

# The Contemporary Tax Journal

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# The Contemporary Tax Journal

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**T**ax Enlightenment

**F**eature Articles

**H**igh Tech Tax Institute

**T**EI- SJSU Tax Policy Conference

**T**ax Maven

**F**ocus on Tax Policy

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## Letter from the Editor

Change is one constant in life. Some changes we can control, like those extra pounds we gain. Others are inevitable, like aging. Some changes take time, such as fine wine. Given the essential catalyst, some changes are rapid, even instantaneous.

Silicon Valley epitomizes change. We are in constant pursuit of innovation - disruptive changes. Companies failing to maintain or outpace technology or market changes become irrelevant. Individuals failing to adjust stagnate. The U.S. tax law, however, is not only slow to change, but also slow to adapt to our increasingly global and digital economy. Change will happen, when the essential catalysts are present.

The topic of change permeates through this edition of *The Contemporary Tax Journal*. In the Tax Enlightenment section, we present four students' work. The "100th Anniversary of the 16th Amendment" transports you to 1913 explaining why and how the United States Constitution was changed to give Congress the power to impose an income tax. Lisa Pan's contribution on research credit clarifies the rules set out by Congress to encourage innovation. Tejal Shah explains the principle residence non-qualified use rule and Yan Jiang analyzes a court case regarding eligibility of double taxation relief for flight crew.

We are very grateful for an expert contribution from Mr. Tom Hopkins, CEO, *Fortisure Consulting L.P.*; and Ms. Kara Boatman, Senior VP, *Fortisure Consulting L.P.*. Written after Apple's 2012 victory against Samsung, their article highlights the challenges in valuing intellectual property (IP) and

explains the accepted valuation methodologies and their impact on the IP values. This is very pertinent information for those of us who work or study in Silicon Valley.

The sessions summaries from the 28th High Technology Tax Institute and the Tax Policy Conference highlight trending tax issues in Silicon Valley. Two Tax Mavens interviews are included in this bumper issue. The interview with Mr. Dan Kostenbauder offers special insights into the tax legislative process in Washington and the challenges in achieving federal tax reform. Sandra Peter's piece gives us a glimpse of Mr. Fred Silva's personality and his involvement in California and local policies development.

The Focus on Tax Policy features seven analyses of tax rules using principles of good policy outlined by AICPA. These evaluations augment our library of tax policy analysis by SJSU MST students. You can read about them [here](#). Finally, thank you to Professors Annette Nellen and Bobbi Makani for their continuous guidance, and Stuti Seth for her artistic and tireless contribution to design and layout. I commend all the students who chose to support this edition. Thank you for your diligence and your contribution to raising awareness on tax issues. Awareness is certainly one essential catalyst to influence change.

**Victoria Lau**  
**Student Editor**

# Tax Enlightenment



## 100th Anniversary of the 16th Amendment

By: Victoria Lau, *MST Student*

February 3, 2013 marked the 100th anniversary of the 16th Amendment. This article explains why lawmakers proposed the 16th Amendments and the legislative process for it to become part of the Constitution of the United States.

the Office of the Commissioner of Internal Revenue (later renamed as the Internal Revenue Services in 1953) to supervise the collection and assessment of tariffs and income tax. These early tax acts included sunset, or expiry, dates and the lawmakers allowed these first income taxes to expire in 1872. The Federal government relied on

“ARTICLE XVI. The Congress shall have power to lay and collect on incomes, from whatever source derived, without apportionment among several States, and without regard to any census or enumeration.”

Figure 1: Amendment 16 of the Constitution of the United States<sup>1</sup>

### Why was the 16th Amendment proposed?

The 16th Amendment authorizes Congress to levy income tax without reference to the States' population. Congress, however, first imposed progressive income tax starting in 1862 primarily to raise revenue for the Civil War. The Tax Act of 1862 also established

<sup>1</sup> From National Archives. Retrieved from [http://www.archives.gov/exhibits/charters/charters\\_downloads.html](http://www.archives.gov/exhibits/charters/charters_downloads.html)

consumption taxes in the form of tariffs as the main source of revenue.

Over twenty years later in 1894 during President Cleveland's administration, income tax at a rate of 2% for incomes over \$4,000 was enacted. This led to the Supreme Court decision in *Pollock v. Farm Loan and Trust Co.*<sup>2</sup> which held that the uniform tax imposed by Congress was unconstitutional as a direct tax on land that was not apportioned among the States based on population. The Court

<sup>2</sup> *Pollock v. Farm Loan and Trust Co.*, 158 U.S. 601, (1895).

formed its opinion based on its interpretation of two clauses of the Constitution: Article I Section 2 which states that “representatives and direct Taxes shall be apportioned among the several States which may be included within this Union, according to their respective Numbers” and under Section 9, that states “No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census.”

Many lawmakers at the time believed that Pollock was erroneous and, given an opportunity, the Court would distinguish or reverse Pollock. However, President William Taft urged Congress to propose a constitutional amendment rather than pass another income tax bill to directly challenge the Supreme Court. Taft was concerned that such a dare would weaken the Supreme Court and harm its prestige.<sup>3</sup> He would later be nominated by President Warren Harding to serve as Chief Justice (1921 – 1930).

### How was the 16th Amendment ratified?

Amendments to the Constitution of the United States must be either proposed by Congress with a two-thirds majority vote in both the House of Representatives and the Senate, or by a constitutional convention called for by two-thirds of the State legislatures. The 16th Amendment, like the other twenty-six amendments to the Constitution, was proposed by joint resolutions from Congress. It was unanimously passed by the Senate on July 5, 1909 and by the House a week later on July 12. Proposals for constitutional amendments do not require Presidential approval.

The proposed amendment must then be ratified by three-fourths of the State Legislatures for it to become part of the Constitution. The federal income tax on

<sup>3</sup> Amar. A. (2006). *America's Constitution*, New York: Random House. p. 409.



Figure 2: Admission of States and Territorial Acquisition from U.S. Bureau of Census<sup>4</sup>

individuals was gaining popularity by this time but it still took 1,302 days for it to move through the States' Legislatures. On February 3, 1913, New Mexico was the 36th State to ratify the Amendment to meet the three-quarter threshold.<sup>5</sup> There were only forty-eight states in the Union in 1913. New Mexico and Arizona joined in 1912 after the 61st Congress proposed the Amendment. Alaska and Hawaii did not gain statehood until 1959 to make up the current fifty states in the Union.

On February 25, 1913, during the last week of the outgoing Taft Administration, Secretary of State Philander Knox signed the proclamation to declare the ratification of the Amendment. President Woodrow Wilson took office on March 4, 1913 and the 63rd Congress enacted the Tariff Act on October 3, 1913.

<sup>4</sup> Form the Perry-Castaneda Library Map Collection. Retrieved from <http://www.lib.utexas.edu/maps/histus.html>

<sup>5</sup> House Doc. 110-50 (2007, Jul. 25). *The Constitution of the United States As Amended*. Retrieved from <http://www.gpo.gov/fdsys/pkg/CDOC-110hdoc50/pdf/CDOC-110hdoc50.pdf>

The 1913 Act introduced a normal income tax of 1% on net income with a personal exemption set at \$3,000, and a six-tier additional tax with a top rate of 6% on net income exceeding

the one hundred years since Congress had been given the authority to impose an income tax.



“The New Man on the Job” by John Scott Clubb, 1913 ([Tax History Project](#))

\$500,000.<sup>6</sup> In 2012 dollars, an individual would pay 1% tax on income over \$69,500 and 7% tax on income in excess of \$11.6 million.<sup>7</sup>

In 1916, about 437,000 taxpayers filed a tax return.<sup>8</sup> In 2010, 142,890,000 tax returns were filed,<sup>9</sup> a three-hundred fold increase in

6 Section II(A)(1) and (2) of the Tariff Act of October 3, 1913 on Imports into the United States, Washington GPO 1913. Reproduced by the Connell University Library on OpenLibrary.org. Retrieved from <http://archive.org/stream/cu31924014051373#page/n1/mode/2up>

7 Per CPI Inflation Calculator from the Bureau of Labor Statistic. Retrieved from <http://data.bls.gov/cgi-bin/cpicalc.pl>

8 Tax Foundation. (2011, Oct. 18). Federal Individual Income Tax Returns with Zero or Negative Tax Liability, 1916-2010. Retrieved from <http://taxfoundation.org/article/federal-individual-income-tax-returns-zero-or-negative-tax-liability-1916-2010>

9 IRS SOI Tax Stats – Individual Income Tax Returns Publication 1304. Retrieved from [http://www.irs.gov/uac/SOI-Tax-Stats-Individual-Income-Tax>Returns-Publication-1304-\(Complete-Report\)#\\_pt1](http://www.irs.gov/uac/SOI-Tax-Stats-Individual-Income-Tax>Returns-Publication-1304-(Complete-Report)#_pt1)

1913 Tax Form ([National Archive](#))



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# Research Credit: A Journey of Uncertainty

By: Lisa Pan, *MST Student*

The passage of the “American Taxpayer Relief Act of 2012” (P.L. 112-240, 1/2/2013) temporarily removed uncertainties surrounding the Research Tax Credit (IRC §41: Credit for Increasing Research Activities) as this provision was once again extended, for the fourteenth time, through the end of 2013. The credit expired at the end of 2011 so the new extension applies retroactively to cover



the 2012 tax year. However, the law was only signed into effect after December 31, 2012;<sup>1</sup> therefore, a taxpayer cannot include the tax benefit in their income tax provision for financial statements ending on December

1 PriceWaterhouseCooper. (2013, Jan. 8). Fiscal Cliff Legislation Extends Research Credit, Resolves M&A-related Credit Issue. WNTS Insight. Retrieved from [http://www.pwc.com/en\\_US/us/washington-national-tax/newsletters/wnts/assets/pwc-legislation-extends-research-credit-resolves-m-issue.pdf](http://www.pwc.com/en_US/us/washington-national-tax/newsletters/wnts/assets/pwc-legislation-extends-research-credit-resolves-m-issue.pdf)

31, 2012. Instead, this benefit must be recognized in the first quarter of 2013.

The research credit is a nonrefundable credit available to businesses that conduct qualified research activity. Taxpayers have to increase their research activity from year to year in order to receive this credit. Lawmakers never passed this as a permanent provision and introduced many changes with each temporary extension. Today, businesses of all sizes claim a total of about \$7.8 billion in research credit annually.

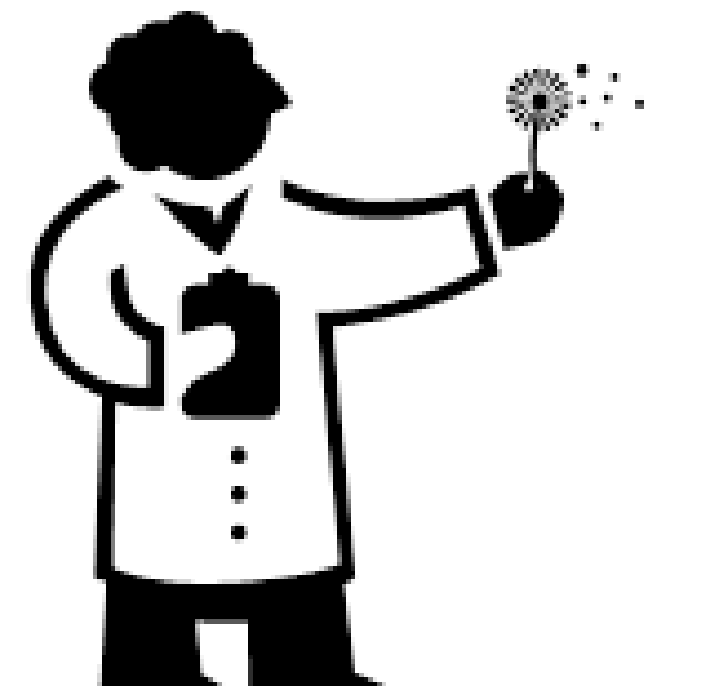
IRC §41 was introduced in 1981 as a temporary provision to stimulate domestic research activities. It has been extended every year since then with the exception of 1995. Each extension brought modifications to the scope of “qualified research.” After the amount of qualified research expense is determined, the taxpayer may choose from the two available formulas (Regular Credit or Alternative Simplified Credit) to calculate the actual credit amount

The Tax Reform Act of 1986 (TRA 1986) provided the most significant change to the definition of qualified research. It added three additional qualifying requirements to the original condition that research expense must first be deductible under IRC §174 (though no double benefit is allowed) to be eligible for the **research credit**.<sup>2</sup>

2 Guenther, G. (2011, Nov. 29). *Research Tax Credit: Current Law, Legislation in the 112th Congress, and Policy Issue Congressional Research Service*. p. 26. Retrieved from

Subsequently, Treasury issued, withdrew, and reissued regulations to clarify the four tests set forth in TRA 1986. One major change in the 2004 final regulations eliminated the requirement to “obtain information that exceeds, expands or refines the common knowledge of skilled professionals in the particular field of science or engineering.”<sup>3</sup> Before this change was made, the IRS believed that research must be for discovery of revolutionary breakthrough in order to qualify for the credit. This test was extremely difficult test to meet. The new regulations expanded this test to include evolutionary advancements.<sup>4</sup>

In *U.S. vs. McFerrin*, the Court of Appeals for the Fifth Circuit held that the 2004 regulations apply retroactively to years before the regulations went into effect. In its analysis, the Fifth Circuit rejected the lower court’s finding that “discovering information meant going beyond the current state of knowledge in the field” and cited from the 2004 regulations



<http://www.ieeeusa.org/policy/eyeonwashington/2011/documents/researchtaxcredit.pdf>

3 Treasury Regulation §1.41-4(a)(3)(ii).  
4 Guenther, 2011, p.27.

that the “discovery of information” test can be satisfied by “elimination of uncertainty.”<sup>5</sup>

Today, a “Four Part Test”<sup>6</sup> is generally applied to determine whether research expenses are qualified for the credit:

## 1) Elimination of Uncertainty

Also known as the “§174” test. IRC §174 initially did not clearly define “research and development” (R&D). Later regulations specified that R&D expenditure “must be related to activities intended to discover information that would eliminate uncertainty concerning the development.”<sup>7</sup> In other words, the end result is initially uncertain and requires further development, testing, and refinement of hypothesis.<sup>8</sup> Interestingly, the law does not require the research to produce a successful outcome.<sup>9</sup> Failure is often a convincing demonstration of the uncertainty test because, by definition, uncertainty implies the process will not always work as intended.

A recent case illustrated this point in practice. In *U.S. vs. Davenport*,<sup>10</sup> the court decided in favor of the IRS because the taxpayer’s testing of software “did not involve a series of trials to test a hypothesis or a series of experiments with one or more alternatives.” The software in question was developed and customized for the taxpayer by a third party and has worked as intended even before testing. Therefore, research credit is not available for the expenses incurred to integrate and test this software.

5 *U.S. vs. McFerrin*, 570 F.3d 672, (CA-5, 2009).

6 IRC §41(d)(1).

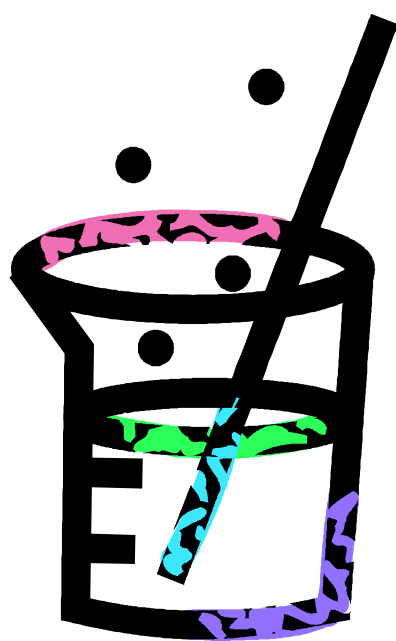
7 Treasury Regulation §1.174-2(a).

8 Conference Report No. 99-841, 1986-3 C.B. Vol 4, 72.

9 Treasury Regulation §1.41-4(a)(3).

10 *U.S. vs. Davenport*, 2012-2 USTC ¶50,568 (DC TX, 2012).





## 2) New or Improved Business Components:

The activity must be undertaken to develop a new or improved business component—a product, process, computer software, technique, formula, or

invention.<sup>11</sup> The 2004 regulations significantly expanded the scope of business component beyond just tangible “products.” This reflected a nationwide shift of research focus at the time as more and more research was geared towards developing intangible assets.

## 3) Technological in Nature:

The process of experimentation has to rely on the principal of physical and biological sciences, engineering, and computer science. This effectively precludes all research in social sciences.<sup>12</sup>

While taxpayers sometimes apply the notion of R&D creatively, courts have generally interpreted the “technological nature” test rather narrowly—limiting qualifying activities to those that are directly related to scientific principles or are laboratory-based. In *Heritage Organization et al vs. Commissioner*,<sup>13</sup> the Tax Court firmly denied the taxpayer’s claim for expenses incurred to research tax planning strategies involving “a set of shell corporations with embedded losses.” Even

though tax research is often a time consuming process with uncertain outcome, it is clearly not a scientific activity in its ordinary meaning. The court did not consider the research was performed for “elimination of uncertainty,” it reasoned that in the world of tax planning, uncertainty is usually eliminated by a change of law and not by actions undertaken by the taxpayer.

## 4) Process of Experimentation

Research is conducted using fundamental scientific principles for a new or improved function, performance, reliability, or quality. The regulations also exclude the improvements of style, taste, and design factors from qualified research.

The research credit can provide eligible taxpayers with tremendous savings, about 13% (federal and state combined) for every dollar generated for businesses is of research expenditure.<sup>14</sup> However, just how effective has the credit been in encouraging research and producing economic benefit for the larger society? Figure 1 gives a snapshot of research expense borne by government and private sector.

The federal government remains the top funder for basic research. However, businesses’ share of applied research has increased steadily since the introduction of the research credit, while the federal share has declined.

Applied research often lacks the “spillover” benefits compared to basic research, but often provides a higher return on investment because it relates more directly to the business’ income producing activity.<sup>15</sup> If spillover benefits are desired and broad scope basic research becomes a requirement to

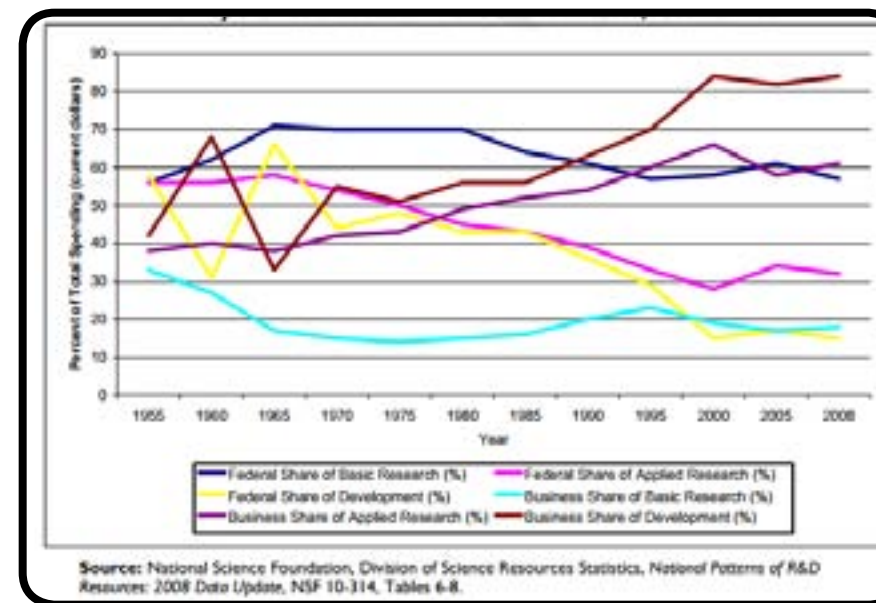


Figure 1: Share of U.S. Spending (in current dollars) on Research and Development Held by the Federal Government and Businesses, 1955 to 2008<sup>16</sup>

<sup>16</sup> Guenther, 2011, p. 31.

claim the credit, the law would revert back to the original “discovery test” which disqualified many innovative research at the time. Since its enactment, the research credit has been a frequently debated legislation:

- What should be changed to target certain desirable research?
- When, if at all, will it become permanent?
- How to carry out the many proposed changes, through comprehensive reform or gradual guidance?

Congress faces the same questions every couple of years whenever the temporary provision sunsets.

From 2005 to 2009, an average of 12 million businesses claimed \$7.8 billion in research credit each year. Figure 2 compares the dollar amount of credit claimed and the number of claimants at each level of business receipts for 2008 and 2009.

Not surprisingly, the largest corporations claimed the greatest amount at over 80%, even if they made up only 13% of the total number of claimants. This 13% is similar to the percentage of credits claimed by smallest corporations, at the other end of the scale in business

receipts.

This pattern potentially suggests that claims for research credit correlates to both a company’s total research activity as well as the share of research among all of its activities. Take the high tech industry as an example, larger companies will incur more research expenses. Although the research expenses are only a very small portion of the companies’ total expenses, the significant dollar amounts would generate decent size credits. At the other end of the scale, early stage tech companies may not have many customers but would be conducting extensive research to develop their first products.

Since the activities of these early stage startup companies are focused on research, these companies are also good candidates for the credit.

Additionally, significant amounts of credits were claimed by mid-size businesses, with receipts between \$10 million and \$50 million. These mid-size businesses, making up 20% of total claimants, received close to \$350 million worth of research credit. One explanation for this statistic is that mid-size companies have tremendous growth potential

<sup>11</sup> Treasury Regulation §1.41-4(b)(2).

<sup>12</sup> Conference Report No. 99-841, 1986-3 C.B. Vol 4, 71.

<sup>13</sup> TC Memo 2011-246.

<sup>14</sup> Oster, R. and Snead, M. (2013, Jan. 15). *Federal and State Tax Credits Overview*, CalCPA Education Foundation Presentation

<sup>15</sup> *Ibid.*

Size of Business Receipts (in whole dollars)	Year							
	2009				2008			
	Amount of Claim		Number of Claimants		Amount of Claim		Number of Claimants	
Under \$25,000	\$207,937	2.67%	1,906	15.42%	\$259,250	3.12%	1,721	13.51%
\$25,000 under \$100,000	\$22,044	0.28%	318	2.57%	\$23,219	0.29%	313	2.48%
\$100,000 under \$250,000	\$21,012	0.27%	293	2.37%	\$29,092	0.36%	385	3.02%
\$250,000 under \$500,000	\$23,788	0.31%	189	1.53%	\$33,854	0.41%	302	2.37%
\$500,000 under \$1,000,000	\$34,440	0.44%	254	2.06%	\$33,297	0.40%	296	2.32%
\$1,000,000 under \$2,500,000	\$68,593	0.88%	1,256	10.16%	\$84,405	1.02%	1,388	10.88%
\$2,500,000 under \$5,000,000	\$88,233	1.13%	1,138	9.21%	\$91,134	1.10%	1,216	9.55%
\$5,000,000 under \$10,000,000	\$78,049	1.00%	1,072	8.67%	\$96,910	1.17%	1,233	9.68%
\$10,000,000 under \$50,000,000	\$348,728	4.49%	2,636	21.34%	\$347,441	4.18%	2,583	20.26%
\$50,000,000 under \$100,000,000	\$199,425	2.57%	800	6.47%	\$182,221	2.19%	797	6.26%
\$100,000,000 under \$250,000,000	\$300,972	3.87%	809	6.55%	\$328,015	3.93%	771	6.05%
\$250,000,000 or more	\$6,380,762	82.08%	1,696	13.64%	\$6,796,532	81.85%	1,734	13.61%
Total	\$7,773,979	100.00%	12,359	100.00%	\$8,303,359	100.00%	12,736	100.00%

Figure 2: Corporations Claiming a Credit for Increasing Research Activities. Claimed credit Amounts (thousands of dollars) and Number of Claimants by Size of Business Receipts [All figures are based on samples]<sup>17</sup>

and were likely to have demonstrated some degree of success, making it easier for them to attract capital necessary to fund more research. For these companies, their aim is expansion in both existing and new markets thus, making research an integral part of that growth strategy.

Much like the research it is intended to stimulate, IRC §41 has been through countless evolutionary refinements over the years, and as a temporary provision, its fate still remains uncertain after 2013. While it is difficult to speculate what the research environment would have been like in the last thirty years without this credit, the benefit it crystal clear. For the U.S. to continue its lead

in technological breakthroughs, companies would have to count on the research credit to embrace many more changes into the future



<sup>17</sup> IRS SOI Tax Stats – Corporate Tax Statistics. Retrieved from <http://www.irs.gov/uac/SOI-Tax-Stats-Corporation-Tax-Statistics>

# Nonqualified Use of Principal Residence

By: Tejal Shah, *MST Student*

In 2008, Congress introduced a new requirement under IRC §121 to limit the gain from sale of home where an individual lives – otherwise known as principal residence. For an individual who owns two homes, the principal residence is the one where the individual spends the majority of his/her time. When an individual is not using his home as principal residence, the new law treats it as non-qualified use and the gain related to non-qualified use is taxable as capital gain.

In 2008, Congress introduced a new requirement under IRC §121 to limit the gain from sale of home where an individual lives – otherwise known as principal residence. For an individual who owns two homes, the principal residence is the one where the individual spends the majority of his/her time. When an individual is not using his home as principal residence, the new law treats it as non-qualified use and the gain related to non-qualified use is taxable as capital gain.<sup>1</sup>

IRC §121 exclusion provision provides that when an individual sells a principal residence, he/she can exclude gain up to \$250,000 (or \$500,000 for married individuals filing a joint return). To claim the exclusion, the individual must have:<sup>2</sup>

- Owned the home for two out of five years before the sale.
- Used the home as principal residence for period totaling two years out of the five years before the date of sale (For the \$500,000 exclusion, both married individuals must meet the use requirement).
- Not claimed the exclusion on sale of home in the last two years.

If the individual fails to meet these requirements, the entire gain is taxable unless the individual sells the home due to employment, health, or unforeseen circumstances.<sup>3</sup> Also, the individual cannot exclude any depreciation claimed on the property for any period after May 6, 1997. If an individual has already claimed depreciation on home, he/she must recapture depreciation as a gain which will be taxed at the preferential rate of 25%.<sup>4</sup>

Many individuals abused the tax-benefit provisions by converting their rental or investment properties into principal residences and then selling them after meeting the use requirements.<sup>5</sup> By doing so they were excluding the entire gain amount up to \$250,000 (or \$500,000 for married individuals filing joint returns).

To stop this practice, Congress added a new rule on non-qualified use of principal residence when it passed the “Housing and Economic Recovery Act of 2008.”<sup>6</sup> Now, an individual cannot exclude the portion of gain which belongs to non-qualified use of principal residence from his/her gross income.<sup>7</sup> Please see Equation 1 for computing gain allocable to nonqualified use below.

$$\frac{\text{Total Period of non-qualified use}}{\text{Total ownership period}} \times \text{Gain on sale of property}$$

Equation 1: To compute gain allocable to non-qualified use according to IRC §121(b)(4)(B)

1 IRC §§1221 to 1223.  
 2 IRC §§121 (a) and (b); Reg. §§1.121-1(a) and (c); and Reg. §1.121-2(b).  
 3 IRC §121(c), and Reg. §1.121-3.  
 4 IRC §1250 on unrecaptured gain.  
 5 Joint Committee on Taxation Report. JCX-63-08, Retrieved from <http://www.jct.gov/s-1-09.pdf>  
 6 PL 110-289 Sec. 3092.  
 7 IRC §121(b)(4). The new law does not affect the non-qualified use period before Jan. 1, 2009.

The term “period of non-qualified use” means any period during which the home was used as a rental or investment property and not as principal residence by an individual.<sup>8</sup> However, the following are exceptions to the period of non-qualified use:

- Any period after the last day home was used as the principal residence by an individual until the date of sale. Also, such period should be within 5 years before the date of sale.<sup>9</sup>
- Any period (not more than 10 years) during which an individual served on qualified official extended duty.<sup>10</sup>
- Any other period of temporary absence (not more than 2 years) due to health conditions, change of employment, or other unforeseen circumstances (as provided in law).<sup>11</sup>

Here is an example to illustrate the difference between the current and prior laws on gain exclusion.

**Facts**

- Taxpayer X buys a home on January 1, 2007 for \$600,000 and rents the place until December 31, 2011.
- From January 1, 2012 to December 31, 2016, X lives in it.
- On January 1, 2017, X moves out and rents the place until December 31, 2018.
- On January 1, 2019, X sells the house for \$800,000. The depreciation claimed on the property when rented was \$50,000.

**Issue**

How much gain will X recognize on the sale of home?

**Computation of gain**

Equation 2 illustrates the computation of the adjusted basis and net gain on sales, and the classification of depreciation recapture and gain.

<b>Cost Basis</b>	<b>\$600,000</b>
<b>Less Depreciation.</b>	<b>(50,000)</b>
<b>Adjusted Basis (a)</b>	<b>550,000</b>
<b>Sale Price (b)</b>	<b>800,000</b>
<b>Net Gain in sale (b-a)</b>	<b>250,000</b>

- **\$50,000: Depreciation Recapture**
- **\$200,000: Gain to be considered for exclusion**

Equation 2: Computation of capital gain

8 IRC §121(b)(4)(C)(i).  
 9 IRC §121(b)(4)(C)(ii)(I).  
 10 IRC §121(b)(4)(C)(ii)(II).  
 11 IRC §121(b)(4)(C)(ii)(III).

