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## THE CONTEMPORARY TAX JOURNAL

*A publication of the SJSU MST Program*



## The Contemporary Tax Journal

Volume 2, No. 1 – Spring 2012



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Lucas Graduate School of Business

## Letter from the Editor

Innovation is the principal driver of value in the global economy. Here in Silicon Valley, one can't drive down highway 101 without passing company after company that has created disruptive technology to improve our world. These are exciting times as we witness, first-hand, the extraordinary pace of change that is occurring during our lifetime. Since 1958, Moore's Law has held true: Computing power has doubled every two years. So far, there have been roughly 27 doublings, which means the power of microprocessors has increased by a factor of 67 million! Spillovers from this invention are clearly fueling the pace of innovation and the resulting societal benefits.

In this issue, we are fortunate to have a tax expert who has contributed a thoughtful executive analysis that addresses innovation and tax reform. Annette Nellen, Professor, Lucas Graduate School of Business- San Jose State University and Director of the High Technology Tax Institute, appeared before the Senate Finance Committee hearing covering tax reform and incentives for innovation held in September 2011. Her written testimony, modified for the journal, explains the need for strategic tax reform and how to link innovation to the design of a tax system. She reviews current tax rules, including the research credit, and how the rules could be improved to spur innovation. In addition, Professor Nellen provides several non-tax recommendations to foster innovation in our country. Let's hope Congress recognizes the importance of innovation for all sectors of the economy and implements meaningful tax reform to promote growth through innovation.

Silicon Valley is known for its world-class talent and that includes the students that contribute to this journal. Included in this issue are sessions summaries from the 27<sup>th</sup> High Technology Tax Institute. New offerings from four students make our tax enlightenment department a good read, as is an informative interview with Larry Langdon in our "Tax Mavens" section you're sure to enjoy. Two new additions to our Focus on Tax Policy section look at increasing the standard mileage rate for charitable work and the idea of allowing unmarried individuals claiming the standard deduction to elect the IRS to prepare their return. I'm very proud of all the student contributions that helped make this issue possible. Take a bow! We value bringing this information in all its complexity to our readers.



Tim Kelly  
Student Editor

PS: Someday Moore's Law will come to an end, but even if it slows to every three or four years, the coming innovations are going to be spectacular. You ain't seen nothin' yet!

# Tax Enlightenment

## New Reporting Requirements for Foreign Financial Assets

By: Christopher Rossi, *MST Student*

What is the best method to keep kids honest with regard to the cookie jar that sits in the middle of the kitchen filled with fresh baked cookies? Count the cookies! Of course, most parents do not go to these extremes over something as small as a cookie, but leave it to the federal government and you can be positive they would be counting the cookies and even the crumbs leftover if certain foreign assets of U.S. taxpayers are involved.

For many years now, the federal government has sought to obtain information with regard to the taxpayer's financial transactions with foreign financial institutions in order to ensure that U.S. taxpayers are properly reporting income that the foreign financial institutions might not be reporting to the Internal Revenue Service. One such information return is the Treasury Department Form TD F 90-22.1, "Report of Foreign Bank and Financial Accounts", ("FBAR"), which requires certain taxpayers to report their interest and/or authority over foreign bank and financial accounts if certain thresholds are met. The penalties, including criminal penalties, are quite steep for failure to file the information report and have been enforced more strictly in recent years.



The "Hiring Incentives to Restore Employment (HIRE) Act" enacted in March 2010 created new reporting requirements primarily for individuals with foreign financial assets. These new reporting requirements apply to more than just foreign bank and financial accounts. These rules are part of the "Foreign Account Tax Compliance Act" ("FATCA") provisions of the HIRE Act.

The new reporting requirements are effective for tax years beginning March 18, 2010, which for calendar year taxpayers would be their 2011 tax year. The new legislation requires that any individual taxpayer who holds an aggregate of \$50,000 or greater in "specified foreign financial assets" must disclose each asset on an individual's income tax return. The IRS has issued federal Form 8938, "Statement of Foreign Financial Assets," to be filed with an individual's income tax return to disclose the required information with regard to the taxpayer's "specified foreign financial assets."

At this point you may be asking yourself, "What is a 'specified foreign financial asset'?" A "specified foreign financial asset" is:

- Any financial account with a foreign financial institution; and
- Any of the following assets not held with a financial institution:
  - Stock or security of non-U.S. person; or
  - Financial instrument or contract whose issuer is a non-U.S. person; or
  - Any interest in a foreign entity.

With that clarified, it is clear that the ten Euros that you brought home with you from your last family vacation is not going to cause you any heartburn with regard to the new reporting requirements.

It is very important that you take time to inventory your personal financial assets to determine whether any of your investments could possibly be considered a “specified foreign financial asset” as there are substantial penalties for failing to disclose under the new rules. If a taxpayer fails to comply with the new information reporting requirements he could face an initial penalty of \$10,000 plus an additional \$10,000 each month after 90 days of receiving a notice from the IRS, not to exceed a maximum of \$50,000.

If you determine that you meet the requirements for the new disclosure, the information to be disclosed is not extensive, such as the name and address of the foreign financial institutions and/or the foreign financial securities. Perhaps the most difficult information to obtain will be the maximum value of the “specified foreign financial asset” during the tax year, which is required to be disclosed. For example, an interest held in a foreign limited partnership may not have an easily ascertainable fair market value unless a valuation report is obtained. With this said, the IRS has recently issued regulations that clarified that the maximum value to be reported only needs to be a reasonable estimate. Additional information can be found in the Form 8938 instructions. It will be interesting to see the extent to which the IRS scrutinizes the value of the assets that are based on estimates.

As always, due to the complexity of the tax law it is highly recommended that you consult your tax advisor if you have any questions or concerns with regard to the new reporting requirements and whether or not they may apply to you. The IRS also maintains a FATCA website at

<http://www.irs.gov/businesses/corporations/article/0,,id=236667,00.html>.



## Can Employees Deduct Meals and Gifts for Co-Workers?

By: Ke Huang, *MST Student*

Many individuals may be interested in the tax treatment of expenses related to business. Some employees are required or encouraged by their employers to pay out-of-pocket for some expenses related to business. Sometimes, employees can obtain reimbursement from the company, but there are times when they are not entitled to such reimbursement based on company policy. When employees cannot be reimbursed, they may wonder whether they can deduct such expenses from their gross income when they file their tax return.

In general, all the ordinary and necessary expenses, paid or incurred during the tax year in carrying on any trade or business, are deductible. Employees may have deductible business expenses, but they must itemize their deductions (rather than claim the standard deduction). However, no deduction is allowed for personal, living or family expenses. The key to whether employment-related expenses are deductible is to determine whether the expenses are ordinary and necessary ones. In addition, there are some limitations on certain expenses. For example, deductions for client gifts are limited to \$25 each.

Let us start with an example which is not uncommon today. Jane is employed as a manager in a company and twenty people report to her. In order to keep morale high and maintain good relationships within the whole department, she usually gives a \$20 gift to her staff members on their birthdays, and she also buys a birthday cake for everyone to enjoy. However, according to company policy, only the cost of gifts to clients can be reimbursed. Jane wonders whether she can get some deduction on her personal tax return since she cannot get reimbursement from the company. After all, the purpose of providing the gifts and cakes to her staff is to help morale and improve productivity, which, she believes, are related to business and therefore should be considered business expenses.

Unfortunately for Jane, several court cases<sup>1</sup> have held that if providing gifts to employees or incurring expenses is not required by the employer, such expenditures are not considered ordinary and necessary business expenses. Even though these expenditures may have contributed to maintaining morale of her subordinates, there are no direct business benefits for Jane, and the gifts were not a condition of her employment. Therefore, the gifts and cakes are not deductible as they are really personal expenditures.

Now, let's move on and take a look at a similar situation: hosting an occasional dinner party or holiday party for co-workers, along with their spouses. Consider Bob, a salaried employee at a

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<sup>1</sup> Such as *Dunkelberger*, TC Memo 1992-723, and *Fountain*, 59 TC 696 (1973).

company. He believes dinner parties and holiday parties will connect department employees more closely and will motivate them to work harder, so he often invites his subordinates to dinner parties. Similar to Jane's situation, his employer only reimburses expenses for entertainment of clients, not employees. Bob is also wondering whether he can claim a deduction on his tax return. Once again, the answer is no. The possibility of some business benefit to Bob's employer does not transform a personal expense of entertaining co-workers into ordinary and necessary business expenses.

Last but not the least, for expenses that employers will reimburse, it is the employee's responsibility to timely submit the receipts. If an employee fails to do so, he or she cannot deduct such expenses from his or her gross income. For example, assume an employee, Sarah, took her clients to dinner, and Sarah was entitled to reimbursement according to the policy of her employer. However, Sarah forgot to submit the receipts for reimbursement on time. Sarah may not deduct the expense on her tax return because it is really her employer's expense, not hers (because reimbursement was available).

Based on the rules described here, it is advisable for employees to consider:

- 1) Finding out from their employers which expenditures are expected of them as a condition of employment and which are reimbursable.
- 2) Submit receipts for all reimbursable expenses within the time limit required by the employer.



Employees with unreimbursed expenses that are required as a condition of their employment must also consider various rules on deductibility and documentation to be able to claim any of the expenses as part of their itemized deductions. For further information, individuals should consult a tax adviser. The IRS website provides information on employee business expenses; see topic 514 at <http://www.irs.gov/taxtopics/tc514.html>.

## IRS Still Battling “Abusive Tax Shelters” 25 Years Later

By: Lindsay Wilkinson, *MST Student*

Long gone are the boom days of the individual tax shelter industry of the early 1980's – the Tax Reform Act of 1986 made sure of that by disallowing passive activity losses from reducing a taxpayer's ordinary income. However, nearly two-and-a-half decades later, legislation is still being passed to try and prevent the use of “abusive tax shelters” by individuals and business owners.

In early 2010, the Health Care Reconciliation Act was enacted which, among a host of other changes, codified the “economic substance doctrine.” This doctrine gives the IRS the power to deny the tax benefits associated with transactions that have no “economic purpose” other than to lower a person's tax liability. Therefore, even if a transaction appears to qualify under the statutory language of the Internal Revenue Code (IRC), the transaction will not be allowed if it does not meet a two-pronged test to determine its economic purpose. As defined in Internal Revenue Code (IRC) Section 7701(o), a transaction (or series of transactions) will be treated as having economic substance only if:

- 1) the transaction meaningfully changes the taxpayer's economic position; **AND**
- 2) the taxpayer has a substantial non-federal income tax purpose for completing the transaction.

Profit motive will be taken into account when determining whether a taxpayer has met the two-pronged test. However, the expected pre-tax profit from the transaction must be substantially greater than the expected net tax benefits in order for the transaction to be respected. Although the “economic substance” concept has been around for quite some time, its application by the courts has been inconsistent prior to enactment of this provision. Previously, some courts held that to have economic purpose, a transaction must pass either one of the two tests to sufficiently satisfy the economic substance doctrine.

It is important to note, however, that this provision does not instruct the courts on *when* to utilize the test nor does it revoke the power of the courts to break apart transactions in order to examine each part for economic purpose. Additionally, this provision is not intended to deny businesses the right to select the option with the most beneficial tax treatment when choosing between alternatives that each have economic substance – such as whether to finance a business with debt or equity.

Under the new act, the penalty rate for the underpayment of tax due to a transaction that is found to lack economic substance is 20%. The penalty is increased to 40% if the taxpayer fails to disclose all relevant facts affecting the tax treatment in the return or in an attached statement. This is a strict penalty with no exceptions available even if the taxpayer had “reasonable cause” to believe the transaction would be allowable.

In conclusion, although the IRS will continue to analyze whether the economic substance doctrine is applicable on a case-by-case basis as it did prior to the enactment of Sec. 7701, this provision has made it clear how a transaction will be analyzed to determine economic purpose and the penalties that could be imposed regardless of a taxpayer's due diligence.

## 2012 CPA Day at the Capitol

By: Elaine Cardiel, *CPA, California Society of CPAs, Silicon Valley San Jose Chapter, Board Member; Berger Lewis Accountancy Corporation, Senior Tax Accountant; and MST Student.*

The California Society of CPAs (CalCPA) is the nation's largest statewide association of CPAs representing more than 38,000 members. The goals of the organization include advocating for members on issues that affect the profession; enhancing and promoting the visibility of the profession; and attracting, educating, and supporting CPAs in their personal and professional development.

To promote these goals, more than 200 CPAs and students from all over California converged in Sacramento on January 18, 2012, to participate in the annual "CPA Day at the Capitol." This event offers CalCPA members an opportunity to meet with California's legislators to discuss issues that impact their clients and profession, to influence the future of the profession in California, and to grow relationships with elected representatives.



How does "CPA Day at the Capitol" work? Weeks in advance, a team at CalCPA diligently schedules each participant to meet with two to three legislators. After being briefed and receiving the appointment schedules from CalCPA, participants proceed to the Capitol building.

The three issues CalCPA asked members to discuss with legislators included interstate commerce, sales tax on services, and financial literacy. Specifically:

- Interstate Commerce: The Uniform Accountancy Act model permits cross-border practice privileges for its 48 participating states. Non-participating states include California and Hawaii. Under the model, state boards of accountancy may take action against any out-of-state CPA who provides any service that could be considered the practice of public accountancy. This directly impacts a tax professional, for example, who files multi-state returns.
- Sales Tax on Services: In order to increase revenue for the state, there have been discussions regarding the taxation of professional services. What if the tax were imposed on tax professionals? CalCPA poses the question to lawmakers as to whether it is right to impose a sales tax on tax preparation services when Californians are mandated by law to file a tax return.
- Financial Literacy: CalCPA offers financial literacy workshops regarding financial topics, such as budgeting, money management, managing credit cards, saving and investing, tax tips,

disaster preparedness, financial preparations and more. CalCPA members wanted to be sure legislators were aware of these public service activities. (Information on CalCPA's Dollar and Sense workshops can be found at <http://www.calcpa.org/Content/25907.aspx>.)

My day included meetings with Assembly members Steve Knight (36<sup>th</sup> District in Southern California), Jim Beall, Jr. (24<sup>th</sup> District in the Silicon Valley), and Bill Berryhill (26<sup>th</sup> District in Central California). As a first time participant in this annual event, I didn't know what to expect. Would the assembly members be invested in the discussions and how in-depth would these discussions be? Would they be tied up by Governor Brown's State of the State address and unable to attend our meetings? What transpired was dynamic and exciting.

I was pleased that Assembly members Steve Knight, Jim Beall, Jr., and Bill Berryhill each made time to meet with us. They were personable, listened to the issues, discussed the issues with us, and asked relevant questions. For example, why wouldn't California want to adopt the Uniform Accountancy Act model? Some CalCPA members believed it was because California, one of the world's largest economies, wanted to adhere to its own standards and operate independent of other states. However, this is not advantageous to CPAs as it limits the ability of California CPAs to practice in other states. On a different note, the legislators were not concerned about the sales tax on services. The issue was not on the legislators' radar, and the group that heavily favored the tax has backed down.

The issue that caught the most resounding support was the need for financial literacy. High school students, college students, foster children, seniors, and home buyers are in need of financial literacy programs. With regard to the urgent need for financial literacy, Assembly member Jim Beall, Jr. told a story about a young man from the foster program who was accepted into Stanford University. The young man got trapped in a cycle of high-interest student loans which he found online. Would a financial literacy program have helped this young man make better choices? Assembly member Bill Berryhill of Stockton emphasized that his district was the foreclosure capital of the country. If the people in his district had the benefit of financial literacy programs, would they have made better decisions regarding the home loans they chose?

The CalCPA members informed the lawmakers that in an effort to promote financial literacy, CalCPA has reached out to high schools throughout California. For schools that are interested, CalCPA will design a financial literacy program specific to the needs of that school and its participants. A small number of schools have embraced the program thus far, and CalCPA is hopeful that more will participate as success stories emerge.

What was my take on visiting lawmakers as part of the CalCPA annual event? I've been a tax professional for six years and spend most business hours in the trenches preparing tax returns and providing tax assistance to clients. It's important to step away from the daily grind in order to understand the bigger picture. As time and technology changes, so do the issues that impact CPAs, the profession, and the clients we represent. CalCPA's "Day at the Capitol" provided the opportunity to become aware of those issues and to see this bigger picture through the eyes of seasoned CPAs, students, legislators, and their constituents.



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*A publication of the SJSU MST Program*

## SEEKING ARTICLES

We are seeking articles on current tax matters for future issues of *The Contemporary Tax Journal*. Manuscripts from tax practitioners, academics and graduate students are desired. If you are interested in seeing your work published in this journal, please read more about our submission policy below and on the website.

Articles must be unpublished and must be your original work. Articles should be 8 to 16 double-spaced pages (2,500 to 6,000 words). Articles are subject to blind, peer review.

Submission deadlines:

Fall Issue:	Deadline February 1
Spring Issue:	Deadline August 1

For more information on the article submission process, please see the submission link on our website at <http://www.sjsumstjournal.com>.

# FEATURE ARTICLE

## Tax Reform and Incentives for Innovation

By: Annette Nellen, CPA, Esq.  
Professor, Lucas Graduate School of Business  
San Jose State University

The 112th Congress (2011-2013) held over 25 hearings on various aspects of tax reform.<sup>2</sup> One of the hearings held by the Senate Finance Committee in September 2011 covered tax reform and incentives for innovation. The author was an invited witness for this hearing.<sup>3</sup> Following is the author's written testimony submitted for the record modified slightly and with a conclusion added in order to fit the format of a journal article.<sup>4</sup>

### Introduction

The topic of the hearing carried with it at least two messages. First, our federal tax system is in need of reform. Second, a tax system should be designed to support (or not hinder) the taxing jurisdiction's economic, societal and environmental goals. Innovation is a hallmark of our country and a key driver for economic growth, improvement in living standards, and a better environment.

This testimony addresses innovation and tax reform in the following areas:

- I. Strategic tax reform.
- II. How innovation ties to tax system design and reform.
- III. Where current tax rules support innovation and where improvements might be made to better support (or not hinder) innovation.
- IV. Comments specific to the research tax credit.
- V. Additional recommendations (non-tax).

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<sup>2</sup> For a list of the hearings and links to the testimony and related documents, see [http://www.cob.sjsu.edu/nellen\\_a/112th-hearings.htm](http://www.cob.sjsu.edu/nellen_a/112th-hearings.htm).

<sup>3</sup> See hearing website at <http://finance.senate.gov/hearings/hearing/?id=ef6a4c10-5056-a032-5212-fbf59e314035>.

