A COMMENT ON WATERSHEDS: RUNOFF FROM THE TAX CODE

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INTRODUCTION

As I write this comment in late fall of 2009, news broadcasts and broadsheets are filled with stories about the meeting of the members of the United Nations Framework Convention on Climate Change in Copenhagen scheduled for December 2009.[1] The stories reflect much of the tenor of the public's concerns about the environment over the past couple of decades: expressions of anxiety about the urgent need for fundamental policy initiatives are paired with continued contestations of the underlying science on climate change and disputes about which countries ought to do more.

What is relatively new to these debates is a focus on tax policy. In particular, media coverage and activist blogs have explored the possibility of, and the need for, a carbon tax—or some alternative policy instrument such as a cap and trade program—from every conceivable angle.[2] Although

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* Editor's Note: Citations herein generally conform to THE BLUEBOOK: A UNIFORM SYSTEM OF CITATION (Columbia Law Review Ass'n et al. eds., 18th ed. 2005). In order to make the citations more useful for Canadian practitioners, abbreviations and certain other conventions have been adopted from the CANADIAN GUIDE TO UNIFORM LEGAL CITATION [Manuel Canadien de la Référence Juridique] (McGill Law Journal eds., 4th ed. [Revue du droit de McGill, 4e éd.] 1998).

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1. *See, e.g.*, Andrew C. Revkin & John M. Broder, *A Grudging Accord in Climate Talks*, N.Y. TIMES, Dec. 20, 2009, at A1 (discussing the unhappiness expressed by many U.N. delegates with the final result); Tom Zeller Jr., *At Climate Talks, a Week of Posturing*, N.Y. TIMES, Dec. 13, 2009, *available at* http://www.nytimes.com/ 2009/12/14/business/energy-environment/14iht-green14.html (discussing the rise of tensions in the weeks preceding the U.N. climate talks in Copenhagen); Sunanda Creagh & John Acher, *Tens of Thousands Rally in Copenhagen*, THE GLOBE AND MAIL, Dec. 12, 2009, http://www.fntg.org/ fntg/docs/TensofthousandsrallyinCopenhagen-TheGlobeandMail.pdf (discussing the march on Copenhagen that urged U.N. member states to agree to a strong climate change treaty); Eric Reguly, *African Countries Stage Three-Hour Boycott in Copenhagen*, THE GLOBE AND MAIL, Dec. 14, 2009, http://www.theglobeandmail.com/news/world/climate-change/African-countries-stage-three-hour-boycott-n-copenhagen/article1400300/ (discussing the boycott of several African nations at the climate change talks in Copenhagen and the rising tension between developed and the developing nations); Denmark, COP15, http://en.cop15.dk (last visited Feb. 7, 2010) (discussing COP15, the United Nations Climate Change Conference of 2009).

2. *See, e.g.*, *Exelon's John Rowe: The Pragmatic Businessman, Favors Cap-and-Trade Over EPA*, GREEN ENERGY REP., Oct. 14, 2009, http://greenenergyreporter.com/2009/10/exelons-john-rowe-the-pragmatic-businessman-favors-cap-and-trade-over-epa/ (discussing John Rowe, the CEO of Exelon's, support of cap-and-trade over regulation by the EPA because it is the most business friendly); Tim Haab, *Another Esteemed Economist's Views on Cap and Trade, Carbon Taxes and the Double*

public discussions about using the tax system as an instrument for the promotion of sound environmental policy are relatively new, scholars have been exploring the use of tax incentives to change behavior for the benefit of the environment for decades.[3] Janet Milne's Article in this Volume of the *Vermont Law Review* makes a fine contribution to that scholarship.

Professor Milne's Article reviews four sections of the Internal Revenue Code that may change taxpayer behavior and advance the cause of watershed protection: Section 126,[4] which allows taxpayers to exclude some payments from income if the payment relates to soil and water conservation; Section 175,[5] which permits a deduction for expenses related to preventing erosion of soil and water; Section 170(h),[6] which grants a charitable deduction for the donation of perpetual conservation easements, the state-provided property tax relief for agricultural land valuation; and Section 180,[7] which enables the deduction of the cost of fertilizer. Professor Milne concludes by assessing the effectiveness of the provisions in improving the quality of the watershed and finds most of the programs wanting.

