From the Editor:

Tax Credits for Hybrids: Is This Any Way to Run an Energy Policy?

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About a month ago, I bought a brand-new car.

My old car was a used Volkswagen Passat that I fell in love with on the test drive. But that fine German engineering, which made the car a pleasure to drive, comes at a high price, especially when it gets old. After a series of very expensive repairs (like a $500 headlight), I couldn't take any more and began cruising the car lots.

And at a Honda dealer, I saw it: a loaded Accord — in *Tax Notes* blue, naturally. A few hours later the Passat was history. I'm not thrilled about having a monthly payment again, but I love the new car.

Aside from being brand new and under warranty, the Accord is more fuel efficient, even though it's larger than the old Passat, because it's a few pounds lighter and has a smaller engine. So my driving presumably now uses less fuel and emits fewer greenhouse gases. And according to data that Marty Sullivan has collected, my Accord is better on those points than some hybrids. But buying those hybrids — like the Chevy Tahoe hybrid, which meets the definition of a gas guzzler under section 4064 — is rewarded with a tax credit, while buying an Accord or even another hybrid, like the Toyota Prius, isn't.

As Sullivan explains, it's all part of the screwy system of tax credits for gas-saving vehicles. The credits are for ''alternative'' vehicles, meaning that hybrid vehicles are the only ones that qualify. And the credits are based on how much gas the hybrid saves over the nonhybrid. So the Tahoe hybrid, which gets only 21 miles to the gallon in the city and 22 on the highway, qualifies for a $2,200 tax credit.

Further adding to the nuttiness is the cap that phases out credits once a manufacturer has sold 60,000 hybrid vehicles. Sullivan says the cap is blatantly protectionist and that it penalizes Toyota and Honda hybrids for being too popular. And it explains why buying a Prius, which gets about 46 miles per gallon in town, no longer qualifies for a tax credit.

Is this any way to run an energy policy? Of course not. But what should Congress do about it? See p. 91 for Sullivan's recommendations.

Taxpayer Advocate Report

National Taxpayer Advocate Nina Olson has released her midyear report to Congress, and she criticizes the IRS's standards for tracking and filtering potential identity theft cases. The Service uses an identity theft indicator in its systems, but it won't apply the indicator unless the taxpayer can show conclusively that he has been a victim of identity theft. That standard is too high, Olson says.

The report also criticizes the IRS's correspondence audit program, which accounts for the majority of audits of individual taxpayers. Olson says the audit-by-mail program confuses taxpayers and often sends out inappropriate requests for documentation. The report also says the program forwards cases for issuance of a stat notice before the full 45-day deadline (p. 106).

In other news, Chief Counsel Donald Korb said international taxation is the ''new frontier'' for the IRS, and upcoming projects will feature joint exams with foreign countries (p. 109). We may be seeing more of this, as evidenced by the John Doe summons that was recently served on the Swiss bank UBS (p. 120). Apparently, the IRS is asking the large accounting firms for help in identifying other foreign banks that fail to report U.S. taxpayers' identities (p. 118).

In other international tax news, the OECD's Committee on Fiscal Affairs has agreed to the text of a new update to the organization's model tax convention. See p. 115 for full coverage.

We also have an interview with Paula Junghans in Conversations this week. Junghans, who specializes in tax and white-collar crime issues, served in the Justice Department's Tax Division from 1998 to 2001, and she shares her thoughts on the Tax Division and criminal tax issues (p. 123).

Hedge Funds

The IRS has issued an announcement and two revenue rulings that are intended to provide some clarity to passive partners in trading partnerships, like hedge funds, on taking interest expense deductions. Another revenue ruling released earlier this year had instructed passive partners that their distributive share of the partnership's interest expense or indebtedness allocable to securities trading is subject to the section 163(d)(1) investment interest limitation.

The latest guidance also clarifies that the interest expense deduction should be taken on Schedule E. The new guidance also says that an upper-tier partnership's management fees are not an ordinary and necessary expense and are properly characterized as section 212 investment expenses (p. 98).

Lee Sheppard gives her take on the new guidance, saying that it can hardly be described as harsh. In fact, some of it is indulgent, she says, and can be seen as incompatible with case law and previous administrative practice (p. 99).

Also on the subject of hedge funds is our special report this week. According to Selva Ozelli, the credit crisis highlighted the various credit risk management techniques of hedge fund managers. She looks at the tax consequences of structured mortgage-backed assets held by foreign hedge funds, and recommends that hedge funds' risk management transactions be closely scrutinized for tax and other regulatory consequences (p. 147).

More Commentary

Camp's Compendium returns this week, and Prof. Bryan Camp says that just because the IRS has the legal authority to act does not mean that it should. He disagrees with the Tax Court's reading of section 6501(c) in *Allen v. Commissioner*, and says that Congress has spoken to the problem of return preparer fraud and expressed policy decisions that are different from those of the *Allen* court (p. 167).

In a practice article, Robert Wood makes a prediction. He thinks a recent private letter ruling — in which the IRS ruled that a taxpayer is not in actual or constructive receipt of periodic payments until they are received — will spur significant growth in the industry servicing nonqualified structured settlements, providing tax savings and tax deferral for litigants (p. 141).

And while Wood is making predictions about structured settlements, Conrad Teitell is gazing into his crystal ball to see what will happen to the estate tax. What does the veteran estate planning lawyer predict? Hint: It isn't full repeal, but see his Current & Quotable on p. 179 for the answer.

In installment sales and open transactions, tax is deferred until payments are received. Prof. Calvin Johnson wants tax accounting to better reflect the internal rate of return or interest-like income from those transactions. In this week's Shelf Project, he suggests keeping deferral but changing the recovery of basis and character rules. He would treat cash received after the year of a deferred payment sale as ordinary income and boot. The proposal would allocate payments first as recognition of the built-in gain on the sold property. Once the entire gain has been recognized, payments would be allocated to the recovery of basis (p. 157).

In Of Corporate Interest, Robert Willens examines debt instruments that contain a payment-in-kind feature and are considered to have been issued with original issue discount (p. 163). And in Tax Facts, the Tax Policy Center outlines the effective federal tax rates for households in the lowest income quintile for 1979-2005 (p. 155).

Letters

We have two letters this week that continue the debate over a statement from our newest columnist, David Cay Johnston. In an interview last month before he became a columnist, Johnston said our tax system redistributes wealth the wrong way — it's "not trickle-down, but Niagara-up." Alan Viard wrote a letter (*Tax Notes*, June 23, 2008, p. 1275), taking issue with the statement based on available data, and Johnston responded at the end of his column last week.

In the first letter, Viard repeats his position, saying the data, even the earlier numbers Johnston cites, back up Viard's position (p. 183). In the second letter, Tom Daley enters the fray. He thinks Johnston is a great addition to the magazine, but he is disappointed with Johnston's "sound bite dismissal," of Viard's first letter (p. 183). ■