House Surtax Plan Sets Up Showdown With Senate

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Healthcare reform hasn't gone as planned for the Democrats. Originally, President Obama wanted a healthcare bill before the August recess. Congress did not meet that deadline — it won't even come close. Despite having overwhelming majorities in both chambers, Democratic leaders hinted last week that a healthcare vote in the Senate might slip into 2010. If that's true, it will be interesting to see how many Blue Dogs in the House and moderates in the Senate will want their name attached to such a bill so close to what could be a dangerous midterm election.

The initial House vote, however, will not happen in 2010. In fact, it is widely expected that the House will have passed its version of healthcare reform by the time this edition of *Tax Notes* is in readers' hands. And despite the Senate's clear signals that a surtax won't pass in its chamber, House Speaker Nancy Pelosi and her fellow Democratic representatives are sticking to their guns. The amended bill keeps the 5.4 percent surtax on high-income individuals. Some new wrinkles were added to the tax portions of the bill, including a repeal (rather than a delay) of worldwide interest allocation and a provision to disqualify "black liquor" from the cellulosic biofuel credit. The latter is in response to concerns raised by Martin Sullivan and others about a recent IRS decision that seemed to open the door to $25 billion more in paper industry tax credits. (For prior coverage, see *Tax Notes*, Oct. 19, 2009, p. 271.)

The Senate won't agree to a surtax, so the question becomes whether the House will accept the excise tax in the Finance Committee bill — a tax that most Democrats are coming to realize will affect middle-income taxpayers. The tension between Senate and House Democrats, combined with fears about 2010 that were hardly allayed by Republican victories in the 2009 Virginia and New Jersey elections, will make the next few weeks particularly interesting for those following the tax portions of healthcare reform. Perhaps for the first time all year, the prospect of no reform at all might be looming.

News Analysis

The government usually wins LILO cases but was recently handed a setback in a claims court decision in *Con Ed*. Lee Sheppard writes that the judge in *Con Ed* ignored a number of key concepts, including present value and basic economics, in analyzing the transaction (p. 619). Specifically, Sheppard calls attention to Judge Marian Blank Horn's dismissal of the timing issue and the judge's overreliance on the mountains of evidence introduced by the taxpayer. In this case, Sheppard concludes, codification of the economic substance doctrine might actually have helped, since it would have prevented Judge Horn from giving such short shrift to the actual numbers behind the leasing transaction.

German conservatives recently won an important victory in national elections, propelling Chancellor Angela Merkel to a second term and allowing her to team with the right-leaning Free Democrats rather than the left-leaning Social Democrats. There are important lessons that the United States, specifically policymakers, can learn from Germany, according to Sullivan. His analysis this week focuses on how the German government seems to have better policies in place to fight unemployment, restore fiscal sustainability, and end tax preferences for debt over equity. His analysis is on p. 627.

Commentary

Like Sheppard, David Cay Johnston takes aim at utilities (p. 713). Instead of focusing on possible sham transactions to escape taxes, however, Johnston criticizes the way Congress collects, and private utility companies account for, taxes. It's old hat to point out that the government needs revenue, but that is the background for Johnston's proposal that Congress replace the income tax on corporate-owned utilities with a tax based on consumption that is just an add-on to electric bills. He doesn't expect utilities to be on board with this change because slick accounting practices and poor policy decisions allow many corporate utilities to enjoy a negative tax rate. Johnston provides data that back up his proposed direct tax, including a study by MSB Energy Associates.

The federal budget situation has caused tax expenditures to come under a lot more scrutiny. In fact, it's hard to find an economist or policy expert who will defend them. That hasn't stopped Congress from using them, of course, but it has at least prompted discussion of using reduced tax expenditures to pay for broad tax reform, including a lowering of nominal tax rates. Edward Kleinbard, former JCT chief of staff, made that argument

before the Volcker tax reform task force last week. (For coverage, see p. 651.) In a special report, Carl Davis writes that Congress should implement a method to review tax expenditures. He argues that now is the perfect time for implementation of a performance review process that has long been delayed. His report presents the merits of a tax expenditure performance review, explains why such a review system could be put in place fairly quickly, and poses several key questions that must be answered when designing the program. The report starts on p. 677.

Information exchange and disclosure are big themes on Capitol Hill, especially in the wake of the recent release of a Baucus-Rangel bill that would use elements of the more stringent Stop Tax Haven Abuse Act to combat individual tax evasion. The IRS chief counsel and Stephen Shay of Treasury testified in favor of the bill last week. At his nomination hearing, Michael Mundaca, the president's new nominee for Treasury assistant secretary for tax policy, also emphasized information reporting as the key to closing the tax gap. (For coverage of Shay's remarks, see p. 636. For coverage of Mundaca's hearing, see p. 633.) Michael McIntyre, however, doesn't think as much progress has been made on this front as it would appear (p. 695). Calling the OECD's black and gray lists a joke, he says that the model information exchange agreement is ineffective and that tax administrators should try to implement a more stringent information exchange model, which he presents as an appendix to his article. McIntyre still thinks there is some hope that tax abuses can be curtailed soon, but he believes the first step is to embrace an effective information sharing model and not settle for agreements that mirror the disappointing recent protocol between the United States and Switzerland.

Employee versus independent contractor status might be the next tax gap battle waged by the IRS. National Taxpayer Advocate Nina Olson has been making that prediction in her annual report for some time. Robert Wood takes a look at employment classification issues as they apply to exotic dancers and uses a recent case from the Boston area to illustrate the varied results that a classification inquiry can generate. Wood concludes that businesses should be more fearful of employee suits on worker status than audits by the IRS. He doesn't think this issue will go away any time soon, and believes employment taxes may soon be the least of employers' concerns. Wood's practice article starts on p. 673.

The president's recent Nobel Peace Prize award generated a lot of controversy in the political world. It would not be unreasonable to say that the award was probably more trouble than it was worth to the administration. Conrad Teitell declines to address the political liability question, but says the prize will cause a tax liability based on the $1.4 million cash award (p. 707). Teitell addresses the tax questions raised by the award of a civic prize, including questions about how to assess and report tax liabilities when the award is assigned to a charity.

New Supreme Court Justice Sonia Sotomayor's most notable tax opinion is *Rudkin v. Commissioner*, which she wrote as an appeals court judge. The opinion was affirmed, but heavily criticized, in *Knight v. Commissioner* by the Supreme Court and Chief Justice John Roberts. Prof. Stephen Cohen wrote an article in August defending Justice Sotomayor's reading of the law. In September, Prof. Douglas Kahn wrote in support of the chief justice's criticisms. Cohen writes this week that Kahn's conclusions are ''contestable and perhaps even untenable.'' He believes that there were at least two possible interpretations of the statute at issue in *Knight* and that Chief Justice Roberts's statement that her reading ''flies in the face of the statute'' was wrong. (For Cohen's original article, see *Tax Notes*, Aug. 3, 2009, p. 474. For Kahn's article, see *Tax Notes*, Sept. 21, 2009, p. 1263. For Cohen's response, see p. 711.) ■