From the Editor:

Will Tax Increases Harm U.S. More Than Spending Cuts?

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The Bush tax cuts will expire at the end of this year, raising income tax rates on virtually all taxpayers. For almost two years, the Obama administration and Democrats have treated the country to a refrain that the tax cuts will be extended for middle-income earners, but that rates on the wealthy (those earning more than $200,000 a year, or $250,000 for joint filers) will go up. But cracks are appearing in the Democratic caucus. Several prominent Democratic senators have started to voice their support for at least a temporary extension of all the Bush-era rates, while other administration officials and House Majority Leader Steny Hoyer have questioned whether any of the rates should be extended.

Allowing the Bush tax cuts to expire would harm the economy in the short run, but extending them permanently would damage the country's fiscal future, according to Douglas Elmendorf, the head of the CBO. If the tax rates revert to their pre-Bush levels, the United States will face deficits totaling $6 trillion over the next 10 years. If the tax cuts are extended for only middle-income taxpayers, that total increases to nearly $10 trillion. The country simply cannot afford that and must come up with an economic policy that balances short-term stimulus with long-term fiscal sustainability, according to Elmendorf. Was this another trial balloon being floated by the administration to see how the nation might react if President Obama breaks his pledge to keep middle-income taxes from rising? It is hard to say. Frankly, it simply looks like another example of the disjointed and often incoherent message from Democrats in Congress and the White House. One wonders if anyone is in charge of attempting to coordinate the majority party's policies.

Senate Budget Committee Chair Kent Conrad used Elmendorf's report as an opportunity to push the idea of tax reform, saying that the nation's revenue system cannot meet its spending needs. Conrad is one of a few Democrats to endorse at least a temporary extension of the upper-income tax rates. His Republican counterpart, Judd Gregg, argued that the CBO numbers simply underscore the need for spending cuts, a common refrain from the GOP. At some point, Congress and the nation must confront the issue of which will hurt least: raising taxes or cutting spending. (For coverage, see p. 822 and p. 824.)

There is no question that Congress is playing with fire by failing to address the Bush tax cuts before the fall. With the election close, the Republicans smell blood and have indicated they will oppose any measure that doesn't include an extension of all rate levels. Obviously this is an attempt to prevent Democrats from extending the middle-income rates and selling that to voters in November as a tax cut. But those tactics could backfire if no deal is reached in a lame-duck session, resulting in a large tax increase in 2011. Will even an expanded Republican congressional party be able to accomplish more in 2011 than it could right now by simply compromising with moderate and conservative Democrats?

The Dodd-Frank Act

Last week Lee Sheppard wrote that the Dodd-Frank Wall Street Reform and Consumer Protection Act changed the tax treatment of some financial products and might have made section 1256 unworkable. This week she looks at the law's other provisions and concludes that the financial regulation overhaul will not accomplish most of its goals. The law fails to restrict the size of banks, and it watered down the Volcker rule to the point of ineffectiveness, according to Sheppard. She believes that a better approach would have been to apply a Tobin tax on transactions or to outright ban financial products that simply increase leverage with no discernible social or economic benefit. She also finds that the capital requirements in the law are not spelled out and are unlikely to mitigate the effects of the next liquidity or credit crisis. The law will do little to prevent another financial meltdown and allows most of the conditions that caused the previous crisis to persist, Sheppard argues. (For the article, see p. 803.)

Commentary

The intersection between administrative law and the tax law might become an area of controversy in the next few years. Several IRS regulations have already been challenged under the Administrative Procedures Act, and these types of arguments will only become more common. General principles of administrative law cannot be ignored by tax practitioners in the wake of the *Intermountain* decision,

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writes Steve Johnson in a special report on p. 837. The Tax Court in *Intermountain* invalidated a temporary regulation involving basis overstatements and the six-year statute of limitations for assessments. Johnson analyzes the important issues in administrative law raised by *Intermountain*, including legislative regulations, how *Brand X* is applied by courts, and the notice and comment requirements of the APA. He concludes that the confusion between general authority and legislative regulations is less than sloppy and distorts analysis of whether regulations are valid.

For a long time economists were mystified that corporations paid dividends to their shareholders even though before 2003, dividends were subject to a higher level of tax than redemptions. Prof. Reuven Avi-Yonah refers to this as the "dividend puzzle" and writes that after tax law changes in 2003, the dividend puzzle was replaced with a redemption puzzle (p. 853). The adoption of partial integration has caused a modest rise in dividends but a sixfold increase in redemptions, according to Avi-Yonah. He presents data on this phenomenon and concludes that the solution is for Congress to make sections 302 and 304 inapplicable to foreign shareholders.

Although no policymaker and neither party has endorsed a VAT for the United States to solve the growing federal budget crisis, consumption taxes remain a popular option among economists and commentators. Victor Thuronyi argues that a VAT should be considered only if other deficit reduction measures prove inadequate (p. 856). Thuronyi writes that there are alternatives to a VAT, including a retail sales tax, that should not be ignored. He believes that it will be tough to gather political support for a VAT, particularly when Democrats might prefer a more progressive tax and Republicans would likely use support for the broad-based tax against anyone who endorsed it. He points out that many states would likely be against the adoption of a federal consumption tax.

Section 6662 assesses a taxpayer accuracy-related penalty and holds the taxpayer responsible for items on a tax return. Section 6694 imposes a penalty on the return preparer for tax positions of which the preparer has knowledge. The IRS might be shifting its position on the due diligence required of a return preparer, according to Kip Dellinger in his latest column (p. 889). Dellinger believes that there are signs that the IRS intends to hold preparers to a higher standard of due diligence and that they will soon be required to ask reasonable questions to verify a client's assertions. This is likely to be fiercely resisted by the practitioner community, but preparers will probably be dissatisfied with the outcome, concludes Dellinger.

A recent IRS letter ruling found that a reincorporation of most of a target's business assets followed by the target's merger into its parent was an upstream reorganization of the parent. Therefore the parent's receipt of its own stock did not trigger deferred intercompany gain. Analyzing this ruling, Jasper Cummings, Jr. finds that downstream D reorganizations might be nearly extinct (p. 869). Cummings questions why chief counsel wouldn't think that a reorganization's parties are determined by where the operating assets end up, but says that if this is the reasoning behind the ruling, it isn't surprising that the result isn't a downstream D reorganization. A *Groman* step transaction could be found if the IRS used a different characterization, Cummings concludes.

Although section 104 concerns income received for personal injuries and physical sickness, there has been very little focus on what constitutes a physical sickness, writes Robert Wood on p. 883. Two recent Tax Court decisions, however, might have expanded the definition of physical sickness. Wood agrees with the Tax Court and supports the expanded scope of the section 104 exclusion. In Of Corporate Interest on p. 865, Robert Willens analyzes the merger agreement between Celgene Corp. and Abraxis BioScience Inc. He wonders whether the use of contingent value rights will allow the parties to treat the merger as a modified open transaction. Charles Rettig explores how tax practitioners should use FOIA requests as part of their procedural toolbox on p. 877. Rettig writes that if an examination is not favorably resolved, a practitioner should consider submitting a FOIA request immediately. ■

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