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Binding Choices: Tax Elections & Federal/State Conformity

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BINDING CHOICES: TAX ELECTIONS & FEDERAL/STATE CONFORMITY

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The federal government wields tremendous power over state fiscal policy because most states' income tax laws conform, at least to some degree, to the federal income tax laws. Extensive literature discusses the advantages and disadvantages of this tax base conformity, but scholars generally assume that the question facing state governments is to what extent the state tax provisions should conform to the federal tax provisions. Where the federal tax law provides explicit tax elections (e.g., a married couple's choice to file jointly or separately), however, state legislators must decide not only whether the state law will conform to the federal law (i.e., affording taxpayers the same 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, and revenue implications of election conformity can depend on whether and how state legislators constrain the taxpayer autonomy provided by the elections. Further, this additional decision presents a fundamental federalism question about how power over state fiscal policy should be allocated among the federal government, the state government, and the taxpayers themselves. Yet, despite the large number of tax elections in the federal income tax law, the existing literature regarding federal/state tax base conformity fails to provide guidance about how state legislators considering conformity to federal tax law should take into account the optionality inherent in explicit elections. This article fills that gap.

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I. INTRODUCTION

I itemized deductions on my 2011 federal income tax return, but I took the standard deduction on my 2011 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.[1] Virginia does not.[2] New York does in some circumstances, but not in others.[3] In New Jersey, this issue is irrelevant.[4]

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[1] CAL. REV. & TAX. CODE §§ 17073, 17073.5 (West 2012); *see also* OR. REV. STAT. § 316.695(1)(c)(A) (2012) (also allowing taxpayers to choose to itemize or to take the standard deduction for Oregon state purposes, regardless of a taxpayer's federal election).

[2] VA. CODE ANN. § 58.1-322(D)(1)(a) (2012). Virginia taxpayers who itemize for federal tax purposes must itemize for state tax purposes, and Virginia taxpayers who 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 (2012).

[3] N.Y. TAX LAW § 615(a) (2012); N.Y. COMP. CODES R. & REGS. tit. 20, §§ 113.1, 114.1 (2012). 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.

[4] 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

Fewer than three percent of married couples in Montana file separate federal income tax returns, but almost fifty-six percent of married couples in Montana file separate state income tax returns.[5] In Montana and in several other states, a married couple is generally allowed to make an independent choice 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 couple[6] to use the same filing status as the couple uses for federal tax purposes.[7] Policymakers

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provided by the Code. N.J. STAT. ANN. § 54A:1-2(c), 2-1, 3-1 to 3-8, 5-1 (West 2012).

[5] Memorandum from Dan Dodds, Tax Policy Analyst, Mont. Dep't of Revenue, to Dan Bucks, Dir., Mont. Dep't 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 because Montana is considering whether to require married couples to use the same filing status for state purposes as they use for federal purposes. S.J. Res. 37, 61st Leg. (Mont. 2009); H.R.J. Res. 13, 62d Leg. (Mont. 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, Del. Individual Resident Income Tax Return, Form 200-01 for Taxable Year 2011, *available at* http://www.whitehouse.gov/sites/default/files/vp_biden_complete_return_2011.pdf.

[6] Given the differences between the federal definition of marriage and the definition of marriage in several states, any mandatory consistency would necessarily be limited to those couples that are treated as "married" for both federal and state purposes.

[7] *See* JEFF MARTIN, STATE OF MONT. LEGISLATIVE SERVS., BACKGROUND REPORT ON MONTANA'S INDIVIDUAL INCOME TAX, S. 61, 2009 Sess., at 4 (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 purposes). States often provide limited exceptions, 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) (2012). Also, many states that allow married couples to file separately give those couples two filing options: filing separately on separate forms, or filing separately on the same form. *See, e.g.*, MONT. ADMIN. R. 42.15.322 (2012); 2010 Mont. Individual Income Tax Return, Form 2, items 3b, 3c; *see also* JARET COLES, STATE OF MONT. LEGISLATIVE SERVS., 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, S. 61, 2009 Sess., at 7 (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 in 1972, because it was difficult to obtain and compare two married filing separate returns for one couple during an audit or review."). For purposes of this discussion, I will generally treat these "filing separately" statuses as equivalent.

in Montana are considering whether to change state law to adopt the majority approach.[8]

Taxpayers can elect to treat some sales of corporate stock as deemed asset sales for federal income tax purposes,[9] *but in a few states, taxpayers can simultaneously opt to treat the transactions as stock sales for state income tax purposes.*[10] States vary as to whether they require and/or allow conformity to federal section 338(h)(10) elections, which tax actual stock acquisitions as deemed asset acquisitions.[11] Over the past several years, state courts and policymakers in Alabama, California, Georgia, Massachusetts, New York, and Virginia, among other states, have struggled with this issue.[12]

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[8] S.J. Res. 37, 61st Leg. (Mont. 2009); H.R.J. Res. 13, 62d Leg. (Mont. 2011); *see also supra* notes 5, 7.

[9] I.R.C. § 338(h)(10).

[10] California explicitly allows taxpayers to do this. CAL. REV. & TAX. CODE §§ 24451, 23051.5(e) (2012) (allowing taxpayers to make different elections, including for section 338(h)(10) elections); Cal. Franchise Tax Bd., Legal Notice 2006-3 (Sept. 28, 2006). The California legislature has considered legislation, however, that would require taxpayers to make the same election for California purposes as is made for federal tax purposes. *See* Kathleen K. Wright, *An Odd Choice in California: Pension Conformity or Independent Elections*, 23 ST. TAX NOTES 887 (Mar. 11, 2002) (discussing the proposed legislation).

[11] *See* BNA, SPECIAL REPORT: 2011 SURVEY OF STATE TAX DEPARTMENTS, at S-93 to S-102 (Vol. 18 No. 4 2011) (surveying the different state approaches to this question). Among other section 338(h)(10) issues on which states may differ: (1) a state may only conform to the section 338(h)(10) election for C corporation or S corporation target companies; (2) a state may require taxpayers to file a separate election for state purposes; (3) a state may allow taxpayers to decline to make a state election, even if a federal election is in effect; and (4) a state may allow taxpayers to make the state election even if no federal election is made. *Id.*

[12] For example, in 2010, the Georgia Supreme Court ruled that a federal section 338(h)(10) election did not apply to a particular transaction for Georgia state corporate income tax purposes. Trawick Constr. Co. v. Ga. Dep't. Rev., 286 Ga. 597 (Ga. 2010) (reversing the Georgia Court of Appeals' ruling that the election *was* effective for state purposes, which reversed the Georgia Superior Court's ruling that the election *was not* effective for state purposes, which rejected the Georgia Revenue Commissioner's position that the election *was* effective for state purposes, which disregarded the administrative law judge's determination that the election *was not* effective for state purposes). In response to the Georgia Supreme Court ruling, the Georgia legislature enacted legislation explicitly providing that all subsequent federal section 338 elections will also apply for state tax purposes. 2010 Ga. Laws 627, § 2 (amending GA. CODE ANN. § 48-7-21(b)(5) (West 2012)).

New York also recently changed its law to negate a ruling which concluded that a federal section 338(h)(10) election for an S corporation did not apply for state tax purposes. Baum, N.Y. Tax App. Trib. Nos. 820837, 820838, (Feb. 12, 2009) (holding that the transaction was a stock sale, and not a deemed asset sale, for New York tax purposes, and thus the mere sale of stock by nonresident shareholders produced non-New York source income); 2010 N.Y. Laws Ch. 57 A. 9710-D, *codified at* N.Y. TAX LAW § 632(a)(2) (2011)

All three of these examples pose the same basic question — 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. Additionally, given that tax elections give taxpayers opportunities to reduce their tax liabilities, this question impacts state tax revenue,[13] thereby presenting a fundamental question about how power over state fiscal policy should be allocated among the federal government, the state governments, and taxpayers themselves.

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.[14] Thus, given the large[15] (and increasing)[16] number of explicit tax elections[17] available in the federal income tax system, state legislators

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(reversing the *Baum* ruling and explicitly providing that nonresident shareholders are to be taxed on their share of the gain from the deemed asset sale); *see generally* JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, STATE TAXATION ¶ 7.14 (3d ed. 2012) (discussing the "conformity issues raised by elections under Section 338," providing details about a section 338(h)(10) conformity controversy in Massachusetts, and citing conformity cases in a variety of additional states).

Much of the state-level controversy about section 338(h)(10) conformity centers on whether the election is respected for state tax purposes (specifically with respect to nonresident shareholders); whether the election is made for state purposes if the state does not recognize consolidated/combined groups for state tax purposes; whether the election is made for state purposes if the state does not recognize S corporations (or if the state does not recognize the particular target corporation as an S corporation); whether gain from a section 338(h)(10) transaction is treated as apportionable business income or allocable nonbusiness income; and/or whether (and how) that gain affects the sales factor for apportionment purposes.

[13] Any impact on revenue is particularly important during this time of fiscal crisis. *See State Budget Update: March 2011*, NAT'L CONFERENCE OF STATE LEGISLATURES (Apr. 19, 2011), http://www.ncsl.org/documents/fiscal/marchSBU2011freeversion.pdf (providing basic information about the budget and revenue situation for each of the 50 states).

[14] *State Personal Income Taxes: Federal Starting Points*, FED'N OF TAX ADM'RS (Jan. 1, 2011), http://www.taxadmin.org/fta/rate/stg_pts.pdf (identifying the conformity starting point for each state).

[15] *See* ANTHONY J. DECHELLIS & KAREN L. HORNE, PRACTITIONERS PUBL'G CO., TAX ELECTIONS DESKBOOK (16th ed. 2010) (discussing over 300 federal income tax elections).

[16] *See, e.g.*, Small Business Jobs Act of 2010, Pub. L. No. 111-240, § 2021(b), 124 Stat. 2504, 2505 (adding a new election to section 179, pursuant to which a taxpayer can elect to treat qualified real property as section 179 property).

[17] As used herein, "explicit tax election" refers to a provision pursuant to which "the taxpayer merely tells the Internal Revenue 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

ought to consider carefully whether and how to incorporate these explicit elections into state income tax regimes.[18]

Generally, the literature about conformity between the federal and state income tax regimes[19] 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. Where the federal income tax provides taxpayers with explicit tax elections, however, 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 that gap.

Of course, the question about the relationship between a taxpayer's state-level tax election and the taxpayer's federal-level tax election could be addressed by federal, rather than state, legislators. Congress could mandate conformity, or Congress could use incentives to encourage states to require that taxpayers make consistent federal and state tax elections.[20] This article, however, approaches the question primarily from the perspective of *state* legislators because (1) there is recent interest in the tax election conformity question at the state level, but there seems to be no indication of interest in this question at the federal level;[21] (2) state tax legislators are better situated

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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; (2) a married couple's ability to elect whether to file federal income tax returns jointly or separately; and (3) buyer and seller's ability to elect to treat a qualified stock purchase as an asset acquisition under section 338.

