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# Tax Elections: How to Live With Them if We Can't Live Without Them

Emily Cauble

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## TAX ELECTIONS: HOW TO LIVE WITH THEM IF WE CAN'T LIVE WITHOUT THEM

**Emily Cauble\***

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\* Assistant Professor, Michigan State University College of Law (visiting at DePaul University College of Law). The author would like to thank Ellen Aprill, Monu Bedi, Leslie Book, Samuel Brunson, John Colombo, Heather Field, Victor Fleischer, Deborah Geier, James Gibson, Andrew Gold, Catherine Grosso, Michael Grynberg, David Hasen, Mary Heen, Max Helveston, Joan Howarth, Mae Kuykendall, Julie Lawton, Benjamin Leff, Cary Martin, Mark Moller, Daniel Morales, Barbara O'Brien, Katherine Pratt, James Puckett, Zoë Robinson, Michael Sant'Ambrogio, Joshua Sarnoff, Theodore Seto, Andrew Spalding, Glen Staszewski, David Thronson, Allison Tirres, participants at the 2012 Critical Perspectives on Tax Policy Workshop hosted by the University of Washington School of Law, participants at the Loyola Tax Policy Colloquium hosted by Loyola Law School Los Angeles, participants at the University of Richmond School of Law faculty workshop, participants at the Cleveland-Marshall College of Law faculty workshop, participants at the Chicago Junior Faculty Workshop hosted by Loyola University Chicago School of Law, and participants at the 2012 Big 10 Untenured Conference for their valuable comments.

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#### INTRODUCTION

Blackstone, a private equity group, sponsors various private equity funds, real estate funds and hedge funds.<sup>1</sup> When Blackstone sponsors a fund, outside investors such as pension plans, educational endowments, financial institutions, and wealthy individuals agree to invest money in the fund.<sup>2</sup> Blackstone selects projects and securities in which the fund will invest, and, in exchange for its efforts, Blackstone receives a management fee plus a percentage of the profits earned by the fund (referred to as carried interest).<sup>3</sup> In 2007, an entity named Blackstone Group LP began trading on the New York Stock Exchange (NYSE).<sup>4</sup> The Blackstone Group LP is an entity that is entitled to a percentage of the payments Blackstone receives by way of

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1. For further discussion, see Victor Fleischer, *Taxing Blackstone*, 61 TAX L. REV. 89 (2008).

2. *Id.* at 97–98.

3. *Id.* at 94, 98.

4. *See id.* at 96–97.

management fees and carried interest from the various funds that it sponsors.<sup>5</sup> Thus, anyone who buys an interest on the NYSE in Blackstone Group LP is entitled to share in what Blackstone receives as a fund sponsor.

Blackstone Group LP is publicly traded; yet, unlike many publicly-traded companies, Blackstone Group LP is able to avoid being treated as a corporation for tax purposes.<sup>6</sup> Thus, Blackstone Group LP is not required to pay corporate level tax on all of its income and saves massive amounts in tax. Blackstone Group LP benefits from this atypical tax treatment as a result of complex tax structuring that relies on many facets of tax law including the ability to electively determine the tax treatment of various entities owned by Blackstone Group LP. This complex structuring illustrates, among other things, the ability of sophisticated taxpayers to use tax elections to obtain favorable tax treatment.

Tax elections affect not only business entities but also individual taxpayers. For example, if a divorced couple has a child and various requirements are met, one of the parents can claim the child as a dependent, and the parents electively decide which parent does so.<sup>7</sup> Moreover, although sophisticated parties like Blackstone are able to save taxes by making favorable elections, many unsophisticated taxpayers who do not obtain adequate advice will fail to reap the potential tax savings resulting from a beneficial election. In the context of the dependency exemption election, for instance, if a couple receives adequate advice, they can use the election to reduce their total tax liability by deciding that the parent who is subject to a higher tax rate will claim the exemption.<sup>8</sup> By contrast, an unsophisticated couple who is unaware of the election may fail to obtain beneficial tax treatment.<sup>9</sup>

Tax elections are prevalent. In addition to the entity classification election upon which Blackstone relies and the dependency exemption election just discussed, examples include: elections by individual taxpayers to either claim the

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5. *Id.* at 94, 98.

6. *See id.* at 97.

7. *See infra* Part I.C.

8. *See infra* Part I.C.

9. *See infra* Part I.C.

standard deduction or itemize deductions; an election that determines the tax treatment of alimony payments; and elections that affect the tax consequences of certain corporate transactions; just to name a few.

In order to obtain more favorable tax consequences as a result of an election, a taxpayer can simply file a given election and need not alter any of the nontax aspects of his or her behavior or transactions. Thus, a sophisticated, well-advised taxpayer generally will have no reason to do anything other than make the most advantageous election possible. Consequently, only unsophisticated taxpayers who do not obtain adequate advice will forgo the potential tax benefits of an election. As a result, tax elections produce unfairness.<sup>10</sup>

Despite the unfairness they cause, tax elections remain. In some cases, the continued existence of an election can only be explained by the political influence of those who benefit from it.<sup>11</sup> In other cases, scholars have identified benign justifications for an election.<sup>12</sup> Ultimately, regardless of the reason for a particular election's endurance, at least some elections are likely to continue to inhabit the tax landscape.

Given the inevitability of at least some tax elections, this Article takes the approach of examining how elections can be designed to mitigate the resulting harms. This Article focuses, in particular, on four features that can be designed to mitigate the unfairness caused by tax elections: (1) default rules; (2) alerting taxpayers to the presence of an election; (3) the deadline for filing an election; and (4) persistence. Default rules determine the tax consequences that follow when a taxpayer fails to make an election by the relevant

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10. Tax elections are not the only examples of tax rules that are biased against unsophisticated individuals. Other examples include opportunities to engage in tax planning by changing nontax features of a planned transaction. Like tax elections, these tax planning opportunities may disproportionately benefit sophisticated taxpayers. For further discussion, see Emily Cauble, *Rethinking the Timing of Tax Decisions: Does a Taxpayer Ever Deserve a Second Chance?*, 61 CATH. U. L. REV. 1013 (2012); Heather M. Field, *Choosing Tax: Explicit Elections as an Element of Design in the Federal Income Tax System*, 47 HARV. J. ON LEGIS. 21, 22–24 (2010); David M. Schizer, *Frictions as a Constraint on Tax Planning*, 101 COLUM. L. REV. 1312, 1319 (2001). While many of the considerations discussed in this Article apply to this type of tax planning as well, this Article focuses on explicit tax elections.

11. See *infra* note 126.

12. See *infra* Part III.

deadline. Steps that could be taken to alert taxpayers to the presence of an election include providing further information on tax return forms and in tax return preparation software. An election's deadline specifies the time by which a taxpayer must make an election. An election's persistence refers to the length of time during which any given election will affect tax consequences.

A number of insightful articles about tax elections already exist.<sup>13</sup> Some articles even discuss how to design features of elections, particularly default rules.<sup>14</sup> This Article builds upon the existing literature in three important ways. First, before applying to tax law the analysis of default rules that has developed in contract law, this Article describes how the differences between tax law and contract law affect the examination of default rules. Ultimately, the relevant differences between tax law and contract law relate to important timing differences between making tax elections and selecting contract provisions. For example, one noteworthy difference between tax law and contract law is the time at which the government becomes involved. At the time parties are establishing the terms of the contract, courts and other governmental bodies are not involved. By contrast, in tax law, the government, in the capacity of providing information on tax return forms, is involved at the time the parties make tax election decisions, at least for elections that are filed at the same time as tax returns. Thus, although in contract law it may be necessary or desirable to encourage one contracting party to provide his or her counterparty with

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13. See, e.g., Heather M. Field, *Checking in on "Check-the-Box,"* 42 LOY. L.A. L. REV. 451 (2009); Field, *supra* note 10; Heather M. Field, *Tax Elections & Private Bargaining*, 31 VA. TAX REV. 1 (2011); Aubree L. Helvey & Beth Stetson, *The Doctrine of Election*, 62 TAX LAW. 333 (2008); Victoria A. Levin, *The Substantial Compliance Doctrine in Tax Law: Equity vs. Efficiency*, 40 UCLA L. REV. 1587 (1993); John MacArthur Maguire & Philip Zimet, *Hobson's Choice and Similar Practices in Federal Taxation*, 48 HARV. L. REV. 1281 (1935); Andrea Monroe, *Too Big to Fail: The Problem of Partnership Allocations*, 30 VA. TAX REV. 465 (2011); Alex Raskolnikov, *Revealing Choices: Using Taxpayer Choice to Target Tax Enforcement*, 109 COLUM. L. REV. 689 (2009); George K. Yin, *The Taxation of Private Business Enterprises: Some Policy Questions Stimulated by the "Check-the-Box" Regulations*, 51 SMU L. REV. 125 (1997); Edward Yorio, *The Revocability of Federal Tax Elections*, 44 FORDHAM L. REV. 463 (1975).

14. See, e.g., Field, *Tax Elections & Private Bargaining*, *supra* note 13; Monroe, *supra* note 13, at 510–12; Raskolnikov, *supra* note 13, at 710–12.

information about legal rules, in tax law, the IRS could directly provide information to less informed taxpayers rather than rely on other taxpayers as the source of information about the law. A second noteworthy timing difference is that contract terms are forward-looking while at least some tax elections are backward-looking.<sup>15</sup> Contract terms govern the parties' relationship going forward.<sup>16</sup> Therefore, the parties design a contract term based on what they anticipate will occur after entering into a contract.<sup>17</sup> Many tax elections, by contrast, are backward-looking.<sup>18</sup> Such elections govern tax consequences for a year that has already closed before the election must be filed. Thus, all information that determines whether the election is beneficial is available at the time the election is due. Because of this timing distinction, in many cases, it will be difficult for a court to determine the contractual term the parties would have wanted at the time they entered into a contract but easy for courts or the IRS to determine what election a taxpayer would have wanted as of the due date for an election.

Second, this Article imports into the discussion of tax election default rules a concept from contract law scholarship—the notion of tailored default rules versus untailored default rules—and uses this concept to make further recommendations regarding tax election default rules.<sup>19</sup> A tailored default rule aims to exactly match what the particular contracting parties would have wanted had they considered a specific term, while an untailored default rule might not match what any particular set of contracting parties would have selected but rather represents what the majority of contracting parties would desire.<sup>20</sup> In contract law, a tailored default rule is typically a vague, flexible standard under which courts supply a term that would be reasonable given the surrounding facts and circumstances.<sup>21</sup> By contrast, an untailored default rule is usually a more certain rule that represents what the majority of parties

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15. See *infra* Part IV.A.2.ii for further discussion.

16. See *infra* Part IV.A.2.ii for further discussion.

17. See *infra* Part IV.A.2.ii for further discussion.

18. See *infra* Part IV.A.2.ii for further discussion.

19. See *infra* Part IV.A.2.iii for further discussion.

20. See *infra* Part IV.A.1.

21. See *infra* Part IV.A.1.

might prefer but that, given its inflexible nature, does not necessarily represent what any particular set of contracting parties might have chosen.<sup>22</sup> In contract law, the main disadvantage of tailored default rules is the difficulty of applying them given their vague nature. However, because of the features that distinguish tax elections from contract law, tailored default rules are often easy to apply in the tax election context and can, in some cases, be quite useful.

Third, this Article explores how the interaction among the various features of tax elections can simplify the task of designing rules to protect unsophisticated taxpayers. For example, although taxpayer-favorable default rules can protect unsophisticated taxpayers, in some cases, it may be difficult to select a default rule that will be favorable for all taxpayers. Nevertheless, in such a case, tax election parameters can protect unsophisticated taxpayers because later filing deadlines could allow more unsophisticated taxpayers to make informed decisions with respect to the election.

This Article proceeds as follows: Part I introduces and discusses five elections used as examples throughout the Article. Part II explains why elections are problematic, and Part III discusses why elections continue to exist despite their many flaws. Finally, Part IV explores how the features of elections should be designed to mitigate the resulting harms.

## I. EXAMPLES OF TAX ELECTIONS

Hundreds of elections exist under current tax law in areas including individual income tax,<sup>23</sup> partnership tax,<sup>24</sup> corporate tax,<sup>25</sup> international tax,<sup>26</sup> and estate tax.<sup>27</sup> Tax elections vary in a number of ways, two of which are

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22. *See infra* Part IV.A.1.

23. Examples include several of the elections discussed in this paper. *See infra* Parts I.A, I.B, I.C.

24. Examples include the elections available under §§ 704(c), 754 of the Internal Revenue Code. I.R.C. §§ 704(c), 754 (2012).

25. An example is the election in § 362(e)(2)(C) of the Internal Revenue Code discussed below. *See infra* Part I.E.

26. Examples include the election to either deduct foreign taxes or take a foreign tax credit. *See* I.R.C. §§ 901(a), 164(a).

27. An example is the election to pay estate taxes in installments. *See id.* § 6166.

significant for purposes of the recommendations made in this Article. First, some tax elections are backward-looking, while others are forward looking. Backward-looking tax elections govern tax consequences for a year that has already closed before the election must be filed. Thus, all information that determines whether the election is beneficial is available at the time the election is due. By contrast, forward-looking elections continue to affect tax consequences in the future and do not merely affect tax consequences for a year that has already closed. Thus, at the time a taxpayer must make a forward-looking election, he or she will not possess all information relevant to assessing the pros and cons of making the election. Second, tax elections vary because some tax elections affect taxpayers whose interests are aligned, while other tax elections affect taxpayers with divergent interests.

This part of the Article describes five elections that will be used to illustrate recommendations made in later parts of the Article. First, this part describes a backward-looking election that affects taxpayers whose interests are aligned, namely, the election by an individual taxpayer to either claim the standard deduction or itemize deductions. Next, this part describes two backward-looking elections that affect taxpayers with divergent interests, namely, an election that determines the tax treatment of alimony payments and an election by divorced parents to determine which parent claims a child as a dependent.<sup>28</sup> The fourth election described in this part, the entity classification election, is a forward-looking election that affects taxpayers whose interests are aligned.<sup>29</sup> The final election described, the election under § 362(e)(2)(C) of the Internal Revenue Code that affects the tax consequences of certain contributions made to corporations, is a forward-looking election that can affect taxpayers whose interests diverge.

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28. Professor Field provides the second and third examples as illustrations for discussing the design of tax elections as well. See Field, *Tax Elections & Private Bargaining*, *supra* note 13. I describe them here because of their usefulness for illustrating the recommendations made later in this Article.

29. For a discussion of why the interests of the taxpayers are aligned, see *infra* notes 222–23 and accompanying text.

*A. The Standard Deduction vs. Itemizing Deductions*

Every year, individual taxpayers choose between claiming the standard deduction and itemizing deductions. If an individual claims the standard deduction then, when calculating his or her taxable income, that individual will subtract the relevant standard deduction amount and personal exemption amount from the individual's adjusted gross income (AGI).<sup>30</sup> The standard deduction is a specific dollar amount, adjusted annually for inflation.<sup>31</sup> For 2012, the standard deduction was \$5950 for a single taxpayer and \$11,900 for married individuals filing joint returns.<sup>32</sup> If a taxpayer elects to itemize deductions then, in lieu of claiming the standard deduction, that taxpayer will subtract from AGI the dollar amount of certain expenses actually incurred by the taxpayer, subject to certain limitations.<sup>33</sup>

Absent an election to itemize deductions, a taxpayer is entitled to the standard deduction by default.<sup>34</sup> Whether this default rule is favorable depends on the amount of actual, itemizable expenses incurred by the taxpayer. However, the default rule is of limited importance because taxpayers are given ample time and opportunity to elect out of the default rule. If a taxpayer files a completed return, he or she will be forced to make an affirmative choice because the taxpayer will report a dollar amount on the relevant line of the return equal to either the standard deduction amount or the total amount of itemizable expenses.<sup>35</sup> Moreover, the return form

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30. AGI is, in turn, calculated by subtracting from a taxpayer's gross income various expenses such as certain trade or business expenses, alimony (unless, as described *infra* Part I.B, the individual does not deduct alimony), and other expenses listed in § 62 of the Internal Revenue Code. See I.R.C. § 62.

31. I.R.C. § 63(c)(4).

32. Rev. Proc. 2011-52 § 3.11(1), 2011-45 I.R.B. 701. The standard deduction is also subject to certain other adjustments. For example, it is increased for aged and blind taxpayers. I.R.C. §§ 63(c)(1)(B), (c)(3), (f).

33. I.R.C. § 63. Certain expenses, such as medical expenses and the charitable contribution deduction, are subject to item-specific limitations. See *id.* §§ 213, 170. Furthermore, certain items are deductible only to the extent that the aggregate of those items exceeds two percent of the taxpayer's AGI. *Id.* § 67. In addition, except for certain items like medical expenses, when a taxpayer's AGI exceeds a given threshold, allowable itemized deductions will be phased out. *Id.* § 68.

34. *Id.* § 63(b).

35. See INTERNAL REVENUE SERV., U.S. INDIVIDUAL INCOME TAX RETURN FORM 1040 at line 40 (2012), available at <http://www.irs.gov/pub/irs->

itself alerts taxpayers to the fact that a choice is being made,<sup>36</sup> and the instructions accompanying the form provide advice to guide taxpayers in making the selection.<sup>37</sup>

The standard deduction default rule is significant only if a taxpayer fails to file a completed return, and the IRS prepares and files a substitute return based on information available to the IRS (such as information provided by employers and other third parties).<sup>38</sup> This substitute return would calculate taxable income based on the standard deduction.<sup>39</sup> However, even in this instance, only a persistent failure to act would preclude the taxpayer from itemizing deductions. When the taxpayer receives notice of the substitute return, the taxpayer can file his or her own return on which he or she can itemize deductions. The return filed by the taxpayer would be treated as a request for audit reconsideration and would replace the substitute return if accepted by the IRS.<sup>40</sup>

Regarding deadlines, the election must be made on a taxpayer's return filed for the relevant year—therefore, the election is due when the tax return is due.<sup>41</sup> The advantages and disadvantages of itemizing deductions depend only on the expenses incurred by the taxpayer and income earned by the taxpayer in a year that will have closed before the election must be made. Thus, at the time the taxpayer makes the election, he or she will possess all information relevant to

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pdf/f1040.pdf.

