The Contemporary Tax Journal

Volume 1
Issue 2 Summer 2011

6-2011

The Contemporary Tax Journal Volume 1, No. 2 ~ Summer 2011

Follow this and additional works at: http://scholarworks.sjsu.edu/sjumstjournal
Part of the Taxation-Federal Commons, and the Taxation-Transnational Commons

Recommended Citation
Available at: http://scholarworks.sjsu.edu/sjumstjournal/vol1/iss2/1

This Full Issue is brought to you for free and open access by the Graduate School of Business at SJSU ScholarWorks. It has been accepted for inclusion in The Contemporary Tax Journal by an authorized editor of SJSU ScholarWorks. For more information, please contact scholarworks@sjsu.edu.
Table of Contents

Letter from the Editor 4

Tax Enlightenment

Renovating? Donate Your Scrap and Get a Deduction 5
Real Estate Professionals: Beware 7

Articles

Character and Source of Income from Internet Business Activities 9

Call for Articles 18

TEI-SJSU High Technology Tax Institute 19

The State of Tax Policy in California Conference

Introduction 20
Understanding the California Economy 21
The California Business Climate 22
Principles of Sound State Tax Policy 23
The Challenged Relationship of California and Its Cities 25
Perspectives on the State of California's Budget, Tax Policy and Fiscal Reform 26
Relevance of the Feds 27
Looking Forward – The Final Session of the Conference 30

Tax Maven: Scott Hodge 32

Focus on Tax Policy 37

Repeal of the Telephone Excise Tax 38
Repeal of the IRC §199 Domestic Production Deduction 43
Applicability of VAT in the United States 48

Tax Maven: Annette Nellen 55
Letter from the Editor

I would like to congratulate all those who contributed to this, our second issue of The Contemporary Tax Journal, a publication of the SJSU MST program. It is incredibly exhilarating to be a part of the creation of a new journal that has brought together the perspectives of students, faculty and colleagues both from within and without academia. As we aspire to ascend the ranks to join the highly regarded collection of academic and practitioner tax journals, it is with great honor that we come to you with roots seeded in the SJSU MST program. As we proceed to further issues, we intend to bring you contemporary tax information from policymakers, practitioners, students and professors.

In this issue, we are pleased to have an article by tax experts from Fenwick & West that fits our "contemporary" focus, exploring a growing issue related to Internet activities and cloud computing concerning the character and sourcing of transactions. In addition, we present two student articles. Shreyasee Patil contributes a piece in which real estate professionals are sure to be interested in. She discusses the material participation test and time commitment requirements that real estate professionals need to know in order to produce active losses from rental real estate. This issue also introduces a “green” theme which we hope to continue in future issues of the Journal. Victoria Lau explains how to achieve the “trifecta” of helping the environment, donating building materials to charity and receiving tax deductions, all while one is renovating a residence or commercial building.

For a better understanding of the tax and fiscal problems facing California and its cities, you will be interested to read our summaries of the TEI-SJSU sponsored ‘State of Tax Policy in California Conference’. Many of the issues facing California are similar to those in the other forty-nine states. Our new “Tax Mavens” section profiles leading individuals in the field of tax. Find out who has a photographic memory and who thinks the Cubs will win the World Series before California overcomes its fiscal challenges! In our Focus on Tax Policy section, you will find three new additions to our library of tax proposals analyzed using the AICPA's ten principles of good tax policy. We hope you find this issue of the Journal both informative and enjoyable.

Finally, bringing this issue to fruition was a delicious and rewarding experience. We owe a very special thanks to Professors Annette Nellen and Bobbi Makani for their tireless efforts and guidance; they are the glue that keeps it all together. To the founding student editor, Ankit Mathur, we are deeply grateful for his continued support, innovative ideas, and entrepreneurial spirit. In addition, I would like to add that work has already begun on the next issue, a testament to the near and long-term viability for the Journal. Heck, we’ve lasted longer than a lot of start-ups! Stay tuned!

All the best,

Tim Kelly
Student Editor
Tax Enlightenment

Renovating? Donate Your Scrap and Get a Deduction

By: Victoria Lau, CPA, MST Student

While most would agree the general public is familiar with the tax benefits of a charitable donation of cash, household goods or vehicles, it is highly likely that only a minority knows that a charitable donation of used building material like wood flooring, cabinets or countertops can also generate a deduction.

Many charities build and renovate homes for the needy. They welcome contributions of used building material in suitable condition to support their work. Think about it. You help the charity with the donation, you get a tax deduction and you save the environment by recycling too! This article covers the basics of how to achieve this trifecta of benefits.

How much you can deduct depends on the *fair market value* of the material you donate when you donate it. The IRS says *fair market value* is the price a willing buyer will pay to a willing seller. If there is no ready market to price the building material, there are accepted methods to determine the *fair market value*.

Extra costs that you may incur to prepare the material for donation are factored into the *fair market value*. For example, your contractor may spend more time to carefully remove flooring or cabinets so they are in better condition for reuse; however you cannot deduct any additional costs that result as part of the charitable contribution.

If the charity removes the scrap material for you, your deduction is reduced by the market price of scrap removal. The law says that the value of a donation must be reduced by any services or benefits provided by the charity. As such, when a charity removes the scrap for you, a deduction for the donation is only available when the value of your donated material exceeds the fair price of scrap removal.

As a general rule, tax deductions are only allowed if certain requirements are met. The laws on charitable contributions, including those of building materials, are no different. In general, as the amount of the charitable donation increases, the record keeping requirements related to those donations become more rigorous.
Set out below are the incremental requirements as the value of your donation increases.

<table>
<thead>
<tr>
<th>Less than $250</th>
<th>Keep record of the donation including the fair market value of the donated material.</th>
</tr>
</thead>
<tbody>
<tr>
<td>$250 to $500</td>
<td>Obtain receipt from the charity</td>
</tr>
<tr>
<td>$501 to $5,000</td>
<td>Complete Form 8283 (Section A) “Noncash Charitable Contribution”</td>
</tr>
<tr>
<td>Over $5,000</td>
<td>Obtain qualified written appraisal by qualified appraiser and complete Form 8283 (Section B) “Noncash Charitable Contribution”</td>
</tr>
</tbody>
</table>

(For more details on the documentation, see IRS Publication 526, Charitable Contributions.)

Focusing on charitable donations over $5,000, you must engage a qualified appraiser to determine the fair market value of the material at the time of the donation. The qualified appraiser must hold a professional designation from a recognized appraiser organization or meet minimum education and experience requirements. Further, the qualified appraiser must also demonstrate the experience in appraising the specific type of material you are donating. As such, if you are donating various building materials, you may need more than one appraisal. Material of the same generic category can be assessed in one qualified appraisal; otherwise, separate qualified appraisals and tax forms are required.

The results of the appraisal must be documented and retained as part of your tax records. An additional form must also be completed with your tax return. This form must be signed by the charity to acknowledge its receipt of the donation. The form must also be signed by the appraiser to verify his/her experience, qualification and independence as well as to acknowledge that he/she is aware that a false or fraudulent overstatement may result in civil penalty. It is best to complete this form when you make the donation and when the appraisal is performed.

Keep in mind that your deduction may be disallowed if the appraiser charges you a fee contingent on the appraised value. Also be advised that while a taxpayer can deduct the appraisal fees as a miscellaneous itemized deduction, it is one of many deductions subject to the 2% limitation of your adjusted gross income (AGI).

The type of charity to which you donate limits your annual deduction. A deduction of 50% of your adjusted income in the tax year that you make the donation is generally available. You can check IRS Publication 78 to determine the limitation percentage that applies to your charity. Unused amounts can be carried forward up to five years.

Keep donation of scrap in mind when you renovate. While it requires additional paper work and likely an appraisal, you will be taking part in a trifecta of benefits; the charity receives much needed building material through your charitable donation, you get a tax deduction and the environment is better off through your act of recycling.
Real Estate Professionals Beware

By: Shreyasee Patil, MST Student

We frequently hear the expression "Let the buyer beware." Well, we can draw an analogy from that phrase for certain real estate professionals. These folks are eligible to deduct their rental real estate losses against income from all other sources assuming no other tax-law limitation prevents this favorable outcome, but they should be cautious that they satisfy all the requirements of this special passive activity loss limitation rule (the rule is in the Internal Revenue Code at Section 469(c)(7)).

