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**Binding Choices:
Tax Elections & Federal/State Conformity**

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SCHEDULE FOR 2012 NYU TAX POLICY COLLOQUIUM

(All sessions meet on Tuesdays from 4:00-5:50p.m. in Vanderbilt Hall-208, NYU Law School)

1. January 17 – Michelle Hanlon, MIT, Sloan School of Management. “Taking the Long Way Home: Offshore Investments in U.S. Equity and Debt Markets and U.S. Tax Evasion.” (with Edward L. Maydew and Jacob R. Thornock).
2. January 24 – Amy Monahan, University of Minnesota Law School. “Will Employers Undermine Health Care Reform by Dumping Sick Employees?” (with Daniel Schwarcz).
3. January 31 – Alex Raskolnikov, Columbia Law School. “Accepting the Limits of Tax Law and Economics.”
4. February 7 – Victor Fleischer, University of Colorado Law School. “Tax and the Boundaries of the Firm.”
5. **February 14 – Heather Field, Hastings College of Law. “Binding Choices: Tax Elections & Federal/State Conformity.”**
6. February 28 – Daniel Shaviro, New York University School of Law. “The Financial Transactions Tax Versus the Financial Activities Tax.”
7. March 6 – Edward Kleinbard, USC Law School. “Reimagining Capital Income Taxation.”
8. March 20 – Susan Morse, Hastings College of Law. “Worldwide Corporate Income Tax Consolidation and a Corporate Offshore Excise Tax.”
9. March 27 – Stephen Shay, Harvard Law School. “Unpacking Territorial.”
10. April 3 – Jon Bakija, Williams College Economics Department. “Jobs and Income Growth of Top Earners and the Causes of Changing Income Inequality: Evidence from U.S. Tax Return Data.”
11. April 10 – Lane Kenworthy, University of Arizona Sociology Department. “Getting taxes right: What can we learn from the comparative evidence?”
12. April 17 – Yair Listokin, Yale Law School. “‘I Like to Pay Taxes’: Lessons of Philanthropy for Tax and Spending Policy.” (with David Schizer).
13. April 24 – William Gale, Brookings Institution. “Fiscal Therapy.”
14. May 1 – Rosanne Altshuler, Rutgers Economics Department, and Harry Grubert, U.S. Treasury Department. “A New View on International Tax Reform.”

BINDING CHOICES:

TAX ELECTIONS & FEDERAL/STATE CONFORMITY

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Most states’ income tax laws conform, at least to some degree, to the federal income tax laws. The literature discussing the advantages and disadvantages of state conformity to federal tax law generally assumes that the question facing state governments is to what extent (if at all) the state income tax provisions should conform to the federal income tax provisions. However, where the federal income tax law provides explicit tax elections, state legislators must decide not only whether the state law should conform to the federal law (i.e., whether the taxpayers should be afforded the same tax choice for state tax purposes), but legislators must also decide whether to bind each taxpayer, for state tax purposes, to the taxpayer’s federal tax choices. This additional decision matters because the simplicity, administrability, revenue, and federalism implications of election conformity can depend on whether and how state legislators constrain the taxpayer autonomy provided by the elections. Thus, given the large and ever-increasing number of tax elections in the federal income tax law, this Article provides guidance about how state legislators considering conformity should take into account the optionality inherent in explicit elections.

¹ Professor of Law, University of California, Hastings College of the Law. The author appreciates the opportunity to present this project at the 2010 Junior Tax Scholars Workshop, the 2011 Law & Society Association Meeting, and the Fall 2011 Northern California Tax Prof Roundtable. She thanks all of the event participants for their helpful feedback, particularly []. In addition, the author thanks [].

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I. INTRODUCTION

I itemized deductions on my 2010 federal income tax return, but I took the standard deduction on my 2010 state income tax return. California, where I live, allows a taxpayer to make an independent choice about whether to itemize for state income tax purposes, regardless of the itemization choice made by the taxpayer for federal income tax purposes.² Virginia does not.³ New York does in some circumstances, but not in others.⁴ And in New Jersey, this issue is irrelevant.⁵

*Fewer than 3% of married couples in Montana file separate federal income tax returns, but almost 56% of married couples in Montana file separate state income tax returns.*⁶ In Montana and in several other states, a married couple is generally allowed to make an independent choice

² CAL. REV. & TAX. CODE §§17073, 17073.5; *see also* OR. REG. STAT. §316.695(1)(c)(A) (also allowing taxpayers to choose to itemize or to take the standard deduction for Oregon state purposes, regardless of a taxpayer’s federal election).

³ VA. CODE ANN. §58.1-322(D)(1)(a). Virginia taxpayers that itemize for federal tax purposes must itemize for state tax purposes, and Virginia taxpayers that take the standard deduction for federal tax purposes can only take the standard deduction for state tax purposes. *Id.* In Vermont, a taxpayer’s decision to itemize or take the standard deduction for federal tax purposes is binding on the taxpayer for state tax purposes too, but in Vermont this is implicit in the way Vermont’s state tax conforms to the federal tax. Vermont’s base for federal conformity is federal taxable income, so the taxpayer’s choice between itemized and standard deductions is already incorporated into the taxpayer’s Vermont taxable income without any action required. VT. STAT. ANN. tit. 32 §§5811(21), 5820, 5824.

⁴ N.Y. TAX LAW § 615(a); N.Y. COMP. CODES R. & REGS. tit. 20, §§ 113.1, 114.1. New York allows taxpayers who itemize for federal tax purposes to elect whether to itemize for New York tax purposes or whether to take the standard deduction for New York purposes. The same option is not provided to taxpayers who take the standard deduction for federal income tax purposes.

⁵ New Jersey state income tax law only allows a limited number of specified deductions, so New Jersey taxpayers lack the standard deduction/itemized deduction choice provided by the IRC. N.J. STAT. ANN. §54A:1-2, 2-1, 3-1 to 3-8, 5-1.

⁶ Memorandum from Dan Dodds, Tax Policy Analyst for the Montana Department of Revenue, to Dan Bucks, Director of the Montana Department of Revenue (Sept. 18, 2009) *available at* http://revenue.mt.gov/content/committees/legislative_interim_committee/married_filing_separately.pdf (citing data regarding tax returns for 2007). I mention Montana, in particular, because Montana is considering whether to require married couples to use the same filing status for state purposes as they use for federal purposes. Montana Senate Joint Resolution No. 37 (2009); Montana House Joint Resolution 13 (2011). Married couples in several states can use different filing statuses for state and federal income tax purposes. For example, Vice-President Joseph Biden and Dr. Jill Biden filed jointly for federal income tax purposes and separately for Delaware state income tax purposes. *See* Joseph Biden & Jill Biden, Delaware Individual Resident Income Tax Return Form 200-01 for Taxable Year 2010, *available at* http://www.whitehouse.gov/sites/default/files/rss_viewer/VPOTUStaxes.pdf.

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about filing status for state purposes, regardless of the filing status elected for federal income tax purposes; in contrast, a majority of states that impose income taxes requires each married couple⁷ to use the same filing status as the couple uses for federal tax purposes.⁸ Policymakers in Montana are considering whether to change state law to adopt the majority approach.⁹

Should taxpayers be required to make consistent federal and state tax elections? States have a vested interest in the answer to this question. This question raises issues of state sovereignty and fiscal federalism. This question affects taxpayer compliance and the cost of administering and enforcing the state income tax system. And, given that tax elections generally give taxpayers opportunities to reduce their tax liabilities, this question impacts state tax revenue.¹⁰

⁷ Given the differences between the federal definition of marriage and the definition of marriage in several states, any such mandatory consistency would have to be limited to those couples who are treated as “married” for both federal and state purposes.

⁸ See Jeff Martin, *Background Report on Montana’s Individual Income Tax for the Senate Joint Resolution No. 37 Study*, at 4 (Sep. 2009) available at http://leg.mt.gov/content/Committees/Interim/2009_2010/Revenue_and_Transportation/Staff_Reports/BACKGROUND_09SEPT.pdf (identifying states that require married couples to use the same filing status for state purposes as they used for federal purpose). States often provide limited exception, such as in the case where one spouse is a resident of the particular state and the other spouse is not. See, e.g., Mont. Admin. R. §42.15.321(1). Also, many states that allow married couples to file separately give those couples two filing options: filing separately on separate forms, and filing separately on the same form. See, e.g., Mont. Admin R. §42.15.322; 2010 Montana Individual Income Tax Return, Form 2, items 3b & 3c; see also Jaret Coles, *Overview of Individual Income Tax Filing Options in the United States, Montana, and the Other States, as well an Evaluation of Benefits and Drawbacks in Revising Montana’s Rate Schedules*, at 7 (Feb. 2010) available at http://leg.mt.gov/content/Committees/Interim/2009_2010/Revenue_and_Transportation/Meeting_Documents/Feb%2018&19%202010/OverviewTaxFiling.pdf (explaining that “the ability to file separately on the same form was implemented [in Montana] by the Department of Revenue (DOR) in 1972, because it was difficult to obtain and compare two married filing separate returns for one couple during an audit or review.”); Jaret Coles, *Individual Income Tax in the United States and Montana: A Roadmap for Future Committee Decisions on House Joint Resolution 13*, at 31-36 (Sept. 2011) available at <http://leg.mt.gov/content/Committees/Interim/2011-2012/Revenue-and-Transportation/Meeting-Documents/September%202011/HJR%2013.pdf>. For purposes of this discussion, I will generally treat these “filing separately” statuses as equivalent.

⁹ Montana Senate Joint Resolution No. 37 (2009); Montana House Joint Resolution No. 13 (2011); see also *supra* notes 6, 8.

¹⁰ Any impact on revenue is particularly important during this time of fiscal crisis. See NATIONAL CONFERENCE OF STATE LEGISLATURES, STATE BUDGET UPDATE: MARCH 2011 (Apr. 2011) (providing basic information about the budget and revenue situation for each of the 50 states), <http://www.ncsl.org/documents/fiscal/marchSBU2011freeversion.pdf>.

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Most state income tax regimes use federal income tax information as a starting point for the determination of a taxpayer’s state income tax liability.¹¹ Thus, given the large¹² (and increasing)¹³ number of explicit tax elections¹⁴ available in the federal income tax system, state legislators¹⁵ ought to consider carefully whether and how to incorporate these explicit elections into state income tax regimes.¹⁶

¹¹ Federation of Tax Administrators, *State Personal Income Taxes: Federal Starting Points (as of January 1, 2011)*, available at http://www.taxadmin.org/fta/rate/stg_pts.pdf (identifying the conformity starting point for each state).

¹² See PRACTITIONERS PUBL’G CO., TAX ELECTIONS DESKBOOK (16th ed., 2010) (providing technical information about how and when to make over 300 tax elections that are available in the federal income tax).

¹³ See, e.g., Small Business Jobs Act of 2010, P.L. 111-240 §2021(b) (adding a new election to section 179, pursuant to which a taxpayer can elect to treat qualified real property as section 179 property).

¹⁴ As used herein, “explicit tax election” refers to a provision pursuant to which “the taxpayer merely tells the Internal Revenue Service (“IRS” or “Service”) how he wishes to be treated for tax purposes[,]” and where the taxpayer “need not take any specific non-tax actions or structure his financial or legal dealings in any particular way in order to obtain his preferred tax treatment.” Heather M. Field, *Choosing Tax: Explicit Elections as an Element of Design in the Federal Income Tax System*, 47 HARV. J. ON LEGIS. 21, 22 (2010). Examples used herein include (1) a taxpayer’s ability to elect to itemize deductions or to take the standard deduction; and (2) a married couple’s ability to elect whether to file federal income tax returns jointly or separately. Other examples include a buyer and seller’s ability to elect to treat a qualified stock purchase as an asset acquisition under Section 338, and an unincorporated entity’s ability to elect to be taxed as a corporation or as a pass-through vehicle.

¹⁵ The question about the relationship between a taxpayer’s state-level tax election and the taxpayer’s federal-level tax election could be answered by federal, rather than state, legislators. For example, Congress could provide that any taxpayer who itemizes deductions for state income tax purposes must also itemize deductions for federal income tax purposes. This Article, however, seeks to provide advice to *state* legislators for three reasons. First, conformity is a choice that is more commonly made by state, rather than federal, policymakers. See *generally infra* Part II.A. Where state legislators decide to provide, for purposes of state tax law, a tax election that is provided at the federal level, the state legislators are well-situated to consider whether taxpayers should be required to make the same choice at the state level as they made at the federal level. In contrast, federal legislators, who have not considered the question of whether there will be state/federal conformity to the provision of the election, are less well-positioned to determine whether a taxpayer’s choice ought to be binding (assuming that the states do, in fact, conform to the provision of the election). Second, there is some interest in this question at the state level, but it is less clear whether there is any interest in this question at the federal level. See *supra* notes 6 and 9 and associated text (discussing the interest of the Montana legislature in the election conformity/binding issue). Third, the existing literature on conformity more commonly considers the perspective of the federal legislators rather than state legislators. See *infra* note 49 (citing literature that argues that the prevalence of conformity suggests that Congress should consider how its actions may

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Generally, the literature about conformity between the federal and state income tax regimes¹⁷ implicitly assumes that the question facing state governments is to what extent (if at all) the state income tax laws should conform to the federal income tax laws. However, where the federal income tax provides taxpayers with explicit tax elections, it is not enough for state governments to decide whether the state income tax law will conform to the federal income tax law. That decision only determines whether the state tax law will provide the same choice that the federal tax law provides. Where there are explicit tax elections in the federal income tax law, state legislators must also determine whether a taxpayer should be bound, for state income tax purposes, to the election choice that the taxpayer made for federal income tax purposes. Yet, the existing literature regarding federal/state tax conformity does not provide guidance as to how state legislators facing the election conformity question should take into account the optionality inherent in explicit elections. This Article fills this gap.

This Article argues that, in order to make informed decisions about state conformity to federal tax elections, state legislators must understand how the traditional conformity analysis is affected by the individual taxpayer autonomy provided by explicit elections. As with conformity questions in general, the question of whether a state should conform to a federal tax election raises concerns about federalism and state autonomy. However, the simplicity, administrability, enforceability, and revenue effects of state conformity to a federal tax election are largely indeterminate without knowing whether taxpayers’ federal tax elections are binding on the taxpayers for state tax purposes. Binding taxpayers to their federal elections can simplify recordkeeping, ease the tax preparation burden for taxpayers, lower the risk of taxpayer mistake, increase the state’s ability to benefit from IRS enforcement efforts, reduce opportunities for tax arbitrage, and affect state revenue (up or down, depending on the alignment and magnitude of taxpayers’ federal and state tax election preferences). Allowing taxpayers to make independent choices, on the other hand, may simplify taxpayers’ decision-making process about what election(s) to make, further the policy benefits of

affect conforming states). Thus, this Article helps to fill a gap in the literature by considering the perspective of the state legislators.

¹⁶ Some commentators criticize tax elections. See Field *supra* note 14, at 26-33 (explaining the criticisms). Nevertheless, this Article assumes the continued existence of explicit tax elections in the federal income tax system. Regardless of the policy merits of providing tax elections, state policymakers will be faced with the decision about conformity to tax elections as long elections continue to be present in the federal tax system.

¹⁷ See *infra* Part II.A.

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providing the election (where state legislators believe that the election, and not just conformity thereto, advances desirable policy objectives), advance individual taxpayer autonomy, and more clearly reflect a conception of the state income tax regime as separate and distinct from the federal income tax regime; independent choices do, however, reduce state revenue. These costs and benefits of binding (or not binding) taxpayers, for state purposes, to their federal tax elections can vary depending on the degree of conformity (e.g., whether the state tax laws conform to the current year’s federal income tax or to the federal income tax as of a particular date in the past) and on the method through which the taxpayer is bound or afforded an independent choice (e.g., whether a taxpayer’s federal election is deemed to be made for state purposes or whether a taxpayer must affirmatively make a state-level election that matches the federal election).

Legislators in different states may ultimately make different decisions about whether to conform to federal tax elections and, where conforming elections are provided, about whether (and how) to bind taxpayers to their federal tax choices. This Article provides guidance to legislators facing these decisions. Specifically, this Article argues that state legislators should be wary of providing for, or allowing, deviation from a taxpayer’s federal tax election (i.e., by decoupling from the federal election or by allowing taxpayers to make independent choices for conforming state elections) (a) if the tax election arises prior to the state’s federal conformity starting point (e.g., a taxpayer’s election whether to itemize or take the standard deduction, if the determination of state taxable income begins with the taxpayer’s federal *taxable* income, rather than the taxpayer’s federal *adjusted gross* income), or (b) if such deviation could require, for state tax compliance and enforcement purposes, information that is not provided on the federal tax return (e.g., if a taxpayer who took the standard deduction for federal purposes wanted to itemize for state purposes). Particularly in these situations, state legislators should inquire whether state-specific policy objectives can be accomplished another way, without decoupling from the election and without allowing independent choice.

