From the Editor:

Are Oil Companies Finally Vulnerable to Credit Rollbacks?

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The five major oil companies had combined profits of more than $77 billion in 2010. With gas prices surging past $4 per gallon (a rise at least partially divorced from the price of crude oil), it is unlikely that their 2011 profits will be significantly lower. The oil industry is one of the most profitable sectors of the economy and is somewhat insulated from economic conditions because of the necessity of transportation and the production of electricity. Despite this, U.S. oil companies receive more than $4 billion in tax subsidies a year, mostly from the section 199 domestic production credit.

These subsidies have long drawn the ire of President Obama and congressional Democrats. Obama has proposed eliminating them in each of his budgets, and the Democratic Congress took up measures that would at least cut the tax preferences every year. But Republicans and lawmakers from oil states have long stood firm against any reduction in the section 199 credit, arguing that it would raise prices at the pump and discourage domestic oil production. It is well known that Republicans favor increased domestic drilling as a solution to rising energy prices, and they have demonstrated little flexibility in their stance — until last week. On April 25 House Speaker John Boehner hinted that he would be willing to consider looking at the tax preferences for oil and natural gas, saying that oil and gas firms ''ought to be paying their fair share.'' This was the first sign of a crack in Republican ranks, and Democrats were quick to go on the offensive.

The president sent a letter to Congress, urging it to act immediately on his budget's proposal to eliminate $46 billion in tax subsidies over the next 10 years. Senate Majority Leader Harry Reid praised Boehner's ''change of heart'' and encouraged Senate Republicans to stop filibustering bills that would eliminate the tax programs. At the end of the week, Finance Committee Chair Max Baucus announced that he planned to introduce legislation that would eliminate subsidies for oil companies, encourage alternative energy production, and support fuel-efficient vehicles. (For coverage, see p. 462.)

A spokesman for Boehner clarified that the speaker still opposed the president's energy plan, and Senate Minority Leader Mitch McConnell repeated his insistence that increased domestic oil production would create jobs and help the economy. Nevertheless, it is hard to believe that Boehner misspoke or that he didn't intend to at least signal the House's willingness to consider taking up an energy package this year. It is also possible that he simply was trying to placate an increasingly irate public on the issue of gas prices, but if so, his remarks seem both strangely specific and needlessly esoteric. (Politicians usually grumble about the gas tax or the strategic oil reserve when they wish to use platitudes to assure the public they care about gas prices.)

Commentary

On January 7 the government issued proposed regulations under section 1273(b) regarding when there is public trading for the purposes of determining the issue price of debt. The goal of the regulations was to solve several difficulties arising from the tax treatment of debt exchanged for property. Although the regulations liberalize existing rules, they stop short of conforming with the statutory rule for determining gain or loss on sales and exchanges, and they can cause significant income distortion, according to Prof. Ronald Blasi (p. 489). Under both the proposed and current regulations, the issue price of an instrument received in an exchange involving publicly traded property is equal to its FMV, but the issue price in an exchange involving non-publicly traded property is equal to the imputed stated principal amount, writes Blasi. He argues that the latter value will not equal or approximate FMV. In his special report, he encourages Treasury to modify the proposed regulations to allow taxpayers to elect to use FMV in exchanges involving non-publicly traded property, concluding that the current rules would be unworkable.

In *Historic Boardwalk LLC*, the Tax Court held that tax credits can be considered when making an economic substance determination. The case involved a rehabilitation project that would not have been undertaken without the availability of $109 million in tax credits. The IRS disagreed with the taxpayers' treatment of the transaction, arguing that the LLC simply passed the tax credits to an investor and was itself a sham. The Tax Court disagreed. The case might provide some guidance to practitioners who are struggling with the implications of the codified economic substance doctrine, Michael Bauer and Kevin Juran write (p. 499). They say that the Tax Court opinion provides additional support for respecting some transactions that have the effect of transferring tax credits as part of the compensation for investing. How the IRS will treat these types of transactions in the future is an open question, they conclude.

Tax expenditures are under scrutiny on Capitol Hill. Obama's fiscal commission proposed dramatic reductions in tax expenditures as a way to help restructure the tax code and reduce the deficit. The president, without providing specifics, also pointed to tax expenditures when he called for deficit reduction that doesn't involve dramatic cutbacks in entitlement spending. Whether Congress will actually move to cut back on tax preferences is unclear, but it is unlikely these subsidies will survive a reform effort unscathed. Martin Feldstein, Daniel Feenberg, and Maya MacGuineas propose capping tax expenditures as a share of a taxpayer's income in an effort to improve the code and generate new revenues (p. 505). Their plan would set a cap of 2 percent of a person's adjusted gross income. For most taxpayers, the expenditures affected would be employer-provided health insurance and the home mortgage interest deduction. The authors write that their plan is fairer than singling out individual tax expenditures for reduction or elimination. They estimate that a 2 percent cap would raise between \$278 and \$360 billion a year. A related Tax Facts on p. 511 breaks down which taxpayers benefit from tax expenditures, finding that tax preferences overwhelmingly benefit the top 20 percent of taxpayers, who receive 65 percent of the benefits.

In this week's Shelf Project, Prof. Calvin Johnson compares corporate equity to an option that reserves gains to the shareholders but shifts losses to creditors (p. 513). He argues that this dichotomy encourages shareholders to increase the volatility of corporate assets, since only the creditors will lose significantly if a corporation defaults. This increases the level of risk in the economy, harming everyone, he writes. Johnson would like to disallow the deduction of credit-risk interest that covers the risk of default. Credit-risk interest tracks the protection against loss that gives equity its optionlike character because the interest is an assessment of how likely it is that the debt will not be repaid, according to Johnson. He concludes that the code's treatment of credit-risk interest is part of a larger problem in how the tax system struggles to distinguish debt from equity.

General releases are often used to terminate litigation. However, they usually say nothing about taxes, which causes unfortunate consequences, Robert Wood writes (p. 519). A general release that says nothing about taxes invites IRS scrutiny, as was demonstrated in the Fifth Circuit in *Espinoza*, Wood says. Wood argues that practitioners should not consider *Espinoza* as simply confirming another narrow reading of section 104. The case was primarily about causation and the lack of language specifying why payments were being made, particularly for tax purposes. Wood concludes that well-advised taxpayers should avoid general releases like the plague.

David Cay Johnston recently took issue with House Budget Committee Chair Paul Ryan's plan to reduce the deficit and reform the tax code. Johnston wrote that Ryan's proposal confirms that Republicans believe that more wealth should be concentrated in the hands of high-income earners. Diana Furchtgott-Roth rebuts Johnston's points in her column this week, pointing out that much of Johnston's criticism seems aimed at Ryan's 2010 Roadmap proposal and not the budget resolution actually passed by the House this year. She argues that Ryan's plan is simply an acknowledgment that the United States faces a serious deficit problem combined with the prospect of ever-increasing government expenditures that are unaffordable. She notes that Ryan's Medicare proposals closely tie increased contributions with income levels and would not result in a transfer of money from poor taxpayers to the rich (as Johnston implies). She concludes that Ryan's plan is actually a serious attempt to address the deficit, while Obama's much less comprehensive proposals are inadequate to control the rise in the nation's debt. (For her column, see p. 523. For Johnston's criticism of the Ryan plan, see *Tax Notes*, April 25, 2011, p. 429.) ■