In a nutshell, to qualify as a “real estate professional" and obtain benefit of the special rule, the individual must:

1) Meet two time commitment thresholds by spending:
   a) More than 50% of work time in real property trades or businesses, and
   b) Over 750 hours/year in real property trades or businesses, and
2) Satisfy a material participation test for each rental real estate activity (or have timely elected to group these activities so as to meet a material participation test).

A real property trade or business is defined as "any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business."

Generally, an individual would want to be a real estate professional to be able to produce active losses from rental real estate that otherwise would be passive activity losses. Passive activity losses are only usable against passive activity income (they cannot be used against wages and investment income).

With this basic background, let's look at a recent case, Todd D. Bailey, Jr., et ux. v. Commissioner, TC Summary Opinion 2011-22, where the taxpayer failed to meet the time threshold requirements.

Just the Facts

Todd D. Bailey, Jr. and Pamela J. Bailey were married and filed joint tax returns. Todd, a physician, and his wife Pamela jointly owned three rental properties which Pamela operated personally without employing a management company. Todd did not participate in the rental activities. The summary of Pamela’s hours in her real estate activities for 2004 was as follows:

<table>
<thead>
<tr>
<th>ACTIVITY</th>
<th>HOURS</th>
<th>RENTAL PERIOD</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alisal Road Inn</td>
<td>324</td>
<td>About 3 days at a time</td>
</tr>
<tr>
<td>Second Street property</td>
<td>358</td>
<td>Year-to-year tenants</td>
</tr>
<tr>
<td>Existing Boise property</td>
<td>24</td>
<td>Rented for all of 2004</td>
</tr>
<tr>
<td>New Boise property</td>
<td>105</td>
<td>Not rented</td>
</tr>
<tr>
<td>Researching potential acquisitions</td>
<td>192</td>
<td></td>
</tr>
<tr>
<td>Grand total for all properties</td>
<td>1,003</td>
<td></td>
</tr>
</tbody>
</table>
Court's Analysis

The wife satisfied the time threshold test of spending more than half of her time in real property trades or businesses. However, the IRS did not find that she performed more than 750 hours of services in “real property trades or businesses” during 2004 considering she made the election to combine all of the rental properties into one activity.

If the wife can include the hours she spent on the Inn, then she easily satisfies the 750-hour time threshold requirement because she spent 1,003 hours on all of her real property trades or businesses for the year. If the hours spent on the Inn do not count, then she does not satisfy the 750-hour requirement and would not qualify as a real estate professional. As a result the net loss from her rental real estate would not be deductible in 2004 as it would be a passive activity loss to be carried forward to future years when she has passive activity income.

The wife argued that the statute and its legislative history allows her to include her hours spent on the Inn, because the statute describes a “real property trade or business” to include any real property rental.”

The IRS counter-argued by pointing to a regulation that provides the following exclusion: “an activity involving the use of tangible property is not a rental activity” for a year if, among other reasons, “the average period of customer use for such property is seven days or less” during the year (Reg. Sec. 1.469-1T(e)(3)(ii)(A)). The parties agreed that the average period of the guests' use of the Inn in 2004 was 3 days. Therefore, the IRS contended that for passive activity purposes for 2004, the wife must exclude hours spent on the Inn from her other rental real estate activity hours.

The court stated that the rationale for segregating the wife's hours is consistent with the disparate reporting of activities, as the Inn is reported on Schedule C. Managing a property with a short rental period is similar to running a business and the other rental real estate activities are reported on Schedule E as a separate and distinct activity. The statute's legislative history reinforces this rationale. In explaining the then-new passive activity loss rules, a congressional tax committee report stated: “A passive activity is defined under the bill to include any rental activity, whether or not the taxpayer materially participates. However, operating a hotel or similar transient lodging, for example, where substantial services are provided, is not a rental activity.”

Conclusion

In summary, the 679 hours the wife spent in 2004 on all of her rental real estate activities excluding the Inn did not exceed 750 hours. Therefore, the wife is not a real estate professional. Consequently, these rental real estate activities are, per se passive (regardless of how many hours she spent in each of them or in the aggregate). Therefore the court supported the IRS disallowance for 2004 of the taxpayer's combined net loss of $16,822 from their Second Street and their existing Boise property.

Planning

For taxpayers to be able to avail themselves of the benefits of being a real estate professional they should plan early and focus on what they can do with their time before year-end to lock in eligibility by working more hours in the rental real estate activities or having people stay longer in real estate rentals so they are considered rentals rather than trades or businesses.
Article

Character and Source of Income from Internet Business Activities

By: Andy Kim, Larissa Neumann, Idan Netser and Jim Fuller
Fenwick & West LLP, Mountain View, CA, http://www.fenwick.com

Introduction

With the increasing interconnectedness of the global economy, the rapid advance of technology, and the ease with which information and services can move around the world, a clear understanding of the U.S. tax rules is vital to the long term success of any global technology-centered company. One of the most important issues in the taxation of U.S.-based multinational companies, particularly those companies that operate primarily in the internet business space, is the character and source of income.

For internet companies, as well as for other taxpayers, determining the character of income often involves trying to distinguish between income from the provision of services and income from intangible property (e.g., royalties). The determination of whether income should be treated as services income or income from intangible property will directly impact how such income will be taxed under the U.S. tax rules, including the application of the source of income rules. For U.S. companies, the source of income is particularly important in determining the extent to which a foreign tax credit can be claimed.¹ For foreign companies and for U.S. companies making payments to foreign companies, the source of income is important to determine whether certain income may be subject to U.S. withholding taxes or taxed as income that is effectively connected with a U.S. trade or business.²

---

¹ Section 904(a) of the Internal Revenue Code (the “Code”) operates to limit a taxpayer’s foreign tax credit to the amount of U.S. tax imposed against the taxpayer’s foreign source taxable income. Due to the mechanics of the § 904 foreign tax credit limitation, U.S.-based taxpayers prefer receiving income that is characterized as foreign source income.

² Non-U.S. persons generally are subject to U.S. taxation on U.S. source income that is considered fixed or determinable annual or periodical gains, profits, and income (e.g., interest, dividends, rents, royalties). §§ 871(a) and 881. Typically, taxation takes the form of a U.S. withholding tax. Thus, the U.S. payor of this income to a foreign person can become a withholding agent, with liability for a failure to withhold. Alternatively, a non-U.S. person’s U.S.-source income, such as U.S.-source services income, could constitute effectively connected income. §§ 871(b) and 882. Non-U.S. persons generally are not subject to U.S. taxation on foreign source income unless the income is considered effectively connected with the conduct of a U.S. trade or business. §§ 871(b) and 882.
Character of Internet-Related Income: Services Income or Royalties?

The rapid growth of internet-related businesses such as online advertising, cloud computing, data warehousing, and internet hosting, adds further significance to the question whether income generated from these activities should be treated as services income or income from the use of intangibles. Among other significant consequences, the characterization of income as services income or royalty income may affect a company’s ability to maximize its foreign tax credits, the amount of income to be immediately taxed under Subpart F of the Code, withholding tax rates, and the application of the § 482 transfer pricing rules.

Traditionally, the distinction between services income and income from the use of intangible property has hinged on whether the owner and the user of the intangible property are the same person. Income derived from permitting another person to use property with a share of the profits reserved by the owner generally results in royalty or rental income. In contrast, property used in connection with the provision of services is considered to be owned and used by the service provider, not the service recipient. The service provider may use its intangible assets in rendering the services, but keeps the assets.