<sup>4</sup> The written testimony is far longer than the five minutes of oral testimony. The author's oral testimony has been reproduced in Nellen, "Tax Reform: Incentives for Innovation," *AICPA Corporate Taxation Insider*, Sept. 29, 2011; available at [http://www.cpa2biz.com/Content/media/PRODUCER\\_CONTENT/Newsletters/Articles\\_2011/CorpTax/Innovation.jsp](http://www.cpa2biz.com/Content/media/PRODUCER_CONTENT/Newsletters/Articles_2011/CorpTax/Innovation.jsp).

## I. Tax Reform Considerations - Need for Strategic Tax Reform

Tax reform must be about more than hitting a certain revenue target or dealing with one problem in isolation of other problems. There must be a reason for change. As has been described in hearings before this committee and numerous reports from tax experts, as well as evidenced by a \$345 billion annual tax gap, growth in the size of the federal tax law and the number of taxpayers seeking tax prep assistance, and concerns that the tax law is harming international competitiveness of U.S. firms, there are plenty of reasons for change.

*Effective* change requires that the goals for the change be identified. This enables an effective blueprint for the reform to be created. Articulation of the goals for reform also enables the effectiveness of the reform to be measured; that is, were the goals achieved? If not, what further changes are needed?

Creating the blueprint for a reformed tax system should be guided by principles of good tax policy. Consideration of principles such as equity, neutrality, economic growth and efficiency, transparency and simplicity can help identify strengths and weaknesses in the tax system and how to fix the weaknesses. A tax system that meets principles of good tax policy will be a stronger system.

*Strategic* tax reform identifies the reasons for change, articulates the goals to be achieved by change, and uses principles of good tax policy as the tools of design. Strategic tax reform should yield a stronger tax system that supports the jurisdiction's economic, societal and environmental goals.

## II. Innovation, Tax Policy and Tax Reform

Investment in R&D has long been viewed by lawmakers, businesses and the public as a key contributor to economic growth.<sup>5</sup> This perspective has justified government funding of medical research, the space program and many other research activities. In 1981, this view supported creation of a research tax credit to address a "concern that the decline in investment in research and development had adversely affected this country's economic growth, productivity gains, and ability to compete in world wide markets."<sup>6</sup>

Certainly, a goal for tax reform should be to support (and not hinder) economic growth. Innovation is a driver of economic growth that can enable U.S. companies to be first to the global marketplace, create operating efficiencies for businesses and households, and lead to greater economic development that supports many businesses.

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<sup>5</sup> As noted by the Treasury Department: "Investments in research and experimentation produce the technological advancements that are an important determinant of productivity growth and improvements in U.S. living standards." See, Treasury, *Investing in U.S. Competitiveness: The Benefits of Enhancing the Research and Experimentation (R&E) Tax Credit*, 3/25/11, page 3; <http://www.treasury.gov/resource-center/tax-policy/Documents/Research%20and%20Experimentation%20report%20FINAL.PDF>.

<sup>6</sup> *TSR, Inc. and Sub. v. Comm'r.*, 96 TC 903 (1991) summarizing the 1981 legislative history that added IRC Section 44F (now Section 41) as part of the Economic Recovery and Investment Act (ERTA) (P.L. 97-34; 8/13/81).

Innovation can factor into tax reform in at least the following ways, listed and then explained below:

- Consideration in helping the system meet the tax principle of economic growth and efficiency.
- Use of the tax law as a vehicle for addressing the societal or spillover benefits inherent in R&D.
- Tax administration and compliance.
- Having a strong fiscal system to support innovation.

First, one principle of good tax policy is *economic growth and efficiency*. In its framework of describing ten principles of good tax policy, the AICPA Tax Division<sup>7</sup> describes "economic growth and efficiency" as "the tax system should not impede or reduce the productive capacity of the economy." This should be considered along with another principle – neutrality. A neutral tax system is one where the tax rules do not affect decision-making. This may sometimes seem to be in opposition to the economic growth and efficiency principle. It is not. Any tax system will have some effect on decision-making; it cannot be avoided. For example, a sales tax has an inherent effect on one's decision to buy a taxable item.

The economic growth and efficiency principle guides tax system design by minimizing adverse effects of the tax. For example, an income tax by its nature allows businesses to consider asset depreciation in measuring income. The selection of the depreciation life and method should not impede economic growth. For example, use of a 20-year depreciable life for a computer will enable measurement of taxable income but will have an adverse effect on economic growth.

Second, the tax system serves as one possible approach to address the fact that there are often spillover benefits to society of private investment in R&D.<sup>8</sup> This position has been noted as an economic justification for the research tax credit. In a 1985 study on the effectiveness of the credit, the Joint Economic Committee stated:

"[T]he total rate of return on private R&D greatly exceeds the private rate of return. That is, private R&D gives rise to benefits to society at large well in excess of the profits it generates for the company that funds the R&D. Such "spillover benefits" or "neighborhood effects" thereby put R&D into the class of goods such as public health and sanitation, education, clean air and water, and defense that fall into the sphere of governmental responsibility."<sup>9</sup>

A company conducting research and incurring costs may not be able to completely reap the rewards of its research because some of the benefit will spill over to others. For example, although research leading to an innovative new drug can be protected by a patent to help a company obtain the

<sup>7</sup> AICPA, *Tax Policy Concept Statement No. 1 – Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals* (2001); available at <http://www.aicpa.org/INTERESTAREAS/TAX/RESOURCES/TAXLEGISLATIONPOLICY/Pages/TaxReform.aspx>; the author of this article was the lead author of this AICPA report.

<sup>8</sup> Another approach for compensating for the spillover benefits are direct government payments or grants.

<sup>9</sup> "The R&D Tax Credit: An Evaluation of Evidence On Its Effectiveness," A Staff Study prepared for the use of the Joint Economic Committee, 8/23/85, page 4.

economic benefits of its research, the fruits of the research will be enjoyed by others upon the patent's expiration. In addition, the existence of the patent and the knowledge gained from the research that created it may lead to developments by others for which the original inventor may not be fully compensated. Because a company may not receive all of the return from its research investment, but will instead share some of it with society, there is justification for public support of such research.

Also, the risks associated with R&D may lead to underinvestment in it, as noted by Congress when it enacted the research tax credit in 1981.

The OECD observes: "Given the contribution of research and development (R&D) to productivity growth, economic performance and the achievement of social objectives, it is generally agreed that governments have a role in encouraging appropriate R&D levels and expenditures."<sup>10</sup>

Providing compensation for the spillover benefits and encouragement for greater investment in R&D through the tax law rather than via direct government subsidy (such as a grant) enables market forces to identify appropriate R&D activities rather than a government agency. The tax approach, though, adds some complexity to the tax law and makes the IRS a reviewer of qualified research rather than an agency with scientific and technological expertise. A tax-based subsidy should consider this side effect in the design of the tax provision (such as by not making the definitions of qualified research too complicated to administer through the tax law).

Considering the first two points above, recognition of an economic justification for government support of R&D should be balanced with the need for a tax system to strive to meet the principles of simplicity, equity, neutrality and transparency.

Third, innovation should be considered in improving the administration of a tax system. For example, new web-based tools might be used to streamline the calculation, assessment and collection of taxes. Administration of the tax system should not be overlooked in tax reform, which often tends to look only at changing the tax base and rate.

Finally, tax reform can strengthen the revenue (and spending<sup>11</sup>) aspect of the federal budget. A healthier federal budget can help support investment, such as by keeping interest rates low. A sound tax system can also help the economy and investment. As noted by President Obama in the section of

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<sup>10</sup> OECD, *Tax Incentives For Research and Development: Trends and Issues*, page 4;  
<http://www.oecd.org/dataoecd/12/27/2498389.pdf>.

<sup>11</sup> Spending exists in the tax law via special provisions that are not crucial to defining the tax base. These items, termed "tax expenditures," include special deductions, exclusions and credits. The benefit provided, such as via a tax credit for higher education expenses, could instead have been line item spending in an agency's budget to provide the benefit to the taxpayer.

the Administration's FY2012 budget report entitled "Competing and Winning in The World Economy":<sup>12</sup>

"Putting the Nation on a sustainable fiscal path and getting our deficits under control are critical to making the United States competitive in the global economy." (page 31)

"Reform our Tax Code to Foster Innovation and Competitiveness. ...Now more than ever, when we want to compete and win in the world economy, we cannot afford a tax code burdened with special interest tax breaks. Successful comprehensive tax reform is a long process, often taking several years, but even though it is a daunting task, we cannot afford to shirk from the work. In an increasingly competitive global economy, we need to ensure that our country remains the most attractive place for entrepreneurship and business growth. As a first step toward reform, the President calls on the Congress to immediately begin work on reform that will close loopholes, lower the overall rate, and not add a dime to the deficit." (page 37)

### **III. Current Rules – Areas of Support for Innovation and Areas for Improvement**

#### **Areas that Support Innovation**

The federal tax law includes a few provisions that incentivize or support innovation in some way. These provisions include:

- Section 174, Research and experimental expenditures, allows taxpayers to deduct research or experimentation expenses incurred in connection with a trade or business.
- Various credits including:
  - Section 41, Credit for increasing research activities (discussed in a separate section of this testimony)
  - Section 45C, Clinical testing expenses for certain drugs for rare diseases or conditions ("orphan drug" credit)
  - Section 48C, Qualifying advanced energy project credit
  - Section 48D, Qualifying therapeutic discovery project credit
- Section 172, Net operating loss deduction – allows for a net operating loss, such as may be created by a start-up company, to be carried back two years and forward 20 years.
- Section 179, Election to expense certain depreciable business assets – enables small companies to expense, rather than depreciate, tangible personal property, limited to the net income from the business. Offers support for acquiring equipment used for R&D activities, for example.

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<sup>12</sup> OMB, FY2012 Budget, "Competing and Winning in the World Economy," at <http://www.whitehouse.gov/sites/default/files/omb/budget/fy2012/assets/competing.pdf>. This report also calls for simplifying and expanding the research tax credit and making it permanent (page 37).

- Section 1202, Partial exclusion for gain from certain small business stock – may help a "qualified small business" C corporation obtain equity financing.
- Section 1235, Sale or exchange of patents – allows individual inventors to treat certain patent dispositions as producing long-term capital gain income, rather than ordinary income.

### Areas for Improvement

Some tax provisions can operate in such a manner as to have the unintended effect of hindering innovation, and some may be in need of modernization to better reflect today's ways of doing business. In a tax policy analysis, these provisions would raise red flags under the economic growth and efficiency principle. A few of these provisions are explained next.

- 1) *Limitations of tax credits:* Tax credits rate well under the principle of equity in that they are worth the same to all taxpayers regardless of tax bracket. However, they may not rate well under the principle of economic growth and efficiency. Most tax credits are nonrefundable and may only be used to reduce regular tax, not AMT.

If a credit is designed to encourage a particular activity or help reduce the costs of risky investments that may have high rates of return, the benefit will be lost if the taxpayer owes no regular tax (such as due to a net operating loss (NOL)) or owes AMT.

*Possible solutions:* Any credit designed to help a start-up company or one that may have a long product development cycle (such as is common in the biotech area), should be fully or partially refundable or a grant process should be considered instead. For example, the American Recovery and Reinvestment Act of 2009 (PL 111-5; 2/17/09; §1603) provided a grant in lieu of credit program for certain energy credits, administered by the Treasury Department. This allowed a cash benefit to be received by taxpayers even if they did not have sufficient tax liability to claim a credit. The grant approach may also enable funds to be received by taxpayers more quickly than under the credit avenue. However, the grant process would likely prove too costly and cumbersome for the thousands of taxpayers that claim the research credit but may be helpful to start-up companies.

A credit designed to provide funds to taxpayers for engaging in a particular activity should be usable against AMT.

- 2) *Depreciation weaknesses:*

- *Some MACRS lives too long:* Where a depreciable life is too long, taxable income is overstated in early years (prior to disposition of the asset) and the effective tax rate of owning the asset is higher than it should be. Where other countries use a shorter depreciable life for certain assets, U.S. companies can face competitive disadvantages. Depreciation lives that are too long may discourage businesses from investing in certain assets. If the assets are ones for which manufacturers qualified for the research

tax credit, part of the underlying purpose for the credit, to encourage economic growth and higher productivity levels, may not be fully achieved.<sup>13</sup>

*Possible solutions:* The depreciable lives of assets under the current MACRS system should be reviewed regularly to determine if they are in line with economic lives. Examples of MACRS lives that should be examined as being too long are computers and semiconductor manufacturing equipment which both have a five year MACRS recovery period, but a shorter life in practice.

- *Section 280F limitations:* Section 280F, *Limitation on depreciation for luxury automobiles; limitation where certain property used for personal purposes*, limits the depreciation that may be claimed on a passenger car. Some of these cars, particularly those designed to get more miles per gallon or use a renewable fuel source, were most likely designed by a business that claimed the research credit for the technology created. A limitation on the depreciation that can be claimed on the car each year acts as a disincentive to purchasing it.<sup>14</sup> More favorable depreciation for the car should act as an incentive to purchase it which could further stimulate research efforts.

*Possible solution:* Exempt from Section 280F, cars that are rated at a specified (high) miles per gallon (mpg). The mpg amount could be increased every few years.

- *Section 179 expensing ignores intangible assets:* Section 179 helps small and medium size businesses by allowing a specified dollar amount of tangible personal property to be expensed rather than depreciated. The benefit is simpler recordkeeping and a lower after-tax cost for the equipment. On a temporary basis, Section 179 also applies to off-the-shelf software purchases. Both tangible and intangible assets are crucial to businesses operating in today's information age. Section 179 is out-dated for only applying to tangible personal property.

*Possible solution:* Expand Section 179 to apply to both tangible and intangible personal property.

### 3) *Funding biases and missed opportunities:*

- *Section 1202:* Section 1202 provides a benefit to non-corporate taxpayers (such as individuals) who acquire original issue "qualified small business stock." If the stock is held over 5 years, only 50% of the gain is taxable to the shareholder.<sup>15</sup> Section 1045 allows for gain deferral if the proceeds from the sale of Section 1202 stock held over

<sup>13</sup> For example, a report of the House Committee on Small Businesses noted that small businesses are reluctant to replace heating and ventilation systems even though doing so would enable them to have more energy efficient equipment. The Committee notes that the disincentive is due to the 39-year life for such equipment that likely has a life of only 15 to 20 years. Per the report, "By reducing the 39-year depreciation holding period, the tax code could be updated to both encourage investment and promote the use of green technologies." *Seven Ways to Stimulate the Economy by Updating the Internal Revenue Code*, 4/10/08, page 10; <http://democrats.smallbusiness.house.gov/Reports/small-business-committee-tax-report.pdf>.

<sup>14</sup> There is an exception under Section 280F for "certain clean-fuel passenger automobiles," but this is a narrow exception (Section 280F(a)(1)(C)).

<sup>15</sup> Recent economic stimulus legislation has temporarily increased the gain exclusion percentage.

six months are invested in Section 1202 stock within sixty days. Section 1202 is an incentive for non-corporate taxpayers to invest in qualified small businesses. However, Section 1202 only applies to stock issued by a C corporation.

- *Unfavorable treatment of a loan to a start-up:* A start-up company, which might consist of one or just a few individuals with an innovative idea to explore, will have limited sources of funds. Such a venture is too risky for traditional type loans. Credit card financing is often used as a last resort but has very high interest rates. The start-up may not yet be at a stage to consider setting up a formal business structure such as a corporation that can issue stock to potentially attract funds. And, the venture may not have the funds for setting up such a structure. The founders may seek loans from friends and family members. These potential lenders may be reluctant though, because in addition to the risk, if the debt cannot be repaid, the loss will be a short-term capital loss (Section 166(d)).

If a C corporation could be set up (time and costs can be prohibiting factors though), original issue stock held by individual investors would likely be Section 1244 stock (if the capitalization is \$1 million or less). If Section 1244 stock becomes worthless, the shareholder can treat up to \$50,000 of the loss as ordinary (\$100,000 if married filing jointly (MFJ)); such loss would otherwise be a capital loss.

*Possible solutions:* Not all ventures involved in innovative work operate as C corporations. Yet such ventures are equally in need of funding. Consideration should be given to whether an incentive comparable to Section 1202 can be offered to individuals who invest in qualified partnerships or S corporations.

To help provide funds to start-up ventures, consideration should be given to modifying either Section 166(d) or Section 1244 to allow all or part of any investment loss to be treated as ordinary. To prevent abuse, particularly where the venture is not a corporation (registered with a state), some other documentation should be required of the venture, such as registering as a business with the state or city and issuance of a copy of that documentation along with a description of the venture and amount of funds loaned.

Another possible solution to encourage investment in start-ups engaged in R&D and innovative work is to provide a tax credit to the investor. This could be similar in concept to the New Market Tax Credit (Section 45D).

Some states have enacted tax incentives for individuals investing in start-ups. For example, Minnesota's Angel Tax Credit "provides incentives to investors or investment funds that put money into startup and emerging companies focused on high technology or new proprietary technology." The credit is refundable.<sup>16</sup>

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<sup>16</sup> Minnesota Department of Employment and Economic Development, Angel Tax Credit; [http://www.positivelyminnesota.com/Business/Financing\\_a\\_Business/DEED\\_Business\\_Finance\\_Programs/Angel\\_Tax\\_Credit.aspx](http://www.positivelyminnesota.com/Business/Financing_a_Business/DEED_Business_Finance_Programs/Angel_Tax_Credit.aspx).

Another approach would be to provide tax credits to the person starting the venture. For example, Nebraska's Advantage Microenterprise Tax Credit Act provides "tax credits to applicants for creating or expanding micro businesses that contribute to the revitalization of economically distressed areas through the creation of new or improved income, self-employment, or other new jobs in the area."<sup>17</sup> Such a credit should be refundable; it need not include the requirement to locate in a particular area. The Corporation for Enterprise Development (CFED) observes that this type of credit can also help tax administration and address the tax gap because the new entrepreneur will respond to the "positive incentive" to enter the tax system in order to claim the credit.<sup>18</sup>

- 4) *Opportunity for R&D cash*: The research credit only rewards research performed in the U.S. In evaluating the after-tax costs of R&D activities, companies with foreign subsidiary earnings offshore may find it is not cost effective to repatriate those earnings to be used in U.S. R&D activities. In addition, many countries offer research incentives which can further encourage the funds to remain offshore.

*Possible solution*: Consider some type of repatriation tax holiday to encourage corporations to bring earnings (cash) to the U.S. A requirement could be added that the funds be used for innovation projects (R&D, worker training, purchase of R&D equipment, hiring, etc.).

