

Another Look at Deleveraging the Tax Code

By Jeremy Scott — jscott@tax.org

The Internal Revenue Code loves debt. Interest is deductible, while equity is not. Generous tax provisions encourage consumers to take on home mortgage debt. The federal government also is more than willing to encourage state and local governments to borrow by subsidizing their bond interest. This favoritism of debt is nothing new; most of these provisions have been in the code for some time. But now may be the perfect opportunity for Congress and policymakers to rethink these traditional biases. After all, the recent fiscal crisis is largely the product of excessive risk taking, both by consumers and the financial sector.

Almost exactly one year ago, Martin Sullivan called for a “deleveraging” of the tax code, specifically targeting the home mortgage interest deduction and the deductibility of corporate interest. He returns to that theme this week in an open letter to Paul Volcker, the head of President Obama’s tax reform task force. Sullivan argues for 10 changes to the tax code that would help prevent another fiscal crisis. His top targets are again the tax bias for corporate leverage and tax provisions that subsidize housing, which leads to more taxpayers borrowing in the form of mortgages. Sullivan writes that lowering corporate tax rates might be a way to equalize the treatment of corporate equity and debt. He also joins with a number of commentators in calling for Congress to end special rules that exempt incentive-based pay from the cap on corporate compensation deductions. (For the open letter, see p. 1295. For the 2008 look at the treatment of debt in the code, see *Tax Notes*, Sept. 29, 2008, p. 1241.)

Sullivan’s tax reform proposals are almost all revenue raisers, and any tax reform next year will have to focus on ways to reduce the nation’s budget deficit and mounting debt. Presidential economic adviser Austan Goolsbee reiterated last week that any quest for revenue will not involve tax increases on those making less than \$250,000 a year. Goolsbee is also the staff director for the Volcker tax reform panel, and in his remarks, he dashed the hopes of those looking for the group to recommend replacement of the income tax with a consumption tax, calling such a reform beyond the task force’s mandate. If Obama is ruling out broad-based tax in-

creases on middle-income taxpayers, perhaps the administration might be more amenable to the type of tax reform proposed by Sullivan. (For coverage, see p. 1306.)

If tax reform becomes the focus of 2010, it will be interesting to see the direction that the administration and Democrat-controlled Congress move in. Obama’s tax pledge severely limits the Democrats’ options to close the federal deficit. Given that 2010 is also likely to be a contentious election year, it seems more likely that any serious tax reform on the scale of 1986 might have to wait until 2011. And it would be contingent on the Democrats maintaining viable majorities in both houses of Congress, since it is unlikely that Republicans will be in any mood to work with the White House after a good showing in November 2010.

A Win for Tax Cheats?

After months of telling taxpayers that there would be no extension of the September 23 deadline to join the voluntary disclosure program for foreign accounts, the IRS reversed course and set a new deadline of October 15. This development, which wasn’t all that surprising despite the Service’s earlier protestations, might become a significant story in the coming weeks. It could be argued that this extension is much more of a benefit to those taxpayers who intended to hold out all year for a sweeter deal than to taxpayers facing logistical concerns about compliance. Stay tuned to *Tax Notes* for reaction to the IRS decision. (For coverage, see p. 1297.)

Commentary

The adoption of international financial reporting standards is a major topic in the world of financial accounting. The George W. Bush administration was a strong proponent of an eventual move to IFRS, but Obama’s choice to head the SEC has seemed more lukewarm. Last week SEC Chair Mary Schapiro reaffirmed her commitment to the convergence of U.S. GAAP and IFRS and promised specifics. (For coverage, see p. 1324.) Suzanne Luttman writes that if the United States intends to adopt IFRS, convergence would be a perfect time to conform book and tax accounting systems (p. 1343). In her special report, Luttman argues that conformity of book and tax would be an easier way to achieve corporate tax reform than attempting to eliminate or restructure the corporate income tax. She presents the advantages and disadvantages of using financial statement income for tax purposes and

WEEK IN REVIEW

concludes that this reform would reduce total tax costs while increasing the transparency of the tax law.

