From the Editor:

Obama's Fiscal 2012 Budget Disappoints Deficit Hawks, GOP

By Jeremy Scott — jscott@tax.org

President Obama's fiscal 2012 budget has finally been revealed, and on the tax side at least, it looks a lot like his 2011 proposal. Many of the same revenue raisers are back, and the president is again proposing a permanent research credit and a long-term alternative minimum tax patch. The real action in the budget is on the spending side, where Obama proposes cutting $700 billion over the next 10 years in order to control the deficit. The problem is that those cuts barely amount to a down payment if the goal is to get to a sustainable deficit, much less a balanced budget.

Over the next 10 years, the president's proposal would add $7.4 trillion in federal debt (making a mockery of any concerns that this would be a U.S. austerity plan along the lines of the budgets in the United Kingdom or other European nations). The budget would result in an estimated $1.1 trillion deficit for 2012, down from $1.65 trillion this year. Most of the spending cuts come from a five-year freeze on non-defense, discretionary spending. Republicans were quick to call the budget inadequate to solve the deficit problem, and the House GOP continued work on a continuing resolution that would cut at least $60 billion from 2011 spending. Republicans have vowed to present their own plan shortly, and it is likely it will involve even deeper cuts over the 10-year period starting in 2012 than those proposed by Obama. (For coverage, see p. 889.)

Obama's budget does not include the type of corporate tax reform he has been pushing in recent weeks. There is no mention of a rate cut or which tax expenditures would be eliminated to keep reform revenue neutral. The administration's failure to include corporate reform in the budget is curious, but unsurprising — the president has shown that he prefers to allow Congress to design the specifics of serious reform proposals. Obama has said he would sign only revenue-neutral reform, something that business continues to insist is not compatible with the president's goal of increasing U.S. competitiveness. (For coverage, see p. 868.)

House Budget Committee Chair Paul Ryan called Obama's budget an abdication of leadership. It is hard to argue with that. The revenue raisers in the budget have almost all been proposed before, in either the 2009 or 2010 White House budgets that made no progress in a heavily Democratic Congress. Does Obama really expect John Boehner to jump at the chance to pass his deduction cap when Nancy Pelosi wouldn't touch it? And even Democratic lawmakers have said that proposals to eliminate section 199 treatment for oil and gas companies aren't going anywhere this year. It is possible that Obama is hoping that by punting on harsh deficit reduction, he can make Republicans look overzealous (much like Clinton did in 1995). But that wouldn't reflect well on his leadership. (For coverage of revenue raisers, see p. 865.)

Another theory making the rounds among commentators is that the president didn't want to preempt bipartisan efforts to adopt the plan offered by the National Commission on Fiscal Responsibility and Reform. If Obama endorsed the fiscal commission's tax, spending, and entitlement reforms, then it might be harder for Republicans in the House and Senate to sign on to the legislation. It is true that at least six senators are working on a legislative version of the fiscal commission's final proposal. That group includes conservative Sen. Tom Coburn of Oklahoma and Majority Whip Richard Durbin of Illinois. Perhaps the president really is hoping that Congress will do the heavy lifting for him. But on this issue he might be waiting a long time for the House and Senate to agree on anything other than short-term continuing resolutions.

Helmsley and Banking Capital

Despite a progressive income tax system, the very wealthy in the United States typically enjoy lower marginal tax rates than middle- and lower-income taxpayers, primarily because of the 15 percent rate for capital gains and dividends. Martin Sullivan uses IRS data based on taxes paid by ZIP code to show this disparity. According to Sullivan, taxpayers who used the Helmsley Building in New York as their filing address had an average income of more than $1 million in 2007. However, that group had an average tax rate of only 14.7 percent. The janitors and security guards who work in the building probably have average tax rates near 25 percent, concludes Sullivan. Only the little people pay taxes, indeed. (For Sullivan's analysis, see p. 855.)

Equity-to-debt ratios in the financial sector have been heavily scrutinized in the wake of the recession and the near collapse of the banking industry around the globe. Many commentators and oversight bodies have pushed banks to maintain higher capital deposits to help avoid a repeat of 2008 and 2009. Lee Sheppard writes that the Dodd-Frank Act and the Basel III standards are not likely to do much to discourage banks from using contingent capital and as a result, being undercapitalized in a future crisis. In her review of remarks from the recent ABA Section of Taxation meeting in Boca Raton, Fla., Sheppard contends that the cost of capital is not nearly as high as banks sometimes claim, and that the tax system's favoritism of debt financing is a political decision that should be corrected. (For her analysis, see p. 857.)

Commentary

Section 2036(a) makes includable in a decedent's estate property given away during life if the decedent retained income from the property or the right to determine who could enjoy the property. A recent Second Circuit decision vacated and remanded a Tax Court holding that section 2036(a) required inclusion of a 49 percent tenant-in-common interest a woman gave her son the year she died. John Bogdanski analyzes some of the questions raised by the appellate court, including the apportionment issue the circuit court remanded to the Tax Court for determination (p. 911).

In February 2009 TIGTA released a report on worker misclassification issues, noting that the most recent study (from 1984!) on its impact estimated that worker misclassification resulted in $1.6 billion in underpayment of tax. The IRS agreed with TIGTA's recommendation that it create a national research program on employment taxes and said it will audit 6,000 employers between 2010 and 2012. Kevin Johnson provides an outline employers can use in light of these increased enforcement efforts in which he emphasizes documentation of a worker's status from the outset (p. 923).

Entitlement reform has been called a ''third-rail issue'' facing the Obama administration. Mark Warshawsky and Alan Viard both address the issue this week, with Warshawsky arguing that recent proposals are unfair to individuals in higher income brackets (p. 929) and Viard criticizing the use of general revenue to finance the program (p. 943).

Jeffrey Maine and Xuan-Thao Nguyen address the tax treatment of intellectual property, an area they say receives surprisingly little attention despite its important economic role (p. 931). They argue that disparate tax treatment between similar taxpayers indicates flaws in the IP tax system.

Baseball season is just around the corner, and George White writes this week about the curveball the IRS threw the tax community late last year (p. 939). White examines the *Robinson Knife* decision, which he suggests influenced proposed section 263A regs dealing with sales-based royalties.

Practitioners have little to go on when faced with IRS assertion of the recently codified economic substance doctrine. Jasper Cummings, Jr. writes that the doctrine is a positive rule of law that should be used to deny tax benefits only after it has been determined that the taxpayer is entitled to the benefits (p. 953). He offers a defense plan, examining how the IRS might strategize, and contemplates Congress's thoughts when codifying the doctrine.

In Woodcraft this week, Robert Wood sheds light on the tax treatment of recoveries for wrongful incarceration (p. 961). Wood writes that while the legal bases for unlawful incarceration lawsuits are similar, the theories for recovery vary, and he discusses how a recent IRS legal memorandum that treated recovery as excludable from income may have solved the issue.

Although he presided over the largest tax reform effort in recent history and enacted a huge tax cut while in office, Ronald Reagan is rarely remembered for his tax increases. In his column this week, Bruce Bartlett discusses the Great Communicator's long record of increasing taxes when necessary, arguing that Reagan fit neither left- nor right-wing political ideologies (p. 965).

Criticizing the ''liberal tax-and-spend orthodoxy,'' Kip Dellinger offers suggestions for thinking about the legitimacy of the media's mantra that taxes on high-income earners should be raised and whether wealth redistribution efforts actually benefit those at the bottom of the income ladder (p. 967). ■