## Analysis

- No exclusion for depreciation deducted. Depreciation recapture of \$50,000 tax at the preferential rate of 25%.<sup>12</sup>
- X meets the requirements stated in IRC §121(a) because he owned and used the home as his principal residence for 2 out of 5 years prior to the sale.
- Therefore, for the remaining gain of \$200,000, X must determine how much gain belongs to the period of non-qualified use and cannot be excluded from his gross income.
- The period of non-qualified use begins from the date when the property was rented on or after January 1, 2009. The timeline, for use is as follows:

1. 01/01/2007 to 12/31/2008, 2 years<sup>13</sup>
2. 01/01/2009 to 12/31/2011, 3years (non-qualified use)
3. 01/01/2012 to 12/31/2016, 5 years (qualified use)
4. 01/01/2017 to 12/31/2018, 2 years (non-qualified use)

- The period from January 1, 2017 to December 31, 2018 will not be included as non-qualified use because of the exception that it is the period after the home was last used as the principal residence but before the date of sale.
- Therefore, the total period of non-qualified use is 3 years. X owned the property for 12 years, i.e. from January 1, 2007 to December 31, 2018.
- As shown in Equation 3, X cannot exclude the gain of \$50,000 because it belongs to the period of non-qualified use. However, X can exclude the balance gain of \$150,000 (\$200,000 less \$50,000) under IRC §121.

<b>Period of non -qualified use</b>	<b>3</b>	<b>X</b>	<b>\$200,000 Gain = \$50,000</b>
<b>Total ownership period</b>	<b>12</b>		

Equation 3: Non-qualified use gain

## Conclusion

Taxpayer X will report a gain of \$100,000 (\$50,000 of depreciation recapture and \$50,000 of gain allocated to non-qualified use) on his tax return in the year of sale. Please see Table 2 which illustrates the comparison between the old and new tax law.

	<b>Under Old Law</b>	<b>Under New Law</b>
<b>Gain On Sale (a)</b>	\$200,000	\$200,000
<b>Exclusion (§121)(b)</b>	4200,000	\$150,000
<b>Taxable Gain after exc</b>	None	\$50,000
<b>Depreciation recapture</b>	\$50,000	\$50,000
<b>Total Gain to be recognised by A</b>	\$50,000	\$100,000

Table 2: Comparison under old and new law

Under the previous law, X would have excluded the entire gain of \$200,000. However, under the new law, X will now be able to exclude a gain of only \$150,000 from his gross income. As per the new law, the non-qualified use period starts only from January 1, 2009. Therefore, X was able to exclude gain from January 1, 2007 to December 31, 2008.

**So, the points to remember about IRC §121(b)(4), the new sub-section, are as follows.**

- The period of non-qualified use starts from January 1, 2009.
- Non-qualified use means the period during which home was not used as the principal residence.
- Gain allocable to non-qualified use period is taxable as capital gain.
- The non-qualified use period does not include:
  - The period after the last date the home was used as principal residence until the date of sale.
  - The period when an individual was away from home due to qualified official extended duty (not more than 10 years).
  - Temporary absence due to health, employment or other reasons (not more than 2 years).

<sup>12</sup> IRC §1(h)(E)(i). Unrecaptured §1250 gain is taxed at 25%.

<sup>13</sup> The new law does not affect the non-qualified use period before Jan. 1, 2009.

# A Tax Haven in the Friendly Skies?

By: Yan Jiang, *MST student*

You may know that U.S. expatriates are eligible for special tax benefits, but have you ever wondered about the tax treatment for flight attendants who fly intermittently between the U.S. and foreign countries? In 2012, the United States Tax Court issued a memorandum opinion, *Christina J. Letourneau v. Commissioner*, TC Memo 2012-45, addressing the use of the IRC §911 Foreign Earned Income Exclusion and IRC §901 Foreign Tax Credit as applied to flight attendants whose work causes them to travel between countries and in international air space.

The Taxpayer, a U.S. citizen, was a permanent resident of France. In 2005, the year in question, she commuted from France to London for her work as a flight attendant for United Airlines, Inc. She primarily flew between London and the United States. Her work time could, therefore, be allocated among activities such as flying over the United States, flying over international waters, and flying over foreign countries. The Taxpayer allegedly paid income taxes to the tax authorities in France and the U.K. In her 2005 U.S. tax return, the Taxpayer applied the IRC §911 Foreign Earned Income Exclusion and excluded her entire W-2 wages from her gross income. Under audit, the IRS determined that only a portion of her wages were eligible for the exclusion and denied her Foreign Tax Credit.

## The issues involved in this case were:

1. Whether the Taxpayer's wages were exempt from U.S. taxation according to Article 15(3) of the 1994 U.S.-France Income Tax Treaty ("Treaty");
2. Whether she was entitled to a larger Foreign Earned Income Exclusion than the IRS had allowed; and
3. Whether she was entitled to any amount of Foreign Tax Credit.

In analyzing the first issue, the Tax Court rejected the Taxpayer's contention that her total wages were exempt from U.S. tax under Article 15(3) of the Treaty. This article generally exempts from U.S. income taxation wages earned by a French resident who is a crew member of an aircraft operated in international traffic. The court agreed with the IRS that the "saving clause" contained in Article 29(2) of

the Treaty takes precedence and the U.S. reserves the right to tax its own citizens as though Article 15(3) of the Treaty does not exist. The Tax Court also objected to the Taxpayer's argument that the application of the saving clause discriminated against her in violation of Article 25(1) (Non-Discrimination clause) of the Treaty. The court explained that the clause is not intended to provide the Taxpayer relief from U.S. income taxation; it merely ensures that France does not impose a more burdensome tax on a U.S. taxpayer than it would impose on French citizens and residents.

On the issue of Foreign Earned Income Exclusion, the Taxpayer contended that her entire wages earned in the year was foreign earned income as defined under IRC §911(b)(1)(A); hence eligible for exclusion. The IRS, however, only allowed exclusion for wages attributed to activities performed in a foreign country and over foreign airspace calculated using United's standard time apportionment tables. Because only income earned from sources within a foreign country is eligible for exclusion,<sup>1</sup> the key issue evaluated by the Tax Court was whether or not international airspace meets the definition of a foreign country under IRC §911. The court cited *Rogers v. Commissioner*<sup>2</sup> which concluded that international airspace is not under the sovereignty of a foreign government; hence it is not a "foreign country" under IRC §911. Therefore, the wages earned by the Taxpayer while working in international airspace is not treated as foreign

*Wages earned by the Taxpayer while working in international airspace is not treated as foreign earned income and ineligible for IRC §911 exclusion*

earned income and ineligible for IRC §911 exclusion.

The Taxpayers also contended that the use of United's apportionment tables to calculate the allowable foreign income amount does not accurately reflect her actual times spent on specific flights. This contention was discounted by

<sup>1</sup> IRC §911(b)(1)(A) provides that the "foreign earned income" is amount received by a taxpayer from sources within a foreign country.

<sup>2</sup> TC Memo 2009-111.

the court because the Taxpayer failed to provide any proof that it is inaccurate or present other more reliable methods.

As a last resort, the Taxpayer suggested that she was entitled to exclude all her wages from gross income in 2005 because she did so in prior years without any challenge from the IRS. The court reminded the Taxpayer that IRS is “not precluded from challenging treatment of an item merely because he has failed to challenge it in the past.”

On the last issue regarding Foreign Tax Credit, the court found that the French taxes allegedly paid by the Taxpayer in 2005 were for tax liability of a previous year and were refunded to her later in that year. Furthermore, the Taxpayer failed to provide any evidence that she paid taxes to France in 2005. With respect to taxes paid to the U.K., the court agreed with the IRS that the Taxpayer is not entitled to the IRC §901 Foreign Tax Credit because the Taxpayer already excluded the income earned in the U.K. from gross income under IRC §911. Double benefits is denied under IRC §911(d)(6).

The most significant message from this Tax Court decision is that international airspace is not a tax haven. Income earned in international airspace is not eligible for IRC §911 Foreign Earned Income Exclusion because it is not earned within a foreign country. Recent similar cases, including this one, indicate that there has been confusion surrounding the definition of “foreign country” in the context of IRC §911. Perhaps Congress will clarify the definition down the road. Meanwhile, it is advisable for practitioners to ensure that U.S. expatriates are not erroneously taking double benefits in applying the IRC §901 Foreign Tax Credit and IRC §911 Foreign Earned Income Exclusion on the same income.





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# Apple's Big Win Highlights Uncertainty in Valuing Tech Investments

By: Tom Hopkins, CEO, *Fortisure Consulting L.P.*,  
and Kara Boatman, Senior VP, *Fortisure Consulting, L.P.*

## Abstract

Apple's victory against Samsung in 2012 reaffirms the power of patents and the extent to which they drive profits in the technology sector.<sup>1</sup> It also highlights the fact that the precise contribution of intellectual property ("IP") to firm value is a matter of perspective. Technology companies must value IP every time they engage in M&A activity, intercompany technology licensing, or tax-motivated IP migration. Significant methodological differences in each area create potential pitfalls for firms and practitioners in an increasingly skeptical investor and regulatory environment.

The profusion of IP litigation presents an additional challenge to technology companies. Expert witnesses and technology-savvy jurors can reach widely divergent conclusions regarding IP value. Moreover, those valuations are likely to differ substantially from results reached in the course of purchase price allocation and transfer pricing studies. Careful management of the preparation and dissemination of these analyses may allow firms to avoid costly misinterpretations of the results.

## Introduction

Apple's 2012 victory against Samsung reaffirms the value of patents and the extent to which they drive profits in the technology sector. It also highlights the fact that the precise contribution of intellectual property ("IP") to firm value is not easily measurable. In *Apple v. Samsung*, Apple's experts estimated that the company losses were in excess of

\$2.5 billion as a result of Samsung's patent infringement. Samsung's experts countered with a figure closer to \$520 million. The jury awarded \$1.05 billion. Which of these calculations, if any, approximates the true value of the infringed patents?

Questions about IP value extend well beyond the courtroom. Technology companies are faced with these questions every time they engage in merger and acquisition ("M&A") activity, intercompany

<sup>1</sup> *Apple, Inc. v. Samsung Electronics. Co.*, 678 F.3d 1314 (Fed. Cir. 2012).



technology licensing, or tax-motivated IP migration. Global technology firms often pursue these strategies simultaneously and, because valuation results are highly sensitive to their analytical context, companies may find themselves in the uncomfortable position of defending very different assessments of the value of their technology. Understanding accepted methodologies and their respective and comparative impact on estimates of IP value can facilitate a coordinated approach to these analyses. Well-reasoned and supported IP valuations may also avoid costly proceedings with courts, financial regulators and tax authorities.

### The Challenge of IP Valuation

IP drives enterprise value in technology-based economies. Unprotected sources of competitive advantage—know-how, processes and talent, to name a few - dissipate quickly in markets “turbo-charged” by immediate and continuous access to information. It’s no surprise, then, to see companies like Apple vigorously defend their IP when they believe it has been unlawfully appropriated. As a result IP claims continue to escalate, with litigants expending enormous resources to quantify the value of the disputed IP.

Even absent litigation, companies pay close attention to IP, continuously searching for new ways to extract value from existing IP and hunting for sources of valuable new technology. Google’s 2012 \$12.5 billion acquisition of Motorola Mobility was part of a specific strategy to expand the market for its Android operating system and protect its smartphone manufacturing partners.

IP exploitation enhances shareholder value by generating competitive advantages that result in higher profits. Firms devote substantial resources to research and development (“R&D”) activity, aggressively pursue IP through M&A, or employ a

combination of both strategies. In addition, companies may extract additional benefits from IP, either by deploying it simultaneously in several locations worldwide or by structuring and/or migrating R&D activities to reduce income tax liability.

In the case of M&A, U.S. and international regulations require that the acquiring entity report the value of the IP it has purchased in order to promote transactional transparency. If the company is migrating R&D activity or licensing the resulting IP to its cross-border affiliates, tax authorities require an IP valuation analysis in order to ensure compliance with the arm’s length standard and associated transfer pricing regulations.

Financial reporting and transfer pricing documentation requirements are not new; most companies are familiar with the accepted approaches to IP valuation for business combination studies and intercompany pricing analyses. Valuation and transfer pricing

*Well-reasoned and supported IP valuations may also avoid costly proceedings with courts, financial regulators and tax authorities.*

practitioners are aware of the differences in these approaches and the need to coordinate the respective analyses, especially when they involve exchanges of the same or similar technology at roughly the same time.

But the recent increase in IP litigation involving the biggest names in the technology sector presents an additional challenge to technology companies. Expert witnesses and technology-savvy jurors can reach widely divergent conclusions regarding IP value.<sup>1</sup>

<sup>1</sup> The *Apple versus Samsung* jury “ignored paid experts” and calculated the damage award itself. (2012, August 27). “Apple Victory Shifts Power Balance.” *The Wall*

Moreover, those valuations are likely to differ substantially from results reached in the course of purchase price allocation and transfer pricing studies, compounding the confusion. In an increasingly skeptical investor and regulatory environment, companies can ill afford suspicions that they have manipulated courts, investors or regulators, by proposing different valuations of IP to suit their purposes in each area.

Even absent direct involvement in IP litigation, technology companies should anticipate more challenges to their intercompany royalty studies and purchase price allocation analyses as information from high-profile litigation becomes public. The fact that significant differences exist across accepted methodologies in each area creates potential pitfalls for firms and practitioners alike.

Understanding these differences will not only allow firms to anticipate and respond to challenges, but may encourage a more coherent approach to IP valuation in the first place.<sup>2</sup>

### Reasonable Royalty Approach

The U.S. Patent Act allows a prevailing plaintiff in a patent infringement suit to recover compensatory damages for the economic harm caused by the infringer.<sup>3</sup> Ideally, a

*Street Journal*, p. A1. (2012, August 25). Elmer-DeWitt, Philip. “Apple v. Samsung: Meet the Foreman of the Jury.” Retrieved from <http://www.fortune.cnn.com>. Occasionally, the difference between the plaintiff’s and defendant’s expert valuation is so extreme and the analyses so complex, that the court or jury is suspected of “splitting the difference” in awarding damages.

<sup>2</sup> For ease of discussion, IP valuation for financial reporting purposes will hereinafter be referred to as “financial valuation” or the “financial reporting approach,” while IP valuation for intercompany pricing purposes will be referred to as “transfer pricing valuation” or the “transfer pricing approach.”

<sup>3</sup> U.S. Patent Act (2012), 35 USC §284 (1952).

damage award is based upon a determination of profits lost to the plaintiff as a result of the infringement. However, in cases where lost profits cannot be determined, either because the claimant has not lost sales to the infringer or because the calculation of lost profits is considered too speculative, the courts will accept a royalty analysis. In fact, even if lost profits can be determined, the Patent Act requires that, at a minimum, damages should reflect a “reasonable royalty” for use of the IP by the infringer.

The reasonable royalty approach posits a hypothetical negotiation between a willing licensor (the plaintiff) and licensee (the alleged infringer). The negotiation is assumed to take place on the date of first infringement. While the term “reasonable royalty” has no economic meaning, in order to be acceptable to both parties it must leave each better off than had it pursued other available alternatives. In the case of the alleged infringer, these alternatives include the possibility of designing around the patent to achieve comparable functionality without infringement. In cases where such a non-infringing alternative is feasible, the reasonable royalty cannot be higher than the design-around cost. Assessment of any alternatives yields a range bounded by the minimum acceptable royalty for the licensor and the maximum acceptable royalty to the licensee.

Typically, the courts accept a royalty analysis based on the IP-related profits anticipated by the infringer at the time of the hypothetical negotiation. In general, the royalty leaves the infringer with a portion of these intangible profits.<sup>4</sup> The argument is that

Retrieved from <http://www.uspto.gov>

<sup>4</sup> The courts may accept royalty rates on the high end of the range in cases of willful infringement, which was the principal finding in *Apple v. Samsung*. In addition, while the hypothetical negotiation is assumed to take place on the date of first infringement, courts sometimes consider

the hypothetical licensee would not agree to a royalty that did not allow it to earn a “reasonable” profit; economics dictates that the licensee would be willing to accept any royalty that results in higher profits than the next best alternative.

### Financial Reporting Approach<sup>5</sup>

For financial statement reporting purposes, an intangible asset is defined as one that is identifiable, “lacks physical substance” and is not a financial asset.<sup>6</sup> As long as that asset arises from legal or contractual rights, the asset will be recognized apart from goodwill. Intangible assets may be marketing-related, customer-related, artistic-related, contract-based or technology-based; this category of assets clearly includes patented technology.

When a U.S. firm makes an acquisition, it must recognize the assets acquired and

would the cost of any asset and allocates the price to the tangible, financial and intangible assets acquired. Assets must be recognized at fair value, defined as the price at which an asset could be bought or sold in a current transaction between market participants.<sup>7</sup>

ASC 350 addresses how acquired intangibles should be accounted for in financial statements, both upon and following their acquisition. It prohibits the amortization of goodwill and some intangible assets, where goodwill is defined as the excess of the purchase price over the fair market value of net assets. The value of any amortized intangibles, those intangible assets that arise from contractual or legal rights or are separable from other assets, must be documented and supported by financial analysis.<sup>8</sup> ASC 805 and ASC 350 effectively require firms to recognize and value intangible assets on

*The FASB accepts three general approaches to intangible asset valuation: the market approach, the income approach and the cost approach.*

liabilities assumed, and adjust for any non-controlling interest in the acquired entity. The Financial Accounting Standards Board (FASB) codified these requirements in ASC 805, which requires firms to use the purchase method of accounting when reporting business combinations. That is, the acquiring firm records the price of the merger as it

subsequent information, especially if it supports a higher royalty rate. In both cases, the court’s discretion is designed to reinforce the punitive nature of the damages award.

<sup>5</sup> The reporting requirements described here are based on Financial Accounting Standards Board statements. However, by design, they correspond closely to international reporting requirements.

<sup>6</sup> Financial Accounting Standards Board (FASB) Business Combinations (revised 2007) Paragraph 3. Retrieved from <http://www.fasb.org>

an individual basis, in order to provide more relevant and reliable information to investors.

Financial valuations begin with the acquisition price and rely primarily on discounted future cash flows and balance sheet analysis. Any excess of the purchase price over the fair value of tangible assets is attributed to intangible assets and/or goodwill. Intangible assets must then be identified and their value separately derived. Any remaining value is classified as goodwill.<sup>9</sup>

<sup>7</sup> FASB.(2009). ASC 805 Business Combinations. Retrieved from <http://www.fasb.org>

<sup>8</sup> FASB.(2009). ASC 350 Goodwill Valuations for Financial Reporting. Retrieved from <http://www.fasb.org>

<sup>9</sup> If the sum of fair values of the assets exceeds the acquisition price, the transaction is viewed as a “bargain purchase” and the gain is recorded on the acquiring entity’s

The FASB accepts three general approaches to intangible asset valuation: the market approach, the income approach and the cost approach. In the market approach, intangible asset value is determined by reference to similar assets that have been sold or licensed. If such market transactions can be identified, the terms of those transactions are used to establish the value of the intangible in question. Increasingly, analysts recognize that IP - by its very nature - exhibits unique characteristics and capabilities, and that the probability of identifying truly comparable sales or licenses is low.

Absent reliable market evidence, the intangible may be valued using the income approach. A discounted cash flow model is constructed, based on assumptions regarding growth, profitability, competition, risk, and asset life. The model then calculates the present value of the stream of future profits attributable to the intangible asset in question.

Under the income approach, an intangible asset’s value is calculated over its “useful life:” the period of time over which the asset is expected to contribute to the reporting entity’s (i.e. the buyer’s) cash flows. As long as the asset is contributing or expected to contribute to future cash flows, it will attract a portion of the firm’s value. The useful life of patented technology is typically viewed as the remaining life of the patent.

Finally, the cost approach may be used. This approach relies on the principle of replacement cost to estimate asset value, and is typically used to value intangible assets such as engineering know-how or technical drawings. The cost approach implicitly assumes that value is somehow tied to cost. In fact, there is no economic link between the development cost associated with a particular technology and the value it ultimately generates. A cost approach, therefore, is

income statement.

unlikely to yield a correct estimate of value, except in rare circumstances.

### Comparison of the Reasonable Royalty and Financial Reporting Approaches

If the market approach is used to value IP in a financial reporting analysis, there is no reason to believe that the determination of value would differ from a reasonable royalty approach using the same methodology. The difficulty arises when the financial valuation and the reasonable royalty calculation both rely on the income approach.

The financial valuation analysis relies on balance sheet data, while a reasonable royalty calculation typically relies on a profit analysis. This difference in methodologies should not result in different IP values; since corporate assets generate cash flows through time, an asset’s value is a stock measure of the discounted cash flows the asset is expected to create. The important distinction between the two approaches is in their respective starting points.

The financial valuation is a “top-down” analysis, in which the market value of the firm is reflected in the acquisition cost. Although the FASB has increased the focus on individual intangible asset identification and valuation, financial reporting analyses are still intended to allocate the total acquisition cost across a variety of candidate tangible

*The financial valuation is a “top-down” analysis, in which the market value of the firm is reflected in the acquisition cost*

and intangible assets. The firm's purchase price often includes a premium over a value calculated strictly on the basis of expected future profits. This premium reflects a variety of factors, including current stock market conditions, anticipated synergies, majority control and other benefits attributable to the anticipated business combination. Arguably, such a premium should be allocated entirely to goodwill. In practice, however, some portion of this premium may be attributed to the firm's IP.

The reasonable royalty approach, in contrast, represents a purely "bottom-up" analysis. The purpose of the exercise is to determine the value of a particular piece of IP, not of the entire firm. No premium value can be allocated to the IP, because the market value of the firm as a whole has not been determined.

Which analysis correctly assesses the value of the IP? Recall the definition of economic value: it is derived from an

*The reasonable royalty approach represents a purely "bottom-up" analysis.... because the market value of the firm as a whole has not been determined.*

asset's ability to generate income. Markets are hypothetically efficient, and in theory a firm's market price should reflect the economic value of its assets. However, the market may experience a temporary shock, or disequilibrium, causing the market value of a public company to rise and fall from day to day. Moreover, bidding wars can emerge for private or public companies, with resulting price spikes. At a particular point in time,

therefore, the purchase price may not reflect the true economic value of the underlying assets. Allocating that purchase price to a firm's individual intangible assets may introduce "noise" into the asset valuation, distorting economic value. The difficulty arises because the analytical starting point is the sale of an entire firm, rather than the licensing of an individual asset, notwithstanding the FASB's focus on an asset-by-asset analysis.

Note that the FASB does not advocate the allocation of a purchase price premium to firm IP. Recent changes to business combination accounting requirements were intended to increase the focus on individual intangible asset identification and valuation and to increase transparency in the financial reporting of acquisitions. To the extent that distortions in estimates of IP value occur, they result from firm incentives to attach as much of the purchase price as possible to intangible assets other than goodwill, since goodwill cannot be amortized. Ironically, the increased transparency required by the FASB may increase firm incentives to overvalue intangible assets.

How do these different approaches alter the estimated value of patented technology? If the purchase price includes a market-based premium, the technology may be valued more highly in a financial reporting analysis than in a reasonable royalty calculation.

### Transfer Pricing Approach

For transfer pricing purposes, intangible asset valuation is required in a variety of circumstances. Section 482 of the Internal Revenue Code and the underlying Regulations (commonly referred to as "the U.S. transfer pricing regulations") require that all transfers of tangible and intangible property within a multinational enterprise (MNE) take place under terms that would prevail if the transacting entities were unrelated. An MNE

that wishes to license its patented technology to other related entities must determine an arm's-length royalty payment. The arm's-length analysis influences the portion of worldwide income that is earned in each tax jurisdiction, and consequently affects the MNE's global tax liability.<sup>10</sup>

The U.S. transfer pricing regulations define an intangible asset as one that "... has substantial value independent of the services of any individual..." and "derives its value not from its physical attributes but from its intellectual content or other intangible properties." The regulations identify categories of intangible property that closely resemble those in the FASB statements. Implicit in the prescribed transfer pricing valuation methodologies, however, is a focus on non-routine intangibles, or those that allow the company to earn supranormal returns.

An intangible is considered valuable and non-routine as long as it generates profits beyond those attributable to routine functions (e.g., distribution and manufacturing). Profits associated with routine intangibles are indistinguishable from returns to routine functions, and consequently cannot be separately valued or transferred. In a transfer pricing context, therefore, only a subset of what constitutes intangible assets for financial reporting purposes is at issue. Patented technology may or may not constitute a valuable, non-routine intangible.

\_\_\_\_\_ U.S. transfer pricing regulations

<sup>10</sup> Internal Revenue Service, Department of the Treasury IRC §§1.482-1 through 1.482-8. Retrieved from <http://www.irs.gov>. The OECD's Transfer Pricing Guidelines for Multinational Enterprises imposes nearly identical requirements on firms with owned operations in member countries.

prescribe three methods for determining an arm's-length price for the transfer of intangible property.<sup>11</sup> The regulations direct the taxpayer to select the method that provides the most reliable measure of an arm's-length result. Similar to the market approach in financial valuation, the comparable uncontrolled transaction ("CUT") method may be used if the MNE member licenses comparable intangible property to or from an unrelated party. The taxpayer can evaluate whether or not the intercompany exchange takes place at arm's length by reference to the comparable uncontrolled transaction. Absent such market evidence, transfer pricing

*In a transfer pricing context... only a subset of what constitutes intangible assets for financial reporting purposes is at issue*

regulations direct the MNE to profit-based methods, including the Comparable Profits Method ("CPM") and the Profit Split Method ("PSM"). The frequent lack of comparable market evidence requires that most analyses rely on these latter methods.<sup>12</sup>

They begin with the identification of routine functions performed by the firm. Arm's-length returns to these functions are determined by reference to the profits of comparable independent firms. These routine profits are then subtracted from total operating profits and any residual profits are attributed to the intangible(s). If the purpose of the analysis is to determine an arm's-length royalty rate, these residual profits represent appropriate compensation

<sup>11</sup> The discussion refers to Reg. §1.482-47. Reg. §1.482-7 addresses intangible transfers in the context of a cost sharing arrangement (CSA) between related parties. Additional methods (income, acquisition price, and market capitalization) may be applied to evaluate intangible asset transactions pursuant to a CSA.

<sup>12</sup> While the PSM can be applied based on evidence from uncontrolled taxpayers, the arm's length analysis typically defaults to a residual profit split.

to the owner of the intangible.<sup>13</sup>

For transfer pricing purposes, the relevant life of an intangible asset is considered to be its “economic” life, or the period of time over which the asset generates supranormal profits. The asset’s economic life is shorter than its useful life; its economic life ends when it no longer generates non-routine profits, while its useful life continues as long as it generates profits for GAAP purposes.

On the surface, the transfer pricing approach to IP valuation appears to closely resemble the reasonable royalty approach. The purpose of the exercise is to determine the economic value of a particular non-routine intangible, or piece of IP, not of the entire firm. In addition, absent market evidence (for comparable transactions or established royalty rates), both approaches typically rely on an estimate of future profits attributable to the intangible, rather than a balance sheet analysis. However, the two approaches can generate significantly different results.

First, recall that the transfer pricing analysis begins with operating profits, and then removes profits attributable to routine functions such as manufacturing and distribution. The reasonable royalty approach removes the costs associated with manufacturing (e.g. depreciation, raw materials, labor) and distribution (e.g. sales and marketing expenses), but does not explicitly remove a return to those costs. In this respect, the IP value suggested by the transfer pricing analysis is likely to be lower than the value implied by a reasonable royalty calculation.

Second, the transfer pricing analysis relies upon a shorter “economic life” than the useful life posited in both the financial

<sup>13</sup> In the case of multiple affiliate contributors to the development of valuable non-routine intangibles, the residual profits will be allocated according the relative size of the contributions.

valuation and reasonable royalty approaches. Assuming identical estimates of future profits associated with the IP, the transfer pricing analysis can generate a lower intangible asset value than a financial valuation or a reasonable royalty analysis.<sup>14</sup>

Third, the transfer pricing analysis returns all of the excess profits attributable to the IP to the intangible asset owner in the form of a royalty. In contrast, the reasonable royalty approach typically divides the value of the IP between the licensor and licensee. This difference will likely decrease the reasonable royalty estimate relative to the transfer pricing royalty.<sup>15</sup>

Finally, while the reasonable royalty approach accounts for feasible non-infringing alternatives available to the licensee, the transfer pricing approach does not. This difference will almost certainly drive the reasonable royalty lower than the transfer pricing royalty, since a reasonable royalty – by definition - shouldn’t cost the hypothetical licensor more than the cost of designing around the patent.

### Implications and Conclusions

While tax authorities and practitioners have expressly rejected court-determined damages awards as arm’s length evidence of intangible asset value for transfer pricing purposes, companies should not assume that the underlying expert analyses regarding

<sup>14</sup> If the likelihood of rapid technological advance is “built in” to the reasonable royalty calculation, its impact on cash flows would be to reduce the expected infringer profits attributable to the technology, thereby reducing the reasonable royalty. This would offset the longer life assumed in the calculation and lower the implied value of the IP.