In his “Jousting With the Tax Man” series, John Klotsche has written that the IRS and taxpayers would benefit from adopting alternative dispute resolution techniques to supplement the current Appeals process. In his third article, Klotsche presents a detailed look at ADR minitrials and shows how they might help in resolving complicated tax disputes (p. 1333). A minitrial blends traditional negotiation, modern-day mediation, and adjudication techniques to push parties toward compromise. According to Klotsche, the minitrial gives parties multiple bites at the apple in order to settle a case and minimizes the role of counsel, forcing decision-makers to take a direct part in negotiations. His article outlines how a minitrial involving the IRS and taxpayers might work and contains a flowchart showing the minitrial process in detail.

The Making Work Pay tax credit was a centerpiece of Obama’s presidential campaign, and Congress enacted a scaled-back version of it in the fiscal stimulus legislation passed earlier this year. One unique feature of the credit was that it was delivered to taxpayers through a temporary reduction in income tax withholding by employers. Prof. Lawrence Seidman writes that this new technique is likely to be a key component of any future fiscal package to stimulate the economy. In his special report, he expounds on the effects of temporary withholding and shows how additional withholding could be implemented if the economic recovery proves weak. Seidman concludes that one advantage of this method is that it gets cash to most households quickly (p. 1355).

Transparency was supposed to be a theme of the Obama administration in the wake of criticism of the secretive way that the Bush administration conducted business. David Cay Johnston isn’t so sure that Obama is keeping his promises regarding openness and transparency. In Johnston’s *Take*, he describes his attempts to obtain transition documents that were used by the IRS to brief incoming

Obama officials about the state of the agency (p. 1381). The problems outlined in the report are nothing new to *Tax Notes* readers, including concerns about staffing, upcoming retirements of senior officials, and an increased agency workload. Johnston says the real issue is how hard it was to obtain these documents. The fight for transparency for tax governance goes on, he concludes.

High-priced employer-sponsored insurance plans (so-called Cadillac plans) are the new target for a Congress looking for ways to pay for healthcare reform. Although a direct cap on employer-sponsored healthcare has lost favor on Capitol Hill, a tax on insurance companies has replaced it. David Bernstein, a Treasury economist, writes that a tax that curbs excessive healthcare benefits would create economic efficiencies and reduce tax expenditures associated with healthcare. In a viewpoint, he outlines problems with implementing such a tax and offers suggestions on how it could be phased in and coupled with a new market structure for insurance plans. The viewpoint is on p. 1371. (For coverage of healthcare reform, see p. 1300.)

New regulations addressing section 104 were recently released. The new guidance removed the tortlike test for the deductibility of settlement payments. Robert Wood writes that although these proposed regulations were welcome, they still failed to address the most important question for section 104: what constitutes physical or physical injury. Wood’s look at the proposed regs appears on p. 1337. Prof. Calvin Johnson believes that publicly traded stock should be taxable in a corporate acquisition. In his Shelf Project article on p. 1363, Johnson writes that publicly traded stock should be treated as boot in an acquisitive reorganization. Robert Willens analyzes redemptions and exchange treatment on p. 1377, specifically looking at the fact patterns necessary for a redemption to be part of an overall financial plan. Tax Facts on p. 1375 shows data on the level of benefits provided by the earned income tax credit, the child tax credit, and the additional child tax credit. ■

© Tax Analysts 2009. All rights reserved. Users are permitted to reproduce small portions of this work for purposes of criticism, comment, news reporting, teaching, scholarship, and research only. Any permitted use of these materials shall contain this copyright notice. We provide our publications for informational purposes, and not as legal advice. Although we believe that our information is accurate, each user must exercise professional judgment, or involve a professional to provide such judgment, when using these materials and assumes the responsibility and risk of use. As an objective, nonpartisan publisher of tax information, analysis, and commentary, we use both our own and outside authors, and the views of such writers do not necessarily reflect our opinion on various topics.