36. Form 1040, line 40, states that a taxpayer should provide: "Itemized deduction (from Schedule A) or your standard deduction (see left margin)." *Id.* (emphasis omitted). The left margin then lists the relevant dollar amounts for the standard deduction, and Schedule A and its instructions walk the taxpayer through the process for calculating itemized deductions. *See id.*

37. Instructions to Form 1040 state the following regarding line 40: "In most cases, your federal income tax will be less if you take the larger of your itemized deduction or standard deductions." INTERNAL REVENUE SERV., INSTRUCTIONS FOR FORM 1040 at 37–38 (2012), *available* at <http://www.irs.gov/pub/irs-pdf/i1040gi.pdf>. The instructions then refer the taxpayer to Schedule A for guidance regarding calculating itemized deductions and continue by describing how the taxpayer can determine the standard deduction amount. *See id.* at 38.

38. I.R.C. § 6020(b) (providing IRS with authority to prepare substitute returns).

39. *See* INTERNAL REVENUE SERV., IRM 4.10.4.3 (Aug. 9, 2011), *available* at [http://www.irs.gov/irm/part4/irm\\_04-010-004.html#d0e470](http://www.irs.gov/irm/part4/irm_04-010-004.html#d0e470).

40. *See* INTERNAL REVENUE SERV., IRM 4.13.1.7(1)(B) (Oct. 1, 2006), *available* at [http://www.irs.gov/irm/part4/irm\\_04-013-001.html#d0e166](http://www.irs.gov/irm/part4/irm_04-013-001.html#d0e166).

41. I.R.C. § 63(e)(2).

assessing its effects. Furthermore, the taxpayer may change the election on an amended tax return filed within the period of the statute of limitations for claiming a tax refund.<sup>42</sup>

Finally, regarding persistence, the election only affects the tax results of the year that has already closed. The taxpayer may make a different decision for any future year.

Overall the parameters of the election are quite generous. Taxpayers are given substantial time to make and revise the election. Tax return forms provide information regarding the pros and cons of making the election, and taxpayers are entitled to make a new election every year.<sup>43</sup> These taxpayer-favorable parameters likely reflect the understanding that many unsophisticated taxpayers must choose between claiming the standard deduction and itemizing deductions.<sup>44</sup> Also, the parameters may emanate from the fact that one purpose of the election is to allow taxpayers to avoid the chore of keeping track of itemized deductions.<sup>45</sup> To not undermine this goal of promoting simplicity, the process for making the election should, itself, be simple.

### B. Alimony

Another election relevant to some individual taxpayers affects the treatment of alimony. By default, alimony payments are included in the income of the spouse receiving alimony<sup>46</sup> and deducted by the spouse paying alimony.<sup>47</sup> However, if both spouses agree, in lieu of following the default treatment, the recipient will exclude the payments from income, and the payor will not deduct the payments.<sup>48</sup>

In the typical case, the default rule is favorable to taxpayers. The default rule is advantageous if the spouse

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42. *Id.* § 63(e)(3); Treas. Reg. § 1.63-1 (2012); I.R.C. § 6511.

43. *See infra* note 54 and accompanying text.

44. *See* Patricia A. Jendraszek, Comment, *An Analysis of the Status of Amended Tax Returns and the Effects of their Use*, 23 HOUS. L. REV. 769, 797 (1986).

45. *See infra* note 129 and accompanying text.

46. I.R.C. § 71(a).

47. *Id.* § 215(a).

48. *Id.* § 71(b)(1)(B). Some aspects of the tax treatment of payments in divorce depend on implicit tax planning rather than explicit tax elections. For further discussion, *see, e.g.*, Deborah A. Geier, *Simplifying and Rationalizing the Federal Income Tax Law Applicable to Transfers in Divorce*, 55 TAX LAW. 363 (2002).

paying alimony is in a higher tax bracket than the spouse receiving alimony, which is often true because the spouse paying alimony usually earns more income than the spouse receiving alimony. In order to demonstrate, assume the payor is subject to a thirty-five percent tax rate, the recipient is subject to a twenty-five percent tax rate, and the amount of alimony paid is \$50,000. By deducting alimony, the payor incurs tax liability that is \$17,500 lower than the liability he or she would have incurred absent the deduction. At the same time, by including the payment in income, the recipient becomes subject to tax liability that is \$12,500 higher than the liability to which he or she would have been subject without this income.<sup>49</sup> Thus, the aggregate tax liability of the parties under the default rule is \$5000 lower than the aggregate tax liability that would have resulted had the parties elected out of the default rule. Moreover, both spouses could share in this aggregate benefit if the spouse paying alimony increases the amount paid in order to shift some of the benefit of the tax deduction to the spouse receiving alimony.<sup>50</sup> If the spouse receiving alimony was subject to a higher tax rate than the paying spouse, the

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49. For simplicity, these calculations assume that including the payment in income (or deducting the payment) is not sufficient to move the paying spouse or receiving spouse into a different marginal tax bracket.

50. See Field, *Tax Elections & Private Bargaining*, *supra* note 13, at 10–11. For example, assume the paying spouse is subject to a thirty-five percent tax rate, the receiving spouse is subject to a twenty-five percent tax rate, and the parties would have agreed to alimony payments of \$50,000 if they opted out of the default treatment. Retaining the default treatment and increasing the amount of the payment to \$70,000 can improve the economic position of both individuals. If the payment was \$50,000 and the parties opted out of the default treatment, the paying spouse would incur a \$50,000 after-tax loss (he or she pays \$50,000 and is not entitled to a deduction). The receiving spouse would achieve a \$50,000 after-tax gain (he or she receives \$50,000 and is not subject to tax on the payment). If the payment is increased to \$70,000 and the parties do not opt out of default treatment, the paying spouse would incur a \$45,500 after-tax loss (\$50,000 pre-tax payment minus \$24,500 tax savings resulting from deducting the payment from income taxed at thirty-five percent). Thus, the paying spouse's economic position is improved by \$4500. The receiving spouse would achieve a \$52,500 after-tax gain (\$70,000 payment minus \$17,500 tax liability incurred as a result of taxing the payment at twenty-five percent). Thus, the receiving spouse's economic position is improved by \$2500. For simplicity, these calculations assume that including the payment in income (or deducting the payment) is not sufficient to move the paying spouse or receiving spouse into a different marginal tax bracket.

parties would benefit from making the election so that alimony was excluded from the income of the recipient and not deducted by the payor.

The parties make the election by designating the payment as not includible in gross income and not allowable as a deduction in the “divorce or separation instrument.”<sup>51</sup> The divorce or separation instrument can include any writing signed by both parties that refers to their written separation agreement.<sup>52</sup> A copy of this signed writing must be attached to the recipient’s first filed tax return for each year in which the election out of default treatment applies.<sup>53</sup> Because the election can be made in a writing attached to the recipient’s return, the parties can decide whether to make the election each year after the year is closed. At that time, the parties will have all the information required to determine whether the election is advantageous.

Regarding persistence, the parties can change the election every year.<sup>54</sup> Thus, if the relative circumstances of the parties change so that a different party is in a higher tax bracket in any given year, the parties can change the election to achieve more favorable tax consequences.

### C. *Divorced Parents and the Dependency Exemption*

Another election relevant to divorced couples determines which parent takes a dependency exemption for a child. If a divorced couple has a child and various requirements are met, then one of the parents can claim the child as a dependent, and the parents electively decide which parent does so.<sup>55</sup>

Regarding the default rule, if no election is made to the contrary, the “custodial parent” takes the exemption.<sup>56</sup> The

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51. I.R.C. § 71(b)(1)(B).

52. Temp. Treas. Reg. § 1.71-1T(b) Q&A-8 (2011).

53. *Id.* Attaching the agreement to an amended return would not be effective. See CINDY L. WOFFORD, BUREAU OF NAT’L AFFAIRS, INC., TAX MANAGEMENT PORTFOLIO: DIVORCE AND SEPARATION, 515-2ND, at II.D.8.

54. Field, *Tax Elections & Private Bargaining*, *supra* note 13, at 10 (citing WOFFORD, *supra* note 53).

55. For either of the parents to claim the child as a dependent for a given year, for example, the child must not have provided over one-half of his or her own support for that year, and, unless the child is disabled, he or she must be younger than nineteen (or a student younger than twenty-four). See I.R.C. § 152(c)(1)(C)–(D).

56. *Id.* § 152(c)(1)(B), (c)(4)(B)(i).

custodial parent is the parent who has custody of the child for the greater portion of the calendar year.<sup>57</sup> The parties can affirmatively elect for the noncustodial parent to take the exemption instead.<sup>58</sup> To make this election for any given year, the custodial parent must sign a written declaration stating that he or she will not claim the child as a dependent for that year, and the noncustodial parent must attach this declaration to his or her return for that year.<sup>59</sup> The default rule will be favorable if the custodial parent is subject to a higher tax rate than the noncustodial parent, but, when the reverse is true, the default rule is unfavorable.<sup>60</sup> It is unclear whether the default rule is more commonly favorable or unfavorable because a parent may have custody for any number of reasons that do not necessarily bear any relation to that parent's income (and thus marginal tax bracket).<sup>61</sup>

Regarding its deadline, the election must be filed by the due date for the noncustodial parent's tax return.<sup>62</sup> By the time the election is due, all relevant information will be available because the benefits of the election depend on the taxpayers' income for the year that will have already closed before the election must be filed. Finally, regarding persistence, the election only needs to affect the year that is already closed because a different election may be made each year.<sup>63</sup>

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57. *Id.* §152(e)(4)(A).

58. *Id.* § 152(e).

59. *Id.* § 152(e)(2).

60. In some cases, other factors affect the analysis, such as the phase-out of the exemption at high income levels. See Field, *Tax Elections & Private Bargaining*, *supra* note 13, at 12.

61. See *id.* at 65–66.

62. I.R.C. § 152(e)(2). If taxpayers later discover that a different election would have been more favorable, it is likely that they cannot change the election merely by amending their tax returns. Occasionally, a statute expressly allows a taxpayer to change an election in an amended return. This is true, for instance, regarding the election between taking the standard deduction and itemizing deductions. See *supra* note 42 and accompanying text. If a statute does not explicitly grant this right, taxpayers generally cannot change elections in amended returns unless: (i) the amended return is filed before the due date for the original return, (ii) the election is consistent with how the taxpayer reported items on the original return, or (iii) the election made on the original return was improper. See Jendraszek, *supra* note 44, at 796–98.

63. The written declaration signed by the custodial parent may release the exemption for only a single year or for more than one (or all) future years. Treas. Reg. § 1.152-4(e)(1) (2012). If the custodial parent releases the

*D. The Entity Classification Election*

Turning from the world of individual taxpayers to the business arena, one election available to many business entities determines how those entities are classified for tax purposes. While certain business entities must be treated as corporations for tax purposes,<sup>64</sup> under the check-the-box regulations, many business entities are allowed to elect their tax classification.<sup>65</sup> If a business entity has two or more owners and is allowed to elect its classification, it may elect to be treated as either a partnership or a corporation for tax purposes.<sup>66</sup> If a business entity has one owner and is allowed to elect its classification, it may elect to be treated as either a disregarded entity or a corporation for tax purposes.<sup>67</sup>

An entity's classification significantly affects the tax treatment of the entity and its owners.<sup>68</sup> If an entity is treated as a corporation for tax purposes, generally the entity will be subject to entity-level tax.<sup>69</sup> In addition, tax losses recognized by the entity may be used to reduce its own taxable income but cannot be taken into account directly by the entity's owners.<sup>70</sup> Furthermore, owners of the entity may be subject to tax when they sell ownership interests in the

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exemption for more than the current year, the custodial parent may revoke the release by providing the noncustodial parent with written notice. Such a revocation would be effective no earlier than the year after the year in which the custodial parent provides written notice or makes reasonable efforts to provide written notice. *Id.* § 1.152-4(e)(3). However, presumably the revocation could be effective earlier if the noncustodial parent agrees.

64. Certain entities (per se corporations) are automatically treated as corporations for U.S. tax purposes. *See id.* § 301.7701-2(b). Such entities include, among others, (i) entities that are organized under a Federal or State statute that describes or refers to the entity as incorporated or as a corporation, and (ii) publicly-traded partnerships that do not earn predominately qualifying income. *See id.* § 301.7701-2(b)(1), (b)(7); I.R.C. § 7704. Per se corporations are not allowed to elect to be treated as pass-through entities. *See* Treas. Reg. § 301.7701-3(a) (providing that only eligible entities—or entities that are not per se corporations—can elect their tax classification).

65. Treas. Reg. § 301.7701-3(a).

66. *Id.*

67. *Id.*

68. For a more complete discussion of the effects of entity classification, see generally WILLIAM P. STRENG, BUREAU OF NAT'L AFFAIRS, INC., TAX MANAGEMENT PORTFOLIO: CHOICE OF ENTITY, 700-3RD, II-XIV.

69. I.R.C. § 11(b).

70. *Id.*

entity or receive certain distributions from the entity.<sup>71</sup> If an entity is treated as a partnership for tax purposes or is disregarded as separate from its owner for tax purposes, the entity will not be subject to tax. Instead, any items of tax income, gain, loss or deduction recognized by the entity will be passed through to the entity's owner(s) for the owner(s) to take into account directly when computing their own taxable income.<sup>72</sup> Thus, treatment as a corporation generally involves two levels of tax, in particular both an entity-level tax and an owner-level tax.<sup>73</sup> By contrast, treatment as a partnership or a disregarded entity (referred to collectively as pass-through entities) involves only one level of tax, the tax imposed at the owner level.<sup>74</sup> Consequently, classification as a pass-through entity typically involves a lesser tax burden than classification as a corporation. However, corporate tax treatment is more favorable in some cases.<sup>75</sup>

If an entity is formed in the United States and is eligible to elect its tax treatment, the entity will receive pass-through treatment unless an election is filed to treat the entity as a corporation.<sup>76</sup> This pass-through default rule is typically, but not always, favorable.<sup>77</sup>

Regarding its deadline, an entity classification election must be filed no later than seventy-five days after the desired effective date for the election (which, in many cases, means seventy-five days after the entity is formed).<sup>78</sup> However, in

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71. *Id.* §§ 301, 1001 (regarding distributions and gain from sale of ownership interests, respectively).

72. *Id.* § 701.

73. *See id.* § 11(b).

74. *See id.* § 701.

75. For an example of a situation in which treatment as a corporation would be more favorable, see *infra* note 88 and accompanying text. In addition, in some cases, treatment as an S Corporation could be more favorable than treatment as a partnership, and an entity will not be treated as an S Corporation absent an affirmative election to be treated as an S Corporation.

76. Treas. Reg. § 301.7701-3(b)(1) (2012). The default rules for non-U.S. entities are different. *Id.* § 301.7701-3(b)(2).

77. *See supra* notes 68–75 and accompanying text.

78. Treas. Reg. § 301.7701-3(c)(1)(iii) (providing that the election can be effective no earlier than seventy-five days before it is filed). This often means that the election must be filed within seventy-five days of an entity's formation because changes to an existing entity's classification could have negative tax consequences in some cases. For example, see *infra* note 100 and accompanying text.

some cases, relief may be granted to file the election late. In particular, if the entity requests relief for a late election within three years and seventy-five days of the desired effective date, the IRS will automatically grant relief if: (1) the entity failed to obtain its preferred classification solely because the relevant form was not filed in a timely manner, (2) the entity either has not yet filed a tax return or has filed returns consistent with its preferred classification, and (3) the entity has reasonable cause for its failure to timely file the election.<sup>79</sup>

Because of these three requirements, a taxpayer's prospects for obtaining relief will be fairly bleak unless, prior to the original seventy-five day deadline, the taxpayer had decided upon the classification that the taxpayer now seeks and failed to file the election merely as a result of a minor error, such as a miscommunication regarding who would file the election.<sup>80</sup> A taxpayer who failed to even consider the availability of the election is unlikely to obtain relief to file a late election.<sup>81</sup> Also, a taxpayer will be precluded from filing a late election if he or she decided to treat the entity one way and now seeks to file an election to treat it differently in order to benefit from hindsight.<sup>82</sup> In other words, the taxpayer may not file a late election because unanticipated economic results of the underlying business or other information that has come to the taxpayer's attention since the original seventy-five day deadline make the alternate classification more favorable. If the taxpayer is not entitled to automatic relief for filing a late election, the taxpayer must request a private letter ruling to

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79. See Rev. Proc. 2009-41, 2009-39 I.R.B. 4.01 (2009), available at [http://www.irs.gov/irb/2009-39\\_IRB/ar17.html#d0e6036](http://www.irs.gov/irb/2009-39_IRB/ar17.html#d0e6036).

80. Courts are most likely to grant relief for late filing of elections under these facts, which suggests that reasonable cause should be interpreted to refer to situations involving minor error or similar facts. For a discussion of when courts grant relief, see MICHAEL B. LANG & COLLEEN A. KHOURY, FEDERAL TAX ELECTIONS ¶ 2.02 (1991); Yorio, *supra* note 13, at 475–76.

81. A taxpayer who failed to consider the election likely does not have reasonable cause for its failure to file, based on when courts grant relief for late filing. For a discussion of when courts grant relief, see LANG & KHOURY, *supra* note 80, ¶ 2.02[3]; Yorio, *supra* note 13, at 476–78.

82. A taxpayer who is attempting to benefit from hindsight likely does not have reasonable cause for its failure to file, based on when courts grant relief for late filing. For a discussion of when courts grant relief, see LANG & KHOURY, *supra* note 80, ¶ 2.02[3]; Yorio, *supra* note 13, at 478.

obtain relief.<sup>83</sup> Requesting a private letter ruling is a costly proposition.<sup>84</sup> In addition, restrictions on the ability to obtain a private letter ruling are similar to the limitations placed on automatic extensions of time.<sup>85</sup>

In some cases, whether pass-through treatment is favorable depends on the economic results achieved by the business, which will be unknown before the due date for filing an election. Therefore, taxpayers may have to make an entity classification decision before all relevant information is available. In other words, unlike the backward-looking tax elections in the individual taxpayer context discussed previously,<sup>86</sup> the entity classification election is a forward-looking election. As a result, taxpayers may make entity classification decisions that seem favorable but prove to be unfavorable in retrospect.