[18] Some commentators criticize tax elections. *See* Field, *supra* note 17, 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 face the decision about conformity to tax elections as long as elections continue to be present in the federal tax system.

[19] *See infra* Part II.A.

[20] *See, e.g.*, Darien Shanske, *How Less Can Be More: Using the Federal Income Tax to Stabilize State and Local Finance*, 31 VA. TAX REV. 413 (2012); Kirk J. Stark, *The Federal Role in State Tax Reform*, 30 VA. TAX REV. 407 (2010) (discussing how federal rules and institutions can be designed to influence the content of state tax laws).

[21] *See, e.g.*, *supra* notes 5, 8, and accompanying text (discussing the interest of the

than federal legislators to consider whether taxpayers should be required to make the same choice at the state level as they made at the federal level;[22] and (3) the state legislator perspective is largely missing from the literature regarding tax base conformity in general. The existing literature typically focuses on the perspective of federal legislators, arguing that the prevalence of conformity means that Congress should consider how potential changes to the federal tax laws could affect states.[23]

Approaching the issues from the perspective of state legislators, this article argues that, 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. The simplicity, administrability, enforceability, and revenue effects of state conformity to federal tax elections are largely indeterminate, however, 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 Internal Revenue Service (Service) enforcement efforts, and reduce opportunities

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Montana legislature in the election conformity and binding issue), note 10 (California), and note 12 (New York and Georgia); *see also, e.g.*, Roy E. Crawford & Russell D. Uzes, *Income Taxes: The Distinction Between Business and Nonbusiness Income*, BNA STATE TAX PORTFOLIOS: CORPORATE INCOME TAXES, 1140-1st, ¶ 1140.06B(7) (explaining that "[a] number of states with combined reporting are currently in the process of determining how to apply the state version of [the election in] I.R.C. § 338(h)(10) to nonunitary corporations [for state income tax purposes]").

[22] This is because state legislators are already deciding whether to provide, for purposes of state tax law, the tax election that is provided at the federal level. Thus, the state legislators can easily consider the binding issue at the same time. In contrast, federal legislators, who generally 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 federal choice ought to be binding (assuming the states do, in fact, conform to the provision of the election).

[23] *See, e.g.*, Jane G. Gravelle & Jennifer Gravelle, *How Federal Policymakers Account for the Concerns of State and Local Governments in the Formulation of Federal Tax Policy*, 60 NAT'L TAX J. 631, 640–43 (2007); Ruth Mason, *Delegating Up: State Conformity with the Federal Tax Base*, 62 DUKE L. J. at 9–10 (forthcoming 2013) (discussing "vertical harmonization benefits"); Ruth Mason, *Federalism and the Taxing Power*, 99 CALIF. L. REV. 975, 1019–21 (2011); Charles E. McLure, Jr., *How to Coordinate State and Local Sales Taxes with a Federal Value Added Tax*, 63 TAX L. REV. 639, 710 (2010); Stark, *supra* note 20, at 423–25; David A. Super, *Rethinking Fiscal Federalism*, 118 HARV. L. REV. 2544, 2593–95 (2005).

for tax arbitrage. Additionally, binding taxpayers to their federal elections can affect state revenue (up or down, depending on the alignment and magnitude of taxpayers' federal and state tax election preferences) and reduce the risk that multi-state taxpayers are less than or more than fully taxed at the state level.

Allowing taxpayers to make independent choices, on the other hand, may simplify taxpayers' decision-making process about what election(s) to make. This would further the policy benefits of providing the election (where state legislators believe 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 reduce state revenue, however. The magnitude of 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 wants 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. Further, this article argues that state legislators who value state-level decision-making autonomy should be wary of answering the tax election conformity question

in a way that raises the likelihood of multiple state taxation for multi-state taxpayers, that significantly exacerbates compliance complexity for multi-state taxpayers, that exports taxation to nonresidents, or that otherwise creates externalities for other states (and their taxpayers), thereby possibly spurring the federal government to intervene.

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 for state purposes. Part VI applies this article's analysis to the three examples of explicit elections with which this introduction began: a taxpayer's choice to itemize deductions or take the standard deduction; a married couple's choice to file jointly or separately; and the choice of parties to a taxable acquisition to tax the acquisition as an actual stock sale or as a deemed asset sale. 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,[24] state income tax laws generally conform to federal income tax laws.[25] Each state approaches conformity slightly differently. States diverge

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[24] *See, e.g.*, Rebecca Bertothy & Jon Belteau, *Stimulating the States – Are They Getting a Boost from the American Recovery and Reinvestment Act?*, J. MULTISTATE TAX'N & INCENTIVES, Jan. 2010, at 12 (discussing trends for decoupling, including with respect to recent federal bonus depreciation and small business expensing provisions, and with respect to federal section 108(i), allowing deferral of recognition from certain cancellation of debt income).

[25] *See* WIS. LEGISLATIVE FISCAL BUREAU, INDIVIDUAL INCOME TAX PROVISIONS IN THE STATES: INFORMATIONAL PAPER 4 (2011) (identifying ways in which each state's income tax regime conforms to or differs from the federal income tax regime).

as to whether they use federal taxable income or federal adjusted gross income as the starting point for the calculation of state taxable income.[26] 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).[27] Further, states differ in the number and type of state-specific modifications that taxpayers are required to make.[28] Depending on a state's particular approach to conformity, taxpayers may be able to make the state-specific modifications using only the information that is already provided on their federal tax returns (facial or recordkeeping conformity), or additional information that is not provided on the federal tax return may be needed for compliance and enforcement purposes (non-facial conformity).[29]

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 non-facial 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 non-facial 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. These benefits come at a cost, however.

1. Benefits of Conformity, In General

The literature discusses the many benefits of state conformity to federal tax.[30] For taxpayers, state conformity to federal tax laws simplifies tax

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[26] 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* HELLERSTEIN & HELLERSTEIN, *supra* note 12, ¶ 20.02; WIS. LEGISLATIVE FISCAL BUREAU, *supra* note 25; *State Personal Income Taxes: Federal Starting Points*, *supra* note 14. Almost all states imposing a corporate income tax use federal taxable income as the state starting point. *See* HELLERSTEIN & HELLERSTEIN, *supra* note 12, ¶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 is rarely used.

[27] *See State Personal Income Taxes: Federal Starting Points*, *supra* note 14 (listing which version of the Code is adopted by each conforming state).

[28] *See* HELLERSTEIN & HELLERSTEIN, *supra* note 12, ¶ 7.03.

[29] 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).

[30] This section's brief description draws heavily from the literature regarding the

preparation, reduces the risk of mistakes, and eases compliance.[31] Among other benefits,[32] taxpayers need not keep separate records for federal and state purposes, so conformity can reduce taxpayers' recordkeeping 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 who pay taxes in multiple states, the benefits of conformity are magnified if many of these states' tax laws conform to the federal tax laws.[33]

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,"[34] on

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interaction between the federal and state tax regimes. *See supra* note 23 (citing additional articles on which this section draws); *see also, e.g.*, HELLERSTEIN & HELLERSTEIN, *supra* note 12, ¶ 7.02[4]; Walter Hellerstein, *Selected Issues in State Business Taxation*, 39 VAND. L. REV. 1033, 1038–41 (1986); Allison L. Westfahl Kong, *The Effects of Federal Tax Expenditures Policy on the States*, 58 ST. TAX NOTES 475, 476–81 (Nov. 15, 2010); LeAnn Luna & Ann Boyd Watts, *Federal Tax Legislative Changes and State Conformity*, 47 ST. TAX NOTES 619 (Feb. 25, 2008); 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); Kathryn L. Moore, *State and Local Taxation: When Will Congress Intervene?*, 23 J. LEGIS. 171, 179–82 (1997); Pomp, *supra* note 29, at 1199–1205; Frank Shafroth, *To Conform or Not to Conform – That is the Question*, 29 ST. TAX NOTES 711 (Sept. 8. 2003); Richard Weiss, *Achieving Uniformity in State Income Taxes: A Worthwhile Goal*, J. MULTISTATE TAX'N & INCENTIVES, Sept. 2008, at 7; Edwin S. Cohen, *State Income Tax Conformity: Knotty Problems in the Branches of the Federal Tree*, WM. & MARY ANNUAL TAX CONFERENCE, Paper 633 (1967), *available at* http://scholarship.law.wm.edu/tax/633; Harley T. Duncan, *Relationships Between Federal and State Income Taxes*, FED'N OF TAX ADM'RS (April 2005), http://govinfo.library.unt.edu/taxreformpanel/meetings/pdf/incometax_04182005.pdf. Many additional resources are not listed.

[31] The stronger the conformity, the greater the benefits described in this section will be. As the degree of conformity weakens, however, the compliance, simplicity, and administrability benefits described in this section generally decrease. *See* Pomp, *supra* note 29, at 1199–1205.

[32] *Cf.* Daniel Shaviro, *An Economic and Political Look at Federalism in Taxation*, 90 MICH. L. REV. 895, 920–21 (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.").

[33] Mason, *Delegating Up*, *supra* note 23, at 11–15 (discussing benefits of harmonization of the tax base between states).

[34] Super, *supra* note 23, at 2595.

third-party reporting information that is already required by the federal government, and on opportunities for data exchanges with the Service.[35] Similarly, conformity allows states to rely on well-developed federal regulations, Service guidance, and federal cases that interpret the relevant tax provisions.[36] 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.[37]

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."[38] Said differently, lack of conformity can hurt a state's business climate, particularly for businesses that operate in multiple states.[39]

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. Moreover, from a multi-state, rather than individual state, perspective, tax base conformity can curb the ability of taxpayers to engage in tax planning to take advantage

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[35] *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 ST. TAX NOTES 165 (July 17, 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 30, ¶ 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).

[36] HELLERSTEIN & HELLERSTEIN, *supra* note 12, ¶ 7.02[4]. *But see* NICHOLAS JOHNSON & ASHALI SINGHAM, CTR. ON BUDGET & POLICY PRIORITIES, STATES CAN OPT OUT OF THE COSTLY AND INEFFECTIVE "DOMESTIC PRODUCTION DEDUCTION" CORPORATE TAX BREAK 3 (updated Jan. 14, 2010) ("States that conform to federal provisions [which are complex and difficult for taxpayers to understand] risk becoming involved with these difficult and time-consuming enforcement issues.").

[37] 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 30, at 1460–61; Super, *supra* note 23, at 2595.

[38] Galle, *supra* note 37, at 703. Alternatively, states 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. This reduces revenue, however, and creates potentially harmful interstate tax competition.