<sup>15</sup> Only in rare cases will the profit division reflect the division between routine returns and returns to non-routine intangibles implicit in the transfer pricing analysis, causing the two analyses to converge.

reasonable royalties can be entirely ignored. Experts testify that these analyses represent their best estimates of the value of intellectual property under certain circumstances and at a specific time. By definition, the litigants are unrelated, so any hypothetical negotiation would satisfy the arm’s length principle. To the extent that these expert analyses or resulting conclusions regarding reasonable royalties are disseminated publicly, companies may have to explain why their analyses of the same IP for transfer pricing or financial reporting purposes generate different results. Unfortunately, the methodology differences between the reasonable royalty, financial reporting and transfer pricing approaches don’t allow for straightforward conclusions as to which approach will generate the highest or lowest estimates of IP value.

In the meantime, what are the implications of disparate valuation analyses? First, litigants may try to introduce either financial or transfer pricing IP valuations in an effort to discredit their adversaries, and/or as evidence of the firm’s “true” view of the value of the disputed patent.<sup>16</sup> Second, investors, financial regulators or tax authorities may examine the litigation history of the firm and attempt to use accessible information regarding reasonable royalty analyses as evidence of IP value in a tax or financial context. A coordinated approach to IP analysis can reduce inconsistencies, but cannot eliminate them. To the extent that firms and practitioners can manage the preparation, dissemination and clarification of these analyses, they may avoid costly misinterpretations of the results.

<sup>16</sup> While these analyses are typically protected by attorney-client privilege, relationships in the technology world are complex. For example, in spite of the recent case and ongoing litigation worldwide, Apple continues to purchase components from Samsung.

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# Summaries for the 28th Annual TEI-SJSU High Tech Tax Institute

*An annual conference sponsored by the Tax Executives Institute, Inc. and SJSU Lucas Graduate School of Business College of Business*

**November 12 & 13, 2012**

## Introduction

The High Technology Tax Institute provides a high quality tax education conference that brings together nationally and internationally recognized practitioners and government representatives to provide insights on current high technology tax matters of interest to corporate tax departments, accounting and law firms, the IRS, academics and graduate tax students.

Certain sessions from the 2012 event are summarized in the articles to follow. We encourage you to read these summaries and to visit the [High Tech Tax Institute](http://www.tei.org) website to view current and past conference materials in greater detail. If you were not able to attend the 2012 Institute, we hope this overview of the topics covered will encourage you to attend a future program.



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# Business Restructurings What's Happening and What's New?

By: Katelyn Truong, *MST Student*

**T**ax planning is essential in all corporations' structuring from the time of incorporation to the point of liquidation. An expert panel consisting of [Ms. Rachel Kleinberg](#) from *Davis Polk & Wardwell LLP*, [Mr. Ivan Humphreys](#) from *Wilson Sonsini*, Mr. David Hering from *KPMG*, and [Mr. Paul Fahy](#) from *A&L Goodbody* addressed tax consequences of organizational changes. This summary highlights two topics covered by the panel: spin-off and IRC §338(h)(10), and intangible transfer under IRC §367(d).

## Spin-off and IRC §338(h)(10)

Ms. Kleinberg discussed how to recognize a loss in a spin-off. Such a transaction is usually tax free for the parent corporation, the spin-off corporation, and the shareholders.<sup>1</sup> If the spun-off corporation

<sup>1</sup> [Fahy, P., Hering, D., Humphreys, I., & Kleinberg, R. \(2012, Nov., 12\). Acquisition Planning and Business Restructuring. \[PowerPoint slides\] Slide 4. Retrieved from \[http://www.cob.sjsu.edu/acct&fin/tax-institute/2012-HTI\\\_Web\\\_Copy/MON\\\_Bus\\\_Restructuring.pdf\]\(http://www.cob.sjsu.edu/acct&fin/tax-institute/2012-HTI\_Web\_Copy/MON\_Bus\_Restructuring.pdf\)](#)

has built in loss; the loss, unfortunately, is not recognized. But with proper tax planning the parent corporation can recognize the loss and the shareholders can receive the stock of the spin-off corporation tax free. Ms. Kleinberg explained that the parent company has to plan a "busted 351" and then make an election under IRC §338(h)(10). IRC §351 states that "no gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control of the corporation." IRC §351 allows taxpayers to form a corporation tax free; thus a "busted 351" changes a tax-free transaction into a taxable one.

To bust IRC §351, the parent corporation sells its old subsidiary stock with the built-in loss to a new corporation for the new corporation's stock. The new corporation acquires the old subsidiary and the parent

corporation transfers the stock it gained from the new corporation. IRC §267(f) disallows loss recognition from sale or exchange of property between two members of a control group, thus the loss is suspended. The parent company then places the stock from the new corporation in a spin-off corporation (a new subsidiary) which distributes the stock to its shareholders. After a "busted 351," both the parent corporation and the newly formed subsidiary need to make the IRC §338(h)(10) election to treat the sale as an asset sale. The company recognizes the loss, which it suspended immediately before the spin-off, after formation of the spin-off corporation. There are many steps to form a "busted 351". These steps are summarized in PLR 201203004. To ensure loss recognition and a tax-free event for the corporation and its shareholders, the company must follow proper planning.

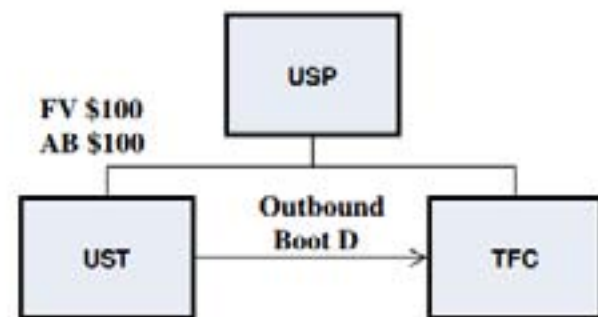
## Intangible transfers under IRC §367(d)

IRC §367(d) addresses transfer of intangibles. Many corporations are moving their intangibles around the world. The IRS is concerned about outbound reorganizations in which U.S. corporations transfer intangibles to controlled foreign corporations without income recognition. IRC §367(d)<sup>2</sup> applies to both outbound IRC §351 and IRC §361 transfers where intangibles from a domestic corporation are transferred to foreign corporations. Both IRC §351 and IRC §361 treat the U.S. transferor as having sold the intangibles in exchange for payments that are contingent upon the productivity, use, or disposition of the IP. There are several reorganization rules available to protect corporations from IRC §367(d). The IRS did not like the “loophole” which protects the companies from recognizing the gain in the transfer. Therefore, it issued Notice 2012-39 in July 2012 to limit the use of those rules. This notice is only directed towards reorganization of a corporation, thus IRC §351 transactions are not affected.

Before the notice, the following depicts how a corporation calculated the gain or loss. The parent company (USP) owned 100% of the U.S. target (UST) company<sup>3</sup> and the target foreign corporation (TFC). The UST had three assets and no liabilities. In a boot D reorganization, the following transactions occurred (illustrated by Figure 1):

- TFC distributed \$80 of cash for UST Goodwill and IP.
- UST distributed U.S. assets with fair market value (FV) of \$20 and \$80 cash to USP.

<sup>2</sup> Ibid., Slide 26.  
<sup>3</sup> Ibid., Slide 20.



US Assets	20	5	15
Goodwill	30	0	30
IP	50	0	50

Figure 1: Notice 2012-39<sup>4</sup>

- UST ceased to exist.
- UST received \$80 cash for the intangibles transferred. According to IRC §367(d), the transfer of intangibles would be treated as a transfer similar to sale of contingent payments (royalties). UST would recognize deemed royalty payments, commensurate with income attributed to the intangible, on an annual basis. When UST distributed the \$20 worth of assets and \$80 cash to USP, UST would recognize \$15 (FV 20 – Basis 5) of gain from the U.S. Asset. UST would not be taxed on the \$15 due to IRC §361(c). USP would not be taxed on the \$80 cash due to boot-within-gain rule under IRC §356. The deemed royalty payments that

<sup>4</sup> Ibid., Slide 10

From pg 20 of conference material [http://www.cob.sjsu.edu/acct%26fin/tax-institute/2012\\_HTI\\_Web\\_Copy/MON\\_Bus\\_Restructuring.pdf](http://www.cob.sjsu.edu/acct%26fin/tax-institute/2012_HTI_Web_Copy/MON_Bus_Restructuring.pdf)

UST would receive from TFC is transferred to USP. Since the deemed royalty payment was valued at \$50, the net repatriation from this reorganization would be \$130 (\$80 cash + \$50 royalties). USP would only be taxed on the \$50 deemed royalty.

After the Notice is issued, given the same scenario, UST would not recognize deemed royalty payments, instead UST would recognize income based on the proportion of property transferred. In this scenario, since the full value of the goodwill and IP would be distributed to TFC, the \$80 would be

recognized by UST. UST would not recognize the gain from the \$15. When UST distributed the U.S. asset and the \$80 cash to USP, USP “steps in the shoes” of UST and would be taxed on the \$80 cash.

These rules are complex so it is wise to seek expert advice in planning corporate reorganizations.





## Indirect Taxes and Emerging Industries

By: Sandhya Dharani, *MST*  
*Student*

The IT evolution towards cloud computing (cloud) technologies have influenced the way modern businesses transact in today's internet era. Technology forecaster Gartner has predicted that the worldwide cloud market would fetch gross revenues of about \$150 billion by 2014. This revenue prediction has caught the attention of states that are now aggressively pursuing additional revenues by asserting new interpretations or applications of laws which predate the advent of the cloud. The expert panelists who participated in the Indirect Taxes and Emerging Industries session at the conference broke down the complexities in the broad area of indirect taxation for cloud-based transactions: Sales and use tax within the United States and Value Added Tax (VAT) for most of the rest of the world. The members of the panel: [Mr. William Lasher](#), Senior Indirect Tax Director at *eBay Inc.*, Mr. James Robinson, Senior VAT Manager at *KPMG LLP*, [Ms. Kim Reeder](#), Partner at *Reeder Wilson LLP*, and Mr. Steve Oldroyd, Tax Senior Director at *BDO LLP*.

### Sales and Use Tax

The determination of state taxability of a business depends mainly on the characterization of the transaction, which involves examining the true object of the transaction. Based on this examination, cloud services may be treated as a sale or lease of tangible personal property (TPP), software license, or service provision. This concept of "true object" as pointed out by Ms. Reeder is a subjective test that is hard to apply in any given circumstance. Mr. Oldroyd remarked this undertaking as "nightmarish" because business has to sift through interpretations of 45 states in determining taxability of cloud services.

For states that only impose sales tax on TPP, cloud transactions may fall outside their tax base because these states may characterize cloud transactions as electronically delivered software so not meeting the tangible definition, or as nontaxable service provision instead of property transactions. States that tax services generally categorize cloud transactions as taxable "information, communication, or data processing services."

Furthermore, Mr. Oldroyd mentioned that Massachusetts has laid out the criteria to identify the true object of the transaction. In one instance, Massachusetts determined that the charge paid by a customer for the use of a hosted service to create newsletters and perform other tasks was subject to sales tax because the true object of the customer's purchase was "to obtain a license to use prewritten computer software." The key focus in Massachusetts' approach is the level of access and control given to the customer over the software application.

Also, the very nature of cloud services creates multi-jurisdictional uncertainty and confusion over sourcing--which state has jurisdiction to tax the cloud transaction. Because states' adopt varying approaches towards the treatment of cloud transactions, sourcing is the major pain point for taxpayers and tax administrators.

Mr. Oldroyd put forth different ways to source according to various state sourcing rules. States may source the transaction to the location of either the origin (seller or server/software) or the destination (end user or benefit received). An example of a state applying the destination approach is the State of New York which ruled that Software-as-a-Service (SaaS) hosted on out-of-state servers is subject to tax in New York if the related software is accessed from a New York location. New York treats this access as "constructively received" software.



The panelists agreed that businesses transacting in the cloud face at least two practical problems regarding sales and use tax. First, states have not come up with substantial and definitive tax rules for these emerging business models. Ms. Reeder expressed that the tax codes are antiquated, but most states are addressing this issue by providing guidance or interpretation in the form of regulations and letter rulings to supplement the existing tax code. This form of guidance allows states to easily change their positions; thus increasing uncertainty and confusion in the tax arena. Second, Mr. Oldroyd attributed the difficulty in determining taxability to the lack of information. He illustrated his point with an example of a supplier who entered into a software sales contract with a New York company. The supplier may not know that the software would be used in the company's training center located outside of New York. He emphasized the importance of documenting all potential problem areas in detail into the contract. A well-crafted contract may not be a panacea, but it would provide businesses a better edge as they navigate through the nebulous cloud environment.

### Value Added Tax

VAT is the type of indirect tax used by over 150 countries. According to Mr. Robinson, VAT in other countries does not face the same characterization problem for cloud transaction as sales and use tax in the U.S. For VAT application, there are goods and services; and services are anything other than goods. He noted that "goods are something physical and identified with the simple 'kick-it' test." "If you kick it and it hurts, it is goods." The supply of goods and services are both taxable. By its name, cloud services are treated as services for VAT purposes. Additionally, Mr. Robinson commented that most jurisdictions have special rules for taxing cloud services. The EU implemented the Electronically Supplied Services Regime (ESS), and some jurisdictions outside the EU, such as Iceland, Norway and Switzerland, have rules similar to the ESS. Cloud services fall within the spectrum of ESS because all cloud services are "delivered electronically."

The biggest challenge, according to Mr. Robinson, is identifying with reasonable certainty "who is responsible for the tax, what should be the tax rate and where it should be due." There are only three possible places where VAT liabilities would be due: where the supplier is located, where the recipient is located, or where the services are performed. If it is sold to individual customers within the EU, the U.S. supplier must register and charge VAT at the rate applicable in the EU country where the customer is located. Robinson said it is not much of a concern for business-to-business transactions because if the U.S. supplier (without a Permanent Establishment in the EU) sells to business customers in the EU, the U.S. supplier does not need to register with an EU jurisdiction for VAT purposes. The VAT will be handled by the business customers in the EU through a reverse-charge mechanism.

Mr. Robinson asserted that technology allows for new ways of doing business, creating a truly global market. He illustrated the digital supply chain by recounting a recent experience. While at Heathrow Airport, he received an e-mail advertising a new movie release. He bought the movie from the Swiss company, downloaded it on his personal cloud storage server in Canada and watched it during his flight to the U.S. The question he posed: "Where did I use the service?" His live streaming movie could possibly bounce through all 3 locations in addition to 55 different server platforms hosted in other countries. Secure payment solutions such as PayPal, which allows anyone to transact anytime and anywhere, have expanded this global

phenomenon. From the VAT perspective, the problem is "everyone can be a customer" in this borderless world.



# Section 199's Importance for Hardware and Software Companies

By: Philip Ma, *J.D., MST Student*

Section 199 of the Internal Revenue Code is a hot topic for U.S. manufacturers. The IRC §199 panel of legal and accounting experts took us through the intricacies of this provision for the “domestic production activities deduction.” The panelists were [Mr. Paul DiSangro](#), Partner with *Mayer Brown*; [Mr. Roderick K. “Rod” Donnelly](#), Partner with *Morgan Lewis LLP*; and [Mr. Rich Shevak](#), Sr. Manager with *Grant Thornton*.

In his opening remarks, Mr. Donnelly mentioned the increasing visibility of IRC §199 as a “poster child for moving America forward” within tax policy circles in the federal government. Enacted in 2004 as a centerpiece of the “American Jobs Creation Act of 2004” (P.L. 108-357, 10/22/2004), IRC §199 was a replacement for tax incentives which encouraged exports of American goods. Such incentives came under pressure from the World Trade Organization as unfair government subsidies. At the time Congress was increasingly concerned with losing American jobs and manufacturing capabilities overseas. IRC §199 addressed these concerns by providing a tax incentive for increasing domestic production activities regardless of whether the products were sold in the U.S. or elsewhere.

In subsequent years, the IRC §199

deduction was increased from 3% of domestic production activities (DPAD) to 9% starting in 2010. At a level of 9%, the IRC §199 deduction can result in an effective tax rate reduction of as much as 3%. However, the calculation is quite complex with many rules and definitions which can limit the amount of the deduction for a particular taxpayer. Over the years the IRS, backed by the Treasury Department, has complained to Congress about the difficulty of administering compliance with IRC §199. Nevertheless, the deduction continues to get support from lawmakers and could be increased substantially under some tax proposals currently under consideration by Congress and the Administration. The message from the panel of experts was that it is worth rolling up one’s sleeves to understand the complexities and challenges of the IRC §199 deduction.

## Alphabet Soup

The panel took us through a primer on the alphabet soup of acronyms for calculating the IRC §199 deductions, including:

- DPAD: “domestic production activities deduction” is the lesser of QPAI or taxable income. QPAI: “qualified production activities income” is equal to DPGR less cost of goods sold and other related expenses.

- DPGR: “domestic production gross receipts” is gross receipts derived from the lease, license, sale or exchange of QPP which was MPGE’d by the taxpayer within the United States. It does not include gross receipts from services.
- QPP: “qualifying production property” includes tangible personal property, computer software, and sound recordings.
- MPGE: “manufactured, produced, grown, or extracted” includes manufacturing, producing, growing, extracting, installing, developing, improving or creating QPP.

The panelists highlighted several Treasury Regulations that provide guidance on getting to DPAD. For high tech companies, the regulations relating to computer software and contract manufacturing are particularly important to understand.

### Computer Software

While computer software is specifically included in the definition of QPP, the Treasury regulations providing guidance on calculating DPGR for software transactions have not accounted for rapid changes in the software industry, namely the trend toward cloud computing and software as a service. Under Treasury Reg. §1.199-3(i)(6)(iii), online software can only qualify as DPGR if either the taxpayer or an unrelated person derives gross receipts from the same type of software delivered on a tangible medium such as a CD or via Internet download. As more and more software are delivered solely as a service via the cloud, it is possible that fewer and fewer software transactions could qualify for DPAD. The panel posited a scenario where the IRS could conceivably deny DPAD to taxpayers selling software only as a service under a theory that the transactions are more like a service (which cannot generate DPGR) than software.



### Contract Manufacturing of Hardware

Recognizing that many hardware product companies use third party contract manufacturers to manufacture their products, the IRS clarified in Treasury Reg. §1.199-3(f)(1) that only one taxpayer can take a IRC §199 deduction with respect to qualifying manufacturing activity. If a contract manufacturer is used, the taxpayer who has the “benefit and burdens of ownership” (BBO) in the relationship gets the deduction. In February 2012, the IRS issued a directive to examiners laying out a three-part test for determining which party has BBO:

1. Contract Terms: What do the contractual terms of the manufacturing relationship say with respect to ownership and risk of loss of manufacturing work in process?
2. Production Activities: Did the taxpayer develop and oversee the manufacturing

process?

3. Economic Risks: Did the taxpayer carry economic risk such as for raw material and other cost fluctuations that could affect the profitability of the manufacturing activity?

While this test provides some guidance for taxpayers, the panel cautioned that it leaves plenty of room in a BBO analysis for IRS examiners to pose extreme fact patterns in an effort to paint the taxpayer into a corner. Taxpayers should examine their facts with respect to contract manufacturing relationships and ensure that the form of these relationships supports the substance of the IRC §199 position being taken as much as possible.

### The Bottom Line

Whether you are a U.S.-based hardware manufacturer or software developer, the panel of experts emphasized that the IRC §199 deduction is an area of substantial tax benefit to look into. However, the rules from the Code, Regulations and other IRS materials are complex and sometimes vague. Tax practitioners should spend some time and effort to understand how to maximize the benefit while minimizing audit risk. Now that Congress and the White House have reached agreement on averting the “fiscal cliff,” corporate tax reform will get more attention in areas such as the IRC §199 deduction as policy makers continue to look for ways to strengthen America’s manufacturing base and stimulate job growth.

A panel of tax experts with different backgrounds discussed IRS examinations, appeals, and litigation processes. Mr. Larry Langdon, a Partner with Mayer Brown LLP and former Commissioner of the Large and Mid-Size Business Division of the Internal Revenue Service (IRS) introduced Ms. Julia Kazaks, Partner at Skadden Arps, LLP; and two

which codifies the economic substance doctrine. It was enacted by “The Health Care and Education Reconciliation Act of 2010” (P.L. 111-152, 3/30/2010). Under the new law, a transaction is considered to have economic substance if, other than federal income tax effects, the transaction changes the taxpayer’s economic position in a meaningful way and if the taxpayer has a substantial purpose for

# IRS Examinations, Appeals and Litigation

By: Devon Lee, MST Student

IRS experts: Ms. Cheryl Claybough, Large Business & International (LB&I) Industry Director for Communications, Technology & Media; and Ms. Laurel Robinson, Area Counsel.

Ms. Claybough began the presentation by explaining the recent reorganization of the LB&I International Division as part of a wider realignment within the IRS. In 2010, the international areas of the LB&I Division were consolidated into one operational group reporting to the Deputy Commissioner in charge of international activities.

A parallel geographical realignment was also introduced which further improved operational efficiency. In addition, Ms. Claybough explained that the IRS examination process shifted from a “tiered” structure to the Issue Practice Groups (IPG) approach which is designed to foster collaboration of different teams within the agency.

Ms. Kazaks discussed IRC §7701(o)

entering into such transaction. Ms. Robinson said that the IRS’s focus is ensuring the statutory economic substance doctrine is applied consistently and appropriately.

Ms. Claybough next explained the Compliance Assurance Process (CAP) as part of her overview of the Pre-Filing and Alternative Dispute Resolution (ADR) initiatives. Under CAP, the IRS examiner and taxpayer work through issues to understand the correct tax treatment before the return is filed. The purpose is to shorten the examination cycle, reduce uncertainty, and unbind audit resources. CAP aims to achieve a “real-time audit” approach where resources are allocated when needed and issues are addressed in a transparent and timely manner.

Ms. Claybough also gave an overview of the Pre-Filing Agreement (PFA) process, which allows a taxpayer to review with the IRS a transaction that is completed but the return of the relevant tax year is not yet due. Ms. Claybough emphasized that the PFA process

puts the issue on the table so the taxpayer understands how IRS would deal with the issue before the taxpayer files the return.

Mr. Langdon and Ms. Kazaks reviewed a typical timeline of the LB&I audits, beginning with the start of an audit and ending with the court opinion. See Figure 1.

Ms. Kazaks explained Fast Track, an available step in the ADR processes. The Fast Track process utilizes the Appeals Unit to act as mediators so issues that are blocking the completion of an audit can be resolved promptly. Mr. Langdon highlighted the advantage of Fast Track where 83% of these cases are resolved in an average of 80 days compared to the average of 400 to 600 days required for cases using the traditional appeal process.

Next, Ms. Kazaks covered issues in the appeals and litigation areas. She stressed that the Appeals Unit is independent, as required by the IRS Restructuring and Reform Act of 1998, from the IRS examiners who are organized under the Services and Enforcement Unit. The mission of the Appeals Unit is to resolve tax controversies fairly and impartially for both the government and the taxpayer. Ms. Kazaks and Ms. Robinson both agreed that taxpayers should try to avoid

litigation because it is very expensive and time consuming. In the litigation area, Ms. Kazaks covered several topics including attorney-client privilege, the work product doctrine, and the use of the motion practice (submitting a case to the court without trial) to streamline litigation. She referred to the *PepsiCo*<sup>1</sup> case to illustrate that litigation takes time, and is unpredictable. The issue addressed by the Tax Court in *PepsiCo* was whether certain financial instruments of the taxpayer should be treated as debt or equity. The instruments had characteristics of both; thus, the taxpayer treated it as equity, while the IRS recast it as debt. The Tax Court ruled for the taxpayer after a lengthy review of the transaction.

Although the panel covered many topics in the IRS examinations, appeals and litigation processes; the important points are highlighted in this article. It can take many years for a disputed issue between a taxpayer and the IRS to be decided by a court decision. These recent changes initiated and developed by the IRS are intended to resolve more disputed issues during the examination and making it more effective and efficient.

<sup>1</sup> *PepsiCo Puerto Rico, Inc. v. Commissioner*, TC Memo 2012-269

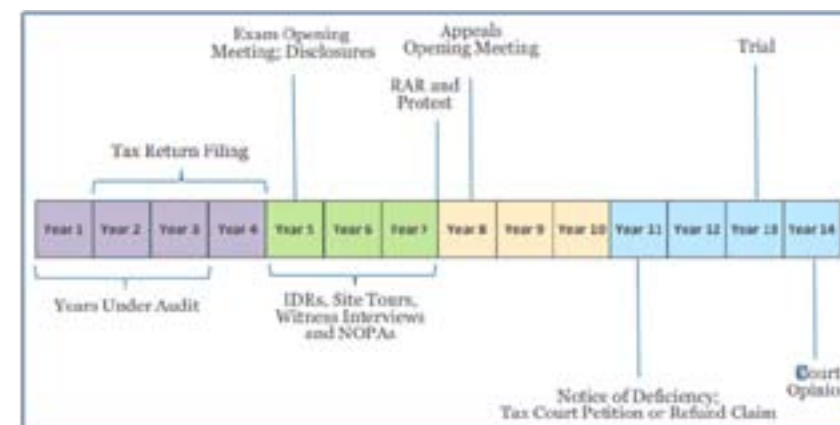


Figure 1: A typical timeline of an IRS examination

IRS Examinations, Appeals and Litigation (2012, Nov 12). 28th Annual High Technology Tax Institute Conference. Retrieved from [http://www.cob.sjsu.edu/acct&fin/tax-institute/2012\\_HTI\\_Web\\_Copy/TUES\\_IRS.pdf](http://www.cob.sjsu.edu/acct&fin/tax-institute/2012_HTI_Web_Copy/TUES_IRS.pdf)

# What is a Patent Box and Do We Want One?

By: Dana Ielceanu, MST Student

## What is a patent box? How to design one? and What are the pros and cons of enacting one?



The questions of *What is a patent box?; How to design one?; and What are the pros and cons of enacting one?* were addressed by a panel of three distinguished speakers: Mr. Kendall Fox, Partner with *PwC LLP*; Mr. Kent Wisner, Managing Director with *Alvarez & Marsal*; and Mr. Sang Kim, Partner with *DLA Piper*. The key ideas presented by the panel are summarized below.

The innovation chain comprises three steps: research, development, and commercialization. One often asked question is “Should tax incentive be provided for technology?” Various studies have concluded that a high proportion of economic growth is due to technological change and R&D is associated with increased productivity. For a jurisdiction to attract R&D investments, it must provide R&D tax incentives as well as more favorable income tax rates than other jurisdictions. According to the 2011 OECD data, the combined federal and average state statutory corporate tax rate in the United States is far higher than all other OECD countries. Furthermore, panelists noted that intellectual property (IP) held in the U.S. is taxed at a rate that is 50% higher than the average tax rate on IP held in the OECD countries.

Another common question is “What types of IP should qualify for a tax incentive?” The panel explained that every country offering R&D tax incentives defines IP differently. Some countries restrict the scope to scientific discoveries while others, like the U.S., focus on the developmental aspect of R&D. Most countries offering tax incentives impose restrictions on the location of the qualifying R&D activities and location of the IP. Countries that require the R&D activities to be performed within its border include: Australia, Brazil, Canada, China, India, South Africa and the U.S. China and Japan require the IP resulting from the qualifying R&D activities

to remain within the country to qualify for tax incentives. Generally, EU countries offering research credits do not impose development requirements.

The research credit in the U.S., Japan, and Spain are not refundable. Countries with refundable credits include Australia, Canada, France, and Ireland. In the U.S., the R&D needs to be “incremental-based” and not volume-based. Other countries offer “super” deductions ranging between 140% (The Netherlands) to 200% (Hungary). Countries that do not provide R&D incentives include Finland, Germany, Israel, Mexico, New Zealand, and Sweden.

As of October 2012, six countries in the EU had adopted the patent box regimes: Belgium, France, Hungary, Luxemburg, Netherlands and Spain. The U.K. will have one in April 2013. The common theory behind the patent box is to provide incentive for the exploitation of IP. However, there are significant design differences across the jurisdictions. Key design questions a jurisdiction must address include:

- 1. What is qualifying IP?** – Belgium restricts IP to only include patents; but other countries, like Hungary, include know-how, trademarks, business names, business secrets, and copyrights.
- 2. What type of income should be eligible for preferential tax treatment?** - Hungary and Luxemburg use royalties while Spain uses the gross patent income. Other countries exclude revenue attributed to manufacturing, as in France. A French taxpayer involved in manufacturing is not allowed to treat a portion of their revenue (the value of the royalty for the IP) as qualifying revenue.

In considering whether the U.S. should adopt the patent box regime, the panelists proposed these additional questions to

consider:

- Should we impose the requirement that IP development be physically performed in the U.S.?
- How do we measure the IP income?
- Should we have a gross or net qualifying IP income?
- If the taxpayer sells the IP, should the taxpayer have a capital gain on sale from qualifying IP instead of a lower effective rate?
- If someone infringes upon a taxpayer's patent and the taxpayer is successful in prosecution, should the award be treated as qualifying income?
- If there is an infringement on someone else's patent, should there be a mechanism for recapturing that tax benefit?

