study of CEOs nearing retirement found that, on average, the executives were promised pension payments in excess of \$1.5 million/year, with some executives being promised over \$5 million/year.* While some observers consider these large pensions to be unfair and a matter of public concern, others argue that as long as pension payments are fully disclosed to investors, this private market should be allowed to operate freely without government interference.

Governments employ various tools to discourage behavior considered socially undesirable or to correct for market failure, including taxation. In calculating their taxable income, corporations currently are entitled to deduct amounts paid out to their executives as pensions, which, for most companies, reduces the effective cost of providing pensions by about 35 percent. Suppose Congress were to consider limiting the deductibility of executive pensions payments. Congress might allow a deduction for the first \$1 million/year paid out to each former executive as a pension, but disallow deductions for pension payments in excess of this amount. For example, if Acme Corp. paid its former CEO a pension of \$3 million in 2008, the first

* See Lucian A. Bebchuk & Robert J. Jackson, Jr., *Executive Pensions*, 30 J. CORP. L. 823, 843 (2005).

\$1 million would be deductible, but the next \$2 million would not be. In this case, the change in law would increase the effective cost to Acme of providing a \$3 million pension by \$700,000.

Would you be in favor of Congress limiting the deductibility of pension payments as described above? Please rate your view on a scale of 1 (strongly object to limiting deductibility of executive pensions) to 10 (strongly support limiting deductibility) and enter the figure in the box below.

[Version #3: Deduction Curtailment, Subsidy Framing]
Student Attitude Survey—Executive Pensions

This ANONYMOUS survey is being administered by Professor [] and will provide data for his research. Your participation is entirely VOLUNTARY. There will be no repercussions if you decide not to participate. If you have any questions about this survey or the research, you may contact Professor [] at [], at [], or by stopping by his office. Thank you for your assistance.

Please consider the following:

Many observers feel that corporate executive retirement packages have grown too large. At the same time that businesses have been cutting back on pensions offered to rank and file employees, pensions received by chief executive officers (CEOs) and other corporate executives have mushroomed. A recent study of CEOs nearing retirement found that, on average, the executives were promised pension payments in excess of \$1.5 million/year, with some executives being promised over \$5 million/year.* While some observers consider these large pensions to be unfair and a matter of public concern, others argue that as long as pension payments are fully disclosed to investors, this private market should be allowed to operate freely without government interference.

In calculating their taxable income, corporations currently are entitled to deduct amounts paid out to their executives as pensions, which, for most companies, reduces the effective cost of providing pensions by about 35 percent. The deduction, in effect, results in a subsidy by U.S. taxpayers. Suppose Congress were to consider limiting the deductibility of executive pensions payments. Congress might allow a deduction for the first \$1 million/year paid out to each former executive as a pension, but disallow deductions for pension payments in excess of this amount. For example, if Acme Corp. paid its former CEO a pension of \$3 million in 2008, the first \$1 million would be deductible, but the next \$2 million would not be. Eliminat-

* See Lucian A. Bebchuk & Robert J. Jackson, Jr., *Executive Pensions*, 30 J. CORP. L. 823, 843 (2005).

ing the tax subsidy on \$2 million of pension payments would save taxpayers about \$700,000, compared with current law.

Would you be in favor of Congress limiting the deductibility of pension payments as described above? Please rate your view on a scale of 1 (strongly object to limiting deductibility of executive pensions) to 10 (strongly support limiting deductibility) and enter the figure in the box below.