Taxpayer Choice in Legal Transitions

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Tax rules change frequently, and each change raises the question of how to deal appropriately with the winners and losers created by the change. Scholars have long discussed this issue of transition policy. The rich literature on tax transition policy, however, implicitly assumes that Congress or, in the case of regulations, the Treasury Department, and not the individual taxpayers who are affected by the change, will ultimately determine when the new law will become applicable to all taxpayers. This is not necessarily the case. Many tax law transition provisions include transitional elections, which cede to the affected taxpayers the authority to choose whether the old laws or the new laws will apply to them during a transition period. This deference to the choices of individual taxpayers merits special attention because tax elections reduce revenue and can increase complexity, and because the policy benefits of a law change can be enhanced or stunted by the manner in which the change is implemented. This attention has been lacking until now. To fill this gap in the literature, this article explains how transitional elections are used in the tax law and analyzes when, if ever, transitional elections should be used as part of tax transition policy. Ultimately, this article aims to help policymakers make informed decisions about whether and when taxpayers should be empowered to make individual choices about the implementation of changes in the tax law.
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I. INTRODUCTION

Tax rules change frequently. New tax bills are enacted into law, and new regulations are promulgated. It is widely accepted that these changes create winners and losers. Consider the oft-discussed example of the immediate repeal of the tax exemption for interest paid on municipal

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bonds. Taxpayers who hold the bonds at the time of the law change will generally see their after-tax return on the bonds decline, and municipalities raising money after the law change may face more expensive borrowing costs; they lose as a result of this change in the law. At the same time, holders of taxable bonds or other investment assets that may have previously competed with municipal bonds for investment dollars may experience price increases, and subsequent issuers of those competing assets may face less expensive borrowing costs due to increased demand for those assets; they are the winners as a result of this change in the law.

Each change in the tax law raises the question of how to deal appropriately with these winners and losers when replacing old rules with new rules. Scholars have long discussed this issue of transition policy. They argue about whether new laws should be nominally retroactive, and they debate the merits of providing transition relief such as grandfather provisions, phased-in effective dates, or delayed effective dates in order

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3 \footnotesize See, e.g., Michael J. Graetz, Legal Transitions: The Case of Retroactivity in Income Tax Revision, 126 U. PA. L. REV. 47, 53-57 (1977) [hereinafter Graetz, Legal Transitions] (using the repeal of the tax exemption for municipal bond interest as an example to illustrate the impact of potential transition rules); see also Eric Chason, The Economic Ambiguity (and Possible Irrelevance) of Tax Transition Rules, 22 VA. TAX REV. 615, 626-37 (2003) (same).

4 See Michael Doran, Legislative Compromise and Tax Transition Policy, 74 U. CHI. L. REV. 545, 548-51 (2007). Note that the after-tax return on the municipal bonds might decline even in the presence of mandatory transition relief, particularly if the transition relief is a phased-in effective date or delayed effective date rather than a grandfather clause. See Graetz, Legal Transitions, supra note 3, at 57-63.


6 See, e.g., Comm. on Tax Policy, Tax Section, N.Y. State Bar Ass’n, Retroactivity of Tax Legislation, 29 TAX LAW. 21, 28 (1975); Graetz, Legal Transitions, supra note 3, at 49, 59-60; Saul Levmore, The Case for Retroactive Taxation, 22 J. LEGAL STUD. 265 (1993) [hereinafter Levmore, Retroactive Taxation]; Note, Setting Effective Dates for Tax Legislation: A Rule of Prospectivity, 84 HARV. L. REV. 436, 437-46 (1970). The term “nominally retroactive” is used to describe any tax law that has an effective date that is prior to the date of enactment of the tax law. Thus, nominally retroactive tax law changes are distinguished from tax law changes that have effective dates on or after the date of enactment (i.e., tax laws that are “nominally prospective”). However, even nominally prospective tax changes can implicitly affect the value and economic consequences of actions taken before the date of enactment; thus, a nominally prospective change may have retrospective impact even though it is not, by its terms, applicable to events occurring before enactment. See Graetz, Legal Transitions, supra note 3, at 49-52 (defining retroactivity); see also Daniel E. Troy, Toward a Definition and Critique of Retroactivity, 51 ALA. L. REV. 1329, 1332-39 (2000) (distinguishing retroactivity from retrospectivity).

7 Grandfather provisions generally provide that the new rule will not apply to transactions entered into prior to the date of enactment of the new law or to assets held prior to the date of enactment of the new rule. See Graetz, Legal Transitions, supra note 3, at 53.
to ease the shift over to the new rule. This literature acknowledges that taxpayers often have input into the substance, timing, and impact of rule changes. For example, taxpayers can vote for elected officials, lobby their representatives, submit comments regarding proposed regulations, and alter their individual behavior in light of an anticipated or upcoming change in the law. However, despite the role that taxpayers may play in the process of changing the law, the extensive literature on tax transition policy seems to implicitly assume that Congress or the Treasury Department ("Treasury"), and not the individual taxpayers who are affected by the change, will ultimately determine when the new law will become applicable to all taxpayers.

This is not necessarily the case. Many tax law transition provisions include transitional elections, which cede to the affected taxpayers the authority to choose whether the old laws or the new laws will apply to them during a transition period. Transitional elections are explicit elections, whereby a taxpayer can opt to have the old rule apply or to have the new rule apply, just by "tell[ing] the Internal Revenue Service ("IRS" or "Service") how he wishes to be treated for tax purposes" and without otherwise altering his economic or legal affairs. Despite the use of

8 Phased-in effective dates generally provide that a new rule "is made effective gradually, for example, one-third in the year after enactment and one-third in each of the two subsequent years." Graetz, Legal Transitions, supra note 3, at 52.

9 Delayed effective dates generally provide that a new rule "is made effective only after the passage of some time, for example, five years from the date of enactment." Graetz, Legal Transitions, supra note 3, at 52.

10 See, e.g., BLUEPRINTS, supra note 2, at 189–91 (recommending the use of grandfather provisions and phased-in effective dates); Chason, supra note 3, at 644 (providing tepid support for grandfather provisions); Graetz, Legal Transitions, supra note 3, at 87 (arguing the use of grandfather provisions should be disfavored); see also infra Part II (providing a brief overview of the debate in the literature regarding transition policy).

11 See infra Part III (providing examples of transitional elections).

12 Heather M. Field, Choosing Tax: Explicit Elections as an Element of Design in the Federal Income Tax System, 47 Harv. J. on Legis. 21, 22 (2010). Explicit elections are distinguished from implicit (or de facto) elections where a taxpayer can self-help by "arrang[ing] his economic and/or legal affairs so as to qualify for his desired tax treatment." Id. For an example of an implicit choice available in the transition context, assume that a new law has a delayed effective date and will become effective as of January 1st of next year. A taxpayer can try to accelerate the transaction so that it is completed this year, in which case the old law would apply to the transaction. Alternatively, the taxpayer can delay the transaction until next year in order to choose to have the new law apply. See infra Part IV.C. (discussing this type of taxpayer reaction to changes in the law). The availability of taxpayer choice in legal transitions, however, goes beyond these opportunities for tax planning. As discussed herein, sometimes Congress uses transitional elections to explicitly delegate to individual taxpayers the task of deciding when the new law will begin to apply to them. If
transitional elections in the Internal Revenue Code ("Code") and Treasury Regulations ("Regulations"), the tax transition literature generally does not specifically discuss these elections, perhaps lumping transitional elections together with general transition relief. Transitional elections differ from general transition relief, however, because transitional elections explicitly contemplate empowering individual taxpayers to decide whether and when they will begin to be affected by the law change. Other types of transition relief do not. The legislative and regulatory deference to the choices of individual taxpayers merits special attention because tax elections reduce revenue and can increase complexity. Moreover, the policy benefits of a law change can be enhanced or stunted by the manner in which the change is implemented.

To help fill this gap in the literature, this paper explains how transitional elections are used in the tax law and analyzes when, if ever, transitional elections should be used as part of tax transition policy. Part II of this paper provides a brief overview of the tax transition literature, and Part III draws on examples of transitional elections in order to demonstrate how they are used in the tax law. Part IV evaluates the policy implications of using transitional elections. Specifically, Part IV examines (i) the ability of transitional elections to accommodate taxpayer expectations about changes in the law, (ii) the extent to which transitional elections can help mitigate public choice concerns about the legislative process, (iii) the information revealing and neutrality enhancing functions that individual choice may serve in the context of tax transitions, and (iv) the impact of transitional elections on revenue and on the complexity and administrability of the tax system. Part V concludes by providing some insight into the situations in which transitional elections may be particularly useful. Ultimately, this Article argues that although transitional elections are far from an ideal approach to transition policy, they may be valuable on a case-

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13 Examples are discussed in Part III, infra.
14 Unless otherwise stated, all “section” references and references to the Code herein refer to the Internal Revenue Code of 1986, as amended.
16 Those who argue for or against the use of a particular type of transition relief could implicitly be considering both mandatory and elective relief. For example, a scholar who argues against the use of grandfather clauses in general would surely also object to allowing grandfather protection at the taxpayer’s option.
17 See Field, supra note 12, at 26–33 (summarizing perceived policy problems presented by explicit elections).
by-case basis, particularly to enable legislative compromise when the tax law changes.

II. THE TRANSITION POLICY DEBATE

While it is uncontroversial that changes to the tax law help some people and hurt others, there is greater divergence of opinion regarding how, if at all, the government should deal with these winners and losers. The vast majority of the scholarship regarding tax transition policy focuses on transition losses and whether the government should provide transition relief. Over time, scholars have taken different positions on this issue, with some scholars advocating for, and other scholars arguing against, the provision of transition relief to mitigate the transition losses.

For many years, the widely accepted approach to changes in the tax law was to protect the reliance interest of taxpayers by avoiding nominally retroactive tax legislation and by providing transition relief, typically in the form of grandfather provisions and phased-in, or delayed, effective dates. It was argued that nominally prospective laws coupled with transition relief were appropriate because taxpayers reasonably relied on the existing law and on the expectation of legal continuity. Moreover, the rationale was that nominal prospectivity and transition relief were needed to mitigate the inequities created when surprise changes in the tax law imposed unanticipated losses (e.g., increased taxes or reduced asset values) on taxpayers who had made economic decisions in response to the existing law.