Note, however, that if assets are produced from the rendering of the services, the service provider typically will not own the newly created assets. In this regard, the rendition of services usually involves the employment of capital and labor for the benefit of another, without the retention by the service provider of ownership rights or interests in the fruits of the services. R&D type services, for example, where it is the service recipient (not the service provider) that obtains

---

3 For this purpose, intangibles generally includes patents, copyrights, secret processes and formulas, goodwill, trademarks, trade names, franchises and other like property. §§ 861(a)(4), 862(a)(4).
4 See, e.g., Commissioner v. Wodehouse, 337 U.S. 369 (1949) (amounts received by the taxpayer for an exclusive copyright to the American market for stories to be written were royalties); Rev. Rul. 74-555, 1974-2 C.B. 202 (payments received by the taxpayer for the use of, or for the privilege of using, copyrights in the U.S. are royalties, and not compensation for labor or personal services, because the taxpayer did not give away control over what the taxpayer was to write or when it was to be written, but merely the right to publish the books or stories that were written.).
5 Boulez v. Commissioner, 83 T.C. 584 (1984) (payments received by taxpayer for conducting an orchestra were payments for the performance of personal services because taxpayer has no property interest in the fruits of his work, i.e., the recordings). Boulez highlights some of the problems in this area. Germany said the taxpayer received royalty income; the U.S. said the income he received was services income. He was taxed in both countries. The taxpayer unsuccessfully sought competent authority relief, but the countries’ competent authorities couldn’t agree. Thus, the taxpayer was forced to litigate, and lost again. Part of the taxpayer’s problem was that his contract wasn’t sufficiently clear as to the nature of his income. Cf. Goosen v. Commissioner, 136 T.C. No. 27 (2011) (“The characterization of petitioner’s on-course endorsement fees and bonuses [as services income or royalties] depends on whether the sponsors primarily paid for petitioner’s services, for the use of petitioner’s name and likeness, or for both. We must divine the intent of the sponsors and of petitioner from the entire record, including the terms of the specific endorsement agreement.”).
ownership of the intellectual property that is developed, are more in the nature of building (developing) property for the service recipient, and thus constitutes the rendition of services.

In determining whether income from internet related activities should be characterized as services income or income from the license of intangible property, it is helpful to consider § 7701(e), which sets forth a list of factors to consider in distinguishing between service contracts and leases. Section 7701(e), although enacted to provide guidance on the availability of certain investments credits, generally applies for all purposes of the income tax provisions of the Code. A services contract can be treated as a lease if certain requirements are met.

Under § 7701(e)(1), factors indicating the existence of a lease (rather than a services contract) include: (A) the service recipient is in physical possession of the property, (B) the service recipient controls the property, (C) the service recipient has a significant economic or possessory interest in the property, (D) the service provider does not bear any risk of substantially diminished receipts or substantially increased expenditures if there is nonperformance under the contract, (E) the service provider does not use the property concurrently to provide significant services to entities unrelated to the service recipient, and (F) the total contract price does not substantially exceed the rental value of the property for the contract period.

Applying these principles to internet related activities, it seems that income from activities such as cloud computing, data warehousing, database access, web-hosting transactions, and the like should be treated as income from services transactions rather than from the use of intangible property. In all of these activities, the operating company providing the service typically owns, controls, operates, and maintains the equipment on which the data or web site is stored. The operator provides customers with access to the equipment and software and the operator has the right to remove and replace equipment and software at will. Customers typically will not have possession of, control over, or any interest in, the equipment and software used. Moreover, customers use the equipment and software concurrently with other customers and pay a volume or time-based fee.

6 See, e.g., Karrer v. United States, 138 Ct. Cl. 385 (1957) (taxpayer's compensation for products developed as a result of the taxpayer's research is compensation for personal services and not royalties because the taxpayer did not own any intellectual property rights in developed products).

7 In 1998, the Treasury promulgated Treas. Reg. § 1.861-18 in an attempt to deal with the characterization of income from software transactions involving computer programs as royalty or sales income. See T.D. 8785, 1998-2 C.B. 496. The key question in this regulation is whether substantially all the rights in the copyright, including the right to freely distribute the copyright, are transferred. The right to freely distribute the article resembles complete control and ownership of the article. If substantially all the rights are transferred, the transaction is a sale. However, Treas. Reg. § 1.861-18 generally does not distinguish between services, royalty, and sales income, since the only services that are covered by the regulation are software programming related services. See Treas. Reg. § 1.861-18(b).

8 See JCT Explanation of the Deficit Reduction Act of 1984, JCS-41-84, at 59. Section 7701(e)(1) reversed a prior case which the government had lost: Xerox Corp. v. United States, 656 F.2d 659 (Ct. Cl. 1981).
The Organization for Economic Co-operation and Development (the “OECD”) also regards income from such activities as services income. The same conclusion can be reached with respect to targeted online advertising. Although targeted online advertising entails the use of intangible property (e.g., search and matching algorithms, and valuable end-user data), the proper treatment of this income should be services income. A company that provides online internet advertising provides valuable sophisticated advertising services that allow advertisers to reach a particular audience. In this regard, an advertising customer generally pays for the dissemination of advertisements to particular users of a given web site, rather than for the customer’s use of end-user data.

In the seminal case of Piedras Negras Broadcasting Co. v. Commissioner, 43 B.T.A. 297 (1941), nonacq., 1941-1 C.B. 18, aff’d, 127 F.2d 260 (5th Cir. 1942), the court found that the situs of the taxpayer’s advertising activities were at the location of its broadcasting facilities in Mexico. Although the court did not have to rule on the character of the income (since both rental income and services income would have been sourced in Mexico), both the Board of Tax Appeals and the Fifth Circuit looked to the broadcasting equipment (i.e., capital) and efforts (i.e., labor) for the determination of the situs of the taxpayer’s income producing activities.

The court’s focus on the location of the broadcasting equipment and labor indicate that these activities should be characterized as services. The location of the broadcaster’s audience (largely in the U.S.) was not a relevant consideration even though advertisers paid for access to that audience. The Fifth Circuit stated that “all services required of the taxpayer under the contracts were rendered in Mexico.” Certain incidental activities in the U.S. – employees crossing the border to collect mail and meet with advertisers to get paid – and the solicitation of business in the U.S. by dependent (an employee) and independent agents did not change this conclusion since the compensation under the contracts was for the services performed in Mexico.

The Service’s holding in PLR 6203055590A (Mar. 05, 1962) provides further support for this conclusion. In PLR 6203055590A, the taxpayer sold advertising to U.S. advertisers for publication in a magazine to be distributed only outside of the United States. For purposes of determining the source of the taxpayer's advertising income, the Service only considered the sourcing rules under §§ 861 and 862 for compensation for labor or personal services. The Service characterized the payments to the taxpayer as “remuneration for its activities in disseminating their advertisements in its magazine published and distributed outside the United States.” According to the Service, the “source of the advertising revenue to be received by [the taxpayer] from the U.S. advertisers, is the capital and labor employed in the publishing and distributing centers [outside the United States] with and through them, [the taxpayer] will carry on the activities to produce the advertising revenue.” In other words, the taxpayer employed capital and labor for advertising, resulting in income from services.

10 See also Korfund Co. v. Commissioner, 1 T.C. 1180, 1187 (1943) (“The Piedras Negras Broadcasting Co. case . . . involved employment of capital and labor in a foreign country in connection with the rendition of service . . . .”).
11 127 F.2d at 260.
The OECD also regards income from online advertising activities as services income. As stated in the OECD Report, “All members of the Group agreed that the payments arising from [advertising] would constitute business profits falling under Article 7 [i.e., business profits] rather than royalties, even under alternative definitions of royalties that cover payments ‘for the use, or the right to use, industrial, commercial or scientific equipment.’”

Sourcing of Internet Services Income

In today’s internet-driven business space, activities such as online advertising, cloud computing, data storage, internet hosting, and customer support often can cross multiple national boundaries and pose a challenge to the application of traditional sourcing rules. As discussed above, the income derived from the activities generally should be treated as income from services, rather than income from intangible property.

General Sourcing Rule.

The general rule is that the source of income for services is the place of performance of those services. §§ 861(a)(3) and 862(a)(3). Traditionally, services have been performed by individuals located at easily identified physical locations. However, as services today increasingly involve multiple activities, personnel, locations, and technologies, determining the place of performance of services has become more challenging. Even with these added complexities, the basic source of income rules for services are still instructive in planning for today’s more complex business transactions.

The Piedras Negras case provides useful guidance in determining the source of income for high tech companies. As discussed above, the Piedras Negras case involved a foreign radio station located close to the U.S. border that broadcasted programming targeted primarily at U.S. listeners. The majority of the foreign radio station’s income was derived from U.S. advertisers. The studio and broadcasting plant were located in a foreign country (Mexico) and the employment of capital and labor was outside of the U.S. The Fifth Circuit stated that the source of income “is the situs of the income-producing service,” that is, the “services required of the taxpayer under the contracts.” Under these facts, the court held that there was no U.S. source income because the principal place of business was outside the U.S. and the labor and activities that produced the income were outside the U.S.