[39] *See* Thomas O. Armstrong, *Statement Before the Senate Finance Committee of the Pennsylvania State Senate on Pennsylvania's Business Tax Structure*, TAX FOUNDATION (May 11, 2004), http://taxfoundation.org/article/statement-senate-finance-committee-pennsylvania-state-senate-pennsylvanias-business-tax-structure (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).

of disparate laws in different states, thereby avoiding full state-level taxation;[40] reduce the risk of double taxation;[41] curtail harmful tax competition;[42] and limit states' abilities to export taxes to nonresidents.[43]

2. Costs of Conformity, In General

Despite the foregoing benefits, conformity can raise significant concerns.[44] Where states conform to the federal income tax laws, state tax bases narrow as Congress adds tax expenditures to the federal income tax law. As a result, federal tax changes can reduce state tax revenue,[45] and this

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[40] Shaviro, *supra* note 32, at 911 ("Tax base disparities present obvious planning opportunities for both taxpayers and governments."); *see also, e.g.*, Michael T. Petrik & Ethan D. Millar, *State and Local Tax Aspects of Corporate Acquisitions*, CORP. BUS. TAX'N MONTHLY, Dec. 2006, at 13-21, 27–29 (discussing planning opportunities to exploit differences in state definitions of business and non-business income that enable taxable acquisitions to be "less than fully taxed at the state level.").

[41] Moorman Manufacturing Co. v. Bair, 437 U.S. 267, 278–79 (1978) (acknowledging that non-uniform state approaches to apportioning income can lead to multiple taxation); Shaviro, *supra* note 32, at 916 ("States can opportunistically choose whatever [tax] base, within the permissible range, appears most favorable to themselves, and thereby collectively engage in effective multiple taxation.").

[42] Mason, *Delegating Up*, *supra* note 23, at 12 (arguing that tax base conformity can "productively channel state tax competition").

[43] Shaviro, *supra* note 32, at 908 (arguing that differences in the tax burdens between jurisdictions raises fairness concerns when the differences allow one jurisdiction to place tax burdens on outsiders).

[44] 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 *supra* Part II.A.1. *See also, e.g.*, Richard M. Bird, *Fiscal Federalism*, *in* THE ENCYCLOPEDIA OF TAXATION AND TAX POLICY 146 (Joseph J. Cordes et al. eds., 2005); 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); Wallace E. Oates, *An Essay on Fiscal Federalism*, 37 J. ECON. LITERATURE 1120 (1999); David E. Wildasin, *Pre-Emption: Federal Statutory Intervention in State Taxation*, 60 NAT'L TAX J. 649, 653–55 (2007).

[45] Stark, *supra* note 20, at 424–25 (discussing volatility of state tax revenues, particularly where state taxes conform to a significant degree with federal taxes); Super, *supra* note 23, at 2596–98 (discussing how changes in the federal tax law undermine states' abilities to collect revenue). A state could mitigate revenue reductions without decoupling if the state legislators increased 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 23, 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

revenue loss will occur without any state legislator action in states that use a rolling approach to conformity (rather than fixed-date conformity).[46] Revenue losses can be particularly problematic because states generally operate under balanced budget constraints.[47] Given the recent fiscal crises facing states,[48] 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.[49]

Conforming states can lose more than revenue; they also sacrifice sovereignty.[50] Increasing conformity means that state legislators increasingly cede to federal legislators the power to change state tax laws and control state tax policy.[51] Thus, "when states adopt the federal tax base as their own tax base, they deliberately or inadvertently import into their

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the federal tax base.

[46] HELLERSTEIN & HELLERSTEIN, *supra* note 12, ¶ 7.02.

[47] *See* David Gamage, *Preventing State Budget Crises: Managing the Fiscal Volatility Problem*, 98 CALIF. 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 35 (Jonathan A. Rodden et al. eds., 2003).

[48] 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 ST. TAX NOTES 375, 380–81 (Aug. 4, 2003).

[49] Gravelle & Gravelle, *supra* note 23, at 642; JOHNSON & SINGHAM, *supra* note 36 (twenty-two states, including the District of Columbia, have decoupled from Code section 199); MICHAEL MAZEROV, CTR. ON BUDGET & 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, CTR. ON BUDGET & POLICY PRIORITIES, NEW FEDERAL LAW COULD WORSEN STATE BUDGET PROBLEMS, STATES CAN PROTECT REVENUES BY "DECOUPLING" (rev. Feb. 28, 2008) (discussing states that have, and should, decouple from additional federal bonus depreciation); *see also* Bertothy & Bertleau, *supra* note 24; Linda O'Brien, *Tax Trends: States Address Declining Tax Revenues*, 83 TAXES 51 (2005); Tower & Boyd, *supra* note 35 (identifying a long list of Code provisions that states frequently modify).

[50] 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 30, at 1472; Joel H. Swift, *Fiscal Federalism: Who Controls the States Purse Strings?*, 63 TEMP. L. REV. 251, 253–54 (1990).

[51] *But see* Super, *supra* note 23, 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").

own tax system federal regulatory preferences . . . ."[52] This runs counter to the notion of state autonomy[53] and can be detrimental for the state because state and federal tax policy objectives may not be aligned.[54] 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.[55]

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.[56] Decoupling, rather 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's taxpayers.[57] Similarly, decoupling may better enable state legislators to

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[52] Mason, *Federalism and the Taxing Power*, *supra* note 24, at 1020; *see also* Dane, *supra* note 44, at 95.

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

[54] This may be the case, for example, because the "[f]ederal 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 29, 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).

[55] 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 44, at 569; *see also* Mason, *Delegating Up*, *supra* note 23; 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).

[56] 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 RICHARD A. MUSGRAVE & PEGGY B. MUSGRAVE, PUBLIC FINANCE IN THEORY AND PRACTICE 454–55 (1989); WALLACE E. OATES, FISCAL FEDERALISM 8 (1972)). 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 generally* Oates, *supra* note 44; Shaviro, *supra* note 32, at 960 (articulating several benefits of state autonomy in taxation); Super, *supra* note 23.

[57] To the extent that a federal tax provision imposes a nonbenefit tax on mobile economic units, perhaps this is 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

tailor state tax policy to reflect the values and respond to the preferences of the more localized constituency.[58]

Moreover, from a multi-state perspective, conformity can limit opportunities for useful tax competition that would help reveal taxpayer preferences,[59] and conformity constrains the "laboratories of democracy" from which we can learn about the benefits and costs of different state approaches (in this case, with respect to taxation).[60]

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.[61] Even the robust literature referenced above is insufficient to provide guidance to state legislators about how to deal with the conformity question, however, 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 income tax 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 state tax law. For example, if a state's tax law conforms to the federal definition of "capital asset," then an asset that is adjudicated to be a capital asset for federal tax purposes is also a capital asset for state tax purposes.[62]

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efficiently imposed at a centralized level. *See* Oates, *supra* note 44, at 1125; Bird, *supra* note 44.

[58] Kong, *supra* note 30; Dane, *supra* note 44.

[59] *See* Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416 (1956).

[60] New State Ice Co. v. Liebmann, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting).

[61] Hellerstein, *supra* note 30, at 1041 (discussing these tradeoffs); McLure, *supra* note 23, at 646; Pomp, *supra* note 29, 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 53 (discussing how greater conformity could allow simplified tax collection); Shaviro, *supra* note 32 (arguing for a more uniform tax base among the states).

[62] Taxpayers may take one position on their tax returns, and the tax authority (federal or state) may challenge that position, successfully or unsuccessfully. The controversy could

If a state's tax law conforms to a federally provided explicit tax election, however, 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 Internal Revenue Code (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.[63] Of course, in addition to conforming the state tax law to Subchapter S of the Code, 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.[64]

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 income tax regime conforms to the federal income tax regime in all material respects;[65] this assumption will be relaxed as the discussion proceeds. Second, assume that no issues unique to state taxation arise from the particular provision;[66] this assumption will also be relaxed

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be adjudicated, however, 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.

[63] *See* James Edward Maule, *State Taxation of S Corporations*, BNA STATE TAX PORTFOLIOS: BUSINESS ENTITIES AND TRANSACTIONS, 1510-1st, ¶1510.02 (discussing different state approaches to the treatment of a corporation that elected S status for federal purposes).

[64] This additional decision is needed regardless of the strength of the state's approach to conformity.

[65] For example, this assumes that the tax consequences of a corporation being classified as an S corporation are substantially similar for state and federal purposes (i.e., S corporations are not subject to entity-level tax in the absence of section 1374 built-in gain).

[66] For example, consider an S corporation with two shareholders who are residents of

when the discussion addresses multi-state taxpayers. Third, assume that the eligibility for, and options available pursuant to, any explicit election are the same for federal and state tax purposes.[67]

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).[68] 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).[69]

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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 question (involving nexus, apportionment, and allocation issues, among others) is absent at the federal tax level because both shareholders are residents of the same (U.S.) jurisdiction.

[67] For example, consider a married couple's choice to file state tax returns as married filing jointly or married filing separately. An assumption that the state and federal election eligibility/options are the same means that the same couples have the same choice under state and federal law; thus, the state definition of "marriage" is assumed to be 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.

[68] A deemed federal choice can be imposed though the state's choice of conformity starting point. If the state tax law adopts 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* VT. STAT. ANN. tit. 32 §§ 5811(21), 5820, 5824 (explaining Vermont's approach to the choice between an itemized deduction and the standard deduction).

[69] Many states take this approach to elections regarding married couples' filing statuses and regarding itemization of deductions. *See, e.g.*, LA. REV. STAT. ANN. § 47:294 (same); N.Y. TAX LAW § 651(b) (generally requiring taxpayers to use the same filing status for federal and state tax purposes); *see also* MARTIN, *supra* note 7, at 4; *see* GA. CODE ANN. § 48-7-27(a) (requiring a taxpayer to make the same state and federal decision about itemization); VA. CODE ANN. § 58.1-322(D)(1)(a) (discussing Virginia's requirement that a

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 a default rule that a taxpayer is deemed to make the same choice for state purposes as the taxpayer made for federal purposes, while allowing the taxpayer to opt out of this default treatment and make a different state tax choice (default federal choice).[70] Alternatively, the taxpayer's state tax choice can be completely separate, unconstrained in any way by the federal tax choice (unlinked choice).[71]

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.[72] 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. The analyses of many of the policy considerations relevant to the traditional conformity discussion, such as simplicity,

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taxpayer makes the same state and federal decision about itemization).

[70] California generally takes this approach to election conformity. *See* CALIF. REV. & TAX CODE § 23051.5(e). Pennsylvania recently changed to this approach for S corporation elections. 2006 Pa. Laws 319 § 307.

[71] Some states, including Montana, take this approach to the filing status for married couples. *See* Memorandum from Dan Dodds, *supra* note 5, at 1; *see also* IOWA DEP'T OF REVENUE, IOWA INDIVIDUAL INCOME TAX EXPANDED INSTRUCTIONS at 3 (2010) (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* CAL. REV. & TAX. CODE §§ 17073, 17073.5; *see also* OR. REG. STAT. § 316.695(1)(c)(A); 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.*, N.Y. TAX LAW § 615(a); N.Y. COMP. CODES R. & REGS. tit. 20, §§ 113.1, 114.1; 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).