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18 See, e.g., BLUEPRINTS, supra note 2, at 181; SHAVIRO, supra note 2, at 26; Doran, supra note 4, at 548–49; Kyle D. Logue, If Taxpayers Can’t Be Fooled, Maybe Congress Can: A Public Choice Perspective on the Tax Transition Debate, 67 U. CHI. L. REV. 1507, 1507 (2000).
20 Note that the proponents of these different approaches do not claim that their preferred approach is absolutely desirable in all circumstances. Rather, they tend to argue in favor of their preferred approach in appropriate contexts. See, e.g., Graetz, Legal Transitions, supra note 3, at 87; Kaplow, Transition Policy, supra note 19, at 164.
21 See, e.g., Comm. on Tax Policy, supra note 6, at 28; Note, supra note 6, at 437–47.
22 BLUEPRINTS, supra note 2, at 189–91 (discussing grandfathering existing assets and phasing in the new law as alternative methods of providing transition relief).
24 BLUEPRINTS, supra note 2, at 185. The tax law generally discourages taxpayers from
Celebrated articles by Professor Michael Graetz and Professor Louis Kaplow rejected this "old view" and argued that transition relief (and grandfathering in particular) generally should not be provided. In separate articles, they argued that "[g]enerally, transitional relief is inefficient because it insulates investors from the real effects of their decisions, and thus distorts their behavior" and instead, "[p]eople should make investments with the expectation that political policies may change." That is, the provision of transition relief inhibits taxpayers' incentives to anticipate socially valuable policy changes and impedes the implementation of those policy changes, thereby reducing the social welfare gains from the policy changes. Further, Graetz united the discussions about nominal retroactivity and prospective transition relief by explaining that "the distinctions commonly drawn between retroactive and prospective effective dates are illusory" because "all changes in law, whether nominally retroactive or nominally prospective, will have an economic impact on the value of existing assets or on existing expectations." Commentators widely embraced the Graetz/Kaplow argument against transition relief for nominally prospective tax law changes, and a few scholars even warmed to the idea of nominally retroactive taxation.

undertaking transactions that are motivated solely or primarily by tax purposes. See, e.g., I.R.C. § 269(a) (allowing the Secretary to disallow tax benefits from acquisitions the primary purpose of which was evasion or avoidance of federal income tax); Treas. Reg. § 1.355-2(b)(2) (2008) (requiring "a real and substantial non Federal tax purpose germane to the business" in order for a corporate division to qualify for nonrecognition under section 355). Nevertheless, it is well recognized that taxpayers have behavioral responses to the tax law and that the tax law can influence the economic decisions made by taxpayers. Thus, even in the absence of an improper, solely tax-motivated transaction, a taxpayer may have reliance interest in the existing law if the tax consequence of a particular action was one of many factors that the taxpayer took into account when making economic choices.

25 Graetz, Legal Transitions, supra note 3.
26 Kaplow, Economic Analysis, supra note 5.
27 Id. at 513.
28 Graetz, Legal Transitions, supra note 3, at 87.
29 Michæl J. Graetz, Retroactivity Revisited, 98 Harv. L. Rev. 1820, 1822 (1985) [hereinafter Graetz, Retroactivity] (summarizing a key argument made in Graetz, Legal Transitions, supra note 3, at 49–63).
31 See, e.g., Levmore, Retroactive Taxation, supra note 6, at 265, 305–07; Stephen R. Munzer, A Theory of Retroactive Legislation, 61 Tex. L. Rev. 425, 444, 448–52 (1982); see also, e.g., Kaplow, Economic Analysis, supra note 5, at 551–52 (concluding that nominal retroactivity may be warranted in some situations in order "to produce the proper incentives").
Despite the enthusiasm for Graetz's and Kaplow's arguments against transition relief for nominally prospective tax law changes, some scholars have tried to reinvigorate the arguments for the provision of transition relief. Professors Mark Ramseyer and Minoru Nakazato argued that the congressional precommitment to provide transition relief might be appropriate given the costs of lobbying. They explain that "Congress should promise to protect taxpayers from its own later tax reform projects" in order to reduce the amount that interested groups are willing to spend in order to lobby against the repeal of the law and to lessen legislators' abilities to "extract protection money" from those interested groups.

Professor Kyle Logue also advocated for governmental precommitment to grandfathering of incentive subsidies (i.e., "provisions whose primary purpose is to alter taxpayers' decisions regarding how they will invest their resources"). He explained that, absent assurance that the incentive subsidy will be protected in the event of a change in the law, taxpayers might demand a premium out of fear of opportunistic behavior by the government. That is, precommitment to grandfathering may reduce the total cost to the government of providing an effective incentive subsidy, thereby enhancing social welfare.

Then, building on the existing literature regarding transitions, Professor Daniel Shaviro published his book, When Rules Change: An Economic and Political Analysis of Transition Relief and Retroactivity. In this comprehensive exploration of transition rules, he argued against the provision of transition relief for tax policy changes. Shaviro's argument differed, however, from Graetz's and Kaplow's; Shaviro argued that "tax legislative politics is quite bad," rejecting Graetz's and Kaplow's assumption that policy changes in the tax law generally improved social welfare. Nevertheless, Shaviro argued that, where "there is no general reason why we should expect things to be getting either systematically

33 Id. at 1158, 1172.
35 Id. at 1138-39.
36 Professor Shaviro distinguishes between what he calls the "policy content" of a rule change (i.e., a change that affects the rule's "steady-state allocative and distributional character") and "accounting content" of a rule change (i.e., implementation details of a rule change "that could in principle be changed without affecting its policy content"). SHAVIRO, supra note 2, at 53-54.
37 Id. at 86.
38 Id. at 13.
better or worse" and given the asymmetry with which Congress typically treats transition gains and losses, the best feasible approach to tax policy changes is to deny transition relief. Despite Shaviro’s support for a norm denying transition relief for tax policy changes, he generally endorsed the view, “strongly rooted in popular sentiment [and] legislative practice,” opposing nominally retroactive tax law changes.

Even in this extremely brief discussion of the very rich literature on transition policy, it is clear that scholars differ on what transition policy they think is best. Despite these differences, the tax transition policy literature implicitly contemplates that transition rules selected by Congress, or, in the case of regulations, the Treasury, will apply uniformly, rather than at the taxpayer’s option. Of course, taxpayers do have some role in determining whether they are subject to the old or new rules, and the tax transition literature acknowledges this role to some degree. For example, taxpayers can lobby Congress about when a new law will become effective. Recall that it is this type of taxpayer behavior that concerns

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39 Id. at 99-100.

40 Id. at 86, 88-91 (“[D]ecisions to provide grandfathering or other transitional adjustment are biased in favor of compensating transition losers, rather than eliminating the gains of transition winners.”).

41 Id. at 98-101.

42 Id. at 104-10. Cf. Daniel J. Shaviro, When Rules Change Revisited, 13 J. CONTEMP. LEGAL ISSUES 279, 291 (2003) (retreating slightly from this position and concluding that “this norm lacks the intellectual coherence to be put on a par with the first two norms [discussed in his book]”).

43 This summary is necessarily oversimplified as a result of space constraints, but I tried to highlight the key parts of the transition debate that will be most relevant to the discussion of transitional elections.

44 Note that scholars differ not only on whether they favor transition relief or oppose it, but also on whether Congress should adopt a generally applicable transition policy or whether transition rules should be determined on a case-by-case basis. Compare Saul Levmore, Changes, Anticipations, and Reparations, 99 COLUM. L. REV. 1657, 1684 (1999) (suggesting that it may be useful to retain some flexibility in the manner and extent to which transition losses are compensated) with Kaplow, Economic Analysis, supra note 5, at 558-60 (favoring “the implementation of a consistent, predictable transition policy”); cf. Doran, supra note 4, at 597 (expressing “agnosticism about whether the better approach would be a defined tax transition policy or a case-by-case resolution of transition issues as they arise in connection with particular substantive policy changes.”).

45 Scholars who oppose transition relief do not suggest that taxpayers should be able to opt for transition relief if they really want it, and even scholars who favor transition relief generally do not suggest that taxpayers should be able to opt out of the transition relief if they do not want it.

46 Generally, only small, well-informed groups with concentrated interests will be able to effectively exercise this power to lobby their legislators. See Ramseyer & Nakazato, supra note 32, at 1163-65 (discussing lobbying as part of the legislative process); see also
Ramseyer and Nakazato. Additionally, taxpayers can modify their behavior in light of a certain or likely upcoming rule change. For instance, a taxpayer can try to accelerate a transaction so that it is complete before, rather than after, the upcoming congressionally-determined effective date of the new law. Scholars are sensitive to this possibility. The tax transition literature, however, seems to implicitly assume that Congress will not explicitly and intentionally cede to each taxpayer affected by a rule change the power to decide whether transition relief will be afforded to him or her.

Yet, many tax law transition provisions do exactly that. New laws sometimes allow the affected taxpayers to make explicit elections about whether the old or new law will apply to them during a transition period. The next Part discusses a few examples in order to illustrate how transitional elections are used in the tax law.

III. UNDERSTANDING HOW TRANSITIONAL ELECTIONS ARE USED

Transitional elections generally fall into two categories: (1) transitional elections that empower taxpayers to decide whether they would like the old rule to apply to them even after the enactment of the new law; and (2) transitional elections that enable taxpayers to decide whether to apply the new rule to events that occurred before the enactment of the new law, making the new rule nominally retroactive. A few examples can help illustrate how these two categories of transitional elections are used.
A. Accepting or Rejecting Post-Enactment Transition Relief

When enacting a new law, Congress may offer post-enactment transition relief, like grandfather provisions, so that the old law can continue to apply to certain taxpayers or transactions even after the enactment of the new legislation. At the same time, Congress may give the taxpayer the option to accept or reject that transition relief. The impact of this type of transitional election may be illustrated by two examples: one where taxpayers can elect into transition relief (as with the transitional election provided upon the enactment of the current law regarding the tax treatment of certain gains from the sale of a principal residence) and one where taxpayers can elect out of transition relief (as with the transitional election provided upon the amendment of section 355’s “active trade or business” requirement for tax-free corporate divisions). The substance of each law change, and the transitional election relevant to each law change, is discussed below.

1. Electing to Accept Transition Relief — Amending the Tax Treatment of Gains from Sales of Principal Residences

Prior to 1997, a taxpayer did not recognize gain on the sale of his or her principal residence as long as, within two years before or after the sale, the taxpayer purchased a new principal residence at least equal in cost to the sale price of the old residence. Additionally, taxpayers over the age of fifty-five could, on a one-time basis, exclude from income up to $125,000 of gain from the sale of a principal residence if the taxpayer owned and

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52 This is only one of two transitional elections that Congress provided when it changed the tax treatment of gain from the sale of a principal residence. The other transitional election enacted in connection with the same substantive law change will be discussed below in Part III.B.2.

