Extender Tax Provisions,

Hearings of the Senate Finance Committee, January 31, 2012

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Opening Statement

Congress needs to exercise budget responsibility and give strict scrutiny to the items of this Extender list. I have gone through the list and conclude that 13 of the provisions, worth about $18 billion over ten years, need to be left expired. They expired at the end of 2011 and good riddance. Rejoice in the news that they are dead.

For nine of the provisions, worth $12 billion over ten years, there is a worthy cause, but the provisions need to be reworked to cut out the fat in the program and government-caused waste. The provisions need to be refocused on their worthy goal with greater efficiency.

For three of the provisions, worth $2 billion over ten years, the government does not know enough to know whether the government is getting its money's worth for its costs. Indeed, there are $6 billion over ten years in the provisions I did not know enough about to talk about them, and there might be junk in the group that I cannot talk about.

The Extender items, in general, are subsidies delivered through the tax system. They are exceptions to the normative rule that "taxable income" needs to describe accurately the standard of living of the taxpayer. These are almost all accounting or tax gimmicks. A subsidy delivered through tax gimmicks is an unfair subsidy because it is hidden. If the subsidy is in the form of federal spending and on the federal budget, the cost is transparent to the Democracy. Federal spending is not popular, but it is clear, and if the Democracy approves of spending, that is legitimate. Tax gimmicks are hard to understand, including for me and this Committee, and that means that they are opaque to the Democracy and not legitimated by the general understanding.

Even beyond my general skepticism about tax gimmicks as an instrument in a Democracy, I have gone through the list and made critical evaluations where appropriate and suggested improvements to the focus and efficiency where appropriate.

Congress has a lot of work to do to cut out the fat and government waste in the worthy goal programs, repeal the bad ones and study the unknowns. It would be easy, and not far from wrong, to let them all stay expired, dead in their graves. Even the good ones are in bad company. But some of the provisions are worse than others.

Congress, in passing these things in the first place, knew that a future Congress, this Congress, needed to look at these provisions with a skeptical eye. Congress, by making them temporary, knew that we could not afford to make the provisions permanent. That judgment was wise. Congress also knew then that these provisions were on the junky side, which is why they told a future Congress to look at them again before passing them. We should listen to their wisdom.

Congress, in its official measurement of the budget, treats these provisions as expired at the end of 2011, as the law in fact provided. We are now running federal deficits that are too large to be sustained. We might expect a budget crisis, that could come on very quickly, in which investors who lend to fund the federal deficit lose faith in American debt. A budget catastrophe can come on very suddenly. These extenders are additional deficits.

In this partisan Congress, it is going to be very hard to find the $38 billion in revenue over ten years to pay for the extenders. In fact, it would be wrong to raise tax rates to pay for these. Tax rate increases do harm. It would be even worse to extend this list without pay-fors. The list does not have that much quality.

The items on this list expired on January 1 and are dead. Resurrecting items retroactively is especially problematic. The arrow of time works only forward so you cannot influence the past. The deals already done are highly likely to be those that would have been done without the tax subsidy. Giving money to a deal done without it just creates a windfall to the beneficiary and waste by the government. There was no contract with Congress for these things or commitment, only some preliminary negotiations or hopes, and the deal is not a deal until the President signs it. If Congress resurrects any of these, it needs to do so only prospectively.

I understand that many of these provisions are extraordinarily popular. Indeed the most popular provisions are those that are the worst from a good government point of view. I am reminded of the high price lawyer, who told his clients, "If you have justice on your side, why do you need me?" Government waste, whatever the platitudes, is very popular. Every government waste gives a bonanza on the other side, and your constituents and supports like the bonanza. Still Congress needs to exercise budget responsibility, *even* over wasteful provisions.

Evaluation of Specifics

The proposed Extenders are listed as follows:

A. "Keep it Dead" list. These are provisions for which the 2011 expiration should be allowed to take hold. I recommend keeping dead 13 provisions that would increase our deficit by about $18 billion over 10 years.

B. "Re-enact only after Better Focus Cuts Down Government Waste" These provisions have a worthy goal, but the provision needs to be redone to focus its cost in a more efficient way. There is fat and government waste in these programs that needs to be cut out. I recommend fat-cutting revisions to nine proposals worth about $12 billion over 10 years.

C. "Too little information to know," covers those provisions in which the government does not even know enough to know whether it is wasting money. These provisions should be re-enacted only after a cost- benefit study collects enough information to see if these are cost effective and well focused for optimal efficiency. I identify three proposals worth about $2 billion over ten

years. All of the $6 billion of proposals I do not comment on would probably fall into this category. I do not know enough to know we do not know enough.

Within the categories, the items are listed, roughly, according to their size by revenue estimate over 10 years, but provisions raising the same issue are grouped together. I do not comment on all of the provisions because my expertise is limited. The analysis draws on the Senate Budget Committee, Tax Expenditure Compendium of Background Provisions (Comm. print 2008) for almost every provision, even when my analysis departs from the Compendium.

A. "KEEP IT DEAD" LIST

1. Exception under Subpart F for active financing income ($5.2 billion over 10 years)

Description. The U.S. parent of a foreign subsidiary engaged in a banking, financing, or similar business is eligible for deferral of tax on such subsidiary's earnings if the subsidiary is predominantly engaged in such business and conducts substantial activity with respect to such business. The subsidiary must pass an entity level income test to demonstrate that the income is active income and not passive income. The proposal extends the provision to the end of 2012.

Assessment. Do not resuscitate because Uncle Sam needs the money.

A lead story in the New York Times has suggested an illegitimate tie-in between the extension of section 954(h) and GE's $11million contribution to school districts in the congressional district of the then Chairman of the House Ways and Means Committee. David Kocieniewski, ''G.E.'s Strategies Let It Avoid Taxes Altogether,'' *The New York Times*, Mar. 25, 2011, at A-1. GE paid no tax in 2010 on $9 billion of economic income. It reports saving about $2.3 billion tax for that year by reason of global activities generally, although it does not break down the savings to the various ways to avoid subpart F.

Fundamental accounting principles require that a parent and subsidiary group of corporations must report on a single consolidated basis. A wholly owned subsidiary is just a separate pocket book~~Bb~~, but U.S. tax law treats a wholly-owned subsidiary with a certificate from a tax haven as if it were a separate entity with a mind of its own. The "kiddie tax" of IRC §1(g) taxes the unearned income of children in the household at the parent's tax rate. Teenagers, indeed two-year-olds, can say no. A consolidated group of corporations is even more of one economic group than a household subject to the kiddie tax. A wholly-owned Bermuda or Cayman Island subsidiary cannot say no.

The treatment of foreign subsidiaries as if they were separate means that the corporations can avoid U.S. tax on income they can allocate by transfer pricing to the overseas tax haven, unless they bring it home. The multinationals abuse transfer pricing to allocate as much of their global income to foreign havens as they can. Affiliated groups have reported average returns of 24 percent in tax haven subsidiaries at the same time that they are reporting 4 percent returns on U.S. affiliates. Martin A. Sullivan, ''U.S. Citizens Hide Hundreds of Billions in Cayman Accounts,'' *Tax Notes*, May 24, 2004, p. 956. Whether profits are shifted by legal but aggressive accounting or by illegal means is not always clear.

