From the Editor:

Economists Double Down on Tax Cuts for Capital Income

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President Obama and his congressional allies would like to raise taxes on wealthy taxpayers. Obama has pushed the complicated Buffett rule for that very purpose. But there is a much easier way to raise taxes on rich individuals who pay low marginal rates: End or reduce the preferential treatment of capital income. While the president has not explicitly endorsed that position, it is the logical outgrowth of his campaign's emphasis on tax fairness. Unfortunately, while Obama, Democrats, and even much of the country might be in favor of raising capital gains rates in the future, many in the economics community continue to push for the complete elimination of taxes on capital.

The Mirrlees Review started as a project to improve the United Kingdom's tax system, but the recommendations issued by the group are much broader. In her analysis of their findings, Lee Sheppard criticizes the economists in the Mirrlees Review for continuing to push for tax cuts and deregulation, despite the lessons learned in the 2008 financial downturn. Free market economics provided intellectual respectability for decades of tax cuts that have bankrupted the country and decreased taxpayer equity, according to Sheppard. She also disapproves of economists' preference for consumption taxes, pointing out that VATs tend to hit lower-income taxpayers hardest, further decreasing the progressivity of the tax system. (For Sheppard's analysis, see p. 526.)

Capital assets already benefit from two subsidies in the tax code, according to a report by Robert Cassanos. He analyzes how realization and the preferential capital gains rate amount to a double subsidy for capital income. A case can be made that the realization requirement can be justified as well tailored to providing incentives for capital formation and job creation, he writes. However, the rate preference cannot be so easily defended. There appears to be no evidence that it has an incremental stimulative effect, and arguments in favor of a lower rate for capital gains are not backed by much empirical evidence, Cassanos argues. His conclusions would not be very welcome to the Mirrlees Review economists. (For Cassanos's report, see p. 595.)

The popularity of capital gains tax cuts among many economists is baffling. While there are strong theoretical arguments against taxes on capital and corporate income taxes, in practice governments depend on those types of levies to maintain some semblance of tax equity. While it might be possible to design a tax system that raises sufficient revenue from the wealthy, is vertically equitable, and doesn't involve the use of capital gains taxes, it is hard to imagine that system being both politically acceptable and administrable. European governments rely on social spending to offset the regressive nature of their tax systems. The United States has no such social safety net, and policymakers should be careful about becoming too enamored of economic theories that would eliminate taxes on capital and corporate income, unless they truly desire a flat or regressive rate structure.

Home Concrete

The Supreme Court dealt a blow to the government's fight against son-of-BOSS transactions last week. In *Home Concrete*, a divided Court held that *Colony* continued to apply and that misstatements of basis do not qualify as omissions from gross income. The ruling is important because it affects the length of time the IRS has to catch inflated basis claims on returns, which can be important in complicated partnership tax proceedings. Most observers were not surprised at the decision, as the government's position directly conflicted with *Colony*. However, the outcome was close, with four justices siding with the majority and Justice Scalia concurring only in the result. Scalia's concurring opinion continued his opposition to the holding in *Brand X*. (For coverage, see p. 523.)

The Supreme Court's holding raises new questions about the deference given to administrative pronouncements that conflict with judicial precedent, according to professor David Shakow (p. 651). The decision severely limits the role of *Chevron* and *Brand X*, Shakow writes. Although the holding makes it clear that Treasury's regulations are invalid to the extent they conflict with *Colony*, little else in the area has been settled by the case, he concludes. Tax practitioners and the government will probably have to return to the Court for future answers.

Esmark and Tax Court Reform

In 1988 Sheppard opined that the Tax Court's decision in *Esmark* was incorrect because the court failed to apply the step transaction doctrine (p. 581). Her analysis prompted a flurry of responses, and many are reprinted here as part of *Tax Notes*' 40th anniversary retrospective. Peter Faber wrote that what offended most people about *Esmark* was not the step transaction doctrine or the court's failure to apply it, but the result (p. 584.) Ronald Bauer of Amoco wrote that Sheppard's version of the step transaction doctrine would be too expansive and that it wasn't a court's place to ignore intermediate steps, but rather to appropriately merge together adjacent steps (p. 586). Robert Willens believed that the IRS had acceded to the decision in *Esmark* and that the government should be careful about trying to overuse the step transaction doctrine to combat tax planning (p. 587). While *Esmark* might have marked a temporary setback to the use of judicial doctrines to combat tax shelters, decisions in the late 1990s and early 2000s have shown that courts are now much more sensitive to aggressive tax planning and more open to using judicial doctrines to combat them.

In a separate set of 40th anniversary articles, Judge Howard Dawson argued in favor of a single trial court for deficiency and refund actions (p. 588), while professor William Soter disagreed, opposing a one-court system (p. 591).

Commentary

Democrats have been trying to raise taxes on oil companies for some time. On the surface, there are sound reasons for progressive attempts to reduce or eliminate tax preferences for the major oil companies. Integrated petroleum firms are reaping record profits and do not seem to need tax incentives to engage in drilling or gasoline production. But raising oil taxes would hurt average Americans, according to Diana Furchtgott-Roth (p. 667). Beyond possibly increasing prices at the pump, Obama's proposed tax hikes would harm millions of Americans whose retirement accounts hold shares of oil companies, she writes. In pension funds in New York, for example, 3.8 percent of assets held are oil and natural gas companies, but those companies account for 9.3 percent of all returns, she writes. Only about 1 percent of the shares of the five major oil companies are held by officers and directors, meaning that tax increases will be passed on to other shareholders, many of whom are average investors, she concludes.

As the IRS Office of Professional Responsibility pushes for more oversight over return preparers and brings more actions enforcing Circular 230 rules, tax practitioners must be wary about potential transgressions. Unfortunately, sometimes the rules over practitioner conduct can conflict with each other. Kip Dellinger highlights a potential conflict between Circular 230 rules and tax return disclosure rules under section 7216 (p. 663). He discusses a scenario that might arise if a return preparer learns of omissions from a taxpayer's return while preparing another return. He suggests several courses of action and recommends that the IRS clarify when a practitioner needs explicit permission to disclose tax return information when such a disclosure is initiated by the taxpayer.

Hard cases make bad law. However, the opposite can also be true, writes Tom Daley (p. 655). Hard law can sometimes produce bad cases. In his analysis of *Bailey*, a Tax Court decision applying the passive loss limitations, Daley finds that the court misapplied the complex passive loss rules and that the decision, despite being a summary opinion, might have important consequences for taxpayers in the future. Daley is particularly concerned because IRS officials have recently indicated that they might agree with the reasoning behind the decision in *Bailey*.

While the rescission doctrine has come under attack from some in the tax community and is being rethought by chief counsel, the ability to undo a tax transaction and start over can be invaluable in practice. Robert Wood looks at whether rescission can be used as a potential cure for constructive receipt (p. 673). Rescission is not easy to qualify for, but it might offer a way for plaintiffs to restructure settlement payments if the defendant is willing to cooperate, Wood concludes. ■