53 Of course, the difference between elections to accept transition relief and elections to reject transition relief is just a difference in the default rule — does the default rule provide immediate application of the new rule unless a taxpayer elects otherwise, or does the default rule provide transition relief unless a taxpayer elects immediate application of the new rule? It is useful, however, to see examples of transitional elections operating in both directions in order to appreciate how transitional elections function and in order to inform the later discussion about the impact of default rules on the utility of transitional elections. See infra Part IV.D.

54 I.R.C. § 1034 (repealed 1997).
used the property as a principal residence for at least three of the five years preceding the sale. These rules created significant complexity because, in order to benefit from the exclusions, a taxpayer had to determine his or her basis in the home, which forced the taxpayer to keep detailed records of transactions and expenditures on home improvements over many decades. Additionally, these rules "encouraged some taxpayers to purchase larger and more expensive houses than they otherwise would in order to avoid a tax liability," which "promoted an inefficient use of taxpayer's financial resources," and "discouraged some older taxpayers from selling their homes," constraining their mobility.

In order to address these concerns, Congress changed the law in 1997 so that a taxpayer could exclude from income up to $250,000 ($500,000 in the case of married taxpayers filing jointly) of gain from the sale of a principal residence, if the taxpayer owned and used the property as a principal residence for at least two of the five years preceding the sale. This exclusion is available regardless of both the taxpayer's age and whether the taxpayer purchased a new residence. Further, this exclusion can be used multiple times during the taxpayer's life. These changes drastically simplified the record-keeping burdens for homeowners and helped to lessen the impact of the tax rules on taxpayers' decisions about whether to sell a home and whether to buy a replacement home (and for how much).

Any sale of a principal residence after the date of enactment was generally subject to the new law. However, Congress allowed certain

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56 STAFF OF JOINT COMM ON TAXATION, 105TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1997, at 54–55 (Joint Comm. Print 1997). In addition to the record-keeping burden, the need for taxpayers to be able to track their basis meant that taxpayers had to spend time on "the difficult task of drawing a distinction between improvements that add to basis, and repairs that do not." Id.
57 Id. at 55.
59 I.R.C. § 121. Note that, while the exclusion can be used multiple times during a taxpayer's lifetime, the exclusion cannot be used more than once every two years. Id. at § 121(b)(3).
61 The date of enactment of the new law was August 5, 1997. However, the new law was nominally retroactive and applied to all sales or exchanges of principal residences occurring after May 6, 1997. Taxpayer Relief Act of 1997, supra note 56, at § 312(d)(1). The retroactive application of this new law is also elective; taxpayers had the ability to elect
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Taxpayers to elect to be treated under a grandfather rule, so that a sale of a principal residence would still be subject to the old laws even though the sale occurred after the date of enactment of the new law. The availability of this transitional election was limited to those taxpayers who had taken specific actions in reliance on the old law. Specifically, the only taxpayers eligible to elect into the transition relief were those who, as of the date of the enactment of the new law, either had a binding contract to sell the principal residence or had already purchased replacement property.

Making the transitional election would be beneficial to some taxpayers and detrimental to other taxpayers, depending on their individual facts and circumstances. This transitional election would be desirable if, for example, a taxpayer eligible to make the election would realize more than $250,000 (or $500,000 in the case of married taxpayers filing jointly) of gain on the principal residence and the taxpayer planned to purchase (or had already purchased) a replacement residence at a cost equal to or greater than the sale price of the original. In that situation, the entire amount of gain would be excluded from income if the old law applied, but the income exclusion would be capped if the new law applied. Thus, a rational taxpayer would want the benefit of the old law and would likely choose to make the transitional election.

On the other hand, some taxpayers eligible for the elective transition relief might decide not to make the election. For instance, consider a

out of its retroactive application. The election with respect to the retroactive application of this new law is separate and distinct from the election discussed in this Part III.A.1 regarding the availability of post-enactment transition relief. See infra Part III.B.2 (discussing the retroactive application of the new law and taxpayers' ability to elect out of retroactive application).


63 As discussed above, Professors Graetz and Kaplow argue persuasively that taxpayers generally should anticipate the possibility of change and should not have a protected reliance interest in the existing tax law. Nevertheless, the idea that taxpayers who rely on the old law should be protected still resonates with some lawmakers, lawyers, taxpayers and academics. See supra Part II; see also Franklin L. Green, The Folly of Long-Term Tax Planning: Comments on the Instability of the Tax Law, 74 Tax Notes 481, 490, 496 (Jan. 27, 1997) (discussing the difficulty faced by tax lawyers and tax planners when trying to plan for the long term in light of unstable tax laws).

64 Taxpayer Relief Act of 1997, supra note 56, at § 312(d)(4). Note that the New York State Bar Association (NYSBA) suggested allowing the transition election to apply more broadly. New York State Bar Association, NYSBA Offers Comments on Tax Simplification Proposals, 97 TNT 104-15, para. 25 (May 30, 1997).

65 In this context, I assume that taxpayers wish to reduce their taxes and increase the value of their assets. Choices that have either or both of these effects are assumed to be beneficial to the electing taxpayer, whereas choices that increase a taxpayer’s taxes or decrease the value of his or her assets are assumed to be detrimental to the electing taxpayer.
taxpayer over the age of fifty-five who had a binding contract to sell his or her principal residence at a gain in excess of $125,000 and who did not want to buy a replacement principal residence. That taxpayer would want the benefit of the new law and would be unlikely to elect to accept the transition relief. Thus, even though Congress did not mandate post-enactment transition relief in connection with this law change, Congress gave certain taxpayers the power to opt into a grandfather provision, thereby allowing each such taxpayer to achieve his or her desired tax treatment despite the changed law.

2. Electing to Reject Transition Relief — Amending Section 355’s “Active Trade or Business” Requirement

The transitional election provided when Congress amended the “active trade or business” requirement for tax-free corporate divisions under section 355 is very similar to the transitional election discussed above in connection with the adoption of a new law regarding gains from the sale of a principal residence. However, this transitional election employs a different default rule and thus works in the opposite direction. That is, with the transitional election in section 355, the new law generally does provide transition relief to taxpayers who have evidenced reliance on the old rules, but taxpayers who want the new rules to apply immediately can elect to reject the transitional relief.

Specifically, in order for a corporate division to qualify for nonrecognition under section 355, the division must satisfy several requirements, including the requirement that the distributing corporation and the controlled corporations each be engaged in the active conduct of a trade or business (“ACTB”). The old version of the ACTB requirement placed a premium on where the active businesses were located in the corporate structure. As a result, corporations often had to undertake

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66 Under the old law, the taxpayer would be able to exclude only $125,000 of gain from income, but under the new law, the taxpayer would be able to exclude up to $250,000 of gain from income ($500,000 in the case of married taxpayers filing jointly). Compare IRC § 121 (amended 1997) with Taxpayer Relief Act of 1997, supra note 56, at § 312(b)(2).

67 I.R.C. § 355(e)(1)(C), (b)(1).

68 Historically, in order for a corporation to be treated as engaged in the active conduct of a trade or business, the corporation either had to directly engage in the ACTB (the “direct engagement rule”), or substantially all of the corporation’s assets had to consist of the stock or securities of controlled corporations that were engaged in the ACTB (the “holding company rule”). I.R.C. § 355(b)(2)(A) (2006) (amended 2007). In determining whether a corporation met the direct engagement rule, the Service historically took the position that the value of the gross assets of the trade or business being used to satisfy the ACTB requirement must constitute at least five percent of the total fair market value of the gross assets of the
significant restructuring just to locate the active businesses in the places within the corporate structure that would enable the ACTB requirement to be satisfied. Commentators criticized this restructuring as inefficient and irrelevant for accomplishing the policy goals of section 355. In response to this criticism, Congress changed the definition of the ACTB requirement so that its satisfaction will be determined by looking at the affiliated groups of the distributing and controlled corporations; this change means that the active conduct of the trade or business can be located anywhere in the corporation's affiliated group. By decreasing the emphasis on the location of the ACTB, the amendment significantly reduced the need for pre-transaction restructuring.

For example, assume Corporation X's only assets consisted of all of the stock of three equally valuable subsidiaries, Corporations M, N, and O. Assume further that only Corporation M and Corporation N were treated as engaged in the active conduct of a trade or business because, for example, Corporation O's business had operated for only two years. A spin-off of Corporation M would not qualify for nonrecognition treatment under section 355 because, immediately after the spin-off, Corporation X would not be directly engaged in the active conduct of a trade or business and only fifty percent of Corporation X's assets (and not substantially all of Corporation X's assets) would consist of stock of controlled corporations that were engaged in the ACTBs. Several different restructuring alternatives would allow the spin-off to qualify for nonrecognition treatment under section 355. Corporation N could liquidate into Corporation X, such that Corporation X would be directly engaged in the ACTB previously operated by Corporation N. Alternatively, Corporation X could contribute all of the stock of Corporation O to Corporation N, so that, immediately after the spin-off of Corporation M, the only asset owned by Corporation X would be the stock of Corporation N; hence, Corporation X would be treated as engaged in the active conduct of a trade or business by virtue of the holding company rule. See Rev. Rul. 74-79, 1974-1 C.B. 81 (illustrating how restructuring can enable the ACTB requirement to be satisfied); see also, e.g., Mark J. Silverman, Corporate Divisions Under Section 355, in TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS, 675 PRACTISING LAW INSTITUTE, TAX LAW AND ESTATE PLANNING COURSE HANDBOOK SERIES 1079, 1151–57 (2005).

See, e.g., William Galanis & Amy Hack, Simplifying Spin-offs: An Examination of Recently Proposed Legislation Regarding the Active Trade or Business Requirement, 1 BUS. ENT. 34, 64 (1999) ("An affiliated group of corporations should not be forced to undergo extensive preliminary restructuring in order to satisfy the active trade or business requirement of Section 355.")


In the example described in note 69, supra, the corporations would not need to engage in any restructuring in order for the spin-off to qualify for nonrecognition under
The amendment to section 355's ACTB rule was generally effective as of the date of the enactment of the legislation. However, Congress included a transition rule that provided that the change to section 355's ACTB requirement would not apply to any distribution pursuant to a transaction which is — (i) made pursuant to an agreement which was binding on the date of the enactment of this paragraph and at all times thereafter, (ii) described in a ruling request submitted to the Internal Revenue Service on or before such date, or (iii) described on or before such date in a public announcement or in a filing with the Securities and Exchange Commission.

This transition rule effectively provided transition relief, in the form of a grandfather provision, to transactions that were clearly in progress as of the enactment date of the rule change and thus were likely structured in reliance on the old rules.