Subpart F attempts to deny the benefits of tax deferral until repatriation to income that is easily moved. For businesses with factories and tangible sources of income, one needs the factory to be overseas to be economically real. Financial assets, by contrast, can be moved to a tax haven with a click of the send button, without any real activities moving overseas. It is said that Cayman Islands is a suburb of Greenwich Connecticut because the financial assets are managed by people who never leave Greenwich but sourced to Cayman's by mere electrons. One small office building in Georgetown, Cayman Islands is the registered home of 18,857 corporations with billions of reported income, and the parking lot is quite modest.

In 1986, Congress made financial services income Subpart F income that was not deferrable, because the financial services are so easily allocated to tax havens without any economic substance to back up the allocated. The proposed re-enactment would continue the repeal of the 1986 anti-abuse provision and allow financial income to be allocated to tax havens. Letting the exception to Subpart F expire as it did on January 1, would mean the U.S. could collect tax on the financial investment income, which is good.

As the Budget Committee Compendium puts it, the tax incentive for investment abroad generally results in an allocation of investment capital that is inefficient from the point of view of both the capital exporting country (in this case the United States) and the world economy in general. Economic theory instead recommends a policy known as "capital export neutrality," under which marginal investments face the same tax burden at home and abroad. Ending deferral of the financial income just brings the taxation of the financial profits back into the general norms, that unconsolidated returns do not reflect economic income and that the income tax in general applies to "income from whatever source derived." (US CONST., 16th Amendment).

2. 15--year straight-line cost recovery for qualified leasehold improvements, qualified restaurant buildings and improvements, and qualified retail improvements ($2.9 billion over 10 years)

Description. The proposal extends for one year, through 2012, the temporary 15-year cost recovery period for certain leasehold, restaurant, and retail improvements, and new restaurant buildings, which are placed in service before January 1, 2013. The extension is effective for qualified property placed in service after December 31, 2011.

Assessment. Let the dead be dead. Do not resuscitate.

The 15-year life for leasehold improvements is too short, and it warps investment into inferior uses. In theory, taxable income should identify the economic income from a property. Improvements to a building will last as long as the building lasts. Under current law nonresidential buildings have a 39-year tax life. Congress, when it thought about it, mandated a 35% tax rate for corporations and highest tax bracket individuals. A tax life of 15 years for the

improvement, however, means that tax reduces the pretax return by only 22%, instead of 35%.[1] With debt financing of the leasehold, the tax rate is negative, that is, tax not only collects no revenue from the 10% profitable investment but gives 13% of the borrowed amount each year.

Congress can make a serious economic study of how long buildings and improvements last. The study, however, is likely to conclude that current lives for all buildings are too short and inconsistent with debt.

The subsidy reducing the real effective (internal rate of return reducing) tax rate to 22% will distort investment into projects that do not have enough real demand for them. A project should carry the cost of capital based upon what consumers are willing to pay for the product. When tax is a subsidy, however, investors waste capital and go into projects without ~~out~~ sufficient real demand, relying the tax subsidy to make up the difference.

A subsidy delivered through short tax lives is also an illegitimate subsidy because it is hidden. If a subsidy is federal spending and on the federal budget, the cost is transparent to the Democracy and gets Democratic legitimacy. The short lives are tax cuts that are opaque to the Democracy and not legitimated by the general understanding.

3. Deduction for state and local general sales taxes. ($2.8 billion over 10 years if AMT is patched)

Description. The proposal extends for one year the election to take an itemized deduction for state and local general sales taxes in lieu of the itemized deduction permitted for state and local income taxes. In 2004, the "American Jobs Creation Act of 2004," (P.L. 108-357) temporarily allowed taxpayers to deduct states in lieu of state income taxes. The sales tax deductibility option has been extended several times, most recently by P.L. 111-312, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010. State and local taxes were among several deductions subject to the phase-out on itemized deductions for taxpayers whose AGI exceeds the applicable threshold amount.

Assessment. Do not resurrect. Enjoy its death.

The general function of calculation of taxable income is to determine the standard of living of the taxpayer. We calculate standard of living and apply tax brackets with different rates for different standards of living because it would do more harm to the sum of human happiness to take a dollar of tax from a taxpayer with a low, subsistence level of income than it would to take a dollar of tax from amounts that would be spent on luxuries.

Amounts lost should be deducted to calculate standard of living, but where a taxpayer gets a quid pro quo in the form of goods or government services, the expenditure should not be

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[1] The calculations available from the author assume a 10% pretax rate of return and constant cash flow over 40 years that yield a 10% return before tax and a 7.8% return after tax.

deducted. Under the is-it-lost theory, the big progressive taxes should be deducted because the state is stealing from Peter to pay Paul, and Peter should get a deduction for his loss. When Peter is getting some quid pro quo for the expenditure that he himself enjoys, however, Peter's taxable income should include the expenditure, and it should not be deducted.

Sales taxes are especially likely to be an expense in which the taxpayer gets goods in return. One incurs sales tax only by voluntarily paying for some good and only because the good is worth its cost or more to the purchaser. We need to give respect to consumer sovereignty of choice and disallow the cost because of the choice. The money is not lost.

It is sometimes hard to distinguish redistributional stealing-from-Peter taxes from Peter-got-the-full benefit taxes, but sales taxes are an easy case in which Peter himself announced the tax was worth paying because he bought the goods, including the tax, voluntarily. The sales tax is part of the cost of consumption.

4. Energy shift credits.

4a. Grants for specified energy property in lieu of tax credits ($1.3 billion over ten years)

4b. Incentives for biodiesel and renewable diesel ($1.1 billion over ten years)

Description. The grants in lieu of credits proposal extends for one year the start-of-construction deadline for the cash grant in lieu of tax credit program, established in Section 1603 of the *American Recovery and Reinvestment Act.* The biodiesel proposal extends for one year, through 2012, the $1.00 per gallon tax credit for biodiesel, as well as the small agri-biodiesel producer credit of 10 cents per gallon. The proposal also extends through 2012 the $1.00 per gallon tax credit for diesel fuel created from biomass.

Assessment. Allow the provisions to die quietly and replace with needed higher taxes on carbon and oil.

We need to move away from reliance on gasoline as quickly as possible to other energy sources, both because we import oil from trouble spots in the world and because fossil fuels pollute and lead to global warming. First, the tax system can induce movement to alternative fuels best by a carbon tax on externalities caused by oil consumption.[2] Second, the oil industry is undertaxed. Redoing computation of oil accounting to lead to an accurate and honest

[2] Ian Parry, *Raise $100 Billion from a $20 CO2 Tax*, 123 TAX NOTES 243 (April, 2009), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1517474

description of oil profits[3] would increase the price of the oil and help the necessary shift to other forms of energy.