For example, assume a group of tax-exempt entities (such as private employer-sponsored pension plans, educational endowments, and private foundations) plan to invest in a real estate fund that intends to buy and sell for-sale housing (such as condominiums) in non-U.S. countries that tax income at a rate lower than the U.S. corporate tax rate. If the tax-exempt entities owned interests in an entity treated as a partnership for U.S. tax purposes and that entity, in turn, owned the for-sale housing, the tax-exempt entities generally would bear a combined U.S. and non-U.S. effective tax rate equivalent to the U.S. corporate tax rate on gains recognized from the for-

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83. See Rev. Proc. 2009-41, 2009-39 I.R.B. 4.01 (2009); Treas. Reg. § 301.9100-3(e)(5). A private letter ruling is written guidance issued by the IRS to a particular taxpayer.

84. See Helvey & Stetson, *supra* note 13, at 355 (stating that the minimum filing fee is \$625 along with the fees for hiring a tax professional).

85. For instance, the IRS will deny a taxpayer a favorable letter ruling if the taxpayer decided to treat the entity one way and now seeks a ruling in order to file an election to treat it differently to benefit from hindsight. Treas. Reg. § 301.9100-3(b)(3)(iii). Also, a taxpayer who failed to seek advice about an election prior to the seventy-five day deadline is unlikely to obtain a favorable letter ruling. This is true because, in order to obtain relief, the taxpayer must have acted reasonably and in good faith. *Id.* § 301.9100-3(a). The regulations list several circumstances in which a taxpayer is generally deemed to have so acted. See *id.* § 301.9100-3(b)(1). None of the circumstances seem to contemplate a situation in which the taxpayer obtained no information about the election prior to the original filing deadline.

86. See *supra* Parts I.A, I.B, I.C.

sale housing.<sup>87</sup> If the tax-exempt entities, instead, invested in a non-U.S. entity treated as a corporation for U.S. tax purposes and that entity owned the for-sale housing, the tax-exempt entities generally would bear an effective tax rate equal to the non-U.S. tax rate (assumed to be lower than the U.S. corporate tax rate, as stated above).<sup>88</sup> Consequently,

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87. Tax-exempt entities are generally not subject to U.S. tax. However, under the unrelated business income tax (UBIT), tax-exempt entities are subject to U.S. tax on income earned from certain activities and investments. See I.R.C. §§ 501, 511–14 (2012). The UBIT requires that a tax-exempt pay tax at regular corporate rates (or at rates generally applicable to taxable trusts in the case of tax-exempt entities that are trusts) on income derived from a trade or business regularly carried on by the tax-exempt and not substantially related to its exempt purpose. See *id.* §§ 511–13. The activities of a partnership are attributed to its partners for purposes of determining whether a tax-exempt partner realizes income subject to the UBIT as a result of an investment in a partnership. Therefore, if a partnership engages in an activity that would be an unrelated trade or business if a tax-exempt partner engaged in the activity directly, income allocated to the tax-exempt partner by the partnership with respect to such activity will be subject to the UBIT. *Id.* § 512(c)(1). Consequently, when a partnership sells for-sale housing, gain from the for-sale housing allocated to a tax-exempt partner is subject to the UBIT because the tax-exempt partner would recognize income subject to the UBIT if it bought and sold for-sale housing directly, assuming it was not substantially related to its exempt purpose. If a tax-exempt entity subject to thirty-five percent UBIT (the corporate rate) invests in a partnership that sells for-sale housing in a non-U.S. country with a tax rate of twenty-eight percent and the housing generates a gain of which the tax-exempt entity's share is \$100, the tax-exempt entity will bear a total tax burden of thirty-five dollars. The tax-exempt entity's share of non-U.S. tax is twenty-eight dollars, and the tax-exempt entity's share of U.S. tax is seven dollars (thirty-five dollars of UBIT minus twenty-eight dollars of foreign tax credits). Thus, the total effective tax rate is thirty-five percent (the corporate rate).

88. Certain types of income are generally not subject to the UBIT. *Id.* § 512(b). Such income includes dividends and capital gain income. *Id.* Special rules apply if the income is debt-financed. *Id.* § 514. If the tax-exempt entities hold interests in an entity treated as a corporation for U.S. tax purposes, the income they earn from the entity will consist of dividends and capital gain income, generally not subject to the UBIT as long as the tax-exempt entities' interests in the corporation are not debt-financed. Furthermore, because the income earned by the non-U.S. corporation (gain from sale of non-U.S. real estate) is generally not subject to U.S. tax when earned by a non-U.S. person such as a non-U.S. corporation, the non-U.S. corporation will not be subject to corporate-level U.S. tax. As a result, the only tax burden borne by the tax-exempt entities will be their share of non-U.S. tax imposed by the country in which the real estate is located. Thus, assuming the non-U.S. tax rate is lower than the UBIT rate, the tax-exempt entities bear a lower tax burden as a result of investing through a non-U.S. corporation than as a result of investing through a partnership. For further discussion of structuring opportunities and real estate funds, see Richard M. Nugent, *Possible Approaches for Avoiding*

assuming the parties anticipate that the for-sale housing will be sold at a gain, the tax-exempt entities will expect to benefit from more favorable tax consequences if they invest through a non-U.S. entity treated as a corporation for U.S. tax purposes. Thus, assuming the tax-exempt entities invest through a non-U.S. entity that is treated as a partnership for U.S. tax purposes by default,<sup>89</sup> the tax-exempt entities will file an election to treat the entity as a corporation effective as of the date of formation.

Suppose that, after the for-sale housing projects are completed and sold, the tax-exempt entities learn that the housing projects, contrary to their expectations, generated economic and tax losses. As a result, the tax-exempt entities would have realized more favorable tax consequences if the non-U.S. entity that held the housing projects had been treated as a partnership, rather than a corporation, for U.S. tax purposes.<sup>90</sup> Thus, if they were able to do so, the parties would file an amended election to treat the entity as a partnership, effective retroactively as of a date before the underlying assets accrued losses. However, existing law precludes the parties from filing such an election because it would represent an attempt to benefit from hindsight.<sup>91</sup>

Regarding the persistence of the election, absent a significant change in ownership of the entity,<sup>92</sup> classification

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*UBTI on Real Estate Investments*, 97 TAX NOTES 271 (2002).

89. If it has two or more members and at least one member does not have limited liability, a non-U.S. entity that is eligible to elect its classification will be treated as a partnership by default. Treas. Reg. § 301.7701-3(b)(2)(A). Thus, assuming that the tax-exempt entities invest in a non-U.S. entity in which one owner has unlimited liability, such as the foreign equivalent of a limited partnership, the entity will be treated as a partnership unless an election is filed to treat it as a corporation.

90. If the entity had been treated as a partnership for U.S. tax purposes, when it sold the housing projects, each tax-exempt partner would be allocated its share of unrelated business losses resulting from the sale. Each tax-exempt partner could deduct the resulting losses against other unrelated business taxable income, subject to certain limitations. I.R.C. § 512(a)(1); Treas. Reg. § 1.512(a)-1(a). By contrast, if the entity is treated as a corporation for U.S. tax purposes, losses that it recognizes will not flow through to the tax-exempt entities.

91. See *supra* notes 80–85 and accompanying text.

92. Treas. Reg. § 301.7701-3(c)(1)(iv) (If more than fifty percent of the interests in the entity change hands, an earlier elective change in classification is possible).

elections can only be changed every five years.<sup>93</sup> However, if an entity is initially classified by default, there is no limit on how soon it could make a first change to its classification.<sup>94</sup> Also, if an entity files an election that is effective as of the date the entity was formed (an initial classification election), there is no restriction on how soon the entity could elect to make a first change to its classification.<sup>95</sup>

Even if the five-year rule prevents an entity from making an explicit election to change its classification, the entity could carry out a transaction that likely achieves the same result.<sup>96</sup> Assume, for example, a U.S. entity with two owners files an election to be classified as a corporation effective one day after the date of formation. This entity would not be allowed to file an election to be treated as a partnership effective earlier than five years and one day after the entity's formation. However, before that date, this entity could distribute all of its assets to its owners in liquidation, and the owners could, in turn, contribute the assets to a newly formed entity treated as a partnership for tax purposes.<sup>97</sup>

Finally, any change, elective or otherwise, will affect an entity's classification prospectively but not retroactively (except that, in the case of an elective change, the effective date could be up to seventy-five days before the election is filed). As noted above, whether any classification decision will prove to be favorable may depend, at least in part, on the economic results of the underlying business that are unknown at the time the decision is made. Furthermore, because any change in classification will be largely

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93. *Id.*

94. *Id.* The five-year limitation only applies if an entity makes an election, thus classification by default would not trigger the five-year limitation. *Id.*

95. *Id.* "An election by a newly formed eligible entity that is effective on the date of formation" does not trigger the five-year limitation. *Id.*

96. Professor Field also makes this observation. See Field, *Checking in on "Check-the-Box," supra* note 13, at n.287.

97. These transactions could effectively mimic the results of an elective change to the entity's classification because, under the Treasury Regulations, when an existing corporation elects to be treated as a partnership for tax purposes, the following transactions are deemed to occur: (i) the corporation distributes all of its assets to its shareholders in liquidation, and (ii) the shareholders contribute all of the assets to a newly formed partnership. Treas. Reg. § 301.7701-3(g)(1)(ii). Thus, this strategy could be effective unless the IRS successfully argues that the new entity should be treated as a mere continuation of the old entity for tax purposes.

prospective, the flexibility to change the entity's classification upon discovering unexpected economic results will not necessarily save the taxpayers from having made an election that proves to be unfavorable. For instance, in the example discussed above,<sup>98</sup> when the tax-exempt entities discover that the real estate fund's assets have fallen in value, they might file an election to change the real estate fund's classification to partnership. The five-year rule would not prevent such a change given that the earlier election to treat the fund as a corporation was an initial classification election that does not trigger the five-year limitation.<sup>99</sup> However, filing a change of election does not save the tax-exempt entities from the unexpectedly negative tax consequences. This is the case because the negative tax consequences will still occur as a result of the fact that the fund was treated as a corporation from the date of formation until the effective date of this later elective change in classification.<sup>100</sup>

*E. The § 362(e)(2)(C) Election*

Section 362(e)(2)(C) contains another election relevant in the business context: when a shareholder, or group of shareholders, contributes property to a corporation in exchange for stock, the shareholder(s) will not recognize the gain or loss built into the property as long as the contributing shareholder(s) own a controlling interest in the corporation immediately after the contribution.<sup>101</sup> To ensure that any built-in gain or loss is recognized at the time of a future transaction, the built-in gain or loss will be preserved.

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98. *See supra* notes 87–91 and accompanying text.

99. *See supra* note 95 and accompanying text.

100. If the election is effective after losses have accrued, the losses will be recognized by the corporation as a result of a deemed liquidation of the corporation and, therefore, the losses will not flow through to the tax-exempt entities. *See* Treas. Reg. § 301.7701-3(g)(1)(ii) (providing that, as a result of the elective change, the corporation will be deemed to distribute all of its assets to the shareholders in liquidation and the shareholders will be deemed to contribute all the assets to a newly formed partnership); I.R.C. § 336(a) (2012) (providing that a corporation will generally recognize losses as a result of a liquidation, so that the corporation would recognize the built-in losses at the time of the deemed liquidation resulting from the elective change in classification).

101. I.R.C. § 351.

For example, assume an individual acquires a parcel of land for \$100. Over time, the value of the land decreases to seventy-five dollars. The individual contributes the land to a newly formed corporation in exchange for all of the corporation's stock. The individual will not recognize any tax loss as a result of this exchange.<sup>102</sup> Under law that existed prior to 2004, the individual's basis in the stock received would be \$100 (the same as the individual's basis in the land),<sup>103</sup> and the corporation's basis in the land would be \$100 (the same as the individual's basis in the land).<sup>104</sup> Thus, if the individual were to sell the stock for seventy-five dollars, the individual would recognize a twenty-five dollar tax loss. Likewise, if the corporation sold the land for seventy-five dollars, the corporation would recognize a twenty-five dollar tax loss. Therefore, the individual would have incurred one twenty-five dollar economic loss (having acquired land that decreased in value by twenty-five dollars), but, rather than sell the land directly and recognize only one twenty-five dollar tax loss, the individual could create two twenty-five dollar tax losses—one to be recognized by the individual and one to be recognized by the corporation.

In 2004, Congress enacted legislation to combat the prospect of an individual contributing built-in loss property to a corporation in order to extract two tax losses from one economic loss.<sup>105</sup> Under rules in effect since 2004, the built-in loss may be preserved at only one level.<sup>106</sup> However, taxpayers can decide whether to preserve the loss at the shareholder level or at the corporate level.<sup>107</sup> In particular, if no election is filed, the built-in loss will be preserved at the shareholder level only.<sup>108</sup> Thus, in the example above, the individual's basis in the stock would be \$100 (preserving a twenty-five dollar built-in loss in the stock), but the corporation's basis in the land would be seventy-five dollars

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102. *Id.* § 351(a).

103. *Id.* § 358(a)(1).

104. *Id.* § 362(a).

105. For an additional discussion, see Douglas A. Kahn & Jeffrey H. Kahn, *Prevention of Double Deductions of a Single Loss: Solutions in Search of a Problem*, 26 VA. TAX REV. 1 (2006).

106. I.R.C. § 362(e)(2).

107. *Id.*

108. *Id.* § 362(e)(2)(A).

(preserving no built-in loss in the land). However, if the individual and the corporation both make an election under § 362(e)(2)(C), the built-in loss will be preserved at the corporate level only.<sup>109</sup> In the example above, if such an election were made, the individual's basis in the stock would be seventy-five dollars (preserving no built-in loss in the stock), but the corporation's basis in the land would be \$100 (preserving a twenty-five dollar built-in loss in the land).

As just described, in the case of the § 362(e)(2)(C) election, the default rule is to preserve the loss at the shareholder level rather than the corporate level. Whether this default rule is favorable depends on many facts, including: whether the corporation recognizes tax gains that could be offset by a tax loss recognized on sale of the contributed property (or offset by depreciation if the contributed property is a depreciable asset), whether the shareholder recognizes tax gains that could be offset by a tax loss recognized on sale of the stock, when the corporation sells the contributed property, and when the shareholder sells the stock.<sup>110</sup> Moreover, these facts will often be unknown at the time the election must be made. Thus, taxpayers will have to make predictions in order to decide what route is favorable.

Making an election under § 362(e)(2)(C) is likely to lead to lower aggregate tax liability taking into account the time value of money (and the default rule is likely to be unfavorable) if the corporation recognizes sufficient taxable income to utilize tax deductions and if either the contributed property is depreciable or the corporation is likely to sell the property before the shareholder sells the stock. In such a case, making an election would reduce the aggregate tax liability of the shareholder and the corporation, taking into account the time value of money. If the corporation has more owners than just the shareholder contributing the property, then the benefit of the lower corporate-level tax burden may accrue to all the shareholders (not just the contributing shareholder). Nevertheless, the contributing shareholder may still agree to make the election if he or she is adequately

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109. *See id.* § 362(e)(2)(C).

110. All of these facts are relevant because the election determines whether the corporation has a higher basis in an asset or the shareholder has a higher stock basis.

compensated by the other shareholders.

Regarding the deadline for this election, the contributing shareholder must provide a signed certificate making the election by the due date for the shareholder's original tax return for the year in which the property contribution occurred.<sup>111</sup> If a taxpayer seeks to file the election late, he or she is unlikely to obtain relief to do so unless he or she requests relief within six months of the due date for filing the original tax return.<sup>112</sup> As mentioned above, the advisability of making the election depends on future events. Thus, taxpayers will not have all relevant information at the time the election is made, and, like the entity classification election, the § 362(e)(2)(C) election is forward-looking. Regarding persistence, once made, the § 362(e)(2)(C) election is irrevocable.<sup>113</sup>

## II. WHY TAX ELECTIONS ARE PROBLEMATIC

Existing scholarship criticizes tax elections for a number of reasons. First, elections erode tax revenue if taxpayers make elections wisely.<sup>114</sup> A taxpayer can simply file a given election and obtain more favorable tax consequences without altering any of the nontax aspects of his or her behavior or transactions. Thus, a taxpayer who uses the election wisely will generally make whatever choice leads to the least

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111. Notice 2005-70, 2005-41 I.R.B. Elections Under § 362(e)(2)(C), *available at* [http://www.irs.gov/irb/2005-41\\_IRB/ar12.html](http://www.irs.gov/irb/2005-41_IRB/ar12.html).

112. Section 362(e)(2)(C) of the Internal Revenue Code election is a regulatory election as its due date is provided by a notice. Treas. Reg. § 301.9100-1(b) (2012). Thus, the guidelines for requesting an extension of time to make the election are contained in sections 301.9100-2 and 301.9100-3 of the Treasury Regulations. Given that the election is not listed in section 301.9100-2(a)(2), section 301.9100-2(b) would govern a taxpayer's ability to obtain an automatic extension of time. Under that provision, if the taxpayer timely filed a tax return for the year in which the contribution occurred, the taxpayer would be able to file a late election automatically as long as it is filed within six months of the due date for the original tax return. A taxpayer may only file the election later than this six-month timeframe if the taxpayer requests and obtains a private letter ruling as described in section 301.9100-3. Requesting a private letter ruling is an expensive exercise. *See supra* note 84. In addition, a private letter ruling will only be granted in limited circumstances. *See supra* note 85 and accompanying text.

113. I.R.C. § 362(e)(2)(C)(ii).

114. *See, e.g.*, Field, *supra* note 10, at 30–31; Yin, *supra* note 13, at 130.

amount of tax liability.<sup>115</sup> In some cases, the taxpayer will not know with certainty whether an election will minimize tax liability because some elections are forward looking. For instance, as discussed previously,<sup>116</sup> the benefits of making an entity classification election or an election under § 362(e)(2)(C) of the Internal Revenue Code depend on future circumstances. Thus, taxpayers will not always be able to achieve favorable tax outcomes because they may inaccurately forecast future events. Nevertheless, because some taxpayers will make elections wisely and will accurately predict relevant future occurrences, even forward-looking elections erode tax revenue.

Second, tax elections produce unfairness.<sup>117</sup> Sophisticated, well-advised taxpayers will be best positioned to take advantage of available elections given that they are more likely to be aware of elections and their consequences.<sup>118</sup> This bias against unsophisticated taxpayers is problematic because it contributes to increasing wealth inequality and interferes with the progressivity of the tax system. Furthermore, unfairness can perpetuate the perception that the tax system is unfair which can, in turn, undermine

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115. See, e.g., Field, *supra* note 10, at 30–31; Yin, *supra* note 13, at 130.