Piedras Negras continues to be relevant to high tech companies today because it addresses issues that arise when a multinational corporation provides complex services in multiple locations. Importantly, the case held that the location of the customer is not relevant in determining the source of income. Just recently, the Fifth Circuit in Container Corporation v. Commissioner, 2011 U.S. App. LEXIS 8961, at *4, 107 AFTR 2d 2011-1831 (May 2, 2011), cited the Piedras Negras case in determining the source of income for guaranty fees and stated that “[i]t is clear

12 OECD Report, supra note 9, at 28.
13 Section 861 sets forth significantly different source rules for services income from those from royalty income. Cf. §§ 861(a)(3) and 861(a)(4). Whereas the source of services income is generally the place of performance of the services (§§ 861(a)(3), 862(a)(3)), income from the use of intangibles, such as royalty income, is generally sourced to the place where the licensee uses or is entitled to use the property (§§ 861(a)(4), 862(a)(4)).
14 127 F.2d at 260-61.
that the source of payments for services is where the services are performed, not where the benefit is inured.”

Many internet companies, like search engines and social networking sites, earn a significant portion of their revenue from online advertisements. An interesting issue with advertisements is that the ad content is usually created by third party advertisers. Advertisers pay for access to potential customers, and they are willing to pay more money if they can be assured that an ad will reach either a large number of people or a selected target audience. To determine the situs of the income producing activity, the IRS or a court generally would apply a facts and circumstances test.

While the location of the servers could be one factor the IRS or a court would consider, the server location alone should not be a determinative factor for sourcing advertising income. Servers often can be located in different locations and are not necessarily the situs of the income producing activity. Server capacity also can be obtained from third parties and can be viewed as a commodity service that arguably does not add a significant amount of relative value. Further, server utilization can switch from one server to another based on capacity, possibly involving servers in different countries. Although one might equate servers to the broadcasting equipment used in the *Piedras Negras* case, the location of the broadcasting equipment was only one factor that was considered in the court’s analysis.

An OECD discussion paper states that in the context of stand-alone computer servers, the functional and factual analysis is likely to show that the server is “performing only routine functions and is reliant on other parts of the enterprise to provide the intangible assets necessary for it to perform most, if not all, of those functions.” Accordingly, the OECD Paper states the activities of the servers are very unlikely to warrant being attributed a substantial share of the profit. The OECD Paper also notes that where personnel are present “to perform maintenance and online services tasks, the quantum of the profit attributable to the permanent establishment would be commensurate with what independent service providers would be expected to earn in a similar situation.”

Since source of income is determined according to the location where the income producing activity occurs (i.e., the location of the services required under the contract), the location of the employees that provide the service and the property used in the service are relevant. If all of a company’s employees and property are located in a foreign country, it normally should be easy to conclude that the source of compensation for services should be outside the U.S. However, additional questions can arise when contributions to the service are provided by third parties.

Contributions to Services from Third Parties.

Complexities can arise when a service provider contracts with related and unrelated parties to perform some or all of the activities necessary to provide the service. Since multinational corporations contract with various related and unrelated entities in various locations, taxpayers should be mindful of situations in which the activities of certain agents could be attributed to the principal for purposes of applying the source of income rules.

---


If a dependent agent conducts activities in the U.S. on behalf of the principal, income earned by the principal but which is generated in part by that agent’s activities could be deemed U.S. source income to that extent. Conversely, if a dependent agent is located in a foreign jurisdiction, then the income potentially could be classified as foreign source services income. However, the activities of independent agents and entities otherwise dealing with the principal at arm’s length generally should not be attributable to the principal and should not affect the source of the income. Further, the fact that a parent and its subsidiary, or two subsidiaries, contract with each other for the provision of services should not automatically create a relationship that would affect the source of income.

In *Miller v. Commissioner*, 73 T.C.M. (CCH) 2319 (1997), aff’d, 166 F.3d 1218 (9th Cir. 1998), the Tax Court held, and the Ninth Circuit affirmed, that services performed by a subsidiary did not create U.S. source income for the foreign parent company in that the relationship between the subsidiary and the parent was essentially no different from that of an unrelated independent contractor. In *Miller*, a foreign corporation was paid by U.S. entities to perform research and development. The foreign corporation subcontracted all of the research and development work to certain related and unrelated entities, including its wholly owned U.S. subsidiary. Since the foreign corporation did not itself perform services in the United States, the court held that there could not be any U.S. source income attributable to the foreign corporation.

In reaching its conclusion in *Miller*, the court found that there was no evidence requiring the court to disregard the corporate form of the U.S. entity. The court treated all transactions between the parent and the subsidiary as being conducted at arm’s length. Even though the U.S. company was a wholly-owned subsidiary of the foreign corporation, it was doing business under its own name as a separate distinct entity and thus the activities of the U.S. subsidiary did not cause the foreign parent corporation to have U.S. source services income. The court stated that in order for the foreign parent corporation to be considered as having U.S. source income by virtue of the performance of services, the foreign corporation itself would have to perform the services through agents or employees of its own. Even here, however, the relevant services should be limited to those services that are required of the taxpayer under the contract, as noted by the Fifth Circuit in *Piedras Negras*.

Based on the principles established in *Miller*, a subsidiary’s provision of services should not be attributed to a different entity in the group in determining the source of that entity’s services income provided that the corporate identity of the subsidiary is respected, the activities are conducted on an arm’s length basis, and the relationship is no different from that of unrelated independent contractors. Both entities

---

17 73 T.C.M. (CCH) at 2323 (“The fact that a lower tier corporation performs some services in the United States is insufficient to support a conclusion that its higher tier parent corporation also performs services in the United States. The two corporations are and should be treated as separate persons unless one corporate form is a sham.”).
should have real operations and exercise a measure of autonomy.\textsuperscript{18}

The Supreme Court in \textit{Commissioner v. Bollinger}, 485 U.S. 340 (1988), established a clear bright line test for when the tax consequences of property held by an agent will be attributed to a principal. This same test could be useful in identifying situations in which the activities of a genuine agent may be attributed to a principal for income sourcing purposes. In \textit{Bollinger}, the Court held that losses generated by apartment complexes that were registered in the name of certain corporations were attributable to the principal because the corporations owned the apartment complexes merely as agents of the principal. The Court held that the activities (in this case, ownership of the apartment complexes) of one corporation should be attributed to another: (1) when the fact that the corporation is acting as an agent is set forth in a written agreement, (2) the corporation functions as an agent and not a principal, and (3) the corporation is held out as an agent to third parties.

The Court reconciled its holding in \textit{Bollinger} with an earlier case, \textit{National Carbide Corp. v. Commissioner}, 336 U.S. 422 (1949),\textsuperscript{19} stating that the parent’s control over its subsidiaries does not establish the existence of an agency relationship and that agreements to pay the parent all profits above a nominal amount are not determinative since income must be taxed to those who actually earn it without regard to assignment.\textsuperscript{20}

\textsuperscript{18} The Supreme Court has maintained that the corporate entity doctrine serves a useful purpose in business life, and that a corporation will remain a separate taxable entity as long as the corporation carries on a business purpose. In \textit{Moline Properties, Inc. v. Commissioner}, 319 U.S. 436 (1943), the Supreme Court held that a corporation is a separate entity and not an agent of its stockholders. However, the Court noted that the corporate form may be disregarded when it is a mere sham or unreal. In \textit{Moline Properties} the Supreme Court held that there was neither an agency contract, nor the usual incidents of an agency relationship, and that the mere existence of a corporation with one or several stockholders did not make the corporation the agent of its stockholders.

\textsuperscript{19} The Court in \textit{National Carbide} held that certain subsidiary corporations were not acting as genuine agents of the parent corporation, and therefore the subsidiaries were required to recognize the full income earned from their respective operations (rather than treating the income as directly belonging to the parent corporation).