5. Special rules for qualified small business stock ($1.2 billion over 10 years)

Description. Generally, non-corporate taxpayers may exclude 50 percent of the gain from the sale of certain small business stock acquired at original issue and held for more than five years. For stock acquired after February 17, 2009 and on or before September 27, 2010, the exclusion is increased to 75 percent. For stock acquired after September 27, 2010 and before January 1, 2012, the exclusion is 100 percent, and the AMT preference item attributable for the sale is eliminated. Qualifying small business stock is from a C corporation whose gross assets do not exceed $50 million (including the proceeds received from the issuance of the stock) and who meets a specific active business requirement. The amount of gain eligible for the exclusion is limited to the greater of ten times the taxpayer's basis in the stock or $10 million of gain from stock in that corporation. The provision extends the 100 percent exclusion of the gain from the sale of qualifying small business stock that is acquired before January 1, 2013 and held for more than five years.

Assessment. Let the whole program expire and good riddance.

The general tax rate on sale or distributions from a C corporation[4] is the capital gain rate now at 15%. Distributions after the death of the original owner are subject to zero tax. The low shareholder 15% tax rate and zero rate after death is our form of "corporate integration," that is, adjustment at the shareholder level to take account of tax paid at the corporate level.

There is no sign that 15% and zero after death is too high within the goal of corporate integration. Corporations avoid tax on their economic income because taxable income is such a terrible loophole-ridden description of the corporation's real economic income. (GE had $9 billion of economic income in 2010 under the stock market assessment but paid tax of almost zero.) The corporate tax is shifted to officers and employees and to all suppliers of capital and not then borne in full by the shareholder-owners. Corporate tax also lowers tax by putting off shareholder tax, which offsets the detriment of corporate tax. The 15% shareholder rate is not bad accommodation with a bad corporate tax base, the deferral of shareholder tax that C corporations give, and the shifting of the corporate burden to others.

Zero tax rate on gain or distributions, as the extender would provide, is too low a rate in general to achieve integration. We need to increase shareholder taxes and lower section 11 tax, as the ease of global investment increases, because corporations can avoid tax by shifting their

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[3] Calvin H. Johnson, *Accurate and Honest Tax Accounting for Oil and Gas*, 125 TAX NOTES 575 (2009) [http://www.utexas.edu/law/faculty/calvinjohnson/accurate-and-honest-tax-acct-for-oil-and-Gas-11-02-2009-tax-notes.pdf].

[4] A "C" corporation is a regular corporation subject to corporate tax of between 15% and 35% under section 11.

activities, but shareholders have to live where they live. Reducing shareholder tax is a move in the wrong direction.

"Small business" is an honorific title in America, up there with Apple Pie, but it is difficult to see what there is about it that deserves a subsidy. Most small business are dry cleaners, propane shops, funeral homes, restaurants, clothes boutiques and hardware stores, doctors, lawyers and insurance salesmen. Small businesses serve their customers well when they stay in business, but are not investing massive capital. They are also inventing new quantum physics storage techniques or decoding DNA secrets with cutting edge research to give benefits to the public at large. The theory of a subsidy is to pay for benefits beyond those to customers and owners, and the primary benefit of a small business to the customers and the owners.

Any tax reduction for small business needs to be given at the individual level, not because of the way by which he makes his money, but because of his standard of living. Taxable income in general needs to describe the standard of living of the beneficiary who gets it. Tax on the near poor maximizes the pain of tax, and a tax on money that is going to be spent for luxuries minimizes the pain of tax. Whether a taxpayer makes his money in a big office building or his own shop, money is money. Money should be treated the same from whatever source derived. Anything else is unfair.

6. Look-through treatment of payments between related controlled foreign corporations under the foreign personal holding company rules ($775 million over 10 years)

Description. The proposal allows deferral for certain payments (interest, dividends, rents and royalties) between commonly owned controlled foreign corporations (CFCs). This provision allows U.S. taxpayers to deploy capital from one CFC to another without triggering U.S. tax. The proposal extends present law to the end of 2012. The proposal is effective for tax years beginning after December 31, 2011.

Assessment. Keep it dead.

Subpart F ends deferral for passive income that can be placed into a tax haven, and this proposal creates an exception to Subpart F and allows the movement of passive income into the haven. The grand norm is that the U.S. taxes income from whatever source derived because it needs the money, and the fundamental accounting principle is that income received by a subsidiary needs to be taxed on a consolidated basis.

7. Premiums for mortgage insurance deductible as interest that is qualified residence interest ($739 million over 10 years)

Description. Under current law, a taxpayer may itemize the cost of mortgage insurance on a qualified personal residence. The deduction is phased-out ratably by 10% for each $1,000 by which the taxpayer's AGI exceeds $100,000. Thus, the deduction is unavailable for a

taxpayer with an AGI in excess of $110,000. The proposal extends this provision for an additional year, through 2012.

Assessment. It is dead and thank goodness

Costs of a home, including the insurance premiums, are a necessary part of a normative tax base that describes the standard of living of the taxpayer. The primary beneficiary of expenditures for a house is the person who lives in the house. Houses are very selfish investments. It is unfair and an economic distortion to subsidize shelter that benefits only the resident. When you subsidize costs that benefit only the person who lives in the house, then the resident pays more than they would be willing to pay off looking only to their real desires. The tax system induces waste in paying for what people don't really want. And the subsidies are expensive.

Perhaps there is a benefit to the neighborhood to have people own their houses instead of renting them. But the benefit does not extend beyond the neighborhood, and thus the subsidy should be paid for by the neighbors. From the perspective of the national economy, renters are also good people because they have greater mobility and can adjust quickly to new opportunities or changes in local situations. Subsidy for housing also diverts capital from more productive uses like innovative research of value to the general public.

People who specialize in housing construction like subsidies to housing. But their considerable talents would do more good for the economy if they were building things that people really wanted, judged without the tax subsidy, instead of the less desired things that have an artificially high demand because of the subsidy.

8. Credits for more efficient and alternate energy.

8a. Credit for certain nonbusiness energy property (IRC §25C) ($610 million over 10 years)

8b. Credit for energy efficient appliances (IRC §25M) ($325 million over 10 years)**.**

8c. Credit for construction of new energy efficient homes ($74 million over 10 years)

Description. The section 25C credit proposal extends through 2012 the credit under Section 25C of the Code for energy-efficient improvements to existing homes, reinstating the credit as it existed before passage of the American Recovery and Reinvestment Act. Standards for property eligible under 25C are updated to reflect improvements in energy efficiency. The section 25M proposal extends through 2012 and modifies standards for the Section 45M credit for US-based manufacture of energy-efficient clothes washers, dishwashers and refrigerators. The construction of energy efficient homes proposal extends for one year, through 2012, the credit for the construction of energy-efficient new homes that achieve a 30% or 50% reduction in

heating and cooling energy consumption relative to a comparable dwelling constructed per the standards of the 2003 International Energy Conservation Code (including supplements).

Assessment. Keep dead.

