From the Editor:

Oil Companies Abusing More Than Environmental Regulations

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As the investigation into the disaster in the Gulf of Mexico continues, it becomes more and more apparent that deepwater drilling companies have been cutting corners and skirting even the flimsy U.S. environmental regulations. The federal government, of course, has played its role in the crisis (both before and during). But it isn't just environmental law that is letting the public down. Some oil services companies have also been allowed to lower their U.S. tax bill through the use of a questionable reorganization strategy.

That is the finding of Martin Sullivan, who writes about how common offshore corporate inversions have been among the oil services industry. According to Sullivan, five oil service companies inverted in the last decade or so, accounting for roughly 20 percent of all corporate inversions. Corporate inversions, combined with income shifting strategies, have allowed these companies to cut their U.S. tax bills by nearly a third, costing the government more than $2 billion in tax revenue, says Sullivan. He points out that the company that has benefited most from inversions is Transocean, the owner of the rig that exploded on April 20. These inversions were allowed to skirt code section 7874 (enacted to stop this type of transaction) because the effective date was changed, says Sullivan. He argues that Congress and President Obama need to move quickly to tilt tax benefits away from these inverted oil companies and to suppress aggressive tax evasion strategies being used by U.S. multinationals using shell companies in tax havens. (For Sullivan's analysis, see p. 1183.)

The corporate inversion issue arguably shows the U.S. tax system at its worst. The relationship between one oil company seeking to preserve its tax benefits from inversion and former House Ways and Means Chair Charles B. Rangel helped cause Rangel to lose his gavel. Unfortunately, transactions like corporate inversions are blessed throughout the tax code and only reinforce the widely held notion that tax policy is being set not by Congress, but by select private interests. The timing couldn't be any riper for serious tax reform that sharply curtails targeted tax expenditures and overhauls the international tax regime.

Extenders

Targeted tax expenditures never seem to die. The most popular ones are renewed continually, and even those enacted in response to a crisis always seem to creep toward permanence. This is most evident, of course, in Congress's annual extenders package, which has encountered a little difficulty this year because of its controversial carried interest pay-for. The newest version of the Senate's extenders package has pared down the carried interest provision again, this time moderating even the House's compromise. This change, along with a higher excise tax on oil companies, has put the timetable for extenders passage in limbo . . . again. As of press time, Senate leaders had not scheduled a vote. What Senate Majority Leader Harry Reid did manage to do last week was propose an extension of the home buyer tax credit, offering an amendment with former real estate agent turned Republican Sen. Johnny Isakson to extend the credit's reach into September of this year. This supposedly temporary measure, designed to help the real estate industry after the housing bubble collapse in 2008, just can't seem to die. Look for Isakson to attempt to make the credit permanent later in the year. (For coverage of the home buyer credit, see p. 1216. For coverage of extenders, see p. 1193.)

Originally, Congress wanted to simply tax carried interest compensation as ordinary income. This pay-for seemed simple enough. Hedge fund managers were being paid enormous sums and benefited from a lower marginal tax rate than most middle-income workers. Now, however, a complicated formula taxing some percentage of carried interests as ordinary income and the rest as capital gains seems likely. Diana Furchtgott-Roth isn't comfortable even with this version of the provision. She argues that denying full capital gains treatment to carried interest profits will cost U.S. jobs. She is also opposed to the provision in the extenders bill that would increase taxes on "enterprise value," which is essentially a business's goodwill. Furchtgott-Roth predicts that increased carried interest taxes will result in lower investment in the projects that most need capital. (For her analysis, see p. 1291.)

Commentary

The financial regulatory reform bill slinking through Congress is not the radical overhaul that many promised in the wake of the 2008 financial crisis that led to a severe recession and the record unemployment that still plagues the United States today. However, it might be an important first step in reining in certain financial practices and products that unnecessarily increase the risk present within the financial system. Thanks to Sen. Blanche L. Lincoln, D-Ark., derivatives are one of the financial products clearly targeted by the Senate's version of the bill. This legislation and changing market practices have caused a number of new tax issues to arise involving derivatives, according to Erika Nijenhuis. In a special report, Nijenhuis writes that regulatory laws are almost certain to require swaps to be cleared through regulated central clearinghouses and be traded on regulated markets such as an exchange (p. 1235). She believes that this may allow derivatives to be treated as section 1256 contracts, something that would be advantageous for many taxpayers. In her opinion, this is not ideal tax policy. Nijenhuis also analyzes initial payments on a swap, discusses open questions on how indebtedness should be treated, and suggests official guidance, either through regulations or legislation.

The tax law is complex. Few would disagree with that. But this complexity typically benefits different parties in different ways, and simplification remains more of a pipe dream than an imminent reality. What some taxpayers consider complex, however, might be simple to others, further muddying the issue. Stewart Karlinsky and Hughlene Burton conducted a survey of tax professionals in large and midsize businesses (p. 1273). Their findings indicate that among this group, international tax issues are generally perceived to be the most complex. In contrast to small-business and individual taxpayers, the authors found that large and midsize tax professionals surveyed were not that troubled by the complexity of alternative minimum tax and depreciation issues. They conclude by suggesting that the IRS conduct research to determine if the U.S. tax system is more complex than other nations' regimes and if U.S. companies are at a competitive disadvantage worldwide as a result of this complexity.

The timing of bonus compensation can be important in determining when a deduction can be taken. Should bonus compensation be deducted in the year it is accrued or in the year the bonuses are paid? George White tackles this issue in his latest Tax Accounting Developments column (p. 1281). According to White, the subject was a major topic of discussion at two recent tax conferences. It came up as a result of a chief counsel memorandum that ruled that deductions could only be taken in the year the compensation was actually paid. White finds, however, that there is a way to secure a deduction when bonus compensation is accrued. He analyzes a bonus pool arrangement that provides that bonuses do not revert to the employer if an individual is no longer employed by the company, and he concludes that this type of arrangement usually allows faster deductibility.

Contingent fee attorneys often struggle with the issue of the deductibility of client costs. Robert Wood writes that most simply assume they can deduct client costs as a business expense, regardless of their fee arrangements (p. 1287). This is not always true. Wood looks at the *Boccardo* case out of the Ninth Circuit and even recent letters by Sens. Max Baucus and Richard Durbin on the issue. Wood concludes that the issue is far from settled and points to the IRS decision not to follow *Boccardo* as proof.

In Tax Facts, Jim Nunns presents data showing the top federal individual income tax rate from 1913 through 2008 (p. 1285). Nunns concludes that even a top rate of 39.6 percent (which the president and congressional Democrats have pledged to return to in 2011) is low by historical standards. ■