\textsuperscript{20} The Second Circuit in \textit{Le Beau Tours Inter-America, Inc. v. United States}, 547 F.2d 9 (2nd Cir. 1976), aff’g 415 F. Supp. 48 (S.D.N.Y. 1976), attributed the activities of a parent corporation to its subsidiary for purposes of determining the source of the subsidiary’s services income. This decision is of questionable validity. The taxpayer in \textit{Le Beau Tours} organized vacations in Latin America for U.S. tourists and claimed that all of its income was from foreign sources because it received its income by making these arrangements in foreign countries for overseas travelers. The U.S. parent corporation performed activities in the U.S. such as advertising and other administrative functions. The taxpayer asserted that its activities only generated foreign source income because the activities performed by the U.S. parent generated U.S. source income only for the U.S. parent. The court recognized that a corporation may divide its business by forming a separate subsidiary. However, the court stated that the U.S. corporation was created for the sole benefit of the Latin America operations. The Second Circuit’s decision in \textit{Le Beau Tours} cannot easily be reconciled with the Supreme Court’s decisions in \textit{Moline Properties} and \textit{Bollinger}. Based on the Supreme Court’s decision in \textit{Moline Properties}, the court in \textit{Le Beau Tours} should have treated the U.S. corporation as a separate distinct entity unless it was a sham operation. According to \textit{Bollinger}, decided after \textit{Le Beau Tours}, the court in \textit{Le Beau Tours} should not have disregarded the separate corporate entity for tax purposes unless the corporation was an agent and held itself out as an agent to third parties. \textit{Miller}, also, is contrary to \textit{Le Beau Tours}.
Although issued prior to *Bollinger*, a technical advice memorandum issued by the Service also is relevant. With facts very similar to those in *Piedras Negras*, the Service held in TAM 8147001 (Jan. 3, 1979), that no agency relationship existed between a foreign corporation, which owned a radio station in a foreign country, and its owner, a U.S. corporation. The U.S. corporation was not the foreign corporation’s exclusive agent and the foreign corporation did not exercise any control over the U.S. corporation’s activities. Further, the foreign corporation did not require that the U.S. corporation only sell radio time on behalf of the foreign corporation’s radio station. Based on these facts, the Service concluded that the source of income was from sources outside the U.S.

In light of this authority, multinational internet businesses should be mindful of how they contract with related and unrelated parties to provide any activities that are necessary to generate the principal’s profits. The characterization of agency relationships, the corporate form, and the agreements are critical to effective international tax planning generally, and the sourcing of income in particular.

**Conclusion**

The character and source of income are important components of any multinational tax planning effort. However, identifying the proper character and source of income for companies that operate in today’s high tech business environment, including internet-related businesses, can be especially important given the ease with which technology and services seemingly can cross national boundaries.

To minimize the likelihood of disputes with both U.S. and foreign tax authorities concerning the character and sourcing of services income, taxpayers are well-advised to clearly specify not only the scope of any rights that are being provided (or not provided) as part of the services, but also the location(s) in which the services are to be performed. Provided that the contract terms reasonably reflect the actual rights and services being provided, having such contract terms in place may go a long way towards avoiding unnecessary surprises and disputes concerning the tax treatment of services income.21

**About the authors**

Andy Kim and Jim Fuller are partners, and Larissa Neumann and Idan Netser are associates in the Mountain View office of Fenwick & West, LLP. Jim Fuller is also a member of the San José State University MST Program’s Tax Advisory Board and a frequent speaker at the TEI-SJSU High Tech Tax Institute. For more information about the authors and Fenwick & West, visit [http://www.fenwick.com](http://www.fenwick.com).

---

21 *Cf. Goosen v. Commissioner*, 136 T.C. No. 27 (2011) (“The contracting parties to the transaction have the burden of making a reasonable allocation of the royalty income between the U.S. and foreign sources.”)
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:
Winter Issue:  Deadline October 1
Summer Issue: Deadline April 1

For more information on the article submission process, please see the submission link on our website at [http://www.sjsumstjournal.com](http://www.sjsumstjournal.com). Thank you.
Since 1984, the Tax Executives Institute (TEI) and San Jose State University have sponsored the High Technology Tax Institute in Silicon Valley. The Institute's focus on relevant tax issues for hardware and software companies, as well as pharmaceutical, biotech, communications, and web-services companies makes it an invaluable, educational tax experience for accountants, attorneys, and corporate representatives who serve high technology companies.

Each Institute session is designed to foster the sharing of tax planning ideas and problem solving strategies at a level consistent with TEI's and San Jose State University's high standards for professional tax education. Lectures are presented by nationally and internationally recognized practitioners and government representatives who have practical experience of implementation.

Attendees are eligible for up to sixteen hours of continuing education credit depending on the requirements of their licensing body. MCLE credit for 14.75 hours has been approved by the State Bar of California.
Feature

The State of Tax Policy in California

A conference sponsored by the Tax Executives Institute, Inc. and SJSU College of Business

February 11, 2011

Topics covered:

Introduction
Understanding the California Economy
The California Business Climate
Principles of Sound State Tax Policy
The Challenged Relationship of California and Its Cities
Perspectives on the State of California's Budget, Tax Policy and Fiscal Reform
Relevance of the Feds
Looking Forward – The Final Session of the Conference

Introduction

On a beautiful Friday, February 11, 2011, the Santa Clara Valley Chapter of the Tax Executives Institute, Inc. and the MST Program within the Lucas Graduate School of Business at San José State University held a conference entitled, “The State of Tax Policy in California.” This conference was held in Palo Alto, California. Tax professionals, local government officials and policy-makers were in attendance and to present on topics including California's current economy, tax climate, tax policy and possible tax reforms.

We encourage you to read the seven conference session summaries that follow to gain a better understanding of California’s economic problems, possible solutions, and general guidance to avoid exacerbating the situation.
Understanding the California Economy

By: Linda Yung, *MST Student*

I was among the fortunate SJSU MST students who had a chance to attend the conference. The topic I selected to cover for *The Contemporary Tax Journal* was “Understanding the California Economy” presented by Nancy Sidhu, Ph.D. Dr. Sidhu is Chief Economist of the Los Angeles County Economic Development Corporation (LAEDC), a private non-profit organization committed to assisting business firms and promoting job growth in Los Angeles. LAEDC produces economic publications that focus on forecasts of national, regional, and industry trends. Dr. Sidhu’s analytical skills and experience have led to her many speaking engagements as well as appearances on network TV and radio stations.

In her presentation, Dr. Sidhu highlighted the economic recovery that is underway but emphasized that this recovery will be unlike the ones we had in the past. High unemployment might be a part of this recovery and many jobs simply might not return. In fact, many people still believe that the U.S. is still in a recession due to the high jobless rate.

According to Dr. Sidhu, while a number of key sectors are growing, construction, local government, and manufacturing are still weak. One reason for this might be related to the tighter lending standards now in place by banks, which has caused them to sit on much of the money that the Federal government made available to them in order to stimulate the U.S. economy. In California, the upturn started in 2010 but industry performances are mixed. For example, hotel occupancy rates are up but the room rates have remained stagnant. As another example, exports and imports are experiencing double-digit growth, as indicated by the numbers reported for “Total Cargo Handled at LA/LB Ports”. However, the increases are due to businesses that had previously reduced inventory on hand and are now buying to restock their inventory to handle the increased level of business. The real question is whether this growth can be sustainable. Furthermore, there has been a sharp decline in personal income and taxable sales, which in turn has a negative effect on the state budget. California tax revenues are cyclical in nature because the basis of the revenue is...
from highly cyclical sources: personal income tax and corporate tax revenue.

Economic Recovery: A Work in Progress

The United States and California have a long road to recovery and some important decisions to make. With the impacts of the federal stimulus program slowly declining, lawmakers will again need to revisit the spending issue. However, given that the new Congress is more fiscally conservative, recovery will most likely happen in the private sector. As indicated by Dr. Sidhu, all is not lost though; new innovations are continually being developed especially here in Silicon Valley. Further hope can be derived from the green movement, which is on track to not only help the environment but also generate new jobs. The overall 2011 economic outlook is positive even if it is slow and steady.

The California Business Climate

By: Tim Kelly, Journal Editor, MST Student

Announcing they were the “grim” panel of the day, Scott Hodge, President of the Tax Foundation, Dan Kostenbauder, Vice President – Tax Policy at Hewlett Packard, and Ray Rossi, Director of External Tax Affairs for Intel Corporation discussed various issues relevant to California’s tax structure and how it affects its business climate.