#### IV. The Federal Research Tax Credit – Basics, Issues and Possible Improvements<sup>19</sup>

##### Brief Background to the Research Credit

IRC Section 41, *Credit for increasing research activities* ("research credit"), was enacted in 1981 as a temporary provision of the law to encourage greater investment in R&D activities in the U.S. The credit was set to expire after five years so its effectiveness could be determined before making this incentive a permanent part of the law. Since 1981, the credit expired and was renewed over ten times, the definition of qualified research expenditures (QRE) and qualified research (QR) changed,

<sup>17</sup> Nebraska Dept. of Revenue, Nebraska Advantage Microenterprise Tax Credit Act; <http://www.revenue.ne.gov/incentiv/microent/microent.html>.

<sup>18</sup> CFED, "Policy Innovation: New Entrepreneur Tax Credit," [http://scorecard.cfed.org/downloads/pdfs/innovationBriefs/InnovBrief\\_NETC.pdf](http://scorecard.cfed.org/downloads/pdfs/innovationBriefs/InnovBrief_NETC.pdf). CFED suggests that to be effective, the credit should be available to sole proprietors, include a system for reaching out to eligible entrepreneurs, have a system for tracking who is using the credit to help measure its effectiveness, and keep the credit simple so it is easy to administer, such as by utilizing information that already exists on other tax forms.

<sup>19</sup> Portions of this testimony are from previous testimony of the author submitted at the request of committee staff for a March 16, 2005 Senate Finance Committee hearing, "Expiring Tax Provisions: Live or Let Die?" S. Hrg. 109-163; <http://finance.senate.gov/hearings/hearing/?id=489b8874-f79a-3b8b-6f12-9bec1647d515>. Hearing report at <http://finance.senate.gov/library/hearings/download/?id=a6a63de3-85b0-47a4-9f96-a4ef488d0af9>.

the formula changed, and a taxpayer's R&D deduction was required to be reduced for the amount of the credit (IRC Section 280C(c)).<sup>20</sup>

The credit for increasing research activities was part of the Economic Recovery Tax Act of 1981 (ERTA) (P.L. 97-34, 8/13/81). ERTA also created ACRS to provide an "investment stimulus" necessary for economic expansion. ERTA has been described as a "tax reduction program [to] help upgrade the nation's industrial base, stimulate productivity and innovation throughout the economy..." In 1981, Congress was "concerned that the performance of the economy had fallen far below its potential."<sup>21</sup>

The federal research tax credit is intended to encourage increased research spending in the U.S. It was enacted to help companies overcome the reluctance to incur significant costs of research for uncertain rewards. "The Congress believed that the provisions of the Act, which are designed to stimulate a higher rate of capital formation and increased productivity, appropriately include incentives for greater private activity in research by operating businesses."<sup>22</sup>

The credit is currently set to expire on December 31, 2011 – its 15<sup>th</sup> expiration date since the first one in 1985. The credit has been extended 14 times, sometimes retroactively. It was allowed to expire once, for the period July 1, 1995 through June 30, 1996.

*Policy Points:* Based on legislative histories related to the research credit, the credit is intended to:<sup>23</sup>

- Encourage businesses to incur costs for research projects despite the reluctance owing to uncertain rewards and significant costs;
- Serve as an incentive to stimulate productivity to lead to greater private activity in research;
- Address the decline in R&D activities in the U.S. that adversely affect economic growth and competitiveness in world markets; and
- Encourage taxpayers to conduct research in the U.S.

The credit was designed to reward research beyond a base amount. The rationale for an incremental credit is that it does not reward research that would have been done anyway.

The credit's structure also benefits companies employing tech workers who tend to have higher than average wages. Some people describe the research credit as a jobs credit.<sup>24</sup> About 70% of QRE

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<sup>20</sup> IRC Section 280C(c) was added by the Technical and Miscellaneous Revenue Act of 1988 (PL 100-647) to require the taxpayer's Section 174 deduction to be reduced by 50% of the research credit. The Revenue Reconciliation Act of 1989 (PL 101-239) changed that to a 100% reduction with the option for the taxpayer to instead take a reduced credit. The election is made on Form 6765, *Credit for Increasing Research Expenses*.

<sup>21</sup> Joint Committee on Taxation, *General Explanation to the Economic Recovery Tax Act of 1981* (JCS-71-81), 12/31/81, Section III, page 17.

<sup>22</sup> Joint Committee on Taxation, *General Explanation of the Economic Recovery Tax Act of 1981* (JCS-71-81), December 31, 1981, page 120.

<sup>23</sup> For example, see Joint Committee on Taxation, *General Explanation of the Economic Recovery Tax Act of 1981* (JCS-71-81), 12/31/81, pages 119 to 121.

<sup>24</sup> For example, in ManuFACTS: R&D Tax Credit, the National Association of Manufacturers refers to the credit as a "jobs credit," [http://www.nam.org/~media/C480FB95A9A645F590486A45AF26821D/RD\\_Credit.pdf](http://www.nam.org/~media/C480FB95A9A645F590486A45AF26821D/RD_Credit.pdf).

consists of labor costs. As noted by the Treasury Department in its 2011 report on the credit, the “credit provides valuable support for ... high-wage tech jobs.”<sup>25</sup>

*Credit formulas:* The research tax credit is generated from “qualified research” (QR). The expenses of QR that qualify for the credit are wages, supplies and generally 65% of contract research expenses. In addition, certain payments to “energy research consortium” qualify as do certain payments by corporations to qualified organizations. Per the general rule of IRC Section 41(a):

“For purposes of section 38, the research credit determined under this section for the taxable year shall be an amount equal to the sum of—

(1) 20 percent of the excess (if any) of—

(A) the qualified research expenses for the taxable year, over

(B) the base amount,

(2) 20 percent of the basic research payments determined under subsection (e)(1)(A) , and

(3) 20 percent of the amounts paid or incurred by the taxpayer in carrying on any trade or business of the taxpayer during the taxable year (including as contributions) to an energy research consortium for energy research.”

The key part of the credit is what is described at (1) above and is often referred to as the “regular credit.” Today, instead of using the formula at (1) above, a taxpayer can elect to use the *alternative simplified credit* (ASC) described at Section 41(c)(5) as follows:

“the credit determined under subsection (a)(1) shall be equal to 14 percent (12 percent in the case of taxable years ending before January 1, 2009) of so much of the qualified research expenses for the taxable year as exceeds 50 percent of the average qualified research expenses for the 3 taxable years preceding the taxable year for which the credit is being determined.”

A taxpayer using the ASC formula may also claim the credit calculated under (a)(2) and (3) above.

A third formula, the *alternative incremental research credit* (AIRC) also existed from 1996 through 2008.

Modifications to the credit calculation are provided for start-up companies because they do not have a base year.

The formulas above are fairly straightforward to apply. Challenges in calculating the credit stem from identifying “qualified research” and QREs, establishing (and proving upon examination) the base amount (particularly for the regular credit where the base amount uses tax data from 1984 to 1988), and having appropriate documentation for the calculation (which can require records beyond what is needed for financial reporting and Section 174 purposes).

*Taxpayer perspectives on the credit:* Taxpayer views on the advantages and limitations of the research credit are highlighted by the following congressional summary of a 2009 hearing of the

<sup>25</sup> Treasury Dept., *Investing in U.S. Competitiveness: The Benefits of Enhancing the Research and Experimentation (R&E) Tax Credit*, 3/25/11, page 2; <http://www.treasury.gov/resource-center/tax-policy/Documents/Research%20and%20Experimentation%20report%20FINAL.PDF>. IRS data reported in “The Credit for Increasing Research Activities: Statistics from Tax Years 2004-2005,” by Eurry Kim, Summer 2008 SOI Bulletin, Table 1 shows that about 75% of the QREs reported by C corporations was for wages for qualified services. Report available at <http://www.irs.gov/pub/irs-soi/04-05crreac.pdf>.

House Committee on Small Business entitled “Helping Small Business Innovators through the Research and Experimentation Tax Credit.”<sup>26</sup>

“The witnesses detailed that the R&D tax credit is vital for American companies looking to stay ahead in increasingly global economy. They emphasized that capital and research lead to new inventions, product, and ultimately jobs. However, since capital and research can take place almost anywhere in the world, it is important for the U.S. economy to keep pace with the rest of the world; changes need to be made. The panel argued that the credit needs to be made a permanent part of the tax code so that firms can rely on the incentive when planning their research budgets. Additionally, the witnesses noted that the complexity of the provision needs to be reduced so that more and more small businesses can take advantage of the credit.”

Similar views have been expressed by larger businesses, lawmakers and others. For example, the 2011 Treasury report on the credit states:<sup>27</sup>

“The Research & Experimentation (R&E) tax credit encourages innovation and provides a powerful incentive for businesses to continue to invest in research projects. Investments in research and experimentation produce technological advancements that drive productivity growth and improvements in U.S. living standards. Businesses may under invest in research, however, because they may not be able to capture the full benefit of their spending. The R&E tax credit is designed to address this underinvestment and to increase the total amount of research activity undertaken in the United States.”

Additional statements on the rationale for a research tax credit are included in the Appendix.

*Who claims the credit:* The research tax credit is claimed by a wide range of businesses in terms of size and industry sector. IRS data for C corporations claiming the research credit for 2005 shows the following:<sup>28</sup>

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<sup>26</sup> House Committee on Small Business, hearing notice at <http://republicans.smbiz.house.gov/News/DocumentSingle.aspx?DocumentID=146836>. Summarized in House Rpt. 111-695 (12/23/10); <http://www.gpo.gov/fdsys/pkg/CRPT-111hrpt695/html/CRPT-111hrpt695.htm>. Hearing transcript, [http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111\\_house\\_hearings&docid=f:50947.pdf](http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_house_hearings&docid=f:50947.pdf).

<sup>27</sup> Treasury Dept., *Investing in U.S. Competitiveness: The Benefits of Enhancing the Research and Experimentation (R&E) Tax Credit*, 3/25/11, page 1; <http://www.treasury.gov/resource-center/tax-policy/Documents/Research%20and%20Experimentation%20report%20FINAL.PDF>.

<sup>28</sup> “The Credit for Increasing Research Activities: Statistics from Tax Years 2004-2005,” by Eurry Kim, Summer 2008 SOI Bulletin; <http://www.irs.gov/pub/irs-soi/04-05crrac.pdf>.

Industrial sector	Percentage of total claimants	Percentage of total credit amount claimed
Manufacturing	43.6	71.2
Wholesale trade	5.3	3.1
Information	9.5	10.0
Professional, scientific, and technical services	29.5	10.2
All other	12.1	5.5

In terms of size of the claiming business, in 2005, 14% of claiming C corporations had business receipts under \$25,000 and represented 3% of the total credit claimed by 11,290 C corporations. C corporations with \$250 million or more of receipts represented 10.5% of total claimants and 79% of the credit claimed.<sup>29</sup>

For tax year 2008, 12,736 corporations claimed the credit (up from 11,290 in 2005). The dollar amount claimed in 2008 was \$8.3 billion (up from \$6.4 billion in 2005). In addition, in 2008, approximately 64,000 individuals claimed \$463 million of research tax credits.<sup>30</sup>

*Effectiveness:* Various studies have shown that the research tax credit has had a positive impact on the amount of research conducted. A 1989 Government Accountability Office (GAO) report, *The Research Tax Credit Has Stimulated Some Additional Research Spending*, stated that the research credit “raised corporate spending on R&E above the level that otherwise would have been achieved.”<sup>31</sup> This study, based on a sample of 800 corporations and economic models, concluded that the credit “stimulated between \$1 billion and \$2.5 billion of additional spending for the 5 years 1981 through 1985.” Such an increase represented an increase of 15 cents to 36 cents for every dollar of foregone tax revenue due to the credit.<sup>32</sup>

As noted in the Treasury Department’s 2011 report calling for an enhanced research credit, “studies show that the credit produces approximately a dollar for dollar increase in current research spending and that this amount could be larger in the longer run.”<sup>33</sup>

<sup>29</sup> *Supra*, Figures B and C.

<sup>30</sup> 2005 data from IRS report, *supra*; 2008 data from Treasury Dept., *Investing in U.S. Competitiveness: The Benefits of Enhancing the Research and Experimentation (R&E) Tax Credit*, 3/25/11, page 5; <http://www.treasury.gov/resource-center/tax-policy/Documents/Research%20and%20Experimentation%20report%20FINAL.PDF>.

<sup>31</sup> GAO, *The Research Tax Credit Has Stimulated Some Additional Research Spending*, GAO/GGD-89-114, Sept. 1989, page 22; <http://archive.gao.gov/d26t7/139607.pdf>.

<sup>32</sup> 1989 GAO report, *supra*, pg. 22.

<sup>33</sup> Treasury Dept., *Investing in U.S. Competitiveness: The Benefits of Enhancing the Research and Experimentation (R&E) Tax Credit*, 3/25/11, page 2; <http://www.treasury.gov/resource-center/tax-policy/Documents/Research%20and%20Experimentation%20report%20FINAL.PDF>.

## Design Considerations Relevant to the Credit's Effectiveness

This section notes some of the questions that need to be examined in helping to make the research tax credit as effective as possible in achieving its goal of promoting and supporting U.S. research. It should be noted though, that the most significant improvement would be to make it permanent so it can be more effectively relied upon and incorporated into long-term research and financial planning decisions that businesses must make.

### 1. Non-permanence

On December 31, 2011, the federal tax research credit expired for the 15<sup>th</sup> time since this temporary provision was added to the Internal Revenue Code in 1981.

Research activities generally involve a long-term view; thus, research incentives that focus on the short-term cannot be fully beneficial and effective. Also, in making long-term plans, a short-term and uncertain incentive will not factor completely into all aspects of the decision-making process. Therefore, with only a temporary credit, the complete goal of increasing research activities may not be fully realizable by businesses, and ultimately, the U.S. economy. Additional support for a permanent credit is the premise that increased research activity increases productivity and growth in GDP, wages and labor skills.

Also, arguably, lack of a permanent incentive puts the U.S. at a competitive disadvantage in the global economy because many countries offer permanent incentives. Many of these countries actively pursue U.S. companies encouraging them to open R&D facilities in their country and to take advantage of tax savings opportunities.

The temporary nature of the credit and its often retroactive reinstatement pose problems for financial reporting purposes. For GAAP purposes, companies may not assume that the credit will be retroactively reinstated. If the credit has expired, it cannot be considered in determining the company's expected effective tax rate. Additional problems arise for fiscal year companies because the credit typically expires in the middle of their year.

### 2. Missing Guidance

Despite enactment in 1981 and significant changes in 1986 and 1989, there are parts of the regulations under Section 41 that have not yet been finalized. Likely causes for the delay are the temporary nature of the provision and the complexity of certain terms. The IRS-Treasury Priority Guidance Plan for 2011-2012 released in September 2012 lists two outstanding projects under Section 41. This is not the first time these topics have been on the plan.<sup>34</sup>

- Regulations on gross receipts and controlled groups of the research.
- Regulations to define and explain the exceptions for "internal use software."

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<sup>34</sup> Treasury Dept. and IRS, *2011-2012 Priority Guidance Plan*, 9/2/11, pages 11 - 12; [http://www.irs.gov/pub/irs-utl/2011-2012\\_pgp.pdf](http://www.irs.gov/pub/irs-utl/2011-2012_pgp.pdf).

### 3. Regular credit

The regular credit of Section 41(a) uses a base period of 1984 to 1988. Gross receipts in the base and more recent four years factor into the formula to determine if the taxpayer's percentage of gross receipts devoted to QRE today is greater than in the base period. Limitations on a "fixed base percentage" and the base amount result in a somewhat complicated formula. Yet, once the dollar amounts are known, the calculation itself is straightforward, although a bit difficult to explain, causing some transparency concerns. The numerous definitions, calculations and limitations of the regular credit can make it less obvious as to what must be done to increase the credit.

Example: Corporation R's data needed to calculate the research credit for 2010:

Research credit data:

<u>Year</u>	<u>Gross Receipts (GR)</u>	<u>Qualified Research Exp. (QRE)</u>
1984	\$28,000,000	\$3,000,000
1985	\$32,000,000	\$4,200,000
1986	\$31,000,000	\$5,000,000
1987	\$34,000,000	\$6,200,000
1988	\$43,000,000	\$6,800,000
[1989 – 2005 – information omitted]		
2006	\$48,000,000	\$8,400,000
2007	\$60,000,000	\$10,200,000
2008	\$68,000,000	\$11,000,000
2009	\$76,000,000	\$12,000,000
2010	\$80,000,000	\$10,000,000

Research Credit Calculation for R Corporation:

Step 1 - determine the "fixed base percentage":

$$\text{Fixed base percentage} = \frac{\text{total qualified research expenses 1984 - 1988}}{\text{total gross receipts 1984 - 1988}}$$

$$\begin{aligned}
 &= \frac{\$3,000,000 + \$4,200,000 + \$5,000,000 + \$6,200,000 + \$6,800,000}{\$28,000,000 + \$32,000,000 + \$31,000,000 + \$34,000,000 + \$43,000,000} \\
 &= \frac{\$25,200,000}{\$168,000,000} = 15.00\%
 \end{aligned}$$

Because 15.00% is below the maximum fixed base percentage of 16%, 15.00% is used.

Step 2 - determine base amount:

Base amount = fixed base % X average annual gross receipts of R for the four preceding tax years

Average annual gross receipts from 2006 to 2009 =

$$[\$48,000,000 + 60,000,000 + 68,000,000 + 76,000,000] \div 4 = \$63,000,000$$

$$\text{Base amount} = 15.00\% \times \$63,000,000 = \$9,450,000$$

Minimum allowable base amount is 50% of the current year QRE:

$$50\% \times \$10,000,000 = \$5,000,000$$

Because \$9,450,000 is greater than the minimum base amount, \$9,450,000 must be used.

Step 3 - determine credit:

$$20\% \times [\text{qualified research expense} - \text{base amount}] + 20\% \text{ of basic research payments}$$

$$20\% \times [\$10,000,000 - \$9,450,000] + 20\% \times \$0 = \underline{\underline{\$110,000}}$$

Thus, the \$10,000,000 of 2010 QRE generated a \$110,000 credit (1.10% of QRE).

Per IRC §280C(c), R Corporation must reduce its R & E expense deduction on its 2010 return by \$110,000 (the amount of the credit), or it may choose instead to take a reduced credit and not change its R & E deduction. R would have generated a higher credit if its 2010 research expenses were greater, its base years' research expenses were less, its base years' gross receipts were more, and/or its gross receipts in the prior four years were less.

Some taxpayers who used a greater portion of their gross receipts for R&D in the base period than is possible today given a change in their operations will not generate a research credit under the regular formula, even though they are engaging in R&D and face the same risk and spillover effects as other companies that have a different base picture and can more easily generate a credit.

Under the regular credit formula, if the actual base amount is less than 50% of the current year QRE, then 50% of current year QRE must be used as the base amount. For example, if a company's base amount is \$50 and its current year QRE is \$120, its base amount for calculating the credit is \$60 (50% of current year QRE), rather than \$50 (the actual base amount). Since a lower base amount generates a higher credit, the 50% base limitation reduces this taxpayer's research tax credit.