The Article will proceed as follows. Part II provides background on the existing literature regarding state/federal tax conformity and explains how the conformity question is presented where the federal income tax law provides explicit elections. Part III analyzes whether states should decouple state income tax law from explicit elections provided by the federal income tax. For those circumstances in which state tax law conforms to the provision of the federal tax election, Part IV explores the concept of taxpayer consistency, and Part V addresses whether and how states should treat a taxpayer’s federal choice as binding on the taxpayer

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for state purposes. Part VI applies this Article’s analysis to the examples of explicit elections with which this introduction began: a taxpayer’s choice to itemize deductions or take a standard deduction; and a married couple’s choice to file jointly or separately. Part VII concludes.

II. UNDERSTANDING THE ELECTION CONFORMITY QUESTION

After providing background regarding states’ differing approaches to federal conformity, this section will briefly summarize the literature regarding the benefits and detriments of such conformity. Then, this section will argue that the existing literature provides incomplete guidance where the federal income tax law provides taxpayers with explicit elections.

A. Federal/State Conformity, In General

Although states have increasingly decoupled from specific federal tax provisions,¹⁸ state income tax laws generally conform to federal income tax laws.¹⁹ Each state approaches conformity slightly differently. States diverge as to whether they use federal taxable income or federal adjusted gross income as the starting point for the calculation of state taxable income.²⁰ State income taxes vary as to whether they conform to the current year’s federal income tax (“rolling conformity”) or whether they conform to the federal income tax as of a particular date (“fixed-date conformity”).²¹ Further, states differ in the number and type of state-

¹⁸ See, e.g., Rebecca Bertothy & Jon Belteau, *Stimulating the States—Are They Getting a Boost from the American Recovery and Reinvestment Act*, 19 J. MULTISTATE TAX’N & INCENTIVES, No. 9, 6 (Jan. 2010) (discussing trends for decoupling, including with respect to recent federal bonus depreciation and small business expensing provisions, and with respect to Code Section 108(i) allowing deferral of recognition from certain cancellation of debt income).

¹⁹ See Wisconsin Legislative Fiscal Bureau, *Individual Income Tax Provisions in the States, Informational Paper 4* (Jan. 2011) available at http://legis.wisconsin.gov/lfb/publications/Informational-Papers/Documents/2011/4_individual%20income%20tax%20provisions%20in%20the%20states.pdf (identifying ways in which each state’s income tax regime conforms to or differs from the federal income tax regime).

²⁰ The vast majority of states that impose a personal income tax use federal adjusted gross income (rather than federal taxable income) as the conformity starting point. See JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, *STATE TAXATION* ¶20.02 (3d ed. updated through Apr. 2011); Federation of Tax Administrators, *supra* note 11; Wisconsin Legislative Fiscal Bureau, *supra* note 19. Almost all states imposing a corporate income tax use federal taxable income as the state starting point. See HELLERSTEIN & HELLERSTEIN, *supra* note 20, at ¶7.02. States could also use *federal tax liability* as the starting point for calculating the amount of state tax liability (for either the personal or corporate income tax), but that approach has been rarely used.

²¹ See Federation of Tax Administrators, *supra* note 11 (listing which version of the Code is adopted by each conforming state).

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specific modifications that taxpayers are required to make.²² Depending on a state’s particular approach to conformity, a taxpayer may be able to make the state-specific modifications using only the information that is already provided on its federal tax return (“facial/recordkeeping conformity”), or additional information that is not provided on the federal tax return may be needed for compliance and enforcement purposes (“nonfacial conformity”).²³

Thus, a state’s degree of conformity may range in strength, from very strong (e.g., federal tax liability or federal taxable income as the conformity starting point, rolling conformity, and very few state-specific modifications none of which result in nonfacial conformity) to significantly weaker (e.g., federal adjusted gross income as the conformity starting point, conformity fixed to a date years in the past, and many state-specific modifications that result in nonfacial conformity). While the desirability of conformity can depend on the degree and details of a state’s approach to conformity, conformity can generally provide significant benefits to taxpayers and states. However, these benefits come at a cost.

1. Benefits of Conformity, In General

The literature discusses the many benefits of state conformity to federal tax.²⁴ For taxpayers, state conformity to federal tax laws simplifies

²² See HELLERSTEIN & HELLERSTEIN, *supra* note 20, at ¶7.03.

²³ Richard D. Pomp, *Restructuring a State Income Tax in Response to the Tax Reform Act of 1986*, 36 TAX NOTES 1195, 1199-1205 (Sept. 21, 1987) (using this terminology to discuss different degrees of conformity, and also discussing “absolute conformity,” where there are no state modifications to the chosen federal starting point).

²⁴ This section’s brief description draws heavily from the literature regarding the interaction between the federal and state tax regimes. See, e.g., Edwin S. Cohen, *State Income Tax Conformity: Knotty Problems in the Branches of the Federal Tree*, WILLIAM & MARY ANNUAL TAX CONF. 1967, Paper 633, available at <http://scholarship.law.wm.edu/tax/633>; HARLEY T. DUNCAN, FED’N OF TAX ADM’RS, RELATIONSHIPS BETWEEN FEDERAL AND STATE INCOME TAXES (April 2005) http://govinfo.library.unt.edu/taxreformpanel/meetings/pdf/incometax_04182005.pdf; Jane G. Gravelle & Jennifer Gravelle, *How Federal Policymakers Account for Concerns of State and Local Governments in the Formulation of Federal Tax Policy*, 60 NAT’L TAX J. 631, 640-43; (Sept. 2007) ; HELLERSTEIN & HELLERSTEIN, *supra* note 20, at ¶7.02[4]; Walter Hellerstein, *Selected Issues in State Business Taxation*, 39 VAND. L. REV. 1033, 1038-1041 (1986); Allison L. Westfalhl Kong, *The Effects of Federal Tax Expenditures Policy on the States*, 58 STATE TAX NOTES 475, 476-81 (2010); LeAnn Luna et al., *Federal Tax Legislative Changes and State Conformity*, 47 TAX NOTES 619 (2008); Ruth Mason, *Delegating Up* at 9-10 (forthcoming) (discussing “vertical harmonization benefits”); Ruth Mason, *Federalism and the Taxing Power*, 99 CAL. L. REV. 975, 1019-21 (2011); Michael Mazerov & Dan R. Bucks, *Federal Tax Restructuring and State and Local Governments: An Introduction to the Issues and the Literature*, 33 SAN DIEGO L. REV. 1459 (1996); Charles E. McLure, Jr., *How to Coordinate State and*

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tax preparation, reduces the risk of mistakes, and eases compliance.²⁵ Among other benefits,²⁶ taxpayers need not keep separate records for federal and state purposes, so conformity can reduce taxpayers’ record-keeping burdens. Additionally, where the federal and state tax treatments align, it is easier for taxpayers to take tax issues into account when making business decisions. Moreover, for taxpayers that pay taxes in multiple states, the benefits of conformity are magnified if many of these states’ tax laws conform to the federal tax laws.²⁷

For states, conformity to federal tax laws can increase the administrability of the state tax laws and can lower the cost of that administration. The stronger the conformity, the more that states can rely on “the Internal Revenue Service’s superior capacity for enforcement,”²⁸ on third-party reporting information that is already required by the federal government, and on opportunities for data exchanges with the IRS.²⁹

Local Sales Taxes with a Federal Value Added Tax, 63 TAX L. REV. 639, 699-702 (2010); Kathryn L. Moore, *State and Local Taxation: When Will Congress Intervene*, 23 J. LEGIS. 171, 179-82 (1997); Pomp, *supra* note 23, at 1199-1205; Frank Shafroth, *To Conform or Not to Conform – That is the Question*, 29 STATE TAX NOTES 711 (2003); Kirk J. Stark, *The Federal Role in State Tax Reform*, 30 VA. TAX REV. 407, 423-25 (2010); David A. Super, *Rethinking Fiscal Federalism*, 118 HARV. L. REV. 2544, 2593-95 (2005); Richard Weiss, *Achieving Uniformity in State Income Taxes: A Worthwhile Goal*, 18-Sep J. MULTISTATE TAX’N & INCENTIVES 8 (2008). Many additional resources are not listed.

²⁵ The stronger the conformity, the greater the benefits described in this section will be. However, as the degree of conformity weakens, the compliance, simplicity and administrability benefits described in this section generally decrease. See Pomp, *supra* note 23, at 1199-1205.

²⁶ Cf. Daniel Shaviro, *An Economic and Political Look at Federalism in Taxation*, 90 MICH. L. REV. 895, 920 (1992) (explaining that nonconformity between federal and state tax laws can be problematic because it “requires taxpayers (1) to know about a host of different rules, (2) separately to exercise judgment about the application of different jurisdictions’ rules, (3) to engage in separate numerical calculations . . . , (5) to file multiple forms – not only tax returns, but information reports, requests for extensions, reports of tax return adjustments required by other jurisdictions, and the like, and (6) to engage in a host of parallel interactions with government officials, such as auditors and legislators.”).

²⁷ Mason, *Delegating Up*, *supra* note 24, at 11-15 (discussing benefits of harmonization of the tax base between states).

²⁸ Super, *supra* note 24, at 2595.

²⁹ See T. Keith Fogg, *Transparency in Private Collection of Federal Taxes*, 10 FLA. TAX REV. 763, 793 (2011); Ralph B. Tower & Caroline M. Boyd, *Tax Base Modifications: The Hidden Barrier to Simplification*, 41 STATE TAX NOTES 165 (2006). A closely related benefit is that conformity also provides opportunities for federal and state administrators to cooperate on enforcement actions and on efforts to improve tax administration. DUNCAN, *supra* note 24, at ¶6.3; see also Mildred Wigfall Robinson, *The States’ Stake and Role in Closing the Federal “Tax Gap”*, 28 VA. TAX REV. 959, 974-80 (2009).

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Similarly, conformity allows states to rely on well-developed federal regulations, IRS guidance, and federal cases that interpret the relevant tax provisions.³⁰ All of these synergies help to reduce both taxpayer fraud and the amount of state resources spent on enforcement and administration of the state tax system.³¹

In addition, since conformity generally makes compliance easier for taxpayers, greater conformity with federal tax laws can increase a state’s ability to “attract capital with the promise of lower tax-planning expenses.”³² Said differently, lack of conformity can hurt a state’s business climate, particularly for businesses that operate in multiple states.³³

Conformity may also benefit the federal government because decoupling can result in state tax policies that undermine the economic and/or social policy objectives of the federal tax laws.

2. Costs of Conformity, In General

Despite the foregoing benefits, conformity can raise significant concerns.³⁴ Where states conform to the federal income tax, the state tax

³⁰ HELLERSTEIN & HELLERSTEIN, *supra* note 20, at ¶7.02[4]. *But see* NICHOLAS JOHNSON & ASHALI SINGHAM, CENTER ON BUDGET AND POLICY PRIORITIES, STATES CAN OPT OUT OF THE COSTLY AND INEFFECTIVE “DOMESTIC PRODUCTION DEDUCTION” CORPORATE TAX BREAK 3 (Jan. 14, 2010) (“States that conform to federal provisions [that are complex and difficult for taxpayers to understand] risk becoming involved with these difficult and time-consuming enforcement issues.”).

³¹ Super, *supra* note 24, at 2595; Brian Galle, *A Republic of the Mind: Cognitive Biases, Fiscal Federalism, and Section 164 of the Tax Code*, 82 IND. L.J. 673, 701-03 (2007); Mazerov & Bucks, *supra* note 24, at 1460-61.

³² Galle, *supra* note 31, at 703. Alternatively, state may try to attract capital by *decoupling*, if the decoupled state provision provides greater tax incentive for capital investment than the conformed tax provision would have. However, this reduces revenue and creates potentially harmful interstate tax competition.

³³ See Thomas O. Armstrong, *Statement Before the Senate Finance Committee of the Pennsylvania State Senate on Pennsylvania’s Business Tax Structure* (May 11, 2004), available at www.taxfoundation.org/research/printer/405.html (discussing the Tax Foundation’s analysis regarding the business tax climate in different states, and using “tax base conformity” as one of the “five major elements of the tax system” that impact businesses).

³⁴ This very brief discussion draws heavily on the rich literature regarding state fiscal volatility, state sovereignty, and fiscal federalism, as relevant in the tax context, including many of the works cited above in Part II.A.1. *See also, e.g.*, Richard M. Bird, *Fiscal Federalism*, in THE ENCYCLOPEDIA OF TAXATION AND TAX POLICY 127-29 (Joseph J. Cordes, et al., eds); John Dane, Jr., *Problems Involved in Conforming a State Income Tax System with the Federal Law*, 47 TAXES 94 (1969); Daniel L. Hatcher, *Poverty Revenue: The Subversion of Fiscal Federalism*, 52 ARIZ. L. REV. 675, 682-84 (2010); Charles E. McLure, Jr., *Understanding the Nuttiness of State Tax Policy: When States Have Both Too Much Sovereignty and Not Enough*, 58 NAT’L TAX J. 565 (2005);

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base narrows as Congress adds tax expenditures to the federal income tax law. As a result, federal tax changes can reduce state tax revenue,³⁵ and this revenue loss will occur without any action by state legislators for states that use a rolling approach to conformity (rather than fixed-date conformity).³⁶ Revenue losses can be particularly problematic because states generally operate under balanced budget constraints.³⁷ Given the recent fiscal crises facing states,³⁸ many states have responded to the adverse revenue effects of conformity by decoupling from recent federal tax changes, such as increased bonus depreciation, which would have been quite costly for states.³⁹

Wallace E. Oates, *An Essay on Fiscal Federalism*, 37 J. ECON. LIT. 1120 (1999); David E. Wildasin, *Pre-Emption: Federal Statutory Intervention in State Taxation*, 60 NAT’L TAX J. 649, 653-55 (2007).

³⁵ Super, *supra* note 24, at 2596-98 (discussing how changes in the federal tax law undermine states’ abilities to collect revenue); Stark, *supra* note 24, at 424-25 (discussing volatility of state tax revenues particularly where state taxes conform, to a significant degree, to federal taxes). A state could mitigate revenue reductions without decoupling, if the state legislators increase the state tax rate applicable to the narrowed base, but state tax rate increases may be undesirable or politically difficult. See Gravelle & Gravelle, *supra* note 24, at 641. Of course, if Congress broadens the tax base, the tax base of conforming states would also broaden, and this would likely increase state tax collections. While this occurred with the enactment of the 1986 Code, the recent trend has been toward narrowing the federal tax base.

³⁶ HELLERSTEIN & HELLERSTEIN, *supra* note 20, at ¶7.02.

³⁷ See David Gamage, *Preventing State Budget Crises: Managing the Fiscal Volatility Problem*, 98 CAL. L. REV. 749, 760-65 (2010) (discussing the “informal forces that lead states to balance their budgets in addition to the formal legal rules that require states to do so”); see also Robert P. Inman, *Transfers and Bailouts: Enforcing Local Fiscal Discipline with Lessons from U.S. Federalism*, in FISCAL DECENTRALIZATION AND THE CHALLENGE OF HARD BUDGET CONSTRAINT (Jonathan Rodden et al., eds.) (2003).

³⁸ Some have argued that state conformity to the federal tax base helped to create state fiscal crises. William F. Fox, *Three Characteristics of Tax Structures Have Contributed to the Current State Fiscal Crises*, 29 STATE TAX NOTES 375, 380-81 (2003).