With more questions than answers, the consensus from the panelists was that it is not easy to craft tax laws to encourage innovation.

**Mark you calenders !!!**

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# Federal Domestic and State Tax Updates

By: Dana Coroiu, *MST Student*

The panel comprised of [Ms. Annette Nellen](#), Director of the *SJSU MST Program*; and [Ms. Jennifer Peterson](#), Tax Partner with *KPMG*; discussed federal domestic tax developments and state tax updates.

Ms. Nellen began her discussion by noting that the federal tax law contains many temporary provisions, with some of them expiring on or after December 31, 2012. Moreover, there are 60 provisions that expired at the end of 2011 and have not been extended. The key expired provisions include the research credit, the Work Opportunity Tax Credit, the AMT patch (which affects many people in California), the deduction for state and local general sales taxes, the deduction for qualified tuition and related expenses (IRC §222(e)), various energy credits, and tax-free distributions of up to \$100,000 from individual retirement plans by person age 70 ½ or older for charitable purposes (IRC §408(d)(8)).

Ms. Nellen also overviewed the health care provisions that will become effective as of January 1, 2013 impacting high income taxpayers. The Patient Protection and Affordable Care Act (H.R. 3590, 3/23/2010) introduced the Additional Medicare Tax of 0.9% on wages and self-employment income in excess of \$200,000 for single individuals (or \$250,000 for married individuals filing jointly). Additionally, a new Medicare tax of 3.8% will be imposed on unearned income (such as interest, dividends, capital gains,

royalties, and rents) of high income individuals.

Other 2013 changes in healthcare include:

- A new 2.3% excise tax on total revenue from sales of medical devices.
- An increase in medical expense deduction threshold to 10% of AGI (this increase will not be effective until 2017 for taxpayers who are 65 or older before the end 2013).
- The introduction of a cap on the medical Flexible Spending Account (FSA) contributions at \$2,500 per year, per employee.

For individuals who work for larger employers, the cost of employer-sponsored health insurance will be reported on their 2012 W-2s as required under IRC §6051(a)(14).

Ms. Peterson provided the state tax update with particular focus on California. She set the scene by commenting that most states still have budgetary issues. States' revenues have begun to grow again, but they are still far from full recovery. High unemployment remains and property tax collections decreased by 5%, or \$25 billion. Ms. Peterson addressed three key tax changes impacting Californians: Proposition 30, Proposition 39, and the City of San Francisco gross receipts tax. All three legislations were approved in 2012. The Proposition 30 and the San Francisco measures are summarized below.

The goal of Proposition 30 was to temporarily raise the sales tax rate and the personal income tax rate. The statewide base sales and use tax rate increases by 0.25% for four years starting on January 1, 2013. The personal income tax rates will increase for individuals making more than \$250,000 for the next seven years. The highest personal income tax rate is increased from 9.3% to 12.3% for single individuals that have taxable income exceeding \$500,000 (or \$1,000,000 for married individuals filing jointly). Ms. Peterson emphasized that the new top rate is retroactively applied to income earned from January 1, 2012.

The San Francisco measure introduces

a new (revised) gross receipts tax on all taxable business activities attributable to the city and replaces the 1.5% payroll expense tax. This new gross receipt tax phases in from 2014 to 2018 as the payroll expense tax phases out. San Francisco is the only city in California with a payroll tax so it was believed that this was not providing the right incentive to bring businesses to San Francisco. The new tax will be imposed at graduated rates that vary by industry. For the financial services industry, the tax, once fully phased in, is expected to be imposed at rates between 0.40% (for gross receipts up to \$1 million) and 0.56% (for gross receipts in excess of \$25 million). Taxpayers deriving gross receipts from business activities from within the city and outside the city are required to allocate their taxable gross receipts in accordance with the new rules.<sup>1</sup>

These are only some of the latest federal and state taxes updates covered by the panel. This presentation was designed to provide tax practitioners an in-depth review of various tax updates and coverage of newly enacted regulations and procedures most relevant to high technology companies.

<sup>1</sup> Ropes & Gray. (2012, Nov. 20). *New San Francisco Gross Receipts Tax May Hit Investment Managers/Fund Sponsors*. Retrieved from <http://www.ropesgray.com/~media/Files/alerts/2012/11/new-san-francisco-gross-receipts-tax-may-hit-investment-managersfund-sponsors.pdf>

# Tax Reform: Status, Needs & Realities

*A conference sponsored by the Tax Executive Institute, Inc., SJSU Lucas Graduate School of Business – College of Business, and The State Bar of California; The Taxation Section, Tax Policy, Practice and Legislation Committee February 3, 2012.*

By: Kenny Cai Ng, *MST Student*

## Introduction

The tax policy conference, “Tax Reform: Status, Needs, and Realities,” was held on February 3, 2012 at Techmart in Santa Clara. During this all day conference, tax practitioners and government employees gathered to find out the latest on federal and state levels tax reform from the speakers and to share their ideas with each other. Because the conference was held in Silicon Valley, the emphasis was on the impact of tax reform on the high tech industries; however, individual tax reform proposals were also covered.

Ms. Annette Nellen, director of the *San José State University MST Program* and the conference, commenced the proceedings by introducing the representatives of the conference sponsors: Ms. Lorraine McIntire, President of the *Santa Clara Valley TEI Chapter*, and Ms. Cynthia Catalino, Chair of the *California Bar Tax Section’s Taxation Policy Committee*. Ms. Nellen then conducted an initial polling, using clickers and instant polling software, to understand the demographics of the attendees, and gauge the audience’s

self-perceived understanding of the tax law. We learned that most of the attendees were natives of California; and about half were employed in corporate tax departments and most were lawyers or CPAs. When asked to rate their level of understanding of the federal tax law, 10% of the attendees said they understood it very well. A majority of the attendees also considered themselves as having a medium level of understanding of California’s tax and fiscal system. The consensus coming from the attendees was that California’s fiscal policy was “quite bad.”

After the initial polling questions, Ms. Nellen overviewed the sessions of the conference. Highlights from these sessions are summarized in this section of the journal:

1. Tax Policy and Issues of Complexity.
2. Federal Tax Reform: Relevance for High Tech Industries.
3. Chairman Camp Proposal: Territorial, 25% and More.
4. California Tax Reform Proposals and Their Prospects.
5. Looking Forward.



## Editor’s note:

*The 2012 Tax Policy Conference also included remarks of Assemblymember Jim Beall (now Senator), as well as a panel on considerations on the effect of federal tax reform on California. That program was presented by Mr. J. Pat Powers, Partner with Baker & McKenzie; Mr. Oksana Jaffe, Chief Consultant with the California Assembly Revenue & Taxation Committee; and Mr. Gregory Turner, Senior Tax Counsel with the Council on State Taxation (COST). The agenda and presenter materials from the conference can be found at the “history” link at <http://www.tax-institute.com>.*



# Tax Policy and Issues of Complexity

By: Lindsay Wilkinson, *MST Student*



One of the biggest challenges facing taxpayers today is the complexity of the Internal Revenue Code and related regulations. With tax reform as the overarching theme of the day, [Ms. Annette Nellen](#), director of *San José State University's MST Program*, set the tone as the first keynote speaker with her presentation on "Tax Policy and Issues of Complexity."

Ms. Nellen reiterated that "The tax law should be simple so that taxpayers understand the rules and can comply with them correctly and in a cost-efficient manner." Although altering the tax law to make it more simple, transparent, and administrable is no small task, there are principles of good tax policy that can be used to evaluate new tax proposals as well as the design of the system as a whole.

Of these ten principles, Ms. Nellen focused her presentation on the principle of simplicity. In addition to making it easier and less costly to comply with the law, a simple tax system reduces errors and builds respect for the laws and those who administer it. It is easy to get frustrated with the current tax system when the instructions for the 1040EZ alone are 40 pages long.

***The tax law should be simple so that taxpayers understand the rules and can comply with them correctly and in a cost-efficient manner.***

So why is our tax system so complex and what can be done about it? Ms. Nellen suggested that first, politicians should stop using the tax law to remedy all problems and phase-out unnecessary special rules that either serve no purpose or can be addressed outside of the tax law. Next, Congress should stop enacting complicated provisions or multiple provisions with similar purposes. This includes overly complicated approaches to prevent possible abuses such as the kiddie tax and AMT. Lastly, lawmakers should always ask, "Is there a simpler way to accomplish what we are trying to do? Did we ask tax practitioners for their advice?"

Although the Tax Reform Act of 1986 was enacted to simplify the tax law by broadening the base and lowering rates, numerous new complicated provisions have convoluted the tax law in the last 25 years. However, by implementing the suggestions mentioned when creating or changing laws, Congress could have a lasting impact on the simplicity of the tax code. As a result, the amount of time and money taxpayers spend just to comply with the law could be reduced.

# Federal Tax Reform: Relevance for High Tech Industries

By: Shadi Mahdinia, *MST Student*

**M**r. Joshua Odintz, a partner with the law firm of *Baker & McKenzie*, and Mr. Michael Hauswirth, a tax counsel with the *House Ways and Means Committee* addressed the impact of federal tax reforms on high tech industries. Mr. Odintz's presentation covered the issues that are fueling momentum for tax reform and how the reform could improve the corporate tax system.

Mr. Odintz explained that high U.S. statutory and effective tax rates, the lockout effect of the worldwide system, complexity and uncertainty of the current system, and the perception that the U.S. system is an outlier are all factors that encourage tax reform. Together, these factors hamper U.S. competitiveness in the global market and reduce business income.

Past reforms brought major changes to U.S. corporate tax structure. For example, the "Economic Recovery Tax Act of 1981" (P.L. 97-34, 8/13/1981) and the "Tax Reform Act of 1986" (P.L. 99-514, 10/22/1986) reduced the corporate tax rates, accelerated the deduction for depreciation, and broadened the tax base. However, no major changes to corporate tax have been introduced since these laws were passed, and the top corporate statutory rate has remained at 35% since 1993. Meanwhile, other countries have reduced their rates so that the U.S. statutory rate is now higher than the average rate of the OECD countries, while the U.S. effective marginal and average rates are at or below the OECD average. Mr. Odintz emphasized that the high U.S. rate is a key driving force for corporate tax reform.

On business income, Mr. Odintz explained that the contribution of corporate tax receipts to total federal receipts has declined because business income has "moved out of corporations." Increasing number of U.S. businesses are structured as LLCs and other pass-through entities because they provide limited liabilities, a single layer of tax, and better tax incentives. Mr. Odintz added that, compared with other OECD countries, the U.S. has significantly greater number of pass-through entities with taxable income in excess of \$1 million, thus creating the largest unincorporated business sector within the OECD.

Mr. Odintz noted that key reform proponents want corporate tax reform to be revenue neutral, simple, and separate from individual tax reform. It should change tax treatment of debt-finance investment, improve efficiency, and change incentives for investing overseas. As reform will potentially create winning and losing industries, he stressed that any reform must

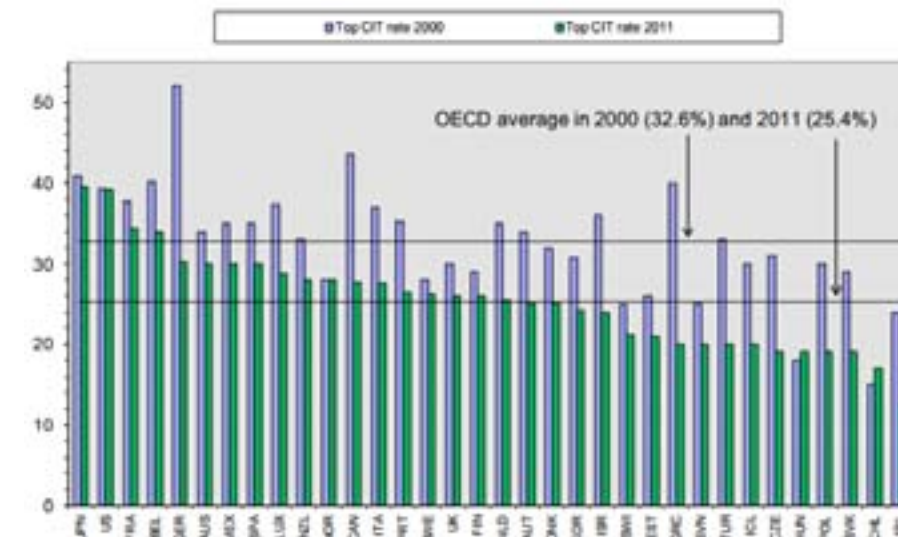


Figure 1 Statutory corporate income tax rates, 2000 and 2011 according to OECD. (2011, Jun. 30). *Tax Reform Trends in OECD Countries*. Paragraph 8. Retrieved from <http://www.oecd.org/ctp/48193734.pdf>

take these industries into consideration.

Another area Mr. Odintz discussed was Chairman Camp's discussion draft which outlines a 95% foreign dividend exemption, the provision of foreign tax credits for passive income, and retention of Subpart F. He also reviewed options to prevent base erosion such as taxing excess intellectual property returns as Subpart F income, taxing low tax cross-border income as Subpart F income, and combining U.S. patent box and Subpart F treatment of intangibles income.

As the final topic, Mr. Odintz explained key aspects of President Obama's insourcing proposals which are intended to reward companies that invest in or bring jobs into the U.S., and eliminate tax advantages for companies moving jobs overseas. If the proposals are enacted, there will be no deduction for outsourcing jobs, and multinationals will be required to pay a minimum level of tax.

*The high U.S. rate is a key driving force for corporate tax reform.*

# Chairman Camp Proposal: Territorial, 25% and More

By: Habiba Hussain, *MST Student*

In October 2011, the House Ways and Means Committee Chairman Dave Camp (R-MI) released an international tax reform discussion draft referred to here as the “Camp Proposal.” In addition to presenting the highlights of the proposal, an expert panel overviewed the U.S. international tax policy framework and how it affects the behavior of U.S. and foreign corporations. The panel was comprised of [Mr. Mark Betker](#), Partner, *PwC LLP*; Mr. Christopher Haunschild, (then) Of Counsel, *DLA Piper*; and [Mr. Mark Hoose](#), (then) Professor, *University of San Diego School of Law*.

The panel explained that the main tenets of tax policy are to tax income once as close to the source as possible, and that tax should be neutral – it should not influence decision making. These tenets are not currently present in the U.S. corporate tax system.

***The main tenets of tax policy are to tax income once as close to the source as possible, and that tax should be neutral – it should not influence decision making. These tenets are not currently present in the U.S. corporate tax system.***

The Camp Proposal is intended to address some of these shortcomings. Highlights of the proposal include:

- Change from a worldwide to a territorial tax system in which all foreign source income is exempted from U.S. income tax. The U.S. is currently the only developed country with a worldwide tax system. In combination with the highest corporate tax rate, U.S. multinationals (MNCs) are at a disadvantage compared to their foreign competitors. The Camp Proposal offers an exemption from active foreign source income earned through controlled foreign corporations (CFC) and foreign branches.
- Reduce the corporate tax rate to 25%, which is important for companies that earn their income in the U.S.
- Introduce a dividend received deduction (DRD) where 95% for foreign-source dividends of a CFC received by domestic corporate shareholders is exempted provided the domestic shareholders satisfy a one year holding requirement of the CFC shares.
- Modify Subpart F by repealing IRC §§956 and 959 on previously taxed income (PTI). Instead, PTI dividends eligible for 95% DRD would be taxed at 1.25%.

- Implement transitional rules to tax accumulated deferred foreign earnings of CFCs at a 5.25% rate. U.S. shareholders would be allowed to pay any U.S. tax on its Subpart F income in equal annual installments over two to eight years with interest.
- Introduce a “Thin Capitalization Rule” that would deny U.S. shareholders a deduction for interest expenses if two tests are not met: the Relative Leverage Test (RLT) and the Percentage of Adjusted Taxable Income (ATI) Test. A taxpayer would fail the RLT when the debt percentage of the U.S. member is greater than the average debt percentage of the worldwide group. To pass the Percentage of ATI Test, the corporate taxpayer’s equity ratio cannot exceed 1.5 to 1, as defined in IRC §163(j).

On base erosion alternatives, the panel discussed three alternative Subpart F ideas included in the Camp Proposals. These alternatives offer three different ways to limit taxpayers’ ability to shift income to low-tax authorities and provide different answers to these important questions in international tax policy design:

1. Does it matter if intellectual property (“IP”) is developed partly in the U.S. or abroad?
2. Should low foreign effective tax rates be viewed as a standalone issue or should it be viewed with other factors?
3. Does it matter if a CFC’s earned income is derived from serving its home country market rather than foreign markets?

The three base erosion alternatives included in the Camp Proposal are described next:

## Option 1 - Obama’s Excess Returns

When a U.S. person transfers intangibles to a related CFC and the intangible generates a high profit margin, the excess income earned by the CFC would be treated as a new category of Subpart F income – foreign base company excess intangible income. The panel’s main concern with this option was that it would encourage taxpayers to relocate R&D activities outside the U.S. because the proposal does not apply to income generated by intangibles developed abroad. The panel prefers an approach that is neutral with respect to the location of the R&D development noting though that additional restrictions on income shifting can be implemented.

## Option 2 - Low Taxed CFC Income

When the gross income from a CFC is subject to a foreign effective tax rate of 10% or less, the income would be treated as Subpart F income unless the same country exception applies. The same country exception applies when:

1. the income is earned from the conduct of a trade or business in the CFC’s country of organization;
2. the CFC maintains a fixed place of business in such country; and
3. the income is derived in connection with property sold or services provided in such country.

The key concern expressed by the panel was that if a CFC operates in a home country

with an effective tax rate of 10% or less and sells into its own homecountry, its income will be treated as Subpart F income irrespective of the other facts surrounding the CFC's earning of the income.

### Option 3 – Carrot & Stick

In this option, all CFC income earned from IP related services or property is treated as Subpart F income, but U.S. shareholders can deduct 40% of income attributable to IP. The Subpart F high-tax exception would apply to this new category of Subpart F income, using 13.5% as the threshold. Unlike the excess returns option, this option limits its application to income attributable to IP, but does not explain how this attribution is to be done. The consensus from the members of the panel was that option 3 is complicated and would require further study. Their main concern is the IP attribution rule because it would create a new requirement for transfer-pricing-type analysis and valuation of IP.

Finally, the members of the panel laid out key criteria for the Camp Proposal to be successful. It should eliminate superfluous rules, such as IRC §§909, 956 and 959; simplify the law; and help raise revenue. It is also important to ensure that U.S. shareholders who are not eligible to receive territorial dividend exemption do not suffer from double taxation on their Subpart F income when earnings are distributed. Overall, the panel believed that Chairman Camp's discussion draft is a significant development toward fundamental corporate tax reform.



# California Tax Reform Proposals and Their Prospects

By: Shadi Mahdinia, *MST Student*

In this part of the conference, a panel of experts reviewed the key aspects of recent California State tax and fiscal reform proposals and assessed their prospects. The panelists included: [Mr. Dean Andal](#), Director, *PwC* and a former member of the California State Assembly; [Mr. David Ruff](#), Principal Consultant, *California Assembly Revenue & Taxation Committee*; [Ms. Gina Rodriguez](#), Vice President of State Tax Policy, *CalTax*; and [Mr. Fred Silva](#), Senior Fiscal Policy Advisor, *California Forward*.

The panel covered a number of recent reform proposals. Highlights of key proposals are summarized below:

### Governor Brown Proposal

This proposal aims to improve fiscal balance by temporarily increasing income and sales tax rates to raise an estimated \$4.8 to \$6.9 million in General Fund revenue.

## Advanced Project Proposal

This proposal is intended to increase funding for early childhood and K-14 education by making significant changes in income tax rates. It is projected to increase revenue by \$10 billion.

## California Federation of Teachers Proposal

The objective of this proposal is to increase funding for a variety of state and local programs. It will permanently increase income tax rates on taxpayers with income in excess of \$1 million. The increased revenue, estimated to be between \$5 and \$6 billion, will be allocated to education, childhood and senior services, public safety, and infrastructure such as local roads and bridges.

## Split Property Tax Assessment Roll Proposal

This proposal will bring non-residential property assessment closer to market value and is expected to generate an additional \$4 billion in tax revenue per year for the state General Fund. It will place non-residential properties on a three year reassessment cycle, exempt property tax on personal properties up to \$1 million, and double the homeowner exemption.

In addition to tax reform proposals, the panel also overviewed these fiscal reform proposals intended to revise California State's budget-making process, spending limit or voting requirements for certain fees and taxes.

## California Forward's Proposal

The objectives of this proposal are to revise the state and local budget processes to focus on results, and to increase state and local governments' authority to integrate local services. Under this proposal, a budgeting

system based on multi-year results would be established, and public programs would work collaboratively with a focus on performance.

## Cal-Tax and the Howard Jarvis Taxpayers Association Proposal

This proposal would revise the state spending limit by resetting the spending limit base year to 2010-11, changing the allocation of money that is in excess of the limit, and clarifying the two-thirds legislative approval for tax increases.

## Environmental Group's Proposal

If this proposal is enacted, the legislature would be able to raise fees with a majority vote for environmental and public health regulatory activities.

The last part of the panelists' presentation was focused on California's Sales and Use Tax (SUT) reform. The panelists addressed the benefits of reform, and explained how the government can use this tax source to generate more tax revenue.

Under current law, California's SUT imposes a sales tax on retailers for the privilege of selling tangible personal property (TPP). The tax is based upon the retailers' gross receipts from TPP sales in California. SUT receipts are the second largest contributor to the state's General Fund revenue behind personal income tax although it wasn't always this way. In the past 80 years, the revenue contribution from the SUT has dramatically decreased as the State transitioned from an agricultural and manufacturing dominated economy to a service and technology-oriented one. This reduction in SUT contribution created a need for the State to increasingly rely on revenue contributions from personal income tax.

The panel suggested that the SUT base could be expanded to cover more services to increase SUT revenue. California currently

imposes SUT on only 21 services, while some states tax nearly all services. The panelists noted that imposing tax on services has benefits. It would promote fairness, stability, and economic neutrality; prevent cuts to vital services; provide funds to reform other areas of tax law; and prevent higher sales tax rates.

Finally, some panelists presented key tax policy principles that lawmakers must consider in expanding the sales tax to services:

- Administrative feasibility;

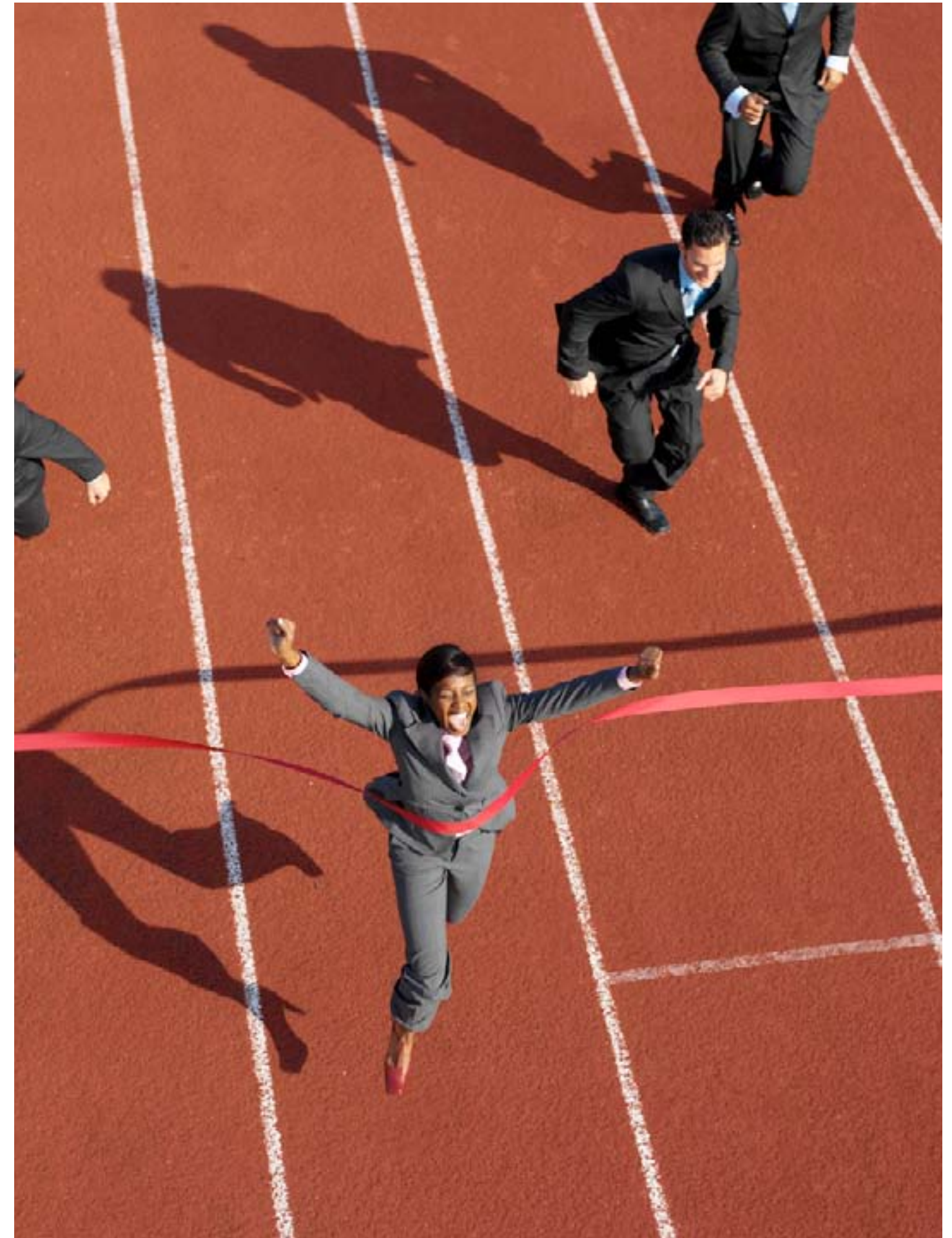
- Avoiding perverse incentives and pyramid effect from taxation of services by businesses;
- Promotion of progressivity; and
- Providing assistance for newly registered service providers.

# Looking Forward

By: Kenny Cai Ng, *MST Student*

In the final session of the conference, Ms. Annette Nellen conducted a final poll to evaluate whether or not there was a change in the attendees' appreciation of tax reform after hearing the day's presentations. The attendees were asked to identify the most realistic federal tax reform. The majority of the attendees believed that letting the lower tax rates expire, and lowering the corporate tax rate are the solutions. However, a majority of the attendees believed that a higher tax rate on high income individuals is the more realistic approach to California tax reform. The last polling question confirmed that the attendees developed a better understanding of the tax law at the end of the conference. The audience had learned that California's largest tax revenue source is from personal income tax.

After the final polling, [Ms. Kim Reeder](#), (then) Partner, Morgan, *Lewis & Bockius*, summarized the key issues that were discussed in the conference. She highlighted that every speaker addressed how interactions of federal and state tax affect tax policy. She summarized panelists' discussion about the difficulty for taxpayers to comprehend the tax code due to its complexity and the effect on tax planning. She stressed the importance to consider issues such as transparency and fairness in designing tax policy but overall, there must be a balance of sound tax policy. Finally, she reiterated the reality that there are always winners and losers in tax reforms, and that some industries would likely fare better than others.



## Tax Mavens

# The Contemporary Tax Journal's Interview of Dan Kostenbauder

Part I on Tax Policy

By: Victoria Lau, *MST Student*

**D**an Kostenbauder is the Vice President of Tax Policy at Hewlett-Packard Company (HP) where he has served for over thirty years. He has held different tax positions at HP including European Tax Manager, Head of State and Local Tax, and Head of Worldwide Transactional Tax. What elevates Mr. Kostenbauder to the level of a Tax Maven is his involvement in the tax legislation process in Washington, D.C. and state capitals throughout most of his career. He has cultivated relationships with high-ranking lawmakers and their staff members; helped explain tax concerns of high technology companies to legislative staff, has testified before the House Ways and Means Committee and Senate Finance Committee on several occasions.

Mr. Kostenbauder is also a regular presenter on tax policy at conferences, including those offered by the Tax Executive Institute (TEI). He has taken leadership roles in national industry groups such as the American Electronics Association and Information Technology Industry Council, as well as state level associations.

I had the pleasure of interviewing Mr. Kostenbauder on April 2, 2013 at the HP global headquarters in Palo Alto, CA. Mr. Kostenbauder recounted interesting and captivating stories from his experience and offered insights into the anticipated federal tax reform. This interview is featured in two parts: Part I focuses on tax policy including Mr. Kostenbauder's tax legislation experiences in Washington, D.C.; and Part II captures his views on tax reform.

**SJSU CTJ: As the VP of Tax Policy at HP, what are you responsible for?**

**Kostenbauder:**

My major responsibility is to represent HP with respect to tax policy. This primarily involves Washington, D.C. in relation to tax policy, but I also have responsibility for the States.

I also assist on specific tax policy matters in other countries, but this international role is primarily to consult with tax managers in the other countries by providing insights. On some issues like the R&D credit, I have been working on it since the mid 1980's so in addition to the general policy and economic



arguments that support having an R&D credit, I am familiar with ways in which the R&D credit can be structured and how that may impact HP not only based on our situation today but also in anticipation of what may be happening in the future.

