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THE CONTEMPORARY TAX JOURNAL
A publication of the SJSU MST program

Welcome Message

Welcome to the inaugural issue of *The Contemporary Tax Journal*!

Since the times when scribes of Egyptian Pharaohs audited their subjects for avoiding taxes on cooking oil, the subject of taxation has been of great importance and many controversies. Taxes in the United States have been around since at least the colonial times, and have been constantly evolving to meet the needs of the current period.

To keep up with this evolving topic, San José State University's MST Program brings you a collaboration of students, faculty and practitioners in the form of *The Contemporary Tax Journal*. Our writers endeavor to keep our readers updated on the latest tax issues and provide analysis of current and future tax policies. Whether you are a tax expert or not, we are certain you will find something of interest inside.

In this issue we have :

- Summaries of some of the presentations made at the 2010 TEI-SJSU High Tech Tax Institute.
- "Tax Enlightenments" on the new Medicare tax and why paying your use tax is a good idea.
- Tax policy analyses on a standard home office deduction and an increase in the gasoline excise tax.

While the journal is published twice yearly, please visit our website more often as we will be providing new content at least monthly (www.sjsumstjournal.com).

Published by SJSU ScholarWorks, 2011

Message from SJSU MST Program Director Annette Nellen ...

I am very pleased to see this inaugural issue of the *Contemporary Tax Journal*. This journal is a student-run online publication of the San José State University MST Program.

Learning does not all happen within the structure of a course and the classroom. Learning is enriched when students engage with the concepts, rules and ideas with classmates, faculty, and experienced practitioners, and when they spend additional time reading and analyzing the law itself. This journal offers students an avenue for enriching their graduate tax learning by engaging with tax compliance, planning and policy areas through writing, editing and researching.

This journal also enables students and the program to provide a community service through broader understanding of the tax law. Two of the four sections of this journal provide this service - "Focus on Tax Policy" and "Tax Enlightenment." While the journal will be published online twice per year, we plan to add tax policy analysis pieces to the website at least monthly (www.sjsumstjournal.com). We hope students, practitioners and policymakers will find this analyses insightful and helpful.

The first editor of this journal, MST student (now alum) Ankit Mathur has done an outstanding job to create a journal that is not from the same mold as most. He wanted it to provide opportunities for students and to engage audiences of varied experience levels. He also found a way to make this look like a journal when viewed on the web (with pages that flip!). His plans for making the website interactive with tax news feeds and MST Program news will be added soon. While the journal is published twice yearly, we will have content that will make you want to visit it more often. Thank you Ankit!

I hope you enjoy this first issue and check back regularly for new policy analysis, news about the MST Program and the annual TEI-SJSU High Tech Tax Institute, as well as many new features to be rolled out in the coming year.

Sincerely,

Annette Nellen, CPA, Esq.
Professor, SJSU College of Business
Director, SJSU MST Program

Letter from the Editor

Public transportation is a great way to be green, but it is difficult to travel this way without overhearing somebody's conversation. Despite my efforts to avoid it, I overheard a passenger telling her friend about her trip to another state to purchase a car. I couldn't help but overhear that her reason for doing so was that she did not want to pay the California sales tax. I thought to myself - she can avoid paying the sales tax, but what about the use tax? Before I could be a "good tax Samaritan" and inform her about her unavoidable use tax obligation, and perhaps save her the trip, they got off the bus and I was left wondering what she would think when she eventually registers the car in California and gets billed for the use tax. It also got me thinking about my knowledge of taxes. When I first came to the U.S, my

understanding of taxes was much less than that of my fellow traveler. In fact, it was practically non-existent since I came from a place where there is no concept of collecting income tax.

But, after a well invested year at San Jose State University's Masters of Science in Taxation program (SJSU-MST), not only have I strengthened my knowledge of taxation under the guidance of professors who are experienced tax professionals, I now have the privilege of introducing *The Contemporary Tax Journal*, the new online tax journal sponsored by the SJSU MST program. The time I spent in the program helped me discover my passion for researching and analyzing complex tax issues, and made me qualified to assist in the creation of a medium through which tax students and professionals can share their knowledge and experiences. That is the main objective of this journal! Sharing tax knowledge through an interesting style that is relevant to both tax professionals and taxpayers.

In our first issue, we bring you a variety of issues highlighted in the 26th Annual TEI-SJSU High Technology Tax Institute, two tax topics of particular interest to individual taxpayers, and two proposals analyzed using principles of good tax policy.

This is the MST program's initial endeavor at putting together a comprehensive collection of tax information. I hope you enjoy reading about the varied tax topics covered in this Winter 2011 inaugural issue.

Acknowledgements

Just as the IRS cannot review our tax returns without the work of many people, this journal would remain a concept if not for the efforts of several people.

Professor Annette Nellen, who set the whole thing in motion with her vision and gave me the opportunity to continuously test and improve my abilities as we designed the journal.

Our student authors, who contributed their time in writing about their interests in taxation.

Professor Thomas Moschetti and Mike Baird, for reviewing and testing earlier drafts of the journal and contributing their experience as tax professionals. And Tim Kelly for his extreme enthusiasm, ideas and support for the project.

Professor Bobbi Makani, for joining the group as advisor and making sure that we stay true to providing a quality journal.

Thanks to all involved for bringing *The Contemporary Journal* from idea to reality.

Sincerely,

Ankit Mathur, MST Fall 2010
Student Editor

Published by SJSU ScholarWorks, 2011

TAX ENLIGHTENMENTS

New Medicare Contribution Tax on Investment Income

By Huan Jin
SJSU MST Student

The Health Care and Education Reconciliation Act of 2010 was signed into law by President Obama on March 30, 2010. It contains a new provision that will subject certain individuals, estates and trusts to a new 3.8% Medicare contribution tax beginning in 2013.

Background

Federal taxes imposed on wages of employees include the OASDI tax and the Medicare Hospital Insurance tax. Before the 2010 Reconciliation Act, there was no Medicare tax levied on unearned income. Unearned income is income from investments, such as interest, dividends and capital gains. The imposition of a 3.8% Medicare contribution tax on unearned income along with an increase in the Medicare Hospital Insurance tax on high-income employees and self-employed individuals, both commencing January 1, 2013, will generate revenue to help finance reforms under the health care legislation.

Explanationx

Who will be taxed?

Generally, an individual taxpayer with some net investment income and modified adjusted gross income (MAGI)[1] above the applicable threshold amount will be subject to the new tax. The threshold amounts are:

(1) $250,000 For a taxpayer filing a joint return and a surviving spouse

(2) $125,000 For a married taxpayer filing separately

(3) $200,000 For other taxpayers (e.g. a taxpayer filing as single)

Trusts with gross income above the dollar amount at which the highest estate and trust income tax bracket begins for the tax year (e.g. $11,200 for 2010) will be taxed. Certain types of trusts are exempted from the tax.[2]

What is included in net investment income?

Net investment income is the investment income reduced by the deductions applicable to such income.

Investment income is comprised of non-business income from interest, dividends, annuities, royalties, rents and capital gains. Income derived from an active trade or business, such as rental income of real estate professionals, is not included, but passive activity income is included. A business of trading financial instruments or commodities is not treated as an active trade or business, thus the income derived from such trade or business will be included in investment income.

[1] MAGI is gross income including foreign earned income reduced by some enumerated deductions.
[2] For details of the new Medicare tax, see Internal Revenue Code Section 1411 and information on the IRS website.

Net investment income excludes any distribution from qualified pension, profit-sharing and stock bonus plans, qualified annuity plans, annuities for employees of tax-exempt organizations or public schools, IRAs, Roth IRAs and deferred compensation plans of state and local governments and tax-exempt organizations.

How to calculate the Medicare contribution tax

- ***For individuals***

  - Step 1 - Calculate the amount of the net investment income for the tax year.
  - Step 2 - Calculate the amount of MAGI for the tax year.
  - Step 3 – Subtract the threshold amount from step 2.
  - Step 4 - Choose the smaller of step 1 and step 3 and multiple by 3.8%.

- ***For estates and trusts***

  - Step 1 - Calculate the amount of the undistributed net investment income for the tax year.
  - Step 2 - Calculate the amount of adjusted gross income (AGI) for the tax year.
  - Step 3 – Subtract the highest estate and trust income tax brackets in begins for the tax year from step 2.
  - Step 4 – Choose the smaller of step 1 and step 3 and multiple with 3.8%.

Examples

(1) In 2013, Sue, a single taxpayer, earns $100,000 in net investment income. Sue's MAGI is $150,000.

- Step 1 - Sue's net investment income is $100,000.
- Step 2 - Sue's MAGI is $150 ,000.
- Step 3 - The excess of MAGI over threshold amount is 0. ($150,000-$200,000)
- Step 4 - Choose the lesser of $100,000 and $0 then multiple by 3.8%.

Sue will incur no Medicare contribution tax in 2013.

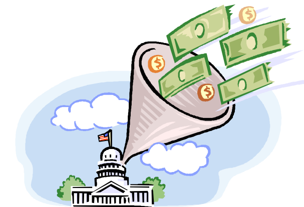
(2) Same as Example (1), above, except Sue's MAGI is $250,000.