³⁹ Gravelle & Gravelle, *supra* note 24, at 642; NICHOLAS JOHNSON & ASHALI SINGHAM, CENTER ON BUDGET AND POLICY PRIORITIES, STATES CAN OPT OUT OF THE COSTLY AND INEFFECTIVE “DOMESTIC PRODUCTION DEDUCTION” CORPORATE TAX BREAK (Jan. 14, 2010) (22 states, including the District of Columbia, have decoupled from Code section 199); MICHAEL MAZEROV, CENTER ON BUDGET AND POLICY PRIORITIES, OBSCURE TAX PROVISION OF FEDERAL RECOVERY PACKAGE COULD WIDEN STATE BUDGET GAPS (May 19, 2009) (discussing states that have, and should, decouple from a provision excluding certain cancellation of debt income from the income tax base); NICHOLAS JOHNSON, CENTER ON BUDGET AND POLICY PRIORITIES, NEW FEDERAL LAWS COULD WORSEN STATE BUDGET PROBLEMS (Feb. 28, 2008) (discussing states that have, and should, decouple from additional federal bonus depreciation); ELIZABETH C. MCNICHOL, CENTER ON BUDGET AND POLICY PRIORITIES, MANY STATES ARE DECOUPLING FROM THE FEDERAL ESTATE TAX CUT (May 23, 2002); see also Bertothy & Bertleau, *supra* note 18; Linda O’Brien, *Tax Trends: States Address Declining Tax*

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Conforming states can lose more than revenue; they also sacrifice sovereignty.⁴⁰ Increasing conformity means that state legislators increasingly cede to federal legislators the power to change state tax laws and control state tax policy.⁴¹ Thus, “when states adopt the federal tax base as their own tax base, they deliberately or inadvertently import into their own tax system federal regulatory preferences”⁴² This runs counter to the notion of state autonomy,⁴³ and this can be detrimental for the state because state and federal tax policy objectives may not be aligned.⁴⁴ Further, state conformity to federal tax law can undermine political accountability by creating confusion about whether and to what extent state legislators should be held responsible for the changes in state tax law and/or level of state services.⁴⁵

State tax policy deference to federal tax policy choices may be particularly problematic with respect to those policy choices that are better made by more decentralized governmental units.⁴⁶ Decoupling, rather

Revenues, 83 TAXES 51 (2005); Tower & Boyd, *supra* note 29 (identifying a long list of Code provisions that state frequently modify).

⁴⁰ The ability to determine tax policy and the power to raise revenue to finance public services are central to the concept of state sovereignty. Mazerov & Bucks, *supra* note 24, at 1472; Joel H. Swift, *Fiscal Federalism: Who Controls the States Purse Strings?*, 63 TEMPLE L. REV. 251, 253-54 (1990).

⁴¹ *But see* Super, *supra* note 24, at 2646 (suggesting that conformity may actually increase state autonomy by giving states greater ability to “shape their own revenue policies [rather] than wasting taxpayers’ time and their own administrative resources implementing idiosyncratic definitions of basic concepts”).

⁴² Mason, *supra* note 24, at 145; *see also* Dane, *supra* note 34, at 95.

⁴³ Robert M. Kozub, *State and Federal Unified Tax Collection: The Piggybacking Concept*, 3 J. ST. TAX’N 195, 210 (1984).

⁴⁴ This may be the case, for example, because the “Federal provision[was] intended to foster national economic policies and [was] not debated in the context of a state income tax. . . . [Such a provision] might not promote local economic growth.” Pomp, *supra* note 23, at 1200; *see also* James P. Angelini & Jerome S. Horvitz, *Federal-State Tax Policy Differentials: Why Piggybacking Will Never Work*, 4 J. ST. TAX’N 125, 133-35 (1985) (discussing ways in which federal and state tax policy goals may compete).

⁴⁵ For example, state legislators may not get the “political benefits of cutting taxes” when a new tax expenditure is incorporated into the state tax law as a result of federal conformity. Nevertheless, state legislators may suffer political stigma if, as a result of such a tax expenditure, state services are reduced or state tax rates are increased. McLure, *supra* note 34, at 569; *see also* Diane M. Ring, *What’s at Stake in the Sovereignty Debate?: International Tax and the Nation-State*, 49 VA. J. INT’L L. 155, 172-75 (2008) (discussing, in the international context, democratic accountability as an important norm of sovereignty in taxation); Mason, *supra* note 24.

⁴⁶ For example, a core insight of the fiscal federalism literature is that redistribution is better handled through more centralized levels of government. *See* Kirk J. Stark, *Fiscal Federalism and Tax Progressivity: Should the Federal Income Tax Encourage State and Local Redistribution?*, 51 UCLA L. Rev. 1389, 1408 (2004) [citing Musgrave

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than conformity, gives states more ability to use state tax policy to respond efficiently to the specific economic needs of the state and the state taxpayers.⁴⁷ Similarly, decoupling may better enable state legislators to tailor state tax policy to reflect the values and respond to the preferences of the more localized constituency.⁴⁸

B. *The Conformity Question for Explicit Elections*

Even this simplified overview demonstrates that state policymakers’ decisions about whether, and to what extent, to conform state tax law to federal tax law require difficult tradeoffs between competing considerations, including simplicity, administrability, state sovereignty, and revenue.⁴⁹ However, even the robust literature referenced above is insufficient to provide guidance to state legislators about how to deal with the conformity question where the federal tax law provides taxpayers with explicit elections.

1. What is Different about Explicit Elections?

With most income tax provisions, state legislators are presented with one key question—Should the state income tax law conform to the federal tax income law? In general, where a state’s tax law conforms to a federal tax provision, that conformity is generally determinative of the taxpayer’s tax treatment under the state tax law. For example, if a state’s tax law conforms to the federal definition of “capital asset,” then an asset that is

& Oates]. So, query whether a state’s tax laws should conform to federal tax provisions that effectuate redistribution through the tax system, particularly if other states do not conform. *See also generally* Oates, *supra* note 34; Shaviro, *supra* note 26, at 960 (articulating several benefits of state autonomy in taxation); Super, *supra* note 24.

⁴⁷ To the extent that a federal tax provision imposes a nonbenefit tax on mobile economic units, perhaps this a provision from which states should decouple; this decoupling may help the state create a more favorable environment for attracting business, while leaving to the federal government the responsibility for imposing taxes most efficiently imposed at a centralized level. *See* Oates, *supra* note 34, at 1125; Bird, *supra* note 34.

⁴⁸ Kong, *supra* note 24; Dane, *supra* note 34.

⁴⁹ Hellerstein, *supra* note 24, at 1041 (discussing these tradeoffs); McLure, *supra* note 24, at 646; Pomp, *supra* note 23, at 1207. Scholars tend to favor state conformity to federal tax law, but they acknowledge that states have legitimate reasons to decouple, particularly from tax expenditure provisions. *See, e.g.,* Kozub, *supra* note 43 (discussing how greater conformity could allow simplified tax collection); Shaviro, *supra* note 26 (arguing for a more uniform tax base among the states). Many scholars discussing conformity focus on recommendations for federal, rather than state, legislators, and these scholars generally argue that the prevalence of conformity means that Congress should consider how potential changes to the federal tax laws could affect states. *See, e.g.* Gravelle & Gravelle, *supra* note 24; Super, *supra* note 24, at 2594, 2651; Stark, *supra* note 24; McClure, *supra* note 24, at 710; Shaviro *supra* note 26.

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adjudicated to be a capital asset for federal tax purposes is also a capital asset for state tax purposes.⁵⁰

But, if a state’s tax law conforms to a federally provided explicit tax election, that conformity merely means that the state’s tax law provides the same choice as the federal tax law provides. With explicit elections, state legislators are presented with an additional question—If the state tax law does conform to the federal tax law (thus, providing a taxpayer with the same choice for state tax purposes as the taxpayer has for federal tax purposes), should the taxpayer be obligated to make the same choice for state tax purposes as the taxpayer makes for federal tax purposes? For example, if a state’s tax law fully conforms to Subchapter S of the Code, we still do not know whether a corporation that is an S corporation for federal tax purposes is also an S corporation for state tax purposes. In order to know the corporation’s state tax classification, we need to know whether the corporation has elected S status for state tax purposes.⁵¹ Of course, in addition to conforming the state tax law to Subchapter S of the IRC, a state could *require* that a corporation be classified the same way for state tax purposes as the corporation is classified for federal tax purposes, but that is a distinct issue, separate and apart from the conformity question.⁵²

Because the conformity question presented to state legislators is more complicated in the context of explicit elections, the policy analysis is also more complicated. This is true even with several simplifying assumptions. Thus, in order to isolate the policy considerations specifically relevant to the conformity analysis for explicit elections, the analysis herein generally makes the following simplifying assumptions, except as otherwise indicated. First, assume that, other than the particular provision being discussed, the state tax regime conforms to the federal tax regime in all material respects;⁵³ this assumption, in particular, will be relaxed as the

⁵⁰ A taxpayer may take one position on his tax return, and the tax authority (federal or state) may challenge that position, successfully or unsuccessfully. However, the controversy could be adjudicated, and a judge could make a final determination as to whether the particular asset is a capital asset for federal tax purposes. This is what I mean when I refer to an adjudication of a substantive issue. Taxpayers are generally precluded from relitigating an issue at the state level if that issue has been adjudicated at the federal tax level. *See infra* Part IV.B.

⁵¹ *See* BNA Tax Mgm’t Portfolio 1510-1st, State Taxation of S Corporations (discussing different state approaches to the treatment of a corporation that elected S status for federal purposes).

⁵² This additional decision is needed regardless of the strength of the state’s approach to conformity.

⁵³ For example, this assumes that the tax consequences of an asset being classified as a capital asset or a corporation being classified as an S corporation are substantially similar for state and federal purposes (i.e., capital assets produce gains taxable at

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discussion proceeds. Second, assume that, no issues unique to state taxation arise from the particular provision.⁵⁴ Third, assume that the eligibility for, and options available pursuant to, any explicit election are the same for federal and state tax purposes.⁵⁵

2. What are the State Tax Law Alternatives for Elections?

Before moving on to the analysis, it is useful at this point to define a few basic methods through which a state can implement conformity in the context of an explicit election. There are a variety of alternatives, but basic options include the following.

If the state conforms to the provision of the election and wants to bind taxpayers to their federal choices, the state law can deem the taxpayer to make the same choice for state purposes as the taxpayer made for federal purposes (“deemed federal choice”).⁵⁶ This binds taxpayers automatically, without requiring state-level taxpayer action. Alternatively, the taxpayer can be required to make an affirmative state-level choice, but the state law can bind taxpayers by requiring each taxpayer to make the state tax choice that is the same as the choice that the taxpayer made for federal purposes (“mandatory matching choice”).⁵⁷

preferred rates and losses that may have limited usability; S corporations are not subject to entity level tax in the absence of §1374 built-in gain).

⁵⁴ For example, consider an S corporation with two shareholders who are residents of different U.S. states. A state that allows such an S corporation to exist must determine if and how the state can collect state taxes on the portion of the S corporation income allocable to the shareholder who resides out of the state jurisdiction. This issue is absent at the federal tax level because both shareholders are residents of the same (U.S.) jurisdiction.

⁵⁵ For example, consider a married couple’s choice to file state tax returns as married filing jointly or married filing separately. Under an assumption that the state and federal election eligibility/options are the same, we would assume (for the moment) that the same couples have the same choice under state and federal law; this means, among other things, that the state definition of “marriage” is the same as the federal government’s definition of “marriage.” Of course, this assumption for this election is not accurate in a number of states.

⁵⁶ A deemed federal choice can be imposed though the state’s choice of conformity starting point. If the state tax law can adopt a federal tax starting point that already incorporates the choice that the taxpayer made for federal purposes, then taxpayer’s federal choice will already be reflected in the federal tax base to which the state tax law conforms. For example, if a state uses federal taxable income as the starting point for state tax conformity, that starting point already reflects the taxpayer’s choice as to whether to take the standard deduction or itemized deductions for federal tax purposes. *See supra* note 3 (explaining Vermont’s approach to the choice between itemized deduction and the standard deduction).

⁵⁷ Many states take this approach to elections regarding married couples’ filing statuses and regarding itemization of deductions. *See, e.g.*, N.Y. TAX LAW §651(b) (generally requiring taxpayers to use the same filing status for federal and state tax

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A state need not bind taxpayers to their federal choices. Instead, a state that conforms to the provision of an election could allow each taxpayer to make an independent state tax choice, even if it differs from the taxpayer’s federal choice. This can be accomplished by providing that the default rule is that a taxpayer is deemed to make the same choice for state purposes as the taxpayer made for federal purposes, but by allowing the taxpayer to opt out of this default treatment and make a different state tax choice (“default federal choice”).⁵⁸ Alternatively, the taxpayer’s state tax choice can be completely separate, unconstrained in any way by the federal tax choice (“unlinked choice”).⁵⁹

And, of course, a state can choose not to conform, and can opt instead to decouple from the federal tax provision. If the state decouples, the taxpayer is denied choice for state tax purposes.⁶⁰ Instead, the state tax law just provides that a particular set of facts are treated in a particular way, without regard to what choice is provided (or made) at the federal level.

III. TO CONFORM OR NOT TO CONFORM?

The existing literature regarding state conformity to the federal tax system provides some insight into the question of whether a state should provide the explicit tax elections that are provided by the federal tax law. This is particularly true with respect to the issues of state sovereignty and fiscal federalism. However, the analyses of many of the policy

purposes); LA. REV. STAT. ANN. §47:294 (same); *see also* Martin, *supra* note 8; *see supra* note 3 (discussing Virginia’s requirement that a taxpayer makes the same state and federal decision about itemization); GA. CODE ANN. §48-7-27(a) (requiring a taxpayer to make the same state and federal decision about itemization).

⁵⁸ California generally takes this approach to election conformity. *See* 33 §§ CAL. REV. & TAX CODE §23051.5(e). Pennsylvania recently changed to this approach for S corporation elections. PA. ACT 67-2006.

⁵⁹ Some states, including Montana, take this approach to the filing status for married couples. *See supra* note 6; *see also* Iowa 2010 Form IA-1040 (Long Form) Expanded Instructions – Individual Income Tax Booklet, pg. 3 (Iowa allows unlinked choice for a married couple’s filing status). Also, several states take this approach to taxpayers’ decisions as to whether to itemize deductions. *See supra* note 2 (California and Oregon); DEL. CODE ANN. §1109. Some states take a mixed approach to elections, for example, allowing an unlinked choice in some circumstances but requiring mandatory matching choices in other circumstances. *See, e.g., supra* note 4 (New York); MD. CODE ANN. TAX-GEN. §§10-217, 10-218 (allowing taxpayers who itemize for federal purposes to make an independent choice for state purposes as to whether to itemize or take the standard deduction, but requiring taxpayers who take the standard deduction for federal tax purposes to make a mandatory matching choice and take the standard deduction for state tax purposes as well).

⁶⁰ That is, unless the state substitutes a unique state-specific election in lieu of the federally provided election.

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considerations relevant to the traditional conformity discussion, such as simplicity, administrability, and even (to some degree) revenue, are largely indeterminate in the context of elections without knowing whether the taxpayer’s federal election will be binding on the taxpayer for state tax purposes.

A. Costs & Benefits of Conformity, Regardless of Whether an Election is Binding⁶¹

Reluctance to cede state autonomy could lead state legislators to consider decoupling from one or more federally provided tax elections. As with traditional conformity questions, state legislators may be disinclined to incorporate a federal tax election into state tax law if the tax election addresses a policy issue that is better addressed at the federal level and/or if the tax election does not reflect the preferences, values,⁶² or needs of the state’s taxpayers.⁶³

State legislators may be concerned about ceding state autonomy and lawmaking power to Congress particularly with respect to explicit elections. Tax elections, in general, have been criticized for creating complexity for taxpayers, increasing administrative burdens on tax authorities, leading to inequities, and reducing revenue.⁶⁴ Thus, state legislators may want to make their own decisions about whether there is good reason to provide taxpayers with an election, rather than deferring to Congress’s judgment. State policymakers that concur with the critiques may be loathe to import a federal tax election into the state tax system, thereby compounding an arguably poor federal tax policy decision to provide an election at all, and potentially leading to confusion about political accountability.

In addition, a state that conforms to a federal tax election cedes power not only to federal legislators, but to taxpayers themselves. An explicit election, by definition, defers to a taxpayer’s choice about how the taxpayer will be treated for tax purposes; by providing a tax election, the lawmakers relinquish to the individual taxpayers the power to determine its tax consequences.⁶⁵ Thus, a state that conforms to a federal tax

⁶¹ The discussion in this section generally assumes relatively strong conformity.

⁶² For example, the state taxpayers could differ from the nation’s taxpayers with respect to how to treat a married couple for tax purposes and with respect to when and whether marriage penalties and bonuses are equitable. This will be discussed further below in Part VI.B.

⁶³ These concerns could lead a state to decouple in order to provide tax treatment that is *more* favorable for taxpayers (e.g., to try to encourage a particular activity) or that is *less* favorable for taxpayers (e.g., to try to raise revenue).

⁶⁴ See Field, *supra* note 14, at 26-33 (discussing criticisms of tax elections).

⁶⁵ See *supra* note 14.