**SJSU CTJ: What was your career path to VP of Tax Policy?**

off the real push for what became the Tax Reform Act of 1986 (TRA of 1986). Treasury had been working on the topic and issued the Treasury I report in late 1984. It was a big deal when the President and the Chairman of the W&M gave a prime time speech in May, 1985. It was a major step in launching the process of tax reform.

In the fall of 1985, I spent six weeks in Washington, D.C. when W&M held markup

*Dan is always intrigued by major scientific advances. If he could have dinner with anyone, Dan would dine with experts from the human genome and particle physics field.*

**Kostenbauder:**

I have been in my current position for the last four years, but part of my job has been working at the federal level since 1985 and at the state level since 1992.

After completing both the NYU Law School and the LL.M. (in Taxation) program, I worked for a Wall Street law firm that specialized in taxation for five years. I realized that I did not want to live in New York City, but wasn't quite sure where I wanted to go. I met a young lady who became and is still my wife. She suggested California and said "you'll like California," so we moved to California. We explored different possibilities, and HP fit a few important criteria. One was that it got us to California, and another was the possibility of becoming HP's European Tax Manager, based in Geneva, Switzerland, which I ultimately did between 1983 and 1985. That was a special opportunity and we really enjoyed that.

The day I arrived home from Switzerland in 1985 was the day that President Reagan and House Ways and Means Committee (W&M) Chairman Dan Rostenkowski gave their big speeches on television that kicked

meetings. It was quite interesting for me. There was a real advantage in being a California company because at the end of the day, I could make a phone call, usually to Larry Langdon who was the head of our tax department at that time. If there were any interesting new ideas, I could ask Larry what we thought about it and he could have someone spend a few hours in the afternoon looking at the potential impact to HP. Lester Ezrati, who subsequently became head of HP's tax department, did an excellent job in providing this analysis. So the next morning, I would know what our views were and the type of impact on HP. It provided us a leg up on the east coast companies as their tax departments were often home for the evening, so they spent their morning figuring out how any new proposal would affect their companies.

I remember my first press interview very well. It was by Alan Murray of the Wall Street Journal who was one of the reporters covering tax reform. It was interesting because the reason I was doing the interview was that Chairman Rostenkowski proposed to capitalize R&D instead of expensing it

under IRC §174 to help increase revenue for tax reform. The tech community didn't really like that, so they had asked the CEO's of IBM and HP to do an interview. Those individuals were not available and the tech community wanted a spokesman to speak out quickly and to do an interview in person. Since I was in Washington, I gave my first press interview.

After my efforts on the TRA of 1986, I spent a good bit of my time involved in federal tax policy while having responsibility for other areas in the tax department. We had an internal reorganization in the tax department in 1992, so I took responsibility for the state and local areas. Later in the 1990's, I gave up the state income tax piece and took responsibility for the worldwide transactional tax group.

My role in federal tax policy has ebbed and flowed in terms of the amount of my time. Some years did not have big tax issues on the agenda so I spent relatively less time in Washington. During other years, I spent a lot more.

**SJSU CTJ: Why is tax policy important to HP?**

*In his State of the Union Address in January 1984, President Reagan asked the Treasury Secretary Donald Regan to prepare "a plan for action to simplify the entire tax code so that all taxpayers, big and small, are treated more fairly." Eleven months later, Treasury issued the "Tax Reform for Fairness, Simplicity, and Economic Growth: The Treasury Department Report to the President, November 1984" (commonly referred to as "Treasury I").*

**Kostenbauder:**

The broad concern is that our non-U.S. based competitors have more favorable tax rules because they generally operate under a territorial or dividend exemption tax system, and they very often have lower statutory rates as well. That competitive differentiation is a great concern. It is very critical over the long haul that the U.S. adopts a tax regime that makes U.S.-based companies more competitive. Our current tax policy certainly has its shortcomings and there are reasons for comprehensive reform. Reform will not only be good for HP and the tech community, but for the entire U.S. economy.

**SJSU CTJ: Was there a specific piece of legislation that you were involved in which is more memorable?**

**Kostenbauder:**

After the 9/11 tragedy, the U.S. economy was not doing particularly well. There was concern that there would be further economic malaise so questions were asked on how we could stimulate the economy. One idea ultimately became referred to as the Homeland Investment Act (HIA). I started working on that at the end of 2001. Efforts picked up in 2002 and by 2003, we had formed a coalition of companies that was fully organized and energetically supporting the legislation. In 2003, there was a Senate vote



of 75 to 25 in favor of the HIA. The bill did not pass in the House that year but the Senate vote created a certain amount of momentum.

In 2004, I made fifteen trips to Washington and that was the most I ever did in one year. The provision met several criteria for my involvement: it was of major importance to HP, HP's involvement could help move the legislation forward, and it had a realistic chance of being passed. You just have to be able to assess whether it was something you want to spend a lot of time and energy on.

The process of creating a record for legislation occurred through hearings. During 2003 and 2004, I testified once at the W&M and twice at the Senate Finance Committee. These hearings are a more formal step that allows the members of the tax writing committees to ask questions and involves submitting written testimony.

Outside the formal process, there are many steps that are probably more important; in particular, meeting with members of Congress and their staff. With respect to the HIA, we were regularly meeting with Congressmen and Senators where HP has a constituent relationship, as well as members of the two tax-writing committees.

We have also tried over the years to have relationships with legislators whether we have strong constituent relationships or not. An example would be relationships with the members of the tax writing committees such as with Chairman Baucus. Although he is from Montana, he went to Stanford and he has been supportive of many tech and international tax issues over the years. He recognizes that having a vibrant R&D community and manufacturing sector in the U.S. would be of benefit to the country overall.

I did a lot of press interviews on the HIA, including for the Wall Street Journal, the New York Times and local Silicon Valley papers.

The issue was active for about three years so the media was interested. HP was willing to speak to the press and I was the person who did most of the speaking. We had CEO support, and Carly Fiorina got personally involved. I had a meeting with her and W&M Chairman Bill Thomas.

There was a lot of very effective coordination with other companies. We agreed on the best political strategy at various stages. We ultimately saw it passed as part of the repeal of the extraterritorial income regime in the American Jobs Creation Act of 2004 [P.L. 108-357, 10/22/2004].

It is frequently a long process to pass legislation.

### **SJSU CTJ: Have you been involved in a piece of legislation that passed which surprised you?**

#### **Kostenbauder:**

Another part of my job since the 1980's

*“Tax Relief and Health Care Act of 2006” (P.L. 109-432, 12/20/2006) §116(b)(1)(A) inserted ‘or assembled’ after ‘constructed’.*

*Effective January 1, 2006, IRC §170(e)(4) defines a “qualified research contribution” to include tangible personal property constructed or assembled by the corporate taxpayer.*

has been to advise HP with respect to tax issues affecting philanthropy. There is a minor provision within the charitable contribution deduction that relates to donations of scientific equipment and apparatus to U.S. universities for research purposes. HP had for years made substantial donations of inventory to

universities. There is a requirement that the inventory be “constructed” by the taxpayer and the definition is provided in the Code under IRC §174(e)(4)(C). Prior to the 1990s, it was not a problem for HP equipment to qualify, but as our vendors became more reliable and our supply chain became more sophisticated in the 1990s, it became less clear that HP could routinely meet the “constructed” requirement.

What was funny was that I had an opportunity to talk to a senior member of the W&M staff when there was a piece of legislation pending that focused on charitable contributions and tax exempt organizations. I told him about the issue and he was sympathetic. He arranged a meeting with the Head of the JCT [Joint Committee on Taxation]. I learned something new in this experience. My original solution involved broader language than necessary to resolve the issue for HP. During the meeting, we agreed to add the words “or assembled” into the clause and not provide a definition for assembled. This was a more elegant and less controversial approach that more surgically addressed concerns. With her help, the legislation passed in the House and Senate but never became law because the two chambers did not hold a conference to agree on the final bill. This went on for about six years. I did not ask for it the last time, but it had become a routine part of the bill. The Senate staff member included it when the bill was re-introduced at the start of a new term of the Congress, and the provision is now part of the Code. It is a good provision that encourages donations to universities. In the scheme of things, it was worth the time and trouble I put into it, which was not a whole lot compared to legislation like tax reform or HIA.

### **SJSU CTJ: You seem to really enjoy the legislative process. What makes it interesting for you?**

*You can find the provision intended to encourage U.S. corporations to repatriate their foreign earnings to promote U.S. job growth under IRC §965 Temporary Dividends Received Deduction. It was created by the Homeland Investment Act (H.R. 767, 108th Cong., 2003-2004) and enacted by P.L. 108-357.*

#### **Kostenbauder:**

There must be a teacher or professor in my psyche, because one of the things you need to do in my position is explain things over and over to new people or to people you met before who might not have fully understood our viewpoint then, but have thought about it since you talked to them a year or so before. I have the patience. My career, however, has mostly involved doing “real” tax work, too, which I enjoy.

**Part II of this two-part interview features Mr. Kostenbauder views on recent discussions on tax reform.**

# Tax Mavens

## The Contemporary Tax Journal's Interview of Dan Kostenbauder

Part II on Tax Reform

By: Victoria Lau, *MST Student*

Part II of the two-part interview of Mr. Kostenbauder, Vice President of Tax Policy at Hewlett-Packard Company (HP), covers recent activities on federal tax reform. Mr. Kostenbauder discussed the reasons for international tax reform, proposed changes and challenges in enacting tax reform.

**SJSU CTJ: There are a lot of discussions about upcoming federal tax reform. Do you think it will happen?**

**Kostenbauder:**

The United States had a big tax reform bill in 1986. By the mid 1990's, there were discussions about tax reform, but focused on value added tax (VAT) and similar types of tax proposals. I became Vice-Chair of the Alternative Tax System Subcommittee or Task Force at the Tax Executive Institute (TEI) because alternatives to the income tax were the flavor of tax reform at that time. One of the big challenges in going to a VAT in the U.S. is that sales tax is the States' major funding source. So it is difficult for the federal government to encroach on that.



*One of the most unusual items in Dan's office is this political button.*

After a while, as new ideas for tax reform were proposed, I would be less energetic and spend less time worrying about it. I knew it would not sneak up on me or HP. People can and did talk about tax reform, but it was not going to happen without serious senior level political leadership coming from the President, the Speaker, the majority leaders, or the Chairs of the tax writing committees. That has not been in place since 1986, until possibly now.

In our current environment, there are several big factors that suggest to me that we are in the early days of tax reform effort. HP considers tax reform a priority and I am

rate. But starting in 1997, the OECD average rate has fallen below the U.S. rate and keeps on trending downward. Now it is approximately ten points below the U.S. rate. Our international competitors, including Canada and the U.K., have gone to much lower tax rates, and continue to lower them. Generally, the OECD countries have territorial systems. Two countries that had a worldwide system like the U.S., Japan and the U.K., moved to a dividend exemption form of territorial system just a couple years ago. Some of the European countries also are adopting "patent box" provisions, which further lower their statutory rates or provide other incentives for earning

*Chairman Baucus announced on April 23, 2013 that he will retire at the end of 2014 and not seek reelection for his 7th term as U.S. Senator.*

spending a lot of my time addressing tax reform. One reason is that Chairman Camp is a strong believer in tax reform now. He released a discussion draft on international tax reform in October, 2011. He has since released other discussion drafts this spring and has organized working groups with bipartisan members. It is more concrete, although there are many details still to be worked out. Chairman Camp also has a personal timetable because the House Republicans have a limit on the number of years a member can be a Chairman or Ranking Member. Next year will be his last year as Chairman of the Ways and Means Committee. Chairman Baucus has also expressed his support for tax reform. Both Committees have held lots of hearings. The President has spoken particularly about corporate tax reform, and has referred to broader tax reform as well.

One main factor supporting reform is that twenty years ago the U.S. statutory rate was lower than the OECD average statutory

income from intellectual property or patents. All this is putting pressure on the international competitiveness of U.S. companies because we are competing against companies in countries with much more favorable rules, particularly for their operations outside the home country. This creates a lot of interest for tax reform in the business community for companies with a lot of international activities.

It is hard to say at the moment whether there will be tax reform. Chairman Camp has been working hard to be in a position to move forward if an opportunity arises, and Chairman Baucus has the Senate Finance Committee moving in that direction as well. It is conceivable that such an opportunity might occur because we still have two big budget issues to resolve later this year, the debt ceiling and the appropriations bills for 2014. It is possible that some definition of a process to do tax reform next year may be added to the legislation to pass these two budget related bills. As usual, there are also major obstacles to achieving tax reform.



**SJSU CTJ: If there is tax reform, what changes would you expect?**

**Kostenbauder:**

Tax reform would include lowering the rates and broadening the base on both the individual and corporate parts of the income tax. The international rules would also include some type of base erosion provision. More broadly, HP would like to see a competitive hybrid territorial system that is comparable to other countries. The proposal that Chairman Camp has put out includes three options for a base erosion provision. We believe that a base erosion provision would be a component of a territorial system.

One big consideration is the challenge related to passthrough entities, because about half of the total business income in the U.S. is earned by passthroughs rather than C corporations. Passthrough entities such as partnerships and S corporations are taxed largely under the individual provisions of the Code, so there is a need to revise the individual Code as well in a tax reform package. This will be politically challenging, with issues such as the mortgage interest, charitable, and state and local tax deduction. These individual provisions are popular and

supported by a lot of special interest groups, so dropping them or cutting them back in order to lower rates will be difficult.

**SJSU CTJ: For the mortgage interest deduction, can legislators make an effective argument that it benefits a small number of wealthy taxpayers?**

**Kostenbauder:**

If the President makes an effort to explain it, he has the “bully pulpit” to make that type of argument.

We shall see what happens in the months ahead, as all this needs to be sorted out in tax reform. Tax reform is not an easy undertaking because just resolving the transitional issues will be challenging. They go to elements of fairness. To the extent that it is viewed by most folks as “I gave something up, but have something in return” and “the system is now simpler and fairer,” the prospects for tax reform will be enhanced.

With the Tax Reform Act of 1986, the U.S. dropped the corporate rate from 46% to 34% and dropped the top individual rate from 50% to 28%. The U.S. certainly experienced a strong decade and a half of growth afterwards. There was a little recession in 1990, but the

economy was strong until the 2000’s.

**SJSU CTJ: In the AICPA Tax Policy Statement, it recommends simplification as a priority in the development of legislation and regulations. Could base broadening and rate lowering provide simplicity in the Tax Code?**

**Kostenbauder:**

It can. Although there is no guarantee that it will.

The Code is complex and seems

*The National Taxpayer Advocate’s 2012 Annual Report to Congress designates the complexity of the tax code as the #1 most serious problem facing taxpayers.*

to get more complex all the time. A major reason is simply that Congress uses the tax code for far more than raising revenue. A good chunk of the tax code’s complexity is not about defining taxable income but is really about executing other elements of social policy including distribution effects. For example, the personal exemption phase-out and the itemized deduction limitation, in addition to raising revenue, are distribution tools and add complexity. Various education credits and retirement benefits are all to achieve social objectives. Different groups may argue whether they serve a good purpose or not, but it has become routine to have them in the Code. My thinking is that simplification is a good idea.

As the world becomes more digitized, some things that might be conceptually complex, such as recordkeeping, can be better managed in the digital economy. It is a relatively slow process, but it is catching

up.

**SJSU CTJ: Do you have any recommendation on how tax professionals can engage in tax policy issues and the legislative process?**

**Kostenbauder:**

It is useful to pay attention to public debate about tax rules. These rules do not spring out of the minds of lawmakers in Washington and happen in a vacuum. A lot of folks are involved when it comes down to drafting legislative language and they are responding to political and economic forces. So by reading newspaper and magazines to stay informed, you can understand the reasons for the complexity of the tax code. It is always difficult to have direct input into the legislative process in Washington, but professional organizations representing the accountants and lawyers will certainly weigh in on technical issues, so providing feedback to these organizations on specific points is also a route open to tax professionals.

# Tax Mavens

## The Contemporary Tax Journal's Interview of Fred Silva

By: Sandra Peters, *MST Student*

Anyone involved in California's state political scene knows Fred Silva. He has been involved in California state and local government for over 40 years. His opinions are highly valued and sought by political and industry leaders. He is currently the senior policy analyst at California Forward.

California Forward (<http://www.cafwd.org>) is a nonpartisan, nonprofit organization working for fiscal, structural and democratic reform in California by restructuring the relationship between state and local government interaction. They advocate empowering local communities to resolve issues and create a responsive democracy with the people of California involved in reform discussions.

Prior to California Forward, Mr. Silva was a policy advisor for New California Network. His contributions also include

nine years at the Public Policy Institute of California developing proposals. He was the bridge between the policy researchers and the Capitol. Many of the state's leaders and politicians rely on his opinion when evaluating proposals and current policy.

I was eager to interview Mr. Silva after hearing him speak at a tax policy conference in Santa Clara. He is very engaging and it is evident he is respected for his insights of California politics and his ability to lead relevant discussion on reform. He clearly understands the nature of our economy and how policy has led us to where we are today. He maintains an outstanding arsenal of facts and statistics in the historical progression of how we got where we are and where we need to go in fixing many of California's political and fiscal issues. He is keenly informed and has written numerous reports on California's fiscal issues. He maintains enthusiasm and an optimistic attitude that reform can be achieved.

I had the pleasure of hearing him again at the American Leadership forum in San Jose. Again, he inspired optimism. After hearing him speak, one is ready to "sign up" to be involved at a local level knowing that a voice can be heard and can make a difference. I was proud to know that Mr. Silva is a San José State University graduate.

The following interview took place before the American Leadership forum in May 2012:

**SJSU CTJ: How did you become involved in the field of state finances?**

**Silva:**

Our family was always involved in the local government. I can "get my arms around it". It seemed manageable as I could see the relationships between policy and local issues.

*He gestures his arms around a large object and seemed quite comfortable and confident that the scale of state finances was no problem.*

**SJSU CTJ: What words of advice do you have for a tax practitioner or student who would like to understand California finances so they can explain where the money comes from and where it goes at the state and local levels?**

**Silva:**

First, understand the underlying economy and how it works, the dynamic nature of it. Secondly, apply tax policy whether on income, wealth, or transactions. Look at preference items of policy and how they work.

*He went on to explain how these three types of tax have evolved over time and how each one contributes to the budget and varies based on the economic environment of the times. He explained these taxes in a 40 year window and easily recited many statistics. Mr. Silva showed an evident passion for making 40 years of economic history compelling grounds for change.*

**SJSU CTJ: What do you think are the three most important reforms for California?**

**Silva:**

1. Governance agenda, continuing on governance reform both local and state,

[particularly], Proposition 28; 2. Results-based state and local government. 3. How to finance local and regional services;

*Proposition 28 was on the June ballot and was approved, calling for changes in term limits in the California legislature. I must have looked puzzled when he mentioned "results-based" government since he eagerly elaborated. He explained that governments should be held accountable based on results of their performances. If a program doesn't produce desired results, then it does not receive funding. It is government accountability to the public through a framework of measuring results including effectiveness and efficiency. He cites Ventura, Sunnyvale and Washington and Oregon State as adopting effective examples.*

**SJSU CTJ: How would you advise a tax practitioner or student to begin involvement in tax policy reform at a state and local level?**

**Silva:**

For a student, [it is important to] understand the system. Gain a foundational understanding of why it is volatile. Spend time at local agencies. Get involved in your local finance and budgeting discussions.

*As a student he worked at the City of Milpitas and Morgan Hill, absorbing all he could about the local finance systems.*

**SJSU CTJ: Have you seen progress or changes in reform initiatives over the years?**

**Silva:**

We've seen different forums over the years and we have made progress.

*His voice is optimistic.*

**SJSU CTJ: You have had a successful career and continue to be very involved. Since the work will continue to evolve and never be completed, how do you avoid discouragement or burn out?**

*First, he looks at me quizzically as if discouragement never occurred to him. After pausing, he simply answered:*

**Silva:**

My debate coach in high school [used to say] "Keep up the debate, it's a path."

Certainly, discussion on reform has kept him on "the path".

**SJSU CTJ: If you could have dinner with anyone, who would it be?**

Silva: My grandfather. He was an architect and urban planner in Los Angeles in the 60s. He knew a lot about the L.A. transportation system from the 20s, 30s and 40s. I would love to know about the inner workings of that.

**SJSU CTJ: What is the most unusual item in your office or something in it that has special meaning?**

**Silva:**

When I left the State, I received a frame of resolutions from the department of finance. It reminds me of the professional relationship we had.

*I am sure he had developed many relationships of mutual respect which is evident in his body of work. He smiles and nods as if reminiscing on all the good relationships he has developed over the years.*

*He smiles and nods as if reminiscing on all the good relationships he has developed over the years.*



### The SJSU MST Program:

**Our goal – to provide the highest quality tax education to meet the needs of the Silicon Valley community.**

<http://www.sjsu.edu/lucasschool/prospective-mst/index.html>



## Focus on Tax Policy: An Introduction

By: Professor Annette Nellen, *SJSU MST Program Director*

This section of The Contemporary Tax Journal includes tax policy work of SJSU MST students. We offer it here and on the journal website to showcase the range of tax knowledge the students gain from the program and to provide a public service. We think the analysis of existing tax rules and proposals using objective tax policy criteria will be of interest to lawmakers and their staff, and individuals interested in better understanding taxation.

One of the learning objectives of the SJSU MST Program is: *To develop an appreciation for tax policy issues that underpin our tax laws.*

Students learn about principles of good tax policy starting in their first MST class - Tax Research and Decision-making. The AICPA's tax policy tool, issued in 2001,<sup>1</sup> which lays out ten principles of good tax policy, is used to analyze existing tax rules as well as proposals for change.

Beyond their initial tax course, SJSU MST students examine the principles and policies that underlie and shape tax systems and rules in the Tax Policy Capstone course. In other courses, such as taxation of business entities 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 seven tax policy analyses included in this section join the growing archive of such analyses on the journal website (under "[Focus on Tax Policy](#)").

- 1) Transferability of the Research Tax Credit.
- 2) Return of the 20% Capital Gains Rate for Certain High Income Individuals.
- 3) Surtax on Millionaires.
- 4) Excessive Compensation – How Much is Too Much?
- 5) Increase and Make Permanent the Research Tax Credit.
- 6) Preferential Treatment of Capital Gains.
- 7) Repeal of the Inclusion of Social Security Benefits in Gross Income.

<sup>1</sup> AICPA. (2001) Tax Policy Concept Statement 1 – Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals. Available [here](#). Professor Nellen was the lead author of this AICPA document.

# Transferability of the Research Tax Credit

By: Erika Codera,  
*MST Student*

The Credit for Increasing Research Activities (IRC §41) has a long and tumultuous history. In 1981, the credit made its debut in the Internal Revenue Code. Congress hoped the credit would help stimulate productivity, growth and competitiveness of U.S. companies. Since its beginning, the statutory credit amount, definitions and formulas have been frequently modified. The credit has also been allowed to expire and has been retroactively reinstated over ten times. Between January 2011 and January 2012 there were more than eleven proposals to revise the research credit<sup>1</sup>. In early 2013, the “Create Jobs by Expanding the R&D Tax Credit Act of 2013”<sup>2</sup> (H.R. 120) was introduced. This Act would extend the availability of the credit through December 31, 2014, increase the rate of the regular credit from 20% to 30% or from 14% to 20% for the alternative simplified credit, and allow the credit to be assigned or transferred from a qualified taxpayer who earns the credit to another taxpayer designated by the qualified taxpayer.

Many agencies have researched and analyzed the need for compensation for the spillover benefits of research and development (R&D) activities, and the strengths and areas for improvement of IRC§41 and its overall effectiveness. It is clear that private market bias against research demands government intervention across all sectors to produce optimal levels of technological development.<sup>3</sup> The Government Accountability Office (GAO) has suggested the need to modify the credit to ensure that it is available for marginal projects, with the benefit for windfall projects reduced. Marginal projects are those which a taxpayer may not invest in without the

tax benefits provided by the government; they are nearly impossible to determine. Projects that will be pursued regardless of government subsidies are windfall projects.<sup>4</sup>

Evidence suggests “the credit has delivered no more than a modest stimulus to domestic business R&D investment.”<sup>5</sup> Despite this, every Administration has supported the R&D credit since its enactment,<sup>6</sup> and there is broad bipartisan support for extending the research credit.<sup>7</sup>

Policy makers should consider the results of years of discussion and analysis in developing their proposals. It is also important to consider principles of good tax policy in developing any proposal. The analysis below examines the efficiency and effectiveness of adding a provision to IRC §41 for qualified taxpayers (small business concerns as defined by the Small Business Act) to transfer credits earned under the provision to a person designated by the taxpayer. Under the proposal, amounts received by the taxpayer for the credits transferred are not included in gross income.

This paper provides an overview of H.R. 120 (113th Congress) and analyzes it using the ten principles of good tax policy outlined in the AICPA Statement #1, Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals.

1 Guenther, G. (2011, Nov. 29). Research Tax Credit: Current Law, Legislation in the 112th Congress, and Policy Issues. Congressional Research Service.

2 H.R. 120 (113th Congress) (2013, Jan. 3). Create Jobs by Expanding the R&D Tax Credit Act of 2013. Retrieved from <http://thomas.loc.gov/cgi-bin/bdquery/z?d113:h.r.00120>:

3 Staff of the Joint Committee on Taxation. (2011, Sep. 16). Tax Incentives for Research, Experimentation, and Innovation. Retrieved from <https://www.jct.gov/publications.html?func=startdown&id=4358>

4 Government Accountability Office. (2009, Nov. 6). Report to the Committee on Finance, U.S. Senate, Tax Policy: The Research Tax Credits Design and Administration can be Improved. Retrieved from <http://www.gao.gov/new.items/d10136.pdf>

5 Guenther, 2011.

6 R&D Credit Coalition (2011, Jun. 2). Research and Development Incentives in the U.S. and Abroad Submitted for the Record of the Hearing on “How Business Tax Reform Can Encourage Job Creation” before the Committee on Ways and Means. Retrieved from [http://waysandmeans.house.gov/uploadedfiles/research\\_and\\_development\\_incentives\\_in\\_the\\_u.s.\\_and\\_abroad.pdf](http://waysandmeans.house.gov/uploadedfiles/research_and_development_incentives_in_the_u.s._and_abroad.pdf)

7 R&D Credit Coalition, (2013, Apr. 15). Comments for the Ways and Means Tax Reform Working Group on Manufacturing, Retrieved from [http://waysandmeans.house.gov/uploadedfiles/r\\_and\\_d\\_credit\\_coalition.pdf](http://waysandmeans.house.gov/uploadedfiles/r_and_d_credit_coalition.pdf)

## Equity and Fairness

*Similarly situated taxpayers should be taxed similarly.*

Allowing the R&D tax credit to be transferred for a price would decrease the perception of equity and fairness. The public will see corporations that potentially have no R&D activities, yet have sufficient profits to purchase R&D tax credits, are able to reduce their average effective tax rates. Taxpayers may feel at a disadvantage because although these corporations have high taxable income, they are paying taxes at potentially low average effective rates. Only a small number of taxpayers, directly impacted by the inherent problem of generating credits that cannot be used currently, would likely see a direct benefit and perceive the policy as equitable and fair.

The policy would also negatively impact vertical equity. Shifting the tax benefit from the entity that rightfully earned it violates the ability to pay principle. Although corporations with large profits and tax liabilities have a greater ability to pay, if they can afford to purchase tax credits, they will not be subject to their “fair share” of the tax burden.

Earning R&D tax credits without the opportunity to obtain immediate benefits is unfair. Quite often, small companies invest heavily in R&D and have little or no tax liabilities for an extended period of time. Such companies are not able to materialize R&D credits (in their current form) until they generate taxable income, which can be years down the line, when the need for the subsidy may be lessened. Compare

this to a large multinational company that has income producing activities that can fund R&D. Such a company is able to utilize credits earned immediately to offset their tax burdens generated from existing profitable lines of business. The two taxpayers described above are not “situated similarly” and, therefore, should have differing rules on how the R&D tax credits function. This proposal mitigates this horizontal inequity.

However, the proposal does not eliminate horizontal inequity. The smaller taxpayer assigning the credits faces a loss on the transaction. It would likely not get paid the full value of the credits earned, and it would have additional costs related to marketing the credit. The larger company buying the credits makes a profit on the transaction because they pay less than the full benefit they receive and their costs to participate in the transaction may be less.

## Certainty

*The tax rules should 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.*

This proposal does not impact the mechanics of qualifying for the credit, calculating the credit, or limiting use of the credit. Amounts paid to purchase credits are not included in income of the seller.

Guidance would be needed on how to treat the costs of the taxpayer acquiring the tax credits.

There is some uncertainty as to who qualifies to transfer or use the credit. The ability of taxpayers to transfer credits is limited. Such limitations increase taxpayer uncertainty. One company comparing itself to another company may be confused why the rules are applied differently. It is not well defined who would be eligible to purchase the credits. The IRS would have to issue regulations that would provide more detailed guidance.