Mr. Hodge got things started with a presentation titled “California Dreaming: A More Competitive Tax Climate?” A series of slides laid out a rather “grim” trend that does not bode well for California. Since 2000, California has lost 346,000 taxpayers to other states, mostly to Arizona, Oregon, Nevada and Texas. This exodus represents a loss of $26.3 billion adjusted gross income from the tax base. These losses also negatively affect other tax regimes such as property and sales. With a corporate tax rate of 8.84%, personal income tax rate as high as 10.55% and sales tax rates averaging 9.06%, Mr. Hodge asserted that California rates are among the nation's highest.

Using a method that looks at over 100 factors to assess the structure of a state’s tax system, California ranks 49th on the Tax Foundation's State Business Tax Climate index. In addition, if you combine the federal and state corporate income tax, businesses in California face a higher rate than competitors in most OECD countries, China and Japan. What does Mr. Hodge suggest? (start looking for jobs in any other state -- except Illinois. Run now and don't look back, see interview in Tax Mavens.) He suggested following an approach similar to Colorado and Utah and
lowering the corporate and individual rates to a uniform 5% and broadening the tax base by eliminating special incentives. Mr. Hodge noted studies from the OECD and others that indicate lower rates can lead to economic growth and may also encourage inbound foreign investment. He also cited research that places 45%-75% of the economic cost of corporate taxes on workers (suggesting that lowering rates will benefit workers). An additional point was made, that when capital flees, labor doesn’t because labor is not as mobile.

Taking a somewhat less “grim” outlook, Mr. Rossi countered with some relevant points from the perspective of a CFO looking at investing in California. From a micro view, states need to offer incentives to targeted industries if they want them to locate in their state. Research tax incentives are important not only to differentiate between states but also to help compete globally. Mr. Rossi commented that California has a “first class” R&D credit. Additionally, targeted property and sales tax incentives are also critical to a CFO’s decision to invest in plant and equipment in a given state. He also pointed out that California tax rules generally conform well to federal tax rules and that California tax administration is better relative to other states. Businesses located in California will pay less to resolve compliance issues compared to other states. Mr. Rossi concluded, “Uncertainty is the enemy of good business decisions.”

Staying true to form, this panel's negative observations rolled over the positives for the future of California’s business climate. They went home with the “Grim Panel of the Day” award. Judging from the response to the poll questions taken at the beginning and end of the conference (see Looking Forward, below) this panel’s message dramatically changed the views of the attendees at the conference.

### Principles of Sound State Tax Policy

**By: Sylvia Han, MST Student**

Professor Annette Nellen, CPA, Esq. Director of MST program of SJSU, as well as an organizer and host of this conference, gave a presentation on the principles and concepts of sound state tax policy.

Ms. Nellen’s presentation was based on the AICPA’s ten principles of good tax policy and the National Conference of State Legislature's (NCSL) nine principles of a high-quality revenue system. Those principles are summarized in the following table:
Ms. Nellen also incorporated the perspective of other groups’ points on this topic. The Joint Venture: Silicon Valley Network groups the AICPA’s ten principles into three categories: fairness, operability and appropriate purpose and goals. The Congressional Joint Committee on Taxation focuses on four questions to evaluate whether proposals represent good tax policy:

- Does the tax system promote or hinder economic efficiency?
- Is the tax system fair?
- Is the tax system simple?
- Is the tax system manageable?

The Government Accountability Office (GAO) adopted three criteria for evaluating tax policy: equity, economic efficiency and a combination of simplicity, transparency and manageability.

Ms. Nellen pointed out that although different tax authorities may use different terminology or have a different focus on their guidance in designing a tax system, the principles are typically the same. By nature, it is difficult for tax rules to meet all principles of good tax policy equally. In reality, a few may not be met in which case it is important to determine if other principles compensate to bring a good balance. The goals of tax reform include enhancing equity and fairness without creating complexity, reducing possibilities of both
purposeful and inadvertent errors, making sure the public understands the laws and how they operate and ensuring that the system can raise the desired level of revenue.

The Challenged Relationship of California and Its Cities

By: Vuong Luong, MST Student

Michael Coleman, creator of CaliforniaCityFinance.com, and a principle fiscal policy advisor for the League of California Cities spoke during lunch. His presentation served to help attendees understand the various constraints that affect California's tax structure and its relationship with local governments. His discussion touched on Proposition 13 (1978), Assembly Bill 8 (1979), the Educational Revenue Augmentation Fund (ERAF) and their effects on California and its local governments.

Californian's opposition to property tax increases led to the passage of Proposition 13 in 1978. The law limits the amount of property tax that can be imposed and requires a two-thirds vote of the legislature for tax increases at the state level as well as a two-thirds vote by voters for special taxes at the local level. Properties were reassessed at 1975 values. The State was given the authority to allocate property tax revenue. This resulted in lower revenues on governments at all levels and restraints on their ability to increase taxes.

The drastic reduction in property tax revenue reduced the ability of local governments to properly fund primary education and resulted in enactment of Assembly Bill 8 (1979). Prior to Proposition 13, the majority of funds allocated to local schools came from property tax collections. To counter the unintended consequence of Proposition 13, AB 8 (1979) was enacted to shift state general funds to the schools.

The shifting of income strained the State’s General Fund. In 1992, the Educational Revenue Augmentation Fund (ERAF) was created to earmark a portion of local property taxes to ensure adequate funding for schools. Local governments are required to apportion a larger share of their property taxes to fully fund ERAF.
Mr. Coleman outlined some of the major changes that have shaped the current relationship between the State and local governments. The ability to generate, allocate, and provide appropriate revenue is essential to a healthy functional government. When the demand for public goods and services increases or when revenue declines due to economic cycles, governments must maintain or increase revenues. Generally, revenues are raised through taxes. Statutes must give authority to entities that can allocate resources more effectively or efficiently. According to Mr. Coleman, governments should have the capability to diversify the mixture of their taxes so they may appropriately predict revenues to ensure liquidity and solvency.

Local governments' rights and authority have shifted to the State. A large portion of their revenue is now collected and reapportioned by the state. Budget problems and a weak economy hinder them from adequately sustaining services for safety, education and welfare. The shift has left many local governments relying heavily on the state’s budget, therefore impeding the proper planning and timing of their finances. Frustrated voters have enacted piecemeal reforms through the proposition process, instead of sustainable reforms. The two-thirds vote and limits on increasing property tax have restricted the government’s ability to generate revenue to cover shortfalls.

The information and analysis given by Mr. Coleman covered only a small component of a very complex piece of California's tax policy. His presentation slides are located on the conference website at http://www.tax-institute.com. Included on the site are links recommended by Mr. Coleman for supplementary information on The Challenged Relationship of California and its Cities. Mr. Coleman's website can be found at http://www.californiacityfinance.com/.

**Perspectives on the State of California's Budget, Tax Policy and Fiscal Reform**

By: Brian Ross, *MST Student*

Three presenters with diverse background and experiences, but each with many years of devotion to taxation, shared their perspectives on various aspects of California's fiscal system and reform prospects.

Todd Robinson, Partner with Berger Lewis Accountancy Corporation in San Jose, CA and adjunct professor at San Jose State University, spoke about California’s conformity with federal tax law as well as the tax burden imposed by California on its residents. On April 12, 2010 Governor Schwarzenegger signed SB 401 into law. This bill changed California’s date of conformity with federal tax law from January 1, 2005 to January 1, 2009. Thus, California law conforms to most of the
changes made during this four-year period. However, California remains two years behind since federal changes for 2009 and 2010 are not included in the conformity law. Some of the more common areas of non-conformity are section 179, bonus depreciation, and capital gains rates.

Mr. Robinson also briefly discussed the tax burden on California residents. The maximum individual income tax rate increased from 9.3% in 2009 to 9.55% in 2010. It is unclear what the rate for 2011 will be. Also, California ranks sixth in tax burden among all states as of 2008. New York, New Jersey and Connecticut are the top three states. The corporate tax rate was unchanged from 2009 to 2010 at 8.84%.

The Honorable Sidney Espinosa, Mayor of Palo Alto, spoke about the state of the City of Palo Alto, California. Palo Alto has a FY2011 budget of $139.4 million and employs about 1,000. Palo Alto is a very wealthy, highly educated, vibrant city. It is home to Hewlett Packard, Tesla, Skype, and many well-known law firms. During the day the city doubles in size due to commuters. The household median income exceeds $100,000. Espinosa mentioned how impressed he was by the high level of knowledge of city issues demonstrated by Palo Alto residents at city council meetings.