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election not only allows Congress to determine state tax policy, but also allows Congress to decide when the taxpayers themselves are empowered to determine the state tax treatment of a particular event. Thus, conformity to federal tax elections affects not only the balance of power between the state government and the federal government, but also the balance of power between the state government and the state taxpayers.

Notwithstanding the foregoing, if state policymakers believe that the election furthers state interests,⁶⁶ conformity to the federal tax election could be viewed as an *exercise* (rather than relinquishment) of state sovereignty.

B. *Costs & Benefits of Conformity that are Largely Indeterminate without Knowing Whether an Election is Binding*

The above analysis of potential sovereignty and federalism consequences of state conformity to federal tax elections generally does not depend on whether a federal tax election is binding on the taxpayer for state law purposes (assuming such election is provided at the state level). However, many other costs and benefits of conformity discussed in the literature are indeterminate without knowing whether a taxpayer’s federal tax election will be binding on him for state tax purposes.⁶⁷

1. Simplicity

State conformity to a federal tax election advances simplicity in that a taxpayer only needs to understand one set of tax rules.⁶⁸ However, the remainder of the simplicity analysis depends not only on whether the state conforms to the provision of the tax election, but also on whether the

⁶⁶ Field, *supra* note 14 (arguing that explicit elections can be useful additions to the tax system for purposes including “reconciling discontinuous regimes [and] facilitating tax classification”).

⁶⁷ Again, this discussion generally assumes relatively strong conformity. As the degree of conformity weakens, most of the policy benefits described herein are reduced and most of the policy costs described herein are increased. *See, e.g. infra* notes 68-72.

⁶⁸ When tax elections are added or removed from the federal tax law, taxpayers in states that use rolling conformity generally recognize this simplicity benefit more than taxpayers in states that use fixed-date conformity. If an election is incorporated into the federal tax system after the state’s conformity date, then taxpayers will still need to understand one set of tax rules for federal purposes and a different set of tax rules for state purposes. Thus, the potential simplicity benefits discussed in this section are much more relevant where the state uses a rolling conformity approach or where the election is already part of the federal tax law as it existed as of the state’s conformity date. Similarly, the more state-specific modifications made to the elections, the less simplicity and administrability benefits arise from conformity; this is especially true where the state modifications result in nonfacial conformity.

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state requires taxpayers to make the same choice for state purposes as for federal purposes.⁶⁹

Consider simplicity of recordkeeping and tax preparation. Even where a state conforms to a federal election, taxpayers’ recordkeeping burdens and tax preparation costs are not simplified if the taxpayer can make a state tax choice that differs from the taxpayer’s federal choice. Different federal and state choices likely mean that the taxpayer needs to keep different federal/state records and that different information is reflected on the taxpayer’s federal/state tax forms. Similarly, the likelihood of taxpayer mistake is reduced and the likelihood of taxpayer compliance is increased only if the taxpayer’s federal tax choice is binding for state tax purposes or if a taxpayer with an independent choice happens to make the same choice for both federal and state tax purposes.

Taxpayers’ abilities to take tax issues into account when making business decisions also depend on whether federal elections are binding for state tax purposes. If the taxpayer can make independent choices, then he must analyze which option better reduces his federal income tax and which option better reduces his state income tax. If the taxpayer is required to make the same federal and state choices, then *in addition* the taxpayer must compare the federal and state tax savings/costs in order to determine which election is tax minimizing, on net. This additional step in the analysis adds complexity, particularly where a specific choice may reduce the taxpayer’s federal tax burden but may increase the taxpayer’s state tax burden (or vice versa). And, this additional decision-making complexity could particularly disadvantage less sophisticated taxpayers.⁷⁰

2. Administrability & Enforceability

As to conformity’s impact on administrability, state conformity to a federal tax election does ease the administration burdens on the state government, in that, state administrators need not spend time providing state-specific guidance regarding the interpretation and application of the tax election (e.g., when/how to make the election and who is eligible). Instead, state administrators can rely on the regulations and guidance

⁶⁹ Taxpayers may make the same choice for federal and state purposes under a binding or mandatory matching choice approach or under an independent choice approach (i.e., where the taxpayer concludes that the choice made for federal tax purposes also benefits the taxpayer for state tax purposes). However, the only way for a state to *ensure* that a (law-abiding) taxpayer makes the same choice is for the state to mandate consistency.

⁷⁰ Cf. Pomp, *supra* note 23 (cautioning that the additional complexity from decoupling should not be imposed on “those who are least able to cope with any additional complications”).

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issued by the Treasury and IRS and can rely on federal caselaw that interprets the statutory language providing the federal tax election.

However, unless taxpayers make the same choice for state purposes as they make for federal purposes, a state’s tax authorities may be limited in their abilities to depend on the IRS to assist in the state’s enforcement efforts. In particular, if a taxpayer makes different federal and state choices pursuant to a tax election available in both regimes, the state tax authorities gain little benefit from information reporting required by, and the ability to share information with, the federal tax authorities.⁷¹ Similarly, where taxpayers can make different federal and state tax elections, states are limited in their abilities to rely on the IRS’s enforcement capacity; this limits a state’s ability to police both taxpayer eligibility for the tax election and the substantive tax consequences that result from the election.⁷²

3. Revenue

As to revenue, if a state decouples from a federal tax election, the state’s approach to decoupling will generally determine the revenue effects. If the state decouples and imposes state tax treatment that is less taxpayer-favorable than the federal tax election, state revenue will increase

⁷¹ For example, consider a state that conforms to the entity classification election under Treasury Regulation section 301.7701-3, and that allows an entity to be classified, for state purposes, differently than the entity is classified for federal purposes. See generally Carolyn Joy Lee, *State Taxation of Partnerships, Limited Liability Companies and their Owners*, 2010 PRACTISING LAW INSTITUTE PARTNERSHIP TAX PRACTICE SERIES: PLANNING FOR DOMESTIC AND FOREIGN PARTNERSHIPS, LLCs, JOINT VENTURES & OTHER STRATEGIC ALLIANCES 215; Ely et al., *State Tax Treatment of LLCs and LLPs: Update for 2010*, 20-May J. MULTISTATE TAX & INCENTIVES 8 (2010) (discussing state tax treatment of LLCs and partnerships). If a multi-member LLC was classified as a partnership for federal income tax purposes, but the LLC elected to be classified as a corporation for state income tax purposes, then the partnership tax information reporting and Form K-1s provided to the LLC’s members (as required for federal tax purposes) may have little probative value for the state tax authority’s ability to levy corporate income tax on the entity or to properly tax the LLC’s members (who, for state tax purposes, would be treated as shareholders in a corporation rather than as partners in a partnership).

⁷² Again, a rolling conformity approach generally provides these benefits more effectively than does a fixed-date conformity approach. With fixed-date conformity, wherever an election is added to or removed from the federal tax law, there will be a period of time during which the election is available for one jurisdiction but not both. For tax periods during this time window, state tax authorities will not be as able to rely on information reporting/sharing and federal enforcement efforts. Similarly, potential administrability and enforceability benefits of conformity decrease as state-specific modifications to the elections increase, particularly if those modifications result in nonfacial conformity.

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(assuming everything else, including the level of economic activity in the state, remains constant). However, this decoupling may make the state’s business climate less favorable, and the state may lose business and taxpayers to other states, which could negate the intended revenue effect. If the state decouples and imposes state tax treatment that is *more* taxpayer-favorable than the federal tax election (e.g., to incentivize particular behavior that the state values), state revenue will decrease (assuming again that everything else, including the level of economic activity in the state, remains constant). Nevertheless, if the state can use this more taxpayer-favorable tax treatment to entice more business and investment to the state, the state might be able to recoup the revenue lost from decoupling.

Where a state chooses to conform to the federal tax election, it can be difficult to determine whether this conformity increases or reduces revenue, at least without knowing whether the federal election is binding for state purposes.⁷³ If a state conforms to the provision of the tax election and allows taxpayers to make an independent choice for state tax purposes, state tax revenue will clearly be reduced.⁷⁴

Where a state conforms to the federal tax election but requires that taxpayers make the same choice for state purposes as they made for federal tax purposes, the impact on the state’s revenue depends on the alignment and magnitude of the taxpayer’s federal and state tax preferences. Consider the situation where a state conforms to the provision of a federal tax election, pursuant to which the taxpayer can elect Option A or Option B. If a taxpayer’s federal and state tax preferences are aligned (i.e., where the taxpayer prefers to elect Option A because Option A minimizes the taxpayer’s federal *and* state tax burdens),

⁷³ Except where explicitly stated, this discussion does not take into account any dynamic revenue effects that could arise as a result of a state’s decision about how to handle the election. That is, the discussion assumes that the level of business activity, capital investment, and economic growth in the state are not affected either by a state’s decision whether or not to provide the election or by a state’s decision to bind taxpayers to their federal choices.

⁷⁴ This assumes rational taxpayers who measure utility in dollars. With unconstrained state tax elections, the taxpayer would make the tax-minimizing choice, which reduces state tax revenue. However, not all taxpayers make tax-minimizing choices, for example, because of mistake or because of an important personal reason (such as a married couple’s desire to keep each spouse’s finances separate). *See* Coles, *supra* note 8, at 14 (noting that the Montana Department of Revenue identified more than 2500 married couples who may have paid more state tax because they filed separately rather than jointly).

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then a state’s conformity to a federal election is revenue reducing for the state.⁷⁵

However, if a taxpayer’s federal and state tax preferences are not aligned (i.e., Option A minimizes the taxpayer’s federal tax burden, but Option B minimizes the taxpayer’s state tax burden),⁷⁶ each rational taxpayer will generally make the election that that best reduces its net tax burden. As a result, a binding election’s impact on the state’s revenue depends primarily on the magnitude of the federal and state tax costs and benefits of each choice available pursuant to the election. Generally, if a particular binding choice (Option A) reduces a taxpayer’s federal tax burden more than that choice increases the taxpayer’s state tax burden, then the taxpayer will make that choice (Option A), thereby increasing state revenue. By requiring a binding choice in these situations, the state effectively claims part of the monetary value of the tax election that Congress provided to the taxpayers, denying to the state taxpayers the full federal tax value of the election.⁷⁷ In the likely less common circumstances where a binding choice (Option B) reduces the taxpayer’s state tax burden more than that choice increases the taxpayer’s federal tax burden, the taxpayer will generally choose to pay higher federal taxes in order to save a greater amount of state taxes (i.e., the taxpayer will choose Option B). Requiring a binding choice in this context causes the state’s taxpayers to pay more total tax than the taxpayers would pay if the state had allowed the taxpayers to make independent choices. However, the federal fisc, rather than the state’s fisc, would reap the benefit of this increased tax payment.

IV. TAXPAYER CONSISTENCY

The foregoing discussion explains that the costs and benefits of state conformity to a federal tax election can depend, in large part, on whether

⁷⁵ Generally, if the state tax regime conforms to the federal tax regime in all material respects, as assumed under the first simplifying assumption, taxpayer’s federal and state tax election preferences should virtually always be aligned. *See supra* note 53. In this case, a state’s conformity to a federal tax election generally will be revenue reducing for the state.

⁷⁶ This is most likely to occur when we relax that first simplifying assumption, such that the state tax consequences of a particular election choice can differ from the federal tax consequences of the same election choice. *See supra* note 53; *see also supra* Parts VI.A.1. & VI.B.1. (discussing when and why taxpayers may have opposing state/federal election preferences for purposes of itemizing and filing status, respectively).

⁷⁷ That is, in this situation, a taxpayer in the state that requires a binding election will receive a smaller net monetary benefit as a result of the federal and state tax elections, as compared to the monetary benefit that a taxpayer in a state that does not require binding elections will receive as a result of her federal tax election.

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the taxpayer’s federal choice will be binding on the taxpayer for state tax purposes. Thus, any state considering conformity to a federal tax election should consider whether and how to bind a taxpayer, for state tax purposes, to the election that the taxpayer made for federal tax purposes.

Before directly confronting those questions (to which I will turn in Part V), this part discusses the concept of taxpayer consistency in circumstances that, through analogy, might provide additional insight into whether and when a taxpayer consistency requirement is appropriate in the state/federal tax election context. Specifically, this part considers how authorities and literature regarding (a) taxpayer consistency in the context of tax elections at the federal level, (b) taxpayer consistency in non-elective contexts where state tax law conforms to federal tax law, and (c) broad judicial doctrines regarding taxpayer consistency, can help to answer the question of whether and when taxpayers’ federal tax elections should be binding for state tax purposes.

A. *Taxpayer Consistency in Elective Contexts at the Federal Level*⁷⁸

Query how a taxpayer’s choice of tax treatment for purposes of one tax regime should affect the taxpayer’s treatment for purposes of another tax regime, or vice versa. This part examines two circumstances where this question is faced. Each involves two distinct tax regimes, where a particular federal tax election is available in one or both regimes.

1. Elective Classification of Foreign Entities

Entity classification for foreign entities is one circumstance in which a tax election can result in an entity being treated differently for two different tax regimes. Under the “check-the-box” regulations, a foreign eligible entity can elect whether it will be treated as a corporation or pass-

⁷⁸ The examples discussed herein focus on election consistency questions involving a single taxpayer. That is, query whether Taxpayer T should be allowed to elect Option A for one purpose and Option B for another. Election consistency questions also arise in multi-taxpayer contexts. That is, query whether Taxpayer T and Taxpayer U must both elect Option A for a single set of facts involving both taxpayers, or whether one of the taxpayers can elect Option B. See, e.g., I.R.C. §§71, 215 (consistency with respect to elective treatment of alimony); I.R.C. §108(i); Rev. Proc. 2009-37; 2009-36 I.R.B. 1; T.D. 9498 (Aug. 13, 2010) (essentially enabling individual partners to make different elections regarding whether to defer the recognition of partnership cancellation of indebtedness income). Inconsistency in the multi-taxpayer context poses risk that a single tax authority could be whipsawed; this concern does not arise in the same way in the single taxpayer context. See generally Heather M. Field, *Tax Elections & Private Bargaining*, 31 VA. TAX REV. 1, 37-60 (2011).

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through⁷⁹ for United States tax purposes.⁸⁰ As a result of this U.S. federal tax election, a foreign entity can be treated differently for U.S. and foreign tax purposes (a “hybrid entity”). Commentators have criticized this elective entity classification regime for foreign entities because, among other reasons, these hybrid entities provide opportunities for cross-border tax arbitrage.⁸¹ Specifically, there are several ways that a U.S. taxpayer can use a hybrid entity to “fully compl[y] with the laws of both the United States and the foreign country, but [] generate[] a net worldwide tax benefit solely due to the inconsistent treatment of the subsidiary by the two jurisdictions.”⁸²

In response to the revenue and other policy problems created by these arbitrage opportunities,⁸³ commentators recommend revising the entity classification rules for foreign entities.⁸⁴ Among a variety of suggested approaches, some commentators have argued that the U.S. should “classify a foreign business entity as a corporation if the entity is subject to an entity-level income tax (under U.S. foreign tax credit principles) under the law of its country of tax residence.”⁸⁵ This approach would align the U.S. tax classification of the entity with the foreign tax classification

⁷⁹ If the entity has multiple members, it can elect between corporate treatment and partnership treatment. If the entity has a single member, it can elect between corporate treatment and treatment as a disregarded entity. Treas. Reg. § 301.7701-3.

⁸⁰ Treas. Reg. § 301.7701-2, -3. The extension of elective entity classification to foreign entities was subject to considerable debate. See Heather M. Field, *Checking In on “Check-the-Box,”* 42 LOYOLA L.A. L. REV. 451, fn. 190-197 and associated text (2009) (discussing the debate).

⁸¹ See, e.g., Diane M. Ring, *One Nation Among Many: Policy Implications of Cross-Border Tax Arbitrage*, 44 B.C. L. REV. 79, 96-100 (2002) (describing examples of arbitrage opportunities available using hybrid entities); Mitchell A. Kane, *Strategy and Cooperation in National Responses to International Tax Arbitrage*, 53 EMORY L.J. 89, 160-65 (2004); see also, e.g., Adam H. Rosensweig, *Harnessing the Costs of International Tax Arbitrage*, 26 VA. TAX REV. 555, 565-68 (2007) (explaining that “tax arbitrage” differs from traditional economic arbitrage because, among other things, “there is no market-based prices correction for international tax arbitrage”); Daniel N. Shaviro, *More Revenues, Less Distortion? Responding to Cross-Border Tax Arbitrage*, 1 N.Y.U. J.L. & BUS. 113, 122-27 (2004) (noting that these “tax arbitrages” are not actually arbitrages, although they are “in the metaphorical sense of exploiting inconsistencies in the application of a shared legal concept”).