- Step 1 - Sue's net investment income is $100,000.
- Step 2 - Sue's MAGI is $250 ,000.
- Step 3 - The excess of MAGI over threshold amount is $50,000. ($250,000-200,000)
- Step 4 - Choose the lesser of $100,000 and $50,000 then multiple by 3.8%.

Sue will incur a $1,900 (3.8 % x $50,000) Medicare contribution tax in 2013. With Sue's MAGI increasing, the Medicare contribution tax Sue owes will also increase. Moreover, only when the dollar amount of MAGI is larger than the applicable threshold amount, is an individual subject to the Medicare contribution tax.

When is the effective date?

The Medical contribution tax starts on January 1, 2013.



Summary

A new provision enacted as part of the 2010 health care legislation will impose a Medicare contribution tax on high-income individuals, estates and trusts beginning in 2013. As time goes by, more individuals will be subject to the tax because the applicable threshold amounts for individuals are not adjusted annually for inflation. While the tax is not effective until 2013, it should be considered in tax planning decisions that affected taxpayers make today.

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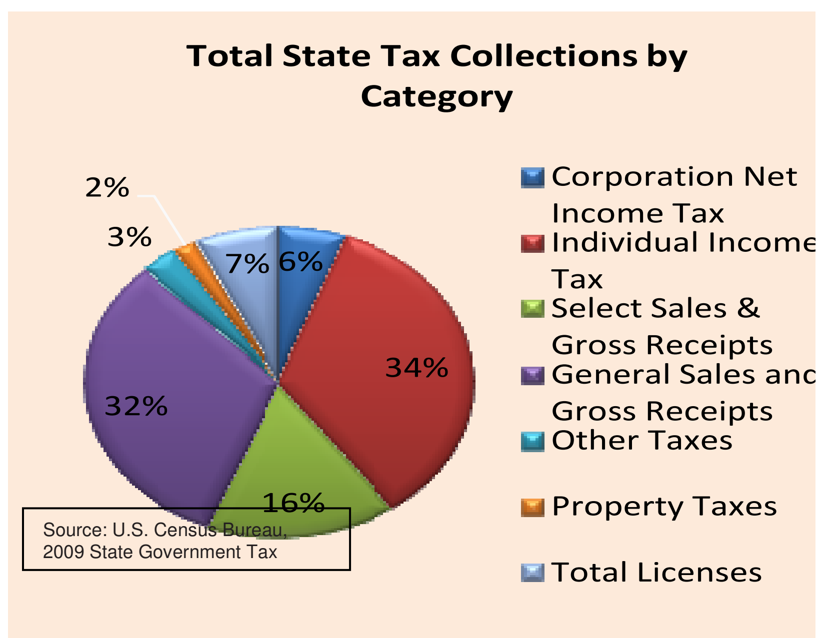
Friends, Students, Taxpayers, Lend Me Your Ears! Pay Your Use Tax!

by Ankit Mathur
SJSU MST Student

"Use tax" you say! Is it not enough to pay sales tax, that States and cities wants us to pay taxes for using something as well? Well, it would be seem unjustified to spring a new tax upon us but here is the surprising news! The use tax is not a new tax. It has existed in states almost as long as the sales tax. In fact, in many states, including California, the use tax has been established since the 1930's!

The sales and use tax accounts for a significant portion of any state's total tax revenue. The chart below shows the aggregate tax revenue for all states from different sources for the year 2009. The general sales and gross receipts tax is second only to the individual income tax in funding state government operations[3].



We are all familiar with the sales tax. It is collected by retailers on purchases of tangible property, that is, something we can see, feel and touch. In many states, the sales tax is also imposed on some services and digital goods. The use tax is slightly different. It is imposed on buyers – both individuals and businesses, by the state in which they reside or use the purchased item.[4] The use tax is reported by the taxpayer on his/her state income tax return and is usually calculated using the state's sales tax rate on items for which the retailers did not collect any sales tax. That means you are bound to be hunting for those receipts from your cruise in Alaska or from the Amazon Christmas shopping spree, come tax filing season.

[3] U.S Census Bureau, (2010). State government tax collections in 2009 (GOVS/10-2). Retrieved from http://www.census.gov/govs/statetax/2009stcreport.pdf.

[4] Scanlan, M A. (2009). Use tax history and its implications for electronic commerce . The Information Society, 25, 220–225.

To understand why we are subjected to this seemingly painful reporting task, let's take a step back into the period of the Great Depression. The year is 1930. The American economy is in shock, and the government is in frenzy. State and local governments are hit hard with soaring unemployment, and more public assistance services were needed for which they did not have the ability to meet financially or institutionally. From these economic ashes rises one of the major revenue reforms of that period - The adoption of the sales tax. Mississippi was the first to adopt the sales tax in 1930 and by 1940 most of the other states followed suit.[5]

Twenty-four states had decided to enact state level sales taxes in that period to boost state revenues, but because each state had a different rate, there was concern that states with lower or no sales tax might become tax havens for taxpayers when they shop in such states. To prevent the taxpayer shopping sprees in tax haven states, the use tax was adopted as a complement to the sales tax.[3] The law on the use tax requires us to pay taxes on taxable goods and services that we purchase, but were not charged sales tax.[6]

Now your next thought must be "Isn't it bad enough that we have our hands full with remembering to pay our federal and state income taxes, and now we have to deal with figuring out another tax?"

Well, the reason paying the use tax becomes our responsibility is that some Internet and catalog retailers that we purchase from, such as Amazon.com, are not required to collect the sales tax in every state. They are exempt from sales tax collection if they do not have any physical presence within the state, which means that the state has no jurisdiction over them for this tax. This rule came about from a Supreme Court decision in 1992 called the *Quill* decision. States do give retailers the option to register with them to collect sales and use tax, but generally, sellers are not inclined to voluntarily collect it due to the associated costs and the possible alienation of customers,[7] Therefore, as buyers, we need to report and pay the use tax when sellers are not required to and are not voluntarily collecting the sales tax from us.

Now imagine if everybody in California, for instance, decided to do their shopping on Amazon.com or with any other company without a physical presence in the state. Students who don't want to pay or cannot afford the exorbitant prices of their campus bookstore already worship online bookstores. And, is such online stores have no warehouses, offices or employees in California, they are not required to collect California sales tax[8]. If the residents were not required to pay the use tax, California would lose about 88% of its $53 billion that is collected by the Board of Equalization through its tax and fees program.[9] What would happen to all the services that are supported by this revenue?

The California Board of Equalization which is responsible for the collection of the sales and use tax, among other taxes, posts a list of the top sales and use tax delinquent accounts. For the third

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[5] Snell, R. (2009). State finance in the great depression. National Conference of State Legislatures, Retrieved from http://www.ncsl.org/print/fiscal/STATEFINANCEGREATDEPRESSION.pdf.

[6] California State Board of Equalization, Sales and Use Tax Department. (2001). Compliance policy and procedures manual Retrieved from http://www.boe.ca.gov/pdf/cpm-01.pdf.

[7] Nellen, A. (2007). California's use tax collection challenges and possible remedies. California Tax Lawyer, Retrieved from http://www.cob.sjsu.edu/nellen_a/TaxReform/CATaxLawyerF07Nellen.pdf.

[8] Halper, E. (2010, February 20). Lawmakers want to tax amazon sales in california. Los Angeles Times,Retreived from http://articles.latimes.com/2010/feb/20/local/la-me-amazon20-2010feb20.

[9] State Board of Equalization, (2010). New board of equalization use tax estimate announced Sacremento: Retrieved from http://www.boe.ca.gov/news/2010/134-10-Y.pdf.

quarter of 2010, $333 million dollars was due for collection,[10] and this amount only refers to the 250 accounts that owe more than $100,000. Include the rest of the 39 million state residents, and the Board estimates a loss of $1.145 billion in sales and use tax every year.[7]

California is just one example of the 45 states, where not all of the sales and use tax owed is collected. Losing this much hurts state budgets and finding ways to collect the money is equally painful and is viewed by many as a waste of tax dollars. The states have to make up for the lost revenue and their only choices are to either reduce services or increase the rates of other taxes. The state of New York has already passed legislation that requires large vendors who are not physically present in the state to collect sales tax from customers who were referred to them by affiliates who operate in that state.[11] The way this New York law works is that online retailers who, for example, pay commissions to website owners for posting links to their merchandise, are presumed to have sales and use tax collection obligations unless then can show that the affiliates with the weblinks are not soliciting sales for them. Amazon is now collecting tax under protest on shipments made to New York. North Carolina, Rhode Island and Illinois have passed similar laws, while other states have considered enacting similar proposals.[6]

So does it mean that the states are winning and we are off the hook from keeping track of our use tax obligations? Not really. Some vendors subject to the new laws in New York, Rhode Island, North Caroline and Illinois have canceled their contracts with the in-state associates (website owners) to no longer be subject to the expanded sales tax collection obligations. Both Amazon and Overstock canceled contracts with their affiliates in states where the law has been implemented (other than Amazon in New York). In California, a letter by Amazon to the governor stated that forcing collections of tax in the state would cause Amazon to sever advertising ties with California based affiliates, which could cost Californians jobs.[12]

Now we all may be thinking that our $100 purchases from out-of state retailers may not contribute much to the state's tax revenue, but they all add up. Also, should keep in mind that not paying the use tax is considered tax evasion.