The transition rule also provided taxpayers with the ability to elect to reject this transition relief. If a transitional election was made, then the new rules would apply to a transaction that would have otherwise been grandfathered and treated under the old rules. This transitional election would be desirable if, for example, the new rules would eliminate the need for restructuring that would have been required in order for a transaction to section 355. Even without restructuring, Corporation X would be treated as engaged in the active conduct of a trade or business immediately after the spin-off because there would have been an ACTB in its separate affiliated group (which included Corporations N and O). See generally Robert Willens, Holding Companies and the Active Business Test, 113 Tax Notes 87, 88 (Sept. 11, 2006) (explaining how the change reduces the need for restructuring).


Note that the legislative history behind the change to section 355's ACTB requirement does not explain why this transitional election was included with the new law. Neither the transition rule nor the election was included in the bill when Representative Thomas introduced the bill on November 10, 2005, but both the transition rule and the election were included in the first amended version of the bill referred by the Ways and Means Committee to the entire House on November 17, 2005.

I.R.S. Notice 2006-81, 2006-2 C.B. 595 provided guidance regarding the procedure for making such an election.
be treated as tax-free under the old rules.\textsuperscript{77} In contrast, the transitional election would not be desirable if, for example, a transaction structured to qualify for nonrecognition under the old rules might fail to qualify under the new rules,\textsuperscript{78} or if the transaction was intended to be taxable under the old rules, but the transaction would qualify for tax-free treatment under the new rules.

Ultimately, section 355's transitional election gave taxpayers the power to turn a grandfathered effective date into a nominally prospective effective date.\textsuperscript{79} Like the election described above regarding the treatment of gains from the sale of a principal residence, the section 355 transitional election provides the best of all worlds to taxpayers who structured their transactions before the rule change — certain taxpayers who can only achieve their desired tax treatment under the old rules are protected and get to use the old rules even though the transaction is consummated after the adoption of the new rules, and taxpayers who would benefit from the application of the new rules can elect to have the new rules apply.

\textsuperscript{77} Consider a transaction that is described in a public announcement before the effective date. Under section 355's old ACTB rules, the parties may have anticipated significant corporate restructuring prior to the actual spin-off. However, Section 355's new ACTB rules may have eliminated the need for that restructuring. As a result, if the restructuring had been planned but had not occurred before the change in the law, the parties would likely want the new rules to apply to the transaction because the new rules would eliminate the need for the restructuring, thereby reducing the transaction costs. Thus, the parties would prefer to reject the grandfather protection.

\textsuperscript{78} This is likely to be rare, but it could occur if, for example, the distributing corporation owned 80% of the voting power and 80% of the number of the nonvoting shares, but not 80% of the value, of the subsidiary operating the active trade or business. In that case, the distributing corporation could use the subsidiary's ACTB to meet the ACTB requirement under the old rules, courtesy of the holding company rule. Under the new rules, however, the subsidiary would not be part of the distributing corporation's affiliated group, and thus the subsidiary's ACTB would not be treated as operated by the distributing affiliated group. See I.R.C. § 355(a)(1)(D)(ii) (using the section 368(c) definition of "control" rather than the section 1504 concept of control).

\textsuperscript{79} Transitional elections that enable taxpayers to accept or reject transition relief apply to a variety of different types of transition relief that Congress might offer. The transitional election in section 355 allows taxpayers to reject grandfathering. There are also transitional elections that allow taxpayers to reject the phasing in of new rules. See, e.g., Pension Protection Act of 2006, Pub. L. No. 109-280, sec. 102, § 303(h)(2)(G), 29 U.S.C. § 1083, 120 Stat. 780, 799 (phasing in section 430's increased funding requirements for single employer defined benefit plans, but allowing taxpayers to elect out of the phase-in, thereby making the full standards set by the new law effective immediately).
B. Electing Into or Out of Nominally Retroactive Application of a New Law

In addition to allowing taxpayers to elect whether to accept or reject post-enactment transition relief, Congress also sometimes allows taxpayers to elect whether to apply the new law retroactively to transactions occurring prior to the date of enactment of the new law. Like the transitional elections relating to post-enactment transition relief, the elections regarding retroactive application of a new law go in both directions, depending on the default rule. In some circumstances, like when Congress enacted section 197 (allowing for amortization of certain intangibles), Congress provides that the new law is generally applicable prospectively, but then gives taxpayers the ability to elect to apply the new law nominally retroactively. In other circumstances, like when Congress changed the law regarding the exclusion of gain on the sale of a principal residence, Congress provides that the new law generally applies nominally retroactively, but then gives taxpayers the ability to elect out of that retroactive application. These examples of transitional elections that enable taxpayers to opt in or out of nominally retroactive application of the new law will be discussed below.

1. Electing Retroactivity — Enacting Section 197 to Allow Amortization of Intangibles

In 1993, Congress enacted section 197 in response to the complexity and uncertainty surrounding the amortization of intangibles. Prior to the enactment of section 197, there was significant controversy about whether taxpayers could amortize the cost of intangible assets, in part, because taxpayers had difficulty ascertaining the value of the intangible asset as separate from goodwill (which was not amortizable), and accurately establishing the intangible asset’s useful life over which its cost could be amortized. In light of this uncertainty, taxpayers often incurred great expense in efforts to establish individual valuations and useful lives for intangibles, and the Service often contested taxpayers’ positions. The

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80 See supra note 53; supra Part III.A.2; see also infra Part IV.D (discussing default rules).
83 See Beil, supra note 82, at 736–37 (discussing the difficulty taxpayers experienced in establishing the useful lives and ascertainable values of intangibles); see also Tim Gray,
enactment of section 197 did not solve the valuation problem, but section 197 did establish a fixed fifteen-year period over which the cost of certain intangible property (including purchased goodwill) could be amortized ratably. This change provided much greater certainty, clarity, and administrability in an area that had been fraught with controversy.

Newly enacted section 197 generally applied to property acquired after the date of enactment, which was August 10, 1993. However, Congress provided taxpayers with the ability to elect to apply section 197 retroactively to intangible property acquired after July 25, 1991. The period for elective retroactivity covered the time period going back to July 25, 1991, the date on which House Ways and Means Committee Chairman Dan Rostenkowski introduced a bill that was substantially similar to the statutory provision that was adopted over two years later. The legislation took a long time to enact, but the retroactive transitional election allowed...

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84 See Beil, supra note 82, at 735–37 (discussing the controversies between taxpayers and the Service); Glenn F. Mackles, 15-Year Amortization of Purchased Intangible Assets — Some Winners, Some Losers, 79 J. Tax’n 332, 332 (1993) (explaining that the “Service vigorously contested taxpayers’ ability to depreciate or amortize the cost of intangible assets”).

85 See Mackles, supra note 84 (explaining that “appraisals are still necessary”).

86 I.R.C. § 197. Note that section 197 imposed many limitations on the amortization of intangibles, including the anti-churning rules of I.R.C. § 197(f)(9).

87 See Beil, supra note 82, at 735, 793.


89 Id. at sec. 13261(g)(2). Congress also provided a second election with respect to new section 197. This additional election provided that, although the new law was generally effective as of August 10, 1993, a taxpayer could elect to apply the old law to intangibles acquired after this date if, as of the date of enactment of the new law, the taxpayer had a binding contract to acquire the intangibles. Id. at sec. 13261(g)(3). This second election is very similar to the election that allowed a taxpayer selling his or her principal residence to elect into grandfather protection. See supra Part III.A.1.

90 H.R. 3035, 102d Cong. (1991); H.R. Res. 292, 102d Cong. (1991) (stating that it is the sense of the House that legislation allowing for the amortization of intangibles be electively retroactive for the period dating back to the introduction of H.R. 3035). There was debate about the period for which elective retroactivity would be provided. The Senate version of one bill would have allowed taxpayers to make an election for all open tax years, but commentators criticized that approach for rewarding aggressive taxpayers and causing too much revenue loss. See Herbert L. Camp, Retroactive Intangibles Rules Would be Windfall for Aggressive Taxpayers, Bar Association Says 1992 TNT 212-47 (Oct. 2, 1992).

91 See Beil, supra note 82, at 763–71 (discussing the path from Rostenkowski’s 1991 bill to the version of section 197 that was enacted in 1993).
taxpayers to benefit from the ultimate enactment of section 197 if they acquired intangible property between the time Rostenkowski’s bill was introduced and the final enactment of the section. Ultimately, the elective retroactive application of section 197 was less about an effort to help taxpayers who may have relied on the promise of intangibles legislation, and more about Congress’s desire to enable the resolution of “numerous pending controversies between taxpayers and the IRS over the [prior] treatment of acquired intangibles[,] thereby . . . clearing] away the substantial load of cases currently on the courts’ dockets.”

Since section 197 simplified the law regarding the amortization of intangibles and enabled taxpayers to amortize even purchased goodwill, many taxpayers may have wanted to elect nominally retroactive application of this new law. For instance, a taxpayer may have wanted to make the transitional election if there was uncertainty with respect to his or her ability to amortize the cost of an intangible asset acquired during the two year period prior to enactment of section 197. However, some taxpayers may have been disadvantaged by the retroactive application of the new law, if, for example, they acquired an intangible asset during the two year period and they could easily determine the asset’s value and accurately establish that the intangible asset’s useful life was shorter than fifteen years. Since nominally retroactive application of section 197 was elective, these taxpayers would not be disadvantaged as long as they did not make transitional elections. Ultimately, section 197’s transitional election gave taxpayers the power to choose nominally retroactive application of an otherwise nominally prospective new law.

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92 Camp, supra note 88 (reprinting a letter to Rep. Dan Rostenkowski and Sen. Lloyd Bentsen from the Committee on Taxation of Corporations of the Association of the Bar of the City of New York, in which the Committee observes that “the pressure to provide for retroactive application of the proposed amortization legislation [was] fueled in part” by the need to resolve controversies and clear dockets). Of course, the elective retroactivity of section 197 could have been more narrowly tailored and provided only in the cases where taxpayers had existing controversies about amortization of intangibles. Importantly, however, that would have rewarded aggressive taxpayers (i.e., the ones who took aggressive positions and were engaged in controversy as a result) while denying the benefit of new section 197 to those taxpayers who had taken more conservative positions (e.g., who just added the cost of an intangible asset acquisition to basis and did not try to amortize the intangible, and thus who did not have any existing controversies with the Service).