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

administrability, and even revenue, however, 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 Election Conformity, Regardless of Whether an Election Is Binding[73]

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,[74] or needs of the state's taxpayers.[75]

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.[76] 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 also 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 taxpayer the power to determine tax consequences.[77] Thus, a state that conforms to a federal tax election not

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[73] The discussion in this section generally assumes relatively strong conformity.

[74] 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 in Part VI.B, *infra*.

[75] 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).

[76] *See* Field, *supra* note 17, at 26–33 (discussing criticisms of tax elections).

[77] *See supra* note 17.

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,[78] conformity to the federal tax election could be viewed as an *exercise* (rather than a relinquishment) of state sovereignty.

B. Costs & Benefits of Election 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). Many other costs and benefits of conformity discussed in the literature are indeterminate, however, without knowing whether a taxpayer's federal tax election will be binding for state tax purposes.[79]

1. Simplicity

State conformity to a federal tax election advances simplicity in that a taxpayer only needs to understand one set of tax rules.[80] The remainder of the simplicity analysis, however, depends not only on whether the state

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[78] Field, *supra* note 17 (arguing that explicit elections can be useful additions to the tax system for purposes including "reconciling discontinuous regimes [and] facilitating tax classification . . . .").

[79] 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 80–84.

[80] 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 non-facial conformity.

conforms to the provision of the tax election, but also on whether the state requires taxpayers to make the same choice for state purposes as for federal purposes.[81]

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 a taxpayer can make independent choices, then the taxpayer must analyze which option better reduces federal income tax and which option better reduces 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).[82] Further, this additional decision-making complexity could particularly disadvantage less sophisticated taxpayers.[83]

2. Administrability & Enforceability

As to conformity's impact on administrability, state conformity to a federal tax election does ease the administrative burdens on the state government in that state administrators need not spend time providing state-

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[81] Taxpayers may make the same choice for federal and state purposes 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). The only way for a state to *ensure* that a (law-abiding) taxpayer makes the same choice, however, is for the state to mandate consistency.

[82] This result likely requires relaxation of the assumption that the federal and state tax laws are the same. *See supra* note 65.

[83] *Cf.* Pomp, *supra* note 29 (cautioning that the additional complexity from decoupling should not be imposed on "those who are least able to cope with any additional complications").

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 issued by the Treasury and Service and can rely on federal case law that interprets the statutory language of the federal tax election.

Unless taxpayers make the same choice for state purposes as they make for federal purposes, however, a state's tax authorities may be limited in their ability to rely on the Service 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 their ability to share information with, the federal tax authorities.[84] Similarly, where taxpayers can make different federal and state tax elections, states are limited in their ability to rely on the Service'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.[85]

3. Revenue

As for 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 (assuming everything else, including the level of economic activity in the state, remains constant). This decoupling may make the state's business climate less favorable, however, 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

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[84] For example, consider a state that conforms to the entity classification election under Treasury Regulation § 301.7701-3 (2006), and that allows an entity to be classified, for state purposes, differently than the entity is classified for federal purposes. *See generally* Bruce P. Ely et al., *State Tax Treatment of LLCs and LLPs: Update for 2010,* J. MULTISTATE TAX & INCENTIVES, May 2010, at 8. If a multi-member LLC were 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).

[85] Again, a rolling conformity approach generally provides these benefits more effectively than does a fixed-date conformity approach. *See supra* note 80.

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 a state's revenue, at least without knowing whether the federal election is binding for state purposes.[86] 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.[87]

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), then a state's conformity to a federal election is revenue reducing for the state.[88]

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),[89] however, each rational taxpayer will make the election that best reduces the taxpayer's net tax burden. As a result, a binding election's impact on the state's revenue

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[86] 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 decisions about whether to provide the election or about whether to bind taxpayers to their federal choices.

[87] This assumes rational taxpayers who measure utility in dollars. With unconstrained state tax elections, the rational 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 7, 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).

[88] Generally, if the state tax regime conforms to the federal tax regime in all material respects, as assumed under the first simplifying assumption, taxpayers' federal and state tax election preferences should virtually always be aligned. *See supra* note 65.

[89] This is most likely to occur when we relax the 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 65; *see also infra* Parts VI.A.1., VI.B.1, VI.C.1. (using examples to illustrate when and why taxpayers may have opposing state/federal election preferences).

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.[90] 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.

4. Multi-State Implications

The foregoing discussion focuses primarily on the implications for each individual state and its single-state taxpayers of conforming (or not conforming) to federal tax elections. Each state's approach to election conformity, however, can have broader implications, affecting other states and taxpayers in other states. This is particularly true when taxpayers pay income tax in multiple states. Thus, when considering tax elections that taxpayers are likely to face in multiple states, state legislators should be wary of making state-level election conformity decisions that create significant externalities, lest they lead to federal intervention or cooperative multi-state coordination efforts.

Whether a state's approach to tax election conformity creates externalities can depend on whether the state binds its taxpayers to their federal tax elections. For example, consider a multi-state taxpayer facing a tax election that is available in the several states in which the taxpayer pays tax. If the multiple states allow independent elections, each of which results in non-facial conformity, each such state magnifies the record-keeping burden of multi-state taxpayers and the administration difficulties of the multiple jurisdictions. The multi-state implications are exacerbated upon

[90] In this situation, taxpayers in states that require 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 taxpayers in states that do not require binding elections will receive as a result of their federal tax elections.

relaxation of the assumption that the states' underlying tax laws are the same (the first simplifying assumption)[91] and relaxation of the assumption that no issues unique to state taxation arise from the provision (the second simplifying assumption).[92]

Where the relevant state tax laws differ, binding taxpayers to their federal tax elections for state tax purposes could result in the imposition of taxes by multiple states on the same income (where the tax bases overlap and the methods for alleviating double taxation are insufficient).[93] Binding elections could also enable a state to try to export taxes to nonresidents, who may be willing to suffer increased taxation by the particular state in order to reduce taxation imposed by the federal government and the taxpayer's home state.[94]

Conversely, where the relevant state tax laws differ and where states opt *not* to bind taxpayers to their federal tax elections, compliance complexity could be particularly problematic. This type of multi-state compliance complexity led to the Streamlined Sales Tax Project (SSTP), which is a collective effort by many states to make the states' sales taxes more uniform in order to increase simplicity and administrability.[95] Additionally, the possibility that a taxpayer could make inconsistent tax choices in different states provides the taxpayer with opportunities for tax planning, which could enable the taxpayer to avoid full taxation at the state level. This could lead to tax competition: states may compete by offering various tax incentives, and individual taxpayers could make the elections that enable them to avail themselves of multiple tax incentives in different

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[91] *See supra* note 65 and accompanying text.

[92] *See supra* note 66 and accompanying text.

[93] *See, e.g.*, Crawford & Uzes, *supra* note 21, ¶1140.06B(7) (explaining that a section 338(h)(10) election can affect a state's apportionment formula); Bobby L. Burgner, *Income Taxes: Special Problems in Formulary Apportionment*, BNA STATE TAX PORTFOLIOS: CORPORATE INCOME TAXES, 1180-3rd, ¶1180.05D (explaining that different states can have different methods of formulary apportionment, which can lead to multiple taxation at the state level).

[94] As with the analysis of the revenue implications of binding federal and state tax elections, rational taxpayers will, when faced with a binding election, make the choice that minimizes net taxes. *See supra* text accompanying notes 88–89. As a result, a nonresident taxpayer might make the election that causes it to pay slightly higher taxes in one state, while enabling it to pay much lower taxes in the taxpayer's home state.

[95] *See* Streamlined Sales and Use Tax Agreement § 102 (as amended through Apr. 30, 2010), *available at* http://www.streamlinedsalestax.org/uploads/downloads/Archive/SSUTA/SSUTA_As_Amended_4_30_10.pdf (explaining that the purpose of the SSTP is "to simplify . . . sales and use tax administration . . . [thereby] substantially reduc[ing] the burden of compliance" by increasing "[u]niformity in the state and local tax bases," "[u]niformity of major tax base definitions," and "[u]niform[ity of] sourcing rules for all taxable transactions," among other approaches).

jurisdictions, some of which would be unavailable if the taxpayer was required to make consistent elections for all jurisdictions. Such tax competition may be productive or destructive depending on the circumstances.[96]

IV. TAXPAYER CONSISTENCY

The above discussion explains that the costs and benefits of state conformity to a federal tax election can depend, in large part, on whether 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[97]

Query how a taxpayer's choice of tax treatment for purposes of one tax

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[96] *See generally* Peter D. Enrich, *Saving the States from Themselves: Commerce Clause Constraints on State Tax Incentives for Business*, 110 HARV. L. REV. 377, 382–405 (1996) (analyzing the causes and effects of interstate tax competition).

[97] 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, 2010-45 C.B. (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 the risk that a single tax authority could be whipsawed, though 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).

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-through[98] for United States tax purposes.[99] 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, hybrid entities provide opportunities for cross-border tax arbitrage.[100] 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."[101]

In response to the revenue and other policy problems created by these arbitrage opportunities,[102] commentators recommend revising the entity

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[98] 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 (2006).

[99] Treas. Reg. § 301.7701-2, -3. (2012). 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 LOY. L.A. L. REV. 451, notes 190–197 and accompanying text (2009) (discussing the debate).

[100] *See, e.g.*, Mitchell A. Kane, *Strategy and Cooperation in National Responses to International Tax Arbitrage*, 53 EMORY L.J. 89, 160–65 (2004); 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); *see also, e.g.*, Adam H. Rosenzweig, *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 price 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").

[101] Rosenzweig, *supra* note 100, at 562–63 (explaining the tax arbitrage objective).

[102] *See, e.g., id.* at 564–65; Ring, *supra* note 100, at 117–24 (discussing adverse policy consequences of arbitrage with hybrid entities).

classification rules for foreign entities.[103] Among a variety of suggested approaches, some commentators have argued that the United States 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 . . . ."[104] This approach would align the U.S. tax classification of the entity with the foreign tax classification of the entity, thereby eliminating discrepancies in entity classification that taxpayers can exploit.[105]

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.[106] 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. 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.,

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[103] *See, e.g.*, STAFF OF JOINT COMM. ON TAXATION, 109TH CONG., OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES (Comm. Print 2005) (recommending that single member foreign eligible entities be treated as corporations for U.S. tax purposes).

[104] ABA, *Report of the Task Force on International Tax Reform*, 59 TAX LAW. 649, 669 (2006).