Also, since the states are threatening to force out-of-state retailers to collect the tax, and the retailers are counter-threatening to cut ties with their in-state affiliates, eventually it is we, the taxpayers who are going to suffer. The loss of revenue generated from such transactions will hurt the state economy and will probably result in more budget cuts.

While any change of heart to pay all our use tax will not affect the outcome of the stalemate between the states and vendors, we will be fulfilling our responsibility to pay our taxes which we have to in any case ("It's the Law"). Also, payment of our use tax may prevent legislators from increasing other taxes.

Payment of the use tax is fairly simple. Almost all states have a line on the state income tax form to report use tax. All you have to do is keep track of your purchases from vendors who did not charge you sales tax, but from whom you purchased a taxable item. There are no complicated calculations, and the use tax rate is the same as the sales tax rate. In California, Governor Jerry

[10] State Board of Equalization, (2010). California's largest sales tax delinquencies for third quarter 2010 Sacremento: Retrieved from http://www.boe.ca.gov/news/2010/95-10-G.pdf.

[11] Broache, A. (2008, May 15). Amazon to collect n.y. sales tax; overstock drops out. Retrieved from http://news.cnet.com/8301-10784_3-9944934-7.html.

[12] Said, C. (2010, February 24). Proposed online sales tax draws criticism. *San Francisco Chronicle*, Retrieved from http://articles.sfgate.com/2010-02-24/news/17953603_1_sales-tax-state-income-tax-e-tailers.

Brown recently signed Senate Bill 86 that will allow taxpayers to refer to a Use Tax Table for purchases less than $1,000 and pay an estimated tax based on adjusted gross income instead of the actual amount of use tax due to the retailer. This seems like a good approach for people who dislike filling their pockets and purses with shopping receipts.

You can find more information on how to report and pay your taxes on your state's department of revenue website. In California, the Board of Equalization's resource center http://www.boe.ca.gov/sutax/sutprograms.htm gives detailed information regarding the sales and use tax.

So, the next time when you shop on Amazon, you will know that there is a tax to be paid, why it exists and how to pay it.

ARTICLES

Seeking Articles – Our Submission Process

Future issues of *The Contemporary Tax Journal* will include two to three articles on current tax topics from tax practitioners, academics and graduate students. If you are interested in seeing your work published in this journal, please read more about our submission policy below and on the website.

Submissions Policies

We aim to provide readers with high quality content covering diverse topics and issues. Of the four sections of each journal, articles is where tax practitioners, academics and graduate students can make their contribution. The other sections – summaries of SJSU tax conferences, "tax enlightenments," and tax policy analysis are exclusive to SJSU MST students.

Articles on latest tax issues will be given first priority. All articles must be unpublished and must be your original work. Articles should be 8 – 16 double-spaced pages (2,500 to 6,000 words). Articles will be subject to blind, peer review.

Submission Deadlines

- Winter Issue (January) – Deadline October 1
- Summer Issue (July) – Deadline April 1

For additional information on the article submission process, please see the submissions link on the website at http://www.sjsumstjournal.com. Thank you.

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FEATURE

26th Annual TEI-SJSU High Technology Tax Institute

Sponsored by

Tax Executives Institute, Inc. &

San José State University College of Business

Summaries written by SJSU MST Students

Introduction

By Ankit Mathur

The Annual High Technology Tax Institute has always been an event of epic proportions. Since 1984, the Santa Clara Valley Chapter of Tax Executives Institute and San José State University's College of Business have sponsored this gathering of some of the most prominent tax professionals in the Silicon Valley and beyond to discuss current and upcoming tax issues relevant to high technology industries.

As usual, the 2010 Institute was led by a panel of nationally and internationally renowned tax practitioners and government representatives. Several SJSU MST students had the opportunity to attend to both learn and report on a presentation for the *SJSU MST Contemporary Tax Journal*.

This year's prominent speakers included Eric Solomon and Heather Maloy. Mr. Solomon was the former Assistant Secretary for Tax Policy in the U.S Treasury Department, now with Ernst &Young. Heather Maloy is the Commissioner of the Large Business and International Division of the IRS.

From the IRS proactively trying to build better relationships with their customers to the humorous exchange by panelists Jeff Sokol and Glen Kohl, the 2010 Institute was a memorable event and a commendable effort by SJSU and TEI.

We hope the summaries that follow provide not only a tax update but a glimpse of the Institute and we encourage our readers to attend the 27th Annual High Technology Tax Institute, scheduled for November 7 and 8, 2011 (http://www.tax-institute.com).

In this special report, you'll find summaries prepared by MST students of the following presentations:

- International High Technology U.S. Tax Current Developments presented by Jim Fuller, partner at Fenwick & West
- International and Multistate Concepts presented by Morgan Lewis tax partners Bart Bassett and Kim Reeder.
- Getting Proper Research Credit presented by Grant Thornton partner Mark Andrus, PWC

partner Jeffery Jones and Internal Revenue Service representative Roger Kave.

- Cross Border Issues presented by Grant Thornton principal David Bowen, IRS representative Steven A. Musher and Fenwick & West partner Ron Schrotenboer.
- M&A Hot Topics presented by Ernst & Young partner and SJSU MST faculty Danni Dunn, Wilson Sonsini Goodrich & Rosati partner Ivan Humphreys and Latham partner Kirt Switzer.
- Successful Tax Practice in China and India, presented by KPMG senior manager Ajay Agarwal, Deloitte managing director Lili Zhang, and Baker & McKenzie partner Jon Eichelberger.
- Federal, Domestic and State Tax Updates, presented by Dr. Annette Nellen, Director of SJSU's MST Program and Tony Fuller, Managing Director with Alvarez & Marsal Taxand, LLC.

International High Technology U.S Current Tax Developments

The Tale of Two Foreign Tax Credits

By Ankit Mathur

James P. Fuller, partner at Fenwick & West, commenced the first morning of the Tax Institute with his presentation on the latest international tax developments. Mr. Fuller, a regular presenter at this conference, referenced his trademark 100+ page presentation throughout, covering such topics as subpart F income, foreign tax credits,and tax treaties.

As much as I want to cover his entire presentation, I will cover foreign tax credits since Mr. Fuller described a very interesting tale that I want to share. It is a tale of denial and lack of foresight; a tale about how Proctor & Gamble was allowed to claim foreign tax credits for taxes withheld in Korea, but was denied a previously claimed credit on Japanese taxes.

Proctor & Gamble's subsidiary in Singapore has its head office in Japan from where it oversees operations n Japan and Korea. Its Singapore operations did not have an office or employees in Korea but contracted with local manufacturers to produce the products and then sold them in the Korean marketplace. The products were already subjected to Japanese taxes on royalty payments, and in 2006 Korean auditors came knocking on the door for their share of royalty payments made on sales in the Korean market. The Koreans attributed the payments as made to Korean sourced income from sales in their marketplace. P&G's Korean counsel provided a written memorandum advising against invoking treaties or challenging the assessment as it would be futile and since the tax assessment was correct, P&G obliged with the taxes.

Now we are back in the U.S where it's time to file the returns and P&G justly files for the credits on its foreign sourced income under Section 901(a).

The IRS initially denied the taxes paid to the Korean authorities because they felt that P&G did not exhaust all of its remedies available to them as they should have under Reg. Section 1.901-2(e)(5). The IRS did not accept the written memorandum provided by the Korean Counsel, but the court decided that it was sufficient proof to show that P&G met the requirements under Reg. Section 1.901-2(e)(5). So this aspect of the case was held in favor of P&G and the

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multinational corporation trades happily ever after. Or does it!

The court did allow claims to foreign tax credits for Korean taxes, but reduced it by the credits claimed for Japanese taxes because P&G did not exhaust their remedies in Japan under Treas. Reg. Section 1.901-2(e)(5). Neither P&G nor its Singapore subsidiary thought of seeking advice from a Japanese competent authority, nor did they challenge or seek a redetermination of the source of royalty income under Japanese law. The court stated, they had no problems with a corporation claiming credits for taxes paid to more than one country on a single stream of income, but the corporation had to first exhaust all of its remedies to reducing foreign taxes. If this rule did not exist, the U.S. Treasury would be forced to foot the bill for such taxes even if they were not properly imposed.

While Japan and Korea may uphold their claims on the same source of income, the court held that it is P&G's responsibility to exhaust all is remedies just as it did by obtaining the memo from the Korean Counsel.

In the end, the IRS did get their way. P&G's lack of foresight lost them their rights to the credits for Japanese taxes even though they were contesting the denial of credits on Korean taxes.

So, the moral of this story is that if you're claiming credits that have caveats such as Reg. §1.901-2(e)(5,) then you need to think of all possibilities and cover all the bases. The case citation is *The Proctor and Gamble Company Subs. v. U.S.* Case No. 1.108-cv-00608 (DC OH, July 2010).

Now for some other international updates by Mr. Fuller:

Affirmation of the Xilinx case: Xilinx, a manufacturer of integrated circuits was denied the deduction of stock compensation under Section 83(h) by the IRS, who claimed the cost should be shared between Xilinx and its Irish subsidiary. The court found in favor of Xilinx stating that the two provisions at Reg. Section 1.482-1(b)(1) and Reg. Section 1.482-7(d)(1) create ambiguity for determining which costs must be shared and that there are many other factors in play, such as the treaty between U.S. and Ireland. The consenting judges found that Xilinx's understanding of the regulations was more widely shared in the business community. The IRS has issued an Action on Decision (AOD) for this case noting acquiescence in result only.

