From the Editor:

Fishing Expeditions: Tools for Tax Enforcement?

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Many legislative initiatives have been undertaken recently to increase taxpayer transparency and reporting, and thus aid tax administration and enforcement. These include the disclosure initiatives in the aftermath of the UBS case, FATCA, and the recently proposed uncertain tax position reporting. Perhaps this is the century for tax transparency.

Lee Sheppard, in down-to-earth fashion, ponders the daily grind of motherhood and the baffling experiences mothers face when raising their children. More importantly, however, she presents her annual Mother's Day gift-giving guide for readers interested in ideas and in brushing up on the latest fashions. She likens the unarticulated cries for attention by babies to the difficult-to-decode "cries" of IRS agents for information in auditing large hedge funds. She compares the experience of hedge fund back-office people responding to IRS IDRs to how they would feel if they were left alone with a crying baby. She also likens IRS audits of hedge funds to fishing expeditions with the initial hurdle of fact-finding, followed by the monumental task of resolving questions that have yet to be addressed at the policy level. Sheppard examines some of these sticky issues and the most controversial financial transactions that get tackled on audit, and discusses the controlling authorities. For her analysis, see p. 487.

Along the lines of fishing expeditions and uncovering as much taxpayer information as possible, IRS Chief Counsel William Wilkins reiterated the Service's position that the uncertain tax position reporting proposal will not be used as a fishing expedition but as a "controlled exploration into hidden taxpayer information" in order to enhance effective tax administration, and it won't serve as an effort to expose otherwise protected documentation. For coverage on practitioner responses to the IRS UTP draft forms, see p. 496 and p. 499.

FATCA is another legislative tool aimed at disclosure of offshore taxpayer transactions and account holdings. IRS officials recently indicated that FATCA guidance will be provided in stages to allow taxpayers and financial institutions to prepare for the new reporting regime. Such guidance, according to the IRS, will be designed to be as burden free as possible. For FATCA coverage, see p. 504 and p. 505.

In the midst of the hot debate in the United States about the possibility of a VAT, Martin Sullivan takes a glimpse at Canada's VAT system. He explores the historical and political forces that led to its enactment, its evolution through the years, and outlines lessons for a possible U.S. VAT. Sullivan emphasizes that Canada's VAT is a transparent tax and the exemptions for necessities are what prevent the tax from being overly regressive, which U.S. liberals opposing the VAT often assert. Moreover, he demonstrates that the VAT in Canada has not led to an increase in overall taxation as conservatives opposing the tax often argue. Ultimately, the author says that the VAT might be the least of all evils in gaining control over the abyss of a mounting federal deficit. However, in order for it to become a reality in the United States, either politicians need to become more courageous or the public must become more enlightened — both of these propositions are perhaps tall orders. For Sullivan's analysis, see p. 493.

Even though the economic substance doctrine has been codified, the common-law basis for the doctrine will likely remain. That notion was recently confirmed by Treasury officials who emphasized that apart from the penalty provision, nothing has really changed in the application of economic substance principles. When asked by practitioners about the role of previous case law, Treasury responded that Congress intended for the doctrine to remain a flexible tool that will be applied in accordance with case law precedent. (For coverage, see p. 501.) In a special report this week on p. 535, Gray Jennings also posits that section 7701(o) is intended to clarify, not replace, the common-law version of the doctrine. He says that Congress intends that the steps a taxpayer undertakes to realize a nontax objective have economic substance even if those steps are arranged to reduce federal income taxes. According to Jennings, the novel part of this approach to common law is that the taxpayer's purpose for one or more steps determines economic substance, regardless of experts' views. He concludes that an approach based on this interpretation would readily identify tax shelters.

Commentary

The regulatory power of Treasury when interpreting tax laws is frequently in dispute in court cases. Guidance issued by the government often tries to overrule or circumvent unfavorable court decisions. But to what extent can Treasury actually overrule Supreme Court precedent? Roger Jones and Andrew Roberson attempt to answer this question in the context of the *INDOPCO* decision on p. 547. The authors believe that Treasury's ability to overrule the Supreme Court frequently causes significant controversy between taxpayers and the IRS. In their opinion, strong arguments exist that Treasury does not have the power to ignore Supreme Court opinions when issuing guidance and that broad readings of the *Brand X* decision are inappropriate.

The *G-I Holdings* district court case recharacterized a loan that in form was to a partner as in substance a loan to the partnership. To reach this conclusion, the court used the disguised sales rules of section 707. The district court is the first to use section 707 to find a disguised sale of property, according to Blake Rubin, Andrea Whiteway, and Jon Finkelstein (p. 553). However, they disagree with the court's conclusion and find it odd that such an important deviation from partnership principles was issued as an unpublished opinion that will be accorded little precedential weight. The authors argue that the court ignored an established line of cases that show when it is appropriate to recharacterize a loan as a disguised sale. Rubin, Whiteway, and Finkelstein find that the court's ''free form analysis'' is completely at odds with the facts in the case.

An IRS ruling from May 2009 explains the tax consequences of surrendering or selling life insurance contracts. A second ruling issued that same month provided tax guidance to the purchasers of these contracts. The IRS concluded that an insured's basis for gain of a cash policy must be reduced by mortality charges. Kenneth Orbach strongly disagrees with this finding (p. 567). He writes that the basis should not be reduced by mortality charges, whether the policy is held by the insured or an investor. He also requests that the IRS clarify the application of section 1234A and its effect on cash value policy surrenders.

Kip Dellinger joins *Tax Notes* in this issue as a regular contributor to the Policy Perspectives column. In his first article, he targets a recent Johnston's Take that seemed to take future tax increases for granted (p. 587). Dellinger believes that government spending remaining at 22.4 percent of GDP should not be taken as an article of faith. He says that the United States would not benefit from higher taxes and that Johnston, millionaires who call for higher taxes, and the Shelf Project ignore the spending side of the government's fiscal difficulties. He concludes by wondering if the IRS should be looking closer at the tax-exempt status of political organizations.

In a recent special report in *Tax Notes*, a group of tax professionals argued that the United States should adopt laws that contribute to the success of U.S.-headquartered businesses that operate in the global economy. Jasper Cummings takes a critical look at that report, finding that its conclusions present only one side of the debate on international tax reform. He also questions the ''trickle-down theory'' implied by the report: that tax reductions for businesses will ultimately benefit the U.S. labor force. (For the report, see *Tax Notes*, Apr. 5, 2010, p. 45. For Cummings's analysis, see p. 575.)

Maintaining a qualified structured settlement fund requires careful tax compliance. Robert Wood looks at ways that a qualified fund can quickly become unqualified and questions several prevailing practices in the structured settlement industry (p. 581). In a viewpoint on p. 560, Robert Feldgarden criticizes the recent Tax Court decision in *Virginia Historic Tax Credit Fund 2001 LP* regarding state tax credits, concluding that the case was both ''very poorly and very wrongly decided.'' The Tax Policy Center presents data on the various ways capital income is treated under the code on p. 573. ■