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

[106] As with "arbitrage" with hybrid entities, the "arbitrage" opportunities that arise from independent elections are not traditional economic arbitrages. *See supra* note 100. For the purposes of this discussion, however, I will use the term tax arbitrage broadly to "describe transactions that involve tax advantages, but no other financial consequences, for the taxpayer." Alvin C. Warren, Jr., *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 100, at 82 (defining arbitrage as the "exploitation of differences between the tax systems of two different jurisdictions to minimize the taxes paid to either or both") (quoting Reuven S. Avi-Yonah, *Commentary on Tillinghast Lecture*, 53 TAX L. REV. 167, 167 (2000)). This broad "arbitrage" concept is consistent with the concept of "tax arbitrage" as used in the cross-border context. *See supra* note 100. 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 the aggregate taxes paid, arguably constitutes an arbitrage opportunity, at least under the broad definition.

where the state and federal tax rules are asymmetric).[107] 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.[108]

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 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.[109]

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.[110] 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 who 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

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[107] This requires the relaxation of the assumption that the operative federal and state tax rules are substantially similar in all material respects.

[108] *See infra* Part VI.B.1. 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.

[109] 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.

[110] *See* Shaviro, *supra* note 100, at 116.

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. 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. The state/federal election question involves multiple tax regimes, however, *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 (AMT), 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 Service generally takes the position that a taxpayer's regular income tax elections are binding on the taxpayer for purposes of the alternative minimum tax.[111] Professor Daniel Lathrope has criticized this position as inconsistent with the Service's "position that the AMT is a separate and independent income tax."[112] He argues that "if the AMT is

[111] Rev. Rul. 87-44, 1987-1 C.B. 3 (election made for regular income tax purposes regarding the carryback of net operating losses (NOLs) applies for AMT purposes); *see also* Marx v. Commissioner, T.C. Summ. Op. 2003-23, 2003 WL 1359267 (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).

[112] 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 "[f]or most purposes, the tax base for the new alternative minimum tax is determined as though the

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"[113] and he suggests that "Regulation [section] 1.55-1(a) appears to permit a taxpayer to make inconsistent regular tax and AMT elections [except in specifically articulated circumstances]."[114] Professor Lathrope cautions, however, that "until the [Service] indicates whether it will treat the AMT as completely separate from the regular tax, the success of a separate AMT election cannot be assured."[115]

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,[116] 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 Nonelective Contexts Where State Tax Law Conforms to Federal Tax Law

The issue of tax consistency also arises in nonelective contexts. In particular, there is case law regarding how a taxpayer's federal tax treatment can affect the taxpayer's tax treatment in a conforming state. States vary somewhat, but the case law 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

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alternative minimum tax were a separate and independent income tax system" (emphasis omitted)).

[113] *Id.*

[114] *Id.* at ¶ 3.02[4] (specifically calling out the NOL carryback election as binding); Treas. Reg. § 1.55-1(a) (1994).

[115] LATHROPE, *supra* note 112, at ¶ 3.02.

[116] Query to what extent this depends on 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 Code provision, as compared to a state that merely incorporates federal tax law by reference?

reported for federal purposes are not binding for state tax purposes.[117]

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 an estoppel."[118] This rationale for treating a federal-level 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.[119]

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[117] HELLERSTEIN & HELLERSTEIN, *supra* note 12, ¶ 7.02[4][c] (citations omitted), ¶ 20.02[1] (discussing some of the caselaw in more detail).

[118] Calhoun v. Franchise Tax Bd., 574 P.2d 763, 765 (Cal. 1978).

[119] 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* STAFF OF THE JOINT COMM. ON TAXATION, 109TH CONG., PRESENT LAW AND BACKGROUND RELATING TO CORPORATE TAX REFORM: ISSUES OF CONFORMING BOOK AND TAX INCOME AND CAPITAL COST RECOVERY 2, 11–19 (Comm. Print 2006); Daniel Shaviro, *The Optimal Relationship Between Taxable Income and Financial Accounting Income: Analysis and a Proposal* (NYU Ctr. for Law, Econ., & Org. Working Paper Series, Paper No. 07-38), *available at* http://ssrn.com/abstract=1017073. Analogies to the book/tax conformity debate, however, 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 the 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." STAFF OF THE JOINT COMM. ON TAXATION, 109TH CONG., PRESENT LAW AND BACKGROUND RELATING TO CORPORATE TAX REFORM: ISSUES OF CONFORMING BOOK AND TAX INCOME AND CAPITAL COST RECOVERY 15 (Comm. Print 2006) (citation omitted). 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 fair way. Taxpayers may employ different methods to minimize tax in the

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.[120] Thus, the argument, in the nonelective context, that federal tax determinations ought to be 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 taxpayers use their 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."[121] 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."[122] Thus, unless a tax election is

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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.

[120] 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. That is a normative, rather than descriptive, assessment. If one election alternative is more "correct" (e.g., consistent with the Haig-Simons definition of income), it may be preferable for a state to decouple from the election and mandate a particular tax treatment. As long as an election is provided, however, any option afforded pursuant to the election complies with the law.

[121] Field, *supra* note 17, at 34.

[122] 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

understood to imbue a situation with substance that is meaningful for purposes beyond federal tax law,[123] the authorities regarding federal/state consistency in the nonelective 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.[124]

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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.

[123] 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 17, 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. IRS Notice 95-14, 1995-14 I.R.B. 7 (explaining the Service's rationale for changing 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 nontax purposes; an entity that is a general partnership under state law remains a general partnership for nontax 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.

[124] *See* Pac. Nat'l Co. v. Welch, 304 U.S. 191, 194–95 (1938); Aubree L. Helvey &

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.[125]

Despite the long history of this doctrine,[126] it is not always clear how (and the extent to which) the doctrine applies. For example, in 2002, the Service changed its litigation position on the doctrine of election, at least in a limited context; the Service "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)."[127] Further, two commentators have argued that, in general, the "doctrine of election should no longer be a 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."[128]

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.[129] 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

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Beth Stetson, *The Doctrine of Election*, 62 TAX LAW. 335 (2009).

[125] IRS Tech. Adv. Mem. 2002-59-059 (Sept. 10, 2002); *see also* Helvey & Stetson, *supra* note 124; 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).

[126] Helvey & Stetson, *supra* note 124, at 340–42 (tracing the development of the doctrine of election).

[127] IRS Chief Counsel Notice 2002-027 (June 6, 2002).

[128] Helvey & Stetson, *supra* note 124, at 336.

[129] 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 ST. TAX NOTES 863, n.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 election.").

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.[130]

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."[131] This limits a taxpayer's ability to change positions vis-a-vis the Service (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 taxing authorities in a single tax period. As with the doctrine of election,[132] 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.

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

[131] Cluck v. Commissioner, 105 T.C. 324, 331 (1995); *see* BITTKER & LOKKEN, *supra* note 122, ¶ 4.3.7; Steve R. Johnson, *The Taxpayer's Duty of Consistency*, 46 TAX L. REV. 537 (1991). 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* note 122, ¶ 5.7.

[132] *See supra* Part IV.C.1.

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."[133] That is, taxpayers are generally bound, for tax purposes, by the terms of the contracts into which they enter.[134] More broadly, the "non-disavowal principle" suggests that a taxpayer should be bound by the form that the taxpayer has chosen for its actions.[135]

Neither of these principles is absolute,[136] 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,[137] 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*),[138] and neither taxing authority has the potential to be "faced with conflicting claims" as a result of the inconsistent positions.[139] Even the Service has conceded that it is consistent with the *Danielson* rule for a tax issue created by the terms of a

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[133] Commissioner v. Danielson, 378 F.2d 771, 775 (3d Cir. 1967).

[134] *Cf.* IRS Field Serv. Adv. 2000-04-009 (Jan. 28, 2000) (articulating and applying the *Danielson* rule).

[135] *See* Commissioner 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 122, ¶ 4.3.6.

[136] *See generally* Bittker & Lokken, *supra* note 122, ¶4.3.6.

[137] *See* Field, *supra* note 17, at 67; *see also supra* note 96 (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).

[138] Danielson, 378 F.2d. at 775; *see also* Michael E. Baillif, *The Return Consistency Rule: A Proposal for Resolving the Substance-Form Debate*, 48 TAX LAW. 289, 309 (1995).

[139] Comdisco, Inc. v. United States, 756 F.2d 569, 577–78 (7th Cir. 1985).

single agreement to be resolved differently by different jurisdictions where the jurisdictions' tests are distinct.[140] 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.[141] In contrast, a tax election, by definition, lacks nontax economic substance, suggesting that any "disavowal" ought not to be particularly troublesome.[142]

D. Conclusion Regarding Reasons for Taxpayer Consistency

Neither the case law 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. The discussions of election consistency in the foreign entity classification and alternative minimum tax contexts may be more helpful, however.

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.

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

[141] *See, e.g.*, Frank Lyon Co. v. United States, 435 U.S. 561, 577 (1978) (respecting the form of a transaction where the form reflected a "distinct element of economic reality"); Nat'l Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 149 (1974) (a taxpayer that engaged in a direct exchange of assets is precluded from disavowing that form in favor of taxing the transaction as an indirect exchange); Burnett v. Commonwealth Improvement Co., 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); *see also* Baillif, *supra* note 138; William S. Blatt, *Lost on a One-Way Street: The Taxpayer's Ability to Disavow Form*, 70 OR. L. REV. 381 (1991).

[142] This, again, raises the question of the nature of a tax election. *See supra* notes 120-122, and accompanying text. To the extent that a tax election is viewed as more than "pure form" and instead conceived of as imbuing the situation with substantive facts that would be meaningful to the state tax authority, then perhaps the nondisavowal principle may strengthen the case for requiring taxpayers to make consistent federal and state tax elections.

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, and this part considers how these arguments are altered when multi-state taxpayers may face the same tax election in multiple states.

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 conformity starting point that is calculated after taking into 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).[143]

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,[144] but a deemed federal choice confers these benefits more effectively than a mandatory matching approach. 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 taxpayers

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

[144] *See supra* Part III.B.1.

to indicate their 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).[145]

Binding elections also increase the state tax authority's ability to benefit from information sharing with the Service and to rely on Service enforcement actions.[146] Again, these benefits are present whether the 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 non-facial 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.[147] Yet 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. 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,[148] the more 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.

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[145] *See supra* Part III.B.3.

[146] *See supra* Part III.B.2.

[147] *See supra* Part III.A.

[148] *See supra* notes 120-122, and accompanying text.

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 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.

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. Additionally, 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 nontax economic substance, the case for using binding elections becomes less compelling.

Independent elections can also increase the simplicity of tax planning.[149] Independent elections, however, generally reduce the simplicity of recordkeeping and tax preparation for taxpayers, and can reduce a state's ability to enforce its tax laws, all as compared to binding elections.[150] 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. A state may be able to increase the 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

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[149] *See supra* Part III.B.1.

[150] *See id.*

default federal choice approach than under an unlinked choice approach.[151] 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 Service enforcement actions and on information exchange/sharing with the Service. This benefit is particularly noteworthy if non-facial conformity could result from a taxpayer's decision to make a state tax choice that differs from the taxpayer's federal tax choice.[152] 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 effectively 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.[153]

C. Considering the Multi-State Perspective

The foregoing discussion also suggests that, where individual state choices about whether to bind taxpayers to their federal tax choices create significant externalities for multi-state taxpayers (complexity, tax avoidance, multiple taxation, or otherwise), various approaches to cooperative action may be appropriate. Given this possibility, state

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[151] *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).

