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The Scrutiny Given to Targeted Tax Credits

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Congress likes targeted tax credits. The legislative branch uses credits as the solution to almost all of the nation's economic problems. Our dependence on foreign oil can be solved by tax credits for alternative energy producers. The wage gap can be eliminated by tax credits aimed at low-income taxpayers and their dependents. The collapse of the housing market can be corrected by a generous credit for first-time home buyers. Never mind that direct action would probably provide better, quicker solutions to these problems.

And these credits are often abused. The paper industry's exploitation of an alternative energy credit has been the subject of intense criticism by Martin Sullivan. The earned income tax credit has angered Republicans in Congress because of perceived abuses (many encouraged by unscrupulous return preparers who do little to verify eligibility when claiming the credit on behalf of clients). And during the home buyer credit's short existence, the IRS has flagged 107,000 of the 1.5 million claims as suspicious, while opening 115 criminal cases. Congress held hearings last week on the credit, focusing on what tools the IRS needs to properly police claims. IRS Deputy Commissioner Linda Stiff said the IRS is pushing to implement new safeguards, but also needs legislative action to allow it to access more documentation. A bill offered by Rep. John Lewis, D-Ga., would impose age limitations on claimants (in response to reports that a four-year-old was able to claim the credit) and allow the IRS to perform prerefund compliance checks. Stiff testified that Lewis's proposal would allow the IRS to front-load efforts to combat housing credit fraud. (For coverage, see p. 371.)

The potential widespread abuse of the credit hasn't tempered some senators' enthusiasm for an extension and expansion of the program. The most vocal advocate for an expanded housing credit is Sen. Johnny Isakson, R-Ga. But efforts to extend the credit appeared to pick up the support of key Senate Democrats last week. So even though the credit encourages taxpayers to continue to overinvest in housing (one of the causes of the housing bubble to begin with) and is ripe for abuse by savvy and unscrupulous individuals and preparers, it looks like it is here to stay. (For coverage of the credit's legislative chances, see p. 372.)

In the long run, Congress should consider cleansing the code of many of these targeted provisions, just as it did in 1986. The critics of tax expenditures are legion (and include former JCT Chief of Staff Edward Kleinbard). These types of provisions generally benefit only a few taxpayers at the expense of the broader public, increase budget deficits, and seldom accomplish their stated purpose. That they are open to distortion and fraud by individuals or even whole industries only further diminishes their appeal.

News Analysis

A taxpayer won a rare victory over the government in a leasing dispute last week, as the Court of Federal Claims ruled in favor of ConEd, granting the utility company a refund for taxes paid after the IRS disallowed rent and interest expenses. In news analysis, Jeremiah Coder looks at the factors that contributed to the government's defeat, including the court's skepticism of the government's expert witness and the potential for ConEd to profit. (For the analysis, see p. 383.)

Coder also looks at the first six months of new OPR Director Karen Hawkins's tenure on p. 380. Hawkins has earned glowing reviews from most practitioners for bringing a real-world approach to OPR's enforcement of Circular 230. Coder concludes that although Hawkins is likely to encounter resistance to her support of initial testing for both enrolled and unenrolled preparers, she has a chance to leave a lasting impression on OPR.

Lee Sheppard focuses on mark-to-market accounting this week. Sheppard recently attended a Tax Executives Institute conference in New York, where the IRS continued to express its skepticism of mark-to-market accounting. Sheppard writes that the IRS refuses to accept taxpayers' book valuations for tax accounting purposes. She also says the IRS has made many hedge funds nervous by issuing generic legal advice that appeared to conclude that offshore hedge fund lending might constitute a U.S. trade or business. In a second analysis piece, covering a New York University Institute on Federal Taxation event, Sheppard comments on the resurgence of tax schemes and how the IRS plans to expand efforts to increase compliance. (For coverage of the TEI conference, see p. 374. For coverage of the NYU event, see p. 378.)

Commentary

In 1983 the Reagan administration and Congress agreed to increase Social Security taxes, causing taxpayers to pay more than was needed for overhead costs and benefits. This contributed greatly to the controversial Social Security Trust Fund surplus that has been used to mask the true federal deficit for almost two decades. David Cay Johnston calls the decision a costly mistake and argues that there were better uses for the $1.3 trillion in extra taxes collected (p. 441). Johnston points out that those funds could have been used by taxpayers to pay off credit card debt or increase their 401(k) balances. The worst part about the extra taxes? The funds no longer exist, according to Johnston. Those surplus taxes have been used to fund other government operations. Johnston concludes by pointing out that the government's mismanagement of Social Security is setting the stage for a battle between baby boomers on the verge of retirement and taxpayers who might be forced to pay higher payroll taxes.

Although lawmakers need revenue to pay for healthcare reform, David Brunori does not believe sound policy reasons exist for taxing soda or other sugary beverages. In fact, Brunori points out that a soda tax doesn't even qualify as a worthy sin tax. Looking at the example of the states, Brunori finds that few have been able to link the benefits of a tax to the externalities the consumption of sugary beverages supposedly cause. He concludes that a tax on soda is unfair to manufacturers and consumers of those products and that any soda tax would be very regressive. Brunori's viewpoint is on p. 426.

In a follow-up to an August special report, Blake Rubin, Andrea Macintosh Whiteway, and Jon Finkelstein examine recently issued guidance on the section 108(i) election to defer cancellation of indebtedness income. Their original report concluded that the new section created several tax and administrative issues for partnerships. In the update, they focus on the flexibility provided by Rev. Proc. 2009-37. They conclude that although a few issues remain outstanding, the guidance does an admirable job of resolving partnership-level election difficulties, questions over the allocation of debt, and difficulties raised by the exchange of property for debt. (For the special report, see p. 417. For the original article, see *Tax Notes*, Aug. 17, 2009, p. 677.)

Tax reform might be slipping beyond 2010. A Senate Finance Committee staffer last week hinted that although some of the groundwork for reform might be laid before midterm elections, Congress is unlikely to be able to complete so daunting a task in one year. (For coverage, see p. 395.) Looking back to the successful tax reform effort of 1986, J. Roger Mentz agrees that completing fundamental tax reform requires laying the foundation first (p. 427). Mentz, who was part of the Reagan Treasury Department, writes that successful reform requires strong presidential leadership, detailed recommendations, revenue neutrality, and a bipartisan consensus. With the president focused on healthcare reform, the government needing more revenue, and Republicans declining to cooperate with the Democratic majority, none of those factors seem likely to be present anytime soon.

The New York City Bar Association recently published a proposal for guidance regarding passive foreign investment company rules. *Tax Notes* presents the report, by Alan Tarr, on p. 443. The NYC Bar recommends changes to the rules governing qualifying electing funds, PFICs, stock attribution, and the application of section 1291(e).

This week's On the Margin column by Kevin Hasssett, Alan Viard, and Alex Wein looks at tax reform efforts in California and what lessons might be learned from that state's budget crisis (p. 431). Rejecting the recommendations of the governor's tax reform commission, On the Margin proposes the complete replacement of the state's personal and corporate taxes with a broad-based consumption-oriented retail sales tax. In a viewpoint, Robert Feldgarden looks at recent guidance addressing mispriced stock options. Feldgarden focuses on how to identify a mispriced option and what can be done to cure the defect (p. 423). Robert Wood's practice article on p. 413 analyzes a recent Tax Court decision on the tax treatment of litigation recoveries. Wood finds that the real problem was not the judge's decision, but how the settlement was structured by the parties. ■

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