⁸² Rosensweig, *supra* note 81, at 562-63 (explaining the tax arbitrage objective).

⁸³ See, e.g., *id.* at 564-65; Ring, *supra* note 81, at 117-124 (discussing adverse policy consequences of arbitrage with hybrid entities).

⁸⁴ See, e.g., JOINT COMM. ON TAXATION, OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES, No. JCS-02-05, at 182–85 (2005) (recommending that single member foreign eligible entities be treated as corporations for U.S. tax purposes).

⁸⁵ A.B.A., *Report of the Task Force on International Tax Reform*, 59 TAX LAW. 649, 669 (2006).

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of the entity, thereby eliminating discrepancies in entity classification that taxpayers can exploit.⁸⁶

The ability to make independent elections for state and federal tax purposes presents a tax arbitrage opportunity similar to the arbitrage opportunity presented by the elective classification of foreign entities. Specifically, where there is an economic incentive for a taxpayer to make different state and federal elections, the taxpayer could generate a tax benefit merely by making inconsistent elections for the different jurisdictions, opting to apply one set of tax rules to the facts for federal tax purposes and opting to apply a different set of tax rules to the same facts for state tax purposes.⁸⁷ In the context of explicit tax elections, this opportunity will generally only arise where the state tax consequences that will apply as a result of a particular election choice differ materially from the federal tax consequences that will apply as a result of the same election choice (i.e., where the state and federal tax rules are asymmetric).⁸⁸ For example, a married couple may have an incentive to make opposite elections if the couple can minimize its federal tax burden by filing jointly, but the couple can minimize its state tax burden by filing separately.⁸⁹

To the extent that state legislators believe that independent state elections pose problematic arbitrage opportunities (and it is not clear that they necessarily do), there are a variety of potential responses. For

⁸⁶ This proposal is both about increasing consistency of treatment and limiting taxpayer electivity, which are related, but slightly different, concerns. *Id.* at 736-55.

⁸⁷ As with “arbitrage” with hybrid entities, the “arbitrage” opportunities that arise from independent elections are not traditional economic arbitrages. *See supra* note 81. However, for the purposes of this discussion, I will use the term tax arbitrage broadly to “describe a transaction that involves tax advantages, but no other financial consequences, for the taxpayer.” Alvin C. Warren, *Financial Contract Innovation and Income Tax Policy*, 107 HARV. L. REV. 460, 471 (1993); *see also* MYRON S. SCHOLES, ET AL., TAXES AND BUSINESS STRATEGY: A PLANNING APPROACH ¶ 5.6 (3d ed. 2005); Ring, *supra* note 81, at 82 (defining arbitrage as the “exploit[ation of] differences between the tax system[s] of two different jurisdictions to minimize the taxes paid to either or both.”). This broad “arbitrage” concept is consistent with the concept of “tax arbitrage” as used in the cross-border context. *See supra* note 81. Explicit tax elections, by definition involve tax consequences, but no other financial or economic consequences. Thus, the ability to make opposing elections in different jurisdictions for the same facts, thereby reducing minimizing the aggregate taxes paid, arguably constitutes an arbitrage opportunity, at least under the broad definition.

⁸⁸ Note that this requires the relaxation of the assumption that the operative federal and state tax rules are substantially similar in all material respects.

⁸⁹ *See infra* Part VI.B.1. Note that some states, like Delaware and Montana, include language, in bold font, in their tax return instruction booklets explicitly drawing the attention of taxpayers to this opportunity to reduce state taxes by making different filing choices for state purposes than they made for federal purposes.

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example, state legislators could respond unilaterally to this state/federal arbitrage opportunity in the same way that some commentators have urged the federal government to respond unilaterally to the federal/foreign arbitrage opportunity presented by hybrid entities—require consistency between the tax treatment in the former jurisdiction and the tax treatment in the latter jurisdiction.⁹⁰

There are several differences between the federal/foreign hybrid entity context and the state/federal election context, so appropriate responses (if needed) to the situations are not necessarily the same. For example, one important difference is that, in the state/federal election context, one jurisdiction is contained entirely within the other jurisdiction, whereas, in the federal/foreign hybrid entity context, the jurisdictions do not overlap. This matters because part of the tax arbitrage concern with hybrid entities is that taxpayers can exploit the differences in the tax laws of two different jurisdictions to reduce the taxpayer’s aggregate tax burden in those two jurisdictions, *as compared to* the tax burden that the taxpayer would have borne had the taxpayer invested entirely in only one of the jurisdictions.⁹¹ That is, the taxpayer opts to invest in two jurisdictions in order to achieve a tax advantage that would have been unavailable if the taxpayer had invested in only one jurisdiction. This is only possible in circumstances where the taxing jurisdictions are non-overlapping sovereigns (in that, a taxpayer that invests in the United States does not necessarily also invest in a foreign jurisdiction). In contrast, the state tax jurisdiction is wholly included in the federal tax jurisdiction; this subsidiarity means that, by investing in a state, a taxpayer must also be investing in the United States. Thus, the arbitrage opportunity in the state/federal election context, where a taxpayer lacks the ability to invest in the smaller jurisdiction without simultaneously investing in the larger jurisdiction, does not pose the same risk of opportunistic behavior as does the arbitrage opportunity in the federal/foreign hybrid entity context, where a taxpayer can freely invest in one jurisdiction without investing in the other jurisdiction.

Another important difference between the federal/foreign hybrid entity context and the state/federal election context involves whether an election is allowed in only one, or both, of the relevant jurisdictions.

⁹⁰ This assumes, in the state/federal election context, that the state legislators act unilaterally in response to federal tax laws that remain unchanged, and in the federal/foreign hybrid entity context, that the federal legislators act unilaterally in response to foreign tax laws that remain unchanged. The policy response need not be unilateral in either situation, but it is likely to be easier for one jurisdiction to take unilateral action to combat a perceived abuse rather than to negotiate joint action with another jurisdiction.

⁹¹ See Shaviro, *supra* note 81, at 116.

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Specifically, the consistency analysis for the entity classification election involves multiple tax regimes, but only *one* of those regimes generally provides a tax election. This treats the foreign tax treatment as a given, presenting the question of whether to make the U.S. federal tax classification mandatory (rather than elective) as well. However, the state/federal election question involves multiple tax regimes, *both* of which provide elections. This raises a slightly different question, asking whether to make the state tax treatment mandatorily the same as the federal tax treatment that remains elective.

2. Explicit Elections in the Alternative Minimum Tax

For purposes of analyzing the state/federal election consistency question, it is also helpful to discuss the consistency obligations for elections in the regular federal income tax and the federal alternative minimum tax, as this is a context in which *both* tax regimes provide elections. Here, the question is whether an election that a taxpayer makes for regular tax purposes is, and should be, binding on that taxpayer for AMT purposes too.

The IRS generally takes the position that a taxpayer’s regular income tax elections are binding on the taxpayer for purposes of the alternative minimum tax.⁹² Professor Daniel Lathrope has criticized this position as inconsistent with IRS’s “position that the AMT is a separate and independent income tax.”⁹³ He argues that “if the AMT is truly separate and independent from the regular tax, a taxpayer should be able to make a tax election for AMT purposes independent of the election made for regular purposes,”⁹⁴ and he suggests that “Regulation §1.55-1(a) appears to permit a taxpayer to make inconsistent regular tax and AMT elections [except in specifically articulated circumstances.]”⁹⁵ However, Professor Lathrope cautions that “until the IRS indicates whether it will treat the

⁹² Rev. Rul. 87-44, 1987-1 C.B. 3 (election made for regular income tax purposes regarding the carryback of NOLs applies for AMT purposes); *see also Marx v. Comm’r*, 2003 WL 1359267 (U.S. Tax Ct. Mar 19, 2003) (ruling that a taxpayer’s election to take the standard deduction for purposes of the regular tax precluded the taxpayer from itemizing for AMT purposes).

⁹³ DANIEL J. LATHROPE, ALTERNATIVE MINIMUM TAX ¶2.01[2] (2009) (citing the General Explanation of the Tax Reform Act of 1986 for the proposition that, “For most purposes, the tax base for the new alternative minimum tax is determined as though the alternative minimum tax were a separate and independent income tax system”).

⁹⁴ *Id.*

⁹⁵ *Id.* at ¶3.02 (specifically calling out the NOL carryback election as binding); Treas. Reg. § 1.55-1(a).

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AMT as completely separate from the regular tax, the success of a separate AMT election cannot be assured.”⁹⁶

The federal tax and a state’s tax are arguably even more “separate and independent” than are the regular federal tax and the federal AMT,⁹⁷ given that the regular federal income tax and the federal AMT are levied by the same taxing jurisdiction, whereas the federal income tax and a state income tax are regimes levied by different jurisdictions. The more important it is to a state’s policymakers that the state’s tax regime is considered to be separate and independent from the federal tax regime, the stronger the argument may be that the state should allow independent elections.

B. Taxpayer Consistency in Non-Elective Contexts Where State Tax Law Conforms to Federal Tax Law

The issue of tax consistency also arises in non-elective contexts. In particular, there is caselaw regarding how a taxpayer’s federal tax treatment can affect the taxpayer’s tax treatment in a conforming state. States vary somewhat, but the caselaw has been summarized as follows:

When a matter of federal income tax liability is disputed but ultimately resolved at the federal level, the question often arises as to the impact of the resolution of the federal dispute on the taxpayer’s state tax liability. For example, courts addressing the same question under the personal income tax have held that (1) issues *litigated* at the federal level are binding for state tax purposes; (2) issues *settled* at the federal level are sometimes, but not always, controlling for state tax purposes; and items merely *reported* for federal purposes are not binding for state tax purposes.⁹⁸

The final federal-level adjudication of a tax issue is binding for purposes of taxes imposed by a state that conforms with respect to that tax issue because the federal and state level provisions “are sufficiently identical to warrant estoppel.”⁹⁹ This rationale for treating a federal-level

⁹⁶ LATHROPE, *supra* note 93.

⁹⁷ Query to what extent this depends the state’s approach to conformity. For example, is a state’s tax system more separate and more independent of the federal tax system if the state actually enacts statutory language that happens to match the relevant IRC provision, as compared to a state that merely incorporates federal tax law by reference?

⁹⁸ HELLERSTEIN & HELLERSTEIN, *supra* note 20, at ¶7.02[4][c] (emphasis supplied) (citations omitted), ¶20.02[1] (discussing some of the caselaw in more detail); *see also* BNA TMP 3010.01(B)(2).

⁹⁹ Calhoun v. Cal. Franch. Tax Bd., 574 P.2d 763, 765 (Cal. 1978).

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adjudication as binding for state-level taxes assumes that there is a “correct” definition of a particular term. Where the federal and state tax terms are “sufficiently identical,” a final federal-level adjudication of the “correct” substantive answer should also provide the “correct” substantive answer for state-level tax purposes.¹⁰⁰

In contrast, with explicit elections, there are multiple possible alternative treatments of the same tax issue, and by definition, all alternatives comply with the law. No alternative is more or less substantively “correct,” under the existing tax law.¹⁰¹ Thus, the argument, in the non-elective context, that federal tax determinations ought to be

¹⁰⁰ Some arguments in favor of increased book/tax conformity reflect a similar concept, i.e., that book income and tax income ought to be the same, or at least that the divergence of book income and tax income likely reflects manipulation or abuse, rather than just differences in the applicable regulatory regimes. See generally Joint Committee on Taxation, *Present Law and Background Relating to Corporate Tax Reform: Issues of Conforming Book and Tax Income and Capital Cost Recovery* (JCX-16-06), May 8, 2006, at 2, 11-19; see also generally Daniel Shaviro, *The Optimal Relationship Between Taxable Income and Financial Accounting Income: Analysis and a Proposal*, available at <http://ssrn.com/abstract=1017073>. However, analogies to the book/tax conformity debate may be less helpful for our purposes than other analogies discussed herein because the book and tax systems generally differ more than tax systems in two different jurisdictions. In particular, book and tax differ in that (a) taxpayers generally have opposite goals—to minimize income for tax purposes and to maximize income for book purposes, and (b) the regimes reflect different fundamental principles that are tailored toward the different users (and uses) of the information provided—the tax system “seeks to measure income for purpose of levying the income tax. . . . [and] favors objectivity, administrability, and consistency among taxpayers,” whereas the “primary purpose of financial reporting is to provide information about a company to investors and creditors” and as a result, the book system “values accuracy and conservatism.” JCX-16-06 at 15. Because of these differing incentives and underlying principles, proponents of book/tax conformity argue that each regime can be used as an effective limit on aggressive behavior in both regimes; that is, when forced to use a single number that balances aggressive tendencies that point in opposite directions, that compromise number is likely to be more “correct” than either of the more aggressive numbers. In contrast, taxpayers subject to multiple tax jurisdictions generally have a single goal—to minimize the aggregate tax paid to the multiple jurisdictions; and the different tax regimes generally share the goal of measuring (and taxing) income in an objective, administrable and consistent way. Taxpayers may employ different methods to minimize tax in the jurisdictions, and tax jurisdictions may employ different methods to measure income appropriately, but there is less benefit in trying to use one regime to curtail abuses in the other, given the general alignment of state/federal taxpayer incentives and of state/federal tax authority goals.

¹⁰¹ One might argue that the provision of the election is bad tax policy, and that the “correct” approach to the particular tax issue would be to mandatorily treat the tax issue in a particular way. However, that is a normative assessment rather than descriptive assessment. Even if one election alternative is more “correct” (e.g., consistent with the Haig-Simons definition of income), then it may be preferable for a state to decouple from the election and just mandate a particular tax treatment. But, as long as an election is provided, any option afforded pursuant to the election complies with the law.

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binding for conforming state tax law purposes is largely unpersuasive in the elective context. If neither option provided pursuant to a *federal* election is the “correct” or “incorrect” substantive tax treatment, then similarly, neither option provided by the *state* election should be substantively “correct” or “incorrect,” so there is little (if any) substantive accuracy to be gained by mandating that a taxpayer uses its federal-level approach for state tax-level as well.

It could be argued that a taxpayer, by making the election at one level of government, is actually selecting the taxpayer’s preferred “correct” substantive tax treatment, and that the taxpayer should use that “correct” answer (once chosen) in all other circumstances. This gets to a fundamental question about the nature of an explicit tax election—Is there substance to a tax election or is a tax election mere form? That is, is a tax election a taxpayer’s statement that establishes “facts” and identifies the “truth of the matter”? Or is a tax election merely the taxpayer’s identification of how tax will be computed?

Tax elections serve a variety of purposes, including “reconciling discontinuous regimes, facilitating tax classification, promoting simplicity and administrability, and condoning tax planning.”¹⁰² Generally, these tax elections, particularly accounting elections, “drastically affect tax liabilities without altering taxpayers’ relations with the outside world;” they “are matters of form rather than substance” that affect the calculation of tax but otherwise have “no nontax ramifications.”¹⁰³ Thus, unless a tax election is understood to imbue a situation with substance that is meaningful for purposes beyond federal tax law,¹⁰⁴ the authorities

¹⁰² Field, *supra* note 14, at 34.

¹⁰³ BORIS I. BITTKER & LAWRENCE LOKKEN, *FEDERAL TAXATION OF INCOME, ESTATES & GIFTS* ¶4.3.3 (2011). Similarly, where, for example, an election (such as a section 338 election) is used to reconcile discontinuous regimes, the underlying substance of the transaction is quite clear. A section 338 election helps to alleviate the stark tax difference between structuring an acquisition as a stock purchase rather than an asset purchase, but there is no ambiguity about the substance of the transaction. The substance of the transaction is clearly a stock purchase and not an asset purchase, and the election does not change that. Rather the election merely changes the way in which the tax is computed. Thus, such a federal tax election is likely to have little, if any, probative value for purposes of determining the substantively correct state tax treatment.

¹⁰⁴ It is possible, for example, that a “classification” election, such as the entity classification election, may be understood to imbue the particular situation with some degree of substance. Elections that facilitate classification are generally useful when substantive classification tests “cease to be meaningful” – that is, where there is some difficulty in determining the truth of the matter. Field, *supra* note 14, at 46-50. The entity classification election provided by Treasury Regulation section 301.7701-3, in part, responds to the difficulty of substantively distinguishing corporations from partnerships. I.R.S. Notice 95-14, 1995-14 I.R.B. 7 (explaining the Service’s rationale for changing

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regarding federal/state consistency in the non-elective context may not be particularly probative in the elective context.

