From the Editor:

Debt Ceiling Debate Begins Again on Capitol Hill

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After lying somewhat dormant all year, debt ceiling discussions are beginning in earnest in Washington, and the tone already isn't good. Senate Finance Committee Chair Max Baucus pushed for a clean debt ceiling bill last week, while his counterpart on Finance, Orrin Hatch, said that no debt ceiling increase will be able to pass Congress without some discussions on spending cuts or tax reform. President Obama and Senate Majority Leader Harry Reid have already said they won't negotiate over a debt ceiling increase, but it is unclear how much leverage they have over the Republican House.

Baucus's statement is something of a surprise, if only because he had indicated earlier this year that he was pushing forward on tax reform in case it could be coupled with a debt ceiling bill (p. 1376). He didn't necessarily contradict that position last week, but he did express his support for an unconditional increase in the federal borrowing limit, which will have to be addressed sometime in the fall. Hatch was emphatic that such a bill would not be able to pass Congress. House Ways and Means Chair Dave Camp has said that he would like to see a firm plan for tax reform put in place as a condition for any debt ceiling increase, but it's not clear how much support that position has with GOP leaders.

Hatch is right that Democrats can't increase the debt ceiling without the consent of the House. And Republicans could refuse to support an increase without another round of concessions from Obama and the Senate. But it is hard to see how the GOP has the high ground in this debate. The party has backed down several times in a row, and the one great concession that conservatives got from the president — the sequester — is unpopular with the public and lawmakers. Republicans might be able to force a debate on the issue, but it isn't likely that they will be able to get a fully offset increase. And the idea of trying to create a tax reform framework as a condition for a debt ceiling bill only hurts the prospects for actual reform.

EO Scandal

The investigation into the IRS exempt organization scandal might have started on a bipartisan basis, but that consensus appears to be breaking down. While both Republicans and Democrats have condemned the IRS's conduct in applying special scrutiny to conservative groups' applications for 501(c)(4) status, the parties are now sharply disagreeing about whether direction for the scrutiny originated in Washington or Cincinnati (p. 1353). Darrell Issa, Camp, and Charles Boustany contended that interviews with Cincinnati employees showed that the policy did not start in that office, while Elijah Cummings claimed just the opposite, relying heavily on the testimony of a ''conservative Republican'' employee in Cincinnati that seemed to suggest he alone was responsible. Republicans seem determined to prove higher-level involvement (and probably hope to find a smoking gun implicating the White House), but Democrats are becoming increasingly skeptical of the direction of the congressional investigations.

The entire EO scandal is the result of the existence of section 501(c)(4) social welfare organizations. Joseph Thorndike writes about the history of the social welfare exemption and is surprised by the paucity of legislative history on the subject (p. 1351). The U.S. Chamber of Commerce seems to be responsible for lobbying for an exemption for social welfare organizations, but Thorndike observes that the final provision doesn't exactly match what the chamber asked for.

Commentary

In 2007 the IRS issued a ruling about the application of the employment-related restriction to acquirer stock received by an employee-shareholder in a reorganization. The ruling depended on a single nonrecognition and gain deferral rule to do double duty, according to Jasper Cummings, Jr. (p. 1425). He argues that the IRS was wrong and that a single rule should be able to prevent two different income items from being recognized by a taxpayer. He criticizes the IRS for not expounding on the section 354 issue in the original ruling. The taxpayer should have been offered the option to pay capital gains taxes on the gain realized in the old stock at the time of the exchange, leaving the later increase to be taxed at ordinary rates, Cummings says. He concludes that the IRS should rethink Rev. Rul. 2007-49.

The applicable high-yield discount obligation rules can prevent deductions for accrued original issue discount. Despite the fact that the AHYDO rules serve as a limit on OID, they do not rely on OID principles, according to Jiyeon Lee-Lim and Y. Bora Bozkurt (p. 1395). The inconsistency makes it difficult to determine what instruments are subject to AHYDO rules, they write. In their special report, they look at several situations showing the effects of the inconsistency between AHYDO and OID rules. They try to show when it is possible to avoid AHYDO characterization in common borrowing transactions and when structuring catch-up payment provisions.

As tax reform discussions continue in Washington, many are concerned that Congress hasn't laid a proper foundation for serious reform. The lack of involvement by Treasury and the White House is a major difference from the successful push before 1986. George Yin, however, focuses on the role of the nonpartisan legislative staff (p. 1415). The value of the nonpartisan staff lies primarily in its responsibility to serve a broad group of legislators with different interests, not in its status as nonpartisan, he writes. He points out how an effective staff can improve the legislative process and improve the quality of tax bills.

The concept of tax reform is dominated by numerous myths that might be out of date. Most lawmakers seem to be assuming that reform will proceed largely along the lines of the 1986 effort, but that model might be obsolete. Scott Semer explores five myths about tax reform and explains why they will hold back the push for reform (p. 1422). Semer looks at the myth of horizontal equity, vertical equity, the importance of the corporate tax, the notion of a balanced budget, and the negative effects of higher taxes. He argues that the corporate tax and balanced budget, in particular, often receive overstated importance in reform discussions. He also concludes that higher taxes won't necessarily lead to economic impoverishment.

After the passage of TEFRA, it was not clear how partnership items could be taken into account when computing a partner's tax deficiency or vice versa. The IRS generally would issue a notice of deficiency if a taxpayer was oversheltered (losses from partnership items offset any proposed adjustment to non-partnership items), disallowing some partnership items for computational purposes only. In 1989 the Tax Court ruled against this practice in *Munro*. Robert Wood and Dashiell Shapiro write about the initial reaction to *Munro* and how it has affected partnership practice (p. 1433). They also discuss how in 1997 Congress ultimately legislatively overruled the Tax Court. *Munro* might still apply to partners who are not oversheltered, but the significance of the decision has been narrowed by section 6234, they write.

The release of the deemed asset sale regulations, which concern section 336(e), has caused quite a stir in the practice community. At numerous events last week, practitioners quizzed IRS officials on how the rules operate (p. 1357). Robert Willens discusses the new flexibility offered by section 336(e) and how it offers additional options for achieving a basis step-up (p. 1439). Unlike section 338(h)(10), the new section does not require a qualified stock purpose, he says. After reviewing several examples of how section 336(e) will operate, Willens concludes that it is a welcome addition to the tax planning arsenal. ■