Nevertheless, the city is still suffering the effects of the Great Recession. For FY2011 there is an expected deficit of $7.3 million. The two largest sources of revenue are sales and property tax. Together they account for one-third of city’s revenue. Both of these taxes are highly cyclical. They go up significantly in boom times and can take a bigger dive in a bust economy. The city has been forced to lay off some full time employees and streamline various departments.

Dean Andal, a former state legislator from Stockton, CA now with PwC, claimed that many people cannot see the connection between the taxes they pay and the services they receive. He also stated that the group with the biggest political impact in the state is the California Teachers Association. They are highly influential in establishing the state budget--42% of the budget is for K thru 12 and another 9% is spent at the collegiate level. Finally, 37% of property taxes are allocated to public school systems. Mr. Andal believes that the state must get wealthier in order to distribute more money to schools.

Relevance of the Feds

By: Zhi Jun Lim, MST Student

Amidst a trillion-dollar federal budget deficit and a jobless economic recovery, a panel of three tax experts weighed in on interrelated tax policy issues affecting both the Federal government and states. The highlighted topics included the ideal level of federal tax policy conformity by California legislators, the sufficiency of nexus including the state’s authority to tax remote businesses as well as impose sales and use tax (SUT) collection obligations on such businesses,
and finally, the possibility of a federal level Value-Added Tax (VAT) and how it might impact California.

Federal Tax conformity and California

Oksana G. Jaffe covered conformity, the challenge of achieving conformity and some considerations of how federal tax law and proposals affect California. Ms. Jaffe is the Chief Consultant of the California Assembly Committee on Revenue and Taxation. In her role, she is responsible for analyzing legislation, providing technical assistance on tax law matters, supporting the annual budget process, reviewing tax issues in hearings, and acting as a liaison with state tax agencies.

The right degree of conformity with Federal tax policies was among the highlights in the panel’s presentations. It is generally agreed that all states, including California, need to find the right balance between full conformity that promotes uniformity and simplicity, and selective conformity that preserves the state’s autonomy over its tax revenues.

As a “selective” conformity state, California has been late in adopting Federal tax policies and provisions. And with the recent enactment of Proposition 26, requiring a two-thirds supermajority vote for any new fees or taxes in California, conformity efforts will be further forestalled. Consequently, this lack of uniformity can present increasing compliance challenges for taxpayers and administrative difficulties for California’s Franchise Tax Board (FTB).

Specifically, the widening difference between federal and state tax provisions may lead to increased complexity for taxpayers struggling to comply with two different sets of rules. To further the complications, often the same terms used under the federal and state tax law can be defined very differently. An additional obstacle to setting the correct conformity level is the substantial risk of tax avoidance by taxpayers who may choose to manipulate the difference between the federal and state tax provisions to their advantage.

Even so, full conformity with federal tax policies is not entirely desirable. There are issues such as the loss of legislative autonomy over state tax policies and the potential volatility of state tax revenues that still need to be addressed.

State nexus issues on state sales tax and business activity taxes.

The second topic centered upon two recent federal bills proposed to address nexus requirements and to stem the state tax gap. Carley A. Roberts, a Partner at Morrison & Foerster in Sacramento, CA discussed this topic. Ms. Roberts’ practice focuses on tax planning and tax litigation on state and local tax matters. She is also the Chair of the Taxation Section of the California State Bar.

The first bill H.R. 5660 (111th Congress), seeks to expand nexus requirements and impose the obligation on remote businesses such as pure online retailers, to collect state SUT. This bill seeks
to preserve a level playing field between traditional brick-and-mortar enterprises and online retailers. It will also serve to close one of California’s largest tax gaps, the Use tax. However, recognizing that this compliance burden could significantly hamper inter-state commerce activities, the bill provides for a small seller exception. Additionally, businesses must meet 18 “minimum specification requirements” before the obligation to collect SUT is imposed on them.

The second bill, H.R. 1083 (111th Congress), will clearly delineate whether and when a state can collect “business activity taxes” from a remote business. It begins by modernizing P.L. 86-272, applying the rule to all sales transactions and not merely sale of tangible personal goods. The bill also clearly defines “physical presence” and establishes a “physical presence nexus standard” in an attempt to promote an equitable business environment and reduce disputes that can lead to costly litigation. However, to avoid an excessive compliance burden, certain activities such as solicitation will be exempted and a de minimis physical presence safe harbor will be established.

The possibility of a federal VAT

The final issue dealt with the possibility of a federal VAT and its impact on California and other states. This topic was presented by Pat Powers, a Partner and the US Chair of the State and Local Tax Practice at Baker & Mckenzie in Palo Alto, CA. His practice focuses on general tax planning including global tax minimization, tax litigation and state tax planning.

While most other developed nations have adopted some form of VAT, the United States has not caught on with this trend. The prominence of a VAT is attributed to its low administrative cost, efficient revenue collection and high compliance rates. In addition, its credit-invoice mechanism is considered superior to the current sales and use tax regime because a VAT eliminates pyramiding issues and assists auditing and enforcement efforts.

High levels of federal debt and a ballooning budget deficit prompted call for consideration of both cost cutting and tax hikes. However, with the maximum federal income tax rates at 35%, further tax rate increases will find little support. This paves the way for proposals for a new federal level consumption tax regime, such as a VAT.

Despite the strong credentials of the internationally used VAT system, states will face more than mere administrative challenges integrating with a federal VAT. First, the encroachment by the federal VAT into the state sales and use tax base could further strain state tax revenues. Second, removal of the state sales tax regime and piggybacking on the federal VAT base will significantly erode state legislative autonomy. If such a federal VAT were indeed adopted, both issues would need to be addressed by striking the right balance between preserving state fiscal independence and conforming to the federal VAT regime.
Looking Forward – The Final Session of the Conference

By: Victoria Lau, MST Student

Looking Forward was the final session of “The State of Tax Policy in California” Tax Conference. Kim Reeder, Partner with Morgan Lewis in Palo Alto, CA started the session by recapping key messages from presenters and panelists during the day. This was followed by an open forum for participants to comment and suggest ways to move forward. Lastly, Annette Nellen from San José State University polled the audience again on questions first asked at the beginning of the day to gauge changes in opinions.

The summary of this final session highlights three notable comments made during the open forum and presents the polling questions where audience responses shifted between the beginning and the end of the conference.

The first of the three notable comments was from an attendee question of whether term limits affect the quality and attention of state legislators. In 1990, Californians voted Proposition 140 into law to limit state legislators to serve a maximum of three terms in the Assembly and two terms in the Senate (assembly members have two-year terms and senators have four-year terms). An attendee responded that term limits have hurt the legislative process because key people with knowledge are not there. He believed that the lack of continuity has empowered staff members who may have their own agenda. In addition, it has made lobbyists more powerful as new legislators place more reliance on them to draft bills. He also observed that in 1992, the state experienced a unique economic crisis with a recession compounded by a shrinking defense industry. During that period, the legislators put aside bipartisanship and worked through the issues together. The reason suggested by the attendee as to why such collaboration was feasible in 1992 but not today is that the legislators had long-term relationships with each other. Term limits have reduced the opportunities for legislators across party lines to forge these relationships. Another attendee added that members are commonly perceived to be only effective in forwarding issues during their second term because they need the first term to find their ways in the legislature and their third term is focused on finding new jobs.

The second notable comment was made by an attendee who believed that computerization of redistricting has a more significant impact than term limits. He commented that redistricting is now a science and redistricted seats do not change parties. In the 2010 general election, only one of the eighty contested Assembly Districts changed party. The background to redistricting is that the federal and state governments adjust the boundary lines of districts following each decennial federal census for population change. The use of computerized redistricting software was first
introduced in the 1960s. However, for the 2010 round of redistricting, the costs of this software has significantly decreased while the technology has advanced such that complex analysis can be performed by users with limited training.

Until 2008, redistricting in California was introduced as bills in the legislature for passage into law. In the 2008 general election, California voters passed Proposition 11 to create the independent Citizens Redistricting Commission to be responsible for drawing district lines for State Senate, Assembly and State Board of Equalization. Voters further approved Proposition 20 in November 2010 to add Congressional districts to the Commission’s control. The attendee added that because seats do not change parties, primaries are where the 2012 elections will be decided.

