*From the Editor:*

## BP, the Gulf, and Tax Deductions

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BP is almost certainly one company that doesn't believe all publicity is good publicity. The oil company ignited another round of criticism when it announced that it expected to receive a $10 billion tax deduction reflecting the estimated $32 billion cleanup costs for the gulf. Almost immediately many in Congress and the Obama administration cried foul, with some looking for ways to forestall the BP move. President Obama's press secretary even asked the company to forgo the deduction voluntarily, an action that isn't likely given BP's soft financial state.

BP's deduction is based on the discounted present-day value of the $20 billion escrow the company agreed to set up, and it includes estimates of penalties that might be imposed under the Clean Water Act, writes Lee Sheppard. Sheppard looks at BP's shrinking financial position, the state of oil industry tax breaks, and the exact nature of the gulf deduction in her analysis on p. 571. Based on her analysis, she is confident that BP will try to deduct the Clean Water Act penalties, something that raised the ire of Sen. Bill Nelson of Florida. Two House Democrats have proposed bills that would try to block BP's deductions. One would bar the company from using section 162, while another would create a new code section. Sheppard also looks at how Obama's proposals to limit tax preferences for oil companies might affect BP's efforts to pay for the gulf cleanup and sell some of its assets.

A related article by Robert Wood looks at whether BP might be able to deduct punitive and compensatory damages (p. 663). The deductibility of punitive damages and fines has been under attack for years, according to Wood, and new proposals in Congress seek to limit or prohibit deductions for these expenses. BP's attempt to deduct $10 billion has only added to the buzz, writes Wood. He criticizes Nelson's suggestion that BP should be barred from deducting both the $20 billion it places into escrow and any punitive damages that arise from the gulf cleanup. The deductibility of punitive damages has not led to defendants fighting any less against their imposition, argues Wood. He also finds it unlikely that judges and juries would take nondeductibility into account when determining awards, leading to the imposition of excessive punitive damages. Wood concludes that the best policy would be to allow punitive damages to remain deductible because not all of them are penal in nature and sometimes their character isn't even purely noncompensatory.

**Congress Recesses**

Aside from the House returning for one day this week to approve a Senate-passed bill that would primarily send funding to struggling states (and includes some controversial offsets involving foreign tax credits), Congress is now officially on its August recess. Let's hope that members find the break restful, because neither the Senate nor the House accomplished much of its long-term agenda in July. The extenders bill, of course, is completely dormant. The small-business bill that occupied most of the Senate's last few weeks is stalled. It is not clear what, if any, energy reform will be accomplished in September. And Democrats can't even agree among themselves on a timeline to discuss the expiring Bush tax cuts, much less how many of the rates will be extended and for how long. It might be tempting to say that this will lead to a busy fall session in terms of tax policy, but that seems overly hopeful. Remember that members must still deal with a budget for next year and return home to campaign in what will surely be a hotly contested midterm election. (For coverage of the Senate's final days, see p. 583. For coverage of the Bush tax cuts, see p. 585.)

**Commentary**

The estate tax is a major political issue, despite the low revenues historically generated by it and the fact that even when it returns in 2011, it will affect a very small percentage of estates. But Republicans have long despised the tax and campaigned for its permanent repeal (apparently not hard enough because the party could not accomplish this goal despite being in power for most of the last decade). Many Democrats, however, favor the tax as a vital part of a progressive revenue regime. Congress must confront the estate tax issue before the end of the year, or the tax will return with what many consider the harsh rates of the Clinton era. Whatever bill emerges from Congress (assuming one actually does) is likely to only deal with the rates and exemption levels. In a special report on p. 615, Prof. Jeffrey Pennell argues that Congress should also consider finally defining the term "transfer." For an estate tax to be valid under the Constitution, it must be imposed on the transfer of wealth, but the code lacks a coherent definition, according to Pennell. He writes that to properly understand when a gift tax is appropriate, transfers should be defined as transactions in which the taxpayer no longer has the value of the wealth being transferred, regardless of where that value goes. His report outlines his proposed reform concept and explores examples in which the existence of a transfer might be debatable.

Making depreciation deductions more generous has become a hallmark of recent stimulus packages. The Bush administration proposed, and received, bonus depreciation in its stimulus packages earlier in the decade, and the Democrats followed suit in 2009. Additional expense and depreciation measures are now under consideration in the Senate. But who does bonus depreciation really benefit? Only the largest small businesses, according to Donald Bruce, John Deskins, and Tami Gurley-Calvez (p. 641). They analyzed tax return information from 1991 through 2003 and found that nearly all depreciation deductions are reported by a very small percentage of large small businesses or by businesses that do not post any adjusted gross income. The data show that while favorable depreciation policy provides tangible benefits to some small businesses, most Schedule C small businesses that report positive income do not benefit from bonus depreciation or expanded expensing limits. The authors conclude that depreciation deductions may primarily be used to strategically avoid tax liability.

VATs are one of the most common types of consumption taxes worldwide. But not all VATs are the same. While most of the world favors the transaction-based credit-invoice VAT, a subtraction-method VAT is in place in Japan, several U.S. states, and a few European nations. Tom Neubig, Robert Cline, and Estelle Dauchy write that the subtraction-method VAT is a viable alternative to the credit-invoice method (p. 656). They believe that it might be easier for the United States to adopt the subtraction method of taxing value added. The authors conclude that U.S. policymakers should take advantage of the range of possible VAT options when entering the debate over consumption taxation in the United States.

Paper returns have been the cornerstone of the U.S. tax system for nearly a century, and forms W-2, 1098, and 1099 have played a critical role in promoting tax compliance. Jay Soled writes, however, that it is time for paper returns to be eliminated by Congress (p. 658). He argues that electronic returns would promote greater compliance and efficiency, but cautions that if Congress decides to eliminate them, it must make taxpayer information available on the Internet. He concludes that we shouldn't shed tears for the end of the paper statement era but should remain focused on promoting a tax system in which administrative ease reigns and taxpayer compliance remains high.

Rising sovereign debt and uncontrolled deficits threaten governments worldwide, but the response to this crisis has varied. In the United States, Democrats and Republicans alike harp on the nation's deficit, but neither party seems willing to consider any serious spending reductions or tax increases to confront the problem. Considering that the deficit under Obama makes the concerns over the problem during both Bush administrations seem quaint, the lack of thoughtful discourse on the topic should concern all taxpayers. The United Kingdom faces a similar situation, but has actually taken steps to confront it, write Diana Furchtgott-Roth and Nathaniel Schorr (p. 671). The Conservative-Liberal Democrat coalition in Britain has proposed a budget that will reduce the U.K. deficit to around 1 percent of GDP by 2015. Furchtgott-Roth and Schorr point out that Democrats in Congress have yet to even debate a budget for next year. They also praise the British budget for including targeted tax cuts to help fight the effects of the lingering recession. The United States will be forced to confront its budget problems eventually, the authors contend, but by the time the Democrats do so, it might be too late. ■