93 Of course, this election only allowed retroactive application of section 197 for a little over two years. Section 197 did not help taxpayers with respect to intangibles acquired on or before July 25, 1991.
2. Rejecting Retroactivity — Amending the Tax Treatment of Gains from Sales of Principal Residences

Congress also afforded taxpayers the ability to choose between nominally retroactive and nominally prospective application of the new law regarding the tax treatment of gains from the sale of a principal residence. This retroactive transitional election is in addition to the election described above that allowed a taxpayer who sold a principal residence after the date of enactment of the new law to choose whether he or she wants to be treated under a grandfather provision. 94

Congress generally provided that the new law applied to all sales or exchanges of principal residences after May 6, 1997. 95 Thus, the generally applicable effective date for the new law was three months prior to the August 5, 1997, date of enactment of the new law. However, Congress allowed taxpayers to elect to avoid this nominally retroactive application of the law. 96 To do so, a taxpayer had to make an election indicating that the taxpayer did not want the new law to apply to any sale or exchange of a principal residence before the date of enactment of the new law. For any taxpayer who sold a principal residence during the three months preceding the date of enactment of the new law, the transitional election may be desirable or undesirable depending on whether the old law or the new law would treat the sale more favorably. 97 Like with the transitional election

94 See supra Part III.A.1 (discussing the other transitional election afforded in connection with this change in the law); see also supra notes 52, 61 (distinguishing the two different transitional elections).

95 Taxpayer Relief Act of 1997, Pub. L. No. 105-34, sec. 312(d)(1), § 121, 111 Stat. 788, 841. I have been unable to find a clear explanation about why May 6, 1997, was chosen as the generally applicable effective date for this new law. Note that (i) this May 6, 1997, effective date for the new law is slightly after the April 17, 1997, introduction of H.R. 1391, 105th Cong. (1997), which proposed a substantially similar change to the law, and (ii) that, on May 7, 1997, four representatives introduced a resolution expressing the sense of the Congress that any exclusion from taxation of capital gains on the sale of a primary residence enacted during the 105th Congress should be retroactive back to January 1, 1997. H.R. Con. Res. 76, 105th Cong. (1997).

96 Taxpayer Relief Act, supra note 93, at § 312(d)(2).

97 The old law may be desirable if, for example, a taxpayer realized more than $250,000 (or $500,000 in the case of married taxpayers filing jointly) on the gain of the principal residence between May 6 and August 5, and the taxpayer already purchased a replacement residence at a cost equal to or greater than the sale price of the original residence. In that situation, the entire amount of gain would be excluded from income under the old law, but the income exclusion would be capped under the new law. Thus, a rational taxpayer would want the benefit of the old law and might choose to make the election to avoid nominally retroactive application of the new law. In contrast, the new law may be desirable if the taxpayer is over fifty-five years old and did not purchase a replacement
available in connection with the enactment of section 197, this transitional
election allowed taxpayers to choose whether or not to apply a new law
nominally retroactively. Thus, some taxpayers benefited\(^9\) from the change
in law even for transactions that occurred prior to the enactment of the new
law, and at the same time, other taxpayers who acted before the change in
the law were taxed under the old law.

IV. EVALUATING THE ROLE OF ELECTIONS IN TRANSITION POLICY

With an understanding of how transitional elections are commonly
used in the Code, the role of elections in tax transition policy can be
evaluated. Specifically, this Part will analyze transitional elections in light
of the different theories about transition policy, reflecting on the role of
taxpayer expectations and on the public choice criticisms of the legislative
process. This Part will also discuss how the availability of individual choice
may function in the context of tax transitions and consider the impact of
transitional elections on issues of revenue, complexity, and tax
administration. Ultimately, this Part concludes that, while there are some
compelling arguments against the use of transitional elections, transitional
elections may be useful on a case-by-case basis, particularly in order to
enable legislative compromise about how to shift from an old law to a new
law and in order to provide the Service with valuable information about
taxpayer preferences.

A. Transitional Elections and Taxpayer Expectations about Changes
in the Law

As discussed in Part II, arguments about transition policy often depend
heavily on taxpayers' expectations about changes in the law and on how the
law should treat those expectations. Scholars who are persuaded that
taxpayers have a legitimate interest in relying on the existing law because of
concerns about the value of certainty in the law,\(^9\) the inequity of imposing
unanticipated losses (e.g., unexpected increases in tax liabilities or
decreases in asset values) on taxpayers,\(^10\) or otherwise, generally argue
against retroactive tax changes and for transition relief. On the other hand,
those who conclude that taxpayer reliance on existing law is unwarranted
because taxpayers should anticipate that policies may change,\(^10\) or who

\(^9\) See supra note 65.
\(^9\) See, e.g., Comm. on Tax Policy, supra note 6, at 21–22.
\(^10\) See, e.g., BLUEPRINTS, supra note 2, at 185; Note, supra note 6, at 439.
\(^10\) See, e.g., Graetz, Retroactivity, supra note 29, at 1823–24; Munzer, supra note 31, at
conclude that protecting taxpayers' reliance on existing law is undesirable because it impedes the adoption of socially valuable policy changes, generally argue against transition relief and sometimes in favor of retroactivity.

While most transition relief provisions only reflect one of these approaches and not both, transitional elections can reconcile the two views by reflecting both approaches simultaneously. With a transitional election that enables taxpayers to decide whether the old or the new law applies to them for some period after the date of enactment of the new law, or even retroactively for some period before the date of its enactment, the transitional election allows those who may have relied on the old law to choose to be subject to the old law. This may protect their reliance interest. At the same time, other taxpayers can choose to have the new law apply to them without delay, and possibly even retroactively; this accelerates the implementation of the new law and rewards those who anticipated the change.

For example, consider a taxpayer who sold a home within three months prior to the date of enactment of the new law regarding gains from the sale.


103 For example, a delayed effective date enables all taxpayers to rely, at least for some period, on the pre-existing rules. While this may help protect reliance interests to some degree, the delayed effective date reduces (or denies) the benefits received by any taxpayers who anticipated a socially useful change in the law. A narrowly drawn grandfather provision is the non-elective transition relief that comes closest to being able to protect both reliance and anticipation. If the grandfather provision applies only to those situations where taxpayers have clearly evidenced action in reliance on the old rules (for example, the binding contract or public announcement requirements for grandfathering in the change to section 355's ACTB requirement), then the transition provision, even without the election, protects the reliance interest of those who have taken actions that demonstrate reliance. All other taxpayers are treated under the new rule, since they are presumed not to have relied enough to justify protecting any such reliance. Nevertheless, a narrowly drawn grandfather provision delays the application of socially valuable policy changes to taxpayers who may have taken certain actions before the enactment of the new law. That said, adding an election to a narrowly drawn grandfather provision may actually undermine the “reliance” explanation for transition relief because the election would allow taxpayers whose actions evidenced reliance on the old rules to benefit from the new rules, despite taxpayers' original expectations.

104 Of course, as discussed later in this Part, this likely means that all taxpayers eligible for the transitional election win at the expense of the fisc. However, to the extent that there is a good reason to protect reliance despite a desire to accelerate the implementation of a new rule, perhaps allowing affected taxpayers to choose the rule applicable to them is an acceptable result.
of a principal residence. 105 If the taxpayer acted in reliance on the rule that allowed for the deferral of all of the gain as long as a replacement home of equal value was purchased, the taxpayer’s reliance interest could be protected through an election to have the old law apply to that transaction. If the taxpayer acted in anticipation of the enactment of the new law while Congress was considering the legislation, the taxpayer can opt to have the new law apply to the transaction by declining to make the transitional election. This rewards anticipation of the change in law. Even if the taxpayer did not anticipate the change in the law, the implementation of a presumably socially valuable law change 106 will be accelerated as long as the taxpayer does not elect the transition relief.

Moreover, the ability of taxpayers to elect retroactive application of a new law defeats a major argument against nominally retroactive taxation — that laws that change the legal consequences of pre-enactment actions unfairly upset taxpayer expectations with respect to the consequences of such actions. 107 Where the taxpayer is the person who chooses to apply the new law to his or her pre-enactment actions, application of the new law to the prior actions is unlikely to disadvantage the taxpayer, and to the extent the taxpayer is disadvantaged, the disadvantage is not caused against the taxpayer’s will. 108 Similarly, the Treasury can issue regulations with retroactive effect only in certain circumstances, 109 one of which is where the regulation applies retroactively at the taxpayer’s election. 110 This use of transitional elections helps to ensure that taxpayers are not adversely affected if they took reasonable actions based on the existing statute before the issuance of the temporary or final regulations; 111 at the same time, using

105 See supra Parts III.A.1, III.B.2.

106 People may disagree about whether this change was good or bad. However, the point here is not to endorse section 121’s treatment of gain from the sale of a principal residence. Rather, the point is merely that the election enables the change in tax law to be accelerated at the taxpayer’s option. That is desirable if the change in the law is socially valuable, although not all changes are.

107 Comm. on Tax Policy, supra note 6, at 23–28.

108 This is a stronger argument where the default rule is nominally prospective application of the new law and where the election allows optional retroactivity. The argument is weaker if the default rule is nominal retroactivity, and taxpayers have to make an affirmative election to avoid this retroactivity. In the latter situation, there is a greater risk that some taxpayers, particularly less sophisticated taxpayers, will be adversely affected without affirmatively choosing such treatment.

109 I.R.C. § 7805(b).

110 Id. § 7805(b)(7).

111 There is often a significant time delay between the enactment of a new statutory provision and the issuance of regulations thereunder. Note that proposed regulations present a slightly different situation. Specifically, proposed regulations have limited precedential
a transitional election to allow retroactive application of a treasury regulation enables taxpayers, at their option, to benefit from the guidance provided by the regulations.\textsuperscript{112}

Despite these possible benefits, transitional elections can also undermine taxpayer expectations in a manner that produces windfalls for taxpayers at the expense of the fisc. For example, transitional elections can create windfall gains by allowing a taxpayer to choose to apply the new law to a post-enactment transaction even if the taxpayer actually relied on the old law when planning the transaction. These gains are most problematic if the change in law is not socially valuable,\textsuperscript{113} in which case, the real problem is with the change in the law and not the availability of a transitional election.

Windfall gains can also arise when a taxpayer who did not rely on the old law when planning a transaction elects to have the old law apply to a post-enactment transaction merely because the old law produces a better tax result than the new law. However, the risk of conferring this type of transition gain on taxpayers who took action prior to the enactment of a new law exists whether the transition relief is elective or mandatory.\textsuperscript{114} The risk that a transitional election will create this type of post-enactment windfall can be mitigated either (1) by narrowly defining the taxpayers or transactions that are entitled to elect grandfather protection, as in the transitional elections used in the change to section 355's ACTB authority. Accordingly, while they provide guidance to taxpayers about how the Service might ultimately resolve a particular issue, taxpayers are not obliged to follow proposed regulations. This makes proposed regulations effectively, although not explicitly, elective while the tax rule remains in flux. In part, this is because proposed regulations, by their very nature, mean that the Service has not yet decided how to handle a particular situation, so taxpayers have some flexibility. That is different from the explicit elections discussed in this paper, where the Service has decided how to handle a particular situation, and that decision entails, at least in part, letting the affected taxpayers make their own choice.

