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From the Editor:

ADR at the IRS

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During law school I spent the end of a summer in Europe studying international alternative dispute resolution with a focus on mediation. Along with mornings spent on the Charles Bridge in Prague, there were afternoons of playing mediator at Humboldt University in Berlin. I learned a lot. The expensive and public winner-takes-all system that is litigation is not always the best way to resolve a dispute.

No way around it, ADR is the wave of the future. Indeed, it is probably happening now at a courthouse near you. When I worked at the Justice Department, I attended more than a few court-ordered mediations. I never settled a case during one, but they were always a worthwhile exercise because I invariably discovered something about the strength of my case.

But what about ADR at the administrative level?

Well, many aspects of mediation could benefit both taxpayers and the IRS. The IRS should like that taxpayers are more likely to comply with the terms of an agreement they helped draft. Taxpayers should like that the process is confidential — who wants their financial laundry aired in public? The process is very affordable compared with litigation. And perhaps the most important thing is that ADR is flexible — it allows the parties to design a process and solution well suited to their needs. This could be valuable to both the IRS and the taxpayer when the number crunching begins in a big-dollar case that involves multiple years and issues.

This important point about flexibility is made by John Klotsche in a special report (p. 1241). Klotsche takes a critical look at the IRS administrative dispute resolution system and concludes it is antiquated and too confrontational, and does not advance the agency's purpose of promoting a high level of compliance. Klotsche wants the IRS to rebuild its dispute resolution processes around ADR. Fan as I am of ADR, though, I wonder if most taxpayer disputes would benefit from arbitration or mediation. A lot of the time the IRS just doesn't have a lot of leeway — like when the law is settled, or the taxpayer kept no records that would substantiate claims. In those circumstances, I think ADR could be a waste of time.

News

Lee Sheppard writes this week on the OECD discussion draft on business restructuring, which attempts to apply the 1995 OECD transfer pricing guidelines to income shifting. As Sheppard explains, restructuring for tax purposes exploits the central weakness of separate company accounting, which is that there is no economic justification for assigning profit to one legal component of a larger whole, as opposed to another. She also points out that the profit-split method is nothing but formulary apportionment by another name (p. 1187).

Days after AIG sued the government for more than $306 million over a tax dispute, the Treasury Department announced that it would make another $30 billion available to the company (p. 1192). The lawsuit involves several issues, but one of them is highly controversial — AIG's allegation that the IRS improperly disallowed some claimed foreign tax credits. According to the IRS, FTC generators such as those employed by AIG wrongly exploit the law by enabling taxpayers to get a credit while incurring no corresponding foreign tax. FTC generators are one of only nine active high-risk Tier I issues. I have heard more than one person in the last couple of days suggest that the government should make the $30 billion in aid subject to AIG dropping its refund claim to the extent it relates to FTCs.

In other news this week, the Obama administration's delay in filling key Treasury Department slots to help address the recession drew criticism (p. 1193). Paul Volcker, chair of the President's Economic Recovery Advisory Board, warned that Treasury is ''weak'' because of ''shameful'' slow progress to fully staff the department. A key reason for the delay has got to be President Obama's rule restricting the lobbying activities of potential appointees before and after service in the administration. It looks like this idealistic rule is proving problematic, to say the least.

Commentary

The next major task for the Obama administration is expected to be comprehensive healthcare reform. Obama's budget outline allocated $630 billion for reform efforts, and the Senate Finance Committee is expected to begin work on legislation starting in May. (For coverage, see p. 1204.) Partly in response to reform efforts, Elise Gould and Alexandra Minicozzi in a viewpoint analyze the effects of limiting the employment-based health insurance exclusion. Limiting the exclusion has been proposed by Finance Chair Max Baucus, but Gould and Minicozzi report that a cap won't necessarily harm so-called Cadillac plans as much as it will affect small firms, businesses with an older workforce, or companies with high average wages. For the study, see p. 1259.

A pair of IRS rulings dominate this week's practice articles. Robert Wood writes about a recent IRS letter ruling that raised questions about the IRS's interpretation of the "physical" requirement to deduct settlement amounts. The ruling allows a taxpayer to deduct a bad-faith settlement from an insurance company because his claim was pursued on account of his injuries. Wood believes that the ruling is clearly correct in applying the section 104 exclusion (p. 1229). Mark Leeds's article concerns a chief counsel memorandum that attacked an ambitious strategy to accelerate losses inherent in accounts receivable. Leeds disagrees with some of the memorandum's arguments, but finds the conclusion to be correct. He advises practitioners not only to properly paper these kinds of loss acceleration transactions, but also to implement the transaction in fact (p. 1233).

Because trusts are mostly used in wealth management settings, Jonathan Zhu writes that many practitioners are unfamiliar with them. In a special report on p. 1247, Zhu looks at cross-border tax issues involving single-owner grantor trusts. He sorts through entity classification rules and proposes that the United States abolish trust residence rules that existed before 1996 and explicitly disregard single-owner grantor trusts for the purposes of determining the income tax liability of its grantor. In Of Corporate Interest, Robert Willens analyzes how bankruptcy can affect the limits on a company's use of net operating and built-in losses (p. 1263). In Estate and Gift Rap, Wendy Gerzog concludes that the IRS is right to try to cut down on abuses related to qualified tuition programs. Section 529 plans invite abuse by allowing the account owner to change the designated beneficiaries without incurring a transfer tax, and Gerzog focuses on last year's advance notice of proposed rulemaking to prevent transfer tax abuses (p. 1267).

Calvin Johnson responds to Donald Rocap's letter to the editor from the March 2 issue of *Tax Notes* and says he is inalterably opposed to taxing imputed income (p. 1271). Replying to a critique of his proposal to tax income from the use of a very big house, he believes that we should only tax income actually received because "doing nothing is a very hard thing to tax." A letter from James Riordan praises Obama's proposed simplification of the estate tax and encourages *Tax Notes* to keep a running commentary on the simplification and complexity aspects of Obama's budget and tax proposals (p. 1271). ■

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