From the Editor:

2010 Comes to a Close

By Jeremy Scott — jscott@tax.org

The second year of the Obama administration was one of nominal triumphs (the passage of healthcare and financial regulatory reform) and actual tribulations (the colossal defeat of the Democratic Party in the midterm elections). While the president and some in the media might call the 111th Congress one of the most significant in history, voters decided that they didn't particularly approve of its accomplishments, and the 112th Congress will have a decidedly different makeup.

Much has been written here about the Bush tax cut compromise worked out by President Obama and the relative ease of its passage despite liberal Democratic objections. But postponing the decision on the lower tax rates enacted in 2001 and 2003 will probably not be the lasting legacy of 2010. Instead, the IRS and administration took center stage in the tax world, even if both the mainstream and tax press often ignored these developments while focusing on political infighting and muddled legislation on Capitol Hill. The implementation of uncertain tax position reporting and the IRS's refusal to provide guidance on the codification of the economic substance doctrine are both likely to profoundly change tax practice in the future. And that is in addition to how the practitioner world might change under the new return preparer registration regime being implemented. Certainly OPR Director Karen Hawkins and Commissioner Douglas Shulman are hoping that return preparation is significantly improved by registration and its accompanying testing and continuing education requirements.

The IRS's administrative changes and the transformation of LMSB into LB&I are why *Tax Notes* has chosen Heather Maloy as its Person of the Year. The specific reasons for Maloy's selection can be found in the Person of the Year article on p. 7, but it is probably safe to say that the tax world will be more significantly changed by the policies Maloy is being called on to impose than all the bluster from Capitol Hill, especially if Dodd-Frank and the healthcare reform law turn out to be paper tigers.

Bank Taxes and Japanese Austerity

One of the triumphs that Obama trumpets when defending his administration's record is the Dodd-Frank financial reform act. Supposedly this complicated piece of legislation will help to prevent a crisis similar to the meltdown of 2008. But the Dodd-Frank act both under- and overreaches, according to a recent book by several NYU professors. The professors believe that the market can largely regulate itself, but that a bank tax is needed to fund any future bailouts. Lee Sheppard strongly disagrees with the authors about the need for regulation, and her analysis of the bank tax proposed by the professors concludes that their proposal is overly complicated and probably not administrable by the IRS. The idea that the market can self-regulate and voluntarily comply with the Dodd-Frank act is seriously undermined by ICE Trust's recent decision not to submit to CFTC oversight, writes Sheppard. (For her analysis, see p. 13.)

In many ways, Japan provides a glimpse into a possible future for the United States. The nations use similar tax systems and now face similar problems. Japan's debt-to-GDP ratio is twice that of America's, but the stagnation of the Japanese economy gives policymakers a clear view of the consequences of failing to address long-term deficits. But not even the Japanese are ready to confront their debt and deficit crisis, according to Martin Sullivan, who looks at Japan's decision to enact a corporate rate reduction without raising its consumption taxes. Sullivan concludes that until Japan is willing to restructure its tax system to pay down its debt and reduce its deficit, it can only play at the margins of true corporate tax reform. Both the United States and Japan must overcome political limitations to tax reform before they can seriously address their economic futures, writes Sullivan. (For his analysis, see p. 19.)

Commentary

Courts interpreting corporate tax laws face a challenge when applying economy reality to the legal fictions that pervade modern transactions. Judges, academics, and practitioners have attempted to find a coherent means to navigate through concepts such as mergers, distributions, liquidations, and step transactions, but their attempts have led only to a collapse of meaning in the corporate context, according to Charles Kingson (p. 83). His special report shows how various corporate transactions are characterized as distributions to shareholders, transfers to third parties, or both. He looks at the overlap between sections 331, 332, 336, 337, 354, and 361. Because tax statutes do not focus on ownership, the increasing levels of abstraction being used to combat tax avoidance simply confuse the interpretation of tax law, Kingson concludes.

The penalty in the healthcare reform law for individuals who forgo health insurance is critical to the theoretical functioning of the reform effort. Insurance companies lobbied heavily for the penalty as a counterbalance to new rules that prevent them from denying coverage. However, the penalty is a toothless guardian against those who wish to avoid the new healthcare system, writes Daniel Mellor (p. 105). The individual mandate is a necessary part of the healthcare reform law, Mellor writes, but he finds that it cannot be adequately enforced by the IRS. Mellor shows how individuals can escape notice for at least two years before their lack of insurance is confirmed by the government and how litigation can extend that time frame. His article also recommends several alternative enforcement approaches, including automatic tax lien foreclosure, reprioritizing tax payments, and the use of refund offsets.

Innocent spouse relief has proved to be a surprisingly controversial and significant issue in the last year. The fight between the Tax Court and the IRS over the statute of limitations imposed by the Service (but not by the statute) has spilled into several circuits and might ultimately require Supreme Court review. Prof. Scott Schumacher hopes the attention focused on the *Lantz* decision and related cases will bring to light the challenges being faced by taxpayers claiming innocent spouse relief and the unnecessary burdens imposed on them by the IRS's administrative process (p. 113). Schumacher doesn't think that *Lantz* should ever have reached the Tax Court because the IRS should be analyzing innocent spouse cases in a completely different manner and deciding in favor of the taxpayer without the need for judicial prodding.

Tax expenditures are becoming a popular target of both public ire and tax reform efforts. Outright tax increases are anathema to the American electorate, but the federal and state governments face serious budget crises. David Cay Johnston believes that these tax subsidies to businesses have grown out of control and are damaging the economy (p. 123). Johnston focuses on sales and property tax breaks provided by governments to induce businesses to location shop. A recent work by Prof. Kenneth Thomas reports on the extent to which these types of subsidies have grown to attract capital and the inefficiency of the measures. Johnston also looks at states' efforts to repeal such tax credits, including Iowa's and Michigan's cessation of their film tax credits. Courts are likely to do little to stop this flow of tax dollars to businesses, so it will be up to the public to put pressure on lawmakers to end these giveaways, according to Johnston.

Damages paid by a business after a settlement or judgment are generally deductible if they are not a penalty. However, most businesses deduct fines paid under the False Claim Act, even though they resemble penalties. Robert Wood writes that the IRS is starting to scrutinize these deductions more closely and that companies should be careful in the future (p. 119). He argues that companies need to give more thought to their penalty characterizations and be creative when reporting these deductions on their tax returns. The IRS is aware that most taxpayers will go out of their way to avoid a penalty characterization, and companies must have thorough documentation in place before preparing a return, Wood concludes. ■