116. See *supra* Parts I.D and I.E.

117. See, e.g., Field, *supra* note 10, at 31–32; Yin, *supra* note 13, at 130, 136; Yorio, *supra* note 13, at 467. The term “fairness” is used here to refer to vertical equity, which is the idea that people with a greater ability to pay taxes should pay more. Tax rules that disadvantage unsophisticated taxpayers violate vertical equity because, at least assuming tax sophistication and wealth are correlated, such rules impose higher tax burdens on less wealthy taxpayers. A tax election can also produce unfairness by granting more favorable tax treatment to persons eligible for the election than persons ineligible for the election. This type of unfairness is likely best addressed by either re-examining the eligibility requirements for a given election or replacing an election with mandatory treatment.

118. See, e.g., Field, *supra* note 10, at 32; Yin, *supra* note 13, at 130, 136. For purposes of the proposal made by this Article, precise definitions of sophisticated and unsophisticated are unnecessary because the proposals made in this Article do not depend on whether or not a particular taxpayer is sophisticated. For purposes of understanding the discussion in this Article, the following, imprecise definitions of sophisticated and unsophisticated should suffice: sophisticated taxpayers have sufficient knowledge of tax law or are sufficiently well-advised to evaluate the pros and cons of making tax elections, and unsophisticated taxpayers lack such knowledge and advice. Assuming that sophistication, in this sense, tends to increase as a taxpayer’s wealth increases, rules that are biased against unsophisticated taxpayers are problematic from a fairness perspective.

voluntary tax compliance.<sup>119</sup>

The bias against unsophisticated taxpayers may be particularly pronounced in the case of elections that are due prior to the date for filing a tax return. If an election is due at the same time as a return, an unsophisticated taxpayer may seek advice in connection with return preparation (or may find guidance provided on a return form). In the context of receiving this advice, the taxpayer could acquire information about the available election.<sup>120</sup> By contrast, if the election is due before a tax return, an unsophisticated taxpayer who is unaware of the election may see no reason to ask for advice and, thus, will remain uninformed. Moreover, if such a taxpayer later learns of the election, any attempt to obtain relief to file a late election will likely fail because taxpayers who do not seek advice before the filing deadline are generally not allowed to file late elections.<sup>121</sup> Conversely, relief likely would be granted to a taxpayer who sought advice prior to the time for filing an election, always intended to make a favorable election, and merely failed to file the proper election because of a minor error. In other words, late filing relief will often be available only to sophisticated taxpayers.

Third, tax elections generate complexity.<sup>122</sup> In order to evaluate whether to make an election, taxpayers must understand the consequences of making the election as well as what occurs if the election is not made. This task can be particularly difficult for elections that affect future years.<sup>123</sup> In addition, taxpayers must determine the proper procedure for making the election.<sup>124</sup> Finally, IRS examiners must be aware of the consequences of the election and how it is

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119. Field, *supra* note 10, at 32 (discussing this in the context of tax elections). For discussions of this phenomenon in the context of tax planning generally, see Michael S. Knoll, *Tax Planning, Effective Marginal Tax Rates, and the Structure of the Income Tax*, 54 TAX L. REV. 555 (2001); Leandra Lederman, *The Interplay Between Norms and Enforcement in Tax Compliance*, 64 OHIO ST. L.J. 1453 (2003); Schizer, *supra* note 10, at 1319.

120. See Emily Cauble, *Making Partnerships Work for Mom and Pop and Everyone Else*, 2 COLUM. J. TAX L. 247, 285 (2011).

121. See *supra* notes 80, 85 and accompanying text.

122. See, e.g., LANG & KHOURY, *supra* note 80, ¶ 1.02[1][c]; Field, *supra* note 10, at 27–30; Helvey & Stetson, *supra* note 13, at 335; Levin, *supra* note 13, at 1588; Yin, *supra* note 13, at 130; Yorio, *supra* note 13, at 463–64.

123. Field, *supra* note 10, at 27–28; Yorio, *supra* note 13, at 463–64.

124. Field, *supra* note 10, at 28; Yorio, *supra* note 13, at 464.

made.<sup>125</sup>

### III. WHY TAX ELECTIONS CONTINUE TO EXIST

As described above in Part II, tax elections are problematic for several reasons. Yet, hundreds of elections continue to inhabit tax law. This part briefly discusses why elections are so prevalent despite their many flaws.

In some cases, tax elections can only be explained by the political influence of those who benefit from them.<sup>126</sup> Nevertheless, scholars have also identified benign justifications for other elections. Two explanations<sup>127</sup> are offered most often.

The first explanation is that some elections provide an option for taxpayers who want simplicity.<sup>128</sup> This explanation, at least in part, justifies giving taxpayers the option to take the standard deduction rather than itemize deductions.<sup>129</sup> The standard deduction is simpler than itemizing deductions because taxpayers can avoid the inconvenience of calculating and maintaining evidence of their actual expenses.<sup>130</sup> Likewise, allowing divorced parents

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125. Field, *supra* note 10 at 29–30.

126. This may be true in the case of certain elections in the partnership tax context. For further discussion, see Cauble, *supra* note 120.

127. A number of other explanations have also been suggested. See, e.g., LANG & KHOURY, *supra* note 80, ¶ 1.02[1]; Field, *supra* note 10.

128. See, e.g., LANG & KHOURY, *supra* note 80, ¶ 1.02[1]; Field, *supra* note 10, at 53–54.

129. See, e.g., John R. Brooks II, *Doing Too Much: The Standard Deduction and the Conflict Between Progressivity and Simplification*, 2 COLUM. J. TAX L. 203, 205 (2011); Field, *supra* note 10, at 53–54; Louis Kaplow, *The Standard Deduction and Floors in the Income Tax*, 50 TAX L. REV. 1, 1–2 (1994); Theodore P. Seto & Sande L. Buhai, *Tax and Disability: Ability to Pay and the Taxation of Difference*, 154 U. PA. L. REV. 1053, 1088–89 (2006). The availability of the standard deduction has also been explained as a means of providing taxpayers with a minimum amount of untaxed income. See, e.g., Brooks, *supra*, at 205; Seto & Buhai, *supra*, at 1088–89.

130. This justification may adequately explain some elections, such as the option to take the standard deduction and the treatment of the dependency exemption. However, this explanation is also often given as the justification for elections that, in reality, do not provide a simple option to taxpayers. For example, the simplification rationale is typically given to explain why taxpayers are allowed to elect among various partnership tax allocation methods under § 704(c) of the Internal Revenue Code. Yet, simplification does not adequately explain that election. While taking the standard deduction truly is simpler than itemizing deductions, in the context of § 704(c), all available methods are complex. For further discussion, see Cauble, *supra* note 120.

to electively decide which parent claims a child as a dependent can be a simplifying measure if the alternative would involve requiring parents to keep records of the relative amount of support each parent provides.<sup>131</sup>

Regarding the second explanation, scholars have observed that, in some cases, if an election were eliminated taxpayers would still choose their tax treatment.<sup>132</sup> However, rather than explicitly electing their desired tax treatment, taxpayers would obtain the same treatment by changing nontax features of their transactions.<sup>133</sup> Scholars frequently offer this explanation as a rationale for the rules regarding entity classification.<sup>134</sup> Prior to the adoption of the check-the-box regulations, businesses were classified as pass-through entities or corporations based on a multifactor test under the Kintner regulations.<sup>135</sup> Under these regulations, an entity that had more corporate features than noncorporate features would be classified as a corporation.<sup>136</sup> The key corporate features were: (1) continuity of life, (2) centralization of management, (3) limited liability, and (4) free transferability of interests.<sup>137</sup> Because some of these factors were arguably easy to manipulate, scholars have observed that taxpayers would obtain their desired classification by setting up an entity with the right number of corporate or noncorporate features.<sup>138</sup>

This type of tax planning raises all the concerns surrounding explicit elections. In particular, this type of planning will reduce tax revenue, produce unfairness (given

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131. LANG & KHOURY, *supra* note 80, ¶ 1.02[1][a].

132. *See, e.g.*, LANG & KHOURY, *supra* note 80, ¶ 1.02; Field, *Checking in on "Check-the-Box," supra* note 13, at 464–68, 497 (explaining this rationale in connection with the check-the-box regulations); Field, *supra* note 10, at 32–33.

133. *See, e.g.*, LANG & KHOURY, *supra* note 80, ¶ 1.02; Field, *Checking in on "Check-the-Box," supra* note 13, at 464–68, 497 (explaining this rationale in connection with the check-the-box regulations); Field, *supra* note 10, at 32–33.

134. *See, e.g.*, Philip A. Curry, Claire Hill, & Francesco Parisi, *Creating Failures in the Market for Tax Planning*, 26 VA. TAX REV. 943, 961–62 (2007); Field, *Checking in on "Check-the-Box," supra* note 13, at 464–68, 497; Schizer, *supra* note 10, at 1319–20, 1320 n.17; David A. Weisbach, *Line Drawing, Doctrine, and Efficiency in Tax Law*, 84 CORNELL L. REV. 1627, 1628–30 (1999).

135. *See* Treas. Reg. §§ 301.7701-2(a)(2)(3) (1960).

136. *Id.*

137. *Id.* § 301.7701-2(a)(1).

138. *See, e.g.*, Field, *Checking in on "Check-the-Box," supra* note 13, at 464; Weisbach, *supra* note 134, at 1628–30, 1629 n.9.

that well-advised taxpayers will be best positioned to effectively tax plan), and contribute to the complexity of the tax system.<sup>139</sup> Furthermore, because taxpayers change nontax features of their transactions, this type of tax planning, unlike explicit tax elections, distorts taxpayers' decision making, which can cause inefficiency if taxpayers forgo transactions that would be preferable for nontax reasons.<sup>140</sup> Of course, whether or not this rationale justifies any tax election depends on what baseline is used for comparison. For example, this rationale may justify the check-the-box regulations if the only alternative is the state of the law as it existed prior to the adoption of those regulations. Under those prior rules, some taxpayers could and did make nontax changes in order to obtain more favorable tax treatment.<sup>141</sup> However, this rationale offers a less convincing justification for the check-the-box regulations if one considers a wider range of alternative rules. One such alternative would involve mandatory classification of entities based on nontax features that taxpayers are less likely to manipulate.<sup>142</sup> Another alternative would involve reducing or

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139. For a discussion of these problems in connection with the tax planning that occurred under the Kintner Regulations, see Field, *Checking in on "Check-the-Box," supra* note 13, at 464–69. For discussions of these problems in connection with tax planning generally, see Cauble, *supra* note 10; Field, *supra* note 10; Schizer, *supra* note 10.

140. For example, prior to the adoption of the check-the-box regulations, a taxpayer might have formed an entity with characteristics that differed from what would have been desirable from a non-tax standpoint. Of course, even under current law, this still might be true because certain organizations are automatically treated as corporations for tax purposes. See *supra* note 64. For additional discussions of inefficiency and tax planning generally, see Cauble, *supra* note 10; Field *supra* note 10, at 22–23 (stating that scholars generally conclude that tax planning is detrimental to societal welfare); Knoll, *supra* note 119, at 555; Schizer, *supra* note 10, at 1319; Weisbach, *supra* note 134, at 1632.

141. See *supra* note 138 and accompanying text.

142. For example, perhaps all publicly traded entities would be treated as corporations while all non-publicly traded entities would receive pass-through treatment. See, e.g., Jerome Kurtz, *The Limited Liability Company and the Future of Business Taxation: A Comment on Professor Berger's Plan*, 47 TAX L. REV. 815, 824 (1992) ("I would argue that public verses private is both a simpler and a more logical place to draw the line between flow-through and separate entity taxation."). Given the value of liquidity, taxpayers may be unlikely to sacrifice public trading in order to obtain more favorable tax treatment. For discussions of the value of liquidity, see Rebecca S. Rudnick, *Who Should Pay the Corporate Tax in a Flat Tax World?*, 39 CASE W. RES. L. REV. 965, 986, 1103–06 (1988); Herwig J. Schlunk, *I Come Not to Praise the Corporate Income*

eliminating the tax distinctions among various entity classifications.<sup>143</sup>

#### IV. MITIGATING THE HARMS CAUSED BY TAX ELECTIONS

As described above in Part III, tax elections persist for several reasons. Moreover, regardless of the reason for a particular tax election's endurance, it would be infeasible to abolish all tax elections.

Given the inevitability of at least some tax elections, this part of the Article examines how elections could be designed to mitigate resulting harms. In particular, this part of the Article discusses four features of elections: (1) default rules; (2) alerting taxpayers to the presence of an election; (3) the deadline for filing the election; and (4) persistence—the length of time during which any given election will affect tax consequences.<sup>144</sup> All of these features could be better designed to mitigate the bias against unsophisticated taxpayers.

##### A. *Default Rules*

One feature to consider when designing any tax election is the default rule, or the rule that applies if the taxpayer fails to make an election by the relevant deadline. Taxpayer-favorable default rules can mitigate the bias against unsophisticated taxpayers.<sup>145</sup> This is the case because, even

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*Tax, But to Save It*, 56 TAX L. REV. 329, 343–47 (2003); Jeffrey K. Mackie-Mason & Roger H. Gordon, *How Much Do Taxes Discourage Incorporation?*, 52 J. FIN. 477, 485 (1997); Jane G. Gravelle & Laurence J. Kotlikoff, *The Incidence and Efficiency Costs of Corporate Taxation When Corporate and Noncorporate Firms Produce the Same Good*, 97 J. POL. ECON. 749, 756–58 (1989).

143. See, e.g., Field, *Checking in on "Check-the-Box," supra* note 13, at 498 (“[T]o justify the CTB election as a simple and efficient approach to line-drawing between business tax regimes applicable to virtually indistinguishable forms of business, the existence of each separate business tax regime must be defended.”). Of course, unifying the different business tax regimes is likely an unrealistic goal.

144. Other features should be considered as well. For example, reducing the level of formality that is required to opt out of default treatment could benefit unsophisticated taxpayers, especially when the default rule is not a tailored default rule; in other words, when the default rule is not taxpayer-favorable in all cases. For a discussion of allowing taxpayers to make effective elections when their intention is clear even if they have failed to comply with all formal requirements, see Levin *supra* note 13.

145. See Field, *supra* note 10, at 67. A similar argument has been made

when such taxpayers fail to file an election before its deadline, they will receive favorable tax treatment by default.<sup>146</sup> At the same time, selecting a favorable default rule will cause greater tax revenue erosion because less tax will be collected from unsophisticated taxpayers who might have failed to file an election even if the default rule was unfavorable. Nevertheless, fairness concerns should outweigh tax revenue concerns given that the additional tax revenue is lost primarily as a result of trapping fewer unwary taxpayers and lost tax revenue can be recouped in fairer ways.<sup>147</sup> If losing the additional tax revenue is untenable, serious consideration should be given to eliminating an election entirely and mandating the less favorable treatment for everyone rather than continuing to impose the less favorable treatment on only the ill-informed. Moreover, regarding complexity, favorable default rules can reduce administrative burdens by diminishing the sheer number of elections that are filed.<sup>148</sup>

The argument for selecting favorable default rules set forth above is fairly straightforward. However, for two reasons, the actual design of default rules becomes somewhat more complicated. First, it is not always easy to select a favorable default rule. Second, extensive contract law literature discusses default rules and the possible information-forcing virtues of using unfavorable default rules or penalty default rules.<sup>149</sup> Thus, no consideration of default rules would be complete without evaluating existing contract law literature and assessing whether penalty default rules

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regarding default rules applicable in the context of inheritance law. See Adam J. Hirsch, *Default Rules in Inheritance Law: A Problem in Search of Its Context*, 73 *FORDHAM L. REV.* 1031, 1051–52 (2004).

146. See Field, *supra* note 10, at 68.

147. In order for the reforms proposed in this Article to promote fairness, foregone tax revenue would have to be recouped in fairer ways, and the analysis in this Article assumes that it will be. If this assumption does not hold true, the proposed reforms will not necessarily promote fairness. For similar discussion, see David A. Weisbach, *Ten Truths About Tax Shelters*, 55 *TAX L. REV.* 215, 240 (2002) (“A common claim is that tax shelters reduce the progressivity of the tax system, because they are available only to the rich. . . . Contrary to this intuition, however, there is no reason to think that reducing shelters directly increases progressivity. If tax shelters were reduced, the extra revenue could be used to reduce other taxes on the rich.”).

148. See Field, *supra* note 10, at 67.

149. *Id.* at 66–67.

could be beneficial. This part of the Article evaluates these points. In order to do so, first, Part 1 discusses the existing contract law scholarship. Second, Part 2 makes some observations about features that distinguish tax law from contract law which will be significant when designing default rules for tax law. Finally, Part 3 discusses the design of default rules for tax elections in detail.

1. *Overview of Contract Law Scholarship Regarding Default Rules*

Default rules play an important role in contract law. Contracting parties typically will not specify every possible term that might govern their relationship. Thus, a court may find it necessary to determine a contractual term in light of the parties' silence. When deciding what term to supply, the court will rely on relevant default rules.<sup>150</sup>

Contract law scholars have observed that, at least in some cases, the default rule should approximate the term to which the parties would have agreed if they had considered the matter and specifically settled on a term.<sup>151</sup> One virtue of such a default rule is that it can reduce the costs of contracting.<sup>152</sup> If the law will supply the term to which they would have agreed, parties can remain silent on a given term and, thus, save the time and energy they would have otherwise spent anticipating and planning for every future contingency and drafting the requisite contractual language.

In addition, as Professors Ian Ayres and Robert Gertner discuss, a default rule that corresponds to the term to which the parties would have agreed could be either a tailored default rule or an untailored default rule.<sup>153</sup> A tailored default rule aims to exactly match what the particular contracting parties would have wanted, while an untailored default rule might not match what any particular set of contracting parties would have selected but rather represents

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150. *See id.*

151. *See, e.g.,* Ian Ayres & Robert Gertner, *Filing Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 *YALE L.J.* 87, 89–90 (1989) (describing and citing to scholarship that argues for default rules that mimic what contracting parties would have wanted).

