

# TAX JOURNAL ARTICLES ADDRESS MAKING TAX LAW, ORPHAN DRUGS, AND DISCRETIONARY/NONDISCRETIONARY DISTINCTION IN PERSONAL EXPENSES.

FEB. 8, 1989

## ===== SUMMARY =====

Samuel P. Guyton, Vice Chairman of the American College of Tax Counsel, Nashville, Tenn., has sent Treasury three summaries of articles from a recent volume of the American Journal of Tax Counsel. The summaries discuss three articles: one by Stephanie J. Willbanks suggesting that Congress adopt general principles and let Treasury provide the details in making tax law; one by David M. Richardson contending that a tax credit for developing orphan drugs is preferable to a direct subsidy; and one by Joel S. Newman suggesting that Treasury consider narrowing the role the discretionary/ nondiscretionary distinction plays in the deductibility of personal expenses.

## ===== FULL TEXT =====

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The Honorable Nicholas F. Brady  
 Secretary of Treasury Dept.  
 15th & Penn Ave. NW  
 Washington, DC 20220

Re: The American Journal of Tax Policy

Dear Secretary Brady:

Under separate cover you will be receiving Volume 6 No. of The American Journal of Tax Policy, which is a publication of the American College of Tax Counsel. This issue of the Journal contains three articles on important and timely tax subjects. Summaries of these articles are enclosed.

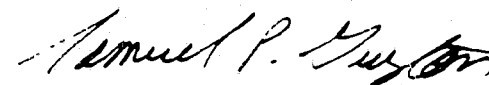
Proposing a major shift in the way tax law is made, Stephanie J. Willbanks suggests in her article that Congress adopt general principles and let Treasury provide the details.

In recommending that Congress reconsider the orphan drug tax credit, David M. Richardson contends in his article that allowing a tax credit for a substantial part of the cost of developing an orphan drug is preferable to a direct subsidy.

Joel S. Newman analyzes the deductibility of nondiscretionary personal expenses and concludes in his article that consideration be given to narrowing the role of the discretionary/nondiscretionary distinction of such expenses.

It is hoped that you will find this issue of the Journal and the enclosed summaries of the articles informative.

Sincerely,



Samuel P. Guyton, Vice Chairman

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The Orphan Drug Tax Credit by David M. Richardson

Professor Richardson begins by describing the orphan drug problem, which is that there are a number of diseases that affect so few victims that it is not profitable for drug companies to develop drugs to treat the diseases. This problem has existed for some time, but has been aggravated by the stricter testing requirements for new drugs imposed by the FDA after the thalidomide problems in the 1970s.

Congress considered a number of ways of addressing the orphan drug problem. Congress chose, however, to make the tax system the principal tool for assisting in the development of orphan drugs.

Professor Richardson argues that this was a sensible decision, in that allowing a tax credit for a substantial part of the cost of developing an orphan drug is a quicker and more efficient means of subsidizing the development than a direct grant program would be. He demonstrates, however, that the design of the orphan drug tax credit is badly flawed.

Many of the flaws arise from the decision to base the orphan drug credit on terms contained in the credit for increasing research expenditures. He points out that the purposes of the two provisions are different--that the credit for increasing research expenditures is a reward for incremental research expenditures over a base period amount, while the orphan drug credit is intended to be a direct subsidy for the development of orphan drugs. He examines in detail the terms of the orphan drug credit and recommends that both in-house and contract research qualify for the credit on the same terms, that the credit be refundable so that unprofitable companies can benefit immediately from the credit, that it be allowed to start-up companies, and that the credit be exempted from the passive activity loss rules and the alternative minimum tax because it is a subsidy and not a tax benefit.

His major recommendation goes to the fundamental problem of any program (tax or nontax) to assist in the development of orphan drugs: What is an orphan drug? He points out situations in which drugs that were predicted to have very small sales have in fact had much larger sales, so that the drug could have been developed at a profit. His recommended solution to the problem is to allow the credit rather liberally for drugs that treat rare medical conditions, but to recapture the credit, with interest, if the sales of the drug are actually sufficient to have justified its development.