Keeping a house warm imposes costs on others that the customer does not pay for. For example, electricity generated by coal plants, puts carbon into the atmosphere which increases global warming. It would be more efficient and necessary in the pending budget catastrophe to reduce carbon emissions by imposing a tax on carbon. People will then avoid the new carbon tax by insulating their house or paying for non-carbon energy sources. In the end, keeping the house warm is a very selfish investment, and gives little or no benefit to anyone outside of that house. Costs that benefit only the person who pays for them should not be subsidized because that causes an increase in cost expenditures not justified by the real willingness of that person to pay for them.

Energy efficiency is not a tax issue, and the government tax writing committees do not know enough from their tax expertise to know how to design. The IRS knows nothing about this stuff and should not be the administration to administer them. These credits have no business being in the Tax Code.

9. Geographically targeted programs:

Empowerment zone tax incentives ($253 million over 10 years)

Accelerated depreciation for business property on Indian reservation ($90 million over 10 years)

Tax incentives for investment in the District of Columbia ($76 million over 10 years)

Description. The Empowerment Zone proposal extends for one year the designation of certain economically depressed census tracts as Empowerment Zones. Businesses and individual residents within Empowerment Zones are eligible for special tax incentives. The Indian reservation proposal extends for one year the placed-in-service date for the special depreciation recovery period for qualified Indian reservation property. In general, qualified Indian reservation property is property used predominantly in the active conduct of a trade or business within an Indian reservation, which is not used outside the reservation on a regular basis and was not acquired from a related person. The DC proposal extends for one year the designation of certain economically depressed census tracts within the District of Columbia as the District of Columbia Enterprise Zone. Businesses and individual residents within this enterprise zone are eligible for special tax incentives. The proposal also extends for one year the $5,000 first-time homebuyer credit for the District of Columbia.

Assessment. The goal is worthy but the programs are government waste. Let die.

According to the Senate Budget Committee Compendium of Tax Expenditures, government-sponsored studies by the Government Accountability Office (GAO) and the Department of Housing and Urban Development (HUD) have failed to link Empowerment Zone and EC designation with improvement in community outcomes. Academic studies have found modest, if any, effects and call into question the cost-effectiveness of these programs.

The programs have flunked the best available cost-benefit analysis.

10. Deduction of inventory in excess of cost.

Enhanced charitable deduction for corporate contributions of computer equipment for educational purposes ($240 million over 10 years)

Enhanced charitable deduction for contributions of food inventory
($138 million over 10 years)

Enhanced charitable deduction for contributions of book inventories to public schools ($60 million over 10 years)

Description. All three proposals allow the donor to deduct the value of inventory given for charitable purposes. The separate proposals extend for one year deductions in excess of cost for (1) computer equipment and software to elementary, secondary, and post-secondary schools (2) food inventory and (3) book inventory to public schools (kindergarten through grade 12).

Assessment. These proposals arise from an accounting fallacy that needs to be corrected, and the provisions all need to die.

These three provisions arise from an accounting mistake or from the cynical taking advantage of an accounting mistake. All allow a combination of exclusion and deduction, which is a double accounting, not unlike counting dollar expenses twice. The double deduction shelters unrelated income from other sources that he has retained the donor. The treatment is not a description of money the donor has lost in favor of the charity by the donation. A deduction of basis of the property alone would accomplish that.

One can confidently attribute these provisions to accounting misconceptions because one could not otherwise explain their pattern. The schools are worthy beneficiaries, but why is a double deduction from taxable income the right pattern? Why does the benefit to the donor depend upon undoing tax, by twice? This feels like an accounting gimmick giving a steal subsidy because the people will not understand it. Stealth subsidies are not legitimate in a Democracy.

Because the accounting mistake of deducting untaxed appreciation is so common, it is worth explaining with patience. Assume a cash-method lawyer properly bills two clients for $40,000 each but collects from only one. There can be no deduction for the $40,000 excluded amount that the lawyer did not receive, no matter how offensive the client has been by not paying. The taxpayer has a standard of living of $40,000 from her practice from the bill she collected. One can reach that result only by allowing no deduction for the $40,000 nonpayment. If we go beyond excluding the nonreceipt and also give the lawyer a $40,000 loss deduction for the unpaid bill, then the lawyer has cash and consumption of $40,000 from the client who paid, but no net income. It is an accounting mistake to allow both an exclusion of the unpaid bill and a deduction for it. Current law fixes the problem by allowing a deduction for only basis, and a cash-method lawyer has no basis in unreceived client bills. But it is a very common fallacy, an accounting mistake, that the lawyer should get a deduction when the client does not pay.

Similarly, a taxpayer cannot take a deduction for services given to charity. If a taxpayer gives $40,000 worth of work to charity, the full and complete accounting remedy is to not tax the taxpayer on salaries he does not have. If we both exclude the $40,000 worth of charitable work and allow a deduction for $40,000, the taxpayer will have $40,000 worth of cash in hand that can be consumed for selfish and greedy purposes, and the accounting error of deduction of amounts that are already excluded would exempt the greedy consumption from tax. This is not a valuation issue but a priority accounting-logic issue that says that double counting should not be allowed. She has the $40,000 worth of cash salary from noncharitable clients and we must tax it, notwithstanding her charitable work. Current law cures the problem by providing that the value of services is not deductible no matter how truly proved up and how valuable the services are.

Giving blood follows the same principle: we do not tax blood you give to charity, but that is sufficient remedy and there is no deduction of the blood either. Allowing a deduction for blood donation would not be to allow a deduction for losses but rather a deduction for money the donor has kept and consumed.

As a matter of logic, the same results should apply if a taxpayer gives $40,000 worth of untaxed appreciation to charity. If I make inventory with a cost of $20,000 that appreciates in value to $60,000 because of my work when I give it to charity, the right deduction to describe my retained and consumable cash is $20,000 and not the value of $60,000. If I have $60,000 of total income, of which $20,000 put into the inventory, then I have $40,000 left after the donation. Allowing a deduction of $60,000 would shelter out the remaining consumable cash that has not been put in the inventory but which I retain.

It is fairly common even for sophisticated tax people to make the accounting mistake. But once the misperception is corrected, it is difficult to see why the mistake is justified.

The proposals under review create separate problems because the deduction of value is not of value based on an arm's length purchase price by real people, but upon an assessment of value. Taxpayers cheat on valuation. They tend to give the old food, the unsaleable books and

the last generation computers to the schools and deduct the list price of the inventory as if that were the value. Old food and old books and old computer inventory do generate valuation disputes because there is no arm's length bargain to validate the asserted value. But it is tragic that the valuation disputes are unnecessary because cost and not value is the proper deduction.

The issue here is not the level of incentive given to a charity but the opaqueness of the gimmick. Transparent subsidies given on budget are fair disclosure to the democracy. But the shelter for amounts retained by the donor are opaque and unfair because they have insufficient disclosure. The democracy can give incentives as budgeted government spending because it understands the costs as real money. Section 170(e)(3), (e)(4) and (e)(5) of the Code do not have fair disclosure of the costs. They are opaque undisclosed tax gimmicks. They are unfair and they need to be stopped.

11. Suspension of 100 percent-of-net-income limitation on percentage depletion for oil and gas from marginal wells ($125 million over 10 years)

Description. The proposal extends through 2012 the suspension on the taxable income limit for purposes of depleting a marginal oil or gas well.