152. *Id.*

153. *Id.* at 91.

what the majority of contracting parties would desire.<sup>154</sup> In contract law, a tailored default rule is typically a vague, flexible standard under which courts supply a term that would be reasonable given the surrounding facts and circumstances.<sup>155</sup> Examples include: the default rule for price provided by Article 2 of the Uniform Commercial Code (UCC) which states that, if parties intend to be bound by a contract but fail to specify a price, the price will be a reasonable price at the time for delivery;<sup>156</sup> the rule providing that the quantity of goods supplied under an output or requirements contract cannot be unreasonably disproportionate to any stated estimate or, in the absence of a stated estimate, to any normal or otherwise comparable prior quantity;<sup>157</sup> and rules governing the time for shipment or delivery of goods.<sup>158</sup>

By contrast, an untailored default rule is usually a more certain rule that represents what the majority of parties prefer but that, given its inflexible nature, does not necessarily represent what any particular set of contracting parties might have chosen.<sup>159</sup> Examples of untailored default rules may include rules under Article 2 of the UCC that govern the place for delivery of goods if none is specified (generally the seller's place of business)<sup>160</sup> or the time for making payment if not otherwise agreed (usually the time at which the buyer is to receive the goods).<sup>161</sup>

The main virtue of tailored default rules is that they can more closely correspond to what the particular contracting parties would have selected. The chief drawback of tailored default rules is that, because they are vague, courts may have to incur more costs to apply them, and they lead to more uncertainty regarding what term will be supplied.<sup>162</sup> When

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154. *Id.*

155. *Id.*

156. U.C.C. § 2-305(1) (1968); *see also* Ayres & Gertner, *supra* note 151, at 95 (discussing this example).

157. U.C.C. § 2-306(1); *see also*, Ayres & Gertner, *supra* note 151, at 92 n.27 (discussing this example).

158. U.C.C. § 2-309(1) (providing a reasonable time as the default rule).

159. *See supra* text accompanying note 154.

160. U.C.C. § 2-308(a) (providing that the default rule is different in some circumstances); U.C.C. § 2-308(b), (c).

161. U.C.C. § 2-310(a) (providing that a different default rule is provided in some cases); U.C.C. § 2-310(b), (c).

162. Ian Ayres & Robert Gertner, *Majoritarian vs. Minoritarian Defaults*, 51

administering a tailored default rule, a court must consider evidence of surrounding facts and circumstances to determine what term is reasonable. By contrast, when implementing an untailored default rule, the court simply consults the relevant legal rule to find a precise term. In addition, given its vague nature, a tailored default rule may be incorrectly applied by a court, and, as a result, the court might supply a term that is not, in fact, the term to which the parties would have agreed.

While there are certain advantages to default rules that approximate the terms to which the parties would have agreed, contract law scholars have also noted that, in certain circumstances, it would be favorable to use penalty default rules (or default rules that do not mimic what at least one contracting party would have wanted). As Professors Ayres and Gertner have discussed, setting the default rule to what at least one contracting party would not have wanted induces that party to contract out of the default rule, and, in the process, that party may provide valuable information.<sup>163</sup>

Penalty default rules could encourage a contracting party to provide useful information in at least three ways. First, if the contracting parties leave a term open, courts must incur publicly-subsidized costs to supply a term.<sup>164</sup> If the contracting parties, instead, specify a term, these publicly-funded costs are avoided.<sup>165</sup> For this reason, Professors Ayres and Gertner suggest that, at least when it would be especially costly for courts to fathom the term that the parties would have selected, a penalty default rule that encourages the parties to specify a term may be helpful.<sup>166</sup> As an example, Professors Ayres and Gertner contrast the price term in a contract for sale of goods with the quantity term.<sup>167</sup> If price is

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STAN. L. REV. 1591, 1596 (1999) (“[D]efault provisions that are standards will often be more expensive to implement than default provisions that are rules. Courts, for example, in filling a price gap currently need to expend judicial resources to determine what the ‘reasonable’ price would have been.” (citation omitted)).

163. Ayres & Gertner, *supra* note 151, at 93–94.

164. *Id.* at 93, 95–97; Ayres & Gertner, *supra* note 162, at 1606.

165. Ayres & Gertner, *supra* note 151, at 93, 95–97; Ayres & Gertner, *supra* note 162, at 1606.

166. Ayres & Gertner, *supra* note 151, at 93, 95–97; Ayres & Gertner, *supra* note 162, at 1606.

167. Ayres & Gertner, *supra* note 151, at 93, 95–97; Ayres & Gertner, *supra* note 162, at 1606.

left open, courts, by relying on the market price, have a fairly easy way of determining the price to which the parties would have agreed.<sup>168</sup> Thus, the default rule for open price terms is a reasonable price and this corresponds to the term to which parties would have agreed. By contrast, if the parties leave the quantity term entirely open, courts will not have access to readily available clues that provide a clear indication of the quantity to which the parties would have agreed.<sup>169</sup> Thus, the courts will not enforce the contract, or, as Professors Ayres and Gertner describe it, the default rule for quantity is zero.<sup>170</sup> A zero-quantity default rule is a penalty default rule given that no parties would bother entering into an agreement to sell nothing. In other words, while there is no way of knowing what quantity the parties would have specified, it is clear that it would have been a number other than zero.<sup>171</sup> It may be advisable for courts to use the zero-quantity penalty default rule because doing so encourages parties to specify the quantity term themselves rather than imposing the cost of uncovering the appropriate quantity term on publicly-subsidized courts.<sup>172</sup> Finally, in addition to courts incurring high costs to investigate the matter, error rates would likely be high because courts would often arrive at a quantity term that was not the term to which the parties would have agreed.

Second, a penalty default rule might encourage one contracting party to provide useful information to another contracting party allowing that other party to undertake contractual duties in an appropriate manner.<sup>173</sup> As an example of this phenomenon, Professors Ayres and Gertner and many others discuss the rule regarding consequential damages set forth in *Hadley v. Baxendale*.<sup>174</sup> *Hadley* establishes the rule that a court will only award

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168. Ayres & Gertner, *supra* note 151, at 93, 95–97; Ayres & Gertner, *supra* note 162 at 1606.

169. Ayres & Gertner, *supra* note 151, at 93, 95–97; Ayres & Gertner, *supra* note 162, at 1606.

170. Ayres & Gertner, *supra* note 151, at 93, 95–97; Ayres & Gertner, *supra* note 162, at 1606.

171. Ayres & Gertner, *supra* note 151, at 97.

172. *Id.* at 93, 95–97; Ayres & Gertner, *supra* note 162, at 1606.

173. Ayres & Gertner, *supra* note 151, at 94, 101–04.

174. *Id.*

consequential damages if those damages are foreseeable.<sup>175</sup> This rule can encourage one contracting party to provide the other contracting party with information about the damages he or she would suffer if the other party breaches.<sup>176</sup> By doing so, each contracting party will have put his or her counterparty on notice about potential consequential damages so that those damages will be foreseeable and, thus, can be awarded if the contract is breached. Finally, encouraging provision of this information may be desirable because, with this information, each party can properly calibrate their behavior so as to take the appropriate level of caution for avoiding breach.<sup>177</sup>

Third, penalty default rules could encourage one contracting party to provide a particular type of information to the other contracting party—namely, information about the law itself.<sup>178</sup> As Professors Ayres and Gertner observed, in some contractual relationships, the parties are likely to have different information about the relevant legal rules.<sup>179</sup> For example, in the employment setting, the employer may have more information about employment law than the employee given that the employer enters into more employment contracts than the employee.<sup>180</sup> Employment arrangements can be at-will, meaning the employer may dismiss the employee for any reason (other than a reason specifically disallowed by antidiscrimination laws, for example) or no reason at all.<sup>181</sup> Under current law, at-will is the default rule so it governs unless the parties contractually agree to a different standard, such as a standard under which an employee can be dismissed only for cause.<sup>182</sup> Compared to the current at-will default rule, a for cause default rule (or a default rule set to what most employers arguably would not

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175. *Hadley v. Baxendale*, (1854) 156 Eng. Rep. 145 (Ex. Ct.).

176. *Id.*

177. *Id.*

178. Ayres & Gertner, *supra* note 162, at 1603, 1606; Ian Ayres & Robert Gertner, *Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules*, 101 *YALE L.J.* 729, 759–61 (1992).

179. Ayres & Gertner, *supra* note 162, at 1603, 1606; Ayres & Gertner, *supra* note 178, at 729, 759–61.

180. Ayres & Gertner, *supra* note 162, at 1603, 1606.

181. *See id.* at 1603.

182. *See id.*

want) might more effectively induce information sharing. If employers had to specifically contract with employees to obtain an at-will standard, in the process, employees could become more informed about the rule that applied to their employment arrangement.<sup>183</sup> By contrast, under the current rules where the default rule arguably favors employers, employers do not have an incentive to reveal to employees information about the at-will status of their employment relationship. The employment relationship will be at-will if the contract is silent about the matter, and, as a result, employers can benefit from at will arrangements without educating the employees about the terms of their employment. Employees might, incorrectly, assume they can be fired only for cause and, as a result, they might demand lower pay, for example, than what they would require if they knew they could be fired without cause.

As described above, penalty default rules conceivably encourage contracting parties to provide information to each other or to a third party such as a court. Although penalty default rules potentially provide these informational benefits, penalty default rules may also be hazardous because, for a variety of reasons, parties will not always opt out of a default rule even if another term would be preferable. The reasons why parties might be stuck with default rules, even if they are unfavorable, fall under two broad headings. First, some explanations fall under the heading of transaction costs.<sup>184</sup> For example, as a result of the cost of obtaining information about applicable legal rules, parties may not learn what the

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183. *Id.* at 1603, 1606.

184. *See, e.g.*, R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960); Robert C. Ellickson, *The Case for Coase and Against "Coaseanism,"* 99 YALE L.J. 611 (1989). Transaction costs could take many forms in addition to the information costs mentioned above in the text. In addition to information costs, transaction costs include get-together costs (the costs of getting the contracting parties together to negotiate for terms other than default terms), and decision and execution costs (costs of deciding on contractual terms and drafting relevant contractual language). *See, e.g., id.* at 615–16. Furthermore, parties might fail to contract away from a default rule if one contracting party strategically withholds information from the other party to avoid loss of bargaining power. For example, a contracting party with high consequential damages might withhold that information from a counterparty to avoid paying a much higher rate. *See, e.g.*, Jason Scott Johnston, *Strategic Bargaining and the Economic Theory of Contract Default Rules*, 100 YALE L.J. 615 (1990).

default rule is and may, incorrectly, assume that it is favorable. If so, they might fail to opt out of the default rule. Similarly, as a result of the costs of obtaining information, parties might fail to consider a future contingency that makes a default rule relevant and, as a result, they might not opt out of the default rule. Second, some explanations for why parties would be stuck with an unfavorable default rule fall under the heading of behavioral reasons. In particular, various studies show that people may fail to opt out of default rules because people behave as if they prefer a rule simply because it is the default rule.<sup>185</sup>

## 2. *Why Tax Law is Special*

In the tax election context, taxpayer-favorable default rules are beneficial in several ways. In particular, they allow taxpayers to avoid the costs of filing elections, they allow the IRS to avoid the costs of processing elections, and they mitigate the bias against unsophisticated taxpayers.<sup>186</sup> Moreover, although, in contract law, penalty default rules might serve the valuable purpose of encouraging contracting parties to provide information to each other or third parties (like courts), various features that distinguish tax law from contract law make penalty default rules less valuable in the context of tax law. Ultimately, the relevant differences between tax law and contract law relate to important timing differences between making tax elections, on the one hand, and selecting contract provisions, on the other hand. This section discusses the relevant differences and how they affect the analysis.

### *i. In the Tax Law Context, Mechanisms Other than Penalty Default Rules can be Used to Ensure that Taxpayers Have Relevant Information*

In tax law, the government becomes involved at an earlier stage and, thus, readily available mechanisms other than penalty default rules can ensure that each affected

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185. See, e.g., Russell Korobkin, *The Endowment Effect and Legal Analysis*, 97 NW. U. L. REV. 1227 (2003); Russell Korobkin, *The Status Quo Bias and Contract Default Rules*, 83 CORNELL L. REV. 608 (1998); Cass R. Sunstein, *Switching the Default Rule*, 77 N.Y.U. L. REV. 106 (2002).

186. See *supra* notes 145–148 and accompanying text.

taxpayer is adequately informed, at least in the case of elections that are not due until a tax return is filed.<sup>187</sup> Furthermore, unlike penalty default rules, these mechanisms are not detrimental to unsophisticated taxpayers.

To demonstrate, in contract law, one contracting party may possess more information about legal rules than the other contracting party. In such situations, selecting a default rule that is disadvantageous for the more informed party could encourage that party to affirmatively contract out of the default rule, and, in the process, provide information to the less informed party.<sup>188</sup> In contract law, scholars provide the example of selecting a default rule under which employees could be fired only for cause, as discussed above.<sup>189</sup>

In the context of the tax election regarding alimony, Professor Field has described a similar potential use of penalty default rules.<sup>190</sup> As Professor Field observes, at least assuming that more wealthy individuals are more sophisticated about tax law, often the payor of alimony may be more knowledgeable about tax law than the recipient.<sup>191</sup> A penalty default rule (in particular, a rule that alimony is not deductible by the payor and is not includible in the income of the recipient) combined with an available election under which both parties could agree to the opposite treatment (alimony is deductible and includible in income) could encourage the spouse paying alimony to inform the recipient about the default rule and the election.<sup>192</sup> Once the recipient is aware of the tax rules, the recipient would be more equipped to demand higher alimony payments in exchange for agreeing to allow the payor to deduct alimony.<sup>193</sup>

As Professor Field acknowledges, there exists, however, a potential flaw with the approach of adopting such a penalty

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187. In some cases, tax elections are due before tax returns must be filed and, in these cases, this alternative solution might not be feasible. However, as discussed below, it may be advisable to eliminate or at least reduce the number of such elections. *See infra* Part IV.C.

188. *See supra* notes 178–183 and accompanying text.

189. *See supra* notes 178–183 and accompanying text.

190. *See* Field, *Tax Elections & Private Bargaining*, *supra* note 13, at 52–54.

191. *Id.*

192. *Id.*

193. *Id.*

default rule for alimony.<sup>194</sup> In particular, while this penalty default rule may operate well in cases in which one spouse is sophisticated and informed, this default rule disproportionately harms couples in which both spouses are unsophisticated and ill-informed.<sup>195</sup> Such couples may be more likely to fail to opt out of the default treatment and, if so, they will incur higher aggregate tax liability (assuming the payor is in a higher tax bracket than the recipient). For this reason, a penalty default rule may be ill-advised, especially given that other means could be used to ensure that the spouse receiving alimony is informed of the relevant rules, as discussed below.

Regarding these other means of informing a party, in contract law, at the time parties are establishing the terms of the contract, courts and other third parties are not involved. Therefore, relying on one contracting party to inform the other party of applicable legal rules may be the only available option. By contrast, in tax law, the government, in the capacity of providing information on tax return forms, is involved at the time the parties make tax election decisions, at least for elections that are filed at the same time as tax returns. Thus, rather than rely on other taxpayers as the source of information about the law, the IRS could directly provide information to less informed taxpayers through tax forms. For example, in the context of alimony, the default

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194. *Id.* “Of course, a default rule that favors a less-informed party does not guarantee that the taxpayer will be able to bargain effectively or that the taxpayers, as a unit, will reach the agreement that best minimizes their aggregate tax burden. Taxpayers may make uneducated or ill-advised decisions.” *Id.* at 54.

195. Given that alimony is generally only awarded when one party has significant wealth, the likelihood of encountering two unsophisticated taxpayers in the alimony context may not be particularly high. Nonetheless, in some cases, the parties may fail to consider tax consequences. Furthermore, the fact that divorcing parties may seek legal representation during their divorce can reduce the likelihood of encountering unsophisticated parties in the divorce context because the parties may be advised by their lawyers. However, not all divorce lawyers will be aware of the relevant tax rules. *Id.* at 24 (“Not all divorce lawyers are sophisticated tax planners . . .”). In addition, not all divorcing parties will have legal representation. *Id.* at 24 n.92 (mentioning that divorcing parties are increasingly representing themselves and observing that, although “divorcing spouses are more likely to retain lawyers in the situations where the dependency allocation election and/or the alimony election may be available . . . a significant number of divorcing spouses . . . proceeded pro se”).

rule could provide (and does provide) that alimony is deductible and includible in income. Furthermore, the recipient could be given the right to elect unilaterally to exclude the payment from income as long as he or she informs the payor so that the payor cannot take a deduction, and as long as the parties have not explicitly agreed otherwise. Finally, information specifically provided on a tax return could inform the recipient of the relevant legal rules and the availability of the election, and electronic tax return preparation can alleviate any additional complexity associated with providing more information to taxpayers, as discussed in Part IV.B. below. Once the recipient was informed of the relevant rules, he or she would be able to demand higher alimony payments from the payor in exchange for agreeing to not exercise the option to exclude the payment from income.

*ii. It is Often Easier to Determine what Taxpayers would have Wanted Than it is to Determine what Contracting Parties would have Wanted*

Timing distinguishes tax law and contract law because, while many tax elections are backward looking, contract provisions are always forward looking.<sup>196</sup> Because of this difference, at least in the case of elections that are backward looking, the IRS can easily determine what election taxpayers would have made. In contract law, penalty default rules can encourage contracting parties to specify terms.<sup>197</sup> For example, as discussed above, the zero-quantity default rule induces contracting parties to specify the quantity of goods they intend to sell because, if they fail to designate a quantity, the court will supply zero as the quantity term.<sup>198</sup> By encouraging contracting parties to indicate a quantity, courts avoid the high costs of trying to divine what quantity the parties desired and steer clear of the risk of determining a quantity that differs from what the parties intended.<sup>199</sup>

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196. See *infra* Part IV.A.2.ii for further discussion.