We believe that this article may persuade Congress to reconsider the orphan drug tax credit and restructure it along the lines recommended by Professor Richardson.

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SIMPLIFYING THE INTERNAL REVENUE CODE THROUGH REALLOCATION OF  
DECISIONMAKING RESPONSIBILITY by Stephanie J. Willbanks

Professor Willbanks proposes a major shift in the way tax law is made. Congress, she says, should draw broad, general principles and the Treasury should provide the details. This would be more likely to provide some stability in tax law, which has been lacking in recent years as Congress has drafted and redrafted highly complex legislation.

The article points out that the Treasury already plays a very important role in drafting legislation as well as in interpreting it. Its workload would not be substantially greater if it could concentrate on solving problems within the bounds of general rules set out by Congress.

Congress is ill-suited to draft detailed tax legislation. Congress has too many other matters to consider and Congress is too amenable to influence by pressure groups. If Congress were freed from deciding all the minor details of the tax law, it could devote more time to considering what tax policies should be and stating those policies in general statutes.

The courts, of course, are necessary as a safeguard against abuses of discretion by the Treasury, but the judicial process is totally unsuited to forming the tax law. First, the judicial process is focussed on a single case, not on general principles. Second, judicial actions take place years after the transaction occurred, so that the law is of little use for planning purposes.

The article considers in detail the section 385 regulations in which Congress directed the Treasury to develop regulations defining the difference between debt and equity in the corporate context. It concludes that the failure of the Treasury to ever issue regulations resulted from a lack of guidance from Congress and from the fact that the debt/equity distinction is so important that any Treasury action would cause great opposition. The author concludes, therefore, that the case of the section 385 regulations does not show that the delegation of detailed rulemaking authority to the Treasury would not work.

We believe that this article is important in focussing attention upon a possible means of reducing the amount of new tax legislation. Even if this means of simplifying the tax laws is not wholly adopted, adoption of the revised decisionmaking procedures in limited areas of the tax law might result in simpler, more consistent laws that could benefit taxpayers and the government alike.

THE DEDUCTIBILITY OF NONDISCRETIONARY EXPENSES by Joel S. Newman

Professor Newman addresses the often discussed question whether deductions should be allowed for personal expenses in the federal income tax. He points out that many--perhaps most--of the justifications of the deductions are based on the fact that many personal deductions are nondiscretionary. There is, however, no discussion in the literature of the reason that the taxpayer's discretion in making an expenditure should affect its deductibility.

The article seeks to remedy this lack. It concludes that the concept of ability to pay--and related concepts such as clear income--may involve the distinction between discretionary and nondiscretionary expenditures, but do not explain why the distinction should be so important. It also concludes that such rationales as pity and moral blameworthiness are too subjective to serve as dividing lines between discretionary and nondiscretionary expenditures.

It might be possible to draw the line between discretionary and nondiscretionary expenditures on the basis of surveys of average expenditures by taxpayers or groups of taxpayers or by determining minimum subsistence levels of expenditures. The article concludes, however, that the average expenditure notion is too subject to consumer whims and the minimum subsistence level is accurate only at the very lowest levels of income.

The question whether an expenditure is discretionary or nondiscretionary also depends on the point of view from which it is viewed. That is, an expenditure may be necessary (nondiscretionary) now because of a discretionary expenditure in the past.

The article then discusses the way two other income tax systems treat nondiscretionary expenditures. The British income tax system makes very little allowance for personal deductions, therefore even nondiscretionary expenditures are generally disallowed. The German system, on the other hand, specifically allows the deduction of certain nondiscretionary expenditures because they are nondiscretionary.

The author's conclusion is that we should narrow the role of the discretionary/nondiscretionary distinction in our income tax. Personal expenditures should be deductible or not on other grounds, e.g., pity, subject to disallowance if the expenditure were determined to be discretionary.

We believe that this article is important in focussing attention again on the personal deductions. By analyzing the discretionary/nondiscretionary distinction often used to justify personal deductions, Professor Newman may point the way to a more consistent system.