The Politics of Austerity: Spending Cuts and the Deficit

By Jeremy Scott — jscott@tax.org

Republicans and conservatives are opposed to tax increases. That isn't exactly big news, but the inflexibility of their position might seem to clash with their stated desire to balance the federal budget and restore fiscal sanity to Washington. This is nothing new, of course. Republicans swept into power in the 1990s partly because of a platform promising tax cuts and a balanced budget. The question is whether the government's growing debt-to-GDP ratio can be solved this time around with spending cuts alone.

Rep. Paul Ryan, R-Wis., thinks that it can, and unlike many of his colleagues on both sides of the aisle, he's willing to point the way. Ryan has released a detailed budget plan that would balance the budget and *reduce* taxes. Of course, he achieves this through what some might consider draconian cuts to discretionary spending, Medicare, and Medicaid. Martin Sullivan writes that Democrats, conservatives, and commentators shouldn't be so quick to dismiss Ryan's plan. Although he believes that some provisions in the roadmap are unworkable (namely Ryan's desire to partially privatize Social Security and eliminate many of the progressive features of the tax code), Sullivan thinks that Ryan's cap on Medicare and Medicaid payments might be the only way to curb growth in entitlement spending significantly. The government is in uncharted financial territory, and radical solutions like those proposed by Ryan might be the only way to deal with the crisis, according to Sullivan. He praises Democrats who have already admitted that Ryan's plan might be a starting point (a group that includes the president) for serious negotiation on the nation's tax and fiscal future. He also condemns tea partiers and others who reflexively seem to oppose both tax increases and cuts to popular entitlement programs, saying that is the equivalent of sticking your head in the sand. (For Sullivan's analysis, see p. 954. For coverage of the president's fiscal commission, see p. 974.)

The tea party movement and conservative fiscal dogma might frequently be attacked by policy wonks and left-leaning Democrats, but Kip Dellinger says that doesn't mean the movement lacks thoughtful members or is wrong about what the future direction of federal spending should be. Dellinger believes that the tea party is mostly about economic freedom and the idea that President Obama's healthcare reform and other initiatives are both driving up government spending and limiting future generations' choices. He is skeptical that an increased tax burden, either on the rich or in general, is the only way to solve the government's budget mess and points out that even European countries are desperately slashing spending and (before the recession) cutting taxes to spur stagnant growth rates (p. 1039).

The bloated nature of the federal budget (including both direct spending and tax expenditures) suggests that tax increases shouldn't be the reflexive solution to the federal deficit and sovereign debt crisis. Ryan is probably right to target healthcare-related expenditures in his roadmap for the future of federal spending. At some point, tea partiers, Democrats, and Republicans will have to accept the fact that we can't have our cake and eat it too.

Textron

Although overshadowed by the IRS's uncertain tax position proposal, the controversy over tax accrual workpapers remained alive in the form of Textron's appeal to the U.S. Supreme Court — at least until last week's certiorari denial. The Court has declined to review the case, despite an overwhelming number of amici briefs that practically begged for clarification of how the work product doctrine applies to these types of documents. The Court's decision will allow the *en banc* First Circuit decision to stand and has left many practitioners scratching their heads. Jeremiah Coder reports that many observers thought the Court would intervene to settle an obvious split in the circuits, while others simply thought it might want to overturn a bad decision by the First Circuit. For reaction to the decision and practitioner speculation on its significance, see p. 951.

Although the government has triumphed in *Textron*, Kenneth Clark writes that it wasn't because of its stated position or its brief (p. 1017). The government's arguments seemed to ignore the First Circuit decision in parts and contained positions that do not serve the public interest, according to Clark. He concludes that by opposing Supreme Court review, the government did not serve the wider interests of the bar or the tax system.

Commentary

The near collapse of the financial industry has caused numerous ripples throughout the economy. One of the new wrinkles in finance is the emergence of distressed debt as a significant investment class. Distressed debt raises several complicated tax issues, including the timing and character of recognized taxable income. David Garlock examines these tax issues and also provides numerous recommendations for improving the tax rules for distressed debt in a special report on p. 999. Garlock suggests targeted fixes to specific problems relating to character and timing, but also includes a proposal for a broad overhaul of the system that would substitute a clear reflection of income standard for the mechanical rules and common law exceptions that govern this area of tax law.

Besides its regressivity, the most common complaint about a potential U.S. VAT involves whether such a tax would be compatible with state and local consumption taxes. Many commentators point to the Canadian experience to show that although a VAT can work in a federal system, it isn't easily implemented. Harley Duncan and Jon Sedon explore the issues involved in coordinating a federal VAT, suggesting that well-designed state and local taxes could be modified to emulate an efficient federal-level tax (p. 1029). The authors concede that a federal VAT would probably involve a loss of autonomy for state tax regimes, but say it would probably increase the efficiency of the U.S. tax system as a whole. Although the VAT has been disavowed by almost every policymaker, including the president, the nation's revenue crunch probably means that it will remain a hotly debated option in the future.

In a controversial recent notice, the IRS held that under certain circumstances it could treat an otherwise domestic partnership as foreign if it would ensure the inclusion of subpart F income in the hands of the ultimate U.S. shareholder. Practitioner response has not been supportive, and the IRS has been on the defensive at various conferences and meetings. In The Partnership Tax Report, Monte Jackel analyzes Notice 2010-41 and disagrees with the IRS's conclusions (p. 1021). Jackel states that the notice's analysis is results-oriented, which he believes undermines rational tax policy and the tax system. Although he finds the transaction described in the notice dubious, Jackel concludes that the notice is wrongly decided under applicable law.

In *Robinson Knife*, the Tax Court held that a manufacturing company using the simplified production method was required to capitalize the costs associated with trademark royalty payments. In March the Second Circuit reversed. The reversal is important because under the Tax Court's reasoning, a portion of the royalty payments was required to be included in a company's ending inventory under its simplified production method. In light of this decision, many taxpayers might want to consider changing their accounting method, write Carol Conjura, Matt Yokitis, and Peter Beale. The authors also look at other postproduction costs that could be affected by the decision, and how the section 199 manufacturing deduction might be modified by accounting method changes in response to the Second Circuit opinion. For their analysis, see p. 1013.

Robert Wood takes a break from his usual analysis to provide 10 ''admittedly annoying'' practice tips for young tax lawyers (p. 1025). Wood's 10 pieces of advice concern responsiveness to clients, being engaged, striving to impress, and asking for work to develop client relationships. He concludes by encouraging young practitioners to enjoy themselves. ■