From the Editor:

When Simplification Means New Complexity

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The increasing use of passthrough entities has caused numerous problems for the U.S. tax system. Passthroughs highlight the antiquated nature of the C corporation tax regime, and they present complicated audit questions, especially because of the interaction between TEFRA and partnerships. For years academics and other commentators have dreamed of a unified regime for passthroughs that would simplify procedures and reduce the inherent arbitrage in choice-of-entity decisions. House Ways and Means Chair Dave Camp has obliged, and he presents an option for a unified passthrough system that would largely replace subchapters K and S.

But taxpayers probably should be careful what they wish for. While Camp's option 2 might be a more efficient tax regime in theory, transitioning to it might not be worth the costs and added complexity. Camp's plan could be an attempt to simplify passthrough taxation, but transition rules and the entrenched nature of the current system may end up negating the theoretical gains from simplification. Marie Sapirie explores that question and looks at why subchapter S might be preferable to the system proposed in option 2 (p. 7). After talking with practitioners, Sapirie analyzed the effects of option 2 on existing partnership agreements. She also looks at how the flexibility of subchapter S might be lost under Camp's unified regime. While subchapter S might seem complex and rigid, the rules have been in place for a long time and taxpayers have become increasingly familiar with them, according to Sapirie. Changing to what seems like a more efficient system on paper might actually make the area more complicated, as taxpayers struggle to deal with the new rules and the merging of subchapter K concepts with current S corporations, she writes.

It has been common in the tax academic world to yearn for an end to subchapter K because of the convoluted nature of TEFRA and partnership allocations. Camp's draft would end both of those, but at the expense of eliminating the subchapter S regime. S corporations are not ideal entities. The rules for eligibility can seem arbitrary, and mistakes can easily bust an S corp election. But that doesn't mean that there isn't a place for S corporations in the future. In fact, it might be fair to ask why Camp's reform option seems to move S corporations closer to subchapter K rather than the reverse.

Camp's International Discussion Draft

Camp's international tax reform draft might be his oldest proposal, but it probably remains the most significant. International tax reform and a lower corporate rate have broader bipartisan support than any reform of financial product or passthrough taxation. Camp's first draft discussed how to move the United States to a territorial system and what antiabuse and anti-base-erosion measures would be required. Martin Sullivan looks at how the Camp draft dealt with contract manufacturing (p. 10). He specifically looks at option C in Camp's draft, which would tax intangible income generated from foreign sales at 15 percent. Sullivan suggests that Camp's option might face WTO concerns. However, if Camp were to adopt an idea first proposed by H. David Rosenbloom in 2004 and revised by Paul Oosterhuis at a recent conference, he might be able to accomplish the same result, Sullivan writes. Camp should focus on making it attractive to use domestic contract manufacturers and eliminate the tax rules that force multinationals to use foreign subsidiaries for this role. Extending the manufacturing exemption would be a small change that might have big results and garner bipartisan support, Sullivan says.

Commentary

Many states would like more money from the federal government. While spending cuts at the federal level have gotten more attention, state budget cutbacks have actually been harsher. Many states have also had to resort to tax increases to offset revenue lost during the economic downturn. While the federal government is unlikely to grant much more money to states any time soon, Phillip Blackman and Kirk Stark suggest that IRS policy might allow states to recapture some money from the federal government by enacting a state income tax credit for charitable contributions (p. 53). The authors point to a chief counsel memorandum that permitted a taxpayer to claim a charitable contribution deduction for the full amount of a gift, even though a portion of the gift was refunded through a state income tax credit. This allows taxpayers to convert state taxes to charitable gifts, something

that would be attractive to AMT payers, they write. While Blackman and Stark recommend that the IRS retract the memorandum, they encourage state governments to take advantage of it while they can.

The SEC is starting to pay more attention to corporate cash being hoarded overseas. *The Wall Street Journal* has recently reported on SEC inquiries about cash listed on companies' consolidated balance sheets. In an update to an article that appeared in *Tax Notes International*, Richard Molina discusses why companies continue to accumulate cash overseas and how accounting rules should treat unrepatriated profits and earnings (p. 65). He writes that the government should revisit a 40-year-old standard on accounting for overseas cash to make it more stringent and objective.

Schedule UTP caused quite a stir when it was first announced. Many corporations believed that the IRS was trying to seek an unfair advantage in selecting issues to audit. But the disclosure of uncertain tax positions hasn't quite caused the sky to fall. In fact, very few UTPs have been reported to the government. Richard Harvey explores why there have been so few disclosures, finding that corporations have changed their behavior in a post-disclosure world (p. 69). He looks at what caused an expectation gap to form between expected and actual disclosures. He also analyzes what actions corporations may be taking to avoid disclosing UTPs. Harvey recommends that the IRS tighten up the regime to force companies to reveal more information on the schedule.

Tax departments have changed over the years. In the past, tax directors might have been successful by making sure nothing happened in their compliance-dominated world. But today's tax directors have to engage in more aggressive tax-minimization strategies. Clint Stretch writes that managing tax risk has evolved as boards and regulators have changed (p. 75). Senior managers are now much more involved in tax planning decisions and tax departments are no longer isolated from other parts of a company, he writes. There is a much greater emphasis on risk and what the acceptable level of risk is, he concludes. He recommends adopting a tax risk strategy that starts with asking if the right people are working on the right tasks with clear guidance on the desired outcomes.

The IRS has basically won the war against SILO and LILO transactions. *ConEd* was the last gasp for taxpayers who thought they could defend the transactions, but a pro-taxpayer decision at the district court level was overturned by the Federal Circuit. Robert Wood looks at the history of how the IRS dealt with these complicated leasing transactions and discusses the mistakes made by tax practitioners and taxpayers (p. 79). While LILOs and SILOs might be relegated to the dustbin of history, equipment leasing transactions will continue to be used, Wood writes. He speculates that aspects of LILOs and SILOs might be retooled as other transactions in the future.

Mitt Romney and discussions over the Buffett rule called public attention to the concept of average tax rates. Average tax rates and marginal tax rates are frequently discussed in the context of the very wealthy, but the fact is that many low-income families face high marginal tax rates, according to Aspen Gorry and Sita Slavov (p. 83). After discussing marginal and average tax rates at different points on the income distribution curve, the authors argue that a proportional tax system with a universal transfer or personal exemption provides a transparent tax code that will handle the trade-offs between marginal and average tax rates.

For those seeking a little lighthearted fun, *Tax Notes* presents its April 1 supplement on p. 89. You can learn about fashion in the tax world and how C-SPAN is dealing with struggling ratings for *Congress*, and participate in a contest to design the perfect tax shelter. ■

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