Professor Milne's piece makes two important contributions to the literature on using the tax system as an instrument for environmental

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Dividend, THE ENERGY COLLECTIVE, Sept. 30, 2009, http://theenergycollective.com/TheEnergyCollective/48912 (discussing carbon tax versus cap-and-trade and the double-dividend question); Matthew McDermott, *Do Cap-and-Trade and Carbon Tax Advocates Both Miss the Point of How to Best Beat Global Warming?*, TREEHUGGER, May 19, 2009, http://www.treehugger.com/files/2009/05/do-cap-and-trade-and-carbon-tax-advocates-both-miss-the-point.php (arguing that the United States should use public funds to push low-carbon research and development and that carbon tax and cap-and-trade are not the solution to reduction of greenhouse gases); Michael Ricciardi, *Reducing CO_2: 'Cap and Trade' or 'Fee and Dividend'?*, ECOLOCALIZER, Dec. 25, 2009, http://ecolocalizer.com/ 2009/12/25/reducing-carbon-cap-and-trade-or-fee-and-dividend/ (explaining both the cap-and-trade and fee and dividend systems); *see also* The Story of Stuff Project, *The Story of Cap and Trade*, YOUTUBE, http://www.youtube.com/watch?v=pA6FSy6EKrM (last visited Apr. 14, 2010) (presenting a popular critical analysis of cap and trade proposals).

3. For more recent contributions see CRITICAL ISSUES IN ENVIRONMENTAL TAXATION, VOLUME VII (Lin-Heng Lye et al. eds., 2009); Nathalie J. Chalifour, *Advancing Biodiversity Conservation In Canada Through Ecological Fiscal Reform - The Current Situation and Future Potential*, *in* CRITICAL ISSUES IN ENVIRONMENTAL TAXATION: VOLUME II – INTERNATIONAL AND COMPARATIVE PERSPECTIVES (Kurt Deketelaere et al. eds., 2006); Reuven S. Avi-Yonah & David M. Uhlmann, *Combating Global Climate Change: Why a Carbon Tax is a Better Response to Global Warming Than Cap and Trade*, 28 STAN. ENVTL. L.J. 3 (2009); David G. Duff, *Tax Policy and Global Warming*, 51 CAN. TAX J. 2063 (2003); Gilbert E. Metcalf & David Weisbach, *The Design of a Carbon Tax*, 33 HARV. ENVTL. L. REV. 499 (2009); Faye Woodman, *The Taxation of Aquaculture in Canada: A Comparison with the Taxation of Agriculture and Its Policy Implications*, *in* AQUACULTURE LAW AND POLICY: TOWARDS PRINCIPLED ACCESS AND OPERATIONS, 244–68 (David L. VanderZwaag & Gloria Chao eds., 2006).

4. I.R.C. § 126 (2006).

5. I.R.C. § 175 (2006).

6. I.R.C. § 170(h) (2006).

7. I.R.C. § 180 (2006).

protection. First, she focuses on one relatively discrete aspect of the environment that is badly in need of attention—watershed pollution. Given this discrete focus, Professor Milne is able to work concretely with the tax policy and tax provisions that might influence behavior in a way that would affect watershed quality. Her Article thus raises specific, immediate, and important questions about how tax policy might be reshaped to better serve environmental needs, thereby avoiding the flaws that can arise when scholars broach topics that are far too broad for any sensible analysis. Indeed, many of the tax sections she reviews have not been subject to serious scholarly review.

Second, Professor Milne centers the watershed. Many legal scholars center "the law," and as a consequence, close off possible avenues for addressing real-world problems. In her Article, Professor Milne locates the environmental challenge at the heart of her paper, centering the watershed in her analysis. She then looks to which policy instruments, including tools of tax policy, may have an impact on our response to its preservation (or contribute to its continued degradation).

If Professor Milne's Article is a watershed, this Comment is more like a meandering stream. I offer two modest and unrelated reflections. First, I review the standard method for evaluating tax expenditure measures (measures like those identified by Professor Milne). The point of this review is simply to highlight that the provisions reviewed by Professor Milne may be analyzed using traditional budgetary criteria in a way that may help evaluate their effectiveness. Second, in order to underline the importance of comparative work in this area of the law, this Comment sets out some of the alternative choices the Canadian legislature has made in designing Canada's equivalent tax provision to Section 170(h),[8] which permits a charitable deduction for the donation of perpetual conservation easements.

I. THE USEFUL ROLE FOR TAX EXPENDITURE ANALYSIS

As Professor Milne notes, a fulsome analysis of the environmental impact of the four tax provisions she identifies is beyond the scope of her Article. This Part of the Comment builds on her Article by elaborating slightly on the appropriate framework for undertaking that more definitive analysis. It is a fundamental tax policy insight, widely attributed to Stanley Surrey, that two types of provisions comprise tax legislation.[9] Some of the

8. I.R.C. § 170(h).

9. STANLEY S. SURREY, PATHWAYS TO TAX REFORM: THE CONCEPT OF TAX EXPENDITURES 17 (1974).

provisions might best be conceptualized as technical tax provisions. The purpose of these provisions is to raise revenue and to assist in achieving the government's distributive goals. These provisions define the essential elements of the tax system: the base, rate, unit, period, and rules of administration. Generally speaking, tax policy scholars evaluate these technical rules of an income tax system by considering whether they promote equity and efficiency, and whether they are administrable.