Assessment. Stay dead.

The percentage depletion allowance is a deduction of imaginary costs. Oil production recovers most of its costs by expensing of intangible drilling cost and pool of capital doctrine (which pays for services out of production and without any basis). The percentage depletion continues to be allowed even when all costs have been recovered.

The percentage depletion allowance arose out of a misperception in the early income tax of what "capital" was that needed to be allowed to compute income. The old conception was that "capital" was the starting value or discovery value of the oil and not its lower "basis." Senator David Reed of Pennsylvania was the floor manager of the 1925 act that created percentage depletion, and he argued that if he discovered a gold mine, basing depletion on cost ''would not allow me an adequate return on my 'real capital.''' [5] ''Real capital'' meant to Reed the extraordinary value of the gold mine when found, not the invested costs in the gold mine. We now use the term "basis" rather than "capital" to describe what needs to be subtracted to compute economic income, which is cost. That corrects the old error.

Public policy needs to increase the tax on the oil and gas industry. We need to be investing in alternative energy sources, both for national security concerns and because of the damage that oil does to the environment. Errors like the percentage depletion increase our national security concerns because they induce a faster use of our domestic reserves; if security concerns are paramount, we should be prohibiting the pumping of domestic oil to save it for the

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[5] Calvin H. Johnson, *Accurate and Honest Tax Accounting for Oil and Gas*, 125 TAX NOTES 575 (Nov. 2, 2009) [http://www.utexas.edu/law/faculty/calvinjohnson/accurate-and-honest-tax-acct-for-oil-and-Gas-11-02-2009-tax-notes.pdf].

future when an international crisis blocks access to foreign oil. The oil from marginal wells should stay in the ground. A higher tax on oil will raise the price of oil and induce consumers to conserve oil and investors to invest in the alternative sources of energy. The old "capital" mistake, giving percentage depletion exclusions for imaginary costs, needs to be corrected as quickly as possible.

12. Basis adjustment to stock of S corporations making charitable contributions of property ($82 million over 10 years)

Description. The proposal extends for one year the provision allowing S corporation shareholders to take into account their pro rata share of charitable deductions even if such deductions would exceed such shareholder's adjusted basis in the S corporation.

Assessment. Keep dead. Pound on it a bit to make sure.

A deduction in excess of basis is always a tax shelter, exempting from tax money the taxpayer has retained and used for his own purpose. The charitable deduction of basis is appropriate to describe the diminution in the donor's standard of living because of amounts given to others. It is unfair, however, to exempt from tax amounts in excess of basis because that represents amounts the taxpayer has kept because that ain't charity. While adjustment to describe standard of living is appropriate within an income tax, a subsidy for amounts not lost is illegitimate. The subsidy delivered as a deduction depends upon tax bracket with the higher subsidy going to the richer taxpayer and the lesser or no subsidy given to worthy donations from out of lower tax brackets. The mirror image of the progressive tax system is never the appropriate pattern for a subsidy that is trying to accomplish something.

Extending the erroneous subsidy to gifts by an S corporation adds damage. A corporation is an artificial entity organized for profit. Taking shareholder money, by a mere majority vote of the directors, and diverting it to a charity of the officer's choice is a breach of duty to the minority shareholders. But even when the donation has full shareholder consent, facilitating a tax loophole is never a good idea.

This is an unfair subsidy because it is sneaky. When the government makes a cash grant by government spending, the budget process makes the cash grant known and generally understood by the electorate. Democratic legitimacy does not attach, however, to sneaky tricks delivered through the tax system because the Democracy does not understand what is going on. This one is UNFAIR.

13. Seven-year recovery period for motorsports entertainment complexes ($29 million over 10 years)

Description. The proposal extends for one year the special seven-year cost recovery period for property used for land improvement and support facilities at motorsports entertainment complexes.

Assessment. Keep dead. Kick to make sure.

Improvements to land to prepare for buildings and make a race track or race course have indefinite value and, like the costs of stock or money in the bank, the costs are not generally depreciable under the tax law. Allowing a seven-year write-off for the improvements to land is a sneaky, unfair accounting trick to reduce tax inappropriately. Using 10% as the appropriate interest rate for risky investment, a seven-year life for an indefinite life asset turns a 35% nominal tax rate in to a 13% tax rate. ~~That is, tax~~Tax with the seven-year life will reduce the 10% pretax return only to 8.7%, whereas the tax rate that Congress voted with on was a tax rate of 35% when it ~~knew~~ deliberated about tax rate in enacting~~what it was doing in~~ section 11. The seven-year write-off reduces the real tax to about a third of the statutory rate or 13%.

Nonresidential buildings are treated as lasting for 39 years, which is a generous treatment. If you assume a 40-year building and the same 10% pretax return, then the seven-year write-off reduces the tax from 35% statutory rate to a real (internal rate of return reduction) rate of 14% or less than half of the statutory rate.

The lower rates to recreational motorsports complexes do harm to the private economy. Recreational complexes that could not carry their cost of capital in absence of tax should not be built. The demand of people coming through the gate is not high enough to carry the real costs. But the tax subsidies through the seven-year write-off mean that we waste money on recreational projects for which there is insufficient real demand. That is inefficient, distorting economics, and it is unfair.

B. RE-ENACT ONLY AFTER BETTER FOCUS CUTS DOWN GOVERNMENT WASTE.

The following provisions have a worthy goal, but the provisions need to be altered to cut out the fat and the government waste.

1. Tax credit for research and experimentation expenses ($7.7 billion over 10 years)

Description. The proposal extends for one year, through 2012, the research tax credit equal to 20 percent of the amount by which a taxpayer's qualified research expenses for a taxable year exceed its base amount for that year and provides an alternative simplified credit of 14 percent.

Assessment. Let the provision expire and replace it. Define research strictly and after the fact to refocus the benefit on costs that give benefits to society at large beyond customers. This can be done with the most bang for the buck by giving the National Science Foundation grant money and by giving NSF money to pay multi-million-dollar awards after the fact to the

research over the last decade with the greatest social benefit. If the NSF will set up a tournament to win a $500,000,000 prize, many people will be induced to try for it. Indeed the NSF could set up 14 of these prizes for a decade and still save money over the cost of this credit.

Increasing the research and experimentation that would give benefits to the general public is a worthy goal, but the waste and the fat need to be trimmed out. The for-profit market will not pay for research unless the developers can charge their customers for it. The really big breakthroughs so influence the country as a whole that they are reflected in benefits far beyond any product the innovator can make or sell. Without government subsidy to research, we would not have had penicillin, lasers or internet. Venture capital funds are looking now for "killer apps," but without the government-paid-for research that created the internet, these killer apps would have no value. But no one knew before penicillin, lasers or internet were created how extraordinary they would be and no one knew how to charge customers to justify the costs of development. Government subsidy for penicillin, lasers and internet was wise expenditure.

