From the Editor:

Congress Fails to Plug the Black Liquor Leak

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Sometimes even the most targeted tax expenditures can cause unexpected problems. When Congress passed several laws containing credits to spur alternative fuel production, it never could have imagined that the primary beneficiaries would be paper mill companies. But poorly worded statutes can have broad consequences, and this particular statute has the potential to cost the federal government approximately $25 billion in revenue over a 10-year period.

The black liquor issue came into focus in Congress last year, with some lawmakers professing outrage over this abuse of the tax system, while others defended the subsidy as saving the American paper industry. The problem was caused by an IRS interpretation that allowed paper manufacturers to take advantage of section 6426's alternative fuel mixture credit and another IRS ruling that allowed black liquor to qualify for the cellulosic biofuel credit. In the healthcare reconciliation bill this year, Congress closed part of the loophole by disallowing the credits for black liquor processes starting on January 1, 2010. But as Jeremiah Coder points out, this won't prevent paper companies from taking advantage of the credit in prior tax years. Coder traces the series of questionable IRS rulings that initially allowed black liquor to qualify for the credits and other guidance that seemed generous in the method prescribed for calculating a credit for the black liquor process. To qualify, paper companies must add a tiny amount of diesel fuel that would otherwise not be used. Coder also points out that Sen. Chuck Grassley has taken notice of the black liquor issue and has requested a revenue estimate from the Joint Committee on Taxation for a proposal to disallow the credit even in past years. (For Coder's article, see p. 347.)

The black liquor controversy would be comical if it weren't so costly. The ability of paper companies to qualify for the various alternative fuel credits is predicated solely on their burning unnecessary fossil fuels (to create the proper mixture), which, of course, contravenes Congress's intention to reduce fossil fuel consumption and the production of greenhouse gases. The fact that the IRS allowed this process to qualify in the first place is somewhat surprising, but Congress's inability to completely plug this revenue leak in its first attempt is just as inexcusable.

Commentary

In the first part of his special report, Michael Schler addressed the statute that governs the receipt of boot in a reorganization transaction and suggested several reforms, some of which have been adopted in a recent House bill. In part two, Schler looks at the regulations on the receipt of boot, including recent and final proposed guidance under section 356. He writes that those regulations make substantial changes to the method of calculating the gain recognized under section 356 and that the changes are difficult to reconcile with the language of the statute. In his conclusion, he urges Treasury to reconsider the regulations in light of Congress's decision not to amend section 356. (For Schler's report, see p. 379.)

Transfer pricing might be set to become the next great battleground in the reform of the U.S. international tax regime. Many analysts have argued that aggressive transfer pricing practices are costing the United States billions of dollars a year in tax revenue and, in a recession, this is an area that Congress can no longer afford to overlook. At a House Ways and Means hearing last week, speakers argued about the viability of the arm's-length method, with *Tax Notes*' Martin Sullivan testifying that the United States should move to formulary appointment. Opponents of Sullivan's position have argued that moving away from the arm's-length method will hurt U.S. competitiveness and jeopardize treaty relationships. (For coverage, see p. 351.) Michael Durst writes that Congress must both fix transfer pricing and protect U.S. competitiveness, and he believes that these two goals are not irreconcilable. In his special report on p. 401, Durst examines the Ways and Means hearing and suggests that Congress should tighten current transfer pricing rules. However, doing so without an offsetting decrease in corporate tax rates would harm competitiveness. Therefore, Durst concludes that Congress must revise transfer pricing only in the course of comprehensive tax reform so that overall business taxation can be carefully controlled.

The expiration of the estate tax and its impending return to Clinton-era rates and exemption levels will presumably force Congress to deal with the tax at some point this year. However, Democrats and Republicans do not seem in any rush to compromise. The failure of a Republican effort to eliminate the tax last week and Democrats' refusal to allow a vote on a compromise plan offered by Sens. Jon Kyl and Blanche Lincoln seem to indicate that a final solution is not close at hand. (For coverage, see p. 361.) Carlyn McCaffrey and Pam Schneider look at one aspect of the estate tax's expiration: the generation-skipping transfer tax. Specifically, the authors address the future prospects of the tax and the implications of its one-year suspension. According to McCaffrey and Schneider, the one-year reprieve has created several difficult questions. (For their article, see p. 407.)

A recent special report in *Tax Notes* argued that the healthcare mandate was unconstitutional, focusing on its status as an unapportioned capitation tax. This argument has prompted a flurry of criticism. In On the Margin, Ryan Lirette writes that the arguments over the constitutionality of the mandate present a false dichotomy. He believes that the mandate will be upheld as either a tax or a regulation of commerce. The unprecedented use of federal power breaks with constitutional norms and cannot be validated under the Supreme Court's traditional tax and commerce analyses, according to Lirette. However, he concludes that less damage will be done to individual autonomy and the federal-state balance of power if the taxing power is used as the proper mode of analysis. (For Lirette's article, see p. 415.)

Some major criticisms of the VAT regimes used in Europe are the potential for evasion, the creation of black markets, and the compliance difficulties that plague that continent's tax authorities. In Views on VAT, Leah Durner and Jon Sedon analyze the complex issue of VAT enforcement and what difficulties would confront the United States if it were to consider the adoption of this form of consumption taxation (p. 431). VAT collection gaps in Europe range from 2 percent in Ireland and Spain to 30 percent in Greece. The income tax gap in the United States is estimated at 16.3 percent. VAT gaps occur because of failures to register, underreporting of sales, missing trader fraud, and carousel fraud, according to the authors. Although VAT regimes can present opportunities for fraud, evasion, avoidance, and noncompliance, Durner and Sedon conclude that with proper encouragement and enforcement measures, these problems can be adequately addressed.

A recent Shelf Project proposal described a way for the federal government to raise $1 trillion a year in taxes without raising rates. Kip Dellinger takes a tongue-in-cheek look at what might happen if the Shelf proposal were actually adopted. Dellinger has a dim view of the economy's future if the tax proposals in the Shelf Project become law and concludes that such a massive tax increase would be unwelcome by almost all taxpayers (p. 439). In his column this week, Robert Wood addresses the debate over the six-year statute of limitations, and in particular whether lawsuit recoveries could be caught within it by virtue of capitalized legal fees. Wood believes that capital gain issues should not be considered basis overstatements even if the IRS's current basis position is upheld (p. 427). ■