197. See *supra* notes 164–172 and accompanying text.

198. See *supra* notes 164–172 and accompanying text.

199. See *supra* notes 164–172 and accompanying text.

In contrast to contract law, in tax law, it is less necessary for the parties to affirmatively make a tax election because, without much effort, the IRS can decide what tax election the parties would have wanted in the case of backward-looking elections. Because tax elections affect tax outcomes only, taxpayers would want whatever election minimizes the aggregate tax liability of the affected taxpayers. Thus, unlike contract terms with respect to which individuals have varied preferences, tax election preferences are rather predictable. Further, many tax elections are backward looking. In other words, in many cases, at the time an election is due, taxpayers will have access to all information necessary to conclude whether a given election minimizes tax liability. For backward-looking elections, in order for the IRS to determine what election taxpayers would have made, the IRS only needs to examine the information that was available to taxpayers as of the due date for the election and mathematically calculate what election would have minimized tax liability.<sup>200</sup> At least if taxpayers provide the relevant information, the IRS can make the determination fairly cheaply and with very low risk of failing to select what the taxpayers would have wanted. Moreover, if the IRS incurs additional administrative costs in order to request necessary information from taxpayers, the IRS could impose a monetary penalty on taxpayers to cover this cost rather than penalize taxpayers by depriving them of the benefits of a favorable election.<sup>201</sup>

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200. Furthermore, particularly as electronic filing of tax returns becomes more and more common, the administrative costs of making this determination will decrease.

201. Other scholars have observed that penalties short of loss of favorable tax elections can encourage taxpayers to file returns and provide information. See, e.g., Levin, *supra* note 13, at 1606; Charles S. Lyon, *Tax Blunders: Treasury Should Reduce Their Cost*, 45 TAXES 575, 594 (1967) (suggesting that late filing of elections could be penalized with a “smaller financial price” than “complete forfeiture of favorable tax treatment”); Yorio, *supra* note 13, at 479. A similar argument has been made regarding court costs in the context of contract law. See, e.g., Eric A. Posner, *There Are No Penalty Default Rules in Contract Law*, 33 FLA. ST. U. L. REV. 563, 571 (2006) (“[T]he obvious remedy . . . is to charge parties a fee for using the court system.”). In the contract law context, while this solution ensures that the contracting parties bear court costs, it does not address the problems stemming from the fact that courts, inevitably, will make errors and supply terms the differ from what the parties would have wanted. By contrast, in the context of some tax elections, it will often be easy to determine what the parties would have wanted so errors will be less likely.

*iii. Tailored Default Rules Are Often Easier to Administer in the Tax Context than the Contract Context*

Also because of the backward-looking nature of many tax elections, tailored default rules in tax law, unlike contract law, often need not be vague, ill-defined standards. A tailored default rule aims to exactly match what the particular parties would have wanted, while an untailored default rule might not match what any particular set of parties would have selected but rather represents what the majority of parties would desire.<sup>202</sup> In contract law, a tailored default rule is typically a vague, flexible standard under which courts supply a term that would be reasonable given the surrounding facts and circumstances.<sup>203</sup> As a result of their vague nature, tailored default rules in contract law are costly to apply because courts must consider available evidence to determine what term is reasonable.<sup>204</sup> In addition, there is a significant risk that a court will select a term that is not, in fact, the term to which the parties would have agreed.

By contrast, in tax law, tailored default rules could often be easy to apply because tailored default rules can be clearly defined. For example, in the context of alimony, the current rule is an untailored default rule.<sup>205</sup> Under current law, by default, alimony is deductible by the payor and is included in the recipient's income.<sup>206</sup> This rule is favorable for the majority of taxpayers because, in most cases, the payor is in a higher tax bracket than the recipient. However, it is not necessarily favorable for any particular divorced couple because, in the case of any particular couple, the recipient could be in a higher tax bracket than the payor.

A tailored default rule would be taxpayer-favorable in all cases, not just in the majority of cases. In the context of alimony, such a rule would provide that, unless the parties elect otherwise: (i) in any year in which the payor is in a higher marginal tax bracket than the recipient, alimony is deductible and includible in income and (ii) in any year in

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202. See *supra* text accompanying notes 154–155.

203. See *supra* text accompanying notes 154–155.

204. See *supra* note 162 and accompanying text.

205. See *supra* Part I.B.

206. See *supra* Part I.B.

which the recipient is in a higher tax bracket than the payor, alimony is not deductible and not includible in income.<sup>207</sup> At least for the election regarding alimony (and other backward-looking elections), a tailored default rule is not difficult to apply. The IRS or the court would only need to know the income information for the payor and recipient for the relevant year (information which should already be included on the individuals' tax returns). With this information, the IRS can apply the tailored default rule to determine precisely what the taxpayers would have wanted.

In cases in which it is difficult to design an untailed default rule, tailored default rules may be particularly useful. For example, as discussed above, it is unclear whether the majority of divorced couples would benefit from the custodial parent claiming a child as a dependent or from the noncustodial parent doing so. This is unclear because it is not obvious whether, in the majority of divorced couples, the custodial parent is in a higher or lower tax bracket than the noncustodial parent. Furthermore, even if this matter is settled empirically, it very well could be the case that the majority is not much larger than fifty percent. In other words, instead of, for example, finding that, in ninety percent of couples, the noncustodial parent is in a higher tax bracket than the custodial parent, one might discover that this is true for only sixty percent of couples. Thus, although an untailed default rule (providing for the noncustodial parent to take the exemption) would minimize tax liability most of the time (in particular, in sixty percent of cases), such a default rule would fail to minimize tax liability quite often (in particular, in forty percent of cases). For this reason, a tailored default rule may be preferable. A tailored default rule would provide that, by default, whichever parent was in a higher marginal tax bracket would take the exemption.<sup>208</sup>

Although applying a tailored default rule to backward-looking elections is fairly simple, applying a tailored default rule to forward-looking elections could be quite costly and difficult.<sup>209</sup> The task of administering a tailored default rule for a forward-looking election more closely resembles the task

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207. For further discussion, see *infra* Part IV.A.3.iii.

208. For further discussion, see *infra* Part IV.A.3.iii.

209. For further discussion, see *infra* Parts IV.A.3.ii, IV.A.3.iv.

of administering a tailored default rule in contract law because all contract provisions are forward looking. When a court employs a tailored default rule in contract law, the court must determine the term to which the parties would have agreed at the time the parties entered into the contract.<sup>210</sup> Because the contract term governs the parties' relationship going forward, the parties would have designed a contract term based on what they anticipated would occur after entering into the contract. For instance, the quantity to which the parties would have agreed in a contract for sale of goods would depend on what the buyer and seller anticipated regarding future business needs, future production capacity, and future market prices. Thus, if a court must apply a tailored default rule to determine what the parties would have wanted, the court would be required to assess what the parties would have anticipated as of the date the contract was formed. The task of applying a tailored default rule to a forward-looking tax election is similar. In this case, too, a court or the IRS would need to discover what future events would have been predicted by the taxpayers as of the election's due date and select whatever tax treatment would have appeared favorable based on those predictions. For these reasons, tailored default rules should be used for backward-looking elections but likely should be avoided for forward-looking elections.

### 3. *Designing Tax Election Default Rules*

The observations discussed above can be used to inform how tax election default rules should be designed in particular cases. As discussed below, unless the default rule is insignificant because of an election's other parameters, tailored default rules generally should accompany backward-looking elections, while untailored default rules should be associated with forward-looking elections. Generally, penalty default rules ought to be avoided.<sup>211</sup>

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210. *See supra* note 154 and accompanying text.

211. This is true for the elections discussed in this Article. It is also true in most other cases, given that penalty default rules can disproportionately harm unsophisticated taxpayers and given that penalty default rules are not particularly useful in the tax context as discussed in Part IV.A.2.

In addition to varying in terms of whether they are backward-looking or forward-looking, tax elections vary with regard to whether they affect taxpayers whose interests are aligned or taxpayers whose interests diverge. If an election affects taxpayers whose interests are aligned, the taxpayers can readily agree on what election is made without one taxpayer compensating another taxpayer for making a given election. If an election affects taxpayers with divergent interests, the identity of the taxpayer who has the right to make the election can significantly affect how the taxpayers share the election's tax benefit which, in turn, has important distributional consequences. Thus, when an election affects taxpayers whose interests diverge, election parameters should be designed with the goal of encouraging parties to share the tax benefit in an equitable manner.

This part discusses proposed election default rules for four categories of elections: (i) backward-looking elections that affect taxpayers whose interests are aligned, (ii) forward-looking elections that affect taxpayers whose interests are aligned, (iii) backward-looking elections that affect taxpayers with divergent interests, and (iv) forward-looking elections that affect taxpayers with divergent interests. The proposed default rules are intended to mitigate the bias against unsophisticated taxpayers.

*i. Backward-Looking Elections that Affect  
Taxpayers Whose Interests Are Aligned*

An example of a backward-looking election that affects taxpayers whose interests are aligned<sup>212</sup> is the choice between taking the standard deduction and itemizing deductions. Generally, in the case of backward-looking elections, tailored default rules may be advisable, as discussed above.<sup>213</sup> However, the current default rule for this election, under which the taxpayer is entitled to the standard deduction, is necessary as a practical matter because the IRS will not be able to calculate itemized deductions if the taxpayer persistently fails to provide information about his or her

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212. In some cases, the election affects only one taxpayer, while, in other cases, particularly in the case of a married couple, the election affects multiple taxpayers whose interests are aligned.

213. See *supra* Part IV.A.2.

actual expenses.

Moreover, in the case of this particular election, because taxpayers are given ample opportunity to make an election,<sup>214</sup> the default rule is of limited importance and likely need not be changed to further protect unsophisticated taxpayers. Providing taxpayers with multiple opportunities to make an election serves nearly the same function as a tailored default rule. Like a tailored default rule, providing numerous chances to make an election allows taxpayers to receive favorable treatment even when they fail to file an election. For instance, if a taxpayer fails to file a tax return (and, thus, fails to elect between the standard deduction and itemizing deductions), the IRS will likely file a substitute return using the standard deduction.<sup>215</sup> Once a substitute return is filed, a taxpayer could file a corrected return.<sup>216</sup> In this return, if it is beneficial to do so, the taxpayer could itemize deductions, and the taxpayer would not lose favorable tax treatment as a result of a failure to initially make an election.<sup>217</sup> Unlike a tailored default rule, repeated opportunities to make an election can only assist taxpayers who eventually take action. Thus, if the taxpayer does not file a corrected return, he or she will not be entitled to itemize deductions even if doing so would be advantageous.<sup>218</sup>

Finally, as discussed above, in the tax context, devices other than loss of favorable tax treatment can encourage taxpayers to provide information.<sup>219</sup> In the case of the standard deduction, the law already takes this approach.<sup>220</sup> A taxpayer who fails to file a return does not automatically lose the opportunity to make a favorable election because the taxpayer can do so in a corrected return.<sup>221</sup> Instead, the taxpayer likely would be subject to a monetary penalty for failure to file, and this penalty, rather than loss of the ability to make an election, can induce timely filing.

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214. *See supra* Part I.A.

215. *See supra* Part I.A.

216. *See supra* Part I.A.

217. *See supra* Part I.A.

218. *See supra* Part I.A.

219. *See supra* Part IV.A.2.

220. *See supra* Part I.A.

221. *See supra* Part I.A.

*ii. Forward-Looking Elections that Affect Taxpayers Whose Interests Are Aligned*

The entity classification election is a forward-looking election that affects taxpayers whose interests are aligned. Even if a business has more than one owner,<sup>222</sup> the owners can easily align their interests because each owner can hold an interest in the business through a different entity.<sup>223</sup>

In order to mitigate the bias against unsophisticated taxpayers, the default rule for entity classification should be taxpayer favorable. However, a tailored default rule would be costly to administer given that the election is forward looking. In order to apply a tailored default rule, anytime a taxpayer failed to file an entity classification election, the IRS would need to assess what the taxpayer would have wanted based on information available to the taxpayer as of the election's due date. What the taxpayer would have wanted depends on the taxpayer's expectations regarding future events, including the future profitability of the underlying business. Thus, the IRS would have to consider evidence bearing on the taxpayer's predictions for the future of the business as of the due date for the election. Making this determination would be costly and the risk of error would be high. Because of the downsides of employing a tailored default rule, an untailored default rule is preferable. Moreover, current law already provides for an untailored default rule, at least for U.S. entities given that, by default, U.S. entities receive pass-through treatment, which is favorable in most cases.<sup>224</sup>

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222. If an entity has one owner, the election can affect two taxpayers—the entity and the owner. However, given that the owner owns 100% of the entity, the interests of the entity and the owner are aligned.

223. For example, if A, B, and, C own a business, they could form a partnership to hold the business assets directly. The partnership could, in turn, be owned by A, B, and, a corporation (100% of which was owned by C). This ownership structure allows C to own the business through a corporation while the other individuals own the business through pass-through entities. Likewise, if C already owned a business that was treated as a corporation and A and B wanted to join the business but preferred pass-through treatment, the corporation owned by C could contribute its assets to a partnership that A and B join. Because businesses can be easily arranged so that all owners obtain their desired tax treatment, owners can easily resolve any disagreement over how to treat the entity.

224. See *supra* Part I.D.

Finally, because the default rule is untailed, some taxpayers will benefit from opting out of default treatment. For this reason, other features of the election should be designed to increase the likelihood that unsophisticated taxpayers will consider the election and make an informed decision. For example, changing the due date for the election to the due date for the entity's first tax return is advisable. If the election is due with a tax return, unsophisticated taxpayers can obtain advice regarding the election in the context of seeking assistance with tax return preparation, and the IRS can alert taxpayers to the availability of the election by providing specific information on tax return forms.<sup>225</sup>

*iii. Backward-Looking Elections that Affect Taxpayers With Divergent Interests*

Examples of backward-looking elections that affect taxpayers with divergent interests include the election regarding the tax treatment of alimony and the election by divorced parents that determines which parent claims a child as a dependent.<sup>226</sup> In the context of these examples, tailored default rules would further the aim of reducing bias against unsophisticated taxpayers, which should be the dominant consideration when selecting default rules, as discussed above.<sup>227</sup> In addition, because the tax elections are backward looking, applying tailored default rules is not overly burdensome.<sup>228</sup> Furthermore, adopting tailored default rules can alleviate the difficulty of designing an untailed default rule in the case of the dependency exemption election.<sup>229</sup> Implementing these recommendations would involve changing the current parameters of these elections.

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225. See *infra* Part IV.B. Some taxpayers will receive tax advice in connection with seeking general legal advice before starting a business. However, not all taxpayers will seek general legal advice, and not all legal advisors will provide adequate tax counsel. It might be possible, however, to provide tax information on formation documents, to at least assist businesses that are formed as state law entities. Such information could alert taxpayers to the existence of the entity classification election even earlier than the tax return deadline.

226. See *supra* Part I.B.–C.

227. See *supra* notes 145–148 and accompanying text.

228. See *supra* notes 205–08 and accompanying text.

229. See *supra* notes 205–208 and accompanying text.

In the context of the alimony election, a tailored default rule would provide that: (1) if the spouse paying alimony is in a higher tax bracket than the spouse receiving alimony in any given year,<sup>230</sup> the payment is deductible by the payor and included in income by the recipient, and (2) if the spouse receiving alimony is in a higher tax bracket than the spouse paying alimony in any given year,<sup>231</sup> the payment is not deductible by the payor and not included in income by the recipient.<sup>232</sup> If neither (1) nor (2) applies because the spouses are in the same tax bracket,<sup>233</sup> the default rule could provide

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230. In particular, rule (1) applies if the payor's marginal tax bracket based on taxable income calculated after deducting alimony is higher than the recipient's marginal tax bracket based on taxable income calculated after including alimony in income.

231. In particular, rule (2) applies if the payor's marginal tax bracket based on taxable income calculated without a deduction for alimony is lower than the recipient's marginal tax bracket based on taxable income calculated without including alimony in income.

232. One might object to the proposal on the grounds that it makes it more difficult to discern what the default rule is. For example, spouses would need to share information about their taxable incomes in order to determine what the default rule is. However, making a default rule more difficult to determine does not necessarily complicate the law because taxpayers can still take action without knowing the default rule. For example, for non-U.S. entities, the applicable default classification depends on whether owners of the entity have limited liability under applicable non-U.S. law. Some taxpayers will file a protective classification election, because determining whether all owners have limited liability could be difficult and involve obtaining an opinion from non-U.S. legal counsel. In other words, they will affirmatively elect their desired tax treatment without knowing for certain that doing so is absolutely necessary (in other words, without knowing for certain that the elected treatment is different than default treatment). Similarly, in the alimony context, even without knowing the default rule, taxpayers could proceed by either: (i) explicitly agreeing that the paying spouse will deduct alimony and the receiving spouse will include alimony in income, or (ii) affirmatively electing the alternative treatment. The spouses would need to share taxable income information with each other if they want to evaluate what election leads to the most favorable tax treatment. However, even under current law, spouses need to share this information in order to evaluate the pros and cons of making a given election.

233. The tie-breaking rule, in fact, could be slightly more complicated. In particular, one could ask why rules (1) and (2) do not apply. This could arise for different reasons. One possibility is that, no matter how alimony is treated, the spouses will always be in the same tax bracket. For example, assume that, prior to taking alimony into account, payor's taxable income is \$60,000 and recipient's taxable income is \$40,000. Assume the amount of alimony is \$10,000. For 2012, an individual will be in the 25% marginal tax bracket if his or her income is between \$35,350 and \$85,650. The payor's taxable income falls in this range with or without the deduction (it is \$50,000 with the deduction and \$60,000 without the deduction). Likewise, the recipient's taxable income falls in

that the payor would not deduct the alimony and the recipient would not include it in his or her income.<sup>234</sup> Regarding opting out of the default rule, the spouse receiving alimony could unilaterally decide to exclude alimony from income in any given year by providing notice to the paying spouse of this decision prior to the tax return due date for that year and including a copy of this notice with the recipient spouse's tax return. The spouse receiving alimony could make this election unless the divorce agreement or an amendment to it applicable to a particular year explicitly provided otherwise. If provided with such notice, the paying spouse would not be allowed to deduct alimony, unless the parties had explicitly agreed otherwise. As discussed below,

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this range with or without including alimony in income (it is \$50,000 if the alimony is included and \$40,000 if it is not). In this situation, the tie-breaking rule described in the text would apply so that, by default, alimony is not deductible and not includible in income. Another possibility is that the parties begin in different tax brackets but the alimony payment is enough to move the parties into the same tax bracket. For example, assume that, prior to taking alimony into account, the payor's taxable income is \$90,000 and recipient's taxable income is \$80,000. Assume the amount of alimony is \$10,000. Again, for 2012, an individual will be in the 25% marginal tax bracket if his or her income is between \$35,350 and \$85,650, while an individual will be in the 28% marginal tax bracket for income over \$85,650 and up to \$178,650. The payor's taxable income reaches the 28% marginal tax bracket without the deduction but does not reach beyond the 25% marginal tax bracket with the deduction (it is \$80,000 with the deduction and \$90,000 without the deduction). The recipient's taxable income reaches the 28% marginal tax bracket if alimony is included in income but does not extend beyond the 25% marginal tax bracket if alimony is excluded (it is \$90,000 if the alimony is included and \$80,000 if it is not). In this case, the default rule could provide that a portion of the alimony is deductible (and includible in income) and a portion of the alimony is not deductible (and not includible in income). The portion that is deductible (and includible in income) is the minimum amount necessary to make it so that the payor's marginal tax bracket, based on taxable income calculated after the deduction of that portion, is the same as the recipient's marginal tax bracket, based on taxable income calculated after including that portion in income. Thus, in the example above, the payor would deduct \$4350 (bringing his or her taxable income to \$85,650 and thus within the 25% marginal tax bracket), and the recipient would include this \$4350 in income (bringing his or her taxable income to \$84,350, still within the 25% marginal tax bracket).