The current subsidies, however, waste money because the cost is spent for costs in which the customer is the only beneficiary, or for costs where the benefits beyond the customer are very modest. "Research" is a nice sounding word, but the current definition of research to include all "innovation" wastes money because it includes costs that need to be fully justified by customer demand or should not be undertaken at all. Subsidizing those costs wastes both government money and private money because they give incentive to products that are not worth their costs.

For example, the R&D credit is given to computer games with dubious or even pernicious general social impact. The NY Times had a page one, above-the-fold article on how Dead Zone 2 was A major beneficiary of tax benefits, including expensing, exclusions with respect to domestic production, and the 20% R&D credit. In Dead Zone 2, the aliens look like baby seals, they bleed and squeal when blasted, unless you play on mute. David Kocienevski, Rich Tax Breaks Bolster Makers Of Video Games, NY Times, September 11, 2011. Onion spoof interviewed a Mother who asked "Does the subsidy mean that computer games are good for you? Oh, it doesn't does it?" No, they are not. Video Games, *Onion,* September 13, 2011. http://www.theonion.com/articles/us-funding-video-games,21364/ The tax subsidies turn a 10% pretax return into a 21% post tax return, on one set of reasonable assumptions. Calvin Johnson, *Capitalize Costs of Software Development*, 124 TAX NOTES 603 (2009). http://www.utexas.edu/law/faculty/calvinjohnson/CapitalizeCostsOfSoftwareDevelopment.pdf]. Whatever we say in speeches, games like Grand Theft Auto IV (teaching gamers how to work for violent drug lords) must represent our highest values because they are among the most heavily subsidized activities in America. Congress needs to get control of this stuff.

Subsidies for the computer games and other cases where customers get the benefit cause waste. Quite disgusting games that would not be produced if they had to rely on their real demand by gamers become rational to develop with the tax subsidies. We thus waste costs on cases where the real (nontax) demand would not justify them. The fact that real demand does

justify the costs is a terrible reason to subsidize an activity if the society at large does not value in excess of what it paid for.

The way to get the biggest bang for the buck is for National Science Foundation to fund fundamental research. The NSF should also set up a winner tournament with a $500 million prize for the innovation with the largest social benefit. Tournaments take advantage of behavior economics to get the most investment from the private sector with the least government cost.

A second best solution is to define research and experimentation strictly to focus on cases in which the primary beneficiary is the general public. The costs should need to qualify as basic or fundamental research or experimentation. Development, meaning the investment for a marketable product, should be excluded. The costs should pass the patent standard – that is, they are surprise breakthrough discoveries beyond what a well trained computer scientist could be expected to develop from the state of the art. Normal development not qualifying as extraordinary unanticipated breakthroughs should not qualify. At the very least, computer games and recreational apps should be excluded.

Given the difficulties of identifying research that will benefit the general public beyond the customers, the credit should be cut to 2% of basis. Costs deducted already get zero tax, and zero tax is well enough subsidy to deliver through the tax system.

2. Above-the-line deduction for qualified tuition related expenses ($2 billion over 10 years)

Description. The Economic Growth and Tax Relief Reconciliation Act (EGTRRA) created an above-the-line tax deduction for qualified higher education expenses. The maximum deduction was $4,000 for taxpayers with AGI of $65,000 or less ($130,000 for joint returns) or $2,000 for taxpayers with AGI of $80,000 or less ($160,000 for joint returns). The proposal extends the deduction to the end of 2012.

Assessment. The goal is worthy, but the program needs to be refocused to cut down the government waste.

The costs of going to higher education is a wonderful investment that will give its high returns over the full lifetime of working. The accurate description of an investment is to capitalize it and then allow a depreciation-like deduction over the useful life of the investment, as the investment shrinks in value as the time remaining shrinks. Education costs have a value over a full 50-year working life of the student. If we assume the long-term 3% discount rate, the present value of a capital investment write-off over 50 years is 51% of the amount paid. A rule of thumb description would be to allow an immediate deduction of half the cost and be done with it.

A deduction of more than 51% is a government subsidy, not an accurate description of the taxpayer's standard of living, and the format of the subsidy needs to be refined. The deduction is worthless to a student who concentrates on studies and so has less than $14,000 of income, because they don't have enough taxable income to use it. It is worth as much as 15% * $4000 or $600 to taxpayers at the top of the allowed range. Roughly 51% is needed to describe the investment in present value terms, so the benefit is about $300 more than needed to describe income accurately. The cut offs are an imperfect remedy for the upside down effect that comes from using the tax system, not to calculate standard of living, but to deliver subsidy. The subsidy is not very much, but too much of it goes to taxpayers who would go into higher education anyway, and delivering to those who would do it anyway is government waste.

The subsidy will also get an annual review of whether we can afford it, only if it is put on the federal spending budget. The federal budget is the primary tool by which the government thinks about comparisons of what to spend money on. Off budget means a less intelligent assessment. An on-budget government spending program would of course not deliver its subsidy with more going to higher bracket taxpayers than to those making too little as a graduate student to pay tax. An on-budget government would be transparent to the democracy and fair. The tax deduction subsidy has a weird pattern and is unfair.

3. Expansion of adoption credit and adoption assistance programs ($762 million over 10 years)

Description. The proposal extends for one year the expansion of the adoption credit and adoption assistance programs. The maximum credit is increased to $13,170 per eligible child (a $1,000 increase). This increase applies to both non-special needs adoptions and special needs adoptions. Also, the adoption credit is made refundable. The new dollar limit and phase-out of the adoption credit are adjusted for inflation in taxable years beginning after December 31, 2010. For the adoption assistance program, the maximum exclusion is increased to $13,170 per eligible child (a $1,000 increase). The new dollar limit and income limitations of the employer-provided adoption assistance exclusion are adjusted for inflation in taxable years beginning after December 31, 2010.

Assessment. The goal is worthy, but the program needs to be refocused to reduce governmental waste.

The benefit from a program includes only the extra children adopted by reason of the governmental cost. Thus, you need to focus all of the federal cost on the marginal cases, where a family would adopt if it can get the federal subsidy, but cannot afford to adopt or would not adopt without it. Daddy Warbucks is going to adopt Orphan Annie (or not) (in the third Act), for reasons independent of the Federal Government paying for his costs of adopting her. Thus money given to Daddy Warbucks is a waste of federal money.

Once a upon a time, a county program gave a $10 bounty for a rat carcass because the rats were eating too much grain. They paid out $18 million under the program for 1.8 million carcasses and felt pretty good about it. But then they found that last year, without the bounty, the farmers' usual reasons for hating rats meant 1,799,997 rats were killed, so the program only added 3 more rats. Hold up a carcass because that county had a $6 million rat. The moral of the story is that you cannot count as a benefit of the program the children who would be adopted anyway; their cost is categorized as government waste.

A means test taking away both credit and exclusion above some level of income is not a perfect way to focus the cost on where it makes a difference, but it is good enough and would improve the efficiency and the cost benefit ratio of this program.

