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From the Editor:

Fiscal Commission Co-Chairs Target Tax Expenditures

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During most debates about the state of the deficit this year, Democrats have pointed to President Obama's fiscal commission. The president challenged the commission to reduce the deficit to 3 percent of GDP by 2015 and has repeatedly urged Congress to seriously consider any proposal that emerges from the group. Last week the first concrete plan emerged from the commission, authored by co-chairs Erskine Bowles and Alan Simpson. Democrats weren't very pleased with the details.

Bowles and Simpson call for heavy spending cuts, a restructuring of Social Security that lifts the cap on payroll taxes and raises the retirement age, and the elimination of all tax expenditures in the code. The last proposal would raise $1.1 trillion annually, but almost none of that would go toward deficit reduction. Instead, Bowles and Simpson want to drastically cut income tax rates, reducing the number of tax brackets to three (with the rates set at 8, 14, and 23 percent). They would eliminate the preference for capital gains and dividends and lower the corporate tax to 26 percent. In total, their plan would cut taxes by $1 trillion annually, leaving $100 billion of their tax expenditure savings for deficit reduction. That means most of the Simpson-Bowles plan's deficit reduction is accomplished by spending cuts and the changes to Social Security and Medicare. (For coverage, see p. 755.)

Democrats cried foul. Soon-to-be-former Speaker Nancy Pelosi said she could not support the cuts to Social Security and Medicare. Sen. Richard Durbin said he couldn't support the plan in its current form, but hoped it would be the starting point for discussions. Senate Budget Committee Chair Kent Conrad was disappointed that the chairs' draft proposal didn't include a consumption tax along with deeper income tax rate cuts. Left-leaning blogs have also claimed that eliminating all tax expenditures, including the mortgage interest deduction, and cutting the top marginal rate to 23 percent amount to a massive tax cut for the rich, something that no progressive should support.

Criticism from the right has been more muted. The Republicans on the fiscal commission (including House Republican leader John Boehner) praised the plan's boldness and hoped it would advance the debate on deficit reduction and tax reform. Other conservative commentators have focused on the corporate and individual rate cuts and wondered what tax expenditures might be saved while preserving these lower taxes.

The Bowles-Simpson proposal is not perfect. In fact, it could be argued that by taking such an extreme position, the chairs essentially punted on presenting a serious plan. By saying that no tax expenditures should survive, Bowles and Simpson have left all the hard work on tax reform to other commission members or Congress, because everyone knows that at least some tax expenditures are untouchable. But to characterize the plan as a tax cut for the rich is misguided. Tax expenditures primarily benefit high-income taxpayers. The mortgage interest deduction in particular is a tax expenditure that is overwhelmingly slanted toward wealthier taxpayers (particularly those who find ways to use it for second homes). And the Bowles-Simpson plan raises the tax rates on capital gains, a source of income overwhelmingly earned by wealthier individuals. So while the chairs' plan contains many flaws, a disguised tax cut for the superrich isn't one of them.

Commentary

A large portion of the tax code is indexed for inflation. Congress enacted an indexation procedure in 1985, but it was not implemented until 1989. Inflation adjustments can have a profound impact on the amount of tax owed by individual taxpayers. In a special report on p. 805, James Young discusses 2011 inflation adjustments to portions of the individual tax system, including the standard deduction, gift tax exclusions, child tax credits, the earned income tax credit, and a variety of education tax credits. Young explains how the Consumer Price Index is used to calculate inflation adjustments and how the expiration of the Bush tax cuts will affect the tax code. He concludes with the hope that identifying the portions of the code tied to the CPI will help practitioners and taxpayers with tax planning.

The debate over the Bush tax cuts has largely focused on what to do with the top two income tax rates and whether to extend the lower rates passed in 2001 and 2003 for high-income taxpayers. Sheldon Pollack believes that the Bush tax cuts are just part of a larger battle over marginal income tax rates that started during the 80th Congress, just after World War II (p. 819). The highest income tax rate at that time was a staggering 94 percent. The ongoing struggle over marginal rates is the result of a lack of a political agreement on the proper level of peacetime taxation, according to Pollack. He also believes that Republicans and Democrats have significant differences over an acceptable level of government spending. He hopes that Congress will reach a compromise rate before the end of the year and won't extend the battle as one party holds out for a 35 percent top rate and the other insists on 39.6 percent.

The Small Business Jobs Act of 2010 included $12 billion in tax incentives. The bill extended bonus depreciation and included more generous expensing limits. One aspect of the bill that has received little attention is the reduction in the AMT limitation on general business credits, according to Dean Zerbe, Shane Frank, Dhaval Jadav, and Benjamin Yaker (p. 827). Despite the lack of publicity for the AMT change, the authors believe that it is one of the more important parts of the law. They analyze the section 38(c) limitation in depth and the potential impact of allowing eligible small business credits to offset AMT liabilities. The downside to the provision is that it applies only to credits generated in 2010, they write.

The IRS relies heavily on regulatory antiabuse rules in order to deter tax evasion and encourage accurate reporting. One such antiabuse rule concerns intercompany transactions and is in reg. section 1.1502-13(h)(1). The IRS recently issued a ruling that used this rule to disregard a partnership's shares in a cooperative. Monte Jackel writes that the ruling is contrary to binding Supreme Court precedent and that it would be inappropriate for the IRS to use regulatory antiabuse rules to trump judicial decisions (p. 835). Grants of rulemaking authority are not unlimited, and only Congress can overrule a Supreme Court decision, writes Jackel. He believes that the IRS's attempt to circumvent a Supreme Court decision is contrary to good tax policy and sound tax administration.

A Tax Court decision in 1998 ruled that personal goodwill could be sold outside a business, which avoids the double taxation present in the corporate tax regime. The decision, *Martin Ice Cream Co.*, is unique because it concerned a sale that lacked a written agreement and a purchaser, Pillsbury, that had no interest in the assets of the business and only wanted the contacts of the owner. Although *Martin* is an important case, it can be misinterpreted, as happened in two recent decisions in which taxpayers were trying to improperly extend the holding, according to Robert Wood (p. 841). Wood analyzes the decisions in *James P. Kennedy* and *Howard* and finds that the transactions involved more than the sale of goodwill alone and that the taxpayers should not have attempted to use *Martin*. Although the taxpayers lost in both cases on the issue of personal goodwill, Wood does not believe that affects the viability of *Martin*, and he encourages practitioners and taxpayers to look closer at their facts.

Banking regulators are looking into a new form of security, known as CoCos, that banks will be required to issue to avoid future financial crises. Robert Willens writes that it is not certain whether these new securities will qualify as indebtedness under the tax code (p. 831). CoCos are supposed to convert to equity if certain triggering events take place. Willens finds that they demonstrate many of the characteristics that courts and the IRS associate with equity and that it is up to the IRS to make a conclusive ruling on their status as indebtedness.

A recent letter from Jasper Cummings, Jr., took aim at *Tax Notes* columns by Alan Viard and Diana Furchtgott-Roth, claiming that both were pushing conservative tax agendas. Kip Dellinger disagrees with Cummings and argues that progressives often seem affronted when other commentators present views of the tax code different from their own. Dellinger points to the plethora of left-leaning authors and articles that routinely appear in *Tax Notes* and comments on how voters in California and Washington rejected progressive tax proposals during the November 2 elections. (For Cummings's letter, see *Tax Notes*, Oct. 11, 2010, p. 257. For Dellinger's response, see p. 845.) ■

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