C. *Judicial Doctrines Regarding Taxpayer Consistency*

Concerns about taxpayer consistency arise in a wide variety of additional contexts. In response, courts have developed doctrines that constrain taxpayer choices and curtail abuse. These doctrines include the doctrine of election, the taxpayer’s duty of consistency, and the non-disavowal principle.

1. The Doctrine of Election

The doctrine of election generally provides that a taxpayer should be bound to the taxpayer’s initial choice between alternative tax treatments.¹⁰⁵ Specifically,

The doctrine of election, as it applies to Federal tax law, consists of two elements: (i) a free choice between two or more alternatives, and (ii) an overt act by the taxpayer communicating the choice to the Commissioner; i.e., a manifestation of choice. A taxpayer who makes such an election may not, without the consent of the Commissioner, retroactively revoke or amend it merely because another alternative now appears to be more advantageous.¹⁰⁶

from a substantive classification system to an elective classification system). In light of this substantive ambiguity, the taxpayer’s entity classification election could be conceived of as tantamount to the taxpayer’s identification of the true “substance” of the nature of the entity. That “substance” identified by the federal tax election could be meaningful, at least to some degree, for purposes of determining the proper state tax treatment. Nevertheless, a classification election need not be understood this way. A classification election could, like many other elections, be understood as a formal tool for determining how to calculate tax in a particular situation, where there may otherwise be multiple possible reasonable ways to calculate tax. For example, an entity classification election does not affect the entity’s treatment for non-tax purposes; an entity that is a general partnership under state law remains a general partnership for non-tax purposes, even if it elects to be treated as a corporation for federal income tax purposes. Thus, query whether such a federal classification election really creates “substance” that ought to be meaningful for state tax purposes.

¹⁰⁵ See *Pacific Nat’l Co. v. Welch*, 304 U.S. 191, 194-95 (1938); Aubree L. Helvey & Beth Stetson, *The Doctrine of Election*, 62 *TAX LAW*. 335 (2009).

¹⁰⁶ T.A.M. 2002-59-059 (Sept. 10, 2002); see also Helvey & Stetson, *supra* note 105; Edward Yorio, *The Revocability of Federal Tax Elections*, 44 *FORDHAM L. REV.* 463 (1975) (considering when and if a taxpayer should be able to reverse a prior elective choice).

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Despite the long history of this doctrine,¹⁰⁷ it is not always clear how (and the extent to which) the doctrine applies. For example, in 2002, the IRS changed its litigation position on the doctrine of election, at least in a limited context; the IRS “will no longer argue that the doctrine of election applies to preclude a taxpayer from amending past years’ returns to elect retroactively to value assets according to their fair market values for purposes of apportioning interest expense under Temp. Treas. Reg. § 1.861-9T(g).”¹⁰⁸ Further, two commentators have argued that, in general, the “doctrine of election should no longer be part of tax jurisprudence . . . [because] the doctrine of election may lack a valid legal foundation and may also be contrary to congressional intent. . . [and because] the doctrine of election creates inequities and ambiguities in tax jurisprudence.”¹⁰⁹

Even assuming that the doctrine of election remains in full force, it fails to address the question of whether a taxpayer should make consistent federal and state tax elections.¹¹⁰ The doctrine of election is intended to limit a taxpayer, who has the benefit of hindsight, from changing a choice after the choice is made, thereby undoing an agreement that the taxpayer had with the particular tax authority. In contrast, if a taxpayer wishes to make a state election that differs from the taxpayer’s federal tax election, the taxpayer is not attempting to retroactively change its federal choice or alter its taxing arrangement with the federal tax authority. That federal choice, once made, determines the taxpayer’s federal tax treatment; by making a contemporaneous, but different state tax choice, the taxpayer seeks to affect its *state* tax consequences, not its *federal* tax consequences. The taxpayer’s chosen taxing arrangement with each jurisdiction is unchanged by the taxpayer’s separate agreement with the other jurisdiction. Thus, the doctrine of election, which is intended to constrain a taxpayer’s ability to retroactively change choices with respect to the taxpayer’s treatment under a *single* tax regime, should be largely inapplicable to the state/federal election conformity question.¹¹¹

¹⁰⁷ Helvey & Stetson, *supra* note 105, at 340-42 (tracing the development of the doctrine of election).

¹⁰⁸ Chief Counsel Notice 2002-27 (June 6, 2002).

¹⁰⁹ Helvey & Stetson, *supra* note 105, at 336.

¹¹⁰ In addition, this assumes that the federal doctrine of election is applicable in the state context. See Giles Sutton et al., *MTC Three-Factor Election in California, Michigan, and Texas*, 56 STATE TAX NOTES 863, fn. 24 (June 14, 2010) (“It is uncertain whether, or to what extent, federal common law regarding tax elections would be applied to any state tax elections.”).

¹¹¹ Said differently, the doctrine of election requires consistency of choice within a single tax regime, while the state/federal election consistency question presented in this Article asks whether to require that a choice in one regime is consistent with a choice

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2. The Taxpayer’s Duty of Consistency

An analogy to the taxpayer’s “duty of consistency” is similarly inapt. “The duty of consistency is based on the theory that the taxpayer owes the Commissioner the duty to be consistent in the tax treatment of items and will not be permitted to benefit from the taxpayer’s own prior error or omission.”¹¹² This limits a taxpayer’s ability to change its position vis-a-vis the IRS (a single tax authority) after the statute of limitations has closed with respect to the first instance of that position (i.e., over several tax periods). In contrast, the federal/state election conformity question discussed herein involves multiple different taxing authorities in a single tax period. As with the doctrine of election,¹¹³ a taxpayer who makes one election for federal tax purposes is not attempting to change that federal tax election by making a different election for state tax purposes; thus, by making different federal and state tax elections, the taxpayer does not violate any duty of consistency vis-a-vis either tax authority. Thus, the taxpayer’s duty of consistency is of little help in answering the state/federal election conformity question.

3. The *Danielson* Rule & the Non-Disavowal Principle

The *Danielson* rule and the broader “non-disavowal principle” also fail to provide much guidance about whether a taxpayer who makes one election for federal tax purposes should be allowed to make a different election for state tax purposes. As articulated by the Third Circuit in *Commissioner v. Danielson*, “a party can challenge the tax consequences of his agreement as construed by the Commissioner only . . . because of mistake, undue influence, fraud, duress, etc.”¹¹⁴ That is, a taxpayer is generally bound, for tax purposes, by the terms of the contracts into which

made in another regime. These are different questions as long as the federal and state governments are respected as separate and distinct regimes.

¹¹² *Cluck v. Comm’r*, 105 T.C. 324, 331 (1995); see Steve R. Johnson, *The Taxpayer’s Duty of Consistency*, 46 TAX L. REV. 537 (1991); BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES & GIFTS ¶4.3.7 (2011). The tax benefit rule is closely related to the taxpayer’s duty of consistency in that the tax benefit rule requires that a taxpayer behave consistently over a period of years (e.g., by including in income amounts recovered that the taxpayer had previously deducted as bad debts). See generally BITTKER & LOKKEN, *supra* ¶5.7.

¹¹³ See *supra* Part IV.C.1.

¹¹⁴ 378 F.2d 771, 775 (3d Cir. 1967).

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he enters.¹¹⁵ More broadly, the “non-disavowal principle” suggests that a taxpayer should be bound by the form that he has chosen for his action.¹¹⁶

Neither of these principles is absolute,¹¹⁷ but even accepting them, they seem unlikely to preclude a taxpayer from making inconsistent elections for federal and state purposes on the grounds that one such election is an impermissible disavowal of the position taken by the taxpayer pursuant to the other election. Treating a tax election as an agreement between the taxpayer and the relevant taxing jurisdiction,¹¹⁸ a different election made in a different taxing jurisdiction is not a rejection of the first agreement. It remains the case that, for purposes of the first jurisdiction, tax will be calculated as agreed; neither jurisdiction is put at risk for whipsaw (one of the concerns that motivated the court in *Danielson*),¹¹⁹ and neither taxing authority has the potential to be “faced with conflicting claims” as a result of the inconsistent positions.¹²⁰ Even the IRS has conceded that it is not inconsistent with the *Danielson* rule for a tax issue created by the terms of a single agreement to be resolved differently by different jurisdictions where the jurisdictions’ tests are distinct.¹²¹ Moreover, even with the broader non-disavowal principle generally binding taxpayers to their chosen form, there is typically some economic substance inherent in the form that the taxpayer attempts to disavow.¹²² In contrast, a tax election, by definition, lacks non-tax

¹¹⁵ Cf. I.R.S. Field Serv. Adv. 2000-04-009 (Jan. 28, 2000) (articulating and applying the *Danielson* rule).

¹¹⁶ See *Comm’r v. Nat’l Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 149 (1974) (“a taxpayer is free to organize his affairs as he chooses, . . . [but then] he must accept the tax consequences of his choice”); *Higgins v. Smith*, 308 U.S. 473, 477 (1940) (“[a] taxpayer is free to adopt such organization for his affairs as he may choose and having [made that choice], he must accept the tax disadvantages.”); see generally BITTKER & LOKKEN, *supra* note 103, at ¶4.3.6.

¹¹⁷ See *id.*

¹¹⁸ See *Field*, *supra* note 14, at 67; see also *supra* note 78 (distinguishing between single taxpayer elections, where any agreement is between the taxpayer and the government, and multi-taxpayer elections, where there may also be an agreement between the private parties).

¹¹⁹ *Comm’r v. Danielson*, 378 F.2d 771, 775 (3d Cir. 1967); see also Michael E. Baillif, *The Return Consistency Rule: A Proposal for Resolving the Substance-Form Debate*, 48 TAX LAW. 289, 309 (1995).

¹²⁰ *Comdisco, Inc. v. U.S.* 756, F.2d 569, 577-78 (7th Cir 1985).

¹²¹ See Tech. Adv. Mem. 97-48-005 (Nov. 28, 1997) (involving the U.S. federal tax authority and a foreign tax authority).

¹²² See, e.g., *Burnett v. Commonwealth Improvement Company*, 287 U.S. 415 (1932) (a taxpayer that operated its business through a corporation is precluded from disavowing the existence of that separate entity in favor of imposing tax as if the shareholder owned the business assets directly); *National Alfalfa*, *supra* note 116 (a taxpayer that engaged in a direct exchange of assets is precluded from disavowing that

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economic substance, suggesting that any “disavowal” ought not to be particularly troublesome.¹²³

D. Conclusion Regarding Reasons for Taxpayer Consistency

Neither the caselaw regarding state/federal consistency in non-elective contexts nor the general judicial doctrines regarding taxpayer consistency provides much guidance as to whether states should allow taxpayers to make state elections that differ from their federal elections. However, the discussions of election consistency in the foreign entity classification and alternative minimum tax contexts may be more helpful.

Specifically, the discussion of elective U.S. classification of foreign entities suggests that, the more problematic a state perceives tax arbitrage opportunities posed by an election to be, the more the state should consider binding the taxpayer to the taxpayer’s federal tax choice. By forcing taxpayers to balance the competing costs and benefits of the tax treatment in the different jurisdictions, the state can try to limit the magnitude of tax arbitrage opportunities. Additionally, the discussion of AMT elections suggests that, the more a state (that conforms to the provision of a federal tax election) values its status as separate and independent from the federal government, the more that state should be willing to allow taxpayers to make independent state tax choices.

V. TO BIND OR NOT TO BIND?

Based on the discussion of taxpayer consistency and based on the earlier discussion about how the possibility of independent elections affects the analysis of whether a state should conform to a federal tax election, this part considers the arguments for using binding elections and independent elections, in light of the alternative ways to implement each approach.

form in favor of taxing the transaction as an indirect exchange); *Frank Lyon Co. v. U.S.*, 435 U.S. 561, 577 (1978) (respecting the form of a transaction where the form reflected a “distinct element of economic reality”); *see also* Baillif, *supra* note 119; William S. Blatt, *Lost on a One-Way Street: The Taxpayer’s Ability to Disavow Form*, 70 OR. L. REV. 381 (1991).

¹²³ This, again, raises the question of the nature of a tax election. *See supra* notes 103 and 104 and associated text. To the extent that a tax election is viewed as more than “pure form” and instead conceived of as establishing the true economic substance of the matter (i.e., imbuing the situation with facts that would be meaningful to the state tax authority), then perhaps the non-disavowal principle may strengthen the case for binding taxpayers to make consistent elections for federal and state tax purposes.

*Binding Choices***A. To Bind – One Set of Facts, One Tax Position**

Parts III and IV suggest that a state may want to bind its taxpayers to their federal tax elections for simplicity and administrability reasons, and in order to curtail possible arbitrage opportunities. The extent of these benefits, however, varies depending on how a binding election is implemented. One approach is to use a deemed federal choice, where the taxpayer’s federal choice is deemed to have been made for state tax purposes, without any additional state-specific action by the taxpayer. A state can take this approach, for example, by opting for a starting point for conformity that is calculated after taking account the taxpayer’s federal election (e.g., if the starting point for conformity is federal taxable income, that figure inherently reflects the taxpayer’s federal choice whether to take the standard deduction or itemized deductions). An alternate approach to implementing a binding election is through mandatory matching, where state mandates that the taxpayer make a state choice that matches the taxpayer’s federal choice. This will typically be necessary if a state uses a conformity starting point that does not yet incorporate the taxpayer’s federal election (e.g., if the starting point for conformity is federal adjusted gross income, that figure *does not* yet reflect the taxpayer’s choice regarding itemization).¹²⁴

Where a state conforms to the provision of a federal tax election, both methods of binding the taxpayer to its federal tax election can simplify recordkeeping, ease the tax preparation burden, and reduce the risk of taxpayer mistake,¹²⁵ but a deemed federal choice confers these benefits more effectively than a mandatory matching approach to binding. The deemed federal choice approach relieves the taxpayer from any obligation to take affirmative state-specific steps to conform when preparing the taxpayer’s state tax return. In contrast, a mandatory matching choice requires the taxpayer to take indicate his election choice for state purposes, and this may require a separate filing. As a result of the need for additional action, a mandatory matching choice may slightly increase the opportunity for intentional or mistaken noncompliance, particularly where the taxpayer has an economic incentive to make inconsistent elections (i.e., where an effective binding election can increase state revenue).¹²⁶

Binding elections also increase the state tax authority’s ability to benefit from information sharing with the IRS and to rely on IRS enforcement actions.¹²⁷ Again, these benefits are present whether the

¹²⁴ A mandatory matching choice can be required even if the election occurs before the starting point for conformity.

¹²⁵ See *supra* Part III.B.1.

¹²⁶ See *supra* Part III.B.3.

¹²⁷ See *supra* Part III.B.2.

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taxpayer is bound via a deemed federal choice or a mandatory matching choice. The latter, however, is not as effective as the former because, with a mandatory matching choice, state tax authorities must spend time and resources processing the separate (but matching) state elections and confirming that the state elections match the federal elections. The simplicity and administrability of binding choices are particularly beneficial where an independent choice could allow the taxpayer to make a state election that requires, for return preparation and for enforcement purposes, information that is not on the taxpayer’s federal return (i.e., where the independent choice would result in nonfacial conformity).

Moreover, binding elections can be used as a response to concerns about tax arbitrage and to skepticism about the value of individual taxpayer autonomy in the tax system. One response to these concerns would be for the state to decouple from the federally provided tax election.¹²⁸ But, if the state nevertheless conforms to the federal tax election, the state can still curtail arbitrage and limit autonomy, albeit to a lesser degree, by requiring the taxpayer to treat the taxpayer’s federal election as binding for state tax purposes. Further, the more strongly the state tax regime conforms to (and values conformity to) the federal tax regime, the more the state ought to use binding elections to tightly link the taxpayer’s state tax treatment to the taxpayer’s federal tax treatment. And the less that state legislators think of a tax election as pure form and the more that state legislators conceive of a federal tax election (once made) as the taxpayer’s statement about the true substance of the particular factual situation,¹²⁹ binding elections can be used to respect that substance for state tax purposes. Again, these objectives can be advanced by both a deemed federal choice and a mandatory matching choice, but the former is likely more effective for the reasons discussed in this section.

B. *Not to Bind – Separate Tax Regimes, Separate Tax Choices*

Parts III and IV suggest that different benefits can be conferred by allowing a taxpayer to make choices about state tax elections that are unconstrained by the taxpayer’s federal election choices. Again, those benefits can vary depending on the method of implementation. A state can afford independent choice to taxpayers by either by providing for a deemed federal choice, where a taxpayer’s state choice is the same as the taxpayer’s federal choice unless the taxpayer affirmatively elects otherwise, or by allowing the taxpayer to make an unlinked choice.