The 50% base amount limitation serves as a cap on the credit (basically limits it to 10% of QRE – which is then further reduced to 6.5% by §280C(c)). This 50% base rule serves to limit the credit for companies with a large increase in QRE over the base amount.

Example: Base amount = \$10

Current QRE = \$20

$$\text{Credit} = 20\% \times \$10 = \$2$$

Modification: Base amount = \$10

Current QRE = \$30

Credit = 20% x \$15 = \$3 (so additional \$10 of current QRE only generated \$1 of credit (10%, not 20%)).

A 1995 GAO study found that for 1992 almost 60% of corporations were subject to the 50% minimum base rule.<sup>35</sup> IRS data for C corporations for 2005 indicated that 76.1% were subject to the 50% base limitation (down from 83.8% in 2001).<sup>36</sup>

#### 4. Size of the Benefit

While the regular research tax credit formula uses a 20% rate and the ASC a 14% rate, the effective rate is smaller due to the incremental nature of the credit and the reduction required by IRC Section 280C(c). The maximum credit possible for the regular credit is 6.5% of the current year's qualified research expenditures (QRE). Also, since not all Section 174 expenditures qualify as QRE, the ratio of the credit to total Section 174 R&D expenditures is in most cases less than 6.5%.

The ASC does not include a base limitation like the regular credit does. The GAO has recommended that a 50% limit be added "to reduce economic inefficiencies and excessive revenue costs resulting from inaccuracies in the base of the research tax credit."<sup>37</sup>

The selection of limited categories of R&E expenditures that qualify for the research credit can have varying impacts on different industries. For example, a labor-intensive taxpayer may be able to generate a higher research tax credit than a capital-intensive one because depreciation is not a QRE.

Competition for R&D work is a global one, and companies must evaluate where to locate their R&D work based on availability of equipment and human talent, operating costs and incentives. Many countries offer incentives for research both through the tax system and direct grants. Reform of the current research credit and consideration of other possible incentives for innovation should consider what other countries offer and the effect on corporate investment and R&D and the economy. Among OECD countries, the U.S. provides one of the lowest subsidies for R&D.<sup>38</sup>

#### 5. Alternative Minimum Tax (AMT)

The research tax credit cannot be used to offset AMT; any unused credit can be carried back one year and then carried forward 20 years. However, for corporations that are in an AMT position for several years, the research tax credit will only be usable in some future year (assuming the carry forward period does not expire for the taxpayer). The value of the credit in encouraging research is reduced when the benefit will not be realizable for a company until a future year.

#### 6. IRS Examinations

The research tax credit is a focal point of IRS examinations due to the impact of the credit on a taxpayer's tax liability, and examinations improve voluntary compliance. The IRS has issued

<sup>35</sup> GAO, *Additional Information on the Research Tax Credit*, GAO/T-GGD-95-161, May 10, 1995, page 6.

<sup>36</sup> "The Credit for Increasing Research Activities: Statistics from Tax Years 2004-2005," by Eurry Kim, Summer 2008 SOI Bulletin, Figure D; <http://www.irs.gov/pub/irs-soi/04-05creac.pdf>.

<sup>37</sup> GAO, *Tax Policy: The Research Tax Credit's Design and Administration Can Be Improved*, GAO-10-136, 11/6/09, page 39; <http://www.gao.gov/products/GAO-10-136>.

<sup>38</sup> Measured using the "B index, 23 countries including France, Canada, Australia and China, provide a higher subsidy. OECD (2009), "Tax treatment of R&D," *OECD Science, Technology and Industry Scoreboard 2009*, OECD Publishing. doi: [10.1787/sti\\_scoreboard-2009-en](https://doi.org/10.1787/sti_scoreboard-2009-en).

examination guides to its auditors and a few industry directives on how to handle certain issues, such as costs of developing internal use software.<sup>39</sup>

IRS concerns with research credits claimed on amended returns led to such claims constituting a Tier 1 issue for the IRS.<sup>40</sup> This means that all such claims will receive some level of review by the IRS. The IRS also issued an audit guide on the claims. In it, the IRS summarizes its concerns with many of the claims:<sup>41</sup>

“There is a growing trend among taxpayers, and their representatives, to submit prepackaged material to support research credit claims. These submissions are usually delivered to examiners in multiple binders. While the submissions often set forth the methodology employed in preparing the research credit claim, the submissions frequently fail to substantiate that the taxpayer paid or incurred qualified research expenses (“QREs”) as claimed.” ...

“A significant number of RC claims are prepared using a hybrid method that does not properly establish the required nexus between QREs and qualified research activities (QRAs).”

Additional examination issues stem from lack of guidance (such as on internal use software) and the level of documentation and “nexus” between the expenses and the qualified research project. Complexities in the definition of QR (Section 41(d)) which involves multiple definitions and tests can raise issues between taxpayers and the IRS.

## 7. Industrial Age into the Information Age

The research credit was designed before widespread use of the Internet, web-based products and services, and even wider use of computers and software. Section 41 should be reviewed to be sure it addresses the type of R&D going on in the world economy today. For example, a modification to the credit in 1986 added a rule that generally, internal-use software does not qualify for the credit (Section 41(d)(4)). Exceptions exist where such software is used in QR or a production process that qualifies as QR or as provided in Treasury regulations (no final regulations exist).<sup>42</sup> In 1986, internal-use software was likely viewed as something that might organize a company’s accounts receivables. Today, internal-use software may be something that represents a company’s entire business operation (such as software developed for web-based services sold to customers). Yet, because the software is not sold or used in a production process, it might be viewed as internal-use with the development costs not treated as QRE.

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<sup>39</sup> The IRS website with links to many of the IRS guides on the credit is at <http://www.irs.gov/businesses/article/0,,id=101382,00.html>.

<sup>40</sup> Industry Directive #1 (2007) - <http://www.irs.gov/businesses/article/0,,id=169273,00.html> and Industry Directive #2 (2009) - <http://www.irs.gov/businesses/corporations/article/0,,id=202712,00.html>.

<sup>41</sup> IRS, Research Credit Claims Audit Techniques Guide (RCCATG): Credit for Increasing Research Activities, May 2008; <http://www.irs.gov/businesses/article/0,,id=183208,00.html>.

<sup>42</sup> See Announcement 2004-9, 2004-6 IRB 441, for background on the internal-use software regulations.

*Possible improvements for the research tax credit include:*

- Make the research credit permanent.
- The regular credit's base years of 1981 to 1988 are arguably too old to justify what a credit should be more than 20 years later.<sup>43</sup> Also, records may not exist or be adequate to enable an acquirer business to accurately calculate the regular credit. Consideration should be given to either updating the base years and having a system enacted for regular updates or repealing the regular credit.
- Consider removing or modifying the 50% base limitation for the regular credit as it has the effect of reducing the credit generated on higher amounts of QREs which likely indicates that more research was conducted.<sup>44</sup> Avoid adding a minimum base requirement to the ASC as it reduces the value of the credit for companies with significant increases in QREs, which is what the credit is intended to encourage and reward.<sup>45</sup>
- Consider only having one formula for the research tax credit for simplification purposes. The use of two different formulas requires taxpayer time to evaluate which is better in any year. Multiple credits also mean additional time spent by the IRS providing guidance. S. 1203 (111<sup>th</sup> Congress) proposed to let the regular credit expire and make the ASC permanent. Advantages of this approach include that fewer definitions are involved (for example, "gross receipts" is only relevant for the regular credit), taxpayer and IRS time need not be spent trying to verify QRE and gross receipts for a set of years in the past for which they may not have adequate records.
- Allow the research tax credit to be used against AMT.
- Allow small and start-up businesses to have a refundable credit.
- To reduce audit difficulties and disputes, restate the purpose of the credit and what types of research activities qualify. In addition, the IRS should be encouraged to follow the GAO recommendation to "organize a working group that includes IRS and taxpayer representatives to develop standards for the substantiation of QREs that can be built upon taxpayers' normal

<sup>43</sup> As noted by Treasury: "The regular credit formula, which determines the base amount with reference to the firm's research intensity (the ratio of its research spending to gross receipts) in the 1984 to 1988 period, clearly is outdated. There is little reason to believe that the firm's ratio of research spending to gross receipts from more than two decades ago, when multiplied by its average gross receipts over the prior four years, is an appropriate base for the taxpayer. In the context of a permanent R&E credit, that base amount will become increasingly irrelevant and arbitrary." Treasury Dept., *Investing in U.S. Competitiveness: The Benefits of Enhancing the Research and Experimentation (R&E) Tax Credit*, 3/25/11, page 8; <http://www.treasury.gov/resource-center/tax-policy/Documents/Research%20and%20Experimentation%20report%20FINAL.PDF>. Similarly, see GAO, *Tax Policy: The Research Tax Credit's Design and Administration Can Be Improved*, GAO-10-136, 11/6/09, page 16; <http://www.gao.gov/products/GAO-10-136>.

<sup>44</sup> The 2009 GAO report, *supra*, page 16, suggests that the effect of the 50% base limit for the regular credit was to create a "windfall" for those taxpayers subject to it. It may be that this interpretation is because the nature of the regular credit formula results in a tax credit of 10% of current year QRE when the 50% base limit applies. Thus, it doesn't look like an incremental credit in that situation. The GAO statement takes the perspective that the taxpayer had too low of a base amount. Another perspective, illustrated in the next footnote, is that current year QRE were higher than in base years and the 50% limit prevents all of the QRE increase from getting full benefit of the credit.

<sup>45</sup> For example, under the ASC, if current year QRE = \$500 and the average of the prior 3 years of QRE is \$150, a credit of \$59.5 is generated ( $14\% \times [\$500 \times (50\% \times \$150)]$ ). This rewards the taxpayer for a greater amount of QRE (and QR) in the current year. If the base were limited to 50% of current year QRE, the taxpayer's credit would be reduced to \$52.5 ( $14\% \times [\$500 \times (50\% \times \$250)]$ ).

accounting approaches, but also exclude practices IRS finds of greatest threat to compliance, such as high-level surveys and claims filed long after the end of the tax year in which the research was performed.”<sup>46</sup>

- To address concerns regarding credits claimed for the first time on amended returns, additional information can be provided and requested on business tax returns to help ensure that all taxpayers are aware of what R&D expenditures may qualify for a credit. For example, a statement can be provided explaining the credit with the question, “Did you engage in qualified research?” There will be times when taxpayers may need additional time beyond the extended due date to compute their research credit, such as due to an acquisition or time needed to gather the necessary records to calculate the credit or determine how much of the R&D was qualified research.
- Review Section 41 in light of the types of business activities of today rather than the 1980s. In particular, consider whether the general exclusion for internal-use software should be clarified to be sure that it is not overly broad given the nature of how software is used today and of web-based technologies.
- Evaluate what an appropriate research credit benefit should be. This evaluation should consider the economics of spillover benefits and benefits to be derived to the economy from greater private investment in R&D, what other countries do to stimulate greater R&D spending, and the interaction with other tax incentives.
- As corporate tax reform discussions focus on reducing the corporate tax rate, consideration should be given to the global competitive realities that, not only do other OECD countries have a lower statutory rate, but they also tend to offer research tax incentives as well.

## V. Additional Recommendations (non-tax)

- Study what other countries do to encourage and benefit from private R&D.
- Consider whether any federal programs and expenditures hinder innovation in some way.
- In making any changes or additions to provide assistance for innovation, consider the varying needs of start-ups and small businesses versus larger businesses.
- Consider the bigger picture for U.S. innovation that also includes the need for and availability of high quality education opportunities for everyone. Relevant education to promote innovation extends beyond science, math and engineering but also includes liberal studies and entrepreneurial business knowledge and skills.
- Consider the recent work of OECD on fostering innovation (see the *Innovation Strategy: Getting a Head Start on Tomorrow*). This project aims to help answer the questions of how governments can better encourage greater innovation and how government can be innovative.<sup>47</sup>

<sup>46</sup> GAO, *Tax Policy: The Research Tax Credit's Design and Administration Can Be Improved*, GAO-10-136, 11/6/09, page 40; <http://www.gao.gov/products/GAO-10-136>.

<sup>47</sup> OECD, *OECD Innovation Strategy: Getting a Head Start on Tomorrow* (May 2010); [http://www.oecd.org/document/15/0,3746,en\\_2649\\_34273\\_45154895\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/15/0,3746,en_2649_34273_45154895_1_1_1_1,00.html)

- To better understand how much the government is investing in R&D and for data analysis, implement accountability measures that track not only direct spending on R&D, but also the spending in the tax law tied to special rules such as the research tax credit.<sup>48</sup>

## Conclusion

Tax reform discussions since at least 2007, have called for lowering the corporate tax rate to improve the competitiveness of U.S. firms in light of other countries having lowered their corporate tax rates.<sup>49</sup> To lower the corporate tax rate in a revenue neutral manner, it has been suggested and computed that many tax preferences must be cut back or eliminated. In an October 2011 report, the Joint Committee on Taxation suggested that to lower the rate to 28% in a revenue neutral manner would include replacing MACRS depreciation with the slower Alternative Depreciation System, eliminating expensing of R&D costs and it was presumed in their calculation that there would be no research tax credit since it would expire at the end of 2011.<sup>50</sup> Needless to say, to achieve a lower corporate tax rate and maintain or even strengthen incentives for innovation will be challenging. In addition, lawmakers also need to consider the effect and cost of individual tax reforms, paying for the continuation of any of the 2001/2003 tax cuts and international tax reform needs.

In terms of incentives for R&D, in addition to items noted in the author's 2011 testimony, lawmakers should also consider the results achieved by a few European countries that adopted "patent boxes" where certain types of income generated from R&D work is taxed at a lower rate.<sup>51</sup>

Corporate reform will require modernizing the tax law to reflect today's global business environment, rapid changes in technology, and the reality that to sustain and grow economic activity, a tax system likely needs to not only not hinder innovation, but likely has to provide incentives to encourage R&D to be performed in the jurisdiction. We will see how tax reform proceeds in the 113th Congress and whether the extensive discussions during the time period of the 112th Congress lead to actual

<sup>48</sup> The White House's R&D Dashboard is a good start. It should include both direct spending and tax expenditures. See <http://www.whitehouse.gov/blog/2011/02/10/rd-dashboard-makes-federal-rd-data-transparent-and-accessible>.

<sup>49</sup> See U.S. Treasury Dept., *Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century*, Dec. 2007; available at <http://www.treasury.gov/resource-center/tax-policy/Documents/Approaches-to-Improve-Business-Tax-Competitiveness-12-20-2007.pdf>. In addition, House Ways and Means Committee Chairman Camp proposed lowering the corporate rate from 35% to 25% (see his proposal of October 2011 at <http://waysandmeans.house.gov/taxreform/>). President Obama called for lowering the corporate rate in a revenue neutral manner in his 2011 State-of-the-Union address (<http://www.whitehouse.gov/the-press-office/2011/01/25/remarks-president-state-union-address>).

<sup>50</sup> See Nellen, "The Rough Road to a 28% Corporate Tax Rate," *AICPA Corporate Taxation Insider*, Nov. 10, 2011; available at [http://www.cpa2biz.com/Content/media/PRODUCER\\_CONTENT/Newsletters/Articles\\_2011/CorpTax/TheRoughRoadto28PercentCorporateTaxRate.jsp](http://www.cpa2biz.com/Content/media/PRODUCER_CONTENT/Newsletters/Articles_2011/CorpTax/TheRoughRoadto28PercentCorporateTaxRate.jsp).

<sup>51</sup> For more information on patent boxes, see Peter R. Merrill, James R. Shanahan, et al, "Is It Time for the United States to Consider the Patent Box?," *Tax Notes*, March 26, 2012; available at [http://www.pwc.com/en\\_US/us/washington-national-tax/assets/Merrill0326.pdf](http://www.pwc.com/en_US/us/washington-national-tax/assets/Merrill0326.pdf). Also see June 2011 information from the United Kingdom at [http://www.hm-treasury.gov.uk/press\\_57\\_11.htm](http://www.hm-treasury.gov.uk/press_57_11.htm).

reforms of the U.S. tax system. The work to design effective tax reforms will certainly be quite challenging, but not impossible.

## **Appendix**

### **Rationale for the Research Tax Credit**

#### **President Obama (2011)**

"The R&E tax credit is a powerful incentive for private firms to make investments in the research and development necessary to keep a pipeline of new and improved products coming to market, which is critical to economic growth and job creation. Yet the United States currently ranks 24th out of 38 countries in the generosity of our R&E tax incentives. That's why, as part of corporate tax reform, the President supports making the R&E tax credit permanent to give businesses the certainty they need to make these important investments. In addition, the Administration wants to expand the credit by about 20 percent, the largest increase in the credit's history, and simplify it so that it is easier for firms to take this credit and make the investments our economy needs to compete."<sup>52</sup>

#### **Treasury Department (2007)**

"The R&E credit is an example of a targeted tax incentive that attempts to correct a market failure. Without a subsidy, the private market might not allocate enough resources to research because private inventors cannot reap the full benefit of their inventions. It can be difficult for inventors to charge all those who use or benefit from their invention. For example, an invention might be copied by others, or it might pave the way for further improvements. Because the inventor might not be able to collect the invention's full return, he has an insufficient incentive to conduct research and develop innovations. He foregoes investments in research that produce social benefits in excess of their private costs. A tax subsidy is one way to increase the return available to the private inventor, and correct for the failure of the private market to reward innovation sufficiently."<sup>53</sup>

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<sup>52</sup> FY2012 Budget, "Competing and Winning in the World Economy," page 37; available at <http://www.whitehouse.gov/sites/default/files/omb/budget/fy2012/assets/competing.pdf>.

<sup>53</sup> Treasury Dept., *Background Paper, Treasury Conference on Business Taxation and Global Competitiveness*, 7/27/07, pages 9 – 10; <http://www.treasury.gov/press-center/press-releases/Documents/07230%20r.pdf>. Note: this background paper points out problems with the credit and other incentives to help justify elimination of preferences in exchange for a much lower corporate tax rate.

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# 27th Annual TEI-SJSU High Tech Tax Institute – November 2011

*An annual conference sponsored by the Tax Executives Institute, Inc. and  
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## 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 expert advice on high technology tax matters of interest to corporate tax departments, accounting and law firms, the IRS and academics.

We encourage you to read the session summaries that follow and to visit the High Tech Tax Institute website (<http://www.tax-institute.com>) to view current and past conference materials in greater detail. If you did not attend the 2011 Institute, we hope this overview of the topics and the depths covered will encourage you to attend a future program.



