From the Editor:

Obama Urges Rearrangement of Deck Chairs on the Titanic

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As the nation's fiscal situation grows bleaker and unemployment and foreclosures remain at record levels, President Obama's response has been surprisingly muted. Despite the fact that Democrats everywhere might benefit from a powerful and coherent message on economic and tax policy from the White House, Obama seems determined merely to advocate from the margins.

Last week the president reiterated his call for the expanded higher education credit in the 2009 stimulus legislation to be made permanent. Arguing that the credit made it possible for millions of Americans to plan for higher education costs, the president encouraged Congress to provide certainty about the credit's future. He also hinted at his openness to eliminate the earnings cap on Social Security taxes and once again stated that he is opposed to extending the Bush tax cuts for those making more than $200,000 ($250,000 for joint filers). While education tax credits are important and Social Security will eventually need to be addressed (with the elimination of the earnings cap the most obvious solution), it is startling that among all the dire economic and tax issues facing policymakers today, the president would choose to focus on those two. It is especially surprising because his party is on the verge of losing a historic number of House seats primarily because of Democrats' muddled and misguided message on the economy and taxes. (For coverage, see p. 282.)

Serious discussion of the expiring Bush tax cuts and the budget deficit seems to have been postponed until after the midterm elections. In fact, it may be put off until the fiscal commission releases a report in early December. That is a major tactical misstep for the majority party, although one that is understandable given the divided nature of its caucus. It is almost certain that the Democrats will lose control of the House. If that occurs, then Republicans are likely to aim for a far greater reduction in taxes than just a permanent extension of a small higher education tax credit.

News Analysis

In 2005 Microsoft made headlines when *The Wall Street Journal* reported that profit shifting to an Irish subsidiary allowed it to shave 3.1 percentage points off its effective corporate tax rate. Martin Sullivan writes that since 2005, Microsoft has been even more aggressive in shifting profits overseas and has now managed to cut 12.1 percentage points off its effective rate (p. 271). He presents data that show that Microsoft's share of profits earned overseas has increased dramatically and that the company now has nearly $30 billion in unrepatriated foreign profits. Sullivan concludes that the culprit is the United States' leaky transfer pricing regime, but he does find that the software giant has not shifted many U.S. jobs overseas.

The UTP reporting proposal by the IRS has caused much frustration among the tax community. Many practitioners have been unsettled by the reach of the proposal and how it was formulated and announced. Jeremiah Coder writes that taxpayers who are being asked to be more transparent with the IRS might appreciate it if the government reciprocated (p. 275). Using Schedule UTP and economic substance guidance as examples, Coder looks at how responsive the IRS has been to stakeholder concerns and taxpayer calls for greater openness.

Commentary

Cancellation of debt has been a theme of the recession, with corporations and individual taxpayers alike renegotiating loans that they can no longer repay. In the corporate context, many shareholders seek to cancel only a portion of such debt to protect equity investments and improve the business's viability as a going concern. Although partially canceled debt is generally seen as not producing COD income if the shareholder's basis in the debt was at least equal to the debt's adjusted issue price, that may no longer be true, according to Scott Levine and Thomas Molins (p. 311). Levine and Molins highlight a debate that has emerged among practitioners about whether these partial debt cancellations are more complicated than they appear. The authors believe that partial debt cancellations are subject to section 108(e)(6) as contributions of capital and are not subject to section 108(e)(10). They conclude that there is little support for bifurcating a partial debt cancellation into part debt-for-debt and part contribution of capital.

The United States is the only major Western democracy that has failed to cut spending or implement some kind of austerity package in the face of growing deficits and rising debt. In fact, the United States is increasing the size of government relative to GDP and reducing "fiscal freedom," writes Richard Cebula (p. 323). He investigates the effect of reduced fiscal freedom on per capita income growth. His study concludes that reduced fiscal freedom leads to a slower rate of real economic growth. He also believes that the increased size of government and large federal deficits hinder economic growth. In the same vein, a viewpoint by David Roberts argues that attempts to generate contempt for taxes and regulation are nothing more than gambits to produce a partisan advantage (p. 331). He writes about a distortion of the ant and grasshopper fable that has been circulating on the Internet. Kip Dellinger also addresses the proper role of increased taxes and increased regulation on p. 363. Dellinger agrees with the premise that more regulation and higher taxes will only harm the economic recovery. Obama's recent business stimulus package is unlikely to help small businesses, writes Dellinger, who adds that looking at economic performance after the tax increases passed during the Clinton administration might lead to an incorrect interpretation of how taxes affect growth.

The expiration of the estate tax and its revival next year has created a bizarre situation in which the tax rules for decedents will vary wildly based on year of death. There is no estate tax this year, but the price for that is carryover basis, rather than a step up to FMV. All of this is the result of the strange way that Republicans tried to kill the estate tax in the 2001 Bush tax cut legislation. Bruce Bartlett believes that using carryover basis may be worse than having an estate tax (p. 361). The expiration of the estate tax and carryover basis will be very hard to administer, writes Bartlett. He points to Congress's brief flirtation with carryover basis in the late 1970s and finds it odd that policymakers would repeat that "fiasco." Bartlett agrees with a recent proposal by Michael Mundaca that would allow taxpayers to choose between the 2009 and 2010 rules when calculating the estate tax for 2010 decedents. He believes that many will choose to apply the 2009 estate tax and receive a step up in basis.

One of the major issues in a corporate reorganization is the allocation of earnings and profits. The consensus position is that all of the target's E&P goes to one acquiring corporation. Every so often, however, someone will suggest that there is statutory authority for allocation of E&P among the acquirer and its controlled subsidiaries, writes Jasper Cummings, Jr. (p. 345). This false reasoning is usually based on ambiguous statements in regulations that are nearly 50 years old, says Cummings. He identifies the vague regulations and then analyzes the issue of E&P allocation. The best interpretation of the statutes and regulations is that they prohibit allocations, he concludes.

Outside physical injury and employment lawsuits, many plaintiffs have difficulty deducting attorney fees because of AMT and itemized deduction limitations. The Supreme Court only partially settled the issue in *Banks*. Robert Wood writes about a theory not addressed by the *Banks* decision: whether the attorney and the client can be viewed as partners (p. 355). He concludes that the threshold for a tax partnership is low and that some decisions imposing partnership treatment in some cases might help taxpayers seeking to deduct legal fees.

Taxpayers are able to deduct the costs of tax planning and controversy work, and Prof. Calvin Johnson argues that this provides a tax subsidy. In this week's Shelf Project, he writes that such deductions should be eliminated (p. 333). He extends his proposal to include the costs of tax litigation and in-house tax experts. He concludes that it is foolish for the tax system to subsidize efforts designed to undercut it. In Of Corporate Interest, Robert Willens looks at which company's E&P can be used to support a boot dividend when a reorganization exchange has the effect of a distribution (p. 341). ■