US-Italy Treaty: Speaking of treaties, U.S & Italy finally agreed upon an income tax treaty and the announcement was made by the Treasury in 2009. It took a mere ten years for this treaty to come into force, but hopefully it will not take another 10 years to make updates to the provision that have become outdated in the last decade. A few other countries that signed a treaty with the U.S. include Malta, Hungary and Chile.

While this summary does not do justice to Mr. Fuller's complete, in-depth presentation, I hope it provides a glimpse of the presentation, and refreshed the memories of those who did attend the event. Mr. Fuller's coverage of the vast array of topics goes to show the numerous opportunities in international taxation and the scope of planning and creativity needed to be successful in this field.

International and Multistate Concepts

Similarities, Differences and Traps

By Zhihua Cai

Which standards determine the jurisdiction that has the authority to impose tax on inbound taxpayers? Does the state conform to the Federal rule about the net operating loss utilization and anti- inversion rules in international restructurings? How does the State report the subpart F income of a controlled-foreign corporation in Water's Edge combined reporting? What is the state trend in application of transfer pricing issues?

These were the questions discussed by Bart Bassett and Kim Reeder, tax partners at Morgan Lewis, at the 2010 High Tech Tax Institute.

Which jurisdiction should tax?

Per Mr. Bassett, from a U.S. Federal standard, the concept of "permanent establishment" is used to determine whether inbound taxpayers should be taxed within a particular jurisdiction. Permanent establishment is constituted if taxpayers are engaged in a U.S. trade or business, and taxation of income is effectively connected with such U.S. trade or business. The definition of permanent establishment typically excludes certain fixed operations, such as the storage of goods or merchandise, or other activities that are preparatory and auxiliary in nature. Further, the standard of permanent establishment is always subjected to the override by U.S. tax treaties. Mr. Bassett emphasized, that the U.S. treaties are only binding on Federal standards, and not applicable to the State's. From a State standard, Ms. Reeder mentioned the concept of "nexus" is used to determine whether inbound taxpayers are subject to tax in a specific State. Nexus exists when the taxpayer is doing business in a state. The nexus principle is also subject to the U.S. Commerce Clause, which requires the taxpayer to have substantial nexus within a state. States may also apply different standards in the income/franchise and sales/use tax contexts. For example, if the U.S. contract manufacturer is engaged to process goods consigned by a foreign taxpayer, it may not form a permanent establishment; however, it may meet nexus standard if it is doing business in this state.

Federal conformity

Net operating losses ("NOLs") from a federal standpoint are subjected to many limitations one of them being Section 382. Each state does not fully conform to the federal standard and has its own rule to limit the net operating loss utilization. For example, CA and some other states have limited the utilization of NOL's because of the budget crisis. The NOL deduction in CA has been suspended for all tax years beginning on or after January 1, 2008 and before January 1, 2012. Carry forward period is also extended. In international restructurings, States do not conform to the federal rule in the application of Section 7874 anti-inversion rule. For example, if a foreign company is restructured as a holding company for the groups, from a federal standpoint, assuming the group does not have "substantial business activities" in the corporation, the anti-inversion provision of Section 7874 causes the foreign corporation to be characterized as a U.S. corporation for all U.S. federal income tax purposes. Thus, Section 367 is not applicable. The transaction is a U.S.-to-U.S. reorganization or a Section 351 transaction. From California's standpoint, it does not follow Section 7874 anti-inversion provision, thus the U.S. characterization of the foreign company is not applicable. Section 367 (a) causes the transaction to be taxable at the shareholder level-triggering any gains (not loss) realized by the

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U.S. shareholders pursuant to Treas. Reg. Section 1.367 (a)-3.

Water's edge reporting issues for CFCs

Ms. Reeder said the Water's edge reporting for CFCs is always complicated. For the water's-edge combined reporting, existing law requires including the "Subpart F" income of a CFC to the extent of the inclusion ratio, regardless of whether the foreign corporation is a California taxpayer. IRC Section 957. Calculating the inclusion ratio involves multiplying the CFC's net income by a ratio of its subpart F income for the taxable year to its earnings and profits for the taxable year. A taxpayer may exclude Subpart F income from the inclusion ratio if it qualifies as high foreign tax income under Section 945(b)(4). Income will qualify as high foreign tax income if a taxpayer establishes that such income is subject to an effective rate of income tax imposed by a foreign country greater than 90% of the maximum rate of tax specified in Section11.

Transfer Pricing – State and local tax trend

Mr. Bassett described that states have begun to use Section 482-like the power to redistribute income among related entities recently. Currently most states incorporate an arm's-length standard consistent with Section 482 or adopt a language that is broader than Section 482 to solve transfer-pricing issues. *Comptroller of the Treasury v. Gannett Co., Inc.*, 741 A2d 1130 (1999). Cal. Rev. & Tax. Code Sec.25104. N.C. Gen. Stat. Sec. 105-130.6. For audit purposes, Section 482 applies to the previous years although those rules are changed for tax years beginning in or after 2007.

The international and multistate concepts are intersected with each other. In some tax issues, states start getting closer to the federal rules, such as the transfer pricing principle. However, in others, states do not conform to the federal rule due to the specific reasons. Having a clearer picture of the similarities, differences & traps among the international and multistate concepts will help provide better tax planning advice.

27th Annual TEI-SJSU
High Technology Tax Institute

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Getting Proper Research Credit

By Tim Kelly

A well- attended concurrent session covered "Getting Proper Research Credit," with Mark Andrus of Grant Thornton, Jeffrey Jones of PwC and Roger Kave from the Internal Revenue Service. Given the fact that the research tax credit lapsed at the end of 2009 you might ask yourself why this session was even included in this year's event?

Historically, countries have enacted barriers to prevent foreign investment in domestic businesses. As trade barriers fell and the developed countries became more integrated, U.S. policymakers have walked a tight rope balancing policy designed to keep jobs and capital at home while attracting foreign investment. One such policy enacted in the early 1980s was the research and development (R&D) tax credit. In simplistic terms, a taxpayer's expenditures to develop and improve new and existing products can be used to generate an R&D tax credit to offset federal income tax. The "cost" of the credit[13] and the focus on enacting revenue neutral legislation has caused Congress to never make the R&D tax credit permanent. Since 1981, the credit has lapsed several times and been temporarily renewed at least a dozen times. Over the past 30 years, the value of the credit has diminished relative to other countries. Studies have placed the United States anywhere from 17th to 24th in a ranking of nations that have incentives to promote research and development expenditures.[14] As a result, more and more U.S. corporations have been conducting a greater percentage of their research and development in foreign countries to take advantage of the more lucrative incentives offered by those countries.

Given the history and economic importance given to the R&D credit, it's expected to be renewed by the end of 2010. The panel indicated there was strong bipartisan support and that President Obama had proposed making the credit permanent to eliminate uncertainty as well as to increase the alternative simplified research credit rate from 14% to 17%[15]. There was no discussion on broadening the variety of R&D expenditures that currently do not qualify, such as in-process R&D.

The majority of the panel discussion focused on the friction between taxpayers and the IRS when a research credit claim is denied based on a lack of "proper" documentation and the linking of a new or improved "business component" to the qualified research expenditures.

I can't define it, but I know research and development when I see it: How do taxpayers properly document R&D and link it to an R&D activity to claim proper credit and survive a subsequent examination by the Service? Taxpayers have relied on their financial records

[13] Per the Joint Committee on Taxation (JCS-1-10), the "cost" of the credit is about $5 billion per year; http://www.jct.gov/publications.html?func=startdown&id=3642.

[14] ITIF, 11/20/10; http://www.itif.org/files/ExpandR&D.pdf, 11/20/2010, and Deloitte (2/10); http://www.investinamericasfuture.org/PDFs/2009Global%20SurveyRandDTaxIncentivesDeloitteFebruary2010.pdf.

[15] Tax extenders bill introduced by Baucus (D-MT) on Sept. 16,2010 to extended R&D credit to 12/31/10. White House research credit proposal, 9/8/2010; http://www.whitehouse.gov/sites/default/files/fact_sheet_re-credit_9-8-10.pdf.

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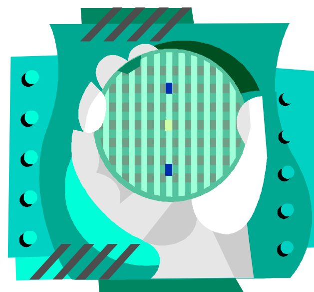
and documentation to substantiate their R&D credit claim, while the IRS has targeted use of estimates in determining qualified research expenses (QREs) and gross receipts to disallow the claim for credit. Examining agents prefer a project accounting approach rather than the more common cost center approach used by a majority of taxpayers. It was suggested that IRS field agents have been inconsistent and failed to take direction from the IRS National Office and the Research Credit Audit Guidelines, which allow for the cost center method to computer a taxpayer's R&D credit. The panel outlined a series of cases[16] that have held in favor of the taxpayer with regard to the use of estimates and employee testimony as a basis for substantiating R&D credit claims.