¹²⁸ See *supra* Part III.A.

¹²⁹ See *supra* notes 103 and 104 and associated text.

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The more that sovereignty concerns make a state wary of conformity and the more that a state views its tax regime as separate and distinct from the federal tax regime, the more the state ought to allow independent choices (and, in particular, *unlinked* choices) in those situations where the state tax regime does conform to a federal tax election. Similarly, where state legislators provide a conforming election because they believe that the election itself (and not just conformity to the election) advances state policy objectives, those policy benefits of the election are stunted unless the taxpayers can make an independent choice. That is, if the state provides the election because state legislators value the election for state-specific purposes, taxpayers should be able to choose freely among the election alternatives for state purposes. And, an unlinked choice more clearly provides taxpayers with the option to elect than does a default federal choice. Moreover, given that tax elections are largely mere form, lacking meaningful non-tax economic substance, the case for using binding elections becomes less compelling.

Independent elections can also increase the simplicity of tax planning.¹³⁰ Independent elections, however, generally reduce the simplicity of record-keeping and tax-preparation for taxpayers, and can reduce a state’s ability to enforce its tax laws, all as compared to binding elections.¹³¹ These adverse effects may not be particularly problematic, especially with respect to elections where taxpayers are likely to make the same state and federal choices.¹³² A state may be able to increase frequency of aligned elections by providing the independent election as a default federal choice rather than an unlinked choice. With a default federal choice, taxpayers must *opt-out* of, rather than *opt-into*, consistent state/federal elections. The “stickiness” of default rules suggests that more taxpayers may end up with the same state and federal choices under a default federal choice approach than under an unlinked choice approach.¹³³ This would increase the state tax authority’s administration and enforcement abilities because, when more taxpayers make state choices that match their federal choices, the state tax authority is increasingly able to rely on IRS enforcement actions and on information exchange/sharing with the IRS. This benefit is particularly noteworthy if nonfacial conformity could result from a taxpayer’s decision to make a

¹³⁰ See *supra* Part III.B.1.

¹³¹ See *id.*

¹³² This is likely to occur when a taxpayer’s state and federal election preferences are aligned.

¹³³ See generally Jason Scott Johnston, *Strategic Bargaining and the Economic Theory of Contract Default Rules*, 100 YALE L.J. 615 (1990) (discussing the power of default rules).

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state tax choice that differs from the taxpayer’s federal tax choice.¹³⁴ Thus, the more frequently that taxpayers with independent election choices are likely to make aligned state and federal tax elections, the more an independent election will be able to confer the simplicity and administrability benefits that are provided by binding elections.

Ultimately, independent elections, whether default federal choices or unlinked choices, are unlikely to advance simplicity and administrability as well as binding elections. Nevertheless, default federal choices may be an intermediate option—allowing independent choices, but still providing at least some of the simplicity and administrability benefits of binding elections. That said, an unlinked choice approach may be easier for taxpayers to understand, in that the state tax election and federal tax election present the same choice with the same default rule. This could be less confusing for taxpayers than the default federal choice approach, which imposes a different default rule for state tax purposes than is provided for state tax purposes.¹³⁵

VI. ANSWERING THE ELECTION CONFORMITY QUESTION: EXAMPLES

Although legislators in different states will weigh the costs and benefits of conformity and binding differently, the foregoing analysis suggests that state legislators should be particularly wary of providing for, or allowing, deviation from a taxpayer’s federal tax election (i.e., by decoupling or by allowing taxpayers to make independent choices for conforming state elections) where simplicity and administrability problems of independent elections are likely to be particularly acute—(a) if a tax election arises prior to the state’s federal conformity starting point, or (b) if such deviation could require, for state tax compliance and enforcement purposes, information that is not provided on the federal tax return.

This part applies this Article’s analysis to the two examples with which this Article’s introduction began: the choice between itemized and

¹³⁴ Consider the situation where the taxpayer elects Option A for federal tax purposes and Option B for state tax purposes. If Option B requires the taxpayer to provide, and the state tax authority to evaluate, information that is not needed for Option A and thus not reflected on the taxpayer’s federal tax return, that nonfacial conformity increases the burden on state administrators. The less frequently this occurs, the lower the administrative burden on the state tax authorities.

¹³⁵ Consider a federal tax election, where Option X applies unless the taxpayer elects Option Y. Assume a taxpayer elects Option Y for federal tax purposes. Under the default federal choice approach, Option Y will also apply to the taxpayer for state tax purposes, unless the taxpayer affirmatively elects back into Option X for state tax purposes.

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standard deduction, and a married couple’s choice to file jointly or separately.

A. *Itemized Deductions vs. Standard Deduction*

1. Background¹³⁶

For federal income tax purposes, an individual has the option of itemizing her deductions or taking the standard deduction.¹³⁷ Typically, a taxpayer will want to itemize deductions if her itemized deductions exceed the standard deduction.¹³⁸ Briefly, itemized deductions¹³⁹ include nonbusiness state and local taxes,¹⁴⁰ home mortgage interest,¹⁴¹ and charitable contributions,¹⁴² among many others.¹⁴³ Generally, itemized deductions are provided to advance “either of two basic rationales: equitable distribution of the tax burden or encouragement of worth-while expenditures.”¹⁴⁴

In lieu of itemizing, a taxpayer can take a standard deduction of a fixed amount.¹⁴⁵ The standard deduction serves both simplification and progressivity functions.¹⁴⁶ It simplifies the income tax by relieving many taxpayers from the burden of tracking and calculating itemized

¹³⁶ If you have read this far, you are probably familiar with much of the background discussed in this subsection, at least with respect to the federal income tax. Thus, you might want to focus primarily on the background with respect to the state income tax, or you might want to skip directly to Part VI.A.2.

¹³⁷ I.R.C. §63. For the 2008 taxable year, itemized deductions were taken on approximately one-third of all federal income tax returns filed. IRS Statistics of Income Division, *Tax Statistics – Individual Income Tax Returns for Taxable Year 2008*, Publication 1304, table 1.2 [hereinafter, “IRS 2008 Tax Statistics”].

¹³⁸ Taxpayers can elect to take itemized deductions even if they do not exceed the standard deduction, but the taxpayer must affirmatively check a box on Schedule A in order to indicate that this is what he wants to do. I.R.S. Form 1040, Schedule A (2010).

¹³⁹ These include allowable deductions other than those deductions listed in section 62(a) and other than the deduction for personal exemptions. I.R.C. §63(d).

¹⁴⁰ I.R.C. §164.

¹⁴¹ I.R.C. §163(h).

¹⁴² I.R.C. §170.

¹⁴³ These three categories of itemized deductions are the most commonly taken by, and the most valuable to, itemizers. IRS 2008 Tax Statistics, *supra* note 137, at Table 2.1.

¹⁴⁴ Allan J. Samansky, *Nonstandard Thoughts about the Standard Deduction*, 1991 UTAH L. REV. 531, 541 (1991) (citations omitted).

¹⁴⁵ For 2011, the federal standard deduction under section 63(c)(2) for a single individual is \$5,800. Rev. Proc. 2011-12 §2.05, 2011-2 I.R.B. 297.

¹⁴⁶ See Samansky, *supra* note 144, at 533-540; John R. Brooks II, *Doing Too Much: The Standard Deduction and the Conflict Between Progressivity and Simplification*, 2 COLUM. J. OF TAX L. ___, at 9-24 (forthcoming 2011).

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deductions,¹⁴⁷ and by relieving tax administrators from the burden of enforcing the limits on those itemized deductions. Further, the standard deduction adds progressivity to the tax system by ensuring that a minimum amount of income is not subject to tax.¹⁴⁸

Most states with income taxes also allow for itemized deductions or a standard deduction. However, states vary with respect to which itemized deductions they allow, and states vary with respect to the amount of their standard deductions.¹⁴⁹ Further, states take a variety of approaches to the question of whether a taxpayer’s choice to itemize or to take the standard deduction for federal income tax purposes is binding on the taxpayer for state income tax purposes.¹⁵⁰

A taxpayer may or may not want to make the same choice for federal and state tax purposes. For example, a taxpayer that itemizes for federal income tax purposes primarily because she pays a large amount of state taxes might want to take the standard deduction for state income tax purposes since states generally do not allow an itemized deduction for state income taxes.¹⁵¹ In contrast, a taxpayer that takes the standard deduction for federal income tax purposes may want to itemize for state income tax purposes where the state allows certain additional deductions that are valuable to the taxpayer.¹⁵²

¹⁴⁷ The tradeoff is that, with this simplification, the precision of income measurement is diminished.

¹⁴⁸ Brooks, *supra* note 146, at 24-43 (arguing that these two functions should be disaggregated); Samansky, *supra* note 146; *see also* Louis Kaplow, *The Standard Deduction and Floors in the Income Tax*, 50 TAX. L. REV. 1 (1994).

¹⁴⁹ *See* RIA ALL STATE TAX GUIDE ¶228-A.5 (collecting state-by-state information); Wisconsin Legislative Fiscal Bureau, *supra* note 19 (providing detailed information about each state’s standard deduction amounts and each state’s allowable itemized deductions).

¹⁵⁰ *See, e.g., supra* notes 2-5, 57, and associated text.

¹⁵¹ For example, the Oregon Department of Revenue indicates that this is the primary reason that an Oregon taxpayer who itemizes for federal income tax purposes might decide to take the standard deduction for Oregon state tax purposes. Oregon Dep’t of Rev., *Oregon Personal Income Tax Statistics for Taxable Year 2009*, at 27 (2011) available at www.oregon.gov/DOR/STATS/101-406-2011-toc.shtml [hereinafter, “Oregon 2009 Tax Statistics”]. *See also generally* Wisconsin Legislative Fiscal Bureau, *supra* note 19, at 11 (noting which states allow deductions for state and/or federal taxes paid).

¹⁵² For example, Oregon allows a special medical deduction for taxpayers 62 years of age and older, and this deduction is an important reason that an Oregon taxpayer who takes the standard deduction for federal income tax purpose might decide to itemize deductions for Oregon state tax purposes. *Id.* In 2009, a higher percentage of Oregon state income tax returns with AGI below \$100,000, itemized deductions for state purpose than for federal tax purposes. *Id.*

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2. Analysis

Several factors should affect a state’s decision as to whether to provide taxpayers with the choice between itemized deductions and the standard deduction (the conformity question), and a state’s decision as to whether a taxpayer provided with such a choice should be obligated to make the same choice for state purposes as the taxpayer made for federal purposes (the binding question).

A state’s response to the conformity question depends, in large part, on whether and to what extent the state values the simplicity and/or progressivity afforded by the standard deduction and whether and to what extent the state values (and thus provides for) the particular deductions that would be itemized. These questions raise a state sovereignty issue because state legislators may balance these concerns differently than does Congress. For example, if a state that determines that some but not all of the federal itemized deductions are appropriate for the state constituency or if a state enacts additional itemized deductions that are specifically tailored to the state constituency,¹⁵³ the state may opt to conform to the election but decouple from some of the federal itemized deductions.¹⁵⁴ Alternatively, if a state determines that the simplicity and administrability of the standard deduction are substantially more beneficial to the state than most itemized deductions would be to the state taxpayers, the state may just opt to decouple from the election and mandate that all taxpayers take the standard deduction.¹⁵⁵

If a state decides to provide taxpayers with the choice to itemize deductions or to take the standard deduction (as most states with income

¹⁵³ States may add state-specific itemized deductions for various reasons, including federalism concerns. Specifically, query whether a state should allow a taxpayer to take a state-level itemized deduction his federal income taxes paid. Some states do, and others do not. RIA ALL STATE TAX GUIDE ¶230 (indicating which states allow such a deduction); *see also generally* Wisconsin Legislative Fiscal Bureau, *supra* note 19, at 11. This is just the reverse of the more commonly asked question of whether taxpayers should be able to take a deduction on their federal income taxes for state income taxes paid. *See, e.g.*, Galle, *supra* note 31.

¹⁵⁴ This is a common approach, though states vary with respect to the specific itemized deductions and the size of the standard deduction. RIA ALL STATE TAX GUIDE ¶228-A.5 (collecting state-by-state information); *see also* Wisconsin Legislative Fiscal Bureau, *supra* note 19.

¹⁵⁵ State legislators might decide to decouple from an election based on a different balance of the competing policy considerations. Consider a state that believes that its income tax system should be less progressive; the state may decouple and either provide no standard/itemized deductions at all or provide only a relatively small mandatory standard deduction. Consider also a state that values precision in the measurement of income more than the state values simplicity; that state might wish to decouple and mandate that all taxpayers itemize.

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taxes do),¹⁵⁶ the state must address the binding question – should a taxpayer’s federal choice be binding for state tax purposes. This assessment should depend largely on how the state legislators trade-off simplicity, administrability, and sovereignty considerations.

A state can reap significant simplicity and administrability benefits by binding each taxpayer to the itemization election he/she makes for federal tax purposes. This is particularly true if the state binds taxpayers through a deemed federal choice approach, by choosing federal *taxable* income as the state’s federal starting point for conformity.¹⁵⁷ However, where a state uses federal *adjusted gross* income (rather than federal taxable income) as its conformity starting point,¹⁵⁸ the state will need to take a mandatory matching approach if the state wants to bind taxpayers to their federal election on the itemization question. That still provides simplicity and administrability benefits, although likely less effectively than a deemed federal choice.¹⁵⁹

The price of this ease is sovereignty. As the state’s itemized deductions diverge from the federal itemized deductions,¹⁶⁰ the simplicity and administrability benefits of binding elections decline, and the tax planning complexities presented by binding elections increase.¹⁶¹ Thus, the more a state’s itemized deductions differ from the federal itemized deductions, the more that the state should consider allowing taxpayers to make independent choice about whether to itemize. This is particularly true where state legislators have added state-specific itemized deductions that reflect the values, ideals, or preferences of the state taxpayers, and where the state legislators want all state taxpayers (and not just those state taxpayers who itemized for federal tax purposes) to be able to take advantage of the state-specific deduction.

Nevertheless, even where a state’s itemized deductions diverge notably from the federal itemized deductions, binding a subset of taxpayers—mandating that taxpayers who take the standard deduction for federal tax purposes also take the standard deduction for state tax purposes—can still confer simplicity and administrability benefits. By prohibiting federal non-itemizers from itemizing for state purposes, states

¹⁵⁶ RIA ALL STATE TAX GUIDE ¶228-A.5.

¹⁵⁷ See *supra* Part V.A.

¹⁵⁸ See Federation of Tax Administrators, *supra* note 11.

¹⁵⁹ See *supra* Part V.A.

¹⁶⁰ This divergence could occur with respect to the limits on the availability of particular itemized deductions, the amounts of particular itemized deductions, and/or the number of itemized deductions allowed (with the state providing a greater or fewer number).

¹⁶¹ See *supra* Part III.B.1.

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can try to avoid nonfacial conformity problems, where taxpayers will need to provide information to the state tax authority (i.e., details about the state itemized deductions) that the taxpayer did not already provide to the IRS.¹⁶²

This suggests that, by bifurcating the decision about which taxpayers are bound, a state may be able to allow taxpayers the autonomy to make independent choices, but limit that opportunity to those situations that are least likely to create significantly increased administrative problems. Specifically, if the starting point for state conformity is federal adjusted gross income, then a state should consider bifurcating the binding decision—allowing federal itemizers to make unlinked state choices, but requiring federal non-itemizers to take the standard deduction for state tax purposes.¹⁶³

Admittedly, allowing any independent choice generally reduces state revenue. But, query whether the state ought to be entitled to any extra revenue that would be collected as a result of binding the taxpayer to make the same itemization/standard deduction choice as the taxpayer made for federal tax purposes. Any increase in state revenue arising from binding taxpayers to their federal itemization choice¹⁶⁴ actually comes from a reallocation, from the state taxpayers to the state fisc, of a tax benefit that Congress intended to provide to the state taxpayers.¹⁶⁵ Where a state essentially claims part of this federal tax benefit, the state may undermine

¹⁶² Note that the nonfacial conformity problem is really only present when taxpayers who took the standard deduction for federal purposes want to itemize for state purposes. In the reverse situation, where a taxpayer took itemized deductions for federal purposes and wants to take the standard deduction for state purposes, independent choice does not create a nonfacial conformity problem. Indeed, *less* information would generally be needed for the state tax return, not more. Thus, in this situation, independent choice does not make enforcement of the state income tax particularly more onerous than enforcement would be under a binding choice approach. In fact, allowing independent choice in this situation may actually increase simplicity because taxpayers do not have to worry about comparing the state and federal tax value of a election choice in order to determine which choice results in the greatest net benefit; the taxpayer can just make the choice that is tax minimizing for each jurisdiction without the planning complexities of binding elections.

