From the Editor:

Balanced Budget Amendment Would Tie Lawmakers' Hands

By Jeremy Scott — jscott@tax.org

The balanced budget amendment is back. A group of Republican senators has introduced a new version of the venerable idea, arguing that it is time for the Constitution to require that the president submit a balanced budget and that the nation's outlays be equal to its revenues. Supporters of the measure claim that the entire Republican Senate caucus supports the amendment, and they argue that the measure is a necessary first step in dealing with the nation's fiscal crisis.

The balanced budget amendment nearly passed during the Clinton administration, when it received several Democratic votes. A thorough analysis of the Senate votes, however, showed that Democratic support seemed to be tied to which senators were facing reelection and was not consistent (suggesting that the progressive party was manipulating its votes to ensure that the measure would always just fail). The new Republican proposal isn't quite the same as the 1990s version. Republicans aren't just seeking to force the government to balance its books; this time they want to make sure that balancing comes at the expense of spending, and not as the result of higher taxes.

The new balanced budget amendment would constitutionally set government spending at 18 percent of GDP. It would also require a two-thirds vote of Congress to raise taxes. This is similar to a provision in the California Constitution that has made it extremely difficult for that state to deal with a serious budget shortfall. Republicans are determined to see their view of fiscal policy enshrined in the Constitution, and the GOP proposal is designed to placate Tea Party concerns that fiscal reform will be accomplished by higher taxes rather than through spending cuts. The Tea Party and other conservatives have pushed the percentage of federal spending relative to GDP as a major issue in any deficit reduction package, and it is likely that the 18 percent figure in the balanced budget amendment will soon become an important part of Republican rhetoric on taxes. (For coverage, see p. 34.)

The chances of a balanced budget amendment ever passing the Senate are slim, so it is hardly worth discussing how this particular proposal might work in practice. What the proposal does show is the increasing inflexibility of the GOP on tax issues. While some senators in the so-called Gang of Six have signaled they might support revenue-raising measures as part of a deficit reduction or tax reform effort, measures like the balanced budget amendment call that commitment into question. Frankly, it would be quite surprising if any GOP senator who intends to serve beyond 2012 casts a vote in favor of a bill that isn't revenue neutral or doesn't contain tax reductions.

Commentary

The IRS and government are determined to define overstatements of basis as omissions of gross income for the purposes of applying a six-year statute of limitations. This struggle has consumed the attention of several circuit courts and led to the issuance of ''fighting'' regulations that attempt to make such omissions of gross income clear. These regulations and their validity implicate the retroactivity rule in the original 1954 version of the section 7805 regulations. Patrick Smith argues that because of the expansion of agency rulemaking discretion that has resulted from the *Chevron*, *Brand X*, and *Mayo* decisions, it is not reasonable to conclude that Congress intended to authorize retroactive application of expanded agency discretion in 1954 (p. 57). Smith believes that retroactive regulations under section 7805(b) should be evaluated using the same standards that apply to retroactive regulations issued by any other agency. He concludes that the overstated basis regulations should be considered impermissibly retroactive.

Cancellation of indebtedness income has become a major issue during the economic downtown, as corporations and taxpayers renegotiated existing debt, often resulting in lower principal amounts, interest payments, or both. COD income also has arisen in less obvious contexts, including reductions in the amounts of penalties assessed by the U.S. Customs and Border Protection agency. Luis Abad, Scott Vance, Craig Koprowski, and Steven Friedman discuss how many multinational companies have started to receive Forms 1099-C from U.S. customs (p. 71). The COD income in question is the result of an automatic settlement practice whereby high initial fines are abated in exchange for a much smaller set amount. Because the initial fines can total $250,000 (the amount of an importation bond) and the reduced settlement amount is only $200, the amount of COD in question can be quite large. The authors write that there doesn't appear to be a valid reason for treating these amounts as COD income and that taxpayers and practitioners should be wary of what stance IRS auditors and the National Office will take on this issue.

The federal income tax started as a targeted levy on the wealthy. Two world wars, however, saw the tax expand to a mass levy on most American wage earners. However, the income tax's status as a mass tax has been in steady decline over the last few decades, according to James Gould (p. 75). Gould points to indexing in the late 1980s as the unanticipated catalyst for this decline, but also highlights the role of targeted tax benefits. The decline of the income tax has created serious consequences for the nation's revenue system and reduced the positive effects of tax cuts, writes Gould. He warns that this might increase the resolve of policymakers to impose a consumption tax on taxpayers who have escaped the reach of the income tax.

The Tax Court's rules of evidence under section 7453 reference the District of Columbia. The court has interpreted these rules to require it to apply the evidentiary precedent of the D.C. Circuit Court in all cases, which runs counter to its usual practice of using the rules of the circuit court to which its decision is appealable. Saul Mezei writes that this rule now sows more confusion than it prevents and that it is time for the Tax Court to use the federal rules of evidence (p. 81). He concludes that the court should be free to apply *Goshen* to evidentiary issues, removing them from outlier status and bringing far more certainty to the area.

The Tax Court's recent decision in *WB Acquisition* reviews the factors used to determine the existence of a joint venture or partnership. Robert Wood and Christopher Karachale wonder whether this restatement of the test implicates attorney-client relationships as the basis for a partnership (p. 87). The authors write that just because a partnership does not exist under state law does not preclude a partnership being found for federal income tax purposes. They analyze the various factors that might be used by the IRS in analyzing such a partnership and advise practitioners and taxpayers to be very careful when setting up the details of an arrangement if they wish a partnership between a lawyer and a client to be respected.

Robert Nassau's April Madness challenge comes to an end this week, with the crowning of a champion on p. 93. Using the bracket format of the NCAA basketball championship, Nassau has whittled his 64 tax provisions down to the final four and now the ultimate winner.

The Republican House has pledged to consider entitlement reform as part of its effort to combat the federal deficit and growing debt-to-GDP ratio. But tackling entitlement spending is easier said than done, and attempts to reform Social Security and Medicare have usually come up short. Diana Furchtgott-Roth writes that without changes to Medicare, it is unlikely the nation's budget crisis can be dealt with (p. 95). She proposes three changes to Medicare: premium support, vouchers, and health retirement accounts. Premium support is based on an idea proposed by former lawmakers John Breaux and Bill Thomas. Medicare cannot keep its promises to future seniors, and it is time for Congress to seriously consider alternatives for debate and discussion, concludes Furchtgott-Roth. ■