234. This choice is somewhat arbitrary. However, it is a logical choice if the recipient is granted a unilateral right to exclude alimony from income. When the spouses are in the same tax bracket, the recipient would likely exercise this unilateral right given that the spouses' aggregate tax liability would not be reduced by allowing the paying spouse to deduct alimony. Because the recipient would likely opt to exclude alimony from income, selecting this result as the default rule can reduce administrative costs.

tax return forms could provide information to ensure that individuals were aware of the election.

The parameters described above accomplish two goals. First, if both spouses are unsophisticated and, as a result, they fail to consider the election and make an informed choice, their aggregate tax liability will, nevertheless, be minimized under the tailored default rule described above.<sup>235</sup> In some cases, the payor might be sophisticated while the recipient is unsophisticated. Moreover, in such a case, the payor would receive favorable tax treatment by default if he or she was in a higher tax bracket than the recipient because, in that case, the payor would be entitled to deduct alimony by default. Thus, it might seem that the payor would lack any incentive to inform the recipient of his or her ability to make a contrary election. Nevertheless, the mechanics of the election described above do induce the payor to provide this information. In particular, the spouse receiving alimony could learn about the available election from tax return forms and could opt out of the default treatment unilaterally (making alimony not deductible and not includible in income). Knowing this, the informed paying spouse would have an incentive to obtain the receiving spouse's explicit agreement not to exercise this election, and the receiving spouse would be positioned to demand greater alimony payments in exchange for agreeing not to exercise the election.<sup>236</sup> In this

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235. As an example of how this would affect taxpayers, consider a couple in which the spouse paying alimony (P) is in a lower tax bracket than the spouse receiving alimony (R) in a given year. Assume the couple is unsophisticated and fails to consider the tax treatment of alimony. Also, assume they have made no designation regarding the tax treatment of alimony in their separation agreement or any amendment to that agreement. The individuals file tax returns. P deducts alimony, and R includes alimony in income. Given the individuals' tax brackets, this treatment results in higher aggregate tax liability than the alternative (P not deducting alimony and R excluding alimony from income). Under current law, the individuals would receive this less favorable tax treatment because it is consistent with the default rule, and they have not taken the necessary steps to opt out of the default rule. Under the proposed rule, the individuals would have reported the wrong tax treatment. By default, in this case, P should not deduct the payment and R should exclude it from income. Furthermore, the individuals did not take the steps necessary to opt out of the default rule. Therefore, they incorrectly reported their tax treatment. Because the individuals reported the wrong tax treatment, they could later amend their tax returns, or the IRS might correct the mistake.

236. This analysis assumes that non-tax law provides the parties with sufficient flexibility to negotiate over alimony payments, which might not

way, the recipient can share in some of the economic benefit resulting from the payor's ability to deduct alimony.

In the context of the dependency exemption election, a tailored default rule would provide that whichever parent is in a higher tax bracket<sup>237</sup> in any given year will claim a child as a dependent.<sup>238</sup> As a result of this tailored default rule, if both spouses fail to consider the election due to a lack of sophistication, their aggregate tax liability, nevertheless, will be minimized.<sup>239</sup> Moreover, this tailored default rule will result in favorable tax consequences more often than an untailored default rule, as discussed above.<sup>240</sup> If the parents are in the same tax bracket in any given year, the default rule could provide that the custodial parent will claim the child as a dependent.<sup>241</sup>

Regarding opting out of the default rule, because there may be policy reasons for ensuring that the custodial parent receives some of the economic benefit of claiming the child as a dependent,<sup>242</sup> the custodial parent could have the unilateral

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always be the case.

237. To take into account the possibility that the exemption could move one or both of the spouses from a higher tax bracket to a lower tax bracket, the default rule could be implemented in a way that is similar to the proposed implementation for alimony discussed *supra* note 233. In addition, to be taxpayer-favorable in all cases, the default rule would need to be more complex because other factors can affect the analysis of which parent should claim the child as a dependent. *See supra* note 60.

238. Such a default rule is not without precedent because a similar rule already applies in some cases in which multiple taxpayers would be entitled to claim a dependent. *See* I.R.C. §§ 152(c)(4)(A)(ii), 152(c)(4)(B)(ii) (2012). One might object to the proposal on the grounds that it makes it more difficult to discern what the default rule is. For a discussion of this concern, see *supra* note 232.

239. This is true as long as either: (1) the taxpayers file their returns correctly (correctly meaning in a way that happens to coincide with the default rule given that the taxpayers have not affirmatively opted out of the default rule), or (2) the taxpayers file their returns incorrectly and either the IRS audits and corrects the returns or the taxpayers eventually discover their error and amend their returns. For further discussion, see *supra* note 235.

240. *See supra* note 208 and accompanying text.

241. This choice is somewhat arbitrary. However, it is a logical choice if the custodial parent is granted a unilateral right to claim the exemption for the same reason that a similar choice is logical in the context of alimony. *See supra* note 234. In addition, this rule helps to ensure that the custodial parent obtains some of the economic benefit of the exemption which is a desirable goal. *See infra* note 242 and accompanying text.

242. *See, e.g.,* Field, *Tax Elections & Private Bargaining*, *supra* note 13, at 67 ("Allocation of the dependency exemption to the parent with custody of the

right to claim the child as a dependent in any given year by providing notice to the noncustodial parent of this decision prior to the tax return due date for that year and including a copy of this notice with the custodial parent's tax return. The custodial parent could make this election unless the couple had explicitly agreed otherwise, and, absent such an explicit agreement, the noncustodial parent would not be allowed to claim the child as a dependent if provided with notice by the custodial parent.<sup>243</sup> Granting the custodial parent this right would give the custodial parent leverage to demand payments from the noncustodial parent in exchange for agreeing not to exercise this right. Thus, if doing so would reduce aggregate tax liability, the noncustodial parent could claim an exemption and pay part of the economic benefit of the deduction to the custodial parent.

Finally, to ensure that the custodial parent was aware of the election and thereby in a position to negotiate with the noncustodial parent, tax return forms could provide taxpayers with information regarding this election.<sup>244</sup> Providing information in this manner reduces the need to identify the spouse who is likely to be more informed<sup>245</sup> and select a default rule that encourages the more informed spouse to educate the other spouse.<sup>246</sup>

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children directs the tax benefit to the household in which the children primarily reside, thereby hopefully conferring a distributional benefit on these households.”).

243. Also, if in any given case the default rule would provide that the custodial parent is entitled to the exemption (because he or she is in a higher tax bracket), then, in order to opt out of the default rule, both parents would have to either: (i) specify in their divorce agreement that the noncustodial parent will claim the exemption, or (ii) check a box on their individual returns affirmatively stating that they have agreed that the noncustodial parent will claim the exemption.

244. For further discussion, see *infra* Part IV.B.

245. This task can be difficult, as Professor Field observes, given that it is difficult to generalize about whether custodial parents or noncustodial parents are typically more sophisticated. See, Field, *Tax Elections & Private Bargaining*, *supra* note 13, at 41–42.

246. The mechanics of the rules proposed in this Article, see *supra* Part IV.A.3.iii, can be more fully illustrated with several examples. In the first example (Example 1), assume the noncustodial parent (NCP) is in a higher tax bracket than the custodial parent (CP). Assume that, at the time of the parents' divorce, NCP is aware of the election and CP is not. In Example 1, by default, NCP would be entitled to claim the exemption because NCP is in a higher tax bracket than CP. See *supra* text accompanying note 238. However, NCP knows

that, at tax return time, CP will see information specifying that CP can unilaterally claim the exemption (and force NCP to not claim the exemption) unless CP has agreed not to exercise this right. *See supra* notes 242–43 and accompanying text. Therefore, at the time of the divorce, NCP will have an incentive to obtain CP's agreement to not exercise this right. In the process, CP will learn about the election (from NCP), and, thus, CP will be in a position to demand greater support in exchange for his or her agreement not to exercise this right. In the second example (Example 2), assume the custodial parent (CP) is in a higher tax bracket than the noncustodial parent (NCP). Assume that, at the time of the parents' divorce, neither NCP nor CP is aware of the election, and, thus, they do not mention it in their divorce agreement. Further, in Example 2, assume the parties do not see information about the election on tax returns and prepare their returns in an uninformed manner. As it happens, NCP claims the exemption and CP does not claim the exemption. In Example 2, by default, CP would be entitled to claim the exemption because CP is in a higher tax bracket than NCP. *See supra* text accompanying note 238. Further, in Example 2, assuming the parties have not affirmatively checked boxes on their returns to opt out of this default treatment, the default rule would still apply. *See supra* note 243. Thus, the parties would have filed incorrect tax returns because CP should have claimed the exemption rather than NCP. Because the individuals reported the wrong tax treatment, they could later amend their tax returns, or the IRS could audit their returns and correct the mistake. In the third example (Example 3), assume the noncustodial parent (NCP) is in a higher tax bracket than the custodial parent (CP). Assume that, at the time of the parents' divorce, neither NCP nor CP is aware of the election. Further, in Example 3, assume the parties do not see information about the election on tax returns and prepare their returns in an uninformed manner. As it happens, CP claims the exemption and NCP does not claim the exemption. In Example 3, by default, NCP would be entitled to claim the exemption because NCP is in a higher tax bracket than CP. *See supra* text accompanying note 238. Further, in Example 3, assuming that CP has not affirmatively exercised his or her right to elect to claim the exemption and, thereby, opt out of this default treatment, the default rule would still apply. *See supra* text accompanying notes 242–43. Thus, the parties would have filed incorrect tax returns because NCP should have claimed the exemption rather than CP. Because the individuals reported the wrong tax treatment, they could later amend their tax returns, or the IRS could audit their returns and correct the mistake. One might object to the results of Example 3 on the grounds that it subverts the goal of allowing the custodial parent to benefit from the exemption. Four responses to this objection are worth noting. First, providing more information to taxpayers, as discussed below in Part IV.B, will decrease the likelihood that Example 3 will occur because the custodial parent will be more informed about his or her rights to unilaterally claim the exemption. Second, if the taxpayers are unsophisticated and are in the same tax bracket, the custodial parent is entitled to the exemption by default which further protects the interests of custodial parents. *See supra* note 241. Third, under the facts of Example 3, rather than correct both tax returns (allowing NCP to claim the exemption and not allowing CP to claim the exemption) so as to decrease NCP's tax liability and increase CP's tax liability, the IRS could determine the appropriate aggregate decrease in the parents' tax liability and apply that to CP's taxes. For example, assume CP is in a 15% marginal tax bracket with or without the exemption, and assume NCP is in a 25% marginal tax bracket with or without

*iv. Forward-Looking Elections that Affect Taxpayers  
With Divergent Interests*

The election under § 362(e)(2)(C) of the Internal Revenue Code is forward-looking and can affect taxpayers with divergent interests. As described previously, if a shareholder contributes built-in loss property to a corporation and the tax loss is not recognized at the time of the contribution, the built-in loss will be preserved for future recognition.<sup>247</sup> In particular, either the contributing shareholder will hold stock in the corporation with a built-in loss so that the shareholder will recognize a tax loss upon a future sale of the stock, or the corporation will hold the asset with a built-in loss so that the corporation will recognize a tax loss upon a future sale of the asset.<sup>248</sup> Under current law, if no election is made to the contrary, the built-in loss is preserved in the shareholder's stock, but, if the corporation and shareholder file an election under § 362(e)(2)(C), the built-in loss will be preserved in the asset held by the corporation.<sup>249</sup>

Whether making the election will reduce the shareholder's and corporation's aggregate tax burden depends on events unknown at the time the election must be filed. For example, the pros and cons of making the election depend on when the corporation sells the asset, when the shareholder sells the stock, and the amount of future income earned by the shareholder and the corporation. Thus, the election under § 362(e)(2)(C) is a forward-looking election, and, as long as the corporation is owned by more than one shareholder, the election affects taxpayers whose interests diverge.<sup>250</sup>

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the exemption. Assume the amount of the exemption is \$3700. The aggregate reduction in taxes (in other words, the amount by which the parents' total taxes would have been lower if NCP had claimed the exemption rather than CP) is  $\$3700 \times 25\% - \$3700 \times 15\% = \$925 - \$555 = \$370$ . The \$370 could be refunded entirely to CP. Fourth, replacing the current rules with a mandatory rule under which only the custodial parent can take the exemption would both protect custodial parents and make it so that an unsophisticated couple who did not use the election advantageously was not disadvantaged compared to a sophisticated couple.

247. See *supra* notes 105–09 and accompanying text.

248. See *supra* notes 105–09 and accompanying text.

249. See *supra* Part I.E.

250. The shareholder who contributes the property may benefit more, individually, from a higher stock basis, while the other shareholders would benefit more, individually, if the corporation had a higher basis in the asset.

Given the forward-looking nature of the election, applying a tailored default rule would be costly and difficult. Applying such a default rule would require the IRS to determine, as of the election's due date, what the taxpayers expected regarding the future income of the shareholder and corporation and other future events.

Therefore, it is advisable to use an untailed default rule that minimizes the shareholder's and corporation's aggregate tax liability in the majority of cases. Without empirical evidence, it is not entirely clear whether such a rule would preserve the built-in loss at the corporate level or shareholder level. However, it is plausible that an untailed default rule would preserve the loss at the corporate level (the opposite of the current default rule). Stated another way, in many (and perhaps most) cases, the corporation would obtain more of a tax benefit from a higher basis in the asset than the tax benefit the shareholder would obtain from a higher basis in the stock.<sup>251</sup>

If the default rule is reversed so that the corporation obtains the higher basis instead of the contributing shareholder, it may be desirable to ensure that the contributing shareholder receives a significant portion of the economic benefit of the tax losses and deductions taken by the corporation, given that the economic loss in the contributed property accrued while held by the shareholder. If more than one shareholder own the corporation, tax losses taken by the corporation may benefit all shareholders (not just the contributing shareholder). In order to achieve the goal of providing more benefit to the contributing shareholder, the election could be designed to give the contributing shareholder the unilateral right to opt out of the default treatment. By providing notice to the corporation before the due date of the shareholder's first tax return following the

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Thus, if the corporation has more than one owner, the interest of the contributing shareholder diverges from the interests of the noncontributing shareholders. If the corporation has only one owner, the election affects taxpayers whose interests are aligned; specifically, it affects the contributing shareholder and the corporation that is wholly owned by that contributing shareholder.

251. This is especially likely to be the case if the asset is depreciable by the corporation so that a higher tax basis entitles the corporation to greater depreciation deductions.

property contribution and by including a copy of this notice with his or her tax return, the shareholder could opt to retain a higher basis in the stock and require the corporation to take a lower basis in the asset. The shareholder could make this election unless the parties explicitly agreed otherwise. If the parties determine that a higher corporate level basis would minimize aggregate tax liability, other shareholders in the corporation could provide an economic benefit to the contributing shareholder in exchange for his or her agreement to not elect out of the default treatment. Finally, to ensure that the contributing shareholder is aware of the election, tax return forms could provide relevant information as described in the next section.

*B. Informing Taxpayers of an Election*

As discussed in the preceding section, designing favorable default rules can mitigate a tax election's bias against unsophisticated taxpayers. In addition, as discussed in this part, including further information about available elections in tax return forms could assist unsophisticated taxpayers.<sup>252</sup> While this information could cause tax revenue loss if unsophisticated taxpayers make more informed election decisions, concerns about fairness should outweigh considerations of tax revenue given that additional revenue would be forgone merely as a result of trapping fewer unwary taxpayers.

Lengthy descriptions of all available elections would undoubtedly overwhelm taxpayers and remain unread. However, technological developments offer a potential solution to this problem. In particular, tax return preparation software (including free IRS provided programs) could (and in some cases already does) ask preliminary questions and, based on the answers provided, only display information that may be relevant.<sup>253</sup> For example, the tax preparation software would only display information about the election related to alimony if a taxpayer answered yes to a

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252. See Maguire & Zimet, *supra* note 13, at 1288.

253. For example, at least one tax return preparation programs asks if the taxpayer owned a home at any time during the year, and, if the taxpayer answers affirmatively, the program prompts the taxpayer to provide information relevant to the tax treatment of homeowners.

preliminary inquiry regarding whether he or she had been divorced.

Finally, providing additional information to taxpayers is most effective for elections that are due at the same time as tax returns because the information can be contained on return forms and in return preparation software. If an election is due prior to a return, the IRS's options for alerting taxpayers to the election are limited. Material on the IRS website could describe the election, but, if taxpayers do not know an election exists, they will have no reason to search for information about it. Thus, the recommendation to inform taxpayers is unavoidably linked to the recommendation that elections should be due at the same time as a tax return, as discussed in the next section.