*SJSU MST students attending the 27th Annual High Tech Tax Institute. From left to right: Srividhya Ramakrishnan, Evie Lee, Shauna Rimel, Linda Yung, Sujin Pradhan, Susan Burt, Tim Kelly, Lisa Pan, Chanpheareak (Luis) Chim, and Pingrong Xue.*

## U.S. International Tax Developments

By: Srividhya Ramakrishnan, *MST Student*

Mr. James P. Fuller commenced the 2011 Tax Institute with his valuable insights and comments on U.S. international tax developments. Mr. Fuller is a partner in the Tax Group at Fenwick & West, LLP in Mountain View, California. In his almost two hour presentation, he briefly covered each of the vast sets of developments and proposals in the international tax field. His 95-page outline addresses in detail, changes and reforms with regard to the foreign tax credit, Section 482, dual consolidated losses, Subpart F income, the new economic substance rules, and proposed and pending legislations.

This summary includes selected developments Mr. Fuller indicated were important with respect to the foreign tax credit and the treatment of transfer of intangibles to foreign country entities.

*Foreign tax credit splitters:* A foreign credit splitting event occurs when a domestic corporation claims foreign tax credit with regard to related income earned by its foreign corporation. New Code §909 provides that in case of a foreign tax credit split the taxpayer can include the foreign tax credit only in the same year its related foreign income is taken into account for U.S. tax purposes.

As per Notice 2010-92 if a foreign tax credit splitting occurs between a domestic corporation and a §902 corporation, then the FTC paid or accrued will not be considered for the FTC computation under §902 or §960 until the related foreign income is taken into account by the related §902 corporation for tax purposes.<sup>2</sup>

Mr. Fuller explained the above ruling using the following example:

“US, a domestic corporation, wholly owns CFC-1, a country A corporation. CFC-1, in turn, wholly owns CFC-2, also a country A corporation. CFC-2 is engaged in an active business that generates \$100 of income. CFC-2 issues a hybrid instrument to CFC-1, which is treated as equity for U.S. tax purposes but as debt for foreign tax purposes. CFC-2 accrues (but does pay currently) interest to CFC-1 equal to \$100. As a result, CFC-2 has no income for country A tax purposes, while CFC-1 has \$100 of income which is subject to country A tax at a 30% rate. For U.S. tax purposes, CFC-2 still has \$100 of earnings and profits (the accrued interest is ignored since the U.S. views the hybrid instrument as equity), while CFC-1 has paid \$30 of foreign taxes. Under the new splitter rule, the related income with respect to the \$30 of foreign taxes paid by CFC-1 is the \$100 of earnings and profits of CFC-2.”<sup>9</sup>

*Section 901(m) – Denial of FTC:* In general, corporations can claim FTC only to the extent of U.S. tax liability on foreign source income. In the case of covered asset acquisitions, when a U.S. corporation



acquires a disregarded entity in a foreign country it is not considered a corporation for U.S. tax purposes, but is instead an asset acquisition with a basis equal to its fair market value. This basis is not necessarily the same as the basis used for foreign tax purposes. The difference would result in more depreciation deduction for the U.S. corporation, thus reducing the U.S. taxable income whereas for foreign purposes, depreciation would be less thus resulting in more foreign tax payment. In order to avoid claiming more FTC and less U.S. tax liability any foreign tax credit arising out of such covered asset acquisition is denied for a domestic corporation.

Following are the categories of covered asset acquisitions mentioned by Mr. Fuller in his outline:

- “(a) A qualified stock purchase for which a §338 election has been made;
- (b) Any transaction treated as an asset acquisition for U.S. income tax purposes and as a stock acquisition (or disregarded) for foreign income tax purposes;
- (c) Any acquisition of a partnership interest if the partnership has a §754 election in place; and
- (d) Any other similar transaction as identified in regulations.”<sup>4</sup>

Mr. Fuller also provided several examples to explain the complications involved in computing the disallowed portion of foreign tax credit as the foreign asset keeps earning revenues and matching them to its U.S. value.

*Section 960(c) FTC:* Section 960 allows a deemed paid credit for deemed dividend otherwise paid directly to the domestic corporation by a foreign CFC. As per §956, if a CFC provides credit support or loan payment to its domestic corporation, it is considered as deemed paid dividend. Since it is a payment made by a foreign corporation to its U.S. parent without going through a chain of high tier or low tier CFC, the amount of foreign tax paid is higher if it is a high tax rate CFC. Therefore the amount of credit under §960 would be greater than §902 deemed dividend credit. Under the new rules under §960(c) foreign tax credits claimed through a deemed paid dividend credit is limited to the amount of foreign tax incurred had it been an indirect dividend distributions. This provision applies to all §956 loans after 2010.

*Intangibles:* Section 367(d) states that “If a U.S. person transfers intangible property that is subject to section 367(d) and the rules of this section to a foreign corporation in an exchange described in section 351 or 361, then such person shall be treated as having transferred that property in exchange for annual payments contingent on the productivity or use of the property. Such person shall, over the useful life of the property, annually include in gross income an amount that represents an appropriate arms-length charge for the use of the property.” Thus §367 does not recognize §351 transfer to a foreign corporation as that of a corporation. Hence the transfer is not tax-free. In case intangible property is transferred through a similar §351 exchange, it would result in imputed royalty for the domestic corporation. For the purposes of this section as per the changes stated by Mr. Fuller, intangibles include goodwill, going concern value and workforce in place. Mr. Fuller emphasized that this is an important issue because any foreign branch could be classified as intangible based on the above provision.

Mr. Fuller covered in detail a lot of changes with respect to international tax and their impact on Silicon Valley companies. He also suggested that the tax departments be vigilant towards upcoming changes as these would affect their tax planning to a greater extent. He concluded by mentioning the territorial proposal from Congressman Camp and emphasized the need for companies to keep up with the international developments and reforms.



## **28th Annual High Tech Tax Institute**

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<http://www.tax-institute.com>

## Compensation Issues in Today's Global Workplace

By: Shauna Rimel, *MST Student*

Mary Hevener, Peter Klinger, and Ken Guilfoyle discussed various compensation issues in today's global workplace.

Ms. Hevener, a partner in Morgan Lewis's Employee Benefits and Executive Compensation Practice, explained requirements that must be met for travel and per diem expenses to be deductible for corporate tax purposes and excluded from wages. Ms. Hevener also discussed state tax complexities for people working in more than one state.

Ms. Hevener began her discussion with the two basic requirements for travel to be deductible. The worker must (1) have a tax home and (2) be away from the tax home overnight. This sounds straightforward until you ask the question "What exactly *is* a tax home?" It's easy to determine the tax home for an individual who only has one work location, but how do you determine the tax home for a person with multiple work locations? Can a person's permanent residence be their tax home? Is it possible not to have a tax home at all?



Three factors are used to determine whether a person's "permanent residence" can be treated as his tax home (per Rev. Rul. 73-529): (1) whether the person lived at his residence while working in the vicinity, (2) whether the person duplicates living expenses when his work requires him to be away from his residence, and (3) whether the person has not abandoned his historical place of lodging, has family member(s) living at his residence, or frequently stays at his residence. Taxpayers lacking a principal business location or a permanent residence are itinerants that can *never* deduct travel expenses because their home is wherever they happen to be working at the time.

Ms. Hevener explained that certain criteria must be met for travel reimbursements to be excluded from a worker's income. In addition to having a tax home and being away from the tax home overnight for a period of time not expected to exceed twelve months, meal and lodging per diems cannot exceed the federal per diem rates, per diems must be paid under an accountable plan, and workers cannot have the option of receiving additional compensation in lieu of a per diem.

"Accountable" plans must meet four requirements: (1) expenses must be paid in connection with services performed, (2) expenses must be substantiated, (3) expense advances must be reasonably calculated not to exceed the amount of anticipated expenditures, and (4) allowances in excess of

substantiated expenses must be returned. If these requirements are not met, the plan is considered “nonaccountable” and all advances and reimbursements must be reported as W-2 wages.

Ms. Hevener then explained state tax issues affecting today’s mobile workforce. She explained that each state sets criteria determining whether income is taxable in the state and that most states have a minimum number of workdays in the state before the state income allocation rules apply, but that this is not always the case. Employers often have difficulties with multistate taxation because the rules differ from state to state, income allocation rules are poorly written in some states, and it is difficult for employers to track the number of days each employee works in various locations.

Mr. Klinger, a compensation and benefits partner at BDO, discussed global stock-based compensation issues. Mr. Klinger explained that some U.S. parent companies and foreign subsidiaries enter into recharge agreements, which are usually negotiated with the foreign taxing authorities. When a recharge agreement is in place, the foreign subsidiary pays the U.S. parent company an amount equal to the spread between the cost of the shares and the option price when the award is exercised or vested. Mr. Klinger explained that recharge agreements could be advantageous when structured correctly because they allow the foreign subsidiary a tax-free mechanism to repatriate cash to the U.S. parent while increasing the foreign subsidiary’s foreign deductions. Potential disadvantages of recharge agreements include the potential increase in social security taxes owed in foreign countries, increased compliance costs with regard to foreign withholding requirements, and the possibility that the equity award could be taxable in multiple countries. Mr. Klinger explained that equity awards are usually allocated to various countries based on the employee’s residency as the equity awards vest, and that this can be problematic as many companies rely on human resources databases that only track the employee’s most recent move.

Mr. Guilfoyle, a Human Resource Management manager at BDO, concluded the panel discussion by explaining how employers can equalize financial consequences for their employees who accept international assignments. Mr. Guilfoyle explained that purchasing power can be equalized by a cost-of-living adjustment, that housing can be equalized by providing a housing allowance, and that social security taxes can be managed with a totalization agreement. Mr. Guilfoyle explained that companies need to be aware that there is always a permanent establishment issue when employees are working in foreign countries on short- and long-term assignments.

## **Selected Developments in Tax Administration; Structure, Policy and Procedure.**

By: Tim Kelly, *Journal Editor, MST Student*

The luncheon program for the first day of the Tax Institute included Diane Ryan, Of Counsel with Skadden, Arps, and former IRS Chief of Appeals, discussing recent changes at the IRS designed to improve the agency's administration of international tax and transfer pricing rules. Reorganization of the international examination functions combines the Advanced Pricing Agreement program (APA) and the Mutual Agreement Program (MAP) to create a more efficient structure for handling transfer pricing issues. The APA program, formerly under the Office of IRS Chief Counsel, will move to the Office of Transfer Pricing Director (headed by Sam Maruca) under the Large Business & International (LB&I) Division's international operation. The latest in a series of changes by the agency, this restructuring is driven by the following: an increase in APA applications, the growing backlog in processing APAs, a majority of cases involving foreign-initiated adjustments, and increasing budget deficits and revenue pressures in all jurisdictions. To meet the goals of efficiency and reduced processing time, the new structure calls for the following: earlier identification of strategic issues, continuity of personnel assigned to a case, hiring of additional specialists, training, and consistency of position nationwide. As with any reorganization, this is a work in progress, and it will take time to realize the benefits of these changes and the impact on taxpayers and tax administration.

Ms. Ryan spoke briefly on changes in the IRS appeals function, noting that joint (LB&I) Division/Appeals Fast Track Settlement program (FTS) cases are up 50%. The program offers taxpayers the opportunity to resolve disputes earlier in the examination process, reducing the time and expense involved for both parties. Additionally, a helpful [summary chart of IRS authority statements](#) and their binding affect on appeals officers was provided.

Final remarks included more detail with regard to APA substantive issues. An APA is a contract between a taxpayer and one or more taxing authorities specifying the pricing method applied to related company transactions. The benefits provide certainty for prospective tax treatment and the financial reporting of potential tax liabilities. An APA can help the taxpayer frame actual and potential transfer pricing issues by being proactive and potentially reducing the costs associated with audit defense and preparation of documentation.

On average, it takes between 26 and 44 months to execute an APA depending on whether it is a unilateral or bilateral/multilateral (more than one tax authority) agreement. Renewals can take 23 to 40 months. APAs typically run for a period of five years. User fees range up from \$50,000 and renewals are around \$35,000. The number of various penalties continues to increase. They are typically asserted in audits and focus on adjustments rather than methodology or pre-transaction analysis because transfer pricing adjustments tend to yield the largest deficiencies. The 20% and 40% penalties can have a significant impact on reporting and senior management.

## Social Media and Internet 2.0: How Do Tax Rules Fit In?

By: Linda Yung, *MST Student*

With the roles of social media and the Internet rapidly expanding, a panel of tax experts discussed the tax implications associated with this new and developing area of business. The panel consisted of Taylor Reid of Baker & McKenzie LLP, Buff Miller of Cooley LLP, Zachary Perryman of PwC, and Eric Ryan of DLA Piper. The topics included a case study, voting control issues for company founders, equity compensation, international tax with respect to virtual economies, and transfer pricing difficulties associated with intellectual property (IP) and social media.

The case study involved a social networking site named Lollol.com (“LOL”) that enables users to customize their user experience. Currently, LOL’s operations are located in Redwood City, CA, but it expects robust worldwide growth. Its current revenue is from advertising and platform licensing. Future revenues could include media distribution, sale of goods and services, and data licensing. In order to address performance issues with the EMEA and APAC markets, LOL’s founders are considering establishing infrastructure operations in regions outside of the US. One issue raised from the case study is how to characterize the revenue from social media streams given that it can include revenue from virtual goods and virtual currency. The significance of LOL is that it represents many other start-up companies in Silicon Valley and applies to other business models such as cloud computing.



The next topic dealt with voting control issues that company founders face when venture capitalists are involved. The panel suggested one method for founders to retain control is to exchange some of their existing common stock for a new class of high-vote common stock. Another method is to distribute a new class of high-vote common stock to the founders. However, there are tax considerations to receiving high-vote stock if there is a material value-differential because the excess value cannot qualify as part of a tax-free exchange. The question then becomes whether the excess value is considered to be compensation or a distribution. In addition, there are tax considerations as to whether the low-vote stock qualifies as voting stock or not. The key factor to make this determination depends on the low-vote stocks’ right to participate in the election of directors.

Equity compensation is another challenge facing social networking companies. Many new companies short on cash find that offering equity compensation helps attract and retain the best and the brightest workers. It also gives workers incentives to work diligently and cooperatively for the benefit of the company. The speakers mentioned two common forms of equity compensation: nonqualified stock options and restricted stock units. The nonqualified stock option is a right to purchase stock at a predetermined exercise price and generally vests over time, giving further incentive to workers to remain with the company. The restricted stock unit is a grant valued in terms of company stock, but company stock is not issued at the time of the grant. It also has a vesting requirement for

distribution. There are tax consequences to both these forms of equity compensation, and each must be carefully weighed with respect to the company's expected IPO date or change in control.

Subsequently, the speakers discussed the topic of international tax with respect to virtual economies. The introduction of virtual currency and virtual goods brings about new challenges to revenue recognition. The difficulty here lies in the characterization of the revenue. Should the transaction be classified as sales, services, a lease, or as a royalty? In order to classify revenue, the speakers suggested looking carefully at all the facts and details of the company and its revenue stream. It is also important to understand how the different pieces of the company's operations fit together. Other difficult areas include: difficulties with sourcing services income, PE (Permanent Establishment) and effectively connected income, subpart F considerations, and territorial division of interests.



The last topic involved transfer pricing difficulties associated with intellectual property (IP) and social media. Oftentimes with social media and internet companies, transfer pricing deals with transfers of IP. The issue includes both identifying the IP elements, and then matching that with an appropriate transfer pricing method. Social media has many other such intangibles that are not typical. According to the speakers, the optimal solution is for the taxpayer to use various methods and assumptions in their analysis to

converge on the chosen inter-company amount. As noted by the panel, the area of social media and the internet is like the Wild West of years past. So far there are no established laws or code sections and only a handful of cases to serve as guidance. As a result the current environment creates some interesting tax challenges and potential opportunities for tax planning.



## Spotlight on Transfer Pricing

By: Pingrong Xue, *MST Student*

Transfer pricing was an important topic at the 27<sup>th</sup> Annual High Technology Tax Institute. It was discussed from four different perspectives by Sean F. Foley from KPMG, John E. Hindings from the IRS APA program, Fred C. Johnson from the IRS A&IC, and Craig A. Sharon from Binham McCutchen LLP.

*IRS Organization Change:* The IRS continues its reorganization effort to improve the efficiency of its international operations. In October, 2010, the IRS brought together the Large and Mid-Size Business (LMSB) division and the international division, and it renamed the division the Large Business and International (LB&I) Division. In 2011, the Advanced Pricing Agreement (APA) and the Mutual Agreement Procedure (MAP) were moved from the office of IRS Chief Counsel to the office of Sam Maruca, the new director for Transfer Pricing Operation in LB&I. The two programs were merged into the new Advance Pricing and Mutual Agreement (APMA) program. Not only was the new APMA program nearly doubled with the combined staffing of the original APA and MAP programs but it also expanded the operation from four to twelve locations.

*Cost Sharing:* Sam Maruca, the new director of Transfer Pricing Operation signaled the potential new direction of cost sharing. The temporary and proposed cost sharing regulation will expire in December of 2011. The final regulation was issued after the conference in December of 2011.

*Taxpayer-Initiated Adjustments:* Taxpayers who operate in high-penalty countries such as Canada and Germany might wish to take preemptive measures in these countries by initiating the transfer pricing adjustments. There is no clear answer as to whether or not taxpayers may receive relief for double taxation if they initiate the transfer pricing adjustment.

*China Business Trust:* The China Business Trust (CBT) is a rather complicated business structure with potential tax savings. Under the structure, the commission earned by CBT is not taxed by China or the U. S. It is almost too good to be true, with the risk of either country closing the loophole. The fact that the IRS does not accept unilateral APA could be a sign for change from the U.S.



International and transfer pricing issues were a common theme of the conference. The signal from the IRS and the Treasury Department is loud and clear: international issues are the top priority of their agenda.

## State Tax Issues Affecting Technology Companies

By: Chanpheareak (Luis) Chim, *MST Student*

This Institute session was presented by Rocky Cummings, Partner, BDO, George Famalett, Partner, PwC, and Kimberly M. Reeder, Partner, Morgan, Lewis & Bockius.

The discussion centered on sales tax nexus issues and their effect on technology companies. As many states face budget deficits, they often become more intent on ensuring all possible taxes are assessed and collected, including on multistate sales transactions. Mr. Cummings pointed out that the *Quill* decision requires companies to have a physical presence in a state to collect sales tax from buyers. However, there is a question as to how much physical presence would mandate the sales tax responsibility for companies with multistate transactions. For example, in 2008, New York imposed "click-through nexus" by enacting a new law to establish nexus between a vendor and New York when a vendor compensates a New York affiliate for referrals to a New York resident buyer. The law applies if vendors pay New York affiliates for such referrals and make sales of at least \$10,000 during a four quarter period from such referrals.

