

### *From the Editor:*

## Administration Appears Ready to Surrender on Bush Tax Cuts

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Republicans are poised to make huge gains during Tuesday's midterm elections. The GOP will almost certainly seize the majority in the House, and while it may fall short of winning enough seats to get to 51 senators, it might enjoy effective control of the chamber when conservative or vulnerable Democrats are taken into account. Anticipating this near landslide, Vice President Joe Biden has signaled that the Obama administration is ready to compromise with Republicans on the expiring Bush tax cuts.

For over two years, President Obama has maintained that he will oppose extension of the Bush rates for those making more than \$200,000. Speaker Nancy Pelosi and Senate Majority Leader Harry Reid also have backed the administration's line. But lately they've been about the only members of Congress willing to do so. Key Democrats have been defecting all year to the Republican side on this issue, arguing that all of the tax cuts should be extended to protect the economy. In fact, many desperate House Democrats are making their opposition to Obama's position the centerpiece of their reelection campaign. (Readers in the Washington area don't need to look far to see the best example of this disingenuous campaigning: Rep. Gerry Connelly, who won election largely by riding on Obama's coattails in 2008, is now presenting himself as an implacable foe of the beleaguered president.) Two Democrats who haven't won their Senate seats yet, Joe Manchin in West Virginia and Chris Coons in Delaware, have indicated that if elected, they will oppose Obama on the tax cuts. In this environment, Biden's statement that the administration is willing to retreat from its position on the upper-income rates is hardly surprising. (For coverage, see p. 509 and p. 511.)

The Bush rates are likely to be the major tax issue of the last part of this year and, if not extended, will likely be the biggest issue facing the new Congress in January. The outlines of a compromise have been known for months: a temporary extension of all rates and a permanent extension for middle-income

taxpayers. Obama and Democratic leaders on the Hill seemed to be the last bastion of resistance. With the administration backpedaling, Pelosi facing irrelevance if not ouster, and Reid not even guaranteed a seat in the next Senate, such a plan might be passed with less difficulty than many think. Of course, there is no guarantee that Republicans will be satisfied with anything less than permanent extension of all of the Bush tax cuts if they sense Democratic opposition on the issue crumbling.

### Fiscal Crises and Cost Basis Reporting

The government is facing a major budget crisis that only will get worse without dramatic action to restructure the nation's tax revenue stream. That is the conclusion of Martin Sullivan in the first of a two-part series focusing on the possible effects of the increasing U.S. debt-to-GDP ratio (p. 499). In the first part, Sullivan outlines the first stage of a possible economic collapse in which increasing government debt crowds out profitable investment and leads to slower economic growth. He looks to data provided by the CBO on how U.S. debt will skyrocket and how some of the numbers provided might not be telling the entire story of the dire situation.

One possible solution to the federal budget crisis is to implement some form of a VAT at the national level. Some believe that a VAT would provide the revenue needed to maintain government spending. Diana Furchtgott-Roth is not opposed to a federal consumption tax, but she is not in favor of it taking the form of a VAT (p. 621). She proposes several changes that would gradually move the income tax system toward a consumption tax, including changes to tax-preferred savings accounts and corporate depreciation. She also analyzes tax reform proposals from Republican Rep. Paul Ryan and Democratic Sen. Ron Wyden. She concludes that the time is right for fundamental tax reform.

Treasury recently released the final cost basis reporting regulations, which take effect on share sales and transfers starting in January. The regulations preserve a scheme that is too complicated and personal to be applied to individual investors by automated programming, according to Lee Shepard (p. 503). She also criticizes the underlying substantive law and finds that the IRS is already taking steps to exclude several classes of investors from reporting. She addresses the forms needed to

report cost basis, steps needed to receive relief from penalties, and how cost basis reporting will affect accounting methods.

### Commentary

Throughout the summer and until the legislation's collapse in the fall, the carried interest pay-for in the extenders proposal generated controversy. The goal of the pay-for was to tax some carried interest compensation as ordinary income instead of as capital gains. During the fiscal crisis, the inequitable tax treatment between wage earners and hedge fund managers attracted public attention. The latest version of the carried interest proposal is staggeringly complex and should be substantially altered before enactment, according to Jack Levin, Donald Rocap, and William Welke (p. 565). The authors point out several serious flaws with proposed new code section 710 in the bill, including its incompatibility with generally applicable tax principles, its incomprehensible rules, and its sweeping grants of regulatory power. They also criticize the proposal's harsh treatment of dispositions of interests in investment and real estate partnerships. They conclude by recommending that Congress limit the reach of section 710 before adopting the bill.

The effect of tax legislation is frequently only measured in the context of the tax type under consideration. But changes to the tax law have distributional effects across the entire code, according to Suzanne Luttmann (p. 581). She criticizes the separation of FICA tax analysis and income tax analysis and argues that it misrepresents the total tax burden on working taxpayers. Specifically, she focuses on the Making Work Pay credit and concludes that Congress's analysis of the credit distorted the soundness of the FICA tax system. She encourages Congress and the administration to adopt a joint analysis of FICA and income tax effects and calls for a general reform of the tax system as a whole.

The President's Economic Recovery Advisory Board recently recommended allowing small businesses to expense their inventory and exclude their customer receivables from tax. Prof. Calvin Johnson disagrees with the idea and calls PERAB's proposal nothing more than a tax shelter or subsidy that actually benefits taxpayers more than if they paid no tax at all (p. 591). He argues that maintaining records on inventory and receivables is not difficult and is becoming cheaper because of advances in computer accounting methods. He concludes that PERAB's proposal is not only prone to abuse, but would be an abuse in and of itself.

The IRS is employing a new global high-wealth industry group. The goal of the group is to bring together IRS specialists to coordinate the compliance review of high-wealth individuals and their related entities. Charles Rettig looks at the IDRs being used by this new group to unwind the complex structures used by the targeted subset of taxpayers (p. 607). Rettig cautions practitioners to be familiar with the IDRs being drafted by the "Wealth Squad" and presents a detailed look at their content. He advises practitioners to exercise discretion when responding to these requests and concludes that a prompt resolution of examinations may not be possible.

Taxes must be considered during the mediation of civil disputes, and a term sheet setting out the major economic points should be used, according to Robert Wood (p. 615). Mediation and alternative dispute resolution are becoming more popular, but parties involved in these processes frequently fail to bring up tax issues, Wood writes. Although this will introduce complexity into the negotiations, Wood believes that it is ultimately in both parties' best interest. In the return of K Rations, Darryll Jones discusses the controversy surrounding the determination of partners' interest in the partnership standard (p. 603). Jones tries to reconcile a recent court decision with scholarly opinion on the topic. ■

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