Next, the panel offered guidance on how to prepare and survive an examination. A few key points that seem obvious are worth mentioning. Taxpayers should know their data, documentation and methodologies ahead of the audit. Employees involved in R&D activities should be aware of the requirements to be effective in an interview. Prepare a road map for the exam team and address the important issues in the beginning. Most importantly, keep communication open from the start and continue to ask if there are any issues. In other words, don't wait until the end of the audit to find out that the exam team has a problem with your documentation.

With time running out the panel quickly reviewed a few other topics including issues regarding controlled foreign corporations in calculating gross receipts[17], qualified supplies expenditures[18] and standards for internal use software[19].



[16] *McFerrin*, No. 08-20377 (5th Cir. 6/9/09), *TG Missouri Corp. v. Comm'r*, 133 T.C. No. 13 (2009), *Trinity Industries, Inc. v. United States*, 691 F. Supp. 2d 688 (N.D. Tex. 2010).

[17] *Proctor and Gamble v US* (S.D. Ohio, 2010) held P&G may disregard inter-company transactions with foreign controlled group members in computing its research credit.

[18] *Trinity Industries v U.S.* (N.D. Tex. 2010) held for taxpayer, depreciable property should be evaluated in the hands of the taxpayer to determine if is subject to the allowance for depreciation.

[19] *FedEx v. U.S.,* (W.D. Tenn. 2009) Taxpayer can rely on withdrawn 2001 regulation IUS high threshold of innovation standard, "The software is innovative in that the software is intended to result in a reduction in cost, improvement in speed, or other improvement, that is substantial and economically significant.

Cross Border Issues

By Marja Mirkovic

The presentation on cross-border or transfer pricing issues covered new legislative proposals concerning intangibles, the future of Section 482 guidance, transfers of intangibles and cost sharing agreements. The presentation was led by David Bowen and Laura Clauser with Grant Thornton, IRS Associate Chief Counsel Steven A. Musher, and Fenwick & West partner, Ron Schrotenboer.

Summing up Transfer Pricing

Transfer pricing is an area of tax compliance that has gained substantial importance and scrutiny. As of January 2009, 48 countries enacted legislation with respect to transfer pricing, as compared to five countries in 1997. Transfer pricing issues are relevant to multinational corporations that have foreign subsidiaries. The purpose of transfer pricing regulations is to ensure that the right amount of taxes are paid in the right location by properly allocating profits and costs between the U.S. parent company and its foreign subsidiaries.

Transfer pricing is the price at which goods, services and intellectual property are transferred between related parties of a multinational business across international borders. Market forces do not set prices between related parties, so related parties could be overcharging or undercharging for particular goods and services. Tax authorities are concerned that this could allow companies to shift taxable profits to different jurisdictions, this concern led to the transfer pricing regulations and enforcement activities.

The Disputed Art of Valuing Intangibles

Intangible assets are gaining more attention from the IRS and the Organization of Economic Cooperation and Development (OECD) as intercompany transactions of intangible property are becoming one of the most common causes of tax disputes. Unlike tangible assets, multiple users can employ intangible property simultaneously without diminishing its usefulness. With the global growth of the technology industry the number of intangibles are rising and being a valuable asset, it demands new rules in identifying, determining and valuing them.

Treas. Reg. Section 1.482-4(b) defines intangibles as including patents, formulae, patterns, processes, expertise, copyrights, trademarks, licenses, systems, procedures, forecasts, customer lists, etc. Currently there is a debate on whether goodwill, workforce and going concern value should be included as intangibles per Treas. Reg. Section 1.482-4(b).

Another issue that was discussed was the difference in valuation of acquired intangibles. The main difference in valuation methods stem from differences in assumptions about the useful life of acquired intangibles. Under the acquisition price method, it is assumed that the useful life of intangibles is perpetual, while under the income method the useful life is six years. A new set of rules is needed to accurately determine the useful life of intangibles. In addition, we need to indentify the facts that are relevant for that determination.

These are only some of the issues concerning valuation and cost sharing methods related to profits from intangibles. We should look out for new sets of guidance and regulation concerning these issues in the near future. This presentation stressed the need for awareness on increasingly significant transfer pricing issues and the need for new regulations concerning intangibles.

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Mergers & Acquisition Developments

By Zhihua Cai

The M&A panel addressed current developments in the area including transaction trends. In addition, in its discussion, the panel touched upon the history of rescission doctrine and relevant private rulings, the application of Section 382 poison pills and charter amendments, and other issues.

Ivan H. Humphreys, partner at Wilson Sonsini Goodrich & Rosati, illustrated that M&A activity has increased roughly 10% in the high-tech sector over 2009. Among these transactions, large public ones have dominated the landscape. For most large-scale public transactions, tax participation is usually fairly limited, and key tax participation occurs in the post-deal integration. For example, deal terms in a public transaction usually do not include tax indemnity agreements, and tax representations made by targets thus serve a diligence and information gathering function. However, Mr. Humphreys noted, compared with the large public transactions, the "mid-market" deals, i.e. the transactions involving the acquisition of private companies under $500 million, have more tax participations in the transaction itself.

Traditionally, acquisitions of venture capital backed private companies did not contain a "pre-closing tax" indemnity. However, currently, separate pre-closing tax indemnity is becoming more prevalent. Mr. Humphreys also mentioned other special deal terms in the private M&A transactions that are different from public transactions.

Danni Dunn, partner at Ernest & Young, LLP, introduced the rescission doctrine that has applied in the corporate mergers and acquisitions context. The doctrine was first established in the landmark case of *Penn v. Robertson*, which allowed taxpayers who had completed a transaction, an opportunity to unwind it, and to treat the transaction as if it had never occurred. The Internal Revenues Service later acknowledged this principle in Rev. Rul. 80-58. Ms. Dunn said that for the rescission doctrine to apply: 1) the parties to the transaction must be restored to the same position they would have occupied had no contract been entered into (the "status quo ante" requirement); and 2) the rescission must occur in the same tax year of each party in which the original transaction took place (the "same taxable year" requirement). Rescission may be effected in the following ways: by mutual agreement of the parties, by one of the parties declaring a rescission of the contract without the consent of the other (only if sufficient grounds exist), or pursuant to a court order. Ms. Dunn noted that business purpose is not required for the introduction of the rescission doctrine, and a tax reason is sufficient for taxpayers to unwind a transaction per the rescission doctrine. Ms. Dunn explained several private letter rulings issued by the IRS in recent years that address the application of the rescission doctrine to particular situations and provides additional guidance to taxpayers who have entered into transaction that they now wish to unwind. However, Ms. Dunn noted that the previous situations addressed by the IRS are all private rulings, instead of revenue rulings. So, taxpayers should be cautious to rely on these private rulings. Seeking a tax advisor's opinion or perhaps requesting a private letter ruling is strongly recommended for specific issues.

Kirt Switzer, partner at Latham & Watkins, LLP, discussed the background and mechanics

of Section 382 poison pills that limit risk of ownership changes if significant net operating losses ("NOLs") are at involved. NOLs can be used to offset a company's future income tax liability when and if a company has taxable income. Under Section 382, changes in ownership can effectively cap the amount of a target's NOL that an acquirer can use to offset its future tax liability if a shareholder owing 5% or more of the company increases its ownership by more than 50% of its lowest level of ownership during the last three years. Mr. Switzer said that public companies may seek to take action, such as charter amendments in bankruptcy proceedings, adopting Section 382 poison pill plans, or charter amendments requiring shareholder approval. Among them, Mr. Switzer mentioned, an application of Section 382 poison pill was upheld by Delaware Chancery Court in *Selectica, Inc. v. Versata Enterprises*, which was finally confirmed by Delaware Supreme Court. Traditionally, the poison pill plans are intended to thwart a hostile takeover, and it is triggered when the stock ownership reaches the threshold of 10-20%. Different from a traditional poison pill, a Section 382 poison pill is designed to protect a company against loss of the use of NOL carryforwards, and the trigger shareholder is around 5%. In that case, the company may trigger shareholder rights to purchase stock at a deep discount to dilute 5% (or potentially 5%) shareholders. However, Mr. Switzer also pointed out that Section 382 poison pills have their limitations because NOL poison pills can't prevent an ownership change and it may potentially create a new 5% shareholder

Indian Direct Tax Code

Changing Horizons for Foreign Investments

By Sampada Deshmukh

India and China are emerging as the two leading powerhouses in the world. These are vast countries filled with opportunities and risks for investors. Both countries have shown their strength during the period of recession with a GDP growth rate of 7.2% (India) and 10.2% (China) in 2008[20] when other countries barely managed to have a positive growth rate.

The High Tech Tax Institute presented an excellent opportunity for tax professionals and students to learn more about the recent developments in the tax regime of India and China. Lili Zheng, Co-leader of Deloitte's Asia Pacific International Core of Excellence based in Hong Kong, started the presentation with a discussion of the importance of India and China today and in the future. Jon Eichelberger, partner with Baker & Mackenzie, provided insightful information regarding recent tax developments in China and also stressed some critical issues for foreign companies looking to establishing and expanding their businesses in this country. Ajay Agarwal from KPMG focused on the Indian Direct Tax Code and its impact on

[20] International Monetary Fund, Initials. (December 2009). *Rebalancing growth in Asia*. Retrieved from http://www.imf.org/external/pubs/ft/fandd/2009/12/prasad.htm.

