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From the Editor:

Debt Ceiling Deal Solves Little in the Long Term

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Depending on whom you believe, catastrophe was averted last week when Republicans and Democrats came together to pass a bill that raised the debt ceiling in exchange for two rounds of spending cuts that should total more than $2.1 trillion. The bill passed both houses of Congress fairly easily, overcoming conservative and progressive opposition (along with Tea Party skepticism that there ever was a crisis). Global and U.S. markets didn't react very well to news of the compromise, as the Dow Jones lost all of 2011's gains and international markets fared even worse.

Although the stock market turbulence was largely the result of fresh trouble in Europe (caused by Italy's refusal to admit it is in the midst of a sovereign debt crisis), the limited punch of the debt deal probably failed to mitigate the sell-off. In exchange for an increase in the debt ceiling that will push the issue beyond the 2012 elections, President Obama and Democrats agreed to two series of spending cuts. The first is an immediate $900 billion in spending reductions. The second will be drafted by a special committee of lawmakers from both houses of Congress. If their recommendations (which may or may not include tax increases) are not passed by November, a second series of mandated cuts will take place, including more than $500 billion in defense cuts over 10 years. The second phase will total $1.2 trillion in deficit reduction. Coincidentally, that amount is almost exactly the cost of extending the Bush tax cuts for upper-income taxpayers. (For coverage, see p. 569.)

Martin Sullivan writes that the Bush tax cuts are now likely to take center stage. Using the CBO's March baseline, the debt ceiling deal seems like an impressive accomplishment. According to Sullivan, it will reduce the projected deficit to 0.7 percent of GDP by 2021. The figure does not take into account the cost of extending any of the Bush tax cuts, AMT relief, or the annual extenders package that Congress usually passes. When the costs of those expiring tax provisions are considered, the debt ceiling compromise will reduce the deficit to 4.3 percent of GDP over the next 10 years, which is not sustainable, Sullivan writes. Although Republicans largely got their way on taxes in the debt ceiling debate, they may now find it difficult to reconcile their commitment to deficit reduction with their desire to extend the Bush tax cuts in full, Sullivan concludes. (For Sullivan's analysis, see p. 567.)

Assuming that the second phase of cuts in the debt ceiling compromise goes into effect, $2.1 trillion in deficit reduction over 10 years is nothing to completely dismiss. That the Pentagon is finally facing real reductions is also heartening to those who would prefer to see the nation's fiscal problems solved without a broad-based tax increase or inflationary tactics. But work remains — in fact, the most difficult part of budget and tax reform is on the horizon. In order to truly achieve fiscal stability and bring future deficits completely under control, Congress will have to consider significant entitlement reform or revenue increases. And given how difficult it was for Congress to agree to $2.1 trillion in deficit reduction that didn't include either of these elements, only the most optimistic observers should believe that the political system can produce anything significant soon.

Treaty Interpretation

Tax treaty interpretation can be a complicated area of international tax law. Despite the OECD's efforts to impose a model treaty on the world, most tax treaties contain myriad exceptions or don't follow the model at all. Lee Sheppard wonders if national courts can resolve the ambiguities in tax treaties, but she isn't confident that the courts and treaties can work together any more efficiently than they work apart. Sheppard reviews how the European fiscal crisis is affecting EU tax policy and provides coverage from a conference in Vienna where practitioners and experts discussed a number of treaty interpretation cases. She also concludes that recent U.N. efforts to become involved in tax treaty negotiation may further diminish the importance of the OECD and reduce the influence of the developed world in tax treaty formulation. (For Sheppard's analysis, see p. 571.)

Commentary

Targeted tax provisions were supposedly eliminated by tax reform efforts in 1985. However, they continue to creep back into the code, much to the chagrin of deficit hawks and policy purists. But sometimes a targeted tax provision is needed. Robert Nassau and Megan Michaloski urge Congress to

alter a provision of the code in order to aid a dozen or fewer low-income taxpayers (p. 623). Taxpayers with too much investment income are ineligible for the earned income tax credit. While this may not seem inequitable, Nassau and Michaloski point out that overpayment interest on tax refunds and the gain from the sale of a principal residence can result in EITC disallowance. They argue that EITC disallowance rules are supposed to prevent taxpayers with low earned income but high investment income from qualifying for the EITC, but the legislative history suggests that they were not intended to affect taxpayers who are truly below the poverty line.

One of the signature achievements of President Reagan was the passage of the Economic Recovery Tax Act of 1981. The 1981 tax cut slashed marginal tax rates and ushered in a new era of supply-side economic thinking that still dominates the Republican Party (and, to a large extent, all of Washington). Bruce Bartlett writes that although the Republicans are wrong to argue that the 1981 tax cut was so expansionary it resulted in no actual revenue loss, it did help the economy transition from high inflation to low inflation at an unexpectedly small economic cost (p. 627). The 1981 tax cut cost the government $6 billion in 1982 and the revenue cost grew to $33 billion by 1985, according to Bartlett. The tax cut was still a success, but that does not mean that a repeat of it today would achieve similar results, Bartlett concludes.

Notice 2010-46 provides the first written guidance for section 871(m), which was enacted as part of the HIRE Act in March 2010. Originally designated section 871(l), the provision affects the U.S. tax treatment of cross-border equity swaps and securities loans on U.S. equities. Mike Gaffney writes that compliance with Notice 2010-46 will be difficult to enforce because of the extraterritoriality of the statute (p. 603). The requirements are also at odds with the treatment of other foreign-to-foreign payments, including royalties, he adds. Gaffney concludes that the rules will make the United States a less attractive and more burdensome location for inbound portfolio investment.

On July 9 New York Yankees shortstop and future Hall of Famer Derek Jeter collected his 3,000th hit. The story was celebrated across the sports world and provided a bright spot in a disappointing season for the Yankees captain. However, Jeter's 3,000th hit also created a flurry in the tax community because the man who caught the ball, Christian Lopez, returned it without compensation. He was subsequently rewarded with a shower of gifts from the baseball team and Jeter, and many media outlets reported that he would probably owe tax on everything received. George White discusses the concept of found property and the tax implications facing Lopez, finding that the issue is more complicated than it appears (p. 631).

There are two book reviews in *Tax Notes* this week. The first, by Robert Wood, looks at *Innocent Spouse* by Carol Rose Joynt (p. 635). In the book, a taxpayer recounts her experience trying to claim relief under the innocent spouse doctrine. Wood looks at the facts of the case and analyzes the recent change in IRS policy. He finds the book a fun read and recommends it to tax lawyers. It is an eye-opener for those unacquainted with the income tax system and shows how difficult innocent spouse cases can be, according to Wood.

The second book review, by Jennifer Bird-Pollan, discusses *Federal Taxes on Gratuitous Transfers* by Joseph Dodge, Wendy Gerzog, and Bridget Crawford (the latter two are frequent contributors to *Tax Notes*). Bird-Pollan finds the book to be timely, clear, and useful, especially following the changes to estate tax law in December 2010 (p. 643). ■

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