From the Editor:

Medicare Net Investment Income Tax Tries to Reach Hedge Funds

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For many U.S. taxpayers, Obamacare has largely been a political and legal sideshow. Most of the law's major reforms have yet to come into force, and the focus of healthcare reform in the last few years has been technical IRS guidance and the Supreme Court's upholding of the individual mandate. But 2013 will see a major piece of the healthcare reform law go into effect: the 3.8 percent tax on net investment income over $250,000 on joint returns. This is the first time that a tax to support Medicare or Social Security will affect unearned income.

The section 1411 tax, like nearly all tax legislation drafted in the last few years, leaves open several questions about who will be affected. Lee Sheppard looks at how the net investment income tax might apply to fund managers, who receive compensation in the form of what most people would call capital gains (p. 915). She points out that the statute must separate business income from investment income, something that the tax law has always struggled to do. Investment managers are frequently compensated through fees, investment income, and gains from the sale of investment assets. Congress clearly wanted hedge fund and private equity managers to pay the new tax, Sheppard writes, but some of these managers might be able to take the position that they are in a trade or business other than that of trading financial instruments or commodities. She also shows how some managers might be able to navigate between the SECA tax and the 1411 tax without paying either one. That clearly isn't how Congress intended the statute to work.

It isn't just fund managers that would like to avoid the reach of the new tax. Investors wouldn't mind paying a lower rate. However, U.S. individual investors in offshore and onshore hedge funds will be subject to the tax, according to Peter Elias (p. 965). He looks at how the proposed regulations will affect hedge fund investors and says that the exact application of the net investment income tax will depend on the structure of the fund, specifically whether it's onshore or offshore. Many investors might be able to defer the tax through the use of an offshore feeder, while those that use a U.S. feeder will be subject to the tax on a current basis, he concludes.

The net investment income tax is the first serious attempt since 1986 to reduce the capital gains preference and solve the problem of wealthy taxpayers paying lower marginal rates than many middle- and low-income wage earners. But like most tax provisions, it is overly complex because of the result of compromises within Congress. Sheppard is right that the complexity of the law will probably make it easier for fund managers and savvy taxpayers to avoid paying it. Like most of President Obama's tax achievements, the 3.8 percent tax will probably end up being fairly hollow. At some point, if Obama is actually serious about tackling the declining progressivity of the tax code and raising taxes on the wealthy, he will have to confront the major issue that causes it: low taxes on capital gains. Complicated surtaxes, tax expenditure phaseouts, and rants about oil and gas preferences do little to solve the tax system's underlying regressivity.

Commentary

Before the fiscal cliff, many might have wondered if the entire tax code was on the verge of becoming temporary. Congress had already engaged in an annual dance to renew smaller provisions, such as the research credit and other extenders, but after the Bush tax cuts were scheduled to expire, a huge amount of tax law was suddenly clouded in uncertainty. The American Tax Relief Act of 2012 impressively solved much of that problem, creating permanent solutions for tax rates, the estate tax, and the AMT. But the fiscal cliff compromise failed to address the problem of rent-seeking, according to Seth Giertz and Jacob Feldman (p. 951). They look at the academic literature that discussed the effects of tax policy uncertainty, and argue that there is more to economic growth than the degree of entrepreneurship. They would like to see fundamental tax reform that is enduring, as opposed to one that is undone by lobbyists and other rent-seekers.

Tax reform, however, can create uncertainties on its own. The prospect of corporate tax reform means that businesses must work to perfect their tax planning under current law while planning a strategy for how to influence legislative action, writes Clint Stretch in his debut column (p. 993). However, there are three barriers to corporate tax reform that must be overcome, he says. He points to an inadequate political system, the fight over a zero-sum game, and the fact that corporations don't vote as affecting the prospects for corporate tax reform anytime soon.

Many consider ATRA a victory for progressive taxation. It increased taxes on upper-income taxpayers by returning to the 39.6 percent top rate and raising the capital gains rate to 23.8 percent. But that one victory overshadows much in ATRA that wasn't very progressive, including the final resolution of the estate tax, writes Edward McCaffery (p. 969). He points out that the bulk of the revenue raised by ATRA was actually from the expiration of the payroll tax cut. The weakened estate tax in ATRA creates numerous problems for progressives, but the most serious is the retention of stepped-up basis at death, McCaffery says. He calls for an end to stepped-up basis, which would end much of the tax planning done by the wealthy. In Tax Facts, Benjamin Harris presents data on just how estate taxes will be affected by ATRA (p. 1005).

The IRS used to perform audits under the taxpayer compliance measurement program. The Service randomly selected individuals and used the audits as a way to measure compliance across the full spectrum of taxpayers. Christopher Bergin reminisces about the TCMP in his From the Publisher column and discusses how the 1998 reforms to the IRS have undermined compliance (p. 1011). Bergin is very critical of so-called tax reformers who demonize IRS personnel as a way to argue for a curtailment of tax enforcement and tax rates.

In 2007 Congress created a new penalty for taxpayers who received excessive refunds (section 6676). Drawing on his experience representing low-income taxpayers who often received what the IRS called excessive refunds, Carlton Smith writes that he has never seen the new penalty asserted (p. 973). He explains that the reason is that the IRS often relies on the section 6662 accuracy-related penalty, which already allows it to assert 20 percent penalties in nearly every case when it could rely on section 6676. But Smith thinks that is the wrong approach. He concludes that the IRS is greatly overconstruing the reach of section 6662 by applying it to disallowed refundable tax credits.

In *Flextronics*, the Ninth Circuit allowed a taxpayer to increase its basis in inventory from $12 million to $48 million because a foreign shareholder allegedly recognized $36 million of untaxed section 357(c) gain. Jasper Cummings, Jr., writes that this was accomplished because the taxpayer artificially bifurcated the purchase of a business (p. 981). He analyzes *Flextronics*, criticizing the court for finding in favor of the taxpayer despite clear evidence that the taxpayer rearranged the transaction simply to produce a noneconomic loss.

Contingent fee lawyers pay costs in many cases. This means that their clients are not out of pocket until after the resolution of the case. Robert Wood looks at the deductibility of these costs and the controversies that plague this area of tax practice (p. 997). The best tax rule prevails only in the Ninth Circuit, according to Wood. He updates the discussion of deductibility by looking at the recent Tax Court decision in *Humphrey*.

Income inequality in the United States has gotten much worse. David Cay Johnston makes that assertion after reviewing the latest study by Emmanuel Saez and Thomas Piketty, which shows that an astonishing 149 percent of increased income from 2009 to 2011 went to the top 10 percent of earners (p. 1007). This is possible because incomes from the bottom 90 percent actually fell, he writes. In 2011 the average AGI of the vast majority fell to $30,437, its lowest level since 1966 when measured in 2011 dollars. Johnston argues that tax policy has had a lot to do with this growing problem.

In Of Corporate Interest, Robert Willens analyzes a case involving a CPA who sold his practice and then almost immediately repurchased it (p. 1001). Willens specifically looks at the ability of the CPA to expense items related to the intangible assets during the sale of the practice, and then amortize them once he repurchased the practice. ■