[152] 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 is not reflected on the taxpayer's federal tax return, that non-facial conformity increases the burden on state administrators. The less frequently this occurs, the lower the administrative burden on the state tax authorities.

[153] 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.

legislators should be sensitive to the adverse consequences their choices about tax elections might create, lest they trigger multi-state coordination efforts or Congressional action.

For example, states could collaborate and try to unify their approaches to tax election conformity. Such collaborative action could be modeled after the efforts to create the Uniform Division of Income for Tax Purposes Act (UDITPA) or after the SSTP, each of which was motivated, in large part, by efforts to increase state-to-state conformity, thereby reducing complexity for multi-state taxpayers.[154]

If the complexity and multiple taxation externalities created by individual state approaches to tax elections are sufficiently severe and if the states do not collaborate to address this problem, Congress may intervene.[155] For example, Congress may try to preempt state law,[156] as Congress considered before the multi-state collaboration efforts of UDITPA[157] and as Congress did with respect to the taxation of internet sales.[158] Alternatively, Congress could encourage, rather than mandate, conformity and binding[159] by providing incentives (monetary or otherwise) to states that bind taxpayers to the federal tax elections for state tax purposes.[160] Instead, Congress could approach the issue at the level of the

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[154] *See supra* note 95 (explaining the source of the SSTP); Joe Huddleston & Shirley Sicilian, *The Project to Revise UDITPA*, NYU INST. ON STATE & LOCAL TAX. § 1.02 (2009), *available at* http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Minutes/The%20Project%20to%20Revise%20UDITPA.pdf (explaining that UDITPA arose in response to the desire to ease compliance through increased uniformity between state income tax laws).

[155] *See* Moore, *supra* note 30 (discussing approaches to, and the likelihood of, federal intervention in state and local tax law).

[156] HELLERSTEIN & HELLERSTEIN, *supra* note 12, ¶ 4.25 (discussing Congress' ability to preempt state tax law pursuant to the Commerce Clause).

[157] H.R. REP. NO. 952, pt.. 4, at 1143 (1965); *see also* Huddleston & Sicilian, *supra* note 154, § 1.02[2] (discussing the Congress's federal intervention efforts that preceded widespread adoption of UDITPA).

[158] Internet Tax Freedom Act, Pub. L. No. 105-277, § 1104(5), 112 Stat. 2681 (1998), as amended by Internet Tax Freedom Act Amendments Act of 2007, Pub. L. No. 110-108, 121 Stat. 1024 (2007); *see generally* Walter Hellerstein, *Internet Tax Freedom Act Limits States' Power to Tax Internet Access and Electronic Commerce*, 90 J. TAX'N 5 (1999).

[159] This assumes, for purposes of illustrating methods of federal intervention, that Congress would conclude that binding taxpayers to their elections is preferable from a multi-state perspective because of the concerns about complexity, administration, and multiple taxation. This is consistent with prior Congressional action, which typically advances uniformity. *See supra* notes 156–158.

[160] *See, e.g.*, Federal-State Tax Collection Act of 1972, Pub. L. No. 92-512, 86 Stat. 919 (offering federal administration and collection of state taxes in order to incentivize states to conform to the federal tax base); *see generally* Stark, *supra* note 20 (discussing how federal

individual taxpayers, for example, by requiring each taxpayer to make the same tax elections for federal purposes as the taxpayer made for state purposes or by denying the federal tax benefit of the election unless the taxpayer makes the consistent state tax election. Depending on the approach to coordination, state legislators could lose some or all of their decision-making power over the question of whether to bind taxpayers to their federal tax elections for state purposes, thereby sacrificing some degree of sovereignty.

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. Moreover, state legislators should be careful when making decisions about conformity and binding to federal tax elections that could increase complexity and decrease fairness for multi-state taxpayers.

This part applies this article's analysis to the three examples with which this article's introduction began: the choice between itemized and standard deduction, a married couple's choice to file jointly or separately, and the choice to tax an actual stock acquisition as a deemed asset acquisition. To the extent they are familiar with any particular federal tax election, readers may wish to focus primarily on the background with respect to the state income tax consequences of the election, or readers may want to skip the relevant background section entirely and proceed directly to the relevant analysis.

A. ITEMIZED DEDUCTIONS VS. STANDARD DEDUCTION

1. Background

For federal income tax purposes, an individual has the option of itemizing deductions or taking the standard deduction.[161] Typically, a

laws can be used to influence the design of state tax laws); Shanske, *supra* note 20 (same).

[161] I.R.C. § 63. For the 2008 taxable year, itemized deductions were taken on

taxpayer will want to itemize deductions if the itemized deductions exceed the standard deduction.[162] Briefly, itemized deductions[163] include state and local taxes,[164] home mortgage interest,[165] and charitable contributions,[166] among others.[167] Generally, itemized deductions are provided to advance "either of two basic rationales: equitable distribution of the tax burden or encouragement of worth-while expenditures."[168]

In lieu of itemizing, a taxpayer can take a standard deduction of a fixed amount.[169] The standard deduction serves both simplification and progressivity functions.[170] It simplifies the income tax by relieving many taxpayers from the burden of tracking and calculating itemized deductions,[171] 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.[172]

Most states with income taxes also allow for itemized deductions or a standard deduction. States vary, however, with respect to which itemized deductions they allow, and states vary with respect to the amount of their standard deductions.[173] Further, states take a variety of approaches to the

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approximately one-third of all federal income tax returns filed. IRS Statistics of Income Division, *2008 Individual Income Tax Returns*, Publication 1304, Rev. 07-2010, tbl.1.2 [hereinafter IRS 2008 Tax Statistics].

[162] Taxpayers can elect to take itemized deductions even if they do not exceed the standard deduction, but the taxpayers must affirmatively check a box on Schedule A in order to indicate that this is what they want to do. IRS Form 1040, Schedule A (2010).

[163] 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).

[164] I.R.C. § 164.

[165] I.R.C. § 163(h).

[166] I.R.C. § 170.

[167] These three categories of itemized deductions are the most commonly taken by, and the most valuable to, itemizers. IRS 2008 Tax Statistics, *supra* note 162, at tbl.2.1.

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

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

[170] *See* John R. Brooks, II, *Doing Too Much: The Standard Deduction and the Conflict Between Progressivity and Simplification*, 2 COLUM. J. TAX L. 205 (2011); Samansky, *supra* note 168, at 533–40.

[171] The tradeoff is that, with this simplification, the precision of income measurement is diminished.

[172] Brooks, *supra* note 170, at 224–26 (arguing that these two functions should be disaggregated); Samansky, *supra* note 168; *see also* Louis Kaplow, *The Standard Deduction and Floors in the Income Tax*, 50 TAX. L. REV. 1 (1994).

[173] *See* RIA, ALL STATES TAX GUIDE ¶ 228-A.5 (2012) (collecting state-by-state

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.[174]

A taxpayer may or may not want to make the same choice for federal and state tax purposes. For example, a taxpayer who 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.[175] In contrast, a taxpayer who 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.[176]

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). These analyses should focus primarily on the individual state perspective because the itemization election is only available for personal income tax purposes and because most individual taxpayers pay state income tax in only one state.[177]

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information); WIS. LEGISLATIVE FISCAL BUREAU, *supra* note 25 (providing detailed information about each state's standard deduction amounts and each state's allowable itemized deductions).

[174] *See, e.g.*, *supra* notes 1–4, 69, and accompanying text.

[175] 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. OR. DEP'T OF REVENUE, OREGON PERSONAL INCOME TAX STATISTICS: CHARACTERISTICS OF FILERS, TAX YEAR 2009, at 27 (2011), http://www.oregon.gov/dor/STATS/docs/101_406_11/101-406-11.pdf [hereinafter, OREGON 2009 TAX STATISTICS]. *See generally* WIS. LEGISLATIVE FISCAL BUREAU, *supra* note 25, at 11 (noting which states allow deductions for state and/or federal taxes paid).

[176] For example, Oregon allows a special medical deduction for taxpayers sixty-two years of age and older; this deduction is an important reason why an Oregon taxpayer who takes the standard deduction for federal income tax purposes might decide to itemize deductions for Oregon state tax purposes. In 2009, a higher percentage of Oregon state income tax returns with AGI below $100,000 used itemized deductions for state purposes than used them for federal tax purposes. OREGON 2009 TAX STATISTICS, *supra* note 175.

[177] Accordingly, the possibility of multi-state coordination ought to have little impact on the states' approach to the itemization election. State legislators in states where multi-

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 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,[178] the state may opt to conform to the election but decouple from some of the federal itemized deductions.[179] 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.[180]

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

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state individual taxpayers are somewhat more common (e.g., perhaps Connecticut and New York) might also consider the multi-state perspective, however. In these states, legislators should also consider whether taxpayers are likely to have incentives to make different itemization elections in the multiple states, and if so, whether the availability of independent elections is likely to have a significant impact on compliance complexity for large numbers of taxpayers and/or substantially increase the risk of multiple taxation, again, for large numbers of taxpayers.

[178] 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 for his federal income taxes paid. Some states do, and others do not. RIA, *supra* note 173, ¶ 230 (indicating which states allow such a deduction); *see generally* WIS. LEGISLATIVE FISCAL BUREAU, *supra* note 25, 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 37, at 14.

[179] This is a common approach, though states vary with respect to the specific itemized deductions and the size of the standard deduction. RIA, *supra* note 173, ¶ 228-A.5 (collecting state-by-state information); *see also* WIS. LEGISLATIVE FISCAL BUREAU, *supra* note 25, at 11.

[180] 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 that state values simplicity; that state might wish to decouple and mandate that all taxpayers itemize.

taxes do),[181] the state must address the binding question — should a taxpayer's federal choice whether to itemize be binding for state tax purposes? This assessment should depend largely on how the state legislators value simplicity, administrability, and sovereignty considerations.

A state can reap significant simplicity and administrability benefits by binding each taxpayer to the itemization election made for federal tax purposes. This is particularly true if the state binds taxpayers though a deemed federal choice approach, by choosing federal *taxable* income as the state's federal starting point for conformity. Where a state uses federal *adjusted gross* income (rather than federal taxable income) as its conformity starting point,[182] however, 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.

The price of this ease is sovereignty. As the state's itemized deductions diverge from the federal itemized deductions,[183] the simplicity and administrability benefits of binding elections decline, and the tax planning complexities presented by binding elections increase. Thus, the more a state's itemized deductions differ from the federal itemized deductions, the more the state should consider allowing taxpayers to make an 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 (by 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 can try to avoid non-facial conformity problems, where taxpayers will need to provide information to the state tax authority (i.e., details about the state itemized

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[181] RIA, *supra* note 173, ¶ 228-A.5.