As new technologies continue to emerge, products change faster than the law. It will be more difficult to determine the nexus for companies that use the cloud computing platform, which has made it easier to reach customers across state lines. A company should be careful in developing new products and services and licensing any tangible assets. A company should look at contracts and marketing because the line item for the revenue should be aligned with the contract terms. More importantly, what to put on the contract should be definitive.

Additionally, Ms. Reeder pointed out that when companies are not sure if they are subject to the sale or use tax in states in which they have customers, they should look to a product descriptions. Also,



Ms. Reeder added that they should look into whether or not such transactions with the states are subject to a tax or if there are any tax exemptions. Ms. Reeder recommended that the company should read the statutes carefully.

The cloud computing platform has changed how the *Quill* decision addresses physical presence to determine nexus. In addition, as each state looks to reduce its budget deficit, it looks to raising more revenue.

Multistate companies face many challenges, as the law is likely to change rapidly regarding nexus. A company must be apprised of updates of nexus and tax base rules for each state because any changes could easily affect the business operation.

## Accounting for Income Taxes

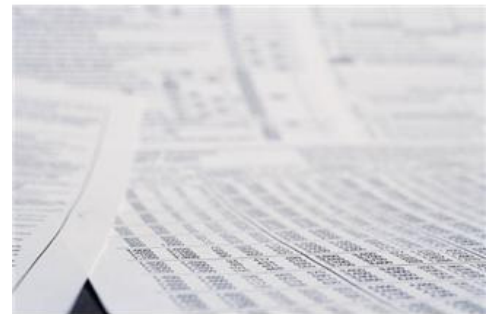
By: Susan Burt, *MST Student*

A panel of seven tax professionals from CPA firms and industry discussed the updates regarding accounting for income taxes as well as the SEC's recent comment letters as they relate to accounting for income taxes.

The Securities and Exchange Commission (SEC) is required to review public company filings every three years. In a typical review the SEC staff provides comments where disclosures could be improved upon and the registrant responds to the comments until all issues have been resolved. After the comment period has ended and issues have been resolved, the SEC publishes the comment letters on its website. Published comment letters provide valuable insight to the SEC's hot topics and are useful in improving upon financial statements and disclosures.

In the past, SEC staff comment letters have focused on liquidity issues, loss contingencies and impairment issues noting that sufficient information must be disclosed to allow an investor to make an informed decision about financial condition and operations. More recently, the SEC has focused on disclosures regarding undistributed earnings of foreign subsidiaries where the U.S. parent company has considered those earnings permanently reinvested. Some of the more salient points on this issue were presented and discussed.

*Permanent Reinvestment of Earnings:* The SEC staff has inquired about a company's policy in accordance with ASC 740 (formerly known as Statement 109: Accounting for Income Taxes) whereby there is a presumption that all undistributed earnings will be transferred to the parent entity unless the parent entity has evidence of specific plans for reinvestment of undistributed earnings of a subsidiary which demonstrates that remittance of earnings will be postponed indefinitely. A company should consider its past experiences of foreign cash repatriation with regard to its position of permanently reinvested foreign earnings. The SEC has commented on the juxtaposition of a company's past repatriation activity to a company's position of permanently reinvested foreign earnings for further explanation.



*Liquidity Related Disclosure:* The SEC staff has commented on the need for expanded liquidity disclosures particularly if a company's position is to permanently reinvest foreign earnings. The SEC believes that although a company may have the intent to fund U.S. operations through ongoing cash flows or borrowings, expanded liquidity disclosures should include the amount of cash held by foreign subsidiaries that would be subject to potential tax if repatriated to the U.S. The SEC looks to Item

303(a)(1) of Regulation S-X whereby a “Company should identify any known trends or any known demands, commitments, events or uncertainties that will result in or that are reasonably likely to result in the registrant’s liquidity increasing or decreasing in a material way.”

*Undistributed Earnings of Foreign Subsidiaries:* SEC staff comment letters have included inquiries as to why a company believes it is not practicable to determine the amount of unrecognized deferred tax liability related to undistributed earnings to foreign subsidiaries. Under ASC 740, whenever a deferred tax liability is not recognized, certain disclosure requirements are required such as a description of the types of differences, cumulative amount of each type of differences and amount of unrecognized deferred tax liability for differences, if practicable. In some cases, it is not practicable to determine the amount of the unrecognized deferred tax liability. In most cases, U.S. companies do not provide U.S. deferred taxes on undistributed earnings of foreign subsidiaries because 1) it is impracticable to accurately calculate the amount of deferred tax liabilities related to undistributed earnings and 2) most companies do not have the intention of repatriating foreign earnings. However, in light of the SEC comments on this topic respondents have added additional disclosure that it is not practicable to calculate the potential deferred tax liability.

*Summary:* In the recent period, the SEC review process has focused on company disclosures with regard to accounting for income taxes particularly where a registrant has significant earnings from foreign subsidiaries. The SEC believes that U.S. parent companies with significant undistributed foreign earnings might not be sustainable and registrants should consider additional disclosure requirements in their public filings.



Dave Gaul, VP Tax for Cypress Semiconductor (pictured above), moderated the panel consisting of Chad Bowar – Ernst & Young, Scott Jaconetty – BDO, Ty Kanaaneh – PwC, Jeff Sokol – Deloitte, Jim Songey – Grant Thornton, and Rusty Thomas – KPMG.

## IRS Examination and Appeals – Tools and Techniques

By: Evie Lee, *MST Student*

A panel of three esteemed tax leaders, Patricia Chaback, Industry Director for the Communications, Technology, and Media (CTM) Industry for the Internal Revenue Service's Large Business and International Division (LB&I), Larry R. Langdon, Partner with Mayer Brown LLP and former Commissioner of the Large and Mid-Size Business Division (LMSB) of the Internal Revenue Service (IRS), and Diane Ryan, Of Counsel with Skadden, Arps, Slate, Meagher & Flom LLP and former IRS Chief of Appeals, discussed various issues relevant to appeals management and shared their expertise on how to execute a smooth examination.

Ms. Chaback started the discussion with a brief overview of the IRS' reorganization of its LB&I Division. Among other things, Ms. Chaback believes that the restructuring will better serve the public by pooling resources together to increase efficiency, creating a network of issue management teams who have expertise in certain areas, and bringing new perspectives to the issues. One evolving area is the Uncertain Tax Position (UTP) schedule and how the phase-in of this schedule has led to questions about the need for the Schedule M-3. Since these schedules can be used to more efficiently determine which taxpayers to audit and pinpoint specific audit areas, LB&I sees this concern as a means to further encourage discussions with the taxpayer on the UTP before Information Document Requests (IDRs) are issued. During this current trend of uncertainty, more guidance is needed.

Ms. Ryan explained an alternative dispute resolution process known as "Fast-track". The goal of this new process is to obtain a resolution at the beginning of the appeals process versus at the end. In order to achieve this goal, both sides need to keep an open mind, all cases must be determined on a facts-and-circumstances basis, open discussion is encouraged, and both sides must be willing to "put their cards on the table." Under the traditional appeals process, cases are resolved in an average of 400-600 days, whereas under Fast-track, 83% of cases are resolved in an average of just 80 days. This relationship approach results in around 5 to 7 times faster resolution that will translate to saved resources on both sides.

Mr. Langdon outlined the Compliance Assurance Process (CAP) program and how it has benefited its participants. CAP was an invitation-only pilot program that started in January 2005 with 17 large corporate taxpayers, which has since grown to include 140 corporate taxpayers. Due to its success, on March 31, 2011, the IRS announced that this program would become permanent.

Taxpayers in the CAP program work with IRS examiners to identify and resolve issues as they arise during the tax year prior to filing their returns, which improves both currency and transparency and strives to achieve a "real-time audit" approach towards compliance. This shortens the exam cycle, reduces uncertainty, and frees up audit resources. As the program is in its infancy, it also comes with



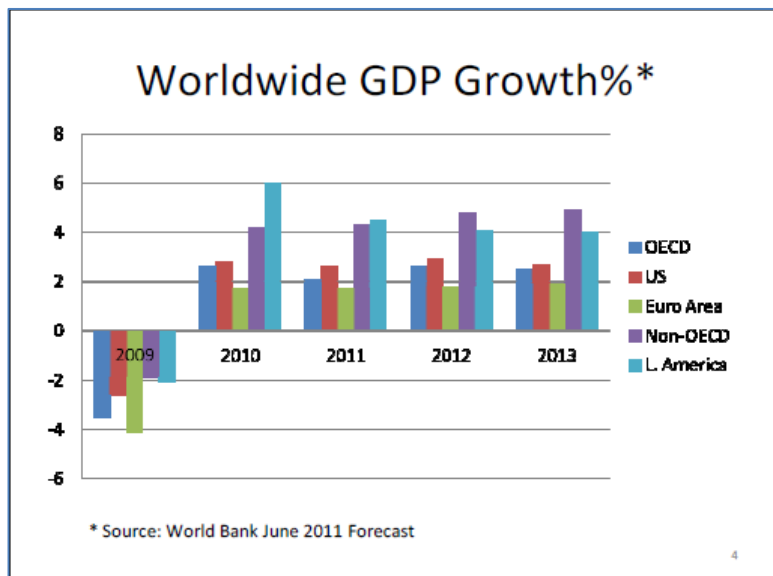
its drawbacks and is not equipped for “emerging issues.” Accordingly, a taxpayer may end up being an experiment for the IRS to set new policies. Additionally, a taxpayer is also susceptible to inquiry regarding transactions before they even occur. At this point in time, there is a lack of clear guidance on what taxpayer profile is best suited for this program and admittance is subjective.



## Doing Business in Latin America

By Victoria Lau, *MST Student*

The World Bank reported that Latin America's GDP grew by 6 percent in 2010<sup>54</sup>, and the growth rates



in 2012 and 2013 are expected to surpass most other regions in the world. This growth is fueled by an expanding middle class with disposable income and high information technology (IT) adoption rates which are spurred by global companies' commodity investments in the region. Mr. Jerry Thompson, VP of Tax from Ingram Micro Inc., introduced these facts as he opened the session on *Doing Business in Latin America*. He portrayed a region with ample opportunities for high-tech companies. This message was repeated by the other two panelists: Mr.

Marcelelo Natale, International Tax & TP Partner from Deloitte; and Mr. Miguel Valdes, Partner from Machado Associados.

The session comprised three parts. First, Mr. Thompson introduced the general economic climate and the IT market trend of the region. He highlighted that the region is in the forefront of technology-generation-skipping with its high adoption of cloud computing and cell phones.

The second part of the session covered tax updates of six major countries. Mr. Thompson explained that Brazil was included due to its economic significance with a population base of 200 million. The other five countries are included as they are economically and politically stable. These other countries are: Argentina, Chile, Columbia, Mexico and Peru. Mr. Natalie covered Brazil, noting the complexity of the VAT system and the challenges a VAT poses to businesses. Mr. Valdes summarized the relevant corporate tax rates, treaty partners, and significant recent and anticipated tax developments for the other five countries. A summary of the key tax facts are presented in Table 1.

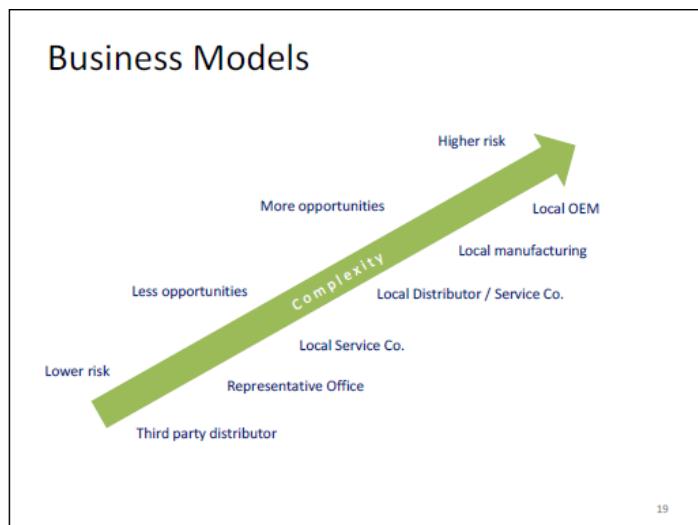
<sup>54</sup> World Bank. (June, 2011). *World Bank Says Developing Countries Need to Shift From Crisis-Fighting to Policies That Will Sustain Growth* [Press Release]. Retrieved from <http://web.worldbank.org/WBSITE/EXTERNAL/NEWS/0,,contentMDK:22933230~pagePK:64257043~piPK:437376~theSitePK:4607,00.html>

**Table 1 Key Features Comparison**

	<b>Brazil</b>	<b>Argentina</b>	<b>Chile</b>	<b>Columbia</b>	<b>Mexico</b>	<b>Peru</b>
<b>VAT</b>	IPI 0-365% ICMS 18% ISS ≤ 5%	21%	19%	16%	16%	17%
<b>Corporate Tax Rate</b>	15%	35%	20%	33%	30%	30%
<b>Dividends Withholding</b>	0%	0%	35%	0%	0%	4.1%
<b>Income Tax Treaty with US</b>	No	Yes	No <sup>1</sup>	No	Yes	No

<sup>1</sup> The Chile-United States Income and Capital Tax Treaty was concluded in February 2010 but is not yet effective.

In the final part, Mr. Thompson gave an overview of the different business models that can be adopted by IT companies seeking to enter emerging markets like Latin America, and he discussed tax



and business factors that may influence the selection.

The rest of this summary highlights three challenges raised by Mr. Natale in his presentation on Brazil's VAT system: lack of transparency due to the complex tax structure, the uncertainty due to pending "tax wars," and compliance difficulties.

The Brazilian tax authority focuses on VAT to generate revenue. Mr. Natale explained that income taxation is not a reliable source due to the country's "roller coaster" economy, hence that tax contributes only one-third of the country's tax collection. Each level of the Brazilian government has

the authority to impose a VAT resulting in five different taxes on products or services. The federal tax is on manufactured products, *imposto sobre produtos industrializados* (IPI). It is levied on every stage of the production process and on import transactions. The rates vary inversely with the necessity of the product, from 365% to nil.<sup>55</sup> The 26 states impose the *imposto sobre circulação de mercadorias e serviços* (ICMS) on the distribution of goods, and the municipalities levy the *imposto sobre serviços de qualquer natureza* (ISS) on services. Mr. Natale said it is possible for VAT to make up 70% of the product or service price. As prices are inclusive of VAT, the tax is not transparent to the taxpayer. Consumers cannot easily differentiate the product value and the taxes paid. Mr. Natale emphasized that it is important for tax professionals to work with their business counterparts to establish the appropriate pricing strategy.

Mr. Natale also explained that the Brazilian VAT system can create uncertainty in tax liability. Although the typical rate of ICMS is 18%, each state has the authority to set its own ICMS rate. Mr. Natale said that some states are locked in “tax wars” by offering lower ICMS rates to attract new investments. In a VAT system, a taxpayer pays tax on the amount that the sale price exceeds the cost of the goods. Mr. Natale explained that the end consumers typically do not reside in states where the goods are manufactured so VAT paid in one state becomes creditable tax in another state; hence “tax wars” ultimately penalize the distributors. The issue of whether states can offer reduced ICMS rates is being decided by the Supreme Court; so tax incentives offered by states may not remain valid.

Reliance on the VAT collection in Brazil has necessitated businesses to collect transactional data. Brazil introduced the Public Digital Bookkeeping System (SPED) which requires businesses to digitize and transmit accounting records, including journals, general ledgers, daily trial balances and balance sheets, as well as transactional documents to support ICMS and IPI payments, and electronic invoicing. Data is transmitted to state authorities and available for use by public authorities and interested parties, including auditors, accountants, buyers, border control, etc. Mr. Natale called the SPED implementation the “silent revolution.” He added that it is geared to collect, and the tax authority is always reaching new historic levels of collection. Most ERP systems, which are focused on management reporting, are unable to collect transaction data at this level. Mr. Natale explained that this compliance requirement creates a barrier for entry to the Brazilian market.

The three panelists summarized by saying that the tax structures in Latin America are complex; however, they emphasized that businesses are highly profitable if you know the rules and “play the game”. Furthermore, they cautioned that if a high tech company does not enter the Latin America market, its competitors would or probably have already entered it.

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<sup>55</sup> IBFD. (June, 2010) Brazil – Corporate Taxation – Country Analyses – 13. Value Added Tax.

## Tax Legislative Outlook

By: Tim Kelly, *Journal Editor, MST Student*

For the Tuesday luncheon program, Nick Giordano, Principal, Ernst & Young, provided an overview of the current prospects for tax reform. The House of Representatives is made up of 242 Republicans, of which 87 are freshman, and 192 Democrats. The Republicans hold 47 seats in the Senate, 10 are up for re-election, and the Democrats hold 53 seats, of which 23 are up for re-election. The current deficit in FY2012 is \$3.5 trillion and projected to be \$8.5 trillion for FY2012-2021 under current policies. Potential issues for Congress to consider before the end of the session (112th Congress) include the following: job creation, deficit reduction, tax reform, expansion of expiring tax provisions, and apportionments.

Regarding the upcoming vote by the debt-cutting super committee, it was pointed out that even if the vote fails (which it did), the automatic trigger of \$1.2 trillion in spending cuts will not take place until 2013, leaving Congress plenty of time to come up with an alternative. Meanwhile, President Obama's deficit reduction plan calls for a mix of spending cuts and revenue raisers. Under the plan, \$577 billion are mandatory spending cuts mostly in the area of Medicare and Medicaid, \$430 billion come from interest savings and \$500 million come from winding down the wars in Iraq and Afghanistan. \$1.5 trillion in revenue raisers come from the expiring Bush tax cuts on high-income earners, limitations on itemized deductions and exclusions, and eliminating special interest tax breaks. Achieving these goals will require major tax legislation.

There are a variety of ideas being discussed in Washington to deal with the deficit and increase global competitiveness. One reform gaining attention in Congress is the enactment of a consumption tax. Both parties have members that have advanced a VAT or some other consumption tax to raise revenue. Others suggest moving toward a territorial system and away from the present worldwide system of taxing domestic companies' foreign-earned profits. The recently released proposal from Congressman Camp, chair of the House Ways and Means Committee, moves toward a territorial system by giving a 95% dividend exemption on foreign source active income of CFCs and 95% exclusion on capital gains on CFC sales. Camp and others advocate a corporate rate lowered to 25% in order to attract investment and improve global competitiveness. The implications of lowering the rate are far-reaching. Every percentage point reduction in rates translates to a loss of \$100 billion in revenue over ten years. It also begs the question: can corporate rates be lowered without lowering individual rates? It may be a hard sell to the voters. The final issue in tax reform is the concern that corporate reform will bypass pass-through entities leaving them with higher rates. Assurance to the small business community that any reform will be pursued as "business" rather than "corporate" will help build consensus.

