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Higher Taxes Might Be Inevitable

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Few would be surprised to learn that the government needs revenue. The IRS is dedicated to closing the tax gap. President Obama is committed to eliminating what he views as favorable tax treatment for multinational firms. Congress is willing to consider any revenue raiser it can find, including silly ones such as a tax on so-called sugary beverages. Motivations in this quest for revenue differ; Obama wants to pass a new wave of progressive legislation, while the IRS is seeking to undo some of the side effects of the 1998 restructuring.

Martin Sullivan has frequently written that the budgets under consideration by Congress and the administration are not fiscally sustainable. At least one prominent government official finally publicly agreed with him. Last week Federal Reserve Chair Ben Bernanke testified that Congress will have to consider higher taxes sooner rather than later. Bernanke addressed the issue of flagging foreign confidence in U.S. government bonds now that the debt-to-GDP ratio is approaching 70 percent. The major issue is whether the nation's creditors will have enough confidence in the government to finance its debt at ''reasonable interest rates,'' according to Bernanke. The answer to that question is probably no. (For coverage, see p. 1182.)

Congress will raise taxes at some point. The tax rates in place now cannot pay for the ''normal'' operations of government. The revenue system certainly cannot pay for the bailout, stimulus, and reform packages either passed or under consideration by Congress. At some point, Obama will need more money. Taxpayers should begin to gird themselves for either a regressive consumption tax or a major shift in income tax rates, and despite the president's promises, if the government wants to raise serious revenue, it will have to tax individuals making less than $200,000 a year.

News Analysis

Obama's international tax reform package did not eliminate deferral. However, Sullivan believes that the deferred deduction proposals were a clumsy way to try to limit it. In fact, Sullivan writes that Obama would have been better off eliminating deferral and lowering corporate tax rates — a reform plan already put forward by the Clinton administration in 2000 and mirrored by House Ways and Means Chair Charles Rangel's 2007 tax reform bill. Sullivan also reiterates his concern that Obama's plan would exacerbate the repatriation problem already in the tax code, although he points out that different firms will experience different effects. This uneven treatment is a major problem with Obama's proposal, according to Sullivan (p. 1163).

Lee Sheppard addresses insurance reserves in her article this week. Sheppard writes that the IRS is beginning to question whether reserves should be reduced by securitization transactions engaged in by so-called special purpose captive vehicles. Her article is partly in reaction to comments made at the recent Federal Bar Association Insurance Tax Seminar (p. 1167). In related news, the IRS reaffirmed that the reinsurance antiabuse rule under section 845(b) is alive and well. An IRS official at the seminar asserted that the Service is committed to applying the rule and pointed to recent guidance that disallowed a transaction between a domestic corporation and foreign reinsurer. (For coverage, see p. 1187.)

Helen Elizabeth Garrett

Echoing comments made here last week, a number of prominent tax experts expressed the opinion that the withdrawal of Helen Elizabeth Garrett's nomination for assistant Treasury secretary for tax policy is likely to harm the administration's tax reform efforts. Leonard Burman of the Urban-Brookings Tax Policy Center and Chris Edwards of the Cato Institute both agreed that Garrett dropping out was a major blow to Obama. ''It's a disaster for tax policy in the Obama administration,'' said Burman. (For coverage of Garrett's withdrawal, see p. 1172. For coverage of Burman's move to academia, see the box on p. 1172.)

Commentary

The Ninth Circuit's reversal of the Tax Court in *Xilinx v. Commissioner* could significantly alter transfer pricing law. If the *Xilinx* decision stands (and an *en banc* rehearing and even an appeal to the Supreme Court are both still possible), then the IRS's ability to challenge and recharacterize cost-sharing arrangements will be considerably enhanced. Prof. Reuven Avi-Yonah believes that the decision also offers the opportunity to explore serious international tax reform. In his viewpoint on p. 1231, Avi-Yonah argues that international tax reform cannot occur without a reexamination of transfer pricing principles. Even read narrowly, *Xilinx* will likely cause more firms to enter into advance pricing agreements with the IRS, and broadly, the decision casts doubt on the viability of the arm's-length standard. The debate over territoriality and deferral can be resolved only if the administration and Congress are willing to undertake transfer pricing reform, according to Avi-Yonah.

Charitable giving is a sacred cow in the United States. When Steve Forbes proposed a flat tax in his 1996 campaign for the Republican nomination for president, he was instantly attacked because the lack of deductions in his plan would reduce charitable donations. When Obama proposed capping deductions for high-income taxpayers, exempt organizations and charities fell over each other in their rush to attack the proposal. It seems that Americans give to charities only because they can deduct their donations, or at least that's the refrain we often hear from lobbyists on Capitol Hill. In his special report this week, David Joulfaian says lower estate tax rates or outright repeal may discourage charitable giving (p. 1221). On one hand, Joulfaian writes, a decrease in the estate tax might increase disposable wealth and encourage giving, while elimination of the tax or a reduction in rates reduces the impact of the exemption currently granted to donations. In the end, the author concludes that ''estimating the effects of estate taxation is a humbling experience and one that requires constant review of our models and methods.'' Estate taxation is also the focus of Bridget Crawford and Jonathan Blattmachr's article (p. 1265). The authors look at who will bear the responsibility for estate tax generated with respect to gift tax included in the decedent's gross estate, absent a specific provision to the contrary. Crawford and Blattmachr believe that case law and the Uniform Estate Tax Apportionment Act are at odds on this issue.

Section 892 offers sovereign investors more favorable tax treatment than is available to foreign private investors. Some commentators have argued that the section creates an uneven playing field and should be repealed. Wei Cui disagrees, pointing out that foreign private investors often enjoy tax advantages that are not taken into account by proponents of section 892 repeal and that sovereign wealth funds do not always receive the favorable home country tax treatment that many assume. Cui concludes that section 892 is a poor starting point for framing issues raised by sovereign wealth funds (p. 1237). In a practice article, Robert Wood again addresses the issue of false imprisonment recoveries (p. 1217). In Wood's opinion, false imprisonment always involves a degree of physicality and therefore should always be excluded from income under section 104. He takes issue with a recent case and expresses concern that the Tax Court decision might push the law in the direction of forcing such recoveries to be included in taxable income. Victor Thuronyi tackles a small part of the tax simplification debate, writing that capital gains should be taxed at death and that the distinction between capital and ordinary income should be eliminated (p. 1244). Jasper Cummings, Jr. looks at the Tax Court's recent decision in *Santa Fe Pacific Gold Co. v. Commissioner* and finds it confusing and poorly reasoned. Cummings's breakdown of the Tax Court's opinion is on p. 1255.

June 10, 2009, should be a date marked on every taxpayer's calendar, according to David Cay Johnston. All of the income taxes paid before that date go to cover the interest on the national debt, writes Johnston (p. 1247). Johnston's Take this week also analyzes the issue of support for taxes and the transparency of the programs they pay for, arguing that property taxes that pay for schools are more popular than income taxes because taxpayers know what their money is being used for. Joseph Thorndike thinks that liberals should adopt some of the libertarian economic platform, or at least moderate some of their antibusiness rhetoric. Comparing Obama's current quest to raise revenue by increasing business taxes to Franklin Roosevelt's New Deal, Thorndike says that the Democrats' soak-the-rich revenue tools might eventually imperil the long-term viability of expensive social programs. Tax History is on p. 1249. Robert Willens analyzes the historic combination of Merck & Co. and Schering-Plough Inc. on p. 1251. Michael Durst's recent speech to the International Fiscal Association international tax seminar in Toronto is on p. 1269. ■

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