[182] *See State Personal Income Taxes: Federal Starting Points*, *supra* note 14, at 7.

[183] 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 smaller number).

deductions) that the taxpayer did not already provide to the Service.[184]

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.[185]

Admittedly, allowing any independent choice generally reduces state revenue. Query, however, 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 choice[186] 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.[187] Where a state essentially claims part of this federal tax benefit, the state may undermine Congress's policy objective of increasing fairness or incentivizing socially useful actions through the particular itemized deductions.

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[184] The non-facial 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 non-facial 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 an 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.

[185] 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 nonitemized deduction, such that a taxpayer could take the special state deduction in addition to taking the standard deduction.

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

[187] *See supra* note 90.

B. Married Filing Jointly vs. Married Filing Separately

1. Background

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.[188] Only a very small percentage of married couples file separate federal income tax returns[189] because filing separately generally results in a *higher* aggregate federal tax burden for the couple than would filing jointly.[190] In contrast, because of the structure of state rate brackets, married couples filing separately may have a *lower* aggregate state tax burden than they would if filing jointly.[191] 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 federal income tax purposes and separately for state income tax purposes.[192]

Some states, like Montana, allow married couples to use a different filing status for state tax purposes than the couples used for federal income tax purposes.[193] Other states, like California and New York, generally

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[188] Some married couples, like couples where one spouse is a U.S. citizen and the other is a nonresident alien, are required to file separately for federal income tax purposes. This discussion focuses on those married couples that 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 both federal and state income tax purposes, setting aside differences in federal and state definitions of "marriage." *See generally* Patricia A. 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); *see also supra* note 67.

[189] For taxable year 2008, the Service received approximately 53.7 million married filing jointly returns and approximately 2.7 million married filing separately returns. IRS 2008 Tax Statistics, *supra* note 161.

[190] Married filing separately is generally disadvantageous for several reasons, including because (a) for 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* James Edward Maule, *Income Tax Liability: Concepts & Calculations*, BNA U.S. INCOME PORTFOLIOS: INCOME, DEDUCTIONS, CREDITS & COMPUTATION OF TAX, 507-3rd, ¶II.B.

[191] 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* Memorandum from Dan Dodds, *supra* note 5, at 4–9 (providing examples to illustrate this phenomenon).

[192] *See, e.g.*, *supra* note 5 and accompanying text.

[193] *See also, e.g.*, *supra* note 71 (noting that Iowa generally takes the same approach as

require that married couples who file jointly for federal income tax purposes also file jointly for state income tax purposes,[194] 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.[195]

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. These questions are merely a subset of the issues state legislators must address when determining how the state should approach the taxation of married couples.[196]

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.[197] This decision can be driven by deeply held beliefs about marriage, gender, and fairness. Extensive literature considers how marriage is, and should be,

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Montana on this issue).

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

[195] For example, a married couple residing 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).

[196] 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.

[197] CONG. BUDGET OFFICE, FOR BETTER OR WORSE: MARRIAGE AND THE FEDERAL INCOME TAX 2–6 (1997) (explaining the policy conflict that leads to debate over marriage penalties and marriage bonuses); Gregg A. Esenwein, *Income Taxation of Married Couples: Background and Analysis*, 90 TAX NOTES 1081, 1082–84 (Feb. 19, 2001) (discussing "conflicting goals of equity" in the application of the income tax to couples); *see also* Boris I. 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).

treated for income tax purposes,[198] 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 penalties[199] 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.

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,[200] 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,[201] a state that decouples and adopts a different definition of the taxable economic unit

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[198] *See, e.g.*, Amy C. Christian, *Joint and Several Liability and the Joint Return: Its Implication for Women*, 66 U. CIN. L. REV. 535 (1998); Lily Kahng, *One is the Loneliest Number: The Single Taxpayer in a Joint Return World*, 61 HASTINGS L.J. 651 (2010); Marjorie E. Kornhauser, *Love, Money, and the IRS: Family, Income-Sharing, and the Joint Income Tax Return*, 45 HASTINGS L.J. 63 (1993); Edward J. McCaffery, *Taxation and the Family: A Fresh Look at Behavioral Gender Biases in the Code*, 40 UCLA L. Rev. 983 (1993); Shari Motro, *A New "I Do": Towards a Marriage-Neutral Income Tax*, 91 IOWA L. REV. 1509 (2006); Lawrence Zelenak, *Marriage and the Income Tax*, 67 S. CAL. L. REV. 339 (1994); 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).

[199] 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 nontax decision whether to marry.

[200] For example, Pennsylvania generally requires married taxpayers to file jointly, except in very limited situations specified by the statute. 72 PA. STAT. ANN. § 7331 (2012); 61 PA. CODE § 117.2. (1972).

[201] 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).

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.[202]

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 regarding 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, the taxpayer's state tax computations may be different from 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 using the taxpayer's federal returns.[203] 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 non-facial 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 Service and precluding the state from relying on Service 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

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[202] *See, e.g.*, TENN. CODE ANN. § 67-2-102 (1985) (imposing a personal income tax just on dividends and interest).

[203] This issue is mitigated somewhat by the option, provided by many states, of filing separately on the same form. *See supra* note 7. 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.

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 their 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 AGI) 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 to eliminate the extra tax cost that would otherwise be imposed because their federal election was binding for state purposes.[204] 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 state-specific beliefs regarding marriage and fairness. This seems to be a very beneficial result, assuming sufficient revenue can still be collected.[205]

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.[206] 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.

As with the election to take the standard deduction or to itemize deductions, this discussion has approached the analysis from an individual state perspective because most individual taxpayers pay state income tax in only one state.[207] As discussed below with respect to the section 338(h)(10)

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[204] These are among the alternatives that Montana is considering.

[205] 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.

[206] 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.

[207] To the extent that a state has a significant number of multi-state individual

election, the multi-state perspective is likely to become more important in the context of business elections because large numbers of businesses operate in multiple states.

C. Actual Stock Acquisition vs. Deemed Asset Acquisition

1. Background

Consider a third example, this one involving businesses rather than individuals: when a corporation makes a "qualified stock purchase"[208] of an S corporation or of a corporate subsidiary, the federal income tax system allows the parties to opt (by making a section 338(h)(10) election) to treat the actual stock purchase as a deemed asset purchase for federal income tax purposes.[209] When the section 338(h)(10) election is available, it is typically advisable for federal income tax purposes.[210] This is because the election often benefits both the buyer (because the post-transaction target corporation receives fair market value basis in its assets, which is beneficial if the assets are appreciated)[211] and the seller (if the gain inherent in the target corporation's assets is less than the gain inherent in the seller's stock in the target corporation).[212] Even where a section 338(h)(10) election will cause the seller to recognize more gain (i.e., because the gain inherent in the target corporation's assets is greater than the gain inherent in the seller's stock in the target corporation), the buyer may be willing to share the value of its tax benefit with the seller in order to compensate the seller for its increased tax cost resulting from the section 338(h)(10) election.[213]

Most states conform to the section 338(h)(10) election at least for

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taxpayers, however, state legislators should increasingly consider the multi-state perspective.

[208] I.R.C. § 338(d)(3) (defining a "qualified stock purchase" as the acquisition, within a twelve-month period, of at least eighty percent of the vote and value of the stock of the target corporation).

[209] I.R.C. § 338(h)(10).

[210] MARTIN D. GINSBURG & JACK S. LEVIN, MERGERS, ACQUISITIONS, AND BUYOUTS: A TRANSACTIONAL ANALYSIS OF THE GOVERNING TAX, LEGAL, AND ACCOUNTING CONSIDERATIONS ¶ 206 (Jan. 2012 ed.). This is in marked contrast to regular section 338 elections, which are rarely advisable because they typically result in an increase in the current tax imposed on the transaction. *Id.* ¶ 205.

[211] Treas. Reg. § 1.338(h)(10)-1(d)(2) (2007). Basis step-up is often important to the buyer because the step up in basis of the target corporation's assets avoids the possibility that multiple levels of *corporate* tax could be imposed on the sale.

[212] I.R.C. § 338(h)(10)(A) (providing that gain is calculated based on a deemed asset sale and that the actual stock sale is disregarded).

[213] Field, *supra* note 97, at 15–21 (discussing the bargaining dynamic between the buyer and seller in the context of a transaction in which a section 338(h)(10) election is made).

certain types of target corporations.[214] Where the target corporation and its shareholders are all taxpayers in one state only (say, State X), then the taxpayers will generally want to make the same election for state income tax purposes as is made for federal income tax purposes. Where the target corporation and/or its shareholders pay income taxes in different states, however, the total income tax levied on the transaction may be reduced if the election can be made for some state jurisdictions and not for others. This is because the states may have different tax bases and because unique state tax issues (including the allocation and apportionment of income) arise for multi-state taxpayers.

For a simplified example, assume that the target corporation is subject to tax only in State X (which imposes a ten percent income tax) and that the target corporation is wholly owned by a parent corporation that is subject to tax only in State Y (which imposes a five percent income tax).[215] If the parent corporation sells all of the stock of the target corporation to a buyer corporation and no election is made for either state's purposes, the transaction generates gain from the sale of stock, which is likely nonbusiness income to the nondomiciliary parent corporation.[216] The nonbusiness income would be allocable to State Y[217] and the parent corporation would be taxable, at State Y's five-percent tax rate, on the gain from the stock sale. If the election is effective for both states' purposes, the transaction generates gain from the deemed sale of the target corporation's assets, which is more likely to be business income[218] apportionable to the

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[214] BNA Special Report, *supra* note 11, at S-94 to S-95 (Apr. 22, 2011) (reporting the results of a fifty-state survey about whether states conform to the federal section 338(h)(10) election for C corporation targets and/or for S corporation targets). *See generally* Andrew N. Needham, *Consequences of a Section 338(h)(10) Election at the State Level*, 48 TAX NOTES 1681 (Sept. 24, 1990) (discussing the variety of ways in which states could treat a transaction for which a section 338(h)(10) election has been made at the federal level). There has been significant judicial and legislative action at the state level since the Needham article, but it provides a useful background about the wide variation in possible state approaches.

[215] This example further assumes that the subsidiary and parent are not part of a unitary business.

[216] *See* HELLERSTEIN & HELLERSTEIN, *supra* note 12, ¶ 7.14[1].

[217] Unif. Div. of Income for Tax Purposes Act §§ 4–8 (1957) [hereinafter UDITPA] (allocating nonbusiness income to the taxpayer's domiciliary state); *see generally* HELLERSTEIN & HELLERSTEIN, *supra* note 12, ¶ 9.11 (discussing whether gain from the sale of stock is treated as business or nonbusiness income for state tax apportionment/allocation purposes).