4. Tax-free distributions from individual retirement plan for charitable purposes. ($556 million over 10 years)

Description. The proposal extends for one year the provision that permits tax-free distributions to charity from an Individual Retirement Account (IRA) of up to $100,000 per taxpayer, per taxable year. The distributions from IRAs directly to the charity allows the taxpayer to avoid the 50% of AGY limitation on charitable deductions to public charities and 30% of AGY limitation on contributions to private foundations. The proposal is estimated to cost $556 million over ten years.

Assessment. Re-enact only after including the distributions within the 50% and 30% of AGY limitations.

IRAs generally reduce the sum of national savings. Individual retirement saving is dominated by target savers who save less when they can meet their retire goals by setting aside less from current consumption. Other savers fund their IRAs by borrowing, collecting an inappropriate interest deduction, or by diverting fixed savings from some other vehicle. These contribute nothing to national savings. The government deficit, which is the symmetrical opposite of savings, gets larger by the tax cost to it of the IRAs.[6]

Whatever one thinks about the 50% and 30% of AGY limitations on charitable deductions, stop treating IRAs as a privileged case.

5. Deduction for certain expenses of elementary and secondary school teachers ($206 million over 10 years).

Description. The proposal extends for one year the $250 above-the-line tax deduction for teachers and other school professionals for expenses paid or incurred for books, supplies (other than non-athletic supplies for courses of instruction in health or physical education), computer

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[6] Calvin H. Johnson, *Repeal Roth Retirement Plans To Increase National Savings*, 128 TAX NOTES 773 (August 16, 2010), [http://www.utexas.edu/law/faculty/calvinjohnson/repeal-roth.pdf].

equipment (including related software and service), other equipment, and supplementary materials used by the educator in the classroom.

Assessment. A worthy goal, but keeping track and auditing these expenses is more than the system can bear or the benefit is worth. Just pay teachers $37.50 each.

There is a 2% of AGY floor on employee expenses that makes a lot of sense. Small items should not be part of the tax system, unless you are willing to put an IRS agent in the classroom counting the supplies used in the classroom, and taking away the deduction for the books and supplies that get home. There is also a standard deduction, now at $11,900 for married couples, that (gloriously!) means that two-thirds of taxpayers do not have to keep track of their records for itemized deductions, and can often file a tax return that is about the size of a post card. The small stuff has to be cleaned out of the recordkeeping and the annual tax return.

Small business expenses are distinguishable and not subject to the 2% haircut or lost if you take the standard deduction because a business keeps serious books for nontax reasons, and an employee usually does not. If the employer pays for the supplies, as indeed the local school board should, then administrative efficiency goes the other way, and we should not sweat the small stuff or burden the tax return with them if some small supplies turn up at home.

It would make more sense to pay every full time primary or secondary teacher with a $37.50 federal check (which is 15% of $250). Don't bother trying to keep track of how they use it at that level, because that imposes a burdensome year round recordkeeping requirement and the $37.50 benefit is not worth the record keeping. Tell them this is prepayment for the love and supplies they will give to their students. The current above the line deduction is too small for the IRS to audit so that cheaters get ahead and honest taxpayers get overburdened with record-keeping. Let these worthy people have a $37.50 federal check and be done with it.

6. Parity for exclusion from income for employer-provided mass transit and parking benefits ($158 million over 10 years).

Description. The proposal extends through 2012 the increase in the monthly exclusion for employer-provided transit and vanpool benefits to that of the exclusion for employer-provided parking benefits.

Assessment. Allow to expire. And repeal exemption for parking as well.

Commuting is treated as a cost of choice of where you live under long standing tax rule. One incurs a long and expensive commute because housing is cheaper the further out you go. Housing costs and commuting costs are trade-offs for the same fundamental need for shelter, and all of the costs of shelter are consumption and part of the appropriate tax base. They should not be deducted in calculating standard of living.

Employees who pay for their own commuting are not allowed a deduction for their costs. Employees who can convince their employer to switch compensation from cash to the employer's paying for commuting, however, get an exclusion that is equivalent to a deduction and avoid tax on the costs. That is unfair! The fact that the employer provides for the cost does nothing to make the costs anything than other than a cost of housing, because employers are always looking for ways to pay their employees with money that will not be taxed to them. Both employer provided and employee provided costs of commuting should be subject to employee tax.

Since exclusion or deduction of commuting is a violation of the fundamental purpose of "taxable income," that is, the computation of standard of living, the deduction is a subsidy, not connected with tax, although it is delivered through the tax system. Every subsidy delivered through a deduction is unfair because the effective value of the transit benefits deduction rises with the marginal tax rate of a recipient. The negation of the bracket system is never the right pattern of distribution when you are trying to accomplish something.

The exclusion of parking costs is even worse. Massive amounts of downtown space are moved from their most productive use over to support for the automobile. Urban areas where space is so valuable get misused, warped by tax. Parking should always be treated as a personal cost, part of the package of where to live, and neither excluded nor deducted.

Employers who are in a position to pay compensation in the form of tax exempt fringe benefits like parking and transit get an unfair advantage over employers who do not have access to the fringes. They can pay employees less taxable cash, and they get a competitive advantage. For optimal efficiency, the tax system should create a level playing field among employers in the competition for good employees.

7. Special rules for contributions of capital gain real property made for conservation purposes ($117 million over 10years)

Description. The proposal extends for one year the increased contribution limits and carry-forward period for contributions of appreciated real property (including partial interests in real property) for conservation purposes.

Assessment. Repeal the deduction for conservation easements in full to get rid of fraud and government waste. There is no real market for conservation easements, and the figures are made up. Conservation easements will also harm our descendants.

Conservation easements are a bad accounting, a double deduction that shelters money the donor gets to keep and party with. For strict accounting that describes a taxpayer's standard of living, unrealized appreciation should not be deducted. To describe the taxpayer's standard of living, the charitable deduction needs to be limited to the taxpayer's basis in the property because deductions in excess of basis shelter money the taxpayer has kept and consumed. Assume a taxpayer (TP) buys rural timber property for $100,000 that grows in value to $1 million because

the high cost of timber is so high. TP gives a perpetual easement to a conversation fund saying that the property will remain forever undeveloped. TP claims the value of the land is now $400,000 and deducts $600,000.

The $600,000 deduction is a double deduction that shelters $600,000 of money that TP can party with. If TP had given the whole property to charity, then it would be appropriate to deduct the $100,000 basis of the property to reflect the fact that TP no longer has it. We should take out of the tax base the $100,000 the taxpayer has presumably already paid tax on. But the unrealized appreciation of $900,000 has not previously been taxed, and it is a double counting to both exclude and deduct the $900,000. The double counting means the TP has $600,000 of shelter deduction that exempts from tax unrelated cash the taxpayer has in hand. The purpose of the charitable deduction is to reflect taxpayer's standard of living for amount given away, and the only the basis of property should be deducted to reflect the amount given away. This is not charity, but greed – a deduction for kept and consumed amounts. (See also the deductions for food, computers and book inventories above, for a similar explanation.)