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foreign businesses in India. This article focuses on opportunities and risks faced by foreign companies while investing in India, as covered by Mr. Agarwal.

India, one of the fastest growing free market economies, presents extended opportunities for all types of investments to foreign companies, foreign institutional investors (FIIs) and non-resident Indians (NRIs). The Indian market, with its one billion plus population, and 8.4%[1] growth rate presents lucrative and diverse opportunities for companies with the right products, services and commitment. With a sustained projected growth rate of 8-10% for the next few years, the Indian economy seems promising and attractive for many foreign companies. However, the constant changing of exchange control and tax regulations require foreign companies to effectively plan their strategies for establishing new or expanding their existing business in India.

Direct Tax Code Bill (DTC) 2010

The Indian government has taken significant steps for simplification of tax laws by enacting the Direct Tax Code (DTC). The DTC replaces the current Income Tax Act of 1961(ITA) and comes into effect starting April 1, 2012. The DTC is considered a necessary and effective step for bringing Indian regulations in line with the global economies. Foreign companies however, need to consider the effects of these revised regulations on their existing or new businesses.

The DTC rules aim at bringing the definition of residency in line with international practice. The company incorporated outside India would be resident in India, if its "place of effective management" at any time in the year is India. The place of effective management of company means: A place where board of directors or executive directors make their decisions. In situations where the board of directors routinely approve the commercial or strategic decisions made by executive directors or officers of the company, the place where such executive directors or officers of the company perform their functions.

General Anti Avoidance Rules (GAAR)

The DTR also aims at regulating abuse of tax rules by introducing General Anti- Avoidance Rules (GAAR) in the Indian Tax regime. GAAR provisions empower the tax authorities to declare an arrangement as impermissible if it has been entered into with the objective of obtaining tax benefits. GAAR is not invoked for every transaction involving tax mitigation. An impermissible arrangement is one, which has tax benefit as the main purpose and satisfies any one of the basic conditions. Private equity funds set up abroad and making investments in India through intermediary holding companies like Mauritius, Cyprus, etc., are likely to come under the preview of GAAR.

Controlled foreign Corporation (CFC) Rules

The CFC rules were introduced as an anti-avoidance measure to prevent tax deferrals and tax avoidance by domestic residents including companies looking to establish foreign entities in low tax jurisdiction and diverting income to such entities. The CFC rules focus on an entity approach rather than income, although income is an important factor as to whether or not CFC rules apply. These rules apply to passive income earned, but not distributed bya foreign company "controlled" directly or indirectly by one or more residents in India. Such income would be treated as deemed distributed and would be taxable in the hands of resident shareholders as dividends received from a foreign company. For this purpose, control means 50% or more control over voting power or capital or a combination thereof of substantial interest /influence or control over income or assets of the CFC. CFC provisions do not apply if tax paid by a foreign company in its country of residence is less than 50% of the tax it would have paid in India as a domestic company as per the DTC in 2010. An

exemption is also available if the CFC is listed on the stock exchange or its income does not exceed INR 2.5 million.

Transfer Pricing Provisions

The DTC rules for transfer pricing are in line with the existing rules as per Income Tax Act, 1961. However, the definitions of "Advanced Pricing Arrangements (APAs)" and "Associated Enterprises (AE)" have been revised.

Associated Enterprises (AE)

An international transaction means transaction between two AEs, either or both of which are non-residents. The definition of AE has been expanded to include a provision for services by one enterprise to another, directly or indirectly, where the conditions are influenced by such other enterprise. It is also required that any one of the enterprise that is part of the transaction be situated in any specific or distinct location as may be specified.[21]

Advanced Pricing Arrangements (APAs)

APA is an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (e.g. methods, comparables and adjustments thereto, critical assumptions as to future events) for determining the transfer pricing for those transactions, over a fixed period of time, which in this case is a maximum of five years. The DTC 2010 broadly provides mechanisms for entering into APA:

- The Central Board of direct Taxes (CBDT) , with the approval of Government of India, may enter into an APA with any person, specifying the manner in which arm's length price (ALP) can be determined in relation to an international transaction.
- The ALP in an APA can be determined by using any method prescribed in the transfer pricing provisions, with such other adjustments as may be necessary or expedient to do so. This ALP shall be binding on both taxpayer and tax authority.
- The APA is valid for period specified in it subject to a maximum of five consecutive financial years.

Transfer of Assets by non-residents Provisions: A non-resident is liable to be taxed in India only on its income having a "source" in India. The concept of source covers income accruing or arising, or incomes deemed to accrue or arise in India or incomes received in India. Under DTC, the deeming income provisions have been expanded to include:

- Income from direct or indirect transfer of capital assets situated in India and
- Income from interest on debt used for earning any income from any source in India

The introduction of the DTC has been considered a noteworthy step to reduce complexity and bring clarity and precision to Indian tax laws. The Codification of GAAR and introduction of CFC rules shows new approaches of the Indian government to deal with tax avoidance. With India's growing importance in the global market it is essential for the foreign companies directing investments and expansion in India to familiarize themselves with the tax rules and assess the impact of these rules on their businesses.

[21] Tax Guru, Initials. (September 19, 2010). *General anti-avoidance rule (gaar),controlled foreign company (cfc) rules and amendment in transfer pricing (tp) provis*. Retrieved from http://taxguru.in/articles/display/29/General%20Anti-Avoidance%20Rul/.

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Federal Domestic and State Tax Updates

By Ami Shah

Uncertainty is the only word that describes this year's position on tax laws. There might be several changes from the Institute date until year end, but this article describes a few of the changes made before December 2010 and summarizes the presentation "Federal Domestic and State Tax Updates" made at the 2010 High Technology Institute by Annette Nellen, Director of the San José State University MST program, and Tony Fuller, Managing Director with Alvarez & Marsal Taxand, LLC.

Several bills were passed in 2010. The Hiring Incentives to Restore Employment (HIRE) Act, Patient Protection and Affordable Care Act and Small Business Jobs Act are just a few examples that made significant impact on the federal tax system.

Here is a summary of some of the new provisions.

Section 179 expensing

For 2010 and 2011, the expensing amount under Section 179 is $500,000with the phase-out starting at $2 million. New law increases the qualifying property cap from $800,000 to $2 million, which effectively increases the availability of Section 179 expensing to many more businesses. Under the new law, the Section 179 expensing deduction does not phase out completely until the cost of eligible property exceeds $2.5 million. Taxpayers may also expense up to $250,000 of the $500,000 for qualified real property.

Bonus Depreciation

New law extended 50-percent first-year bonus through December 31, 2010 (it had expired at the end of 2009). Extension is retroactive to January 1, 2010. New law also extends, through 2011, the additional year of bonus depreciation allowed for property with a recovery period of 10 years or longer, and for transportation property (tangible personal property used to transport people or property). Bonus depreciation is not limited by the size of the business, unlike practical access to the Section 179 "small business" expensing. Bonus depreciation is by far the most expensive single tax break in the bill, weighing in at $5.4 billion over 10 years, but carrying an initial cost of $29.5 billion in its first two years because of accelerated depreciation that would otherwise be deducted in later years.

Small Business Stock

The American Recovery and Reinvestment Act temporarily increased the Section 1202 percentage exclusion for qualified small business stock issued to a non-corporate investor from 50 percent to 75 percent for stock acquired after February 17, 2009 and before January 1, 2011, and held for more than five years. New law raises the exclusion to 100 percent for gain on stock acquired after September 27, 2010 and before January 1, 2011. Under the new law, the excluded gain will not count as an AMT preference item, but the five-year holding period continues to apply.

S Corporation Built-in-Gain

For tax years beginning in 2011, the S corporation built-in gain recognition period is 5 years, thus making it easier to avoid the built-in gains tax. So, there is no built-in

gains tax on net recognized built-in gain of a S corporation for the tax year beginning in 2011 until the 5th year in the recognition period (since converting from C to S) preceded that tax year.

General Business Credit Carry back

New law extends the carryback period for eligible small business credits to five years. Eligible small business credits are the sum of the general business credits, such as the research credit, determined for the tax year with respect to an eligible small business. The extended carryback provision is effective for credits determined in the taxpayer's first tax year beginning after December 31, 2009.

Heath Insurance Deduction for Self-Employed

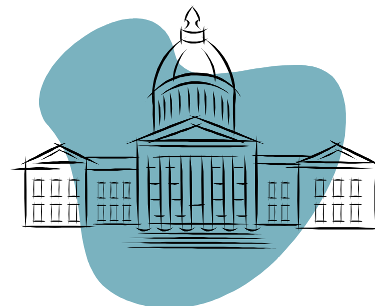
Usually a self-employed individual can take deductions for health insurance costs paid for the individual and his or her immediate family for income tax purposes. However, in determining the self-employment income subject to self-employment taxes, the self-employed individual cannot deduct any health insurance costs. Under the new law, the deduction for income tax purposes for the cost of health Insurance is allowed in calculating net earnings from self-employment for purposes of self-employment taxes. The provision only applies to the self-employed taxpayer's first tax year beginning after December 31, 2009.

Removal of Cellular Telephones from Listed Property

New law removes cell phones and similar personal communication devices from their current classification as listed property under Section 280F, thereby lifting the strict substantiation requirements of use and the additional limits placed on depreciation deductions.

