From the Editor:

House Democrats Muster Last Gasp of Defiance

By Jeremy Scott — jscott@tax.org

Although many of them will not be returning to Congress next year (arguably because of their positions on tax and fiscal policy), House Democrats aren't quite ready to go quietly into the night. The House Democratic caucus passed a nonbinding resolution refusing to bring President Obama's tax cut compromise to the floor without significant (but unspecified) changes. What these Democrats hope to accomplish by making their president look uncomfortable is hard to fathom, but their vote did not prevent the Senate from introducing the president's plan and scheduling a Monday vote.

Obama's compromise with Republicans is just that: a blending of the two sides' positions. The Republicans receive a two-year extension of all the tax rates in the 2001 and 2003 Bush tax cuts (including those applying to dividends and capital gains). In exchange, the package includes an extension of unemployment benefits, a one-year payroll tax holiday, and several tax credits and programs espoused by Democrats or the president over the last two years. None of these terms should have surprised House Democrats. In fact, many of them have repeatedly voted with Republicans to block passage of an extension of just the middle-income tax rates. It has been clear for several months (and was crystal clear after the midterm elections) that the Bush tax cuts would be extended at all levels — if not during the lame-duck session, then in early January when the Republicans take control of the House and increase their share of the Senate. Only the most stubborn of liberal lawmakers could possibly have thought that they would be successful in letting the top rates expire after watching the White House shift its position after the last few weeks.

What may have shocked progressives was how quickly the president seemed to surrender on the estate tax. In the compromise, the White House agreed to a two-year estate tax plan that includes a $5 million exemption and a 35 percent rate. That is a far more generous estate tax than existed during the George W. Bush administration and, to many, it seemed to have been slipped into the tax cut package without much discussion. Democrats might have been ready to swallow a nearly total defeat on income tax rates, but they seem to be balking at giving in to Republicans on a tax that affects only a tiny minority of estates (and taxpayers in general).

The refusal of the House to introduce and vote on the compromise followed several days of attacks on Obama from liberals. This led to the president spending most of the week criticizing (and sometimes harshly rebuking) his critics from the left. The White House was also put in the curious position of agreeing with Republicans that failure to extend all of the Bush tax cuts would threaten the economy (and senior White House adviser Larry Summers even suggested that a double-dip recession was on the horizon if Congress didn't act, something he was forced to partially retract later in the week). (For coverage of the compromise, see p. 1159.)

All of this is probably at least somewhat amusing to congressional Republicans. In fact, Sen. Lindsey Graham suggested that if Democrats didn't like the compromise, they could wait until next year, and Republicans would introduce a different proposal when there are fewer Democrats around. There is no doubt that Republicans would prefer to handle the Bush tax cuts now and save a debate over permanent extension for the 2012 presidential and congressional elections, but there is no rush to do so. A Republican House could easily pass a two-year extension in January, and such a bill would probably exclude many of the pet Democratic priorities that made it into the president's package. This is almost certainly the best deal congressional Democrats will get in the near future, and that makes their vote look more petulant than principled.

Commentary

Section 1603 grants received a temporary reprieve by being included in the compromise tax cut package working its way through the Senate. (For coverage, see p. 1194.) The program provides a nontaxable grant for taxpayers investing in certain energy projects and is designed to encourage investment in alternative energy production in an economic environment when tax credits aren't as valuable. However, Noah Baer points out that the grant is not a tax program but a separate subsidy administered by Treasury (p. 1217). In his special report, Baer addresses whether IRS technical guidance regarding eligible property applies to the grant

program. He acknowledges that the program incorporates section 48 energy property definitions, but he believes that does not necessarily mean all IRS guidance is applicable. He concludes that this issue is likely to become significant when the grant program expires and taxpayers are again operating under less permissive interpretations by the IRS.

The estate tax compromise between the White House and congressional Republicans allows 2010 estates to choose between the new exemption and rate level or the modified carryover basis rules in place for the tax's one-year expiration. However, that does little to clarify the uncertain rules that apply to the gift tax regime, according to David Starbuck, who analyzes the 2010 rules (p. 1231). Starbuck looks at several common fact patterns dealt with by practitioners daily and finds that the state of the law presents potential opportunities for aggressive tax savings. Alternative approaches are described by George Jackson on p. 1237. He writes that qualified disclaimers provide some families with a postmortem opportunity to refine estate plans to take advantage of the 2010 estate tax holiday.

The debate between Richard Jacobus and Blake Rubin, Andrea Macintosh Whiteway, and Jon Finkelstein continues this week, as Jacobus responds to their criticism of his position on the *G-I Holdings* decision (p. 1241). The dispute concerns whether the court's disguised sale ruling is dicta. Jacobus writes that the government did propose at least one disguised theory in the case. He also believes that the holding by the court has correlative effects on the taxpayer's liabilities for tax years in controversy during the case. This confirms that the court's ruling is not dicta, according to Jacobus.

Current law allows businesses that sell services or receive rents or royalties to pay tax on the receivables only when they are collected. This allows customers to immediately deduct the liability, but does not force a corresponding inclusion in income. Profs. Calvin Johnson and Greg Polsky propose eliminating this ''tax float'' by either taxing the receivables immediately or deferring the deduction until the income is taken into account (p. 1243). Their view is based on the fact that receivables can be replicated every year and should be viewed as a continuous pool. This allows the tax float to continue indefinitely.

Punitive damages are generally taxable. In 1996 that view was enshrined by a U.S. Supreme Court decision and a statutory change to section 104. However, there is a narrow exception for this treatment that exempts limited damages for wrongful deaths, according to Robert Wood (p. 1257). Wood writes that punitive damages remain a murky area despite the IRS's efforts to impose a bright-line rule. Rarely are punitive damages paid following a judgment in which the punitive character of the damages can be determined with certainty, he concludes.

Bernard Madoff's Ponzi scheme victimized many taxpayers and was the largest in history. Initially the IRS was slow to provide any relief to taxpayers affected by the loss of their Madoff investments, but with prodding from Congress, it eventually released guidance designed to allow taxpayers to take advantage of theft loss deductions. However, Kip Dellinger writes that this guidance did not explicitly cover those who indirectly invested with Madoff through other partnerships (p. 1261). Dellinger believes that these indirect investors were supposed to be covered by the notice and that the IRS made representations to Congress that these taxpayers were not excluded. He finds, however, that as taxpayers have attempted to claim their theft loss deductions, the Service has taken a much harsher approach. Dellinger describes several cases in which theft loss deductions were denied and concludes that the IRS needs to take action to prevent agents from taking this line (which contradicts the position of the National Office) because Madoff victims deserve better treatment. ■

© Tax Analysts 2010. All rights reserved. Users are permitted to reproduce small portions of this work for purposes of criticism, comment, news reporting, teaching, scholarship, and research only. Any use of these materials shall contain this copyright notice. We provide our publications for informational purposes, and not as legal advice. Although we believe that our information is accurate, each user must exercise professional judgment, or involve a professional to provide such judgment, when using these materials and assumes the responsibility and risk of use. As an objective, nonpartisan publisher of tax information, analysis, and commentary, we use both our own and outside authors, and the views of such writers do not necessarily reflect our opinion on various topics.