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SPECIAL REPORT

The Internal Revenue Code: Looking Ahead to 2020

Editor's Note: At the Southeastern Association of Law Schools 2010 Annual Conference, panelists focused on areas needing clarification or major revision. Two of their presentations are excerpted below.—Gail Levin Richmond, Nova Southeastern University, Davie, FL

Three Once and Future Issues

By Charlene Luke*

Ten years is a long time in the world of tax; after all, few (if any) would have predicted this year's estate tax conundrum ten years ago. In this short column, I will restrict myself to commenting about a handful of tax issues.

Economic Substance Doctrine

I will begin with the recent codification of the economic substance doctrine, which seems fitting since it has been about ten years since the first serious proposals for codification were made. The result, section 7701(o), is not as bad as it could have been. Codification has ended textualist arguments about whether courts could use the doctrine, has resolved the question of whether both purpose and objective economic change are required, and has adopted a qualitative approach to the problem of judging pre-tax profit potential. Above all, section 7701(o) has preserved the flexibility of the common law doctrine, which is of critical importance given the cat-and-mouse game of tax avoidance. Now that the doctrine has been codified, it is doubtful that it will be repealed anytime soon, particularly given the way revenue estimates play out. My hopes are that, over the next ten years, section 7701(o) will remain fairly skeletal and that any brighter line rules are worked out in regulations and litigation since such a course seems more likely to keep the doctrine agile.

While section 7701(o) is itself fairly unobjectionable, the pairing of strict liability penalties with such an open-ended doctrine is problematic. Section 6662(b)(6) imposes a strict 20% penalty if tax benefits are disallowed because a transaction lacks economic substance, and that penalty is raised to 40% for "nondisclosed noneconomic substance transactions." I.R.C. § 6662(i). *See also* I.R.C. § 6664(c)(2) (no reasonable cause exception for economic substance violations); I.R.C. § 6676(c) (strict liability for excess refund claims). So long as the economic substance doctrine is raised only to attack fairly obvious abuse, the penalties seem likely to remain in place. But should the

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doctrine be successfully used (or perhaps even unsuccessfully raised) against less obviously abusive transactions, Congress may revisit the penalties. Given this possibility, the strict liability provision may prove to act as a constraint on when the Service raises the doctrine and when courts use it to strike down transactions. For more on new section 7701(o), see Charlene D. Luke, *What Would Henry Simons Do?: Using an Ideal to Shape and Explain the Economic Substance Doctrine*, 11 Hous. Bus. & Tax L.J. __ (forthcoming 2010), *available at* http://ssrn.com/abstract=1647666; Martin J. McMahon, *Living with (and Dying by) the Codified Economic Substance Doctrine*, University of Florida Levin College of Law Research Paper No. 2010-13, *available at* http://ssrn.com/abstract=1623822.

Carried Interests

The issue of partnership carried interests has perhaps been generating even greater discussion than the codification of economic substance. Several proposals have been aimed at the carried interest problem, and at some point, it seems likely that the temptation of the revenue estimate tied to the provision will overcome the lobbying of various interest groups. While the use of partnerships to convert income character should be addressed, current proposals for section 710 seem far too convoluted. Many tax scholars have written about carried interests, but here in this brief comment, I will draw attention to the work of Karen Burke. She argues that section 707 could and should be used to deal with this problem, and she rightly points out that the problem is not simply a matter of character conversion but also of income shifting. A partnership has to have capital gains and other partners accommodating enough to allocate those capital gains away from themselves and to the holder of the carried interest. A flexible, regulatory solution would also seem more conducive to the handling of a tax avoidance problem. *See* Karen C. Burke, *The Sound and Fury of Carried Interest Reform*, 1 Colum. J. Tax L. 1 (2010); Karen C. Burke, *Fuzzy Math and Carried Interests: Making Two and Twenty Equal 710*, 127 Tax Notes 885 (May 24, 2010).

Character of Income

I will conclude with a pie-in-the-sky tax reform wish: Eliminate the distinction between capital and ordinary income. Just as source is essentially irrelevant to the question of whether something is an accession to wealth, it should be irrelevant to the question of tax rate. If the disparity between ordinary and capital were removed, then, for example, while partners could still attempt to shift income among themselves, partnerships could no longer be used to convert ordinary gain to capital gain. Ending the difference in treatment between ordinary and capital would no doubt raise the profile of other types of tax-reduction techniques, but tremendous simplification still could occur and at least some tax-reduction behavior avoided. ■

Wish-List for the Federal Tax System in the Year 2020

By Joseph M. Dodge*

Twenty-twenty is fine for hindsight, but not for foresight. The only prediction I shall hazard is that few, if any, of the items on my wish-list below will be enacted.

The organizing theme of my wish-list for the Year 2020 is that the individual federal income tax be intelligible as a tax based on ability to pay and as simple as possible. Distinctions without a difference should be abolished. Given space constraints, I will try not to belabor the obvious, retread familiar ground, or deal with issues peripheral to the main theme (such as abolishing stepped-up basis). This is not the occasion for proposing radical changes, such as moving to a mark-to-market accretion tax, abolishing all tax expenditures, or radical simplification.

The estate and gift tax should be replaced by a "realization" accessions tax, which is a tax on unearned income (rather than a tax on death or entrepreneurial success). *See* Joseph M. Dodge, *Replacing the Estate Tax with a Re-Imagined Accessions Tax*, 60 Hastings L.J. 997 (2009), shorter version at 122 Tax Notes 1151 (Mar. 2, 2009).

The corporate income tax has no justification except to raise revenue on a "source" basis. There is no reason for it to be computed in essentially the same way as the individual income tax. The present system suffers from inaccurate accounting and an incentive to engage in tax-shelter activity. I would repeal the existing tax and replace it with a tax on corporate book income.

Turning to the individual income tax, a priority would be to simplify the structure of the tax computation, to wit:

1. All true tax expenditures (subsidies) should be converted into refundable tax credits, which would be summarized on a new Schedule X. (We can leave open the question as to what is a true subsidy. For example, I think charitable contributions should be a deduction, but others may disagree.)
2. The distinction between capital gains and losses should be abolished. (To placate the opponents of this move, I would offer a tax-free rollover investment account.) The problem of selective realization of

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