\textsuperscript{112} Typically, the period of elective retroactivity of treasury regulations dates back to around the time when the relevant Code section was enacted or revised. See, e.g., Temp. Treas. Reg. § 1.355-2T(i)(1), (i)(3) (2009) (providing that the "hot stock" regulations apply to corporate divisions after the date of the regulations, but allowing taxpayers to retroactively elect to apply these regulations to transactions occurring back to the date on which the relevant statutory provision was changed).

\textsuperscript{113} This might suggest that the provision of transitional elections should depend on the quality of the new law. However, it may be difficult to determine whether a change in the law is good or bad, in which case it may be problematic to tie transition policy to the quality of the law change. See Shaviro, supra note 2, at 47–48, 86–88, 98–101.

\textsuperscript{114} See Blueprints, supra note 2, at 189; Graetz, Legal Transitions, supra note 3, at 87. Whether relief is elective or mandatory does not affect the availability of the windfall because a rational taxpayer will opt to receive any available windfall by exercising the transitional election in a way that best reduces the taxpayer's tax burden.
requirement or in the change to the treatment of gains on sale of a principal residence, or (2) by using a phased-in effective date or a delayed effective date (rather than a grandfather rule at all) as the transition relief that may be elected.115

Additionally, transitional elections can create gains when taxpayers are given the ability to choose whether to apply the new law retroactively; windfall gains arise in this context because taxpayers may get the benefit of a new policy even if they did not anticipate the change in the law. This concern may be most obvious in the context of incentive subsidies.116 For example, if an incentive subsidy is applied retroactively, it will serve to reward those taxpayers who correctly anticipated a socially valuable change in the law, but other taxpayers, who would have undertaken the incentivized action without the subsidy, just get a windfall.117 This is a problem with retroactive tax legislation regardless of whether retroactivity is elective because neither mandatory nominal retroactivity nor elective nominal retroactivity can effectively distinguish between these different types of taxpayers.118 Moreover, if the change in the law is not socially valuable, then elective retroactivity exacerbates the negative consequences of the change.119

Further, even though a taxpayer who chooses to apply the law retroactively may not be disadvantaged against the taxpayer’s will, other taxpayers may be harmed. Taxpayers who have the option to apply the law retroactively but choose not to (for simplicity reasons, due to lack of knowledge about the ability to make the retroactive election, or otherwise) may end up paying more tax than similarly situated taxpayers who did choose retroactive application of the new law.120 Additionally, the ability of

115 Commentators have argued that phased-in effective dates and delayed effective dates are much less likely to create windfall gains than are grandfather provisions. See BLUEPRINTS, supra note 2, at 189–91; Graetz, Legal Transitions, supra note 3, at 87.
116 See Logue, supra note 34, at 1133.
117 Alternatively, this “windfall” could be viewed as a reward for having undertaken “good” behavior. However, efficient incentive subsidies should use the smallest “incentive” that will effectively bring about the desired level of the desired behavior, so it seems unnecessary and inefficient to provide such a reward to taxpayers that would have undertaken the desired behavior without the subsidy.
118 Nevertheless, when retroactivity is elective, taxpayers will generally only opt for retroactive application of the new law if it is taxpayer favorable. In contrast, if retroactivity is mandatory, then the new law will apply retroactively to all taxpayers whether or not it is taxpayer favorable.
119 Note that I do not believe that, when changing the law, Congress endeavors to make the law worse. Rather, I just acknowledge that some law changes may not be beneficial. Cf. shaviro, supra note 2, at 45–47, 86–88, 99–100.
120 For a discussion of the harm to the fisc, and thus to the taxpayers who are not
taxpayers to choose to apply the law retroactively may generate as much of a sense of unpredictability in, and unfairness of, the tax system as congressionally mandated nominal retroactivity of a new law.\textsuperscript{121}

Nevertheless, for those situations where nominal retroactivity may be desirable,\textsuperscript{122} making retroactivity elective may enable Congress to allow for a longer period of retroactivity than Congress may have been able or willing to mandate. For example, the more than two year period of elective retroactivity for section 197 is quite long given that Congress generally does not enact legislation that is effective earlier than January 1 of the year of enactment.\textsuperscript{123} At the same time, making retroactivity elective rather than mandatory may minimize the potential harm to those taxpayers whose prior actions were undertaken in reliance on prior law.

Despite the risks that transitional elections can create windfall gains to taxpayers and despite the corresponding adverse impact on the fisc,\textsuperscript{124} the ability of transitional elections to simultaneously protect reliance interests and allow for the acceleration of the implementation of, and reward anticipation of, socially valuable changes in the law means that transitional elections may help enable compromises in certain lawmaking situations. This compromise approach may have some value, particularly where legislators have difficulty balancing the merits of allowing policy changes to have retroactive effect and rapid implementation, on one hand, against the merits of protecting reliance interests and avoiding nominal retroactivity in the law, on the other.\textsuperscript{125}

\footnotesize{eligible for the transitional election, see infra Part IV.D.}

\textsuperscript{121} See id. All explicit elections, not just transitional elections, raise fairness concerns about treating similarly situated taxpayers differently because electivity “allows persons undertaking the same activity to obtain different tax results,” among other reasons. \textit{STAFF OF JOINT COMMITTEE ON TAXATION, 110th CONG., A RECONSIDERATION OF TAX EXPENDITURE ANALYSIS 65 n.149} (Joint Comm. Print 2008). \textit{See generally Field, supra note 12, at 31–32} (discussing fairness as a problem presented by the use of explicit elections).

\textsuperscript{122} See, e.g., Levmore, \textit{Retroactive Taxation, supra note 6, at 273–78} (discussing when and why retroactivity may be appropriate).

\textsuperscript{123} See SHAVIRO, supra note 2, at 105. Of course, whether the effective date of a new law is the date of enactment, January 1 of the year of enactment, or some other specific date, a line is still drawn between taxpayers who are or may be subject to the new rule and taxpayers who are not. \textit{See infra Part IV.C} (discussing the line-drawing issue).

\textsuperscript{124} \textit{See infra} Part IV.D (discussing the likely revenue impact of transitional elections).

\textsuperscript{125} Cf. SHAVIRO, supra note 2, at 110–11 (identifying the possible conflict between the norm of “allow[ing] the imposition of policy change retroactive taxes” and the norm of “prevent[ing] the imposition of nominally retroactive taxes”, and concluding that the antinominal retroactivity norm should prevail).
B. Transitional Elections, the Legislative Process, and Public Choice

The ability to use transitional elections to compromise on transition policy may also be useful in light of the imperfect process through which legislation is made.\textsuperscript{126} The literature on the legislative process and public choice explains that "concentrated interest groups often benefit at the expense of more widely scattered groups, even if the diffuse group has much more at stake overall."\textsuperscript{127} These concentrated interest groups can employ lobbyists to try to influence tax (and other) legislation,\textsuperscript{128} and legislators can extract rents from these interest groups in various forms, including campaign contributions.\textsuperscript{129} The impact of interest group politics is not limited to the substantive tax legislation itself; public choice problems can arise in the transition context as well.\textsuperscript{130} For example, interest groups may lobby for generous transition relief in order to protect the members of the group from the application of a disadvantageous new law, and interest groups may advocate for retroactive application of a taxpayer-favorable new law so that members of the group may benefit from the new law even for transactions that occurred before enactment.\textsuperscript{131} While these small, concentrated groups of vocal constituents may press for a particular transition policy, there may be larger, diffuse groups who may prefer a different approach to the transition, but who cannot effectively lobby for their preferred approach due to problems of aggregation,

\textsuperscript{126} See, e.g., id. at 64–66 (describing some of the problems in the legislative process); Ramseyer & Nakazato, supra note 32, at 1171–73 (discussing lobbying by special interests and rent extraction by legislators).


\textsuperscript{129} See Ramseyer & Nakazato, supra note 32, at 1171–73.

\textsuperscript{130} See id.; see also Shaviro, supra note 2, at 73–81; Levmore, supra note 6, at 279–88 (discussing "interest groups as opponents of retrotaxation").

\textsuperscript{131} See generally Shaviro, supra note 2, at 73–81 (detailing the political choice problems posed by transition policy).
organization, or information.\textsuperscript{132} A non-elective policy of transition relief or retroactivity may favor the former constituents at the expense of the latter,\textsuperscript{133} or vice versa. In contrast, an elective transition provision may strike a compromise that acknowledges that different groups of taxpayers may have different preferences regarding transition policy, even if some groups are unable to communicate their preferences to their legislators effectively.

By providing taxpayers with the ability to elect whether or not to accept transition relief or apply a new law retroactively, the choice about how to handle the transition is disaggregated. Each individual taxpayer with sufficient information can make an independent choice about his or her desired approach to the transition;\textsuperscript{134} each taxpayer can achieve his or her preferred transition treatment without the power or expense of an organized lobbying group. As a result, the silent, unorganized group of taxpayers would not be subjected to the transition policy desired by only the special interests. Thus, a transitional election can provide an opportunity to reach a legislative compromise when legislators who believe that one approach to the transition is likely more appropriate from a pure policy perspective have difficulty resisting the political pressure to take a different approach to the transition.\textsuperscript{135} Lobbying and involvement of interest groups in the legislative

\textsuperscript{132} See id. at 66–73. The point here is to acknowledge the possibility of a divergence between the preferences of vocal constituents and quiet constituents. Of course, the preferences of a majority of taxpayers may align with the preferences expressed by the vocal few. As a result, we should not assume that the quiet want something different than the vocal, but we should be sensitive to the possibility.

\textsuperscript{133} One need not assume any improper intentions by the legislators in order for this to be a plausible outcome. This is, in part, because legislators may lack information about the transition preferences of the silent, diffuse group.

\textsuperscript{134} Unfortunately, as is the case with many other explicit elections, taxpayers may lack sufficient information to make tax-minimizing decisions about how to exercise a transitional election. In the absence of sufficient information for taxpayers, allowing private choice in transitions may be more harmful than helpful, particularly with respect to less knowledgeable, less sophisticated taxpayers. Thus, it may be unwise to use transitional elections where taxpayers are unlikely to be able to make educated decisions about how to exercise the election. At the very least, transitional elections should generally employ default rules that meet the expectations or preferences that a majority of taxpayers would have if the taxpayers had sufficient information (assuming those expectations or preferences can be determined by legislators). See infra Part IV.D (discussing how default rules can be designed to minimize the risk that transitional elections will adversely affect unsophisticated taxpayers).