## Convenience of payment

*A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer.*

This proposal does not significantly impact the convenience of payment principle of good tax policy because it will not impact the current tax filing and payment rules. However, due to increased complexity of reporting credits earned, purchased, used or sold, there likely will be issues related to timing and substantiating credits which will negatively impact the convenience of payment principle



## Economy of Collection

*The costs to collect a tax should be kept to a minimum for both the government and taxpayers.*

This proposal will cause increases in costs of auditing returns, decreasing the economy in collection. If a taxpayer that uses the credits did not earn them, the IRS would not be able to audit at that level the nature of the costs or the calculation of the credits. When the IRS audits taxpayers that earned the credits and sold them, if there is a change to the amount of the credit that had been previously transferred, it would be difficult to collect the additional tax due from the purchaser. Also, the high level of audit risk associated with R&D credits would likely impact the marketability of the transfers. The efficiency of these transactions would likely be low.

## Simplicity

*The tax law should be simple so that taxpayers can understand the rules and comply with them correctly and in a cost-efficient manner.*

Several factors of the proposal increase complexity:

1. effective period is only two years,
2. applicability is limited to “qualified taxpayers,” and
3. administrative burdens and taxpayer compliance costs are high.

Although this proposal attempts to simplify the definition of “qualified taxpayer” by referencing section 3 of the Small Business Act, it complicates this definition by adding an additional threshold of average number of employees during the year.

## 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.*

The R&D tax credit is designed to encourage investment in R&D, thus making the general provision biased. The new marketability of credits may cause further distortions in taxpayer decisions. This proposal may potentially encourage some taxpayers to invest more in R&D activities if they have an option of monetizing the credits currently. Also, buyers of credits may infuse too much funding, causing an inefficient level of investment in R&D. These possible effects negatively impact the neutrality principle of good tax policy.

## Economic Growth and Efficiency

*The tax system should not impede or reduce the productive capacity of the economy.*

Measuring economic efficiency is extremely difficult and uncertain. Because this proposal potentially distorts taxpayer behavior, it may impede economic growth and efficiency. However, positive externalities that occur with R&D activity impact the ability of companies to fully capture the financial benefits of their investments. Tax benefits are one way to make up for the spillover. This proposal also makes the tax benefits realizable more immediately, so it may help economic growth and efficiency because the influx of cash into businesses will provide them the opportunity to invest more.

### Transparency and Visibility

*Taxpayers should know that a tax exists and how and when it is imposed upon them and others*

This proposal negatively impacts the transparency and visibility of the tax law. It significantly increases perceived inequities, increases administration costs, results in more errors, and is short lived, which causes frustration for taxpayers and advisors to plan transactions and comply with the law. The tax base and rate are not affected. However, shifting benefits between taxpayers makes it more difficult for lawmakers and policy analysts to see the impact of the subsidies provided by the government and determine if the policy is effective.

### Appropriate Government Revenue

*The tax system should enable the government to determine how much tax revenue will likely be collected and when.*

Allowing the transfer of credits may make the determination of tax expenditures more predictable and reliable. Many taxpayers who claim credits are not able to currently use them, and it is difficult for the government to know when they will likely be able to use them. This causes uncertainty in timing of tax expenditures

### Minimum Tax Gap

*A tax should be structured to minimize non-compliance.*

This proposal may encourage non-compliance. Taxpayers may be more aggressive in their determination of credits they have an option of transferring the credits to other taxpayers. Also, because the level of complexity is increased, unintentional noncompliance may increase. The consequence of errors (whether or not intentional) may not be clear. As a result, taxpayers may be more careless in their application of the proposed provisions.

## Rating summary

<b>Equity and Fairness</b>	+/-
<b>Certainty</b>	-
<b>Convenience of Payment</b>	-
<b>Economy in Collection</b>	-
<b>Simplicity</b>	-
<b>Neutrality</b>	-
<b>Economic Growth and Efficiency</b>	+/-
<b>Transparency and Visibility</b>	-
<b>Minimum Tax Gap</b>	-
<b>Appropriate Government</b>	+

## Conclusion

The transferability provision of H.R. 120 (113th Congress) does not represent good tax policy based on the analysis of the AICPA's ten guiding principles. It does not significantly contribute to the efficiency or effectiveness of IRC §41. Instead of getting another taxpayer involved in the transaction, the government can make the credits fully or partially refundable. The impact of the expenditure would essentially be the same; however, principles of good tax policy may be better served. Instead of using the tax law to meet the need of society to subsidize spillover costs of R&D, the government should consider programs like providing grants or financing, which could be more which efficient and effective in meeting their economic goals.

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# Return of the 20% Capital Gains Rate for Certain High Income Individuals

By: Victoria Lau, *MST Student*

“The American Taxpayer Relief Act of 2012” (P.L. 112-240, 1/2/13) introduced a maximum 20% rate<sup>1</sup> on adjusted net capital gain for high income individuals with taxable income over \$450,000 if they are married or \$400,000 if they are single. Prior law remains effective for individuals with taxable income below these thresholds: married individuals pay 15% tax on capital gains when their taxable income is between \$72,000 and \$450,000; and are not liable for capital gains tax when their income is below \$72,000. The applicable taxable income thresholds by filing status are listed in *Table 1*.

Net Capital Gain and Qualified Dividend				
Taxable Income by Filing Status				
	MFJ	Single	MFS	HOH
0%	\$72,500	\$36,250	\$36,250	\$48,600
15%	Up to \$450,000	Up to \$400,000	Up to \$225,000	Up to \$425,000
20%	Over \$450,000	Over \$400,000	Over \$225,000	Over \$425,000
25%	Unrecaptured Gain from Sale of Depreciable Real Property			
28%	Gain from Sale of Collectibles and §1202 Small Business Stock			

Table 1: Five-tier Capital Gain Rate Structure, effective as of Jan. 1, 2013<sup>2</sup>

Adjusted net capital gain includes net capital gain and qualified dividends as provided under IRC §1(h)(3). It excludes certain gains and they are taxed under different rates: individuals pay 28% tax on gains from sale of collectibles and certain small business stock,<sup>3</sup> and 25% tax on unrecaptured depreciation from sale of real property.<sup>4</sup>

The definition of capital gain is broad and the rules are provided in Subchapter P Capital Gains and Losses. Capital gains and losses are classified as long-term if the taxpayers held the property for more than a year before it is sold; otherwise, they are classified as short-term.<sup>5</sup> Net capital gain generally means the excess of long-term capital gain over net short-term capital loss.<sup>6</sup> Qualified dividend income, comprises dividends received from domestic and certain foreign corporation, is added to net capital gain for preferential treatment under §1(h)(11).

Income other than capital gains, except for short-term gains, is subject to the higher ordinary rates, up to 39.6% in 2013.<sup>7</sup>

The maximum capital gains rate of 20% applied prior to 2003. The lawmakers reduced the maximum rate to 15% when they enacted the “Jobs and Growth Tax Relief Reconciliation Act of 2003” (P.L. 108-27, 5/28/2003). It was a temporary reduction to last until December 31, 2008. But the lawmakers extended it twice. It was first extended to the end of 2010 when they enacted the “Tax Increase Prevention and Reconciliation Act of 2005” (P.L. 109-222, 5/17/2006); and extended again to the end of 2012 by “Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010” (P.L. 111-312, 10/23/2009).

This analysis uses the ten principles of good tax policy outlined in the *AICPA Statement #1, Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals, to evaluate the resumption of the 20% maximum capital gain rate as compared to the maximum 15% rate effective from 2003 to 2012*.

<sup>2</sup> IRC §1(h)(1) provides the capital gains rates and Rev Proc 2013-15 §2.01 provides the regular income tax brackets for 2013.

<sup>3</sup> IRC §§1(h)(4) and (5).

<sup>4</sup> IRC §§1(h)(3) and (6).

<sup>5</sup> IRC §1222

<sup>6</sup> IRC §1222(11).

<sup>7</sup> IRC §1(a) and §1(h).

<sup>1</sup> IRC §1(h)(1)(D), as amended by PL 112-240 §102.

## Equity and Fairness

*Similarly situated taxpayers should be taxed similarly.*

Equity is commonly assessed based on the concept of horizontal and vertical equity. For horizontal equity, similarly situated taxpayers should pay the same amount of tax and vertical equity provides that taxpayers with greater ability to pay should pay more tax.

Under the new law, two similarly situated taxpayers with the same amount of taxable income may pay different amounts of tax on their capital gain if their mix of capital gain and other taxable income is different. For example, two married taxpayers have income of \$500,000. If one taxpayer has capital gain of \$50,000 and other income of \$450,000; he will pay 20% tax on all of his capital gain. If the other taxpayer has \$250,000 of capital gain and the remaining in earned income, \$200,000 of his capital gain will be taxed at the lower 15% rate. This horizontal inequity only applies though, to approximately 4% of taxpayers who have income in excess of \$500,000; above the 20% capital gain rate thresholds.<sup>8</sup>

Although horizontal equity is not met for this 4% of high income taxpayers, they pay

<sup>8</sup> IRS SOI. (2007) Tax Stats for 2007: Table 2a on Returns with Short-Term and Long-Term Capital Gains and Losses by Size of AGI and Selected Asset Type. Approximately 4% of returns with long-term gain transactions are filed by taxpayers with AG in excess of \$500,000. Retrieved from <http://www.irs.gov/uac/SOI-Tax-Stats-Sales-of-Capital-Assets-Reported-on-Individual-Tax>Returns>

more tax on their capital gain due to the new tax rate. This 4% of taxpayers accounted for 68% of the \$970 billion capital gains reported in 2007.<sup>9</sup> Taxpayers with adjusted gross income (AGI) over \$1 million (making up 1.5% of taxpayers) reported \$566 billion capital gains, or an average of \$1.6 million of capital gain each.<sup>10</sup>

The conclusion as to whether or not the new maximum capital gain rate attains vertical equity depends on the perception of the evaluator which is influenced by past experience, and information or misinformation available.<sup>11</sup> Some taxpayers believe the preferential rate benefits all taxpayers; for example, Krugman claimed that "low capital gains rates are being showered on everyone."<sup>12</sup> Many lower income taxpayers do not own capital assets, such as a home or stock. If they are homeowners, the national medium home price is \$178,000<sup>13</sup> so gains realized by most taxpayers when they sell their home are not taxed. IRC §121 allows married individuals to exclude gains of up to \$500,000 (\$250,000 for single individuals) from income when they sale their home provided certain conditions are met.

Equity should also be evaluated in the context of the entire tax system because taxpayers are subject to a range of different

<sup>9</sup> *Ibid.*

<sup>10</sup> *Ibid.*

<sup>11</sup> AICPA, (2007). Guiding Principles for Tax Equity and Fairness, New York, NY. p 3. Retrieved from <https://www.aicpa.org/INTERESTAREAS/TAX/RESOURCES/TAXLEGISLATIONPOLICY/Pages/TaxReform.aspx>

<sup>12</sup> Root, W. (2012, Jan. 24). Paul Krugman Is Wrong About Capital Gains Taxes. *Forbes*, Retrieved from <http://www.forbes.com/sites/wayneroot/2012/01/24/paul-krugman-is-wrong-about-capital-gains-taxes/>

<sup>13</sup> National Association of Realtors. (2013, Feb. 11). Fourth Quarter Metro Area Home Prices Show Strongest Performance in Seven Years. Retrieved from <http://www.realtor.org/news-releases/2013/02/fourth-quarter-metro-area-home-prices-show-strongest-performance-in-seven-years>

types of tax.<sup>14</sup> The effective income tax rate, combining ordinary income and capital gain, is not progressive above a certain income level. The reason is that higher income earners have a greater portion of their total income from capital gains;<sup>15</sup> therefore, higher income earners can have an effective tax rate lower than taxpayers with only earned income. In 2007, when the maximum capital gain rate was 15%, the effective income tax rate was 24.1% for individuals with AGI between \$1 and \$2 million and fell to 19.4% for taxpayers with AGI above \$10 million.<sup>16</sup>

Including the 3.8% Medicare tax on unearned income,<sup>17</sup> the effective tax rate on the income for this group of taxpayers will exceed 23.8% in 2013. This rate is still lower than the effective tax rate of 34.4%<sup>18</sup> if the taxpayer earns \$1 million from employment. Thus the new rate structure adds progressiveness to the income tax structure compared to the rate structure prior to 2013.

Equity can also be evaluated in relation to time: whether or not the total tax obligation of the taxpayer is appropriate over the long-

<sup>14</sup> AICPA. (2005). *Understanding Tax Reform: A Guide to 21st Century Alternatives*. New York, NY. p 11. Retrieved from [http://www.aicpa.org/InterestAreas/Tax/Resources/TaxLegislationPolicy/TaxReformStudies/DownloadableDocuments/AICPA\\_Understanding\\_Tax\\_Reform%20\(2005\).pdf](http://www.aicpa.org/InterestAreas/Tax/Resources/TaxLegislationPolicy/TaxReformStudies/DownloadableDocuments/AICPA_Understanding_Tax_Reform%20(2005).pdf)

<sup>15</sup> IRS SOI Tax Stats. (2010). Individual Income Tax Returns Table 1 – Individual Income Tax, All Returns, Sources of Income and Adjustments for 2010. Retrieved from <http://www.irs.gov/uac/SOI-Tax-Stats-Individual-Income-Tax>Returns>

<sup>16</sup> Sullivan, M. (2009, Dec. 14). Economic Analysis: Is the Income Tax Really Progressive? *Tax Notes*. Retrieved from <http://www.taxanalysts.com/www/features.nsf/Articles/53521CB22AEB44AA85257B1D006058FC?OpenDocument>

<sup>17</sup> IRC §1411 introduces the 3.8% tax on net investment income over \$250,000 for married taxpayers and \$200,000 for single taxpayers.

<sup>18</sup> Calculated on regular income of \$1,000,000 per IRC §1(h) and Rev Proc 2013-15 §2.01.

run and not distorted by changes in income and wealth. Capital gain is calculated in annual tax periods; therefore, a taxpayer engage in property transactions that may trigger the 20% maximum rate may reduce his annual income by spreading the dispositions over several tax periods. Benefits from a reduced tax rate may be offset by inflationary or opportunity costs. Time-related equity is inherent in a tax system with accounting periods<sup>19</sup> because tax liabilities are calculated using a short term 12-month measure and inflation affects the value of a dollar.<sup>20</sup>

<sup>19</sup> IRC §441(b) provides that the taxpayer's annual accounting period is a calendar year or a fiscal year.

<sup>20</sup> AICPA. *Tax Equity and Fairness*, 2007, p. 7.

## Certainty

*The tax rules should 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.*

**F**requent expiration and extension creates uncertainty. P.L. 112-240 provides certainty. It is a permanent extension of the 15% preferential rate;<sup>21</sup> and the 20% rate is a permanent provision.

However, taxpayers with a mix of capital gain and other income close to the thresholds may not know whether they pay the maximum 20% rate when they sell or dispose of property. They may earn more income after the sale thus increasing their taxable income above the thresholds. This uncertainty may impact close to 3 million taxpayers; the 12% that reported capital gains with AGI between \$200,000 and \$1,000,000.<sup>22</sup> The portion of taxable income subject to the lower 15% rate would not be material for taxpayers earning over \$1,000,000.

## Convenience of Payment

*A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer.*

**P**.L. 112-240 does not impact this tax principle for most taxpayers because it does not change how and when capital gain tax is paid.

However, the 3 million taxpayers with a mix of capital gain and other income close to the thresholds may not be able to calculate their estimated tax payments accurately because they may not know whether or not their annual taxable income is above the thresholds when they sell their property.

## Economy of Collection

*The costs to collect a tax should be kept to a minimum for both the government and taxpayers.*

**T**o support the new law, the IRS will need to revise applicable forms and instructions.

The IRS will also incur costs to educate taxpayers, tax practitioners and tax administrators on how to calculate the tax using the new 20% rate. A taxpayer only pays at 20% tax on the portion of capital gain when combined with other taxable income exceeds the threshold. Taxpayers may think that the 20% rate applies to all capital gain when the taxable income exceeds the top bracket.

## Simplicity

*Tax law should be simple so that taxpayers understand the rules and can comply with them correctly and in a cost efficient manner.*

**P**.L. 112-240 increases the number of capital gain rates to five (0%, 15%, 20%, 25% and 28%) thus increasing complexity.

In determining whether the 20% applies, the taxpayer must calculate his taxable income and capital gain. Only the excess of capital gain when combined with other taxable income over the threshold amounts is subject to the 20% rate. The use of more than one value to determine applicability of the 20% rate adds complexity.

<sup>21</sup> P.L. 112-240 (1/2/2013) §102(a) struck out PL 108-27 §303 which contains the sunset date of December 31, 2008.

<sup>22</sup> IRS SOI Tax Stats, 2010.

## 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.*

The resumption of the 20% rate influences taxpayers' decisions in two ways.

First, taxpayers accelerated their gain realization in 2012 before the anticipated increase became effective<sup>23</sup>. The 20% rate also applies to qualified dividends; so many companies declared special dividends or moved up dividend payments toward the end of 2012. Some companies even borrowed to pay the special dividends.<sup>24</sup>

Second, the government anticipates that with the higher capital gain rate, taxpayers will hold on to their assets for longer period; thus realizing fewer capital gains.<sup>25</sup> The reason for this is the "lock-in" effect created by the realization requirement where income from appreciation of assets is not taxed until sale or disposal. Thus taxpayers in evaluating new investment alternatives need the expected

23 Collins, M & Rubin, R. (2012, Oct.19). Wealth Advised to Sell for Gains Before Unfriendly 2013. *Bloomberg BusinessWeek*. Retrieved from <http://www.businessweek.com/news/2012-10-19/wealthy-advised-to-sell-for-gains-before-unfriendly-2013>

24 Talley, K. & Russolillo S. (2012, Nov. 28) Costco to Spend \$3 Billion on Special \$7 Dividend. *The Wall Street Journal*. Retrieved from <http://online.wsj.com/article/SB10001424127887324705104578147513153831692.html>

25 Elmendorf, D. (2009, Sep. 25). Letter from the CBO Director to Congressman Bilbray. pp. 2-3. Retrieved from [http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/106xx/doc10629/09-25-letter\\_bilbray.pdf](http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/106xx/doc10629/09-25-letter_bilbray.pdf)

return to cover the capital gain tax liability that would be imposed.<sup>26</sup> An increase in capital gain rate may amplify the disincentive for taxpayers to dispose of their assets at a gain.

One government study on taxpayers' sensitivity to changes in the capital gain rates concluded that taxpayers are less sensitive to a long-term permanent rate change than a short-term transitory change.<sup>27</sup>

26 Cameron, D. & Manning, E. (2012). *Federal Taxation of Property Transactions*, New York, NY: LexisNexis. p. 69.

27 United States Congress (2012, Jun. 15). JCX-56-12 New Evidence on the Tax Elasticity of Capital Gains: A Joint Working Paper of the Staff of the Joint Committee on Taxation and the Congressional Budget Office. JCX 56-12. Retrieved from <https://www.jct.gov/publications.html?func=fileinfo&id=4472>.

## Economic Growth and Efficiency

*The tax rules should 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.*

Some commentators and academics consider that the disincentive for taxpayers to sell their assets due to the "lock-in" effect hampers mobility of capital investment in the economy.<sup>28</sup> They believe that a higher capital gain rate alters capital flow thus reducing economic growth and efficiency.<sup>29</sup> Combined with the 3.8% Medicare tax on unearned income, the average rate (including average state rate) is 27.9%, significantly higher than the OECD average of 16.4%.<sup>30</sup> This may reduce the attractiveness of U.S. investment and hamper domestic economic growth.

A counter argument to this view is that a large portion of capital gains is earned by tax-exempted pension funds.<sup>31</sup> While individual taxpayers are discouraged to sell their assets, the GAO reported that its impact on the allocation of capital is minimal.<sup>32</sup>

28 *Ibid*, p. 70.

29 Pomerleau, K. (2013, Feb 20). The High Burden of State and Federal Capital Gains Taxes. Tax Foundation. Retrieved from <http://taxfoundation.org/article/high-burden-state-and-federal-capital-gains-taxes>.

30 *Ibid*.

31 CBO (2002, Oct 9). Capital Gains Taxes and Federal Revenues. p. 5. Retrieved from <http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/38xx/doc3856/taxbrief2.pdf>

32 *Ibid*.

## Transparency and Visibility

*Taxpayer should know that the tax exists and how and when it is imposed upon them and others.*

As illustrated under the certainty principle, the majority of the taxpayers should know the true cost of a transaction and how the increase in rate affects them. Only about 12% of taxpayers (with income between \$200,000 to \$1,000,000, and a mix of capital gain and other income) may have difficulty identifying when the new rate applies.

### Minimum Tax Gap

*A tax should be structured to minimize noncompliance.*

The government estimates that misreporting of income from capital assets contributed \$11 billion<sup>33</sup> toward the total federal tax gap of \$345 billion in 2001.<sup>34</sup> Taxpayers are more likely to comply if income is subject to information reporting or withholding. From 2011, brokers are required to report basis for sales of securities.<sup>35</sup> There are no withholding and other reporting obligations for capital gains.

P.L. 112-240 is unlikely to increase the noncompliance rate for majority of the taxpayers because the new law does not change how and when these taxpayers pay capital gain tax. However, the capital gain tax calculation is more complex for 12% of taxpayers (with income from \$200,000 to \$1,000,000 and a mix of capital gain and other income). If these taxpayers do not understand the new calculation, their noncompliance risk may increase.

<sup>33</sup> GAO. (2006, Jun.). Capital Gains Tax Gap, GAO-06-603. Retrieved from <http://www.gao.gov/products/GAO-06-603>

<sup>34</sup> IRS. (2006, Feb. 16) IRS Updates Tax Gap Estimates, IR-2006-28. Retrieved from <http://www.irs.gov/uac/IRS-Updates-Tax-Gap-Estimates>

<sup>35</sup> Reg §1.6045A-1 Statements of information required in connection with transfers of securities.

### Appropriate Government Revenues

*The tax system should enable the government to determine how much tax revenue will likely be collected and when..*

Historical data and economic forecasts should allow the government to estimate the impact of the new rate on revenue with reasonable accuracy.

The capital rate change in P.L. 112-240, including the permanent extension of the 15% and the return of the 20% rate, is estimated to reduce government revenue by \$289 billion over the next 10 years: \$58 billion from capital gain and \$231 billion for dividends.<sup>36</sup> Baseline for this analysis is for adjusted net capital gain to be taxed at ordinary rates. Specific analysis of the effect of the 20% increase is not readily available from government sources.

<sup>36</sup> United States Congress. (2013, Feb.). General Explanation of Tax Legislation Enacted in the 112th Congress. JCS-2-13.

## Ratings Summary

Equity and Fairness	+
Certainty	+
Convenience of Payment	+/-
Economy in Collection	-
Simplicity	-
Neutrality	-
Economic Growth and Efficiency	+/-
Transparency and Visibility	-
Minimum Tax Gap	-
Appropriate Government	+/-

## Conclusion

The resumption of the 20% capital gain rate improves equity and certainty when compared to the temporary 15% rate in place from 2003 to 2012. Unlike previous changes to capital gain rate, P.L. 112-240 is a permanent provision. The new maximum rate impairs the principle of neutrality and simplicity. Furthermore, the requirements for economy of collection, transparency and minimum tax gap are not fully met. More data is necessary to conclude fully on economic growth and efficiency, and appropriate government revenue.

### Possible Improvements

Tax changes are often influenced by factors other than the desire to introduce good tax policy. The resumption of the 20% capital gain rate was largely introduced to remedy a perception of inequity: high earners are not paying their “fair share.”<sup>37</sup> Revenue raised may be

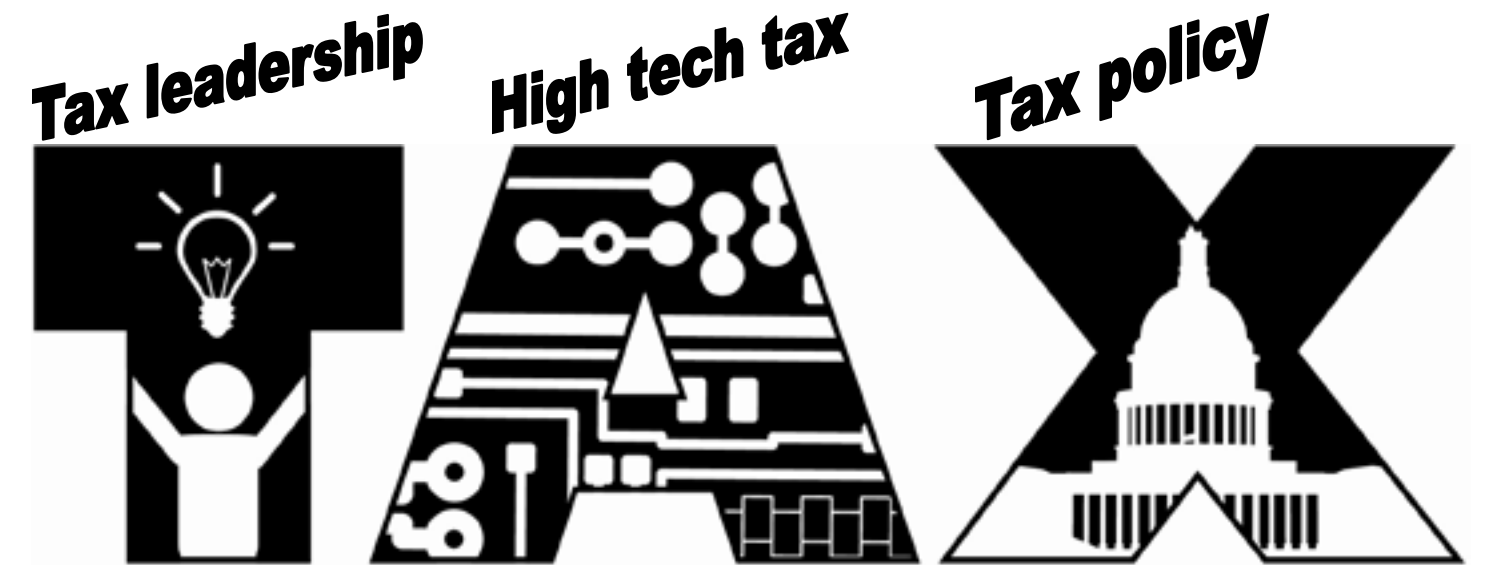
<sup>37</sup> Obama, B. (2012, Nov. 6). President Barack Obama: My Vision for America. CNN Opinion. Retrieved from <http://www.cnn.com/2012/11/02/opinion/obama-vision-for-america>



offset by changes in taxpayers' behaviors, for example, by deferring realization.

Lawmakers should set simplicity as a high priority when designing tax law. The National Taxpayer Advocate ranked complexity of the tax code as the most serious problem facing taxpayers in the 2012 annual report to Congress. In addition to the simplicity principle, the new 20% maximum rate impairs the principle of economy of collection, transparency and minimum tax gap.

Lawmakers could enact a two-tiered capital gain tax system with a 0% rate for individuals with taxable income below \$72,500 (married taxpayers are subject to the 25% ordinary income tax rate beyond this amount) and a 20% for individuals with income above this amount. The 20% rate could apply to all capital gains including collectibles, small business stock and recapture depreciation from real property. Such a change meets the tax policy principle of simplicity and vertical equity.



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# Surtax on Millionaires

By: John Lowrie, *MST Student*

Despite similar proposals, which have been buzzed about in the past, the surtax on millionaires proposed late in 2011 was received with much controversy.<sup>1</sup> If one particular proposal were to be enacted, a 5.6% tax on modified adjusted gross income in excess of \$1,000,000 would be imposed on non-corporate taxpayers for tax years starting after December 31, 2012.<sup>2</sup> While intended to help fund President Obama's jobs plan, opponents of the legislation declared it just the contrary: This proposal would be a job killer. Some supporters of the proposed surtax were unable to locate a small business millionaire who felt the resulting increase in their marginal tax rate would influence hiring decisions.<sup>3</sup>

The numerous political views about the surtax on millionaires are subjective in nature and ultimately fail to address this important question: Does the proposed legislation qualify as good tax policy? In an effort to evaluate the proposal in an objective manner, the following analysis will avoid examining the proposed legislation under a tinted political light by reviewing the surtax on millionaires based on the ten principles of good tax policy as provided by the AICPA.

1 Hook, J. (2011, Oct. 6). Democrats Float Tax on Top Earners. *The Wall Street Journal*. Retrieved from <http://online.wsj.com/article/SB10001424052970203476804576612930412626412.html>

2 American Jobs Act of 2011, S.1660, 112th Cong., 2nd Sess. (2012).

3 Keith, T. (2011, Dec. 9). GOP Objects To Millionaires Surtax; Millionaires We Found? Not So Much. NPR. Retrieved from <http://www.npr.org/blogs/itsallpolitics/2011/12/09/143398685/gop-objects-to-millionaires-surtax-millionaires-we-found-not-so-much>

## Equity and Fairness

*Similarly situated taxpayers should be taxed similarly.*

The surtax on millionaires has the intention of promoting vertical equity in that those who are subject to the tax are assumed to have a greater ability to pay taxes. Presumably those who have modified adjusted gross income greater than \$1 million should have a greater ability to pay taxes than those with income less than that threshold. The income threshold for the top tax bracket for married filing jointly in 2012 was \$388,350<sup>4</sup>. As such, while taxpayers with \$388,350<sup>4</sup> of income have a lesser ability to pay tax than taxpayers with \$1,000,000 or more, each level of income is subject to the same rate. The surtax on millionaires would address this disparity and, as a result increase vertical equity. Do note, however, that this same vertical equity could be achieved by merely adding an additional tax bracket to the current income tax brackets. This point will be discussed further under the principle of simplicity.

