From the Editor:

Can a Tax Incentive Ease the Unemployment Problem?

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In a thought-provoking piece this week, Martin Sullivan explores the dimensions of the recently introduced Hire Now Tax Cut Act of 2010, S. 2983, or the Schumer-Hatch employment incentive. According to Sullivan, the incentive will be a windfall to employers without necessarily expanding the aggregate workforce. It would merely provide a tax benefit for employers to replenish the turnover in their existing workforce. Sullivan believes that the tax incentive in the bill falls short of its policy goal of creating additional jobs and reducing unemployment. Moreover, Sullivan identifies the potential for abuse if some countermeasures are not included in the law. He thinks the tax incentive could encourage firings of existing employees and discourage employers from cultivating and retaining their workers. In addition, he identifies complexities in the application of the legislation. For example, it would be difficult to determine whether a new hire is replacing an existing employee. Under the bill, a prospective employee whose wages would be exempt from payroll taxes cannot replace another employee except if that employee quits or was fired for cause. For Sullivan's analysis, see p. 906.

This week Sullivan also looks at the research credit and argues that, for a variety of reasons, Congress should consider eliminating the 29-year-old provision (p. 891). He reviews a string of court decisions that show that the credit is becoming largely unadministrable. The practical difficulties in determining which expenses are qualifying expenses also undermine the effectiveness of the credit. Most important, however, is Sullivan's argument that the ability of companies to claim the credit ex post facto on amended returns undermines the legislative intent behind the credit, which is to act as an economic incentive to encourage research and development activities. Many corporate and small-business taxpayers, according to Sullivan, are not incentivized by the credit to intensify their research activities, but instead receive a windfall from the government. The elimination of the credit could fund a 1 percent reduction in the corporate tax rate.

Bank Taxes and VATs

There are alternatives to the bank fee proposed by President Obama that would do a better job of reining in risks in the financial sector, writes Lee Sheppard in her third look at banking industry reform efforts. This week Sheppard focuses on different approaches to taxing the financial sector to discourage the growth of too-big-to-fail firms and excessive trading. She believes that the experience of other countries shows the efficacy of some form of a transactions tax or even a VAT on financial services. Both would probably work better than the president's proposal, says Sheppard. She also rebuts the idea that a VAT is too ''European'' for the United States by pointing out that the House health-care bill included what amounted to a VAT on medical equipment. For Sheppard's analysis, see p. 898.

Our Views on VAT column returns this week to explore the differences between a retail sales tax and VATs (p. 983). Leah Durner and Bobby Bui compare a typical VAT regime with the sales tax systems that exist at the state and local levels in the United States. The authors write that understanding how a VAT can operate within the confines of the retail sales tax regimes already in effect is central to the debate over whether the United States should adopt a VAT.

In a news analysis piece this week, Sheppard also reports on a discussion among government officials and practitioners on the application of and guidance under section 7874 — the anti-inversion rule — and its corporate residence aspects. For coverage, see p. 913.

Commentary

At the moment, Republicans seem to have the upper hand in the estate tax debate. Many moderate Democrats oppose a return to 2009 exemption and rate levels, but estate tax opponents will eventually have to compromise or the tax will revert to Clinton-era law. Democrats in favor of a permanent extension of 2009 law also favor retroactive application of the tax, which would undo the effects of the 2010 repeal. This has raised questions about the constitutionality of a retroactive tax. Jay Starkman argues that if Congress does choose to retroactively impose the estate tax, courts will do their best to uphold it (p. 971). Starkman points to the 1993 retroactive estate tax proposed by President Clinton. Courts denied several refund claims based on constitutionality challenges, and the Supreme Court declined to review the matter. The *Carlton* decision cited by many other proponents of retroactivity also reinforces the view that a retroactive tax will be constitutional, according to Starkman. He concludes that although there will be challenges to the estate tax, any chance of a taxpayer victory is remote.

Tax-exempt entities are discouraged from engaging in business outside their tax-exempt purpose. The backstop to this policy decision is the so-called fractions rule, which imposes a tax on the unrelated business income of a tax-exempt firm. In a special report, David Kahn echoes the belief of many that the fractions rule of section 514(c)(9)(E) has a well-deserved reputation for being difficult and complex (p. 953). The rule comes into play when certain types of tax-exempt organizations (primarily pension funds and educational organizations) wish to acquire real estate through a partnership. In these situations, the organizations must be careful about partnership allocation rules. Kahn's report explains the fractions rule, describes its practical aspects, and then addresses problems that arise when drafting partnership agreements.

All-cash D reorganizations have frequently been a topic of discussion at various conferences and meetings with IRS officials. This is primarily because of the newly finalized regulations dealing with stockless D reorganizations and basis allocation. Jonathan Zhu writes that the IRS needs to clarify its position on a potential basis disappearance that can result in D reorganizations involving tiered entities. According to Zhu, the loss of basis in these transactions is the wrong result, and the IRS needs to specify where the basis should attach. His practice article is on p. 950.

Guidance on the election to become an electing investment partnership was issued soon after the passage of the 2004 law that mandated a reduction in basis for assets in which a partnership had a substantial built-in loss. That guidance, however, left many questions unanswered, although practitioners seem to feel that way about most guidance. Those questions are key, according to Kristen Hangen and William Weatherford, because the recession has left many partnerships with assets having fair market values less than their cost bases. The article provides an overview of the mechanics of the electing investment partnership election and discusses where additional guidance is needed (p. 945). The authors conclude that many investment partnerships may begin to reexamine the election as a means of avoiding the mandatory basis step-down rule.

The pending expiration of the 2001 and 2003 tax cuts means that America is at a tax policy crossroads. Obama would like to raise taxes on upper-income taxpayers, while Republicans are calling for both tax simplification and further tax reductions. Diana Furchtgott-Roth believes that the choice should be spending and tax reductions (p. 989). She cites the findings of Christina Romer, the chair of the president's Council of Economic Advisers. A paper written by Romer found that legislative tax changes have far more harmful effects than tax increases resulting from changes in economic activity or lack of inflation indexing. Furchtgott-Roth believes that this paper provides powerful support to the bill sponsored by House Ways and Means Committee member Paul Ryan, R-Wis., which would drastically simplify the tax code by offering a choice between the current code and a regime that limited deductions and used a flat rate.

David Roberts has a problem with the inclusion of a taxpayer's full Social Security number on certain information returns, such as W-2s. He writes that the inclusion of the full number offers little benefit while sharply increasing the risk of identity theft. Roberts proposes using only a shortened form of the Social Security number (p. 974). Robert Wood's latest Woodcraft column looks at emotional distress awards and the latest impetus to exclude those recoveries from income. Wood analyzes a recent Tax Court decision and National Taxpayer Advocate Nina Olson's 2009 report to Congress and concludes that an expansion of section 104 seems inevitable (p. 977). ■