How to Solve the Government's Long-Term Fiscal Problems

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Regular readers of *Tax Notes* are more than aware that the government is facing a revenue crisis and that the result is likely to be serious tax reform, broad-based tax increases, or, most likely, both. Contributing editor Martin Sullivan has spent most of the last year analyzing the problem from many angles, and the Congressional Budget Office and Office of Management and Budget both recently issued reports that largely confirmed Sullivan's earlier predictions about the size of future federal deficits, the rising debt-to-GDP ratio, and the inadequacy of the nation's tax system to deal with these issues.

Alex Brill thinks the problem might even be worse than the CBO and OMB have estimated because of the likelihood that many provisions in the American Recovery and Reinvestment Act of 2009 will not expire as scheduled, but will be extended by Congress. In On the Margin, Brill looks at a number of provisions in the stimulus bill and concludes that over $130 billion will be added to the deficit each year by stimulus measures that are scheduled to expire but likely won't be allowed to. The largest culprits include the Making Work Pay tax credit, the expansion of the earned income tax credit, and the student financial assistance measures. If Brill is correct, then Congress will need to find an additional $1.3 trillion over the next 10 years to close up the federal deficit, on top of the $9 trillion in deficits forecasted in the latest OMB report. (For On the Margin, see p. 1117.)

The most obvious way to deal with this budgetary challenge is to raise taxes (or, in the new political jargon, find revenue raisers). One revenue raiser that's gaining momentum overseas and attracted the attention of economists in late 2008 is a tax on securities transfers, commonly referred to as a Tobin tax. Lee Sheppard and Sullivan look at Britain's recent flirtation with a securities transfer tax and analyze both the desirability of a Tobin tax in the United States and whether it could have prevented or ameliorated the near collapse of the financial sector last year (p. 1055). The authors present both the pros and cons of the tax, but conclude that its primary benefit would be a curb on short-term speculation, something neither believe was a major cause of the financial industry's recent woes. In the end, the best argument for a Tobin tax is that it might raise upwards of $100 billion annually and could be spun as a tax that falls primarily on the wealthy. That might make it appealing to the Obama administration because of its self-imposed limitation on any income tax increases on those earning less that $250,000.

David Cay Johnston believes that taxes are the answer to a number of the nation's problems and that an increase in taxes does not always equate to a decrease in wealth. In Johnston's Take, he uses the example of a garbage collection tax from his neighborhood to make a broader point about the efficiency of bargaining for services as a group and how the taxes paid for a public program can end up being less than the cost to individually contract for that same service (p. 1145). Johnston hopes that Congress and taxpayers will realize that Americans might actually be better off paying taxes to the government for healthcare and letting the government bargain for insurance prices for the nation as a whole.

President Obama's tax reform task force is expected to deliver its recommendations in early December. With the search for healthcare reform pay-fors likely to consume most of the low-hanging revenue-raiser fruit, ideas such as a stock transfer tax and even the first U.S. VAT might be part of any tax reform discussion. However, policymakers are probably better off looking at broad-based reform like that of 1986, rather than simply trimming at the edges of what is an ever-growing problem with the U.S. federal tax regime.

Commentary

Not that long ago, the United States faced a bursting investment bubble involving exotic debt securities. Several important banking institutions were facing collapse under the weight of investment portfolios overwhelmed with those securities, and the government stepped in to bail them out. No, it wasn't 2008, but the savings and loan crisis at the end of the 1980s. Congress's response to the bailout was to introduce a set of rules that limited the interest deductions on applicable high-yield discount obligations (AHYDOs). The rules were extremely harsh and complex, but were largely unused for the 20 years following their passage. In 2008, amid the collapse of another investment bubble, many corporations found themselves being denied interest deductions under the AHYDO rules.

Congress decided to suspend the law it devised to combat the earlier crisis until the new crisis passed. According to Viva Hammer, however, that suspension is not enough and businesses should prepare themselves for the return of the AHYDO rules, barring more legislative action. In her special report on p. 1095, Hammer explains the history of the AHYDO rules, how they apply to corporate debt, and attempts by Treasury and Congress to ''mitigate their barb during the financial crisis.'' Hammer concludes by offering some long-term solutions to the problem of what to do when the rules reappear in a few short months. Hammer hopes Treasury and Congress will take appropriate action to give taxpayers more predictability in the future without having to resort to multiple temporary fixes.

On August 12 the IRS released Notice 2009-70, requesting comments on the application of the rules for creating and maintaining multiple layers of built-in gain or built-in loss to partnerships. In The Partnership Tax Report, Monte Jackel has responded by looking at anti-mixing-bowl rules, partnership tiers, and separate partnership subinterests, among other topics (p. 1133). After analyzing most of the 2007 regulations' examples (particularly the controversial Example 3), Jackel concludes that the application of section 704(c) principles is complex and that taxpayers and the government should take advantage of this opportunity to shape debate and future guidance.

Mediation at the IRS has become something of a hot topic lately. Earlier this year, Tax Analysts hosted a conference on alternative dispute resolution at the IRS, and former IRS official John Klotsche has written two articles proposing extensive changes to ADR practices at the Service. (For Klotsche's ''Jousting With the Tax Man'' series, see *Tax Notes*, Mar. 9, 2009, p. 1241, and *Tax Notes*, July 27, 2009, p. 357.) Judge Carolyn Parr joins in the chorus proposing changes to mediation at the IRS, arguing in a viewpoint that postappeal mediation simply isn't working (p. 1113). Judge Parr points out that the fundamental problem hindering IRS mediation is a lack of trust on both sides. The structures in place seem solely designed to protect the IRS from wily taxpayers, according to Judge Parr. She points toward biases against outside mediators, the prohibition of ex parte contact, and unequal incentives to settle. Although she concludes that the IRS's willingness to engage in mediation is laudable and that Appeals' decisions are often a fair final word, Judge Parr offers a number of solutions designed to reform mediation in the postappeals process and hopes these simple changes can fix the problems.

Prof. Calvin Johnson continues with his suggestion to force the capitalization of investment expenditures that are currently deductible (p. 1121). The final omnibus proposal addresses the capitalization of officer and employee compensation paid to investigate corporation acquisitions; payments for termination of a contract; and the costs of exploration for and development of oil, gas, and mineral deposits. In a practice article on p. 1091, Robert Wood analyzes an IRS memorandum released in July 2009 regarding the income tax consequences of employment-related judgments and settlements. Although Wood finds the memo helpful, he still concludes that practitioners and taxpayers ''badly need more guidance on the section 104 issues.'' Robert Willens writes on p. 1131 about a recent IRS ruling that blesses a REIT spinoff. Willens concludes that ''contrary to popular belief,'' the IRS does issue rulings on transactions in which a C corporation converts itself into a REIT. ■