At first glance, horizontal equity is to be expected for the millionaires subject to this tax. After all, it is assumed that all millionaires have one thing in common: they have plenty of income to meet basic human needs. Digging deeper however, there could be two very differently situated millionaires. Consider a millionaire who earns all their income from long term capital gains. Under the proposal their initial million

dollars of income is only subject to a 15% capital gains tax rate. Contrast that to a sole proprietor who earns his income from his business. Under the proposal, the sole proprietor's initial million dollars of income is subject to a 35% income tax rate. While a claim can be made that all millionaires have income available to pay additional taxes, clearly not all have an equal ability to pay additional taxes.

The surtax on millionaires has further horizontal inequality as a result of a lack of differential treatment for single, head of household and married filing jointly taxpayers. Under the current income tax brackets, equity is granted to these different filing statuses by increasing the income thresholds for each of these filing statuses respectively. Clearly the intention of the current income tax system is to tax taxpayers in each filing status differently. The proposed legislation, however, only differentiates the income threshold for married filing separately taxpayers thus creating a marriage penalty.

As with most income tax considerations time related equity also becomes a consideration, because income tax is calculated at one point in time, the end of the year, rather than over a lifetime. Setting a threshold of increased tax at \$1 million will inevitably encourage taxpayers to try and schedule their income over time in a manner where they do not exceed the million dollar threshold. Consider the sale of an asset

valued at \$4,000,000, such as a business. A taxpayer able to sell the asset in an installment sale with five annual payments of \$800,000 avoids this proposed tax, while a taxpayer who receives the full payment in the year of the sale has \$3,000,000 subject to the proposed tax.

The level of equity and fairness of the surtax on millionaires depends on how much weight vertical equity receives. While a case can be made for inequities amongst the millionaires, ultimately those with income of such levels have a greater ability to pay. If these inequities are a concern, they could easily be addressed by an initial surtax on income over \$1,000,000 coupled with another higher surtax imposed on a higher income amount. Keep in mind the current income tax system is already generally considered fair with its current progressivity. This tax proposal merely adds a new layer of progressivity to the tax system.

## Certainty

*The tax rules should 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.*

The functionality of the proposed legislation seems obvious under a preliminary review. A taxpayer's income greater than one million dollars is subject to an additional 5.6% tax. Since the tax is due and paid at the same time as regular income tax calculations, taxpayers will surely understand when and how to pay the tax. Unfortunately, what is likely not certain is how to calculate Modified Adjusted Gross Income (MAGI). The average taxpayer has a minimal idea of how to do such a calculation. They probably know nothing more than what can be obtained from the name of the term: adjusted gross income, modified in some manner. Potential confusion is compounded by the several definitions of MAGI that exist in the Internal Revenue Code. The proposed legislation does provide its own definition of MAGI, which certainly helps, however it would aid the taxpayer in understanding the definition of MAGI tied to one that high income taxpayers are likely to be familiar with. Such an example would be MAGI as defined under IRC §68, Overall Limitation on Itemized Deduction phase out.

<sup>4</sup> U.S. Treasury. (2011, Oct. 20). Rev. Proc. 2011-52, 2011-45 IRB. Sec. 3 2012 Adjusted Items

## Convenience of Payment

*A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer.*

A taxpayer who will be subject to the surtax on millionaires will surely be calculating and paying income tax liability every year. As such the proposed legislation does not result in an increased difficulty in the timing or the manner that the tax is paid.

## Economy of Collection

*The costs to collect a tax should be kept to a minimum for both the government and taxpayers.*

The proposed legislation will cause the government to incur costs in the form of additional training for IRS enforcement as well as issuance of guidance to the taxpayers; however the government already has system in place to enforce the collection of income tax. As such the cost of collection should not hinder the effectiveness of the tax. As stated in the convenience of payment section, taxpayers already calculate their income tax. The tax proposal in question would merely add an additional step to that income tax calculation, and software programs can perform the calculations. While any additional step to calculating a tax liability will result in increased compliance cost, this cost to taxpayers should not hinder the effectiveness of the tax.

## Simplicity

*The tax law should be simple so that taxpayers understand the rules and can comply with them correctly and in a cost-efficient manner.*

As previously discussed, the proposed tax law initially appears simple. Income in excess of \$1,000,000 is subject to an additional 5.6% tax. The income which is subject to the tax is not merely taxable income, but rather the more intricate MAGI. The determination of modified adjusted gross income, which is necessary to calculate the additional tax on income in excess of \$1,000,000, adds a layer of complexity to the proposal. While the calculation is likely not unduly complex, the various definitions of MAGI throughout the IRC may lead to confusion.

As suggested by the AICPA principles of good tax policy, the simplest approach to collecting the tax should be pursued. An approach which would better fit this principle would be to merely add an additional income tax bracket to the current brackets. By doing so the top tax bracket would move from a 35% tax rate to a 40.6% tax rate on income greater than \$1,000,000. This modification to the proposal would accomplish AICPA goals of achieving the simplest approach. The modification would also minimize compliance burdens by collecting the tax through a concept which taxpayers already are familiar with as well as improve transparency by allowing taxpayers to visualize tax burdens all displayed on one rate schedule.

## 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.*

Neutrality may be hindered through the proposed legislation's effect on entity form decisions. Since the tax is imposed on non-corporate taxpayers, it may influence some pass-through entities which intend to reinvest profits within the company to incorporate. The decision for sole proprietors and members of pass-through entities to incorporate their business as a result of the proposed surtax will only be further incentivized if the corporate income tax rate is lowered as President Obama<sup>5</sup> and many legislators<sup>6</sup> suggest. While the decision to incorporate is influenced by much more than just the proposed legislation, the surtax on millionaires unquestionably adds an additional consideration. Neutrality will also be negatively impacted as proposed legislation will affect a taxpayer's decision in the timing of income. As mentioned in the prior discussion on time related equity, the additional tax on income in excess of \$1,000,000 may influence taxpayers to alter transactions in an attempt to delay the timing of income in order to ensure income is less than \$1,000,000 in any given year.

While the surtax on millionaires has its neutrality faults, those faults are kept to a minimum. Ultimately the tax accomplishes the goal of raising additional revenues to support President Obama's job stimulus plan. It does not favor particular industries nor is it attempting to influence taxpayer behavior. At its core the proposed legislation maintains the concept of neutrality.

<sup>5</sup> Goldman, J. & Rubin, R. (2012, Feb. 22). Obama Readies Plan to Cut Corporate Tax Rate. Bloomberg. Retrieved from <http://www.bloomberg.com/news/2012-02-22/obama-to-ask-congress-to-lower-corporate-tax-rate-to-28-remove-loopholes.html>

<sup>6</sup> Bendavid, N. (2012, Mar. 19). House GOP Budget to Target Tax Rates. The Wall Street Journal. Retrieved from <http://budget.house.gov/News/DocumentSingle.aspx?DocumentID=285510>

## Economic Growth and Efficiency

*A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer.*

Although the increased tax revenue from the surtax on millionaires is intended to support a job stimulus package, there is a concern that it would in fact impede the economy through reduced job growth from small businesses. The rationale is that small businesses are most vulnerable to a reduction in income, and as such, the reduced after tax income would affect a small business's decision to hire new employees. However, note that the surtax on millionaires would not affect corporations, and therefore, corporate jobs should not be hindered. The businesses that could potentially be affected by the proposed legislation are sole proprietorships, partnerships, S-corporations and LLCs. In order to analyze the effect of the tax on these small businesses, first the pool of small businesses which would be affected must be identified.

A study conducted by the Treasury in August 2011 attempted to quantify the number of non-corporate small businesses.<sup>7</sup> The study points out that merely receiving income from a sole proprietorship, partnership, S-corporation or LLC does not make the taxpayer a small business owner. Considerations included whether the taxpayer is actually earning income

from a business (as opposed to income from a hobby, a side rental activity or as contract employee) and the significance of the business income in relation to total income. The report further considers that a small business may not actually be an employer. Of those who were determined to be a small business employer who report business income on their personal return, merely one percent have income greater than \$1,000,000. Under analysis derived from this report, the impediment on job growth, or the economy as the whole, assumed to result from the surtax on millionaires appears to be overstated. Perhaps this is why supporters of the proposal were unable to locate any millionaire small business employers who felt the tax increase would affect hiring decisions; there is only a small minority of businesses affected by the proposal to be found.

<sup>7</sup> United States Department of Treasury, Office of Technical Analysis, (2011, Aug.). Methodology to Identify Small Businesses and Their Owners, Retrieved from <http://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/OTA-T2011-04-Small-Business-Methodology-Aug-8-2011.pdf>

## Transparency and Visibility

*Taxpayers should know that the tax exists and how and when it is imposed upon them and others.*

Transparency and visibility is hindered by the same factors which hurt the tax proposal's certainty and simplicity. Taxpayers are likely to understand that income in excess of \$1,000,000 is subject to the additional 5.6% tax. What is less transparent is how that income threshold is determined since it is calculated on MAGI.

Since this income definition is different from "taxable income," it will not be completely clear to the taxpayer whether transactions will increase or decrease their MAGI. Just like certainty and simplicity, transparency and visibility would benefit if the tax was calculated on Taxable Income. Alternatively, as stated prior, transparency could be aided by tying the definition of MAGI for the surtax on millionaires to another provision's definition already familiar to high income taxpayers.

## Minimum Tax Gap

*A tax should be structured to minimize noncompliance.*

As a result of the surtax on millionaires, unintentional non-compliance may result from confusion over the calculation of MAGI. Again, this could be mitigated by using an existing definition of MAGI that is already familiar to high income taxpayers.

Despite potential unintentional non-compliance due to the additional layer of complexity, an argument could be made that this proposal would actually reduce the minimum tax gap. As a result of the proposal, tax collected from millionaires will increase. This will result in a larger portion of total tax revenue derived from these individuals. While there is no indication that millionaire taxpayers are innately inclined to be more law abiding taxpayers than those with lower income, millionaires are much more likely to be audited.<sup>8</sup> Increased audit risk should lead to increased timely compliance, thus lowering the tax gap. Hindering this argument is that increased tax by the proposal will further incentivize millionaires to take action to avoid or evade taxes, such as moving income to offshore "tax havens."

<sup>8</sup> Ellis, B. (2012, Mar. 23). Audit Rates of Millionaires Nearly Doubles. *CNN Money*. Retrieved from [http://money.cnn.com/2012/03/23/pf/taxes/tax\\_audits\\_millionaires/index.htm](http://money.cnn.com/2012/03/23/pf/taxes/tax_audits_millionaires/index.htm)

## Appropriate Government Revenues

*The tax system should enable the government to determine how much tax revenue will likely be collected and when.*

If the Treasury report is any indication, clearly there is substantial data available for the government to estimate the taxpayers who would be subject to the tax and their income levels. As such, the amount of potential revenue to be generated from the surtax on millionaires can easily be determined. The time of the collection is certain since it will be when the rest of income tax from individuals is collected.

## Rating Summary

<b>Equity and Fairness</b>	+/-
<b>Certainty</b>	+/-
<b>Convenience of Payment</b>	N/A
<b>Economy in Collection</b>	+
<b>Simplicity</b>	-
<b>Neutrality</b>	+
<b>Economic Growth and Efficiency</b>	+
<b>Transparency and Visibility</b>	+/-
<b>Minimum Tax Gap</b>	+
<b>Appropriate Government</b>	+

## Conclusion

The proposed legislation meets six of the ten principles of good tax policy, has a mixed review on three and fails to meet one. While the proposed surtax on millionaires overall meets the principles of good tax policy overall, it certainly could be improved.

### Possible Improvements

Equity could be improved by creating different income thresholds for each filing statuses. Confusion related to the calculation of MAGI, which hurts certainty and simplicity, could be alleviated by tying the definition to one used in a provision already familiar to high income taxpayers. An improvement that would address all of the mentioned principles would be to add an additional, or perhaps several, new tax brackets for high income individuals. Collecting the additional tax revenue through the new tax brackets would also benefit transparency.

Ultimately, the goal of the proposed legislation is to raise revenues to support President Obama's job stimulus plan. This would be better accomplished with the new tax bracket approach. By doing so, a larger tax base could be encompassed by targeting individuals with high income yet under \$1 million. This would offer the chance for a tax increase less than the suggested 5.6% on taxpayers with income less than \$1 million. Furthermore the additional brackets would provide the opportunity for a tax increase greater than 5.6% on taxpayers with extremely high income. Such a potential group is the top 400 taxpayers who have an average annual income of \$270 million<sup>9</sup>. Lastly President Obama's job stimulus plan is a temporary plan and as such only needs temporary funding. For that reason, it seems appropriate that the proposed legislation be a temporary provision.

The suggested improvements would also address this question: "Why start the tax rate increase at \$1 million?" The tax increase as initially proposed arbitrarily targets millionaires. This seems more like good politics rather than good tax policy. While it is easy to gain support for a tax increase against a demographic group that few will express sympathy for, a broader and simpler approach through the before mentioned improvements will result in a proposal that is just better tax policy.

<sup>9</sup> United States Department of Treasury, Internal Revenue Service. (2012, Apr. 8). The 400 Individual Income Tax Returns Reporting the Highest Adjusted Gross Incomes Each Year, 1992-2008. Retrieved from <http://www.irs.gov/pub/irs-soi/08intop400.pdf>

# Excessive Compensation – How Much is Too Much?

By: Lisa Pan, *MST Student*

**M**arissa Mayer is not your normal Silicon Valley executive. Aside from heading the multinational Yahoo, Inc. at age 37, she is also among the highest compensated individuals. Her first year compensation package at Yahoo totaled \$60 million, consisting of salary, bonus, restricted stock, and stock options vesting over several years.<sup>1</sup> One might presume a package of this size would surely produce some unfavorable tax consequences for Yahoo if one knows that the law includes a deduction limit for executive compensation. Yet Marissa's salary of exactly \$1 million falls safely under the current limitation of executive compensation, which disallows a publicly traded company from deducting its chief executive officer's remuneration in excess of \$1 million.<sup>2</sup> However, current law does not limit performance-based bonuses and certain deferred compensation.<sup>3</sup> As a result, public companies can often deduct executive compensation far exceeding the apparent statutory limit.

On January 4, 2013, U.S. House Representative Barbara Lee (CA-13) introduced H.R. 199 to target excessive compensation. H.R. 199, the "Income Equity Act of 2013," amends IRC §162 to add a new limit on the deduction of any full time employee's compensation to the greater of \$500,000 or 25 times the salary of the lowest-paid fulltime employee. More importantly, the proposed bill defines compensation broadly to include "wage, salary, deferred compensation, retirement contribution, options, bonuses, property," and any other form deemed appropriate by the U.S. Treasury Department. In addition, unlike IRC §163(m), H.R. 199 does not restrict its application to only publicly traded companies as defined by the Security and Exchange Act.<sup>4</sup> The body of the bill does not specifically define the term employer, but it does treat a controlled group of corporations, partnerships, or service organizations as one employer.<sup>5</sup> This means the lowest-paid employee's salary in one entity can affect the deduction limitation on all entities in a closely related group.

People concerned with the income spread between certain corporate executives and

1 Strauss, G. (2012, Jul. 20). Marissa Mayer's Yahoo CEO Compensation Nearly \$60 Million. USA Today. Retrieved from <http://usatoday30.usatoday.com/money/industries/technology/story/2012-07-19/Yahoo-Ceo-compensation-Marissa-Mayer/56341912/1>

2 IRC §162(m)(1). [also note that the rule applies to the other top 4 paid execs]

3 IRC §162(m)(4).

4 Income Equity Act of 2013, H.R. 199, 113th Congress, 1st Session (2013).

5 IRC §52(1) & (2), and IRC §414(o).

rank-and-file workers may argue that this proposal is a much needed update to the U.S. tax system. After all, average workers do not receive creative forms of compensation that are common at the upper level. According to Representative Lee's press release, this bill targets the various forms of compensation not currently covered by IRC §163(m), such as private jets for executives. By making these expenses nondeductible for tax purposes, taxpayers would, as described by Congresswoman Lee, no longer subsidize excessive forms of compensation<sup>6</sup>. Opponents of H.R. 199 may argue that employers, not government, should decide the appropriate amount of compensation. Nevertheless, both liberals and conservatives would agree that neither IRC §163(m) nor H.R. 199 prevents a company from paying any amount to its employees; they merely take away some tax benefits with regards to high levels of compensation. Moreover, it is readily apparent that existing law only limits certain kinds of compensation, and a more comprehensive system should be considered.

The following discussion based on AICPA's Ten Principles of Good Tax Policy provides an objective analysis on the fairness, operability, and appropriate purposes of H.R. 199. Given the existing salary limitation in the tax law, it does not analyze the use of such a limitation.

6 Williams, N. (2009, Mar. 20). Congresswoman Barbara Lee Introduces Income Equity Act. <http://lee.house.gov/press-release/congresswoman-barbara-lee-introduces-income-equity-act>

## Equity and Fairness

*Similarly situated taxpayers should be taxed similarly.*

This proposal is designed to address existing inequality in compensation. It allows for more horizontal as well as vertical fairness among taxpayers. Under the current system, a corporation paying an employee \$10 million in annual salary can only deduct \$1 million as expense, but another corporation paying its employee \$10 million in performance bonuses is not subject to the \$1 million limitation. In both situations, the employee receives the same amount of compensation and the employer has paid the same dollar amount. Even if a bonus is inherently more uncertain than salary, the uncertainty does not make up for \$9 million of tax deductions (a potential saving of \$3 million based on 35% corporate tax rate). By subjecting various forms of compensation to the same limitation, this proposal provides horizontal equity to employers in similar situations.

Furthermore, the proposal also enhances vertical equity because smaller companies often lack the resource to structure complex compensation packages. By treating all forms of compensation equally, smaller companies are not punished for lacking tax planning resources.

## Certainty

*The tax rules should 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.*

Overall, the proposal makes the limitation on excessive compensation more certain. Instead of going through hundreds of pages of code, regulation, and judicial decisions to find what can be excluded from the \$1 million limit, companies simply cannot deduct more than \$500,000 or 25 times the salary of the lowest paid full time employee, regardless of the compensation form. In the case of Yahoo, there will be no question on the disallowance of Marissa Meyer's performance based bonuses and most of her stock options.

The one drawback on certainty is that the basis for measuring the limit—salary of the lowest-paid employees—may not be as certain. Is compensation defined in the same way for the lowest-paid employee as for the executive, or is it simply the amount reported on Form W-2? Regulations and administrative guidance are needed to further clarify the rules.

## Convenience of payment

*TA tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer.*

H.R. 199 does not have a direct effect on the convenience of payment. Because the deduction for compensation is reported along with other trade or business deductions, the additional tax liability will be paid via regular estimate payments.

## Economy of Collection

*The costs to collect a tax should be kept to a minimum for both the government and taxpayers.*

Again, because the proposal makes tax liability more certain, it increases the economy of collection. Companies would not have to spend additional resources on structuring compensation packages. Similarly, the government can also save some resources when auditing these areas.

However, under existing rules the compensation limitation only applies to covered employees at publicly traded companies.<sup>7</sup> H.R. 199 would likely include both public and private companies as well as non-corporate entities. The IRS would need to put tremendous resources in writing interpretations, educating its own staff, and providing taxpayer assistance. Due to unfamiliarity, there would likely be many cases of non-compliance in initial years. All of this will increase compliance and administrative costs.

<sup>7</sup> IRC §162(m)(3).



## Simplicity

*The tax law should be simple so that taxpayers can understand the rules and comply with them correctly and in a cost-efficient manner.*

The proposal creates additional compliance burden for taxpayers. It requires companies to file a report containing compensation information for the top five employees, an average of all non-managerial and executive employees, and the lowest-paid full time employee.<sup>8</sup> For publicly traded companies that already report this in their SEC filings, the information may be readily available.

However, for the vast number of employers not filing with the SEC but is covered under H.R. 199, the rules create additional compliance requirement. The information gathering process can be challenging because personnel and compensation level often change multiple times in a year. Because the rule affects not just publicly traded companies, smaller businesses may lack the resources to keep track of the required information.

Furthermore, H.R. 199 also creates administrative tasks for the government to process the new information. The benefits of such tasks cannot be easily identified.

Depending on how “lowest compensation” is defined, businesses may have an incentive to adjust employees’ compensation package to make all forms of earnings more apparent. For example, reporting health insurance premium paid by the employer on Form W-2 allows taxpayers

and government to gain a better understanding of the entire compensation package, as opposed to just taxable income. However, these additional reporting also adds to existing complexity.

## 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.*

The existing law is not neutral with respect to taxpayer behavior. Likewise, the new proposal will probably result in behavioral changes. First, it may affect the labor structure of a company. For example, one way to get around the limitation is to reduce or outsource the low paying positions, such as janitorial services and administrative personnel. There is also an incentive to hire part-time or contract workers to perform the low-paid tasks so their pay does not count towards the deduction limit.

As Representative Lee’s press release states, this bill would “encourage companies to raise the pay of workers at the bottom.”<sup>9</sup> In other words, its goal is not merely raising revenue but also influencing taxpayer behavior. This incentive tends to favor investment in labor – higher paid labor translates to higher deduction limit – as opposed to investment in machinery.

Nevertheless, the effect of H.R. 199 on excessive compensation is still limited because it does not, and cannot, prevent companies from paying employees high salaries; it merely limits the deductibility of these payouts. Clearly, many companies have legitimate reasons to, and will continue to, pay millions in compensation to their most valuable employees.

## Economic Growth and Efficiency

*The tax system should not impede or reduce the productive capacity of the economy.*

H.R. 199 can impact economic growth and efficiency in two major ways. First, pay increase among the lowest-paid workers can lead to increase in overall consumption. Second, H.R.199 has the potential to shift private investment from machinery to labor.

As mentioned in the Neutrality principle, this bill creates incentive for companies to increase salary for the lowest-paid employees, which could produce a broader economic benefit. For instance, when 100 workers making \$30,000 each receive a 10% pay increase, they are likely to spend most of the increase (a total of \$300,000) on goods and services, thus encouraging economic activities. In contrast, an executive making \$3 million may spend only a portion of his 10% pay raises (also a total of \$300,000) on consumption because one household can only consume so much.

Also related to the neutrality principle, this bill tends to encourage spending on labor rather than machinery. When companies invest in labor training that increases the overall skill of the labor force, it increases productivity and promotes innovation. However, when it makes the most economic sense to replace expensive labor with machines operated by low-paid labors, companies may be reluctant to do so due to loss of tax benefits.

<sup>8</sup> “Income Equity Act of 2013”, 2013.

<sup>9</sup> Williams, 2009

## Transparency and Visibility

*Taxpayers should know that a tax exists and how and when it is imposed upon them and others.*

Even though the public may not be aware of the nuances of tax law, the continuous widening of income gap in the U.S. is alarming to many. Recent publicity on the effective tax rates of the wealthiest Americans (average of 18% for the richest 400<sup>10</sup>) led to much public debate on income equality. The proponents of this bill will likely spend a lot of effort publicizing its equality component. At the same time, H.R. 199 directly targets some of the biggest corporations, whose executive compensation often receives negative news coverage.

For employers, the effect of H.R. 199 is easily visible because they are already calculating the deductible amounts of compensation on their tax returns every year. As some previously deductible payouts now become nondeductible, they can easily see the true cost of this proposal.

## Minimum Tax Gap

*A tax should be structured to minimize non-compliance.*

The tax gap will likely be small because this proposal is very inclusive on the types of compensation disallowed for deduction. In other words, there are fewer ways to structure deductible compensation in excess of the statutory limit.

However, the likelihood of noncompliance also depends on the clarity of the law. H.R. 199 leaves some crucial terms undefined, such as “employer” and “salary of the lowest paid employee.” A lack of uniform understanding will create inconsistency and loopholes in the rule, which may be costly to resolve (such as using multiple lawsuits) if not addressed early on.

## Appropriate Government Revenue

*The tax system should enable the government to determine how much tax revenue will likely be collected and when.*

The government can predict some, but not all, additional revenue to be collected from this proposal. For the more subtle forms of compensation, such as luxury auto and personal service, the government will need to dig deeper into the financial statements of companies to find out exactly how much benefit is provided to the employees.

One way to help with the revenue prediction is to require more reporting, but this also conflicts with the principle of simplicity. This demonstrates that a tax proposal may not be able to satisfy all principles of good tax policy at once.

According to an Economic Policy Institute report, roughly \$121.5 billion in executive compensation was deducted from 2007-2010, and roughly 55% of which was for performance based bonuses.<sup>11</sup> If all of the performance-based bonuses had been nondeductible, it would have raise an additional \$20 billion in revenue from 2007-2010.

This number is not a precise indication of revenue in the future, however, because taxpayer behavior often changes with the change of law. This makes accurate estimation difficult because it's not all clear what actions taxpayers may take to reduce tax liability.

<sup>10</sup> Lenzner, R. (2011, Jul. 25). The 400 Richest Americans Pay An 18% Tax Rate. *Forbes*. Retrieved from <http://www.forbes.com/sites/robertlenzner/2011/07/25/the-400-richest-americans-pay-an-18-tax-rate/>

<sup>11</sup> Balsam, S. (2012, Aug. 14). Taxes and Executive Compensation. *Economic Policy Institute*. Retrieved from <http://www.epi.org/publication/taxes-executive-compensation/>

## Rating Summary

Equity and Fairness	+
Certainty	+
Convenience of Payment	N/A
Economy in Collection	+/-
Simplicity	-
Neutrality	-
Economic Growth and Efficiency	+/-
Transparency and Visibility	+
Minimum Tax Gap	+/-
Appropriate Government	-

## Conclusion

**H**.R. 199 intends to introduce more fairness and certainty to the existing tax system, and it does so by treating all forms of compensation equitably. It falls short on operability because the reporting requirements put additional compliance burden on taxpayers. Similarly, government also has to invest additional resources in administering this rule. H.R. 199 will unavoidably influence taxpayer behavior, which violates the neutrality principle, but it may also help promote some degree of economic efficiency. If H.R. 199 does become law, it will need clear definitions on key terminology to strengthen compliance. Clarity will also help taxpayers understand its impact better and allow government to make more accurate revenue estimation.

As the analysis of H.R. 199 shows, it's often unlikely for a law to meet all ten principles of good tax policy. Policymakers face a difficult task of weighing the importance of one principle against another.



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# Increase and Make Permanent the Research Tax Credit

By: Chloe Chen, *MST Student*

In 2011, Senate Finance Committee Chairman Max Baucus (D-MT.) and Ranking Member Orrin Hatch (R-UT) introduced The GROWTH Act (Greater Research Opportunities With Tax Help) (S.1577; 112th Congress). This legislation would amend IRC §41 of the Internal Revenue Code to raise the rate for the “alternative simplified credit” from 14% to 20%. S.1577 would also modify the rules for calculating the credit and make this credit permanent.

Senate Bill 1577 makes various changes to IRC §41, including the termination of standard research credit formula and basic research payment calculation (§41(e)), a change on determination of expenditures (to aggregate qualified research expenses) and a few other modifications of special rules. S. 1577 also proposes an inclusion of qualified research expenses of an acquired person (§41(f)), which has been included in the extension of the credit with the American Taxpayer Relief Act of 2012.

The research and development tax credit under IRC §41 was first enacted in 1981 and has been extended fourteen times. It will expire for the fifteenth time on December 31, 2013.

The Obama Administration included a proposal in its fiscal year 2012 budget to expand the research tax credit and make it permanent. The plan is estimated to cost the government about \$106 billion over the next ten years, according to the Treasury Department.

S.1577 was introduced to simplify and update the research credit. It was also proposed to give businesses certainty by eliminating the possibility of expiration and to create more job opportunities. Senator Hatch stated that:<sup>1</sup>

“By giving businesses a leg up on the competition in this global economy, we can help them grow and create the jobs American families need. Our workers are facing competition from countries across the globe, so this boost to innovation and research here at home is critical to our economy,” Baucus said. “Making the research and development tax credit simple and permanent gives innovative American businesses the certainty they need to make job-creating investments and the ability to compete in markets across the globe.”

He also noted in a 2011 Finance Committee Press Release that, “A permanent R&D tax credit rewards innovation and entrepreneurship, and gives American businesses the certainty

they need to invest, grow and hire. This legislation makes sense, has strong bipartisan support, and is essential to ensuring our nation’s job creators have the tools they need to compete around the world.”<sup>2</sup>

The policy analysis below uses the ten principles of good tax policy outlined in the AICPA Statement #1, Guiding Principles of Good Tax Policy: *A Framework for Evaluating Tax Proposal, to analyze S.1577.*

1 U.S. Department of the Treasury. (2011, Feb). *General Explanations of the Administration’s Fiscal Year 2012 Revenue Proposals.* p. 32 & Table 1. Retrieved from <http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf>

2 U.S. Senate Committee on Finance. (2011, Sept. 19). Baucus, Hatch Look to Boost Innovative American Industries, Provide Certainty with Permanent Research and Development Credit. Retrieved from <http://www.finance.senate.gov/newsroom/chairman/release/?id=cd16c8e7-2423-4f13-bf62-45e3d3527b31>.