Regardless of the path taken, revenue-neutral tax reform is likely to require significant broadening of the base by reducing tax expenditures. Repeal of corporate tax expenditures such as MACRS, expensing of R&D, and LIFO are some of the most expensive. On the individual side, the exclusion for employer-provided health care, mortgage interest, and reduced tax rates on dividends and long-term capital gains top the list of expensive tax expenditures. Most likely these issues will not be addressed until after the fall 2012 election.

## The New Approach to International Tax Rules

By: Sujin Pradhan, *MST Student*

One topic discussed was “The New Approach to International Taxation,” presented by Eli J. Dicker, Tax Executives Institute, John S. Peterson, Baker & McKenzie LLP, Channing Flynn, Ernst & Young LLP, and Barton W.S. Bassett, Morgan, Lewis & Bockius.

Mr. Dicker informed the audience that the agenda would focus on five broad areas: an OECD update, tax reform, FATCA, Notice 2007-13, and the substance over form principles in an international context.



Mr. Peterson started with the OECD update because the U.S. subscribes to the OECD model. One of the areas of importance to OECD is transfer pricing (TP). More companies were locating IP ownership in low-tax jurisdictions such as Singapore, Ireland, and Switzerland. Hence, in 2010, to limit the ability of companies to restructure, the OECD updated the transfer price guidelines (TPG) which consisted of updated guidance on business restructurings and profit methods.

The rules are not perfect; there are still opportunities to disregard the TPG, especially when it comes to taking positions on intangibles. Mr. Peterson pointed out that Chapter IX of the TPG does not define intangibles as required to provide a solid platform for current multinational issues. He gave an example of German legislation where “profit potential” is taxed as an intangible. Therefore, the OECD has a huge task when it comes to providing guidance on what can and cannot be considered an intangible. He also informed the audience that the OECD is currently convening meetings on this topic.

The U.S. Treasury and the IRS face a similar situation. What does it mean to own an intangible? A good example is when there is a legal owner of a trademark as opposed to an owner who enhanced the value of an intangible as a licensee. Mr. Peterson mentioned a common scenario in Silicon Valley where engineers leave companies and start their own company using previous employers’ IP and trade secrets. Hence, more guidance is needed. Cloud computing has centralized what is dispersed among various countries. Have intangibles been transferred? The position of the OECD on “profit potential” and “business opportunities” is going to affect the U.S. position and positions of other countries where U.S. companies have operations.

Mr. Flynn spoke about how companies should prepare themselves in speculation of tax reform. The rules are going to get more complex and tax reform may or may not achieve its intended goal to reduce the deficit, stimulate the economy, and enhance competitiveness. He mentioned the “discussion draft” of an international tax proposal from Congressman Camp that reflects a reduction in corporate tax rate to 25% and forms a territorial tax regime. However, taxpayers would be paying the same tax with the reduced 25% rate because many corporations pay a similar rate now with favored deductions, R&D credit, accelerated depreciation, etc. He emphasized that planning is going to be vital with respect to

moving to a territorial regime and potential repatriation of prior overseas earnings. For example, if a corporation has permanently reinvested foreign profits, it may not have liquid assets but still might be required to pay a tax on such profits.

Some immediate actions that should be taken are to look at qualitative and quantitative effects on businesses, to inform management, and most importantly to influence policymakers. Mr. Flynn also mentioned that 10/50 companies (which own at least 10% but less than 50%) must be aware that they could be taxed on their prorated share of earnings from the beginning of time. Tax practitioners and companies need to keep in mind that this proposal is still in the “discussion draft” stage.

With regard to Notice 2007-13, subpart F income, services must be performed outside the CFC country of incorporation and must have “substantial assistance” from a U.S.-related person. Taxpayers want more clarity on the definition of “substantial assistance”.

FATCA is relevant to technology companies even if it is primarily a banking provision. Taxpayers who use foreign banks to hide investment income will find that this new set of rules is targeted at them. Technology companies could be subject to such provisions because many get involved in activities such as payment processing which is a banking activity.

Mr. Bassett discussed “substance over form” in the international context. One case that companies are watching is a Supreme Court case in India, the *Vodafone* case. India taxes capital gains realized by nonresident parties when they sell stock in an entity located in India. The U.S. tax treaties with India do not prohibit the imposition of Indian tax on capital gains realized by a U.S. resident seller.

In this case, *Vodafone*, a British multinational telecommunications company, bought stock in a Cayman subsidiary which is owned by a Hong Kong (HK) parent. The Cayman subsidiary owned a Mauritius subsidiary which owned an Indian joint venture. The buyer did not apply withholding tax because it was not a direct purchase of Indian stock. This was an indirect disposition of stock situation. India asserted a \$2.6 billion deficiency. *Vodafone* lost in the Lower Court, and the case is now in the Supreme Court. (Note: *Vodafone* won the case in January 2012.)

Mr. Bassett also mentioned a Chinese case involving a U.S. buyer who bought stock in a Hong Kong (HK) entity which owned 49% interest in a Chinese joint venture. The U.S. buyer lost the case because the HK corporation had no office, employees, or any other assets other than the joint venture shares. Therefore, although the U.S. buyer bought stock in the HK corporation in form, in substance it was the purchase of the Chinese joint venture.

As indicated by Mr. Bassett, the key point here is to identify the withholding issue early, to talk to the business team about the right to withhold tax, and to seek indemnification from the seller because substance over form is gaining momentum internationally.

## The World Class Tax Organization

By: Lisa Pan, *MST Student*

At "The World Class Tax Organization" discussion, panelists Lorraine McIntire, President of the Santa Clara Valley TEI Chapter, Don Waite, former CFO of Seagate, and David White, former CFO of NVIDIA and Sanmina-SCI, shared insights on the role of tax professionals in larger corporate setting. Specifically, the panelists shared personal experiences and general understandings of how tax professionals can play a broader part in multifaceted business transactions, as well as the unique challenges tax professionals face compared to other functions within a company.

Tax professionals have undergone extensive training to appreciate the complexity of tax law and its practice environment. However, while the tax aspects are important in any transactions, it is often not the sole intention of setting up a business transaction. As a result, the business side typically pours enormous resources into maximizing the business benefits, with tax consequences being a secondary consideration. They tend to "let the tax people worry about the tax," said Mr. Waite in the discussion, and it's not unusual to find



"a separation between the business side and the tax side" in a large organization, when in reality, "the people are all working under the same mission and towards the same goal". As a CFO, Mr. Waite called for closer integration between the two sides, including having tax personnel learn about the transaction in a comprehensive manner instead of just focusing on the tax details and giving the business development team an opportunity to learn the tax implications of their work.

Mr. White pointed out that the separation between business and tax would develop naturally, as tax is a highly specialized field that branches to even more specific areas. The different challenges a tax department faces can already be overwhelming: different filing requirements, addressing IRS audits, keeping up with new laws, reporting to various levels of organizational and regulatory authorities, etc. However, Mr. White agreed with Mr. Waite that without a broader appreciation of the business side, the tax department will become even less involved in business, and in turn, can grow into an even more separated function.

The panelists offered insights on how management could better integrate business and tax, so each side may achieve the best they can. Ms. McIntire stressed the importance of communication among different functions and different levels of an organization. For example, having leaders from the tax department participate in business meetings, even if the discussion is not primarily tax-related can help facilitate understanding from both sides. On the other hand, training should be provided to the business development team to better appreciate the tax complexities of their work. After all, the business details do affect the work of the tax, and the tax outcomes are a part of the business.

"Ultimately", the panelists highlighted in a closing note, "everyone is working together to create value to the company." Ongoing communication is key to enhancing relationships across the board. For shareholders and management, it is what the company can create as a whole that matters the most, not the individual achievements of a particular function.

## Federal Domestic and State Tax Updates

By: Evie Lee, *MST Student*

During that last session of the conference, Annette Nellen, professor and director of the San José State University's Masters of Science in Taxation (MST) program and Jennifer Petersen, Tax Partner in KPMG's State Tax practice, spoke about the various federal domestic updates and general state revenue actions and tax trends. The following highlights some of the many topics that were discussed.

Ms. Nellen briefly discussed the 100% bonus depreciation expense of qualified property acquired between September 8, 2010 and January 1, 2012. Such property must be new assets placed in service before 2012 and meet the IRC §168(k) requirements. As a planning strategy for individuals, since individual tax rates may be higher after 2012, it may be beneficial to consider not front-loading depreciation deductions. However, corporate tax rates may decrease, which means that corporations may benefit from accelerated depreciation. The dollar limitation for Section 179 expensing for both 2010 and 2011 is \$500,000 and the reduction in the dollar limit starts to phase out at \$2 million. For 2012, the dollar limitation is \$125,000 and dollar limit starts to phase out at \$500,000, and falls to \$25,000 and \$200,000 after 2012, respectively.

Another federal domestic update covered was the new voluntary settlement program that is part of the "Fresh Start" program announced by the IRS in September 2011. Under this program, eligible employers can file Form 8952: Application for Voluntary Classification Settlement Program (VCSP) to achieve proper compliance with worker classification by making a 10% employment tax liability payment covering the compensation paid to workers for the past tax year. The taxpayer will not be liable for any interest and penalties on the liability and will not be subject to an employment tax audit with respect to worker classification. The VCSP may sound like a good idea, but there are some issues to consider: (1) states may not conform to the federal settlement, which means that there may be state penalties and interest assessed; (2) the effect of the reclassification on any retirement plans, fringe benefit programs, stock options, etc.; (3) the effect on the unemployment tax rate; and (4) the effect of a possible IRS audit.

Ms. Petersen began her presentation with the discussion of why state budget deficits are likely to persist and expected to run at \$120 billion or more per year through FY 2013. Some reasons mentioned include: (1) the federal stimulus has run its course; (2) retail sales and the housing market continue to lag; (3) unemployment remains inordinately high; and (4) the long-term outlook for federal assistance is not good. In order to generate more state revenue, more than 20 states have implemented tax amnesties. For example, Michigan and Washington started an amnesty program in 2011, and Arizona is scheduled to start one in 2012. Other revenue actions include accelerating tax payments, deferring tax attributes, and the sale-leaseback or leasing of state assets. Some states have increased excise taxes on cigarettes and alcohol and implemented taxes on plastic bags. States will continue to make changes to their tax policy in order to bridge the deficit gap, which means that the current trend of more aggressive state audits will continue, resulting in more challenging audits and longer resolution times.

## HIGH TECHNOLOGY TAX INSTITUTE

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Attendees are eligible for up to sixteen hours of continuing education depending on the requirement of their licensing body. Sign-in and sign-out sheets and a reporting form will be available at the Institute and must be used by anyone needing a certificate of completion for continuing education requirements. Approval is pending for MCLE credit from the State Bar of California.



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# Tax Mavens

**“Steeped in IRS law, and very effective at putting his experience in government to good use.”**

**(Chambers USA, 2010)**

***The Contemporary Tax Journal's Interview of Larry Langdon***



By: Shadi Mahdinia, *MST Student*

Larry Langdon is well known in the practice of federal tax law due to the numerous high-level positions he has held over his long career and the contributions to the profession. He was the first Commissioner of LMSB (now LB&I) Division of the IRS from 1999 to 2003. Prior to his role as Commissioner, he held senior level positions in the private sector with leading firms such as Hewlett-Packard, Vetco, Inc., and the Ford Motor Company. He is currently at Mayer, Brown, LLP in Palo Alto as partner and director of the firm's Global Tax Practice.

Mr. Langdon believed he could make a material difference at the IRS and did so, in particular, by bringing efficiency to the examination process. He was able to institute dispute resolution processes designed to reduce appeals time, eliminate corporate tax shelters, and introduce innovative management strategies, such as the Pre-Filing Agreement Program. Earlier in his career, he served as a volunteer at the Tax Executives Institute for many years, including as president from 1986 to 1987. Mr. Langdon is a frequent speaker at state and national tax conferences.

Following are the questions and answers from an interview of Mr. Langdon conducted in February 2012.

**SJSU CTJ:** After a long career in corporate tax, why did you accept the job of IRS Commissioner of LMSB (now LB&I)?

**Langdon:** I had been vice president, tax, licensing and customs at Hewlett Packard for 22 years, and it was time for me to retire as an officer of HP. Charles Rossotti, as the new commissioner of the IRS, spent three months recruiting me. Ultimately, I was interested in the job because I was interested in public service, and I had several ideas that I thought would be helpful to improve tax administration for corporate America. After graduating from the MBA program at Harvard, Charles Rossotti worked for David Packard when Dave was Deputy Secretary of Defense. Mr. Rossotti wanted to bring HP management skills to the IRS, and he believed that by recruiting me, that might occur. Mr. Rossotti was an excellent executive during his years as CEO of American Management Systems. He allowed the operating division commissioners to have a fair degree of autonomy and accomplish their own goals and objectives, like sector executive stewards in corporate America. His management style was very similar to that which I had experienced at HP, and that was very attractive to me.

Debbie Nolan was Deputy Commissioner LMSB and a career IRS executive. She and I had the opportunity to recruit all the executives into the LMSB management team. We called this team “The Team of 38”, and every quarter we met as a team to formulate our goals and objectives, discussed the changes we were implementing, and evaluated our successes and failures. We were able to select those executives from 200 executives at the IRS by using behavioral interviewing. That is, by asking them: How do they lead people? How do they lead change? What is your business acumen? What are your technical abilities? These types of questions enabled constructive and proactive evaluation. We brought six executives from outside including Carol Dunahoo, Director of International and Competent Authority and Cliff Jernigan, Senior Technical Advisor, Communications, Technology and Media.

One of the key factors which created the opportunity for success was the 1997 hearings by the Senate Finance Committee that had improperly disparaged the IRS workforce by calling them incompetent and not service-oriented. After we started the operations of LMSB, we found that the majority of the IRS employees and managers were very service-oriented and wanted to support the long-term success of the agency. The employees and managers actively helped move the IRS to new goals and objectives that we had at LMSB – we were able to increase service to taxpayers, speeding up the dispute resolution process, putting new tools and techniques in place, including pre-filing agreements, and fast-track appeals. A pre-filing agreement allows a taxpayer to come to the IRS and resolve disputes prior to filing a return. The fast track appeals process allows IRS agents and taxpayers to go to an appeals officer and resolve the issue in a quick professional manner; in fact it reduced the time needed for the dispute resolution process by 90%.

Working at the IRS was a very rewarding and challenging experience for me, and the LMSB team at all levels were able to accomplish a great deal. In the process, we all realized that

bringing change to the government is not always easy, so sometimes we had to take two steps forward and one back.

**SJSU CTJ:** When you were the Commissioner of LMSB you took on the project of addressing tax shelter problems. What did you do to control these transactions and how successful were you?

**Langdon:** In the 1990's many CPA firms, law firms, investment bankers, and financial product-marketing firms were selling tax-motivated transactions to corporate America. Some of these transactions were too aggressive and would not be sustained by the IRS and the courts. So, at LMSB, we established the Office of Tax Shelter Analysis, a team to evaluate these transactions and get out early published guidance to taxpayers and IRS personnel. To accelerate the review of questionable transactions, Commissioner Rossotti approved a Disclosure Initiative, whereby taxpayers could disclose a transaction, provide the name of the promoter, provide the marketing and promotion opinions and materials, pay appropriate taxes and interest, but be forgiven any penalties. We started auditing promoters, which allowed thousands of transactions to be disclosed to the IRS.

We had another challenge with about 50% of LMSB managers and employees eligible for retirement. We solved this challenge by having LMSB recruit qualified people from outside the IRS. We were able to recruit qualified people at Grade 13, at which compensation is about \$100,000 per year. The recruiting classes were limited to tax professionals with more than 15 years of experience, a Masters in Tax, a CPA or law degree, and experience in CPA firms, law firms, or corporations. Currently, the IRS needs to continue to recruit people that have management experience in corporate America and CPA firms.

**SJSU CTJ:** What are the most important challenges the IRS faces today, and how do you think the IRS can address the challenges it faces given limited budget, frequent law changes, and a more global business environment?

**Langdon:** Studies indicate that the U.S. Treasury loses more than 15% of revenue because of a lack of effective compliance under the tax laws. The U.S. tax system is based on voluntary compliance. This means that people must have confidence in the system, understand it, and file returns in a proper way. The IRS has a limited budget and I believe the IRS has about 18,000 revenue agents to audit the entire country. As a point of reference, China has 1,000,000 agents. Since effective and visible tax administration insures tax compliance, the IRS needs an increase in its examination budget.

Another major obstacle to tax compliance is the complexity of tax laws, particularly the income tax laws. I would eliminate the middle class from the income tax system and provide a value added tax system to fund the federal government, as these taxes are easily administered in large manner. The income tax system is too complicated for individuals, and it is a real burden. We need to have a more balanced tax system that mirrors the tax system of our global trading

partners. We are in a global economy, and all of our trading partners have a consumption or value-added tax system.

**SJSU CTJ:** What is the prospect for major federal tax reform?

**Langdon:** In spite of being a fan of exempting the middle class from the income tax system and the addition of a value added tax system, I do not think we are going to have major tax reforms soon. We need to have a more robust economy before Congress can enact the necessary tax reforms. Like many others, I am concerned about our federal deficit and the lack of our global competitiveness.

**SJSU CTJ:** You have devoted a lot of time to volunteer work and getting involved with professional organizations throughout your career. How would you recommend that a young tax professional get involved in serving the tax profession, and why?

**Langdon:** I have always been a fan of being involved in professional organizations in any way I can. If you are a CPA, get involved in the CPA society; if you are a company tax professional, get involved with the Tax Executives Institute; if you are a chief tax officer, get involved in the chief tax officers' group in your industry. As part of career development, you need to learn and work with others and participate in professional groups. We need good leadership in the tax profession, particularly by people who have graduate degrees in taxation. You should shoulder that as an important part of your responsibility.

I am also on six non-profit boards, and I am a fan of the volunteer sector of American society. Volunteers do make a difference, so look for areas in which you can volunteer and make a difference.

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

**Langdon:** I guess my first choice, which would be impossible, is with Warren Buffett. I know every MBA student in this country would like to have lunch with Warren Buffett. So, my second choice would be the Secretary of the Treasury, Timothy Geithner, for a lot of different reasons. First, as you know, yesterday President Obama put out his new tax proposals, and I would like to hear the Secretary of the Treasury's views on those tax proposals. Second, perhaps more importantly, is to know more about the Secretary's views of the global economy and in its effect on the future with regard to all the challenges facing the United States, Europe and Asia. Third, to talk about what the Secretary has done to improve the economic environment. This is important, because I know that we are all concerned about future jobs. These are the reasons why I would like to have lunch with Timothy Geithner.