\textsuperscript{135} Consider, for example, a legislator who believes that the new law reflects better policy and who wants to implement it right away, but who is sympathetic to pleas for protection for actions taken in reasonable reliance on pre-existing law. Similar compromises might be struck when some group of legislators wants to implement a new policy right away,
process is part of our current political reality; consequently, absent an expectation that legislators will resist these pressures, a transitional election compromise may be a plausible way for legislators to protect the transition interests of the quiet, diffuse group of taxpayers.

There is a risk that increased use of transitional elections would just encourage more extensive lobbying by competing interest groups who desire different approaches to the transition, thereby exacerbating legislators' abilities to extract rents from interested parties. In particular, if members of the more diffuse group realize that there is a compromise option to transition policy, where they could obtain something valuable merely by making a case to their legislators, without the need to outdo the small, powerful group (which they would be unable to do), the members of the more diffuse group might participate in lobbying efforts that might have previously been futile. Nevertheless, allowing affected taxpayers to determine whether a new or old law will apply to them during a transitional period could provide a mechanism for legislators to protect silent, diffuse groups despite the power of interest groups involved in transition policy. As a result, in certain situations, transitional elections may help limit the impact of the public choice problem by turning a transition policy decision into a private choice for each affected taxpayer.

C. The Role of Individual Choices in Transitions

The provision of this type of individual choice through transitional elections\(^{136}\) may reveal information about taxpayers and enhance neutrality, thereby conferring policy benefits independent of the arguments about transition policy and public choice. For example, to the extent that the Service can track information about the exercise of transitional elections,\(^{137}\)

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\(^{136}\) Transitional elections are only a subset of the many situations in which the tax law enables taxpayers to make individual choices about how the tax law will apply to them. Some of these individual choices, like transitional elections, are explicit tax elections, pursuant to which taxpayers can check a box or file a form to tell the Service how they would like to be treated for tax purposes. Such explicit tax choices are distinguished from implicit tax choices, pursuant to which "the taxpayer arranges his economic and/or legal affairs so as to qualify for his desired tax treatment." Field, supra note 12, at 22.

\(^{137}\) In order for transitional elections to produce this kind of information for policymakers, the Service must be able to identify how many taxpayers make a particular transitional election and how many do not. The Service keeps data on many elections made by taxpayers. See, e.g., Heather M. Field, Checking In on "Check-the-Box", 42 Loy. L.A. L. Rev. 451, app. at 525–27 (2009) (utilizing data obtained from the Service's Statistics on
the information revealed by taxpayers' choices may prove useful to legislators in understanding taxpayer reactions to the new law and in appreciating if and how the preferences of a broad spectrum of taxpayers differ from the preferences of vocal interest groups. That information may be relevant when legislators make future decisions about analogous transition issues.

Further, the Service may be able tailor its enforcement efforts based upon information gleaned from the transitional elections made by taxpayers. For example, consider the election that allowed taxpayers to apply section 197 retroactively to intangibles acquired during the two plus years preceding enactment. By making the election, taxpayers effectively agreed to a fifteen-year amortization period for the relevant intangibles. Taxpayers who amortized intangibles acquired between July 25, 1991 and August 10, 1993, but who did not make the election, likely claimed shorter amortization periods for their intangibles. The transitional election may have enabled the Service to direct more enforcement efforts towards the non-electing taxpayers and focus efforts to dispute ascertainable useful lives of intangibles on the assets owned by this smaller, self-identified group of taxpayers.

In addition to the valuable information revealed when taxpayers exercise elections, the provision of a transitional election may confer neutrality benefits by reducing the influence that the change in the tax law exerts on taxpayers' business decisions. Without the transitional election, there is a temporal discontinuity between the old and new laws, that is, a

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139 See Alex Raskolnikov, Revealing Choices: Using Taxpayer Choices to Target Tax Enforcement, 109 Colum. L. Rev. 689, 689, 707-10 (2009) (proposing that taxpayers be able to elect between two different enforcement regimes and discussing the Service's ability to target its enforcement efforts based on the choices made by taxpayers).

140 See supra Part III.B.1.

141 I.R.C. § 197(a).

142 Field, supra note 12, at 36-37 (explaining that explicit elections that resolve discontinuities in the tax law can make the law more neutral).

143 See id. at 35 (arguing that "reconciling discontinuous regimes" is one major potentially useful function of explicit elections in the tax law). The discontinuity here is temporal; any change in the tax law creates this type of discontinuity because a law change
small change in the date on which a transaction is undertaken can result in a large change in the tax treatment of the transaction because of the effective date of the new law. A transitional election may be able to mitigate this result more effectively than mandatory transition relief. Of course, transition relief itself is intended to ease the impact of a change in law, even without an election. However, even where Congress provides transition relief via a grandfather provision, phased-in effective date or delayed effective date, the transition policy still creates a bright line between the period governed by the old law and the period governed by the new law. Similarly, since Congress rarely makes legislation nominally retroactive, there is commonly a bright line separating the periods before and after the enactment of a new law.

As a result of these bright lines, taxpayers may have an incentive to accelerate or delay a transaction solely for tax reasons. Allowing each taxpayer to make an individual choice about whether the old or new law applies during a transitional period may reduce this incentive and may increase the taxpayer’s ability to undertake transactions on the timeframe that is optimal for the taxpayer’s non-tax business purposes. Note that any limitations on the availability of the transitional election (e.g., which taxpayers can make the election, how long the election is available, etc.) themselves create other (and possibly a greater number of) bright lines, each of which may create a discontinuity in the application of the law. However, the availability of an election spreads out the bright lines, thereby deemphasizing the importance of the single moment in time when the law would otherwise change. This gives taxpayers more flexibility to arrange their affairs in the way that is optimal for business purposes, and thus, the election may reduce the overall magnitude of the inefficiencies and inequities created by the discontinuities. As a result, using a transitional election rather than a congressionally mandated transition rule might lessen the extent to which a law change distorts taxpayers’ actions around the time of the change in the law.

gives rise to two different tax regimes — one applicable before the effective date of the change, and one applicable after the effective date of the change.


145 Even when the law is nominally retroactive, there is still a bright line, but the bright line occurs before the date of enactment of the new law.

146 See JOEL SMEEROD & JON BAKIJA, TAXING OURSELVES: A CITIZEN’S GUIDE TO THE DEBATE OVER TAXES 131 (4th ed. 2008) (“A major goal of tax reform is to make our tax system more “neutral” so that it exerts less unwanted influence on our economic choices.”).
D. The Impact of Transitional Elections on Revenue, Complexity, and Administrability Issues

Despite the potential benefits of using transitional elections, an elective approach to transitions in the tax law suffers from potentially serious problems. In addition to the above-discussed concerns, transitional elections are clearly revenue-reducing.\textsuperscript{147} Any transition relief is costly, even without an election.\textsuperscript{148} The addition of an election to a transition provision likely exacerbates the revenue effect of the transition policy. This is because, with the addition of an election, a rational taxpayer will exercise a transitional election in a way that most effectively reduces his or her tax burden.\textsuperscript{149} Since both the taxpayers who benefit from the transition relief and the taxpayers who benefit from the accelerated adoption of the new rule will be able to reduce their tax burdens, the availability of the election likely reduces revenue even more than non-elective transition relief.

Moreover, transitional elections can be quite complex. Changing the tax law creates complexity itself because taxpayers must understand the new law and must be able to determine whether the old or new law applies to them. Adding a transitional election compounds this complexity because, in order to exercise the transitional election in a way that minimizes taxation, taxpayers have to understand how both the old and new laws would apply to them and determine which law produces the better result. This may not be particularly problematic because taxpayers will often compare the application of the old law with the application of the new law even in the absence of a transitional election.\textsuperscript{150} However, unsophisticated taxpayers may lack meaningful choice if they are unaware of the election or unable to effectively evaluate how the law change affects them. Further, transitional elections can be complex even for sophisticated taxpayers because many transitional elections are enacted off-code;\textsuperscript{151} the transitional

\textsuperscript{147} See Field, supra note 12, at 30 (explaining why it is “virtually axiomatic” to say that elections are revenue reducing).

\textsuperscript{148} Commentators have devoted significant amounts of time to comparing the relative costs of different methods of transition relief. See, e.g., Graetz, Legal Transitions, supra note 3, at 57–63 (comparing the costs of different methods of transition relief).

\textsuperscript{149} See supra Part III (giving examples of how taxpayers may want to elect to apply an old rule rather than a new rule, or vice versa, in order to better reduce their tax burdens).

\textsuperscript{150} For example, if a new law is adopted with a delayed effective date, the taxpayer may want to compare how a planned transaction will be taxed under the old law and under the new law. Depending on which result is preferable, the taxpayer may decide to accelerate or delay the transaction in order to achieve the taxpayer’s desired tax result.

\textsuperscript{151} See, e.g., supra note 74 (off-code transitional election for the change to section 355’s ACTB requirement); supra notes 62, 95 (off-code transitional elections for the change to the tax treatment of gain from the sale of a principal residence).
election is in the public law enacting the change, but the transitional election is not actually codified in the Code. This increases the difficulty of determining whether a transitional election may be available and, if so, how it might apply. Additionally, the enactment of off-code transitional elections reduces the transparency of the law, which can adversely impact the perception of fairness in the law.

Further, transitional elections enacted by Congress rarely articulate how a taxpayer can make the election. The technical details for making the election generally must be explained in regulations or other administrative pronouncements. While this is commonly the case with explicit tax elections, the time lag between the enactment of a transitional election and the issuance of guidance regarding how to make that election may be particularly problematic in the context of legal transitions because transitional elections are often relevant only for a short window of time. Absent guidance about how to make a transitional election, a taxpayer may be unable to make the election, or a taxpayer may try to delay the decision about whether to make the transitional election until guidance is published, which could keep returns open for a long period of time and hamper the administration of the tax laws.