# Principles of Good Tax Policy Evaluation

## Equity and Fairness

*Similarly situated taxpayers should be taxed similarly.*

**R**&D tax credits are potentially available to all industries, regions and firms regardless of size.

Companies of all sizes and in all industries can claim the R&D tax credit. Although the distribution of firms might be scattered, R&D tax credits are equally available to all industries, regions and firms that incur “qualified research expenditures.”

The principle is not completely entirely fair with respect to horizontal and vertical equity, as explained next.

The R&D tax credit may favor research activities over others by companies with similar financial conditions. For example, a manufacturer and a service agency may be taxed differently because the manufacturer is more likely to be involved with researching activities and thus has a greater chance of obtaining the R&D tax credit. At the same time, the manufacturer also has the greater investment in uncertainty and spillover effects, causing the inequity.

In addition, new small firms are comparatively at an unfavorable position because they are in the early years of an R&D project; which means they might have little or even no taxable income. Consequently, since the credit is not refundable, they may not be able to use the credit until a future year when they have taxable income.

## Certainty

*The tax rules should 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.*

**T**he legislation is certain; it would amend the IRC §41 to raise the “alternative simplified credit” from 14% to 20%. S.1577 would also make the R&D tax credit permanent, which would increase the stability of the R&D tax credit and strengthen the impact of the R&D policy on relevant investment. The proposal would further enhance the value of the credit. Companies would know the R&D credit would be available consistently for the duration of their R&D project.

In addition, the legislation includes the termination of base amount and basic research payment calculation, making the simplified credit the only formula. Certainty will increase with the simplification because it will be easier to determine the amount of the credit.

## Convenience of payment

*A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer.*

**T**he R&D tax credit is comparatively easy to claim. The firms can claim qualified R&D tax expenses by attaching Form 6765 to their tax return. S.1577 only increased the “alternative simplified credit”, so the convenience of payment wouldn’t change.

However, determining qualified research and qualified research expenditures is still a complex process with the difficulty of identifying and tracking qualified research expenditures still remaining.

## Economy of Collection

*The costs to collect a tax should be kept to a minimum for both the government and taxpayers.*

**S**enate Bill .1577 will reduce the claiming cost of R&D tax credits. The administrative and audit time will be reduced with the termination of basic research payment calculation. At the same time, less time will be needed to determine the credit amount since there will be only one formula to select. The only possible cost for government for the legislation will be the modification of forms.

## Simplicity

*The tax law should be simple so that taxpayers can understand the rules and comply with them correctly and in a cost-efficient manner.*

The R&D tax credit will be simpler with the repeal of the regular formula and the basic research credit of IRC §41(e). For example, there will no longer be a need to measure gross receipts or have data from the 1984 to 1988 base years.

In addition, with the amendments of IRC §41(f), the credit will be determined by the aggregate qualified research expenses instead of “the qualified research expenses, basic research payments, and amounts paid or incurred to energy research consortiums”, making the R&D tax credit simpler for controlled groups.

## 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.*

The legislation is not supposed to be completely neutral since the R&D tax credit was designed to encourage R&D activities.

Greater government support might make the United States a more attractive location for R&D investments. An increased R&D tax credit may encourage more foreign innovative activities to take place in the United States.

However, increasing the tax credits does not necessarily provide the start-up firms more incentives to invest in R&D in their early years because it is unlikely for them to have taxable income.

At the same time, research-oriented employment in the U.S. would be greater with the increased alternative simplified credit. A study in 2008 by Ernst & Young shows that the combination of the existing credit and the strengthening of the alternative simplified credit would result in an increase of 130,000 jobs in the short-term and 300,000 jobs in the long term.<sup>3</sup> According to the Milken Institute’s report, Jobs for America (2010),<sup>4</sup> if the credit were strengthened and made permanent, total

<sup>3</sup> Ernst & Young LLP. (2008, Apr.). Supporting Innovation and Economic Growth. Retrieved from <http://www.investinamericasfuture.org/PDFs/R&DTaxCreditStudy2008final.pdf>.

<sup>4</sup> Milken Institute. (2010, Jan.). Jobs for America. Retrieved from <http://www.milkeninstitute.org/pdf/JFAMilkenInstitute.pdf>

employment would rise by 510,000 in 2017.

The only unintended negative effect the incremental credit may have is in tax planning as some firms might distort the timing of R&D expenditure in order to maximize the amount of tax relief.

## Transparency and Visibility

*Taxpayers should know that a tax exists and how and when it is imposed upon them and others.*

Because the increased rate for the credit will be indicated on the tax form for the credit, companies that have formerly claimed the R&D tax credit will easily notice the increase when they claim the credit.

However, publicity for an increase is still needed to be sure all companies consider it in their R&D investment and location decisions.

## Economic Growth and Efficiency

*The tax system should not impede or reduce the productive capacity of the economy.*

Research and development is crucial in the economic growth of a country as a strong national security needs the support of innovations which leads to increased productivities.

However, the United States only ranked 24 among 38 industrialized countries offering R&D tax incentives in 2009; the U.S. share of global R&D dropped from 38% in 1999 to 31%.<sup>5</sup> It is time to provide more tax incentives in order to attract more R&D investment into the U.S. market.

As mentioned in the above section regarding neutrality, S.1577 will provide a stronger incentive for research activities to be located in the United States. This may help the U.S. to attract more multinational R&D investment and consolidate the leading position in the global competition since innovation is known to be an important driver of economic growth and investment.

Nonetheless, if the incremental R&D tax credit causes a big increase in the wages of scientists and engineers because of the inelastic supply of them, then some of the potential benefits in R&D projects will be offset by an increase in the cost.

Additionally, some R&D projects supported by an R&D tax credit might have decreasing marginal productivity. There is no way to avoid the additional activities of such projects whose prospects are questionable. If the innovation is not successful, resulting in commercialization and wide adoption, the tax credit will become a government expenditure with no return.

## Minimum Tax Gap

*A tax should be structured to minimize non-compliance.*

An increased credit may encourage some firms to reclassify their expenditures in order to maximize their R&D tax credit. If firms improperly classify some of their non-R&D activities as R&D investment, it will result in a spurious measurement of R&D expenses

## Appropriate Government Revenue

*The tax system should enable the government to determine how much tax revenue will likely be collected and when.*

There will be an increase in the tax cost for the increased credit. It should be fairly easy to determine how much additional tax credit will be claimed based on the information collected from prior year's Forms 6765 and other government data on private R&D.

The tax credit encourages the R&D activities that will likely raise the relevant businesses' revenue and therefore the government tax revenue. However, the evaluations of these positive impacts are difficult because of the lag in time between R&D investments and the innovative results of the credit.

<sup>5</sup> National Association of Manufacturers.(2012, Aug). ManuFACTS: R&D Tax Credit. Retrieved from <http://www.investinamericasfuture.org/PDFs/TalkingPointsbytheNAM.pdf>

## Rating Summary

<b>Equity and Fairness</b>	+/-
<b>Certainty</b>	+
<b>Convenience of Payment</b>	+/-
<b>Economy in Collection</b>	+
<b>Simplicity</b>	+
<b>Neutrality</b>	+
<b>Economic Growth and Efficiency</b>	+
<b>Transparency and Visibility</b>	+
<b>Minimum Tax Gap</b>	+/-
<b>Appropriate Government</b>	+/-

## Conclusion

The increase in and permanence of the R&D tax credit is expected to lead to an increase in investments in R&D projects, and eventually to an increase in innovation outcomes. This may also have some indirect effects, such as increasing the wages of research workers and location of R&D activities. The proposal meets the principles of certainty, economy in collection, simplicity, neutrality, economic growth, efficiency and transparency. However, improvements could still be made in order to increase the equity and efficiency of R&D tax credits and minimize the tax gap.

First of all, in order to improve equity, the tax credit should be fully or partially refundable in order to help more start-up companies that have lower income to get more tax credit. Also, it is important to be able to evaluate the R&D outputs in order to increase the efficiency and thus the value of the R&D tax credit. For example, outputs based on the time duration of a project and the number of patents the company gained should be measured so that the rate of return of the R&D tax credit can be evaluated. In addition, more audits are needed to eliminate the abuses, such as the reclassification of R&D expenses, although it will increase the administrative cost of the tax credit.

Overall, the legislation to increase the R&D tax credit is a good legislation since it accords with most principles of good tax policy.



# Preferential Treatment of Capital Gains

By: Jenny Phan, *MST Student*

The maximum tax rate for capital gains under the federal income tax is currently 20%,<sup>1</sup> while the top rate for ordinary income is 39.6%. There are three main justifications for this preferential treatment of capital gains:

1. alleviate the “bunching effect;”
2. to account for inflation; and
3. to spur investment and stimulate the economy.

This paper briefly discusses each of these justifications and why each may be flawed. The ten principles of good tax policy are applied to the preferential treatment of capital gains to evaluate its merits.

The “bunching effect” arises when the accumulated gain is all realized in the year of sale and, consequently, potentially pushes the taxpayer into a higher marginal tax rate than would have been the case if the gain had been taxed each year (even though not realized). Capping the capital gains rate at 20% prevents taxpayers from being forced into the higher rate for ordinary income. However, tax on any gain was deferred while the taxpayer held the property and, thus, perhaps justifies a non-preferential rate.<sup>2</sup>

The next justification for a preferential rate is that part of the gain actually represents inflation rather than any real purchasing power. However, a definite maximum rate of 20% regardless of how many years the investment is held after one year is not a proper adjustment for inflation. Instead, upon sale, the basis of the capital asset could be adjusted for the effects of inflation based on the time period the asset was held. Another approach is to gradually lower the rate each year to ensure that inflation is properly accounted for. These approaches better serve the principle of equity and fairness because it ensures that taxpayers who held the investment for merely a year and one day will not benefit from the preferential 20% rate when inflation has not yet had the kind of impact to merit the lower rate.

The last justification is that a lower capital gains rate serves the goal of encouraging investments, which in turn, creates jobs and facilitates economic growth. However, there is no evidence that a lower capital gains tax rate leads to economic growth. Two recent separate studies, one done by Leonard Burman from Syracuse University’s Maxwell School and another from the Congressional Research Service, found that there is no causation or even correlation between capital gains tax rates and economic growth.<sup>3</sup>

The justifications for a lower rate on capital gains may not hold up. However, application of the ten principles of good tax policy will reveal some justification for the preferential rate. The policy analysis below uses the ten principles of good tax policy outlined in the AICPA Statement #1, Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposal.

1 Some high income taxpayers may have an additional tax of 3.8% imposed on their capital gains under IRC § 1411.

2 Cameron, D. & Elliott M. (2012) .Federal Taxation of Property Transactions. LexisNexis.

3 Greeley, B. (2012, Oct.). Keep Looking for the Economic Benefit. *Bloomberg Businessweek*. pp.31-32. .

## Equity and Fairness

*Similarly situated taxpayers should be taxed similarly.*

There are generally two aspects of equity: horizontal and vertical. Horizontal equity requires that taxpayers with the same amounts of income pay the same amounts of tax.<sup>4</sup> Vertical equity requires that taxpayers with more income pay more in taxes.<sup>5</sup> Consider two taxpayers, A and B. A has ordinary income of \$100,000 from wages. B has income of \$100,000, but \$50,000 of it is capital gain income. A will be taxed at his marginal rate while B will only be taxed at his marginal rate on \$50,000 while the other \$50,000 of his income will be taxed at 15% (B has not reached the threshold yet for the top 20% capital gains rate). Assuming both A and B are single, using 2013 tax rates, A's tax liability will be approximately \$18,493 while B's tax liability will only be \$13,429. While A and B have equal amounts of income, they will not have the same tax liabilities. Horizontal equity, therefore, is not met.

Assuming A and B have different amounts of income: \$200,000 and \$180,000 respectively. However, the \$200,000 of A's income is all from capital gain. A's \$200,000 will be taxed at 15% because it has not yet reached the threshold for

<sup>4</sup> AICPA (2007). Tax Policy Concept Statement 4 – Guiding Principles for Tax Equity and Fairness. New York, NY. p. 5. Retrieved from <http://www.aicpa.org/InterestAreas/Tax/Resources/TaxLegislationPolicy/Advocacy/DownloadableDocuments/TPCS%204%20-%20principles%20for%20tax%20equity%20and%20fairness.doc>

<sup>5</sup> *Ibid.* p.3.

20%, while B will be taxed at his marginal rate of 28%. Even though A has more income, B will have the higher tax liability. Therefore, vertical equity is also not met.

## Certainty

*The tax rules should 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.*

Even though it may seem simple that the top rate on capital gains is 20%, it may not be as simple to figure the amount of tax liability. One may think, for example, that if an individual is in the top bracket, then the entire capital gains will be taxed at 20%. However, this may not be the case. The taxpayer must figure which portion of the gain is taxed at 15% and which is taxed at 20%. If the individual is in the top bracket, either a portion of the capital gains will be taxed at 15% and the rest at 20% or the entire amount will be taxed at 20%. In addition, if this individual has capital gains from unrecaptured depreciation on real property or collectibles, both of which have different capital gains rate (25% and 28%, respectively),<sup>6</sup> the tax computation is even less clear. Certainty, therefore, is not met.

<sup>6</sup> IRC §1(h).

## Convenience of payment

*A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer.*

The preferential rate on capital gains does not affect when or how taxpayers pay their tax liability. However, at the time of the property transaction, a taxpayer may not know his annual taxable income to determine whether the estimated payment should be made at the 20% rate, the 15% rate or a combination of the two rates.

## Economy of Collection

*The costs to collect a tax should be kept to a minimum for both the government and taxpayers.*

Since the 20% rate is new for 2013,<sup>7</sup> there will likely be an increased compliance and administrative burden for taxpayers and the government. Taxpayers need to comprehend and adjust to the new rule. The government needs to ensure taxpayers are applying the new rule and applying it properly. Economy in collection, therefore, is not met.

## Simplicity

*The tax law should be simple so that taxpayers can understand the rules and comply with them correctly and in a cost-efficient manner.*

During the Senate Finance Committee and House Ways and Means Committee hearing on Tax Reform and the Tax Treatment of Capital Gains, Senator Max Baucus (D-MT) said that the rules on capital gains are too complex. There are over 20,000 pages in the IRC devoted to capital gains and this “invites people to use all kinds of shenanigans to game the system.”<sup>8</sup>

Although it may be simple for taxpayers to understand whether they are subject to the 20% or 15% rate, they may have more difficulty in figuring their tax liability. For example, they may think that their entire capital gains amount is subject to the 20% rate because they are in the top bracket. However, this may not be the case because a portion of it may be subject to the 15% rate. Also, if they have capital gains from depreciation or collectibles, subject to 25% and 28% respectively, their tax calculations are even more complex. Simplicity, therefore, is not met.

<sup>8</sup> Baucus, M. (2012, Sep. 20). Opening Remarks from Committee on Finance and Committee on Ways and Means: Tax Reform and Capital Gains. Retrieved from <http://www.finance.senate.gov/imo/media/doc/20120920%20MSB%20Opening%20Statement.pdf>

## 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.*

Even though the rate on capital gains is increased to a top rate of 20%, it is still less than the rate on ordinary income. According to Dr. Burman, taxpayers are encouraged to engage in activities that produce capital gain income, such as private equity and hedge funds in order to benefit from the preferential rate. There is also an incentive to find ways to convert their ordinary income to capital gain income.

The usual argument, which violates the neutrality principle, for a lower rate on capital gains is that it encourages investments, which then stimulates the economy. However, as noted above, studies found that there is no significant correlation between the capital gains rate and economic growth. Neutrality is not met.

## Transparency and Visibility

*Taxpayers should know that a tax exists and how and when it is imposed upon them and others.*

Taxpayers are likely aware of the new 20% rate given the high-attention paid to the capital gains rate. However, it may be difficult to know their overall marginal rate as well as their capital gains rate because of multiple rates.

<sup>7</sup> The 20% maximum capital gains rate was added by the “American Taxpayer Relief Act of 2012” (P.L. 112-240, 1/2/13).

## Economic Growth and Efficiency

*The tax system should not impede or reduce the productive capacity of the economy.*

**T**ax law should not impede or reduce an economy's productive capacity. Tax law should encourage economic growth.<sup>9</sup> During the Senate Finance Committee and House Ways and Means Committee hearing on Tax Reform and the Tax Treatment of Capital Gains, Dr. Burman discussed the negative impacts of a lower capital gains rate on the economy. He contended that people make investments that do not make economic sense when evaluated without the tax break on capital gains. People invest in things that are entirely inefficient<sup>10</sup> and that only make sense to invest in because of the lower capital gains rate. This is money that could have gone to more productive investments. Also, there is a waste of human capital because, according to Dr. Burman, there are very intelligent people dedicating their time to trying to figure out ways to convert ordinary income to capital gain. There is an entire industry dedicated to doing just this, and this is time and energy that these people could have spent on doing more productive things for the economy.

The typical argument for a low capital gains rate is that it spurs investments. For example, during the Senate Finance Committee

9 AICPA. (2009). *Tax Reform Alternatives: Tax Reform Alternatives for the 21st Century*. (New York, NY). p. 15.

10 Burman, L. (2012, Sep. 20). Statement before the House Committee on Ways and Means and Senate Committee on Finance: *Tax Reform and the Tax Treatment of Capital Gains*. Retrieved from <http://www.finance.senate.gov/imo/media/doc/092012%20Burman%20Testimony.pdf>

and House Ways and Means Committee hearing on Tax Reform and the Tax Treatment of Capital Gains, Mr. Verrill, from the Angels Capital Association, pointed out that angel investors provide 90% of the outside equity raised by start-ups that are too small to qualify for bank loans or support by venture capital firms. He contends that raising the capital gains rate would reduce angel investments in these companies.<sup>11</sup> However, studies done by Dr. Burman and the Congressional Research Service, covering periods between 1950-2011 and 1945-2010, respectively, showed that there is no significant correlation between a lower capital gains rate and economic growth. Perhaps these two conflicting testimonies can be explained by economics professor Harald Uhlig from the University of Chicago. Professor Uhlig contends that it's possible that a lower capital gains rate promotes economic growth, but "the effect is too small to see among the wars and recessions of the 20th century."<sup>12</sup> A more comprehensive study should be done to evaluate the true impact of the capital gains rate on the economy.

11 Burman, 2012.

12 Greeley, 2012.

## Minimum Tax Gap

*A tax should be structured to minimize non-compliance.*

**P**eople are still incentivized to convert ordinary income to capital gains because of the lower rate on capital gains. However, there is no tax gap if they are doing this legitimately.

## Appropriate Government Revenue

*The tax system should enable the government to determine how much tax revenue will likely be collected and when.*

**T**he government should be able to predict how much more revenue will be collected with the new 20% rate if it can accurately predict how many taxpayers with capital gain income will be subject to the new rate.

## Rating Summary

Equity and Fairness	-
Certainty	-
Convenience of Payment	+/-
Economy in Collection	-
Simplicity	-
Neutrality	-
Economic Growth and Efficiency	+/-
Transparency and Visibility	+/-
Minimum Tax Gap	+/-
Appropriate Government	+

## Conclusion

The new preferential treatment on capital gains only meets the principle of appropriate government revenues. It partially meets principles of convenience of payment, transparency and visibility, and minimum tax gap. It fails five principles: equity and fairness, certainty, economy in collection, simplicity and neutrality, and arguably also fails economic growth and efficiency. This rule is, therefore, weak, and because the justifications for it are also weak, one must wonder why this rule is still in place and who really benefits from this rule? According to Dr. Burman, the top 400 earners in 2009 had 16% of the capital gains. According to Senator Baucus, the capital gains rate is the main reason why many wealthy individuals pay lower taxes. It seems that comprehensive tax reform may not be fully realized unless the issue of the capital gains rate is addressed.

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# Repeal of the Inclusion of Social Security Benefits in Gross Income

By: Sujin Pradhan, *MST Student*

## Background

**S**ocial Security (“SS”) benefits were not taxed until 1984. The nontaxable treatment of SS benefits before 1984 was derived from administrative rulings in 1938 and 1941. The primary reason for adoption of this position was that SS benefits were made for general welfare<sup>1</sup>. Social security became taxable when Congress passed the “Social Security Disability Benefits Reform Act of 1984” (P.L. 98-460, 10/9/1984).

Social Security benefits are not solely funded by employees’ payroll tax. Other contribution sources include employers matching payroll tax and the interest earned by the Trust Fund. Roughly 15% of the total contribution is made by the taxpayer. Hence, 85% of the SS benefits are contributed by the remaining sources. Based on this reason, the 1979 Advisory Council decided that the nontaxable treatment of the SS benefits was wrong. Thus, the proposal was made to tax half of the SS benefits with threshold exclusions set. In 1983, President Reagan signed the Amendments and up to 50% of SS benefits became taxable.<sup>1</sup>

In 1993, an additional set of thresholds was added and up to 85% of the SS benefits became potentially taxable for high income taxpayers. Lawmakers believed that reducing the exclusion for Social Security benefits for these high income taxpayers would enhance both the horizontal and vertical equity of the individual income tax system by treating all income in a similar manner.<sup>2</sup>

## Current Law

Social Security benefits received during a tax year may be taxable depending on how much income a taxpayer has from other sources. In general, SS benefits are taxed if a taxpayer’s sum of modified adjusted gross income (MAGI) and one half of his SS benefits exceed the base (threshold) amount.

When such sum exceeds the base amount, the taxable amount is the lesser of:

1. Half of the SS benefits or,
2. Half of the excess amount over the threshold.

Section 86(c)(1) of the Internal Revenue Code of 1986 provides that the base amount for a single taxpayer is \$25,000 and \$32,000 for taxpayers filing joint returns. For taxpayers with an excess amount (MAGI plus half of SS benefits over the base amount) more than the adjusted base amount (\$34,000 and \$44,000 for single and married taxpayers, respectively), up to 85% of SS benefits may be taxable.

As evident, the tax law is complex. SS benefits are taxed under a two tier system. If the taxpayer’s excess amount is more than the first tier threshold but less than the second tier threshold, up to 50 % is taxable. If the excess amount is more than the second tier amount then up to 85% is taxable.

## Proposal

On January 15, 2011, Congressman Ron Paul (R-TX) introduced H.R. 150 “Senior Citizens Tax Elimination Act” (112th Congress, 2nd Session) to repeal the inclusion of SS benefits on gross income.

This bill, if enacted, will change an existing tax law on Social Security benefits. It is important that such proposals be evaluated before implementing them into tax laws. In 2001 the AICPA published a report outlining a set of ten principles as preliminary steps to analyze such tax proposals. Analysis of the “Senior Citizens Tax Elimination Act” using those ten principles follows.

<sup>1</sup> U.S. House Committee on Ways and Means. (1980). *Tax-free Status of Social Security Benefits: Report to Accompany H.Con Res. 351. ( 96th Cong., 2d Sess.) No. 96-1079.*

<sup>2</sup> Social Security Administration. (2012, Aug.). *Taxation of Social Security Benefits.* Retrieved from <http://www.ssa.gov/history/taxationofbenefits.html>

# Principles of Good Tax Policy Evaluation

## Equity and Fairness

*Similarly situated taxpayers should be taxed similarly.*

As per the current rule, certain high income taxpayers pay higher tax. Higher income taxpayers could pay tax on up to 85% of their SS benefits. Other taxpayers could pay tax on up to 50% of their SS benefits or may not pay tax at all. On the surface it seems like the existing tax law meets equity and fairness. However, the threshold amounts are not indexed for inflation. Therefore, it may not meet fairness criterion because the taxpayers who were considered high income in 1984 (or 1993) may not remain as high income taxpayers today. As a result, the number of taxpayers subject to tax is only going to increase in the future making more low income taxpayers subject to such tax. Also, the exclusion amount is the same regardless of where taxpayer lives. A taxpayer with AGI of \$34,000 in Wyoming may be considered high income while a taxpayer with the same income in New York may not be considered a high income taxpayer.

If the tax on SS benefits is repealed, no taxpayers pay tax on the SS benefits regardless of their income level. While it might be helpful for low income taxpayers, the high income taxpayers will reap the benefit as well. Hence, equity and fairness is still not achieved. A better solution could be to adjust the threshold amount (index to inflation) so that lower income taxpayers will not be subject to tax.

## Certainty

*The tax rules should 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.*

The taxable amount for SS benefits is calculated when the taxpayers file their tax returns. While the law does explain how the amount is to be determined, the calculation itself can be very confusing. Even with the use of tax software, taxpayers will not have confidence on the correctness of the calculated amount.

Repealing the tax definitely enhances certainty because taxpayers do not need to perform the complex calculations to determine their amount of taxable SS benefits.

## Convenience of payment

*A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer.*

The current tax law does not meet this principle. Taxpayers are required to pay the taxes with their respective tax returns. If they failed to make payments, they will be charged with interest. While the taxpayer can elect to have a portion of the benefits withheld, it might not be in his best interest to do so if he is likely to be a low income taxpayer for that taxable year. Moreover, IRS does not pay interest for the taxes withheld.

Repeal of the tax will help meet this principle because taxpayers will not have to pay taxes on SS benefits at all.

## Economy of Collection

*The costs to collect a tax should be kept to a minimum for both the government and taxpayers.*

Currently, it costs taxpayers money to file their tax returns and be in compliance with the SS benefits tax laws. Since the calculation is complicated it is challenging for a taxpayer to file their own tax returns. Even if the taxpayer is low income and might not owe any taxes, he still might have to get help from a tax preparer and incur compliance costs just to find out if the SS benefits are exempt.

Repealing the tax will save taxpayers money. At the same time, the IRS does not need to use its resources to audit taxpayers for noncompliance.

## Simplicity

*The tax law should be simple so that taxpayers can understand the rules and comply with them correctly and in a cost-efficient manner.*

**T**he current law is not simple. In addition to the complex calculation, most taxpayers have difficulty understanding MAGI. Repealing this complicated tax law will enable taxpayers to better understand the simplified tax rules. Once repealed, taxpayers have no compliance cost which makes the new law more cost-efficient.

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## 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.*

**U**nder the current law, taxpayers might be motivated to get rid of tax exempt bonds or defer capital gains, if it helps keep their MAGI below the threshold amount.

Repealing the tax will help meet neutrality because taxpayers will not be motivated to alter their decisions to keep their MAGI below the threshold amount.

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## Economic Growth and Efficiency

*The tax system should not impede or reduce the productive capacity of the economy.*

**R**epealing tax on SS benefits will give taxpayers more money to spend. In addition, they will save money on compliance costs. It will result though, in less revenue for the government which might lead to an increase in taxes elsewhere.

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## Transparency and Visibility

*Taxpayers should know that a tax exists and how and when it is imposed upon them and others.*

**C**urrently, taxpayers are aware of the fact that SS benefits are taxable. However, not all taxpayers are taxed on their SS benefits. Taxpayers under the threshold amounts do not get taxed. This creates confusion about whether or not a taxpayer is exempt. Taxpayers can easily have difficulty understanding MAGI and how their taxable SS benefits are calculated.

Repeal of the tax will increase transparency and visibility as taxpayers will know that they will not pay tax on their SS benefits at all.

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### Minimum Tax Gap

*A tax should be structured to minimize non-compliance.*

**U**nder the current law, the likelihood of non-compliance is high. Taxpayers may not file returns simply because they do not want to pay taxes on their benefits. The IRS has to use its resources to go after such taxpayers. There are also high chances of unintentional noncompliance. Taxpayers might not file tax returns believing they are under the threshold. For example, they might not be aware that tax-exempt interest is included in the calculation of MAGI which could put them above the threshold amount making SS benefits taxable.

Repealing the tax definitely eliminates non-compliance issues.

### Appropriate Government Revenue

*The tax system should enable the government to determine how much tax revenue will likely be collected and when.*

**R**evenues generated under the first tier of tax are dedicated to the Federal Old-Age and Survivors Insurance Trust Fund and Federal Disability Insurance Trust Fund. Any additional taxes from the second tier are dedicated to the Federal Hospital Insurance Trust Fund and Supplementary Medical Insurance Trust Fund.<sup>1</sup>

Once the tax is repealed no money is collected. Thus, the Government must find other means to supplement those funds.

<sup>1</sup> U.S. Congress. Joint Committee on Taxation. (2011, Jun. 21). JCX 36-11 Description Of The Social Security Tax Base. Retrieved from <https://www.jct.gov/publications.html?func=startdown&id=3798>

## Rating Summary

<b>Equity and Fairness</b>	-
<b>Certainty</b>	+
<b>Convenience of Payment</b>	+
<b>Economy in Collection</b>	+
<b>Simplicity</b>	+
<b>Neutrality</b>	+
<b>Economic Growth and Efficiency</b>	+/-
<b>Transparency and Visibility</b>	+
<b>Minimum Tax Gap</b>	+
<b>Appropriate Government</b>	-

## Conclusion

**R**epeal of the tax on SS benefits meets most of the tax policy principles that the current law fails to meet except equity and fairness. However, this might be compensated by taxing high income individuals more on other sources of income. Also, the government must find alternative sources to fund the programs which are currently funded by the tax on SS benefits.



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