# 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 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, 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>56</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 work on tax policy in the capstone course. In other courses, such as corporate taxation and accounting methods, students learn the policy underlying the rules and concepts of the technical subject matter in order to better understand the rules and to learn more about the structure and design theory of tax systems. The MST Program also has an elective course - Tax Policy and Tax Reform.<sup>57</sup>

Two tax policy analyses are included in this section and join the growing archive of such analyses on the journal website (under "Focus on Tax Policy").

- 1) Increase in Standard Mileage Rate for Certain Charitable Work
- 2) Election by Certain Individuals to Have Their Income Tax Return Prepared by the IRS



<sup>56</sup> AICPA, *Tax Policy Concept Statement 1 – Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals*, 2001; available at <http://www.aicpa.org/INTERESTAREAS/TAX/RESOURCES/TAXLEGISLATIONPOLICY/Pages/TaxReform.aspx>.

Professor Nellen was the lead author of this AICPA document.

<sup>57</sup> Information on this MST course (BUS 225R) can be found at [http://www.cob.sjsu.edu/nellen\\_a/bus225R\\_reading.html](http://www.cob.sjsu.edu/nellen_a/bus225R_reading.html).

## Increase in Standard Mileage Rate for Certain Charitable Work

By: MST Students in Spring 2012 BUS 223A Tax Research, and BUS 225R Tax Policy and Tax Reform

IRC Section 170(i) allows taxpayers to claim a mileage deduction equal to 14 cents per mile driven in a passenger automobile<sup>58</sup> for work performed for a charitable organization. As with other charitable contributions, individuals must itemize their deductions to be able to claim the mileage deduction. H.R. 499 (112th Congress) proposes to increase this rate to 51 cents "in the case of the delivery of meals to homebound individuals who are elderly, disabled, frail or at risk." The higher rate would apply starting on the date the legislation is enacted.

The tax law allows for use of an optional standard mileage rate for certain travel in lieu of maintaining records to compute the actual costs of gas and related automobile expenses. For business, medical and moving related miles, the IRS sets and periodically adjusts the rates. The rate for charitable miles is the only one of the mileage rates set by statutory provision.

For 2012, per Notice 2012-1, the mileage rate for business travel is 55.5 cents per mile and for medical and moving mileage is 23 cents per mile.<sup>59</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 H.R. 499.

### Principles of Good Tax Policy Evaluation

Principle	Application	Rating
<b>Equity and Fairness.</b> Similarly situated taxpayers treated similarly.	<p>This proposal singles out one type of charity for different treatment. While the type of charitable work covered by H.R. 499 involves more driving than most types of charitable work, the costs per mile of any charitable work are the same. Thus, is inequitable to treat similar driving dissimilarly.</p> <p>The mileage rate for charitable driving is different than for moving or medical driving because the charitable rate is set in statute. The rate would be higher than 14 cents per mile if the IRS were allowed to adjust that rate to reflect changes in the costs of driving.</p> <p>A 51 cents per mile rate for charitable driving would be similar to the 2012 rate for business driving. The rates should not be the same though because the business rate includes depreciation. No</p>	--

<sup>58</sup> Per Revenue Procedure 2010-51, the standard mileage rate also applies to vans, pickups, or panel trucks.

<sup>59</sup> For details on the mileage rates and the IRS adjustments, see Revenue Procedure 2010-51.

	depreciation is allowed for charitable driving because the car is not used in a trade or business.	
<b>Certainty</b> 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 proposal seems narrowly tailored, but the definitions of the "elderly, disabled, frail and at risk" may not be clear.  Individuals who drive for more than one charitable organization will have added recordkeeping to determine 51 cents per mile versus 14 cents per mile.  Some issues can arise. For example, if meals are delivered to a home where one recipient meets the H.R. 499 definition but another does not, would the higher mileage rate still apply?	+/-
<b>Convenience of Payment</b> A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer.	H.R. 499 does not provide funds for gasoline to volunteers when they need it. That is, the benefit of the higher mileage rate will be derived when the volunteer files his tax return, rather than when it might actually be needed (when they purchase the gasoline).	--
<b>Economy in Collection</b> The costs to collect a tax should be kept to a minimum for both the government and taxpayers.	The IRS will need to provide definitions of the "elderly, disabled, frail and at risk." IRS audit costs will likely be low because this deduction is only claimed by itemizers (about one-third of individuals) and the number of individuals engaged in this kind of specific charitable work is likely low.  Consideration should be given to modifying the applicable language to tie to existing definitions, such as at IRC Section 170(e)(3) and Reg. §1.170A-4A for certain donations of inventory and other property to the "ill, the needy, or infants."	+/-
<b>Simplicity</b> The tax law should be simple so that taxpayers can understand the rules and comply with them correctly and in a cost-efficient manner.	There could be some confusion on the definitions of "elderly, disabled, frail and at risk." There could also be some complexity for volunteers needing to keep records to separate charitable driving covered by H.R. 499 from other charitable driving.  While volunteers could calculate actual expenses rather than use 14 cents per mile, it is simpler to have a standard mileage amount.	+/-
<b>Neutrality</b> The effect of the tax law on a taxpayer's decisions as to how to carry out a particular transaction or whether	H.R. 499 may affect taxpayer behavior. Volunteers may be more willing to volunteer for organizations addressed by H.R. 499 if the mileage rate were higher. It is likely though, that many volunteers do not consider the costs in taking on the work of the charities covered by H.R. 499.	--

to engage in a transaction should be kept to a minimum.	The impact is unlikely to be significant because H.R. 499 will only benefit volunteers who itemize deductions and keep adequate records to claim the mileage deduction.  As gasoline prices go up, the change by H.R. 499 likely becomes less of an incentive because the 51 cents per mile is not adjustable by the IRS to reflect changes in costs of driving.	
<b>Economic Growth and Efficiency</b> The tax system should not impede or reduce the productive capacity of the economy.	Likely no effect.	n/a
<b>Transparency and Visibility</b> Taxpayers should know that a tax exists and how and when it is imposed upon them and others.	The eligible charities will likely inform volunteers of the law changes. Tax preparers and tax prep software will make the change obvious as a new question will need to be asked as to how many charitable miles are eligible for 51 cents per mile rather than 14 cents per mile.	+
<b>Minimum Tax Gap</b> A tax should be structured to minimize non-compliance.	There is likely only a minimal effect on the tax gap because the current deduction is not well known and people do not always keep records on their mileage. Also, the deduction is only available to individuals who itemize their deductions.	n/a
<b>Appropriate Government Revenues</b> The tax system should enable the government to determine how much tax revenue will likely be collected and when.	It may be difficult for the government to determine from 1040 data how many miles are driven for the type of charitable work covered by H.R. 499. The charitable organization likely has data on how many miles are driven, but it may not be easily accessible and it would not be known how many of the volunteers itemize deductions and for those who itemize, how many even bother to claim 14 cents per mile versus claim actual expenses versus do not bother to claim.	--

## Conclusion

Based on the application of principles of good tax policy, H.R. 499 would benefit from modification. It appears that the rationale for this proposal is to address the fact that the type of charitable work referred to in the proposal requires significant driving by volunteers. With increased costs of gasoline and Section 170(i) fixing the mileage rate at 14 cents per mile, individuals may opt not to engage in this type of volunteer work.

However, because the law also allows volunteers to compute the actual costs of driving, the law change is not critical. Of course, use of a standard mileage rate is simpler than calculating actual expenses.

The inequity of singling out one type of charitable work for a higher mileage rate could be addressed by allowing the IRS to adjust the mileage rate for all charitable driving as it is allowed to do for medical, moving and business driving. This would result in an increase from 14 cents per mile.

To help identify which charities meet the H.R. 499 definition, the IRS could require eligible charitable organizations to note on Form 990 that their work involves having volunteers deliver meals to the elderly, disabled, frail and at risk. This information could also be included on the IRS website for verifying the status of organizations (Exempt Organizations Select Check - <http://www.irs.gov/charities/article/0,,id=249767,00.html>).

Simplification and administration would also be enhanced by using terms already used in the law, such as IRC Section 170(e)(3) and Reg. §1.170A-4A for certain donations of inventory and other property to the "ill, the needy, or infants."

H.R. 499 does not appear to be well targeted to address its intended purpose. Because the mileage rate is only allowed for individuals who itemize deductions, not all volunteers will benefit. Thus, it does not help the charities get more volunteers. An alternative, outside of the tax law, would be to allocate funds for the affected charities to which they could apply. The charities awarded the mileage grants could use the money to reimburse volunteers for their gasoline purchases. Consideration would also need to be made as to whether the volunteers should be given the option of taking the gasoline money and foregoing any mileage deduction or still being allowed to claim 14 cents per mile.

## Election by Certain Individuals to Have Their Income Tax Return Prepared by the IRS

By: MST Students in Fall 2011, BUS 223A Tax Research Class, Fall 2011

H.R. 1069 (112th Congress) proposes to amend IRC Section 6020, *Returns prepared for or executed by Secretary*, to allow certain unmarried individuals who claim the standard deduction (rather than itemizing deductions) to have their income tax return prepared by the IRS. Individuals using the surviving spouse or head-of-household filing status would not be eligible to make the election. Also, individuals with gross income from a trade or business may not make the election.

An individual making the election can still opt not to have the IRS-prepared return filed. Per H.R. 1069, the IRS "may not use either the election or failure to sign in any way that disadvantages the taxpayer."

The IRS must report to Congress by August 31, 2013, how many returns were prepared under the new rule, whether the program should be expanded to include other taxpayers, and whether any changes are needed.

The sponsor of H.R. 1069, Congressman Jim Cooper (D-TN), states that the purpose of the proposal is to simplify compliance for individuals and utilize information the IRS already has. Per the sponsor: "Make the IRS do your paperwork. They already have much of your tax information like copies of your W-2 and 1099s. Today they use that information to catch you if you make a mistake. Why not get the IRS to use that information to help you instead of punish you?"<sup>60</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 Proposals*, to analyze H.R. 1069.

### Principles of Good Tax Policy Evaluation

Principle	Application	+/-
<b>Equity and Fairness</b> Similarly situated taxpayers treated similarly.	Within the narrowly defined category of eligible taxpayers - single (other than those using either the head-of-household or surviving spouse filing status), claiming the standard deduction and without gross income from a trade or business, taxpayers are treated the same, regardless of income level. However, not all individual taxpayers with similar income levels are treated similarly. For example, an individual with \$50,000 of wage income may take	+/-

<sup>60</sup> Congressman Cooper press release of March 15, 2011; available at [http://cooper.house.gov/index.php?option=com\\_content&task=view&id=456&Itemid=73](http://cooper.house.gov/index.php?option=com_content&task=view&id=456&Itemid=73).

	<p>advantage of the election to have the IRS prepare her return, but an individual with the same income who claims the head-of-household filing status, may not make the election. Some of the inequity can be excused though because H.R. 1069 is a trial measure as indicated by the fact that it is a new program and the IRS must report on its effectiveness after one year and the feasibility of extending the program to other taxpayers.</p>	
<p><b>Certainty</b> 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.</p>	<p>H.R. 1069 does not include the details of how and when the election is to be made, how to ensure that a return is filed and how individuals submit information, such as eligibility for certain credits and special reporting requirements. For example, a spouse in a same-sex marriage in a community property state is required to report one-half of each spouse's community property income and withholding on a return and is not allowed to file as married for federal income tax purposes. Guidance would be needed as to how the information needed by the IRS to prepare the returns would be submitted.</p> <p>Guidance will also be needed on how the IRS obtains information from electing individuals on their sales of capital assets.</p> <p>The IRS will also have to provide guidance on what income from a trade or business means. Does that include a sole proprietorship, a farm, an interest in a partnership or S corporation, a rental property, or any income for which a W-2 or 1099 is not issued?</p>	-
<p><b>Convenience of Payment</b> A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer.</p>	<p>Presumably, individuals would pay their tax in the same manner as without H.R. 1069. If the IRS handles the filing for an individual, but does not also handle calculation of estimated tax payments (if any) for the subsequent tax year, individuals may have large liabilities and penalties when they file the subsequent year's return.</p> <p>H.R. 1069 allows participating individuals the choice of filing the IRS prepared return or preparing their own. Depending on how long it takes for the IRS to provide the return to electing taxpayers, such taxpayers may not have enough time to prepare their own return should they decide to do so after seeing the IRS return. While they can file an extension of time to file, they may need more time to determine how much (if any) they owe to the IRS or may face burdens in getting an extension filed.</p>	+/-

<p><b>Economy in Collection</b></p> <p>The costs to collect a tax should be kept to a minimum for both the government and taxpayers.</p>	<p>Costs will increase for the IRS as they will require more employees and computing capacity to prepare returns and communicate with electing taxpayers. The IRS will also need to issue guidance on how to make the election and provide necessary information to enable the IRS to complete a return.</p> <p>Preparation costs should go down for electing individuals. Per H.R. 1069 sponsor Congressman Jim Cooper (D-TN): "It is estimated that around 40 million Americans would be able to use this service saving \$2 billion in preparation fees and 225 million hours of preparation time. Converting that time into money, it is estimated that savings could reach \$44 billion over 10 years."<sup>61</sup></p> <p>Some opponents of IRS prepared returns observe that costs to providers of information, such as employers and financial institutions may go up if Congress were to advance the due date for information returns in order to allow the IRS time to prepare the returns.<sup>62</sup> H.R. 1069 does not propose to change due dates for filing of information returns.</p>	+/-
<p><b>Simplicity</b></p> <p>The tax law should be simple so that taxpayers can understand the rules and comply with them correctly and in a cost-efficient manner.</p>	<p>Compliance should be simplified for electing individuals. However, some complexity may exist if an individual does not know if they are ineligible because they qualify for head-of-household status or should be itemizing deductions. Also, since the system is not in place, it is unknown whether the process of individuals providing the information to the IRS and interacting with the IRS will be simple. Given complexity of some notices that the IRS sends to taxpayers and the lack of one responsible person for a taxpayer to interact with, it is possible that individuals may find it difficult to comply with what the IRS requires of them to participate in the H.R. 1069 program.<sup>63</sup></p> <p>The aim to simplify and improve compliance will not be fully realized by all participating individuals as many will also need to file state income tax returns.</p>	+/-

<sup>61</sup> Congressman Cooper press release of March 15, 2011; available at

[http://cooper.house.gov/index.php?option=com\\_content&task=view&id=456&Itemid=73](http://cooper.house.gov/index.php?option=com_content&task=view&id=456&Itemid=73).

<sup>62</sup> See letter provided to the Senate Finance Committee by Joseph Cordes, Professor of Economics at The George Washington University and Arlene Holen, Senior Fellow at the Technology Policy Institute, 4/25/11; available at <http://www.techpolicyinstitute.org/files/comment%20to%20senate%20finance1.pdf>.

<sup>63</sup> For example, in the 2011 National Taxpayer Advocate report to Congress, it is noted that about 78% of examinations are conducted by correspondence. The report notes that such examinations occur "in a highly automated campus setting where no single IRS employee was responsible for the audit, making it more difficult for the taxpayer to communicate with the IRS about his or her case." IR-2012-6 (1/11/12); <http://www.irs.gov/newsroom/article/0,,id=252284,00.html>.

<b>Neutrality</b> 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.	To be effective, H.R. 1069 must change taxpayer behavior to encourage eligible individuals to have the IRS prepare their return, rather than preparing them on their own, purchasing tax preparation software, using a VITA site, <sup>64</sup> or hiring a paid return preparer.	—
<b>Economic Growth and Efficiency</b> The tax system should not impede or reduce the productive capacity of the economy.	The H.R. 1069 tax preparation proposal will result in some loss of revenue for return preparers as well as for companies selling tax preparation software. Given the small subset of eligible taxpayers and the reality that not all will take advantage of the IRS preparation services, the effect is likely to be low.	+/-
<b>Transparency and Visibility</b> Taxpayers should know that a tax exists and how and when it is imposed upon them and others.	The IRS will need to find ways to let individuals know of the new preparation program and how to participate. Because the IRS no longer mails tax forms and instructions to taxpayers, it may be challenging for the IRS to find effective ways to let individuals know of the program.	—
<b>Minimum Tax Gap</b> A tax should be structured to minimize non-compliance.	H.R. 1069 should result in a small decrease in the tax gap as it may improve compliance and better ensure that all of the W-2 and 1099 forms an individual receives are reporting on the return and that any deductions or credits are properly computed and claimed.  The program may result in some individuals paying more tax than they owe (a reverse tax gap effect) because they may not know of special deductions or credits or filing status they are eligible for unless the IRS is able to incorporate some type of questionnaire, for example, that helps individuals determine this information.	+/-
<b>Appropriate Government Revenues</b> The tax system should enable the	The government should be able to estimate the cost of creating a system whereby the IRS prepares returns for some taxpayer and the likely tax revenue to be collected.	+

<sup>64</sup> VITA stands for Volunteer Income Tax Assistance which is a program run by the IRS where trained volunteers prepare tax returns for primarily low-income individuals. See <http://www.irs.gov/individuals/article/0,,id=107626,00.html>.

government to determine how much tax revenue will likely be collected and when.		
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## Conclusion

The aim of H.R. 1069, reducing compliance costs for individuals and reducing the likelihood of missed reporting of W-2s and 1099s, seems laudable. Yet, there are many details to work out, such as creating a system to enable the IRS to notify eligible taxpayers and to prepare the returns timely and accurately.

Possible improvements to better enable H.R. 1069 to meet the principles of good tax policy include:

- Providing funding to the IRS to enable them to comply with the legislative proposal including being able to make eligible individuals aware of the program.
- Piloting the program first in states without an income tax so that the tax compliance burden of electing individuals is reduced. Should the system work, later expansion could be with states that allow a similar program so that individuals are more inclined to elect to use the system because both their federal and state income filing would be simplified.
- Incorporate a system to help individuals and the IRS preparers know if the individuals are eligible for preferential deductions, credits or filing status. Interactive tools similar to what the IRS currently uses, for example, to help individuals know if they are required to file, could be considered (<http://www.irs.gov/ita/>).
- Reduce the likelihood of individuals not knowing what W-2s and 1099s were issued to them but not received by having the IRS provide that information to them prior to filing with enough time for individuals to file. Such a system was proposed by IRS Commissioner Shulman in April 2011.<sup>65</sup>
- Simplify the individual income tax system to make it easier for individuals to file their returns on their own or for the IRS to do so without the need to gather numerous pieces of information.

<sup>65</sup> See remarks of Commissioner Shulman at the National Press Club, IR-2011-38 (4/6/11); available at <http://www.irs.gov/newsroom/article/0,,id=238204,00.html>.



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