# WEEK IN REVIEW tax notes

## From the Editor:

### Permanent Tax Policy as Stimulus

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Over the last two decades, Congress has enacted a large number of temporary tax provisions designed to stimulate the economy and then expire. Some temporary tax provisions, such as President Bush's 2001 and 2003 tax cuts, were intended to be permanent from the start despite their temporary labels. But others, such as bonus depreciation and President Obama's payroll tax cut, were labeled and defended as countercyclical fiscal policy — measures that were supposed to go away after the economy recovered. But the state of tax politics has made it unlikely that any tax cut will fade quietly into the sunset, whatever the original intentions of its supporters.

Republicans, of course, resist the expiration of almost any tax provision, with Grover Norquist and his supporters arguing that any increase in revenue is a tax increase. This includes the expiration of temporary tax provisions and extenders. But this line of reasoning is no longer confined to the GOP. Democrats and Obama are now using similar arguments to push for an extension and expansion of payroll tax cuts. Obama has said that Congress should not allow taxes to rise on middle-income taxpayers. This change in tone from progressives means the end of temporary tax provisions, according to Joseph Thorndike. The "sticky" nature of tax cuts, even those intended just as stimulus, will limit policy options for future lawmakers and add to the nation's growing fiscal problems, Thorndike writes. He says that neither party is likely to impose much discipline on the spending side of the budget, while the permanent nature of most stimulus tax programs will continue to reduce revenues received. He concludes that the state of tax policy means that the United States is unlikely to avoid a budget catastrophe soon. (For his analysis, see p. 406.)

Thorndike is most likely correct. If the payroll tax cut is extended by Congress, it probably will end up being a permanent part of the tax code, regardless of whether it is given a transitory expiration date. As Thorndike asks, when will it ever be a good time to increase taxes on the middle class? Republicans are resistant to all tax increases, and Democrats have spent the last two years limiting their flexibility by repeatedly emphasizing their opposition to higher taxes on middle-income earners. Neither party has given itself much room to maneuver without breaking some pledge to voters.

#### The 999 Plan

Herman Cain's meteoric rise to the top tier of Republican presidential contenders has brought increased scrutiny of his 999 tax plan. The Cain plan would overhaul the federal tax system and replace it with a 9 percent income tax, a 9 percent business tax, and a 9 percent national sales tax. Cain, under fire from both the right and the left, has argued that his plan would encourage economic growth and greatly simplify the tax code. He has rejected criticisms that it would raise taxes and has called his approach revenue neutral. Edward Kleinbard writes that the plan might result in substantial new revenue, but that it would shift the tax burden from wealthier taxpayers to those with lower incomes (p. 469). According to Kleinbard, the 999 plan functions as an effective 27 percent payroll tax on wage income. Thus, it would materially raise taxes on low- and middle-income taxpayers, some of whom pay little or no income tax and effectively a 15.3 percent payroll tax. Kleinbard also describes the sales tax component of the plan as a one-time tax on existing wealth and analyzes how Cain's proposal would affect capital income and returns on equity.

#### Foreign Tax Credit Generators

Multinational companies are sensitive to double taxation issues. Many aggressively lobby governments for general foreign tax credit provisions and then spend heavily on tax planning to avoid having income subject to tax in two separate jurisdictions. Frequently, however, this planning crosses the line and results in no or too little tax being paid. According to Lee Sheppard, the government recently won an important victory in Pritired, which addressed foreign tax credit generators. The facts in Pritired were particularly bad for the taxpayer, Sheppard writes. The taxpayer pushed the limit with its affirmative use of derivatives to ensure the tax credit result, she says. Sheppard also criticizes the court for going overboard in its reasoning, but she points out that judges frequently provide alternatives in order to avoid being overturned on appeal. (For the analysis, see p. 400.)

#### Commentary

In the 1970s and early 1980s, Congress enacted various tax provisions that benefited the real estate

industry. They led to an abundance of abusive tax shelters that contributed to rising real estate prices, high interest rates, and a tax gap. The Tax Reform Act of 1986 tried to curtail these shelters. The goal was to limit deductions and credits available to passive investors. However, the limitations in section 469 are now outdated and should be repealed, writes George Jackson (p. 447). Section 469 produces unintended effects, imposing an unfavorable tax environment on noncorporate real estate investors in a depressed market whose collapse had little to do with income tax rules, Jackson argues. He concludes that depreciation recapture rules have adequately addressed the problems section 469 targeted and that Congress should repeal the limits on passive activity deductions.

Victims of natural disasters claiming federal income tax deductions for losses that later receive an insurance settlement may be required to recognize that settlement as ordinary income. Because of how legal fee deductions are treated by the AMT, this may trigger additional tax liability, reducing the relief intended by casualty loss rules, according to Nathan Oestreich, Jim Williamson, and Steven Gill (p. 461). They provide an analysis of how the AMT can interact with casualty loss rules and other tips on how taxpayers might be able to avoid the reduction in tax relief. In the end, victims should seek tax advice on how to structure an insurance or legal settlement to avoid these traps for the unwary, the authors conclude.

In *Bulas*, the Tax Court decided that an accountant working primarily from home was not entitled to take a business tax deduction for his bathroom, which was used almost entirely by clients. The court allowed Bulas to take a deduction for a bedroom being used as an office. Erik Jensen writes that the standard used by the court requiring that the bathroom be used exclusively for business was unreasonably narrow and inconsistent with the standard used to evaluate the home office deduction (p. 480). Although Jensen agrees that Bulas should not have been granted a deduction based on the facts, he writes that the Tax Court should have based the rejection of the deduction on substantiation issues and not on an overreaching definition of exclusive.

Congress has had great difficulty passing budgets in recent years. In fact, it has become common practice to fund the government using continuing resolutions instead of going through the full appropriations process. While some might blame divided government for the trend, the Democrats did not manage to pass a budget in either of the two years they controlled Congress and the White House. Diana Furchtgott-Roth writes that an improved budget process could help the country confront deficit and tax policy problems (p. 483). She describes the Honest Budget Act, proposed by two Senate Republicans, which would eliminate the use of budget gimmicks and increase the transparency of the budget process. The act would also require pay-fors for emergency funding, stop automatic pay increases, prevent revenue raised from time shifts, and tie appropriations to a budget. Furchtgott-Roth argues that the act would be improved by also requiring annual votes on entitlement spending, requiring the use of GAAP by the federal government, and linking spending to receipts three years earlier.

The IRS recently created a voluntary relief program for worker status that is designed to encourage companies to begin properly classifying workers as either employees or independent contractors. While the program might seem straightforward on its face, a decision to enter into it requires an examination of a wide range of legal and tax issues, writes Robert Wood (p. 487). Wood points out that changing worker classification could result in lawsuits filed by the reclassified workers based on their past status (former independent contractors might demand employee-like benefits, for example). Wood concludes that the success of the classification program is not ensured and that many taxpayers with legitimate reasons to participate might choose not to. ■

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