A second category of tax provisions are explicitly designed not to raise revenue, but instead to provide implicit subsidies to those who behave in ways that the government wishes to encourage or who are deemed to be entitled to some form of relief because of their circumstances. Referred to as tax expenditures, these provisions are the functional equivalent of direct spending programs. Instead of simply writing a check to a program recipient, programs delivered through tax legislation enable the government to essentially offset the taxpayer's tax check against the government's subsidy check. In other words, the intended recipient pays less tax, which is functionally equivalent to paying the required tax and then receiving a subsidy check from the government. Each of the rules described in Professor Milne's Article might be best described as tax expenditures: in each case, they are really just spending programs that the government delivers through the tax system. To illustrate, instead of offering taxpayers who donate conservation easements a charitable tax deduction, the government could tax them on the value of the capital gain associated with the disposition of the property and then provide them with a check of some amount in recognition of, and to encourage, their donation.

Characterizing these kinds of environmental provisions as tax expenditures gives their analysis some additional punch, for two reasons. One reason might be broadly characterized as psychological: if people think that what is being received by others is "just a tax break" they might be less critical about whether the spending program is appropriately designed and delivered. For example, if we know that our neighbor gets a tax break because he puts in new, energy efficient windows, we might be inclined to think that it's a fair provision because broadly speaking we think paying less tax is good. If instead he received the same amount as a check from the government, we might be inclined to ask whether that payment is the best use of government money. Perhaps that money might be better spent on playgrounds, or schools, or health care. Perhaps it could be better targeted. Our thinking about the appropriateness of the program changes although what the government has done is functionally the same.

Second, thinking of these programs as tax expenditures encourages us to bring the more rigorous evaluative criteria for budgetary programs to bear. Those budgetary criteria have been refined over the years, but as a general matter their application requires asking a range of relatively straightforward questions. First, tax scholars and policy makers look to determine whether the government has a reasonable policy objective that is being served by the tax provision and the priority of that objective in relation to other government spending needs. Second, budgetary analysis encourages scholars and policymakers to consider the broad range of possible instruments that might be used to achieve the relevant objectives. These objectives include: direct spending programs, regulation, direct provision of particular benefits, educational programs, etc. Third, if a tax provision is to be used to achieve the objective, tax expenditure analysis encourages the analyst to conceptualize it as functionally equivalent to a spending program in evaluating its design features. Once conceptualized as equivalent to a spending program, an obvious range of questions might be asked about the provision:

> (1) Whether the provision is fair. Does the spending program disproportionately benefit high-income or low-income earners, women or men, people in different geographical regions of the country, and so on?
>
> (2) Whether the provision is efficient. Does it reach the intended beneficiaries? Does it reward people who would have engaged in the particular behavior absent the spending program (is it target inefficient)? Does it encourage people to engage in or avoid the intended behavior?
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> (3) Whether the provision can be administered efficiently. Does it cost an excessive amount to administer? Is it administered by the right government body? Do taxpayers know about the incentive? Is it easy for them to understand and apply for?

II. COMPARING ALTERNATIVE DESIGN APPROACHES TO THE CHARITABLE DEDUCTION FOR CONSERVATION EASEMENTS

One of the four tax provisions reviewed by Professor Milne is the charitable deduction for perpetual conservations easements offered by

Section 170(h).[10] This provision finds its Canadian equivalent in the enhanced charitable tax credit and deduction offered for donations of full or partial interests in ecologically sensitive land, available under Canada's *Income Tax Act*.[11] The last of the questions identified in the list of budgetary concerns mentioned above focuses on the appropriate design features of a tax expenditure. The Canadian approach to the design of the tax expenditure for the donation of ecologically sensitive land might be compared with its American counterpart as a means, not of evaluating which is more effective, but simply to underline that even once the tax system has been chosen as the appropriate instrument for achieving the identified government objective, there is a wide spectrum of design options that need to be canvassed.[12]

In Canada, an individual who makes a charitable contribution usually receives a non-refundable tax credit. The credit is calculated by applying the lowest marginal tax rate (15% federally) to the first $200 of the donation, and then the highest rate (29% federally) to the balance. Generally speaking, in any one year a taxpayer cannot receive a tax credit for charitable contributions in excess of 75% of her net income. If she has excess credits, she can carry them forward for five years. After that, the credits expire. In addition, if a taxpayer makes a donation of capital property, like land, she would also have to pay tax on the capital gain arising from the deemed disposition. For donations of ecological gifts, this subsidy is enhanced in two ways. First, the disposition is not subject to the 75% income restriction, and second, it is not subject to capital gains tax.

