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From the Editor:

Will Hedge Funds Be Able to Avoid Dividend Withholding?

By Jeremy Scott — jscott@tax.org

Withholding taxes are typically chimeras. The United States proposes withholding and then gives in on the issue during treaty negotiations. But recently Congress has taken a renewed interest in using withholding as a means of increasing international enforcement. Withholding was a big part of FATCA (although Treasury seems determined to water it down through its implementation efforts) and also of new section 871(m), which was designed to stop hedge funds from using total return swaps in lieu of direct equity ownership.

Lee Sheppard has long criticized U.S. policy on withholding. In her analysis of the section 871(m) regulations and their effect on futures contracts, she points out that the screaming over the code section has died down and now practitioners are lobbying the government for exceptions to the rule (p. 143). The government is determined to simplify the proposed regs, according to IRS chief counsel's Mark Perwien, but he cautioned that taxpayers might not be pleased with the simplified version. Sheppard writes that exempting futures contracts from section 871(m) would create the ultimate synthetic investment tool, because futures are also exempt from regulation under Dodd-Frank. The intent of the statute was to close the dividend loophole, she writes, pointing to comments by Sen. Carl Levin. Perwien said that Congress intended there to be withholding on any transaction with the potential for tax avoidance. Such a result would not please the Chicago exchanges, according to Sheppard. If futures contracts were excused from withholding, it might move more transactions to exchanges and out of the opaque swaps area, she writes. But it would not please Levin, whose wrath the IRS and Treasury would probably like to avoid, she concludes.

Treasury's record on implementing anti-evasion laws passed by Congress is getting worse. If the simplified regulations exempt futures contracts from section 871(m) withholding, it would certainly undermine the will of Congress. While there might be enough gray areas in the written statute to allow Treasury to adopt that interpretation, why would it? Why should the administrator of the nation's tax and revenue system go out of its way to exempt taxpayers from something that was obviously intended to curb abusive transactions and contracts being used by the financial sector? At some point, Congress should expect Treasury and the IRS to actually attempt to implement the intent of the numerous enforcement laws, such as FATCA and section 871(m), that are able to pass the divided body. Otherwise the nation will never be able to recapture revenue lost from the use of shady financial products.

Tax Reform

The options for tax reform are much narrower than some assume. There simply isn't that much revenue that can be raised on the individual side by cutting tax expenditures. Martin Sullivan attempts to construct a realistic, but aggressive, tax reform proposal by showing just how much revenue can be raised from individual tax expenditures (p. 150). It isn't enough to accomplish House Ways and Means Chair Dave Camp's goal of reducing the top rate to 25 percent, but Sullivan's plan would raise about $170 billion per year, which would reduce rates by 10 percent. The plan would involve cutting 18 percent of the cost of individual tax expenditures, which total $991 billion a year. Sullivan says that is only possible by expanding Obama's deduction cap from 28 percent to 15 percent.

While Sullivan outlines an aggressive tax reform plan that would reduce tax expenditures in exchange for lower individual tax rates, Ernest Christian, Gary Robbins, and George Schutzer do not want to see a similar bargain made on the corporate side. In their special report, they argue that a corporate rate reduction that is partially paid for by postponing depreciation deductions would do more economic harm than good (p. 187). Any increase in revenue from changes to depreciation would produce permanent reductions in plants and labor, but would raise revenue only in the short term, they write. Adopting a suggestion made by Alex Brill, the authors propose making 50 percent first-year expensing permanent for all businesses and phasing in a 10-point reduction in the corporate tax rate. They contend that the economic gain would exceed the dynamic revenue cost.

In the return of his column for *Tax Notes*, David Cay Johnston addresses the fiscal cliff compromise and laments that tax reform is probably a dead issue

because of Republican intransigence on the revenues (p. 237). He writes that the compromise did little to address the long-term fiscal crisis affecting the federal government, pointing out that it raised very little revenue and cut no spending. He criticizes policymakers who are targeting Social Security for cuts, pointing out that the program doesn't add $1 to the deficit. Johnston concludes by calling attention to the fact that although the fiscal cliff deal will reduce deficits by about $737 billion over 10 years, interest on the federal debt alone will cost $770 billion in 2023.

Commentary

Before the Supreme Court's decision in *NFIB*, a few commentators argued that the individual mandate functioned as a direct tax, which must be apportioned equally among the states according to the Constitution. To the surprise of some, the Court actually addressed the direct tax issue. Mark Berg looks at *NFIB* and summarizes the state of the law regarding the prohibition against unapportioned direct taxes (p. 205). He writes that nothing in the opinion should be seen as changing the conclusion that wealth tax proposals are properly considered direct taxes and therefore would be unconstitutional unless equally apportioned among the states.

The fiscal cliff compromise has only one major positive point: permanence of individual income rates. That's the argument of Diana Furchtgott-Roth, who criticizes the deal for featuring higher rates, marriage penalties for women, energy subsidies, and increased complexity (p. 215). The new tax system that the deal creates was not designed rationally, instead being thrown together at the last minute by Senate Minority Leader Mitch McConnell and Vice President Joe Biden, she writes. She is critical of the fact that so many energy subsidies were included in the package and argues that Congress missed an opportunity to accomplish much more.

When a taxpayer is assessed a penalty, he can attempt to raise a reasonable cause defense. The argument is that the taxpayer reasonably relied on a tax professional when staking out his return position. The IRS is very skeptical of the defense and fights in court against penalty abatement. Kip Dellinger says it is time for that attitude to change, and writes that two recent cases show that the reasonable cause defense is alive and well in the Tax Court (p. 221). Dellinger discusses the Tax Court decisions in *Gaggero* and *Rawls*. In both cases, the court allowed penalty abatement after carefully analyzing the relationship between the taxpayers and their advisers and looking at the competence of the tax professional in question. Dellinger concludes that the results of the cases should cause the IRS to rethink its position that just because advice is wrong, it cannot be reasonably relied on.

In his State of the Tax Practice column, Monte Jackel analyzes what should happen when a tax practitioner in a firm comes to a conclusion that is different from the consensus or the majority view of the firm (p. 225). He writes that the proposed Circular 230 rules provide no guidance on what a practitioner should do if he disagrees with his firm's position on a matter. He concludes that the ethical rules should make it clear that in today's practice world, the individual judgment of a practitioner is often subordinated to that of others at his employer. Tax professionals should not be forced to imperil their future because of unrealistic ethical requirements, he argues.

Although goodwill is common to almost every business acquisition, goodwill owned by an individual is often confusing. Robert Wood and Brian Beck address how state law and the tax code deal with personal goodwill (p. 231). They look at the types of personal goodwill that have been addressed by the courts and then at how these types of cases become bogged down in factual analysis. ■

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