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April 9, 2013

Ray Beeman, Esq.
Tax Counsel and Special Advisor
for Tax Reform
Ways and Means Committee Office
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Tax Reform Proposals—
Reducing Complexity and Small Business/Pass-throughs

Dear Mr. Beeman:

One of the objectives of your tax reform efforts is to reduce unnecessary complexity. With that in mind, I would like to suggest that you replace the tax base for the new section 1411 “Medicare contribution tax” on unearned income with a simpler measure based on taxable income with adjustments.

The tax was enacted in 2010 and became effective at the beginning of this year. Its purpose is to extend the self-employment tax to unearned income of high-income individuals. The tax base is “net investment income,” which is the sum of (1) a list of specified categories of passive income (e.g., interest and dividends) not derived in a business described in (2), (2) gross income from certain types of businesses, and (3) net gains from dispositions of property (not held in a business not described in (2)). The tax base is then reduced by allocable deductions. Last December, the IRS issued proposed regulations applying the tax (“Proposed Regulations”).

Section 1411 adopts a new tax regime that relies to some degree on Chapter 1 tax concepts, but in many respects is independent of and parallel to existing income and self-employment taxes. It is extraordinarily complex. This is borne out by a quick perusal of the Proposed Regulations and practice commentaries that are starting to emerge.¹ The statutory

¹ See, e.g., the two articles in the January 23 and March 25 editions of Tax Notes by Kara Friedenberg discussing the effect of the tax on alternative investment funds.

language has led to rules and sub-rules that have no apparent policy rationale. For example, substitute dividends are taxed but not dividend equivalents paid under swaps (unless connected with certain businesses). Income from CFCs and PFICs is subject to a different regime from the regular tax. Losses from dispositions of property may or may not count depending on various factors. NOL carryovers cannot be used because (according to the IRS) doing so while keeping track of what is in or out of the tax base would be too complex. Apparently credits for foreign taxes are not allowed, so income from foreign jurisdictions may be double taxed, although some have questioned whether credits may be allowed under treaties.

Much of this complexity appears (at least to many of us who were not in the room when the drafting took place) to be simply pointless.

One interesting question is the degree to which certain categories of income fall between the cracks of the self-employment tax and section 1411, and whether those gaps are deliberate or merely a consequence of how the statute was drafted, without much thought being given to the particular income category.

Congress can have its tax and spare the country material compliance burdens by replacing the definition of net investment income with (1) taxable income, adjusted by eliminating (2) any item subject to self-employment tax, wages, retirement benefits, and other specified items.² The specified items could include items that on some policy ground are now excluded from the self-employment tax. Consideration also should be given to allowing a foreign tax credit.

This approach has two advantages. First, it would be vastly easier to apply, with the focus being on the adjustments. Second, there would be specific identification in the statute of the categories of income that are not caught by the self-employment tax or section 1411, so that at the least Congressional intent would be clear.

With best wishes,

Sincerely,

James M. Peaslee

NY2713839

² My practice does not cover employment or self-employment taxes, and others who know more about them could do a better job describing the adjustments. My main point is that the base should be taxable income with appropriate adjustments.