Some, but not all, of these concerns about complexity and administrability can be mitigated by carefully designing the transitional election. For example, each transitional election should provide a default rule that articulates how a taxpayer who does not make an election will be treated. Default rules are the difference between the election to reject

153 For example, none of the statutes providing for the transitional elections described in Part III explained how to make the relevant elections.
154 See, e.g., I.R.S. Notice 2006-81, 2006-2 C.B. 595 (explaining how to make the transitional election with respect to the change to section 355’s ACTB requirement).
155 See generally Field, supra note 12, at 28, 70–71 (discussing this as a common problem with explicit elections in general).
156 See LANG & KHOURY, supra note 15, at ¶ 1.03[4]. On the other hand, elections can be used to enhance administrability by reducing the risk that a taxpayer will take inconsistent positions and whipsaw the government. For example, if a taxpayer elects into grandfather protection with respect to the amortization of intangible assets acquired after August 10, 1993, that election applies to “all property acquired pursuant to the [binding] contract with respect to which such election was made.” Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, sec. 13261(g)(3), § 197, 107 Stat. 312, 540; see also supra note 89 (describing this election). That is, by making the transition election, the taxpayer agrees not to take inconsistent approaches to amortizing intangibles acquired pursuant to the binding contract.
transition relief (like for the change to section 355's ACTB requirement) and the election to accept post-enactment transition relief (like for the change to the rules regarding gain on the sale of a principal residence). Similarly, the difference between electing into retroactivity, as in section 197, and electing out of retroactivity, as in the pre-enactment election for the change to the rules regarding gain on sale of a principal residence, is merely an issue of the default rules. While the choice of default rule does not change the substance of the tax treatments available to the taxpayer, the default rule can have a significant impact on how the election operates. For instance, the number of elections that need to be filed can be reduced, and the potential harm to taxpayers who lack the knowledge or sophistication to make an election can be minimized, by adopting transitional election default rules that correspond to the expectations and preferences of a majority of affected taxpayers, assuming that those expectations and preferences can be determined.

Additionally, transitional elections can be simplified by drawing clear and narrow boundaries defining those situations in which the transition decision is ceded to the taxpayer. Eligibility requirements for the transitional election should be carefully defined to accomplish the objective behind the provision of the election. For example, if the goal of a transitional election is to protect taxpayers who may have relied on an old rule, then only taxpayers whose actions clearly evidence reliance on those old rules should be eligible to make the election. The elective grandfather provisions discussed herein do just that; they limit the post-enactment election to those taxpayers who took specific actions that reflect reliance on the old rules, like publicly announcing a corporate division or buying a replacement principal residence. Additionally, limiting the time period for which the election may be made can help to simplify the administration of the election. For instance, for retroactive transitional elections, there may be a desire to extend the period of elective retroactivity back over a period of years. The desire for retroactivity should be balanced, however, with

\[\text{\textsuperscript{157}}\text{See supra Part III.A.}\]
\[\text{\textsuperscript{158}}\text{See supra Part III.B.}\]
\[\text{\textsuperscript{159}}\text{See Field, supra note 12, at 66–69 (discussing the choice of default rules for explicit elections).}\]
\[\text{\textsuperscript{160}}\text{As the discussion regarding public choice and the legislative process demonstrates, it can sometimes be difficult to ascertain the preferences of a majority of affected taxpayers. See supra Part IV.B.}\]
\[\text{\textsuperscript{161}}\text{See Field, supra note 12, at 69–70 (discussing the choice of eligibility limitations for explicit elections).}\]
\[\text{\textsuperscript{162}}\text{See supra Part III.A.}\]
\[\text{\textsuperscript{163}}\text{See supra notes 122–123 and accompanying text.}\]
the complexity that may arise if the election causes taxpayers to go back and amend tax returns from several past years.

While the revenue, complexity, and administrability concerns about transitional elections can be mitigated through the design of the parameters of the election, these issues may be compelling reasons to be wary of the use of transitional elections. Accordingly, transitional elections should only be used in limited circumstances.

V. CONCLUSION

The purpose of this paper is neither to advocate for a consistent policy of using transitional elections for every change in the tax law nor to argue for a significant increase in the use of transitional elections. Rather, this paper merely seeks to draw attention to the phenomenon of explicitly-granted taxpayer choice in legal transitions, to explain when and why such choice may be granted in the tax law, and to suggest that transitional elections may be useful in selected situations on a case-by-case basis.

Although some scholars support a case-by-case approach to tax transitions, others advocate for the adoption of a transition policy that would be generally applicable to most changes in the tax law. Even the latter acknowledge, however, that occasional deviations from a widely accepted transition policy might be appropriate in certain situations. As a result, transitional elections may be relevant even if a relatively uniform tax transition policy is adopted. Moreover, since Congress has yet to adopt a widely applicable approach to tax transition issues, the current approach to tax changes generally appears to be a case-by-case method. Absent a precommitment to a uniform tax transition policy and given our political

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164 See, e.g., Levmore, supra note 44, at 1684 (suggesting that it may be useful to retain some flexibility in the manner and extent to which transition losses are compensated).

165 See, e.g., Shaviro, supra note 2, at 98–110 (articulating norms for tax law transitions); Kaplow, Economic Analysis, supra note 5, at 560; Ramseyer & Nakazato, supra note 32, at 1157–59, 1174 (advocating a policy of precommitment to transition relief in order to reduce the costs of lobbying and the opportunities for rent extraction); Logue, supra note 34, at 1131–32, 1138-39 (advocating precommitment to transition relief in order to reduce the total cost of incentive subsidies); cf. Doran, supra note 4, at 597 (expressing "agnosticism about whether the better approach would be a defined tax transition policy or a case-by-case resolution of transition issues as they arise in connection with particular substantive policy changes.

166 See, e.g., Shaviro, supra note 42, at 280.

167 Note, however, that the use of transitional elections as exceptions to a generally uniform approach to tax transition policy may reduce the willingness of taxpayers to trust congressional precommitment to the articulated transition policy, which could reduce the efficacy of such a policy.
reality where tax legislation is frequently achieved through compromise, elections may be a useful alternative approach to tax transitions in those situations where the benefits of transitional elections outweigh the detriments.

The case for using transitional elections may be most persuasive in situations where, as in the transitional elections described in Part III, there is significant uncertainty about whether individual taxpayers will prefer to be subject to the old or new law during a transition period. In these situations, transitional elections may provide a tool for balancing taxpayers’ reliance interests with the desire to accelerate the implementation of socially valuable policy changes, even if only a small number of vocal taxpayers actively lobbied their legislators for a particular approach to the transition. Further, it is in these situations where allowing some individual choice in the transition from the old law to the new one may provide neutrality-enhancing flexibility for taxpayers affected by the change in the law. Moreover, where there is uncertainty about taxpayer

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168 However, if the uncertainty about taxpayer preferences regarding the law change is a result of a poorly designed law, it generally would be better to fix the law than to provide a transitional election. The transitional election available in connection with the change to section 355’s ACTB requirement may be an example of this. See supra Part III.A.2 (discussing this election). If the new ACTB test (the affiliated group rule) had not replaced the old holding company rule, but rather had been added as an alternative way in which transactions could meet the ACTB requirement, then there would have been no uncertainty about whether taxpayers seeking nonrecognition treatment would prefer the old test or the new one. All such taxpayers would prefer the new rule, although some taxpayers who structured their transactions to be taxable under the old rule might not want the new one to apply. This approach, which would still have accomplished the policy objectives behind the active trade or business requirement, would have largely eliminated uncertainty about taxpayer preferences regarding the rule change. See Willens, supra note 72, at 3–4. Thus, the public choice concerns would be mitigated, there would be little need to worry about whether reliance interests needed protection, and the value of, and need for, the transitional election would be minimized.

169 One example of this is the election that enables taxpayers to opt out of retroactive application of the new law regarding the tax treatment of gains from the sale of a principal residence. See supra Part III.B.2 (discussing this election). The generally applicable retroactive effective date of the new law accelerates the implementation of the presumably socially valuable law change, but the election protects the reliance interests of those taxpayers who sold their homes before the old law was changed.

170 Of course, this compromise does little to help taxpayers who are ineligible to make the election. In fact, the compromise likely makes those taxpayers worse off than they would have been without the availability of the election. This is the case because the transitional election allows a greater reduction in the tax burden for all taxpayers directly affected by the law change, thereby reducing revenue to the fisc. See supra Part IV.D.

171 Examples of this include the elections into or out of grandfather protection in connection with the change in law regarding the tax treatment of gains from the sale of a
preferences regarding the law change, transitional elections can provide the Service with useful information about taxpayer preferences and can help the Service target its enforcement efforts. Thus, in these situations, the advantages of using a transitional election may outweigh the possible adverse consequences.

Compare the situation where there is uncertainty about which directly-affected taxpayers are harmed by the law change to the oft-discussed possibility of eliminating the exclusion from income for interest paid on municipal bonds. In the latter situation, rational taxpayers holding the bonds would, with a high degree of uniformity, want to retain the tax preference for as long as possible. In that case, a transitional election would be either a huge administrative hassle, if each taxpayer had to affirmatively elect in order to get the benefit of whatever transition relief was available, or basically irrelevant, if transition relief applied unless taxpayers affirmatively elected to accelerate the elimination of the preference, which few rational taxpayers would do. As a result, the only likely noteworthy consequences of using a transitional election in that context are the addition of complexity to the tax law and the reduction in revenue collected by the government. In such a case, legislators should just select a congressionally mandated approach to the transition instead of using a transitional election.

Thus, where taxpayers are expected to have virtually uniform preferences about the application of the old or new law during a transition period, transitional elections should be used sparingly, if at all. However, where taxpayers who are directly affected by the law change are likely to have different preferences about the application of the old versus the new law during the transition period, transitional elections may help the Service learn valuable information about those preferences, may increase the neutrality of the tax law, and may facilitate compromises. This is particularly true where there is reason to believe either that both reliance

principal residence and the change in law regarding the amendment of section 355’s ACTB requirement. See supra Part III.A. Taxpayers aware of the possibility of the upcoming change in law may have otherwise accelerated or decelerated their transactions for only tax reasons, possibly selecting timing that is not optimal for non-tax business purposes.

172 One example of this is the election available in connection with the retroactive application of section 197, allowing for the amortization of intangibles. See supra Part III.B.1.

173 Even envisioning a transitional election in this case as a compromise between taxpayers holding the municipal bonds, who may have relied on the tax preference and who want it to apply as long as possible, and other taxpayers, who may have anticipated the repeal of the tax preference and/or who may just want this base-broadening change to be effective as soon as possible, the election would accomplish basically nothing. This is because rational holders of municipal bonds generally would not opt to accelerate the repeal of the preference.
and anticipation should be protected, or that the imperfect legislative process may result in the use of a transition policy that favors a small, concentrated, vocal group at the expense of a large, diffuse, quiet group.

Ultimately, by understanding when transitional elections are used in the tax law and by appreciating the policy implications of their use, policymakers can balance the benefits and detriments of using elections as part of transition policy. Thus, policymakers can make informed decisions about if and when taxpayers should be empowered to make individual choices about the implementation of changes in the tax law.