¹⁶³ If state legislators want to add a state-specific deduction that they believe should be available to all state taxpayers, perhaps that deduction can be incorporated as an additional non-itemized deduction, such that a taxpayer could take the special state deduction in addition to taking the standard deduction.

¹⁶⁴ This assumes that a particular election choice decreases federal taxes more than the choice increases state taxes.

¹⁶⁵ That is, in this situation, a taxpayer in the state that requires a binding election will receive a smaller net monetary benefit as a result of the federal and state tax elections, as compared to the monetary benefit that a taxpayer in a state that does not require binding elections will receive as a result of her federal tax election.

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Congress’s policy objective of increasing fairness or incentivizing socially useful actions through the particular itemized deductions.

B. *Married Filing Jointly vs. Married Filing Separately*

1. Background¹⁶⁶

Consider an additional example: the federal income tax system and most state income tax systems generally allow married couples to elect whether to file jointly or separately.¹⁶⁷ Only a very small percentage of married couples file separate federal income tax returns¹⁶⁸ because filing separately generally results in a *higher* aggregate tax burden for the couple than would filing jointly.¹⁶⁹ In contrast, because of the structure of state rate brackets, married couples filing separately may have a *lower* aggregate tax burden than they would filing jointly.¹⁷⁰ As a result, many married couples may have an economic incentive to use different filing statuses for federal and state tax purposes, preferring to file jointly for

¹⁶⁶ Again, you may be familiar with much of the background discussed in this subsection, at least with respect to the federal income tax. Thus, you might want to focus primarily on the background with respect to the state income tax, or you might want to skip directly to Part VI.B.1.

¹⁶⁷ Some married couples, like couples where one spouse is a U.S. citizen and the other is a non-resident alien, are required to file separately for federal income tax purposes. However, this discussion focuses on those married couples who are entitled to make a choice between joint and separate filing. Note, also, that this discussion focuses on taxpayers who are treated as married for federal income tax purposes. The definition of marriage varies from state to state, but the question presented here is whether a couple that has the federal income tax choice whether to file as married filing jointly or married filing separately must make the same choice for state income tax purposes.

¹⁶⁸ For taxable year 2008, the IRS received approximately 53.7 million married filing jointly returns and approximately 2.7 million married filing separately returns. IRS 2008 Tax Statistics, *supra* note 137.

¹⁶⁹ Married filing separately is generally disadvantageous for several reasons, including because (a) in couples where one spouse earns much more than the other, the rate brackets operate such that the couple will usually pay less tax if they file jointly; and (b) many federal tax benefits are not available for married taxpayers filing separately. Nevertheless, married couples may want to file separately either to avoid joint and several liability for the other spouse’s tax liability or to enable a lower earning spouse to take certain deductions, such as medical expenses, that are subject to AGI floors. *See generally* BNA TMP 507-2nd, II.B.

¹⁷⁰ For example, consider the state of Montana, where married two-earner couples will usually pay less Montana tax in the aggregate if they file separately rather than jointly. *See* Dodds Memo, *supra* note 6, at 4-9 (providing examples to illustrate this phenomenon).

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federal income tax purposes and separately for state income tax purposes.¹⁷¹

Some states, like Montana, allow each married couple to use a different filing status for state tax purposes than the couple used for federal income tax purposes.¹⁷² Other states, like California and New York, generally require that married couples who file jointly for federal income tax purposes also file jointly for state income tax purposes,¹⁷³ and require that married couples who file separately for federal income tax purposes also file separately for state income tax purposes. Where states allow married taxpayers to make independent filing status elections, rational taxpayers will generally make tax-minimizing choices, which, in many circumstances, means using different filing statuses for state and federal purposes. Where states require married taxpayers to use the same filing status as the couple used for federal income tax purposes, rational taxpayers will calculate which filing status provides the greatest net tax minimization.¹⁷⁴

2. Analysis

Again, several factors, including sovereignty, administrability, and revenue concerns, affect a state’s decisions whether to provide married couples with a choice of filing status and whether to require a married couple to use the same filing status for state purposes as the couple used for federal purposes.¹⁷⁵ These questions are merely a subset of the issues

¹⁷¹ For example, in Montana, more than 55% of married couples filed separately for state tax purposes, even though less than 3% of Montana married couples filed separately for federal tax purposes. *See* Dodds Memo, *supra* note 6.

¹⁷² *See also, e.g., supra* note 59 (noting that Iowa generally takes the same approach as Montana on this issue).

¹⁷³ Of course, there are exceptions to this rule, for example where one spouse is an out of state resident.

¹⁷⁴ For example, a married couple resident in a state that binds married couples to their federal filing statuses would likely prefer to file jointly if filing jointly reduces the couple’s federal income tax burden by \$3,000, even if filing jointly increases the couple’s state income tax burden by \$500. *See generally* RIA Tax Alerts Developments, *2009 Law Changes Make Separate Filing Better for Many Married Upper-Income New York Couples*, RIA article ta-072009-0046 (July, 14, 2009).

¹⁷⁵ This discussion focuses on married couples to whom both the federal and state election apply, setting aside situations in which the state requires separate filing and setting aside differences in federal and state definitions of “marriage.” *See generally* Patricia Cain, *Taxing Families Fairly*, 48 SANTA CLARA L. REV. 805 (2008) (discussing the federal tax treatment applicable when the federal and state concepts of family/marriage differ).

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state legislators must address when determining how the state should approach the taxation of married couples.¹⁷⁶

A state’s treatment of marriage, in general, reflects the way in which the particular state resolves the conflict between the goals of marriage neutrality, progressivity, and equal treatment of married couples.¹⁷⁷ This decision can be driven by deeply held beliefs about marriage, gender, and fairness. Extensive literature considers how marriage is, and should be, treated for income tax purposes,¹⁷⁸ and this discussion does not aim to retread that ground or to argue for any particular approach advocated by commentators. Rather, this part acknowledges that, in order to reflect the values and preferences of the taxpayers in a particular state, the state’s legislators may want to tax married couples differently than does Congress. For example, a state’s legislators may want to approach marriage bonuses and marriage penalties¹⁷⁹ and/or joint and several liability differently than Congress does. Where these issues may involve a married couple’s ability to elect filing status, state legislators must consider how to implement these state-specific policies.

¹⁷⁶ Other such issues include the number and width of the rate brackets, the applicable tax rates, and the amount and availability of particular tax deductions and credits.

¹⁷⁷ Congressional Budget Office, *For Better or Worse: Marriage and the Federal Income Tax* 2-6 (June 1997) (explaining the policy conflict that leads to debate over marriage penalties and marriage bonuses); Gregg A. Eesenwein, *Income Taxation of Married Couples: Background and Analysis*, 90 TAX NOTES 108 (Feb. 19, 2001) (discussing “conflicting goals of equity” in the application of the income tax to couples); see also Boris Bittker, *Federal Income Taxation and the Family*, 27 STAN. L. REV. 1389, 1395-96, 1416-19 (1975); Lawrence Zelenak, *Doing Something About Marriage Penalties: A Guide for the Perplexed*, 54 TAX L. REV. 1, 6-7, n.26 (2000).

¹⁷⁸ See, e.g., Lily Kahng, *One is the Loneliest Number: The Single Taxpayer in a Joint Return World*, 61 HASTINGS L.J. 641 (2010); Shari Motro, *A New “I Do”: Towards a Marriage-Neutral Income Tax*, 91 IOWA L. REV. 1509 (2006); Amy C. Christian, *Joint and Several Liability and the Joint Return: Its Implication for Women*, 66 U. CIN. L. REV. 535 (1998); Edward J. McCaffery, *Taxation and the Family: A Fresh Look at Behavioral Gender Biases in the Code*, 40 UCLA L. REV. 983 (1993); Lawrence Zelenak, *Marriage and the Income Tax*, 67 S. CAL. L. REV. 339 (1994); Marjorie E. Kornhauser, *Love, Money, and the IRS: Family, Income-Sharing, and the Joint Income Tax Return*, 45 HASTINGS L.J. 63 (1993); Wendy Richards, Comment, *An Analysis of Recent Tax Reforms from a Marital-Bias Perspective: It is Time to Oust Marriage from the Tax Code*, 2008 WISC. L. REV. 611 (2008).

¹⁷⁹ These terms are usually used when comparing the tax burden of two single people to the tax burden of those same two people if they are married to each other. The concept is similarly applicable in the married filing jointly/married filing separately context, in that a married couple filing separately may pay more or less tax than that same couple filing jointly. That said, the issues may be less pressing in the joint/separate filing context than in the single/married context, in that the former does not affect the couple’s non-tax decision whether to marry.

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In an effort to define the taxable economic unit differently than Congress does, states may consider decoupling from the filing status election and eliminating married couples’ ability to make a choice about filing status. A state could provide state-specific mandatory treatment for taxpayers, for example, possibly requiring all married couples to file jointly,¹⁸⁰ or requiring each taxpayer (married or not) to file as a single individual. Because the filing status decision occurs at the very beginning of the tax preparation process and may affect so many income and deduction calculations throughout the tax preparation process,¹⁸¹ a state that decouples and adopts a different definition of the taxable economic unit risks foregoing most of the simplification and administration benefits of conformity. Decoupling can complicate both compliance and enforcement, unless the state also adopts a significantly simpler tax base.¹⁸²

Thus, it may be in states’ interests to conform to the federal income tax system’s definition of taxable economic units and to conform to the election regard married filing status. If a state conforms to the election, then it must also determine whether to bind taxpayers to their federal filing status choices. This determination, again, requires state legislators to make difficult tradeoffs between simplicity, administrability, revenue, and state and personal autonomy.

Consider a state that conforms to the filing status election, but allows married taxpayers to make an independent state choice because, for example, state legislators are particularly concerned about marriage penalties; by not binding married couples to their federal filing statuses, taxpayers can freely opt for the state filing status that best reduces any state marriage penalty. This is likely to increase complexity and decrease the administrability of the state tax system. With independent choice, as with decoupling, taxpayer’s state tax computations may be different than the taxpayer’s federal tax computations, so the risk of mistake/noncompliance may increase, and the state largely foregoes the ability to check the accuracy of the reported information by relying on the

¹⁸⁰ For example, Pennsylvania generally requires married taxpayers to file jointly, except in very limited situations specified by the statute. PA. STAT. ANN. 72 §7331; PA. CODE 61 §117.2.

¹⁸¹ Such calculations typically include how income and deductions are allocated between spouses. Cf. Richard B. Malamud, *Allocation of the Joint Return Marriage Penalty and Bonus*, 15 VA. TAX REV. 489 (1996) (discussing the complexities that arise when income, deductions, and tax liability must be allocated between spouses).

¹⁸² See, e.g., TENN. CODE ANN. § 67-2-102 (imposing a personal income tax just on dividends and interest).

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federal returns.¹⁸³ For example, where a couple files jointly for federal purposes and separately for state purposes, the couple must allocate its income and expenses between the spouses for state purposes only. This results in nonfacial conformity because the taxpayers must determine, and the state must evaluate, information that was not needed for federal purposes, diminishing the state’s ability to benefit from information sharing with the IRS and precluding the state from relying on IRS enforcement actions to police the allocation between the spouses.

These complexity and administrability concerns can be particularly difficult with this election because the federal filing status election occurs prior to the state’s starting point for federal conformity. That is, if a married couple is allowed to use a state filing status that is different from its federal filing status, state conformity to the provision of the election produces little administrative benefit because the computation of the *couple’s* state tax burden cannot begin from the *couple’s* joint federal AGI (or TI) because, for state purposes, the spouses are not filing jointly as a couple. In contrast, if a married couple is generally bound to its federal filing status, states have a much greater ability to rely on the figure used as the couple’s conformity starting point; the couple can focus its tax-preparation efforts, and the state can focus its resources, on only those state-specific calculations needed to get from the couple’s conformity starting point (say, federal adjusted gross income) to the couple’s state taxable income.

Given the significant complexity and administrative problems that can arise when a married couple’s state filing status is different from the couple’s federal filing status, a state should consider whether there is a way to reflect state-specific values regarding the proper treatment of marriage, *without* decoupling or allowing independent elections. For example, a state may be able to mitigate the risk of marriage penalties without allowing taxpayers independent choice by changing the size and rates for the tax brackets applicable to married couples, or by allowing married couples to take an additional deduction in order eliminate the extra tax cost that would otherwise be imposed because their federal election was binding for state purposes.¹⁸⁴ Thus, the state could generally benefit from the simplicity and administrability benefits of conformity and binding, while still implementing a state-specific tax policy that reflects

¹⁸³ This issue is mitigated somewhat by the option, provided by many states, of filing separately on the same form. *See supra* note 8. If the spouses file separately on the same form rather than on separate forms, it is not as difficult for the state tax authorities to compare the sum of their individual items of income and expense to the joint income and expenses reflected on the federal tax return.

¹⁸⁴ These are among the alternatives that Montana is considering.

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state-specific beliefs regarding marriage and fairness. This seems to be a very beneficial result, assuming sufficient revenue can still be collected (though this assumption may be counterfactual).¹⁸⁵

In contrast, if the state binds married couples to their federal filing statuses without making other rate/bracket/deduction changes to mitigate a potential marriage penalty, state revenue could increase.¹⁸⁶ Ultimately, when deciding how to approach the filing status election for married couples, a state must make difficult trade-offs between sovereignty, simplicity/administrability, and revenue.

VII. CONCLUSION

Tax elections in the federal income tax provide taxpayers with choice. This presents states with choice too, not just about whether to conform to or decouple from the tax election, but also (where the state conforms to the election) about whether to bind taxpayers to their federal tax choices. Different states will make different decisions, based on different policy tradeoffs.

State-specific policy choices may lead legislators to consider decoupling from a federal tax election (as many states have with respect to provisions like bonus depreciation). Or, state-specific policy choices may lead legislators to conform and allow independent choice because the legislators believe that it is good state policy to provide the election, and because allowing taxpayers to exercise personal autonomy with respect to the choice furthers the state-specific objectives of the election itself. But, simplicity and administrability concerns suggest that legislators should be particularly wary of these options (1) where the election arises before the state’s federal conformity starting point (as with the married filing status election) and (2) where independent choice pursuant to the election could lead to nonfacial conformity (as with taxpayers who take the standard deduction for federal purposes, but who want to itemize for state purposes). And, even where there are compelling state sovereignty considerations, before decoupling or deciding to conform but allow independent choice, legislators should consider whether the state-specific policy objectives can be accomplished another way, so as not to forego the simplicity and administrability benefits of conformity and binding.

¹⁸⁵ Revenue collections may be problematic because this approach is likely revenue reducing; recall that this approach largely aims to afford the taxpayers the same economics as independent filing status choice, but without sacrificing the simplicity and administrability benefits of binding choice.

¹⁸⁶ The federal benefit of filing jointly rather than separately likely exceeds the additional state cost of filing jointly, so the couple would likely file jointly in order to minimize net tax burden.

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Although this Article discusses these lessons for state legislators primarily in the context of two explicit tax elections relevant for individuals, these lessons are applicable to a wide variety of tax elections, including elections such as the business entity classification election and the election to tax certain stock acquisitions as deemed asset acquisitions.¹⁸⁷

Ultimately, concern for simplicity and administrability generally suggests that states should conform to federal elections and bind taxpayers to their federal choices. Sometimes revenue needs trump, and sometimes other state-specific policy preferences prevail. But, in order to make an educated decision about state conformity to a federal tax election, state legislators must appreciate how *their* choice is affected by the availability of *taxpayer* choice.

¹⁸⁷ Specifically, a state considering whether to conform to the federal entity classification election under Treasury Regulation section 301.7701-3 should be wary because the entity classification election is one of the first critical tax choices for a business, which will clearly arise prior to the state’s federal conformity starting point. Additionally, a state considering whether to conform to the federal section 338(h)(10) election (pursuant to which certain stock sales are taxed as asset sales) should be wary for several reasons, including because nonfacial conformity would result if taxpayers could make an independent choice to make a state-level election without also making a federal-level election (i.e., for state tax purposes, the purchase price would have to be allocated among the assets deemed purchased, but no allocation would need to be made for federal tax purposes).