It is sometimes said that the TP must be given the privilege of capital gain on appreciated property because the TP could always sell the property. But there is no market for conservation easements. TP could not sell. Capital gain for $600,000 on an imputed sale and ordinary income for the $600,000 on the gift yields a tax windfall of the difference (35%-20%) for a fictitious sale that could not be replicated in the real world. The right deduction is no deduction for the capital gain amount in conservation easements, not the combination of capital gain and ordinary deduction.

The same absence of a market means that conservation easements are like the subprime liars' mortgages—the value is made up. Far better to require TP to sell to the charity with cash the charity has raised from some unrelated donor, because then and only then will we get arm's length purchases that validate the value. That would end the fraud and the bad accounting.

Conservation easements also will do more harm than good to the future of our country. Suppose that the purchasers of Manhattan had slapped on a conservation easement requiring the land remain dedicated to corn and foxes. That would have destroyed about $164 billion in present value terms because, with the current development that was actually allowed, so many people want to live or work in Manhattan. The conservation easement would have stopped all that. If the original Chicagoans had slapped a no-development easement around Fort Dearborn, we never would have had our Chicago. We need to let the future decide on how best to use its land: they will know better than we do what is the highest and best use of their United States, once it is no longer our land.

8. Reduction in S corporation recognition period for built-in gains tax ($189 million over 10 years)

Description. If a taxable corporation converts into an S corporation, the conversion is not a taxable event. However, following such a conversion, an S corporation must hold its assets for a certain period in order to avoid a tax on any built-in gains that existed at the time of the conversion. The American Recovery and Reinvestment Act reduced that period from 10 years to 7 years. The proposal extends the reduced holding period for sales occurring in 2012.

Assessment. Stay dead.

The normal rule is that becoming a pass through entity requires the immediate recognition of corporate gain. When a corporate entity converts to a partnership, which is the other form of pass through that competes with the S Corporation, there is an immediate gain recognized to the corporation and to the shareholders. Recognition of gain by the corporation when it becomes a partnership was required by the Tax Reform Act of 1986, which followed the recommendation of the prestigious private American Law Institute. The reason for the recommendation was to stop what was then called the "golden triangle:" Corporate purchasers were getting a step up in basis for business assets including inventory and short life depreciable assets, while the corporate seller was avoiding any tax on the sale. The various forms of the golden triangle did require the shareholders to pay tax on gain from the value of the sale, but with shareholders who turned over their assets or heirs of recent decedents there was not much shareholder gain. Current law is symmetrical. If the buyer gets a higher basis, the selling corporation must recognize gain.

Consistency would require an S election to constitute a constructive sale on which the corporation recognition of its built-in gain is recognized. Both partnerships and S corporations are pass through entities and no viable distinction can be drawn from their tax status. The 1986 compromised with consistency, however, and instead added a taint, requiring corporate recognition of gain if the corporate assets were sold within ten years after the election. The proposed resurrected provision would reduce the taint period to seven years. Sales after seven years of the election would have no corporate level tax.

Shareholders who buy shares at a discount because the corporation has appreciated assets including inventory and intangibles that buyer and seller expect to produce tax will get a windfall when they avoid the tax within the corporation whose shares they have just purchased. The ten-year taint was part of the 1986 deal and it seems we should keep to the deal.

There is, on the other hand, now almost no commitment to preserving the corporate tax.

9. Expensing of "brownfields" environmental remediation costs ($184 million over 10 years)

Description. The proposal extends for one year the provision that allows for the expensing of costs associated with cleaning up hazardous "brownfield" sites.

Assessment. First best result would be to let the provision remain in peace among the dead. But a viable alternative, with some extra administrative burden, is to allow some expensing to get basis down to value. To prevent windfalls, the alternative would disallow deductions that would reduce the adjusted basis of the land to an amount lower than its value. All cleanups would be treated as capital investments to land. The taxpayer should never be allowed to deduct a cost he has not lost because that understates his economic income and standard of living. But he would deduct the basis to reduce adjusted basis to value.

As a matter of theory, the calculation of economic income requires that the taxpayer have a basis in an investment equal to the remaining value. We use internal rate of return as the universal yardstick of economic income. To identify~~,~~ internal rate of return adjusted~~the~~ basis needs to be kept equal to the bank account that is just like this investment. That bank account balance is the value of the investment. If the taxpayer's basis is higher than its value, reflection of income would allow a deduction to get basis down to value.

The expensing or more than necessary to calculate income will create a windfall to buyers who buy well located land at a discount knowing that they will need to invest some cleanup costs to allow the land to be used to its full potential. Cleaning up the toxic waste on brownfield is a capital investment that makes the land valuable. Many of the brownfield sites are close to metropolitan centers and will be valuable properties under a building foundation because of their location if the toxic damage to the land can be repaired. The ability to deduct an investment means, as a matter of economics, that the internal rate of return from the investment is taxed at zero rate. When debt and expensed investments are combined, the tax is less than zero, the taxpayer shelters unrelated income from tax, and taxpayers go into investments that would not be undertaken in a nontax world.

While calculation of economic income requires that basis be deducted to get down to value, the administrability of the tax system requires that a taxpayer sell the property in order to have a bargained exchange that will validate the value. We ordinarily require an arm's length sale of property in order for the tax system to recognize its reduced value. The administrative value of the sale is so we can ascertain lower value needs to be applied to brownfields.

C. TOO LITTLE INFORMATION TO KNOW

1a. Work opportunity tax credit ($971 million over 10 years)

1b. New markets tax credit ($857 million over 10 years)

Description. Under current law, businesses are allowed to claim a work opportunity tax credit equal to 40 percent of the first $6,000 of wages paid to new hires of one of nine targeted groups. These groups include members of families receiving benefits under the Temporary Assistance to Needy Families (TANF) program, qualified veterans, designated community

residents, and others. The WOTC program is currently set to expire December 31, 2011. The proposal extends this provision through December 31, 2012 and would be effective for employees hired after date of enactment.

Under the New Markets Tax Credit (NMTC) program, the federal government provides investors with either five cents or six cents of federal tax credits (depending on the amount of time that has passed since the original investment was made) for investments in low income communities. The proposal extends for one year the new markets tax credit, permitting a maximum annual amount of qualified equity investments of $3.5 billion each year.

Assessment. These programs are not tax related, and knowledge of tax is of no help. The government has too little information to determine whether the benefits justify the costs.

Cutting the credit in half to 20% for the work opportunity credit and to 2-1/2 to 3% for the New Markets Tax Credit, however, would save money and allow a controlled experiment as to what the impact of the credit is.

2. Definition of gross estate for RIC stock owned by nonresident not a citizen of the U.S. ($8 million over 10 years)

Description. Although stock issued by a domestic corporation generally is treated as property within the United States, stock of a RIC that was owned by a nonresident non-citizen is not deemed property within the United States in the proportion that, at the end of the quarter of the RIC's taxable year immediately before a decedent's date of death, the assets held by the RIC are debt obligations, deposits, or other property that would be treated as situated outside the United States if held directly by the estate (the "estate tax look-through rule for RIC stock"). The proposal permits the look-through rule for RIC stock to apply to estates of decedents dying before January 1, 2013.

Assessment. The government does not have enough information to determine whether it is getting its money's worth from its cost.