[218] BNA Special Report, *supra* note 11, at S-96 to S-97 (reporting the results of a fifty-state survey regarding whether the states treat gain from a section 338(h)(10) transaction as apportionable business income or allocable nonbusiness income). This example assumes that both State X and State Y treat 338(h)(10) gain in the same way, as either apportionable business income or allocable nonbusiness income. The analysis is more complicated if this is

state in which the business is operated (here, State X).[219] Thus, the target corporation would be taxable at State X's ten-percent tax rate on the gain from the deemed asset sale.[220] If there is no election in one state (say, State X) but there is an effective election for the other state (State Y), the transaction could escape state income taxation entirely; for State X purposes, the transaction would be taxed as an actual stock sale, generating nonbusiness income allocated entirely to State Y, but for State Y purposes, the transaction would be taxed as a deemed asset sale, generating business income apportioned entirely to State X.[221]

That is, while a section 338(h)(10) election may be tax minimizing from a federal income tax perspective, it may not be tax minimizing from the perspective of one or more state income tax(es). Thus, if independent elections are allowed, taxpayers may wish to make different choices for federal and state purposes, and taxpayers may also wish to make different elections for different states. The analysis becomes more complicated when the target corporation and/or shareholder(s) each pay income tax in multiple states (particularly if the relevant states have different definitions of "business income" and/or different apportionment formulae), but the concept remains the same. That is, if independent section 338(h)(10) elections are allowed, the sale of a multi-state business is susceptible to tax planning which could enable taxpayers to be subject to less than full state income taxation on the transaction.[222]

Most states, however, prohibit independent section 338(h)(10) elections.[223] Rather, they typically bind taxpayers to their federal choice.[224] Where the federal election is binding, rational taxpayers will, again, calculate whether the election is tax minimizing, taking into account the tax imposed by all taxing jurisdictions.

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not true.

[219] UDITPA § 9; *see generally* HELLERSTEIN & HELLERSTEIN, *supra* note 12, ¶ 9.02.

[220] This also assumes that the gain upon the deemed liquidation of the target corporation is treated by State Y as business income, such that the deemed liquidation would not trigger the recognition of gain that is taxable in State Y.

[221] *See supra* note 220.

[222] *See* Petrik & Millar, *supra* note 40, at 20-21 (discussing such planning opportunities); Crawford & Uzes, *supra* note 21, ¶ 1140.06B(7) (same).

[223] BNA Special Report, *supra* note 11, at S-94 to S-95 (indicating that very few states allow taxpayers to make a federal but not state election or to make a state but not federal election).

[224] *Id.* (noting that, for most such states, the binding state election is deemed to be made and no state-level matching election filing is required).

2. Analysis

Once more, a variety of factors influence a state's decision about whether to afford a section 338(h)(10) election at the state level and whether to bind taxpayers to the choice made at the federal level. Given the prevalence of multi-state business, this analysis must include not only the individual state perspective, but also the multi-state perspective.

From the individual state perspective, the section 338(h)(10) election is less laden with community-specific value judgments than is, for example, the married filing status election.[225] This suggests that sovereignty concerns are less likely to drive state legislators to decouple from the section 338(h)(10) election.

Where the election is available at the state level, simplicity, administrability, and revenue issues are presented if states allow taxpayers to make independent elections. These issues include the possibility that independent elections may reduce tax-planning complexity because taxpayers would not need to compare the magnitude of tax benefits and costs from different jurisdictions in order to make tax-minimizing choices.[226] Yet independent elections likely increase compliance complexity for several reasons because any 338(h)(10) election clearly arises prior to the state's federal conformity starting point. Further, if a section 338(h)(10) election is made at the federal level, but not at the state level (or vice versa), then different taxpayers may be responsible for taxes on the transaction gain. For example, where the target corporation is affiliated (but not consolidated) with the parent corporation, the target pays the tax on the gain if an election is made, but the parent pays the tax on the gain if no election is made.[227] Moreover, if there is an election for one jurisdiction and not another, the amounts of gain recognized and the character of the gain likely differ.[228] As a result, the recognition of different amounts of gain and the involvement of different taxpayers can increase compliance complexity for taxpayers, in that the way a taxpayer reports the transaction for federal tax purposes may be of very little help when the taxpayer is determining how to report the transaction for state tax purposes.

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[225] The section 338(h)(10) election serves primarily to reconcile the discontinuity between the way the tax code treats stock purchases of businesses and asset purchases of businesses. *See* Field, *supra* note 17, at 35–46. *Cf. supra* Part VI.B.2. (discussing how a state's decision about how to handle the filing status of married couples reflects the state's values about marriage, gender, and fairness).

[226] *See supra* note 82 and accompanying text.

[227] *See* GINSBURG & LEVIN, *supra* note 210, ¶ 206.2.2.

[228] *See id.* ¶¶ 206.1.2, 206.3.3 (noting that a section 338(h)(10) election can change the amount and character of gain recognized from the transaction).

Nevertheless, multi-state businesses engaged in section 338(h)(10) election transactions likely use professional tax preparers, so the increase in compliance complexity for taxpayers may not be terribly problematic.

The administrability impact on state tax authorities of different federal and state 338(h)(10) elections, however, can be significant. Where a different amount of gain is recognized for state and federal purposes, and particularly where a different taxpayer is responsible for that gain for state and federal purposes, the state tax authority basically foregoes its ability to piggy-back on the enforcement efforts of the Service. Administrability issues can be particularly problematic if the election is made at the state level but not at the federal level. This situation results in non-facial conformity because the purchase price would have to be allocated among the assets deemed purchased for state tax purposes, but no allocation would need to be made for federal tax purposes. Additionally, the state would have to determine whether the transaction met the eligibility requirements for the election, but no such eligibility inquiry would be needed at the federal level. These issues create even more work for the state tax authorities because they cannot rely on the Service's assessment of eligibility and reasonableness of purchase price allocation. This suggests that a state may be able to advance simplicity and administrability by prohibiting taxpayers from making a state-level election if they have not also made a federal-level election, or by (more generally) binding taxpayers to their federal section 338(h)(10) elections.

Given the prevalence of businesses that operate in multiple states, state legislators ought to consider not only the policy implications of federal-to-state section 338(h)(10) election conformity and binding, but they should also take into account the implications of state-to-state coordination with respect to this election. The multi-state perspective allows state legislators to determine how their decisions about state-level section 338(h)(10) elections impact their state's business environment, affect their state's taxpayers who also operate in other states, and alter the risk of federal intervention with respect to this issue.

The complexity concerns raised by state-level section 338(h)(10) elections can be exacerbated when the seller and/or target corporation operates in multiple states. The magnification of the complexity problem, however, stems less from the possibility of making different election choices in different states, and more from differences in the underlying states' income tax laws. That is, significant complexity exists regardless of whether multi-state taxpayers are required to make the same election choice in multiple states because the complexity arises from different states'

eligibility requirements for the election,[229] from different states' treatment of section 338(h)(10) gain from the deemed asset sale as apportionable business income or allocable nonbusiness income,[230] and from different states' treatment of section 338(h)(10) gain for purposes of determining their formulary apportionment factors.[231]

Similarly, these differences in the relevant state tax law implications of section 338(h)(10) elections are the primary reasons that multi-state taxpayers may be subject to more or less than full state taxation on the 338(h)(10) transaction. Thus, neither this over-/under-taxation nor the resulting concern about equitable treatment of multi-state taxpayers is avoided by binding taxpayers to their federal elections.[232] This possibility of over-/under-taxation has resulted in significant controversy over the state tax consequences of federal section 338(h)(10) elections.[233]

Coordination between the states, either voluntarily through multi-state action or mandatorily through federal intervention, could reduce the frequency of these controversies and alleviate the compliance complexity and fairness concerns that arise in connection with the taxable acquisitions of multi-state businesses where section 338(h)(10) elections are available. Moreover, coordination could curtail any efforts by states to export tax to nonresidents by making strategic choices about whether to bind taxpayers to their federal 338(h)(10). Neither multi-state coordination nor federal

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[229] BNA Special Report, *supra* note 11, at S-94 to S-95. State-to-state differences in eligibility criteria mean that, upon the acquisition of a target corporation, the election may be available in one state but not another state. This creates compliance complexity for the taxpayer whether or not the taxpayers are bound to their federal election for purposes of the state in which the election is available.

[230] *Id.* at S-96 to S-97. State-to-state differences in the classification of 338(h)(10) gain can result in the same gain being treated as apportionable for purposes of one state and allocable for purposes of another state. This creates compliance complexity and the risk of over-/under-taxation even if taxpayers are bound to their federal elections for state purposes.

[231] *Id.* at S-98 to S-99 (indicating how section 338(h)(10) gain affects each state's apportionment factor). State-to-state differences in apportionment factors and in how 338(h)(10) gain affects apportionment factors can result in more or less than 100% of the gain being taxed at the state level (e.g., if fifty percent of the business's sales occur in each of two states, but both states overweigh the sales factor in their apportionment formulae). This is true even if 338(h)(10) elections are binding at the state level and even if all states treat the 338(h)(10) gain as apportionable business or allocable nonbusiness income. *See generally* Burgner, *supra* note 93, at ¶ 1108.05(D) (explaining how differences in states' apportionment formulae can result in multiple taxation for businesses).

[232] Binding elections can result in either over- or under-taxation, but independent elections should result only in the risk of under-taxation assuming rational taxpayers that are well advised.

[233] *See* HELLERSTEIN & HELLERSTEIN, *supra* note 12, ¶ 7.14.

intervention regarding the section 338(h)(10) election will likely accomplish very much, however, unless states also increase coordination with respect to the underlying state law. This suggests that there may be a more compelling case for UDITPA reform[234] than for binding taxpayers to their federal section 338(h)(10) elections for state tax purposes.

VII. CONCLUSION

Tax elections in the federal income tax provide taxpayers with choices. This presents states with choices 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 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. Simplicity and administrability concerns, however, 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 non-facial conformity (as with taxpayers who take the standard deduction for federal purposes, but who want to itemize for state purposes). Additionally, 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. Moreover, legislators should remember that, to the extent their decisions about election conformity and binding create significant adverse consequences for other states and/or for multi-state taxpayers, their decisions increase the risk of federal intervention.

Although this article discusses the foregoing guidance for state legislators primarily in the context of three explicit tax elections, the article's recommendations are applicable to a wide variety of tax elections,

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[234] *See* Huddleston & Sicilian, *supra* note 154, at 4 (describing current efforts to reform UDITPA).

including elections such as the business entity classification election and the election to accelerate the imposition of tax on forfeitable property granted in exchange for services.[235]

Ultimately, concern for simplicity and administrability generally weigh in favor of conforming to federal tax elections and binding taxpayers to their federal choices. Sometimes revenue needs trump these considerations, and sometimes other state-specific policy preferences prevail. Yet, 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.

[235] 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 83(b) election should consider the risk of non-facial conformity that would result if the taxpayer made the election for state purposes but not federal purposes (i.e., for state tax purposes, the property would have to be valued upon grant, but no such current valuation would be needed for federal purposes).