More Changes to Come

Tax cuts signed by President George W. Bush in 2001 and 2003 are due to expire at December 31, 2010. President Obama wants them extended only for couples earning up to $250,000 (singles up to $200,000), saying the cost to extend them for the wealthiest Americans is too high. Republicans want them extended for everyone, so that no one's taxes rise while the economic recovery is weak. At November 8, 2010, Congress had not finalized many issues at hand, but the panelists noted that additional legislation was expected before year end.



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FOCUS ON TAX POLICY

This section of the *SJSU MST Contemporary Tax Journal* showcases work of SJSU MST students and provides a public service. This section is devoted to analysis of tax proposals and existing tax rules using principles of good tax policy. These analyses and others will be indexed and highlighted on the Journal website so as to be readily accessible by lawmakers, their staff and others who are involved in and interested in improving our tax systems.

Tax Policy and the SJSU MST Program

One of the learning objectives in the San José State University MS Taxation Program is:

> To appreciate tax policy issues and foundations of the income tax law.

In practice, this objective is addressed beyond only the income tax. Students learn about principles of good tax policy starting in their first MST class - Tax Research and Decision-making. The AICPA's Tax Policy Concept Statement 1 – *Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals,* is used for this purpose. This report,[22] issued in 2001, lays out ten principles of good tax policy that have been used by lawmakers and others for decades, if not centuries. Additional work on tax policy evaluation occurs in the capstone MST course. In other courses, such as corporate taxation and accounting methods, students learn the policy underlying the rules and concepts of the technical subject matter in order to better understand the rules and to learn more about the structure and design theory of tax systems. The MST Program also has an elective course - Tax Policy and Tax Reform.

Tax Policy and the SJSU MST Contemporary Tax Journal

This inaugural issue of the journal includes two tax policy analyses. The first was prepared as part of an individual project in the tax policy and reform elective course offered in spring 2010. The second was developed by the students in the fall 2010 tax research class.

A Standard Home Office Deduction

By Karen Connolly

Spring 2010

Introduction

If you are self-employed or you use a portion of your home for business, you might be able to deduct the associated costs. But you must meet tax law requirements to qualify, and if you do qualify, then taking the deduction involves determining how much of the residence is used exclusively for business, what portion of the year it is used, and then deducting a portion of qualified expenses based on that.

Many taxpayers who qualify for the deduction do not claim it because the calculation is too complicated (for example, the IRS instructions are 35 pages long). The result is that many home-based businesses miss out on a deduction to which they are lawfully entitled. A 2006 survey conducted for the National Federation of Independent Business Research Foundation found that 75% of small-employers polled said the home office deduction would apply to their business, but only 15% of those respondents said they had a good understanding of the rules.[23] The key hurdles cited for not taking the deduction are the strict qualifying requirements, complexity of the form and instructions, and fear of being flagged for audit by the IRS.[24]

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[22] This AICPA report can be found at http://www.aicpa.org/InterestAreas/Tax/Resources/TaxLegislationPolicy/Advocacy/DownloadableDocuments/Tax%20Policy%20Concept%20Statement%20No.%201.doc. Professor Annette Nellen, Director of the SJSU MST Program, was the lead author of this report for the AICPA.

[23] Tom Herman, "Fear of the Home-Office Deduction," *The Wall Street Journal On-Line*, 1/16/08, page 2; http://online.wsj.com/article/SB120043939156266924 41.html.

[24] Testimony of Scott Scribner on behalf of The National Association for the Self-Employed, "Regulatory Burdens on Small Firms: What Rules Need Reforms?" before the House Committee on Small Business Subcommittee on Regulations, Healthcare and Trade, 07/30/08, page 22; http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_house_hearings&docid=f:42523.pdf.

Simplifying this deduction is at the top of the tax reform recommendations published by the SBA Office of Advocacy in 2009.[25] Current proposals would give taxpayers the option to take a standard home office deduction instead of using the calculation method. The rationale offered for a standard office deduction is that it would simplify the deduction and save time and money for both taxpayers and the IRS.

Several bills have been introduced in Congress to simplify the deduction. H.R. 3615 (111th Congress) proposed a standard deduction of $1,500 and S. 1349 and H.R. 3056 (111th Congress) relaxed the requirements for clients to be physically present in the home office and allowed for de minimis use of business space for personal use (that is, the exclusive use requirement is relaxed).

Evaluation of an optional standard home office (HO) deduction against principles of good tax policy

Principle	Application	Rating
Equity and Fairness – Are similarly situated taxpayers taxed similarly? Also consider any different effects based on an individual's income level and where they live.	In general, a standard HO deduction increases fairness for small businesses. While corporations can fully deduct their operating costs, home-based businesses often cannot.[26] Adding to this inequity is the fact that many taxpayers who qualify, do not take the deduction because of the complex calculation, record-keeping requirements, and fear of an audit. Similarly situated taxpayers are those who definitely use a home office, but don't take the deduction for the reasons noted above. A standard HO deduction, particularly along with limited relaxation of the exclusive use rule, would reduce this inequity. Because of the simplicity of a flat deduction amount over the current calculation method, the addition of a standard HO deduction tends to favor less sophisticated taxpayers who do not have access to paid tax assistance to prepare their returns. This also improves fairness. For employees, working at home for the convenience of their employer, a standard HO deduction would continue to be reported as an itemized deduction which favors those who itemize deductions. However, since the existing HO deduction for employees is already reported as an itemized deduction, the addition of a standard HO deduction does not further affect equity/fairness because there is no change to the current treatment. The standard HO deduction would continue to be subject to the 2% AGI limitation which tends to limit the benefit for high-income taxpayers. And for an individual subject to AMT, a HO deduction may be a factor contributing to a taxpayer's AMT status so many employees may choose to forego the HO deduction altogether, irrespective of a standard deduction alternative. While a standard deduction amount for HO expenses favors those with actual HO expenses less than the standard deduction, there will be others with actual expenses greater than the standard amount who prefer the simplification of a standard deduction. The amount of the standard deduction should be established based on current filing data, with the amount adjusted annually for the effects of inflation.	+
Certainty – Does the rule clearly specify when the tax is to be paid, how it is to be paid, and	A standard deduction for HO expenses specifies when and how the taxpayer is to take the deduction and it is no different than the current calculation method for taking a HO deduction. A taxpayer completes Form 8829, Expenses for Business Use of Your Home, to determine the allowable expenses and the amount is reported on Schedule C for self-employed taxpayers, as a reduction	+

[25] SBA: Office of Advocacy, Letter Re: Recommendations for Tax Reform. 09/29/09, page 1; http://www.sba.gov/advo/laws/comments/tax09_0929.html.

[26] Nydia Velazquez, House Committee on Small Business, *Broken Promises: The Stalled Agenda for American Small Business*, page 23; http://www.house.gov/smbiz/democrats/Reports/BrokenPromisesReport.pdf.

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how the amount to be paid is to be determined?	of tentative profit/(loss), or on Schedule A for employees, as a miscellaneous itemized deduction, subject to the 2% of AGI limitation.[27] The typical wording of the bills proposed in Congress is to amend §280A(c) to allow for a Standard Home Office Deduction Amount, to be the lesser of (i) $1,500, or (ii) gross income derived from the individual's trade or business.[28] Since a flat amount is more certain than the current rules, addition of a standard HO deduction increases certainty.	
Convenience of payment – Is tax due at a time that is convenient for the payor?	The standard HO deduction would be claimed on the annual return. This is convenient for the taxpayer and represents no change from the current HO rule.	+
Economy in collection – Are the costs to collect the tax at a minimum level for both the government and taxpayers? Also consider the time needed to implement this tax.	The cost to collect would be minimal since this is an addition to the existing HO deduction rules within an established reporting framework. Existing forms, procedures and rules would require modification for the addition of a standard HO deduction but the cost of an addition to existing documents would be minimal compared to implementing entirely new legislation. Other than these modifications, minimal time would be needed to implement the standard HO deduction. If taxpayers abuse the rule, such as claiming the standard HO deduction even if they do not use their home as an office within the Section 280A requirements, additional IRS resources will be used to address the problem. However, the IRS can include questions on Form 8829 to help prevent abuse.	+
Simplicity - Can taxpayers understand the rules and comply with them correctly and in a cost-efficient manner?	The addition of a standard flat amount for a HO deduction is straightforward for understanding the rules and provides a simplified method over the current calculation approach. As referenced earlier, almost half of taxpayers claiming a HO deduction in 2001 made errors.[29] By making the standard deduction optional, taxpayers can choose which method to use, increasing the likelihood they will choose the method they are most confident in calculating correctly. The cost of claiming the HO deduction will decrease for taxpayers because the simplified flat amount allows the option to skip the cumbersome calculation method altogether if desired. A standard HO deduction will not only ease the burden on small business but also improve compliance.[30]	+
Neutrality - The effect of the tax law on a taxpayer's decisions as to how to carry out a particular transaction or whether to engage	For taxpayers who are eligible but do not claim the deduction, a standard HO deduction would increase the likelihood of taxpayers taking the deduction who are already eligible for it. In May 2008, a National Association for the Self-Employed online poll found that over 60% of home-based businesses that were not currently claiming the HO deduction would do so if a standard deduction option was available.[31]	+/-

[27] IRS Publication 587, page 18

[28] H.R. 1509 (111th Congress), Home Office Simplification Act.