In the United States, the standard approach is to grant an itemizing taxpayer a deduction equal to the value of the charitable contribution. The value of the deduction is therefore determined by the taxpayer's marginal tax rate. As in Canada, there are limits to the total deduction available. For capital property, the limit is usually 30% of the taxpayer's adjusted gross income. As in the Canadian context, the United States offers special incentives for the donation of conservation easements. The deduction limits for those gifts are lifted so that they can value up to 50% of adjusted gross income and the carry-forward period is 15 years.

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10. I.R.C. § 170(h).

11. *Income Tax Act*, R.S.C. c. 1 (5th Supp.), § 118.1(3), § 110.1(1) and § 38(1.2), *available at* http://laws.justice.gc.ca/PDF/Statute/I/I-3.3.pdf.

12. I am deeply indebted to the thorough paper on the taxation of conservation easements prepared by Ellen Zweibel and Karen Cooper. This Part of the Comment is distilled from their more detailed work. *See* Ellen Zweibel & Karen Cooper, *Charitable Gifts of Conservative Easements: Lessons from the US Experience in Enhancing the Tax Incentive*, 58 CAN. TAX J. (forthcoming 2010).

Although there are many design features of the enhanced charitable tax credit/deduction in the United States and Canada that might be compared, in this Comment I focus only on two: the choice of a tax credit versus a tax deduction and the administrative oversight of the tax expenditure.

Tax expenditures may be delivered using credits, deductions, exemptions, reduced rates, or deferral of taxation. Canada and the United States have chosen fundamentally different design approaches for individual donors of ecologically-sensitive land. In Canada, the government provides a non-refundable tax credit. The credit value changes based on the value of the donation—with one value for the first $200 and a second value for subsequent amounts. Despite this quirky aspect of the charitable credit, its value to the taxpayer is the same regardless of the taxpayer's marginal tax bracket. In other words, a taxpayer in the lowest marginal tax bracket will receive the same implicit subsidy for his contribution as a taxpayer in the top bracket. The United States's tax expenditure is designed as a tax deduction. Thus, the value of the benefit varies based on the tax bracket of the taxpayer: the higher the taxpayer's income, the more the deduction is worth to her.

As an aside, neither of these approaches is ideal, but the Canadian approach is better. As mentioned, tax expenditures are the functional equivalent of direct grants. A government would never suggest that a high-income taxpayer should receive a larger direct grant than a low-income taxpayer for the donation of the same piece of land; however, providing a tax expenditure by using a tax deduction does precisely that. The Canadian tax credit is fairer, but it is not as fair as granting a refundable credit. If a Canadian donor does not pay tax (because she has loss carry-forwards or because she is a low-income taxpayer) then she receives no government subsidy for her contribution.

A key issue in the design of tax expenditures is which administrative body should oversee their enforcement. Indeed, the administration of the tax expenditure subsidy for charitable contributions has been frequently criticized: as poorly integrated into established forms of public review; lacking transparency; lacking oversight of what is really a private land-use form of control; and under-resourced (for private land owners who should be monitoring and maintaining the land subject to the easement).[13] In Canada, the ecological gifts program is administered by Environment Canada, which, among other things, has to pre-certify the gift, including the appraisal value. In the United States, the IRS undertakes post-donation

13. Lorne Sossin, *Regulating Virtue: A Purposive Approach to the Administration of Charities*, *in* BETWEEN STATE AND MARKET: ESSAYS ON CHARITIES, LAW AND POLICY IN CANADA (Jim Phillips, Bruce Chapman & David Stevens eds., 2001).

audits and attempts to require compliance with detailed rules about the nature of the gift. However, recognizing that these provisions are spending provisions that have nothing to do with the technical tax system, it would seem to make sense for the tax subsidy for donations of ecologically sensitive land to be administered by an environmentally sensitive government body, and for pre-donation reviews to be conducted.

III. THE IMPORTANCE OF CONTINUING THIS WORK

Professor Milne's Article invites tax scholars and policymakers to take a closer look at the details of our current taxing legislation and to evaluate their impact on the environment. She takes the important step of starting with the environment and then asking how law, and tax law more specifically, might be used to address some of the world's most urgent environmental problems. I hope others heed her call: that would be a watershed in its own right.