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From the Editor:

How a Perfect Tax Becomes Broken

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It might be hard to believe, but gas taxes once enjoyed almost universal support. They were conceived of as a way to help fund road construction, replacing property taxes, and the public was generally supportive of those goals and didn't mind paying a few extra cents at the pump. That all changed in the 1990s, when the purpose of the gas tax was changed and taxpayers suddenly became much more hostile to it.

So what happened? Congress attempted to use the federal gas tax for deficit reduction, which undermined the tax's original purpose of funding road construction, according to Joseph Thorndike (p. 463). Before the 1990s, the federal gas tax was very closely tied to the Highway Trust Fund and enjoyed widespread support because of the success of the interstate highway system. Presidents Bush and Clinton, however, were desperate to reduce the deficit and decided to increase the popular tax. Support for the gas tax quickly evaporated, and by 1997 Congress had reversed the change, returning all gas tax revenues to the Highway Trust Fund. But the damage was done, Thorndike writes. Politicians are reluctant to raise the tax, which has stagnated, he argues, adding that road costs have steadily risen and now require general funds to meet them. State gas taxes are also unpopular. Thorndike says it is time for Congress to bite the bullet and raise the tax, and even index it to inflation. All of the new revenue should be tied to infrastructure maintenance and improvements, he concludes. Congress broke the gas tax, and it is up to lawmakers to fix it, even if the tax has now become unpopular, he says.

Thorndike might be right that Congress broke the gas tax and undermined the levy's popularity, but it's not entirely clear that anything can be done to fix it. Gas taxes are unpopular because of their regressivity — they can amount to taxes on working for the most part. They also no longer approximate a user fee, something Thorndike points out in his article. Increased fuel efficiency means that people can travel more miles on less gas, decreasing tax collections. Many policymakers are considering more innovative means to fix infrastructure funding, including vehicle miles taxes (which have been tested in the Pacific Northwest). A vehicle miles tax is much closer to a user fee than the modern gas tax, but it raises serious privacy and administrability concerns.

It may be time to move away from the idea of user fees to pay for roads. Everyone — even those who don't drive — benefits from local, state, and interstate roads. It shouldn't be so hard to convince the public to use general revenues to maintain them. And it shouldn't take bridges collapsing to draw taxpayer attention to the inadequate revenue sources maintaining our fragile infrastructure.

International Tax Reform

There is broad consensus in Washington to reform the corporate tax, which means lowering the overall rate and changing the rules applying to multinationals to prevent base erosion. In other words, tax reform will have winners and losers. Martin Sullivan looks at a possible loser that many may not have considered: domestic research and development (p. 459). U.S. tax policy encourages research through the research credit, which has almost universal popularity despite its temporary (but perpetually extended) status. Sullivan writes that the U.S. tax system encourages research spending through leaky tax rules that allow multinationals to shift profits to low-tax jurisdictions. Changing those rules to prevent income shifting might harm research spending, he writes, but he concludes that the current tax system is an inefficient and opaque way to encourage research.

Transactions that allow tax deductions when no foreign tax has been paid are also likely to fare poorly if international tax reform ever happens. The government is doing its best to shut down foreign tax credit generators right now, but the results are mixed, according to Lee Sheppard (p. 451). She analyzes the state of foreign tax generator case law and points out why the government is determined to stop these transactions. The results are so contrived and hokey that the United States isn't likely to give up, despite a few reverses in court, she says.

Commentary

Republican budget conferee Rep. Tom Cole of Oklahoma is open to changing the rules on carried interest as a possible revenue raiser (p. 475). At least that's what he implied when naming possible compromises that might emerge from the conference (he later said he thought the chances of changing

carried interest rules were remote). The tax treatment of carried interest has long been controversial, and bills to subject it to ordinary income rates have been floating around Congress for years. But William Weigel says that such changes have two fundamental flaws: It is impossible to distinguish carried interest structures from other forms of compensation that have long enjoyed capital gains treatment, and new section 710 is unlikely to generate much additional revenue (p. 503). He concludes that lawmakers should target income attributable to personal services by focusing on the character of the income and deductions for the services.

While financial products may be unfamiliar territory to most of the tax bar, short sales have been around long enough that all practitioners should know how they work, writes Jasper Cummings (p. 517). However, the rules governing short sales under section 1233 make little sense, he argues. He looks at the history of the section and how antiabuse rules were developed. The classic short sale of borrowed stock is actually treated differently than very similar transactions, Cummings finds.

After years of delay, the IRS finalized the repair regulations in September. Temporary and proposed rules have been around in various forms since 2004. The final repair regs are not without controversy, but they have been greeted with relief as practitioners and taxpayers can finally begin to plan under and comply with the rules. James Atkinson reviews the changes made by the final regulations and discusses what the next steps are for taxpayers (p. 535). Although the regulations are thorough, more guidance is needed from the IRS before detailed procedural steps for compliance can be developed, he argues.

On May 9 the IRS issued a memorandum that concluded that the bonds of a development district do not qualify as the bonds of a political subdivision. The TAM said that a government unit must be accountable to a general electorate. The TAM calls into question the status of special districts, a widely used financial tool of local and state governments, according to Ellen Aprill (p. 547). Such a change in how special districts are treated is unprecedented and should not occur through the issuing of a TAM, she argues. Instead, the IRS should issue new rules subject to notice and comment procedures, she writes. She concludes that the TAM's conclusions are without basis in precedential tax authorities, local government law, and Supreme Court cases.

Companies frequently face litigation and resolve it through settlements. The tax issues facing settlement are well documented, and many lawyers focus on the deductibility of settlement payments. But Robert Wood points out that you sometimes need to look beyond the payment and at why it is made to correctly determine deductibility (p. 555). He looks at how imputed interest in legal settlements can affect immediate deductibility and suggests ways around potential issues when structuring settlements. ■

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