[29] Statement of Christopher Wagner Deputy Commissioner, Small Business/Self-Employed Division Internal Revenue Service before the House Committee on Small Business Subcommittee on Regulations, Healthcare and Trade, 07/30/08, page 8; http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_house_hearings&docid=f:42523.pdf.

[30] Testimony of Keith Hall, National Tax Advisor, The National Association for the Self-Employed, House Committee on Small Business Subcommittee on Finance and Tax Hearing on "How the Complexity of the Tax Code Hinders Small Businesses." 05/07/09, pages 52 - 58; http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_house_hearings&docid=f:48882.pdf.

[31] Hall testimony, *supra*..

in a transaction should be kept to a minimum.	But it is likely that the addition of a standard HO deduction could influence taxpayers to create home offices that don't already have one. However, in order to take the standard HO deduction, the taxpayer must still meet the stringent eligibility requirements. So, taxpayers cannot take the deduction simply because they decide to have a HO. Eligibility will still be driven by the qualifying business use as determined by taxpayer circumstances (or in the case of an employee, for the convenience of the employer.) Rules to prevent abuse of the standard HO deduction would also help to reduce the likelihood of intentional noncompliance. See Minimum Tax Gap below.	
Economic growth and efficiency – Will the tax unduly impede or reduce the productive capacity of the economy?	The standard HO deduction will enhance economic growth and efficiency because the time and cost used to calculate the deduction under the current method could be used by entrepreneurs to grow their businesses. Every dollar spent on tax professionals is less money reinvested into small businesses.[32] Simplification of complex calculations such as the HO deduction can improve economic efficiency.	+
Transparency and Visibility – Will taxpayers know that the tax exists and how and when it is imposed upon them and others?	Taxpayers will know that the optional standard deduction exists when they prepare their tax returns. The standard deduction will be visible to taxpayers on modified tax forms and instructions. Small business organizations and the U.S. Small Business Administration are also likely to help small business owners know of the new rule.	+
Minimum tax gap – Is the likelihood of intentional and unintentional non-compliance likely to be low?	Providing a simple standard deduction that is a flat amount could increase the likelihood of intentional non-compliance. Individuals who do not have home offices could intentionally take the deduction to which they are not entitled. To deter abuse of the standard deduction, instructions could be modified to explicitly remind taxpayers of the qualifying requirements to take the deduction and/or rules could be added to ensure compliance. For example, taxpayers could be required to answer a set of questions (under penalties of perjury) and attach them to the return in order to take the standard deduction (part of Form 8829). And, the standard deduction amount should be the lesser of $1,500, or business income, so that some level of income is required to take the deduction. As a positive, the likelihood of unintentional non-compliance would be reduced by providing certainty of the deduction amount for taxpayers who are currently calculating the HO deduction incorrectly.	-/+
Appropriate government revenues – Will the government be able to determine how much tax revenue will likely be collected and when?	The cost of providing a standard HO deduction could be estimated using the current level of returns filed with a HO deduction plus an increase for additional taxpayers who would be expected to take the deduction once simplified. For example, the 2007 IRS Taxpayer Advocate Report indicated that while 8 million of the 20 million Schedule C filers in 2003 had a HO, only 2.7 million claimed the deduction.[33] If 60%[34] of the other 5.3 million eligible filers took a $1,500 standard deduction, the total deduction amount would be about $4.8 billion.	+

[32] Hall testimony, *supra*..
[33] House Committee on Small Business Report, *Seven Ways to Stimulate the Economy by Updating the Internal Revenue Code*, April 2008, page 6; http://www.house.gov/smbiz/democrats/Reports/small-business-committee-tax-report.pdf.
[34] Hall testimony, *supra*..

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Tax Analysis Summary

A standard home office deduction meets the principles of good tax policy other than minimum tax gap.

Possible Improvements

- To address the tax gap issue, rules could be added to prevent the standard deduction from being abused, and without increasing complexity. For example, adding questions about the home office to Form 8829, could help individuals know if they qualify for the deduction and discourage abuse.
- Relax the exclusive use requirements to allow for de minimis personal use. This would bring greater equity to small businesses operating out of their home relative to businesses that own or rent separate office space.

Increasing the Gasoline Excise Tax

By SJSU Tax Research Students (Bus 223A)

Fall 2010

Introduction

The Highway Trust Fund, primarily funded by the gasoline excise tax, has had shortfalls in recent years and an $8 billion transfer from the General Fund was required in 2008.[35] The shortfall stems from people buying less gasoline either due to its high price or because they now drive an alternative fuel vehicle. One solution to the funding shortfall would be to increase the gasoline excise tax, such as from the current 18.4 cents per gallon[36] to double that or more.

Evaluation of an increased federal gasoline excise tax

Principle	Application	+/-
Equity and Fairness – Are similarly situated taxpayers taxed similarly? Also consider any different effects based on an individual's income level and where they live.	While all taxpayers pay the same amount of excise tax for every gallon of gasoline they purchase, the effect in terms of income vary among taxpayers. The gasoline excise tax is a regressive tax in that it represents a greater portion of the income of a low-income taxpayer relative to a higher income taxpayer. For example, assume two individuals each purchase the same number of gallons of gasoline and each pay gasoline excise tax of $200 during the year. If one individual has $20,000 of income and the other has $200,000 of income, the tax represents 1% of the income of the low-income taxpayer and 0.1% of the income of the high income individual.	—
Certainty – Does the rule clearly specify when the tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined?	An increase in the tax rate does not change the certainty level for the tax.	n/a

[35] See Department of Transportation timeline at http://www.dot.gov/affairs/highwaytrustfund/timeline.htm.
[36] See Department of Transportation, Highway History at http://www.fhwa.dot.gov/infrastructure/gastax.cfm.

Convenience of payment – Is tax due at a time that is convenient for the payor?	Increasing the tax rate will not affect convenience of payment as taxpayers will know the cost of a gallon of gasoline before purchasing it.	n/a
Economy in collection – Are the costs to collect the tax at a minimum level for both the government and taxpayers? Also consider the time needed to implement this tax.	Given that the tax is collected from the producer or refiner, rather than the final consumer, economy in collection will not be affected by the increase in the tax rate.	n/a
Simplicity - Can taxpayers understand the rules and comply with them correctly and in a cost-efficient manner?	The gasoline tax will not be simpler or more complex with a rate change. Since the tax base and all definitions and rules remain the same, there will be no change in this principle.	n/a
Neutrality - The effect of the tax law on a taxpayer's decisions as to how to carry out a particular transaction or whether to engage in a transaction should be kept to a minimum.	A higher gasoline excise tax will lead many taxpayers to purchase less gasoline because the price is likely to be higher (producers are likely to pass the higher tax along to consumers).	—
Economic growth and efficiency – Will the tax unduly impede or reduce the productive capacity of the economy?	A higher gasoline excise tax is likely to have adverse effects on the economy. Higher gasoline prices will adversely affect the transportation and travel industries. Higher gasoline excise taxes will better fund the Highway Trust Fund such that funds will not need to be taken from the General Fund. Thus, other taxes do not have to be increased or spending decreased, including spending on highway maintenance and construction.	**+ / --**
Transparency and Visibility – Will taxpayers know that the tax exists and how and when it is imposed upon them and others?	Like many excise taxes, the gasoline excise tax is not visible to the final consumer even though the payor (often the producer or distributor) likely passes its cost along to the consumer. For example, a consumer's receipt from filling up their car tank with gasoline will not list the amount paid that represents their share of the gasoline excise tax. Thus, an increase in the gasoline excise tax will not be obvious as a tax increase. It is likely that many buyers will just view it as a regular price increase.	—
Minimum tax gap – Is the likelihood of intentional and unintentional non-compliance likely to be low?	Because the gasoline excise tax is paid by the manufacturer or refiner rather than the final consumer, compliance rates are high. This will not change with a higher rate.	n/a

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Appropriate government revenues – Will the government be able to determine how much tax revenue will likely be collected and when?	There should be little challenge in determining how much tax will be generated from a higher gasoline excise tax. Data exists on price elasticity of gasoline will help determine how much tax is likely to be generated from a higher gasoline excise tax.	+

Tax Analysis Summary

An increased gasoline excise tax does not meet three principles of good tax, meets one, is mixed on two and a few of the principles are not helpful in analyzing this type of tax change. Thus, it is mixed as to whether the proposal meets the principles of good tax. Consideration should be given as to whether any changes can be made to the proposal to better enable it to meet more of the principles of good tax policy.

Possible Improvements

To address the equity issue, a credit could be added to the income tax to provide relief to low-income individuals. To address the transparency issue, sellers could be required to note the excise tax amount on receipts given to final consumers. The neutrality issue may be one that cannot be addressed. Higher gasoline prices will result in people buying less gasoline. While that may also mean that individuals are driving less and causing less wear and tear on the roads, this is not necessarily true. That is, individuals may be driving more fuel efficient cars and actually driving more. Congress should consider other ways to impose a gasoline excise tax rather than a fixed amount per gallon of gasoline. Alternative approaches include imposing a tax based on miles driven. Such a proposal should also be evaluated against the principles of good tax policy.

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