### C. Election Deadlines

Regarding timing, later filing deadlines would promote fairness because more unsophisticated taxpayers could discover that an election exists.<sup>254</sup> Particularly for elections that are currently due before the taxpayer's return, delaying the deadline until the return's due date could reduce bias against unsophisticated taxpayers for two reasons. First, even an unsophisticated taxpayer who is ignorant of an election's existence will likely be aware of the obligation to file a return and, in the context of seeking assistance with return preparation, the taxpayer would be more likely to learn about and obtain advice regarding an election.<sup>255</sup> Second, establishing the return filing deadline as the due date for an election would make it possible to include information about the election on return forms and in return preparation software in order to enlighten unsophisticated taxpayers. In the case of most elections, the due date already coincides with the deadline for filing returns.<sup>256</sup> However, this is not the case for all elections. For example, the entity classification election often must be filed before the due date for the entity's first tax return.<sup>257</sup>

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254. See Lyon, *supra* note 201, at 594.

255. See *supra* note 120 and accompanying text.

256. See, e.g., Helvey & Stetson, *supra* note 13, at 338.

257. See *supra* Part I.D. It is not clear why the entity classification is due when it is. When the Treasury proposed the current regulations, some

While later filing deadlines promote fairness, they also result in additional lost tax revenue. Moreover, unlike adopting favorable default rules and providing taxpayers with additional information, delayed filing deadlines would cause reduced tax revenue not merely because unsophisticated taxpayers made more favorable elections. Rather, delayed filing deadlines for forward-looking elections could also cause revenue loss because sophisticated taxpayers would make more favorable elections at a time when they possess more information that bears on the pros and cons of a given election. To use the entity classification election as an example, a given classification's advantages and disadvantages depend, in part, on the economic results realized by the entity.<sup>258</sup> If regulations granted taxpayers more time to make a decision regarding entity classification, taxpayers would possess greater information about the economic results of the entity, and they would be able to make election decisions that more effectively reduce tax liability. In other words, more time would not simply allow unsophisticated taxpayers to correct their mistakes regarding tax law but also allow sophisticated taxpayers to correct decisions based upon mistaken predictions.<sup>259</sup> Consequently,

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commentators suggested that taxpayers should be allowed to make classification elections with their first tax returns. The Treasury did not heed this recommendation and, regarding its reason for dismissing the recommendation, stated simply, "Treasury and the IRS continue to believe that it is appropriate to determine an entity's classification at the time that it begins its operations." See 61 Fed. Reg. 66584, 66586. (1996). It may be that the Treasury spurned a later deadline because of the increased tax planning opportunities it would create. See *infra* notes 258 and accompanying text. The election under § 83(b) of the Internal Revenue Code provides another example of an election with an early deadline. This election determines the tax treatment of certain transfers of property made to service providers and must be filed no later than thirty days after property is transferred. I.R.C. § 83(b)(2) (2012). A later filing deadline for this election may not be feasible because it would provide taxpayers with too great of an opportunity to make tax revenue-reducing elections. If this is the case, serious consideration ought to be given to replacing the election with mandatory treatment.

258. See *supra* Part I.D.

259. The revised deadline would provide that the initial classification election was not due until the entity filed its first tax return. Any subsequent changes to elections could still be due within seventy-five days of their effective dates. The revenue effect of this change might not be particularly large. Even if the due date is delayed until the tax return date, the taxpayer only possesses information about the entity's operations for a little more than its first year.

a balanced approach to filing deadlines may be warranted. One way to adopt a balanced approach would involve delaying the deadline for an election until the due date for filing a tax return while, at the same time, increasing the persistence of the election, as discussed in Part IV.D. below.<sup>260</sup>

Another way to institute a balanced approach would combine early filing deadlines with more readily available relief for unsophisticated taxpayers to file late elections. As discussed above,<sup>261</sup> a taxpayer is unlikely to obtain permission to file a late election unless he or she evaluated the election prior to its original deadline and always intended to make a given election. These current rules offer little or no assistance to unsophisticated taxpayers who, prior to an election's deadline, may have had no intention with respect to the election whatsoever.

The current rules do serve a practical purpose by helping to ensure that taxpayers do not use information obtained since an election's deadline to make a more favorable election than what they would have made based on information available as of the original deadline. To prevent a taxpayer from using hindsight in this manner, a court or the IRS must determine what election the taxpayer would have made based only on information available as of the election's due date. This task is fairly straightforward if the taxpayer can demonstrate that, prior to the election's deadline, he or she clearly revealed an intention to elect the same tax treatment that he or she now seeks to elect. For example, the taxpayer could present memoranda from advisors stating that the

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The election would still have a significant forward-looking component. In other words, the pros and cons of making the election would still depend on the results of the business in future years which will be unknown by the taxpayer at the time the election is made. Nevertheless, some tax revenue may be relinquished, and the tax revenue forgone is not merely a consequence of mitigating the bias against unsophisticated taxpayers but also results from expanding tax planning opportunities available to sophisticated taxpayers.

260. Increasing persistence is not always a viable option because some elections are irrevocable and thus, already persist indefinitely. The § 83(b) election discussed above is an example of an election that is irrevocable in most circumstances. See Treas. Reg. § 1.83-2(f) (2012) (regarding revocability of the election), and see *supra* note 257 for further discussion of this election. For elections with early deadlines that already persist indefinitely, policymakers ought to consider the possibility of replacing the election with mandatory treatment.

261. See *supra* notes 80–85 and accompanying text.

election should be made, and the taxpayer could explain that a miscommunication regarding who would file the paperwork was the only reason the election was not timely filed. By contrast, if a taxpayer did not even consider an election prior to its deadline, the court or the IRS would need to examine information available as of the election's original due date to attempt to determine what the taxpayer would have wanted if he or she had considered the election. For the entity classification election, for instance, courts or the IRS would consider evidence bearing on the taxpayer's likely predictions, as of the election's due date, regarding the future profitability of the business. The court or the IRS would then decide, based on this information, what election an informed taxpayer would have made. Completing this task would be challenging for the same reasons that applying a tailored default rule to a forward-looking tax election is difficult.<sup>262</sup> Both exercises require the court or the IRS to place itself in the position of the taxpayer as of an earlier date and decide what a more sophisticated taxpayer would have elected.

Nevertheless, the task of providing late filing relief to unsophisticated taxpayers will not always be insurmountable, and, when it is feasible to provide relief, courts or the IRS should not hesitate to do so. In some cases involving forward-looking elections, a taxpayer could prove that he or she would have made a different election based on information available as of the election's due date, and he or she failed to do so only as a result of a lack of understanding of the election's tax consequences.<sup>263</sup> A flexible doctrine could allow courts or the IRS to provide relief when taxpayers are able to meet this burden.<sup>264</sup> In addition, applicable rules could be reformed to

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262. See *supra* Parts IV.A.3.ii, IV.A.3.iv.

263. For instance, in some cases, the taxpayer's lack of sophistication will be obvious. Also, it could be the case that a different election would have always been more favorable as long as the taxpayer's business was expected to be profitable and the taxpayer can convincingly show that he or she anticipated profits. If the taxpayer can show that the economic outcome of the business was expected, it would be natural to infer that the taxpayer failed to make a different election because of misinformation about tax law. Thus, this taxpayer is not attempting to benefit from hindsight because he or she would have made a different election had he or she understood the tax consequences.

264. The difference between a flexible doctrine that grants relief for late filing and a tailored default rule is significant. In the case of a tailored default rule, any time taxpayers failed to make an affirmative election, courts or the

more readily grant relief for late filing of backward-looking elections. In the case of backward-looking elections, it will often be clear that the taxpayer is not attempting to use hindsight because all relevant information was already available as of the election's original due date. For example, assume the default rule for the dependency exemption remains what it is currently so that, by default, the custodial parent claims the exemption.<sup>265</sup> Further, assume that, in the year 2012, a noncustodial parent was in a higher tax bracket than a custodial parent so that the divorced couple could save taxes if they opted out of the default rule. The couple is unsophisticated and does not adequately consider the election before filing their tax returns for 2012. Sometime later, they discover the availability of the election and seek relief to amend their 2012 returns to opt out of default treatment. The couple would be able to convincingly show that opting out of the default rule was the most beneficial choice based only on information available at the time the original returns were filed. Therefore, existing rules could be reformed to more readily grant relief in such a situation. For administrative reasons, some time limit should be placed on taxpayers' ability to change backward-looking elections. Similar to the current rules for the standard deduction, taxpayers could be allowed to change backward-looking tax elections on amended returns filed within the period of the statute of limitations for claiming a tax refund.<sup>266</sup> To address any concerns about increased administrative costs, the IRS could charge a fee for

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IRS would need to determine what treatment would have appeared favorable based on information available as of the original due date for the election. With a flexible doctrine, on the other hand, courts or the IRS only need to answer this question in cases in which taxpayers can present evidence that convinces the court or the IRS that a given tax treatment clearly would have appeared favorable based on information available as of the election's original due date.

265. For further discussion of this election, see *supra* Part I.C. If the current default rule were replaced with a tailored default rule, as proposed above in Part IV.A.3.iii, the taxpayers in the example discussed in the text above would have filed returns incorrectly. Under a tailored default rule, if the parties do not consider the election and do not take steps to opt out of default treatment, the noncustodial parent would be entitled to claim the exemption in this example. If, as in the example above, the parties file returns in a manner that is not consistent with this treatment, they should be able to file amended returns to correct their error.

266. See *supra* note 42 and accompanying text.

changing elections in an amended return.<sup>267</sup> This method for addressing cost concerns is less severe than a complete loss of ability to make a favorable election.

#### *D. Persistence of Elections*

As discussed in the preceding section, delaying the filing deadlines for elections can reduce bias against unsophisticated taxpayers. However, delaying deadlines also leads to lost tax revenue. Furthermore, at least in the context of forward-looking elections, some additional revenue is relinquished because sophisticated taxpayers engage in more effective tax planning. Thus, with respect to timing of elections, a balanced approach is appropriate and could be implemented by delaying the deadline for an election until the due date for filing a tax return while, at the same time, increasing the persistence of the election. This can be demonstrated in the context of the entity classification election.

Regarding persistence, under current law, entity classification elections can be changed every five years.<sup>268</sup> Furthermore, if an entity is initially classified by default, there is no limit on how soon it could make a first change to its classification.<sup>269</sup> Also, if an entity files an election that is effective as of the date the entity was formed (an initial classification election), there is no restriction on how soon the entity could elect to make a first change to its classification.<sup>270</sup>

Sophisticated taxpayers can take advantage of this flexibility to classify an entity differently during different periods of time in order to obtain the most advantageous possible tax consequences. For example, assume a group of tax-exempt entities plan to invest in a real estate fund that intends to buy and sell for-sale housing (such as condominiums) in the United States. The tax-exempt entities anticipate that the fund will generate tax losses in early years

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267. See Lyon, *supra* note 201, at 594. This would not be unprecedented. Under current law, for example, taxpayers are charged filing fees when they submit requests for private letter rulings. These fees pass administrative costs onto taxpayers.

268. See *supra* Part I.D.

269. See *supra* Part I.D.

270. See *supra* Part I.D.

as it ramps up its business. After an initial period of generating losses, the fund is expected to generate tax gains. If these expectations are realized, the tax-exempt entities will obtain the most beneficial tax treatment by investing through an entity that is treated as a partnership in early years.<sup>271</sup> In later years when the business is producing tax gains, the tax-exempt entities could obtain more advantageous tax treatment by investing through an entity treated as a corporation and funded, in part, with debt.<sup>272</sup> Consequently, assuming the tax-exempt entities invest through an entity that is treated as a partnership by default, the tax-exempt entities will initially refrain from filing a classification election so that they may benefit from partnership treatment in early years. A couple years later, the tax-exempt entities will file an election to treat the entity as a corporation going forward. The five-year limitation will not preclude the tax-exempt entities from changing the classification of the entity because the entity's original default classification did not trigger the five-year limitation.

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271. If the entity is treated as a partnership in the loss years, each tax-exempt entity will be allocated its share of unrelated business losses generated by the partnership. Each tax-exempt entity can deduct the resulting losses against other unrelated business taxable income, subject to certain limitations. I.R.C. § 512(a)(1) (2012); Treas. Reg. § 1.512(a)-1(a) (2012). By contrast, if the entity were treated as a corporation for U.S. tax purposes, losses that it recognized would not flow through to the tax-exempt entities.

272. In years in which the fund generates gains, if the tax-exempt entities invested through a partnership, they would be subject to tax at thirty-five percent on all gains from sale of housing by the fund because such gains would constitute income subject to the UBIT. For further discussion, see *supra* note 87. By contrast, if the tax-exempt entities invest through a U.S. entity treated as a corporation and funded in part with debt, the tax-exempt entities will earn income that is characterized as dividend income, capital gain income, and interest income. The tax-exempt entities will generally not be subject to tax on this income. For further discussion, see *supra* note 88. This result should not be affected by § 512(b)(13) of the Internal Revenue Code (a provision that subjects tax-exempt entities to tax on interest paid by certain controlled entities) as long as no tax-exempt entity's interest in the corporation is more than fifty-percent. Furthermore, while the U.S. entity treated as a corporation is subject to entity-level tax generally at a rate of thirty-five percent, this entity's taxable income is reduced by interest expenses paid on its debt financing, subject to certain limitations. See I.R.C. §§ 11, 163(a), 163(j). Thus, the aggregate tax liability of the fund and the tax-exempt entities can be reduced by treating the fund as a corporation and financing the fund, in part, with debt.

The persistence of the classification election would increase if the five-year time period were lengthened or if classifications by default and initial classification elections started the five-year (or greater) time period during which classification elections were disallowed. If lawmakers instituted these changes, taxpayers likely would attempt to plan around the new restrictions. In particular, taxpayers would enter into actual transactions that replicate the tax consequences that follow from an elective change to an entity's classification. In the context of the real estate fund described in the preceding paragraph, for instance, the tax-exempt entities could, as above, refrain from filing an election so that the entity is treated as a partnership for the first two years. If default classification triggered the five-year (or greater) limitation, the tax-exempt entities could not electively change the classification of the existing partnership. However, they could cause the partnership to: (i) contribute all of its assets to a newly formed entity treated as a corporation for tax purposes and (ii) distribute the stock in the new corporation to the tax-exempt entities in liquidation of the partnership. The tax-exempt entities could claim that these transactions resulted in the same tax consequences as an elective change to the entity's classification.<sup>273</sup> Thus, for the suggested reform to have any

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273. If the tax-exempt entities elect to change the fund's classification from partnership to corporation, the parties will be treated as if: (i) first, the partnership contributed all of its assets and liabilities to a newly formed corporation in exchange for stock in the corporation and, (ii) second, the partnership liquidated by distributing stock in the corporation to the tax-exempt entities. Treas. Reg. § 301.7701-3(g)(1). As a result of these deemed transactions, the parties generally should not recognize any gain or loss. I.R.C. §§ 351, 731 (providing for non-recognition on the deemed contribution of assets to the corporation and providing generally for non-recognition on the deemed distribution of stock by the partnership, respectively). Likewise, similar treatment should follow if: (i) the partnership actually contributed all of its assets to a newly formed corporation, and (ii) the partnership subsequently liquidated by distributing stock in the corporation to the tax-exempt entities. At the time of step (i), the partnership likely holds assets with built-in gains. However, generally, the partnership should not recognize these gains. *Id.* § 351. This is true at least as long as the IRS does not successfully argue that the transaction lacks a business purpose and should be ineligible for non-recognition treatment under § 351. Likewise, when the partnership distributes stock in the corporation to the tax-exempt entities, the partnership and the tax-exempt entities generally should not recognize gain or loss. *Id.* § 731. Alternatively, the IRS might challenge the claimed results of these transactions

real impact, other measures would have to supplement the increased persistence. These measures would prevent taxpayers from easily circumventing the restrictions on elective changes.<sup>274</sup>

If a later deadline was adopted in tandem with increased persistence, sophisticated taxpayers would benefit from some additional information when making the original classification decision. In particular, taxpayers would be aware of the results of the entity's operations from the time it was formed until the due date for filing the first tax return. However, taxpayers would have less ability to revise entity classification in the future in response to changed economic circumstances. The increased persistence, thus, leads to additional tax revenue collection that, at least partially, offsets any tax revenue lost as a result of later filing deadlines.

Finally, increased persistence could, at the same time, aggravate the bias against unsophisticated taxpayers. If such taxpayers fail to make a beneficial classification decision at the outset, they will be burdened by the negative consequences for a longer period of time.<sup>275</sup> For this reason, a rule providing for increased persistence might be adopted in combination with rules allowing taxpayers more leeway to revoke or revise tax elections that were mistaken from the outset. Such rules would mirror the provisions for late filing relief discussed above.<sup>276</sup>

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by asserting that the new entity should be treated as a mere continuation of the old entity for tax purposes.

274. For example, courts could apply a stronger business purpose requirement when determining whether property contributions receive non-recognition treatment under § 351. As a result, when the partnership contributed its assets to a newly formed corporation as an attempt to plan around the five-year rule, the partnership likely would be required to recognize any built-in gains in its assets. Thus, the tax-exempt entities would recognize significant income subject to the UBIT when the assets were contributed to the corporation. To avoid this result, the parties likely would treat the fund as a corporation from the outset (and, as a result, forgo the tax savings resulting from treating the fund as a partnership in its early, loss-generating years).

275. See Lyon, *supra* note 201, at 594.

276. See *supra* notes 263–64 and accompanying text.

## CONCLUSION

Tax elections are harmful. They cause tax revenue erosion, unfairness, and complexity. Despite their numerous flaws, elections are, and likely will continue to be, prominent features of tax law. Given the ubiquitous nature of tax elections, their parameters should be carefully crafted so as to mitigate the damage that they cause. This Article recommends a number of measures that could moderate the negative consequences of elections. First, default rules should be taxpayer favorable. Second, steps should be taken to alert taxpayers to available elections. Third, if at all possible, elections should not be due until a taxpayer is required to file a tax return, and, in some cases, unsophisticated taxpayers should be more freely allowed to file late elections. Finally, in some cases it might be advisable to increase the persistence of elections while, at the same time, more readily grant relief to unsophisticated taxpayers who can show that a given election was ill-advised from the start.

Many of these recommendations will promote fairness but, at the same time, lead to additional tax revenue loss. However, at least when additional tax revenue is surrendered merely as a result of trapping fewer unwary taxpayers, fairness ought to be prioritized because lost tax revenue can be recouped in fairer ways. If relinquishing the additional tax revenue is untenable, serious consideration should be given to eliminating an election entirely and mandating the less favorable treatment for everyone rather than continuing to impose the less favorable treatment on only the ill-informed.