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From the Editor:

Recession Causes Top 400 Taxpayers Some Pain

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The financial sector was spared most of the damaging effects of its own meltdown by federal government intervention, something that the public only vaguely grasps (and probably did not support). That meant that the impact of the recession caused by the bursting of the housing bubble and the high leverage of financial institutions fell more heavily on those who became unemployed, most of whom were certainly not in the finance and banking industries. But another group also felt the pinch of the economic downturn: the 400 highest-income taxpayers in 2008.

In his breakdown of recently released IRS data, David Cay Johnston finds that the top 400 taxpayers saw a 24.4 percent reduction in their incomes in 2008. This was caused almost exclusively by a sharp decline in income from capital gains, as asset prices plummeted and sales either were not made or were made with depressed prices. The income of the top 400 taxpayers fell below its 2006 level, but remained above their income earned in 2005, writes Johnston. He points out that in real terms, the top 400 taxpayers' income grew at a more rapid rate than that of other taxpayers, who experienced a real decline in wages over the same period. Johnston also found that the effective income tax rate paid by the top 400 taxpayers averaged 18.1 percent, which is almost exactly the same rate paid by a single taxpayer earning just under $64,000 and claiming a standard deduction. Thus, middle- and low-income taxpayers probably don't need to feel sorry for their wealthier brethren. (For Johnston's article, see p. 641.)

The most important aspect of the top 400 data from the IRS is the effective tax rate paid by the wealthiest Americans. Because of capital gains preferences and other tax-deferral provisions, the highest-income taxpayers generally enjoy surprisingly low effective tax rates. Although Republicans are right that the nation has a serious spending problem (particularly in the areas of defense, healthcare, and energy), it is also not a stretch to argue that the United States has a serious progressivity problem as well.

ABA Section of Taxation Meeting

The ABA tax section met in Washington recently, and *Tax Notes* has full coverage of the event beginning on p. 663. At various panels, IRS officials clarified some of the guidance that might be released in the remainder of the plan year, defended OPR's discipline process (p. 682), and outlined transfer pricing priorities (p. 677). Congressional staffers informed practitioners that tax changes are possible in a debt ceiling bill (p. 678) and that tax reform hearings might soon focus on exempt organizations (p. 706). Giving the Woodworth lecture that opens the conference, Pamela Olson argued that policymakers would be wise to give up some aspects of 1986-style tax reform (p. 671), while former House staffer John Buckley told a panel that any tax reform effort will have to consider how to deal with U.S. manufacturing (p. 687). Lee Sheppard reports on the departure of Sheila Bair from the FDIC (p. 663), a discussion of variable prepaid forward contracts (p. 665), and how the IRS is dealing with the RIC Modernization Act (p. 667).

Commentary

The IRS's rescission doctrine has received attention this year in the wake of remarks by William Alexander that the Service might be rethinking its application. Sometimes called the "unwind doctrine," rescission allows taxpayers to disregard a transaction for tax purposes if the parties return to the status quo before the deal in the same tax year. John Prebble and Chye-Ching Huang write that the origins of the rescission doctrine may be confused (p. 721). Although the doctrine is based on Rev. Rul. 80-58, that ruling misinterprets *Penn v. Robertson*, according to the authors, who find that *Penn* does not in fact support the principle of rescission. The lack of a valid legal basis accounts for the confusion about the requirements for rescission, the authors write. Prebble and Huang argue that the government must establish that there are convincing arguments grounded in either the law or tax policy for a rescission doctrine and not simply assume that those arguments exist.

In her first column for *Tax Notes*, Caroline Harris discusses the country's deficit problems and the various, halfhearted attempts at solving them (p. 733). Harris outlines her own plan for tax and deficit reform, writing that the tax code should be modernized to promote growth, job creation, and investment. She calls for comprehensive reform,

that addresses corporations, passthroughs, and individuals. She also criticizes policymakers for not addressing transition rules in any of the plans offered so far. Harris is critical of the president's fiscal commission and his budgets, concluding that they rely too heavily on tax increases to close the deficit.

Senate Finance Committee member Ron Wyden is committed to tax reform. He previously offered a plan with former Sen. Judd Gregg and has reintroduced a modified proposal with Sen. Daniel Coats. The Wyden-Coats plan would reduce the corporate tax rate, eliminate most tax expenditures, and greatly simplify the tax code. In contrast to Wyden-Gregg, it offers a repatriation holiday as a means of transitioning to the new corporate and international tax system. In his latest column, Michael Durst praises the tax reform plan, but suggests several tweaks to its international provisions (p. 741). Durst recommends reducing the corporate rate to 20 percent and introducing more progressivity into the individual income tax. Durst concludes that a corporate rate in the 20s will greatly reduce income shifting by multinationals and will help foster economic growth and restore public confidence in the tax system.

At the ABA tax section meeting, an IRS official said that taxpayers can rely on the 1997 proposed self-employment regulations when dealing with section 1401 taxes. Monte Jackel questions the validity of this statement and calls on the government to issue guidance in this area, particularly after the *Renkemeyer* decision by the Tax Court (p. 745). Jackel argues that the meaning of the term "limited partner" is not defined in the statute or the regulations. This leads to confusion on whether a partner is subject to self-employment taxes. Taxpayers can have the best of both worlds if the official's statement is true, he writes. Instead, he proposes that the government ask for comments on a re-proposal of the 1997 regs. At a minimum, Treasury should issue a notice stating that taxpayers may at their election rely on either the proposed regulations or the words of the statute, Jackel concludes.

The Republican Party has argued that the Bush tax cuts have not affected the deficit. Its position is that spending must be reduced and that taxes cannot be part of any reform plan. Unfortunately for them, the facts are not on their side, according to Bruce Bartlett (p. 757). He writes that raising taxes is an equally valid way of eliminating the deficit and that the Bush tax cuts cost the government substantial revenue. Bartlett points out that the public primarily blames the Bush administration for the deficit. He concludes that revenue increases should be a part of any deficit solution. While Bartlett is correct that tax cuts lower revenues, it is curious that the public blames George W. Bush for the deficit problem given how much smaller deficits were under the previous administration than under President Obama.

In the second part of his Shelf Project proposal to curtail compensatory stock options, Prof. Calvin Johnson continues his argument that high-risk investments are encouraged by the tax code (p. 737). Robert Wood presents a list of the top 10 mistakes made by contingent fee lawyers on p. 751. In their article on p. 729, Andrew Gross and William Maas remind readers that state budget cuts can have serious federal tax implications. ■

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