From the Editor:

The Accidental Intentional Healthcare Tax Expenditure

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Tax expenditures are under siege. If the more extreme rhetoric is to be believed, any and all tax benefits are on the chopping block to pay for a package that averts the fiscal cliff. Republicans are willing to raise $800 billion through some kind of deduction cap or other loophole closers. President Obama, of course, wants to raise rates just on the rich. Frantic lobbying is probably underway to save the deductions for home mortgage interest, charitable giving, and state and local income taxes.

But the nation's largest tax expenditure seems relatively safe. The exclusion for employer-provided healthcare insurance would not be affected by either a rise in tax rates (favored by Democrats) or by any kind of deduction cap (favored by Republicans). After being discussed extensively in 2009 during the healthcare reform negotiations, employer-provided healthcare seems in little danger. That's disappointing to many economists, who have argued that the exclusion is inflationary, distorts the healthcare market, and is an accidental product of World War II wage controls. Joseph Thorndike disagrees with the latter assertion, pointing out the difference between a policy being an accident and simply having unintended consequences. He explores the history of the exclusion from its roots as a way around price controls to its place as a major benefit to union workers. While the exclusion might be inefficient, its central place in U.S. healthcare policy is no accident, he writes. Congress deliberately overruled the IRS and put the exclusion in the 1954 code, he points out. (For his article, see p. 1141.)

One of the major problems with the GOP's deduction cap is that it wouldn't deal with the exclusion, writes Martin Sullivan. The exclusion is the largest tax expenditure, but it would not be affected by a deduction cap. That means that any deduction cap would be distortionary, favoring some tax benefits over others, he argues. He points out five major problems with a deduction cap and concludes that it would eventually turn into another alternative minimum tax. Because the various cap proposals would not be indexed to inflation, over time the cap would affect more and more taxpayers at lower income levels. That means Congress would ultimately be faced with having to patch the deduction cap, much like it must pass an AMT bill every year, Sullivan says. (For his analysis, see p. 1139.)

Commentary

All of Washington agrees that the U.S. corporate rate is too high. Everyone from the president to the chair of the Ways and Means Committee wants to lower the rate. The only question is how far (most reform plans target 25 percent) and how to pay for it. The latter is such an important point, however, that few actually expect a corporate rate reduction to happen soon. Robert Pozen and Lucas Goodman propose paying for a corporate rate reduction by limiting the deductibility of interest payments (p. 1207). That kind of change could pay for a reduction to 25 percent and would help to change the tax code's bias toward debt over equity financing, they write. Their plan would limit the deduction to 65 percent of a company's interest expense. They conclude that Congress will be hard-pressed to find a better option to fund a cut in the corporate rate.

For some policymakers, just a cut in the corporate rate is insufficient — they would like to see wholesale reform of corporate and business taxes. Rep. Devin Nunes, R-Calif., has built on the so-called X-tax to propose the American Business Competitiveness Act, which would replace the corporate tax with a ''non-value-added consumption tax.'' George White looks at how the act would function and delves into the history of taxation (p. 1237). Nunes's proposed reform might create problems in the depreciation area, as well as with taxpayers using the accrual method, according to White.

The Second Circuit recently affirmed the Tax Court's decision in *Union Carbide*, an important case for taxpayers analyzing research credit claims under section 41. Although the Tax Court disallowed Dow's claims, its analysis, which the circuit court affirmed, is very taxpayer friendly, according to John Dies, Jeremy Fingeret, and Scott Weese (p. 1225). *Union Carbide* provides a clear definition of the term ''uncertainty'' and discards the discovery tests standard, the authors write. The court's holding on the business component test is also pro-taxpayer, they find. They conclude that Dow's loss was a huge gain for taxpayers and that the appellate holding reinforces that if a taxpayer can demonstrate that supplies were used and consumed in direct connection with a qualified business component, those supplies can be deducted even if they weren't initially purchased for a research-related purpose.

The Supreme Court will soon hear arguments in *PPL Corp*., a key case that might provide a definition for an income tax, at least in the context of a British tax on windfall utility profits. The case has been subjected to considerable attention. Most analysis, however, has focused on substance over form, which is an incorrect characterization of the issue, writes Jacob Goldin (p. 1229). That glosses over the question whether the tax is actually an income tax, he says. Because the British tax is levied on average profits instead of total profits, it is very different from the conventional definition of an income tax, Goldin argues. He finds that the tax is not really an income tax at all and that its use of average profits is a significant distinction.

The estate tax has become an overlooked aspect of the fiscal cliff discussions. That wasn't true in 2010, when Congress agreed to reinstate the tax with a much more generous exemption and lower rate than existed before the tax's brief expiration. During the 2010 negotiations, Obama's willingness to accept the GOP's demands on the estate tax caused some consternation among progressive economists and lawmakers. But during the latest debate over the extension of the 2001 and 2003 tax cuts, the estate tax has gone almost unmentioned. That isn't surprising, given that the tax raises only $11 billion, writes Jeffrey Pennell (p. 1232). He discusses several possible futures for the estate tax, including that Democrats might be willing to consider repealing the tax in exchange for higher tax rates on wealthy taxpayers. If Congress does consider repealing the tax, it should implement zero-basis transfers, instead of carryover basis, Pennell writes. Under his proposal, any property that transfers at death would have a zero basis instead of its basis in the hands of the decedent. That would be a change from the rules that existed during the tax's one-year hiatus, but it is a more favorable alternative, he writes.

In a special report discussing F reorganizations, Jasper Cummings, Jr., argues that in attempting to defeat the liquidation-reincorporation tax shelters, the IRS has essentially repurposed F reorganizations into E reorganizations (p. 1193). Cummings analyzes how the repurposing of F reorganizations has harmed tax administration and discusses the probable fate of the 2004 proposed regulations. He argues that the new doctrine of F reorganizations creates too much electability for taxpayers.

The taxation of income from Native American gambling creates numerous issues for practitioners and taxpayers. Robert Wood looks at how the IRS is dealing with the expansion of gambling income and how the Service treats Native Americans (p. 1241). He concludes that Native American tax questions are likely to consume much more of the IRS's resources. ■