The last of the three notable observations tied into the state nexus issues covered by the Relevance of the Feds panel. In the open forum, one participant noted that it was “ironic” that these bills relating to state taxes are heard by the House and Senate Judiciary Committees and not by the House Ways and Means and Senate Finance Committees that handle federal taxes. The Judiciary Committees have oversight for state compacts, or agreements; so that may be the reason why they have responsibilities for the nexus bills. The concern raised by the participant was that these committees might not have state taxes as their priority.

After the open forum, Ms. Nellen polled the audience with the same questions asked at the beginning of the day to rate participants understanding of California’s tax and fiscal system. Responses to two questions significantly shifted in the afternoon. The first was on whether California has a good business climate. In the afternoon polling, 86% of the participants said "no" which was much higher than the morning polling. The second question followed the same dire outlook. In the morning, less than half of the participants placed California’s business climate in the bottom quintile amongst the states. In the afternoon polling, almost all participants placed California in the bottom two quintiles and 56% place the State in the bottom 20%.

Ms. Nellen polled one additional question before closing the conference: Who is responsible for solving California’s fiscal problems? Of the available options of elected officials, voters, businesses, and all of the above; 80% of the audience chose all of the above. Ms. Nellen and Ms. Reeder reiterated one key purpose of the conference, which is for participants to learn more about the issues so they can educate others and help the State address the problems.
Major Tax Reform – Are we reaching the tipping-point?

Q & A with Scott Hodge, President of the Tax Foundation

“I think the Cubs will win the World Series before California overcomes its fiscal challenges.” - Scott Hodge

By: Tim Kelly, MST Student

Scott Hodge is the president of the Tax Foundation, a nonpartisan tax research group based in Washington, D.C. and one of the nation’s leading visionaries on tax policy, the federal budget and government spending. He has authored several books on the federal budget and government spending. His editorial and opinion pieces have appeared in many leading publications such as The Wall Street Journal, The Washington Post, USA Today and The Washington Times. In addition, he is regularly interviewed on major radio and television network news shows broadcasted through CBS, NBC, ABC, CNN and Fox.

The mission of the Tax Foundation is to educate taxpayers about sound tax policy and the size of the tax burden borne by Americans at all levels of government. One of the Tax Foundation’s most popular tools for educating the public is Tax Freedom Day® which is a date when Americans will work to have earned enough money to pay the year’s tax obligations at the federal, state and local levels. This year, the date arrived on April 12, the 102nd day of 2011. Detailed facts and figures from hundreds of studies on tax policy and government spending at the federal level and all fifty states can be found at the Tax Foundation’s website, www.taxfoundation.org.

Fun Fact 1:
Scott Hodge’s uncle Max Hodge created the Mr. Freeze character for Batman!
Given the turmoil surrounding government deficits and tax reform, we thought it would be good to get an update from Mr. Hodge on the prospect for major tax reform at both the federal and California levels.

**SJSU CTJ:** We haven’t had major tax reform in this country since President Reagan and Representative Rostenkowski worked together in 1986. The frequency of Congressional hearings on the topic has increased relative to previous years. Two recent presidential commissions, the Economic Recovery Board, chaired by Paul Volker, and the National Commission on Fiscal Responsibility and Reform, co-chaired by Erskine Bowles and Alan Simpson, call for comprehensive tax reform. With all this activity, one might think we are getting closer to major tax reform for both businesses and individuals.

**HODGE:** I think momentum is building for fundamental tax reform, but we are in what could be called the "build up" stages that could culminate in action sometime in 2013. Typically, Washington needs to chew on big issues for a while until there is critical mass for actual legislation. The prelude to Reagan's 1981 tax plan was Jack Kemp's tax cut proposals during the late 1970s. The 1986 reform was preceded by the so-called Treasury 1 and Treasury 2 reports. We are in a similar phase of trial balloons and public debates that will be absorbed into next year's presidential campaigns. I do believe tax issues will be top tier issues in the 2012 election debate. This will be a very welcome debate.

**SJSU CTJ:** On the corporate side, the Tax Foundation supports lowering the corporate tax rate and moving to a territorial system to level the playing field and make U.S businesses more competitive in the global market. Realizing that it takes leadership from the President and legislature to pass major tax reform legislation, what do you think will get us to the tipping point and when will it happen?

**HODGE:** I thought the tipping point in the U.S. debate would be Japan's announcement that it would cut its corporate rate in 2011. The earthquake and tsunami obviously derailed Japan's legislative agenda and the indignity of the U.S. assuming the place of top tax rate in the industrialized world. That threat will remain out there into next year. Don't forget, however, that Canada and the U.K. both cut their corporate tax rates this year and will make further cuts next year. So when we think of low tax competitors to the U.S., we're no longer talking about the Irelands and Singapores of the world -- the Big Boys of the G7 are now getting into the game and we are falling further and further behind.

**SJSU CTJ:** What reforms are needed for individual taxpayers in order to sell corporate tax reform to the voters?
HODGE: We think about this question a lot because there is a lot of anti-corporate sentiment in America right now. We must find ways to convince people that the lion's share of the economic burden of corporate taxes falls on workers through lower wages and productivity, while the remaining share hits them directly in their 401k. We have to personalize the issue or the debate will be swamped by stories about General Electric's tax bill.

Don't forget that corporate and individual reforms are inexorably linked. First, the top rates for individuals and corporations are at the same level for the first time in the history of the code. Second, there is now more business income taxed under the individual code that under the corporate code so we have to think in broader terms of "business tax" reform, not just "corporate" reform. The bottom line challenge, however, is overcoming public opinion. That will be a tough hill to climb.

SJSU CTJ: Here in California, we are facing a never-ending budget crisis. What are the prospects for California in overcoming its fiscal challenges, reducing its high tax burden and improving its business climate?

HODGE: If I were you, I would start looking for jobs in any other state -- except Illinois. Run now and don't look back. LOL

I think the Cubs will win the World Series before California overcomes its fiscal challenges. Greece may overcome its fiscal challenges before California. In many respects, California is a microcosm for the U.S. Politicians have made promises they can't keep (and taxpayers can't afford) and the tax system is broken beyond repair -- besides being too progressive. The only question is, which will default first, California or the U.S. government.

SJSU CTJ: Are there lessons to be learned from current and proposed tax reforms underway in other states such as Rhode Island, Vermont, Georgia, Michigan, Ohio and Wisconsin?

HODGE: The lesson is that tax competition is alive and well in the states. We have fifty laboratories of democracy and it is fun to have a national perch to watch it unfold. Not long after Illinois fell on its sword with a massive tax rate hike on individuals and businesses, Indiana cut its corporate tax rate and Michigan replaced its old
system with a conventional corporate tax. We'll be watching closely to see if (and how many) people and firms move out of Illinois to their Midwest neighbors with friendlier tax systems. I know the Wisconsin governor is anxious to get in the game and overhaul their tax system because Wisconsin has had one of the highest tax burdens in the nation for more than four decades. New Jersey Governor Christie is trying to reverse that state's image as one of the worst business climates in the nation. My only wish is that Washington would catch the tax competition fever.

**SJSU CTJ:** ‘Fail often and fail early’ is a saying we often hear in Silicon Valley. In your efforts to educate taxpayers on tax reform, what works best to effect change?

**HODGE:** Well, overcoming misperceptions may be the hardest task of all. Despite the fact that roughly half of all American households pay no income taxes, people still believe that the Bush tax cuts benefited only the ‘rich’ and that the ‘rich’ don't pay their fair share. What does seem to work is the assurance that tax reform will level the playing field. People are inherently insecure that the guy next door has found a loophole that allows him to save more on his taxes than they can. I think most people would support tax reform if they were assured that Donald Trump paid the same rate of tax they do and couldn't avoid paying his "fair share" by hiring clever tax advisors. I think we can move the reform ball over the goal line if we can convince people that tax reform will bring simplicity and the certainty that everyone will pay equally.

**SJSU CTJ:** As we look ahead to the coming tax reform showdown, are there any new studies coming out of your research department that you would like to tell us about?

**HODGE:** At the federal level, we are heavily focused on building the economic and intellectual case for corporate tax reform. Look for studies on effective tax rates, territorial versus worldwide systems, "good" versus "bad" base broadening, and "who really pays the corporate income tax."

At the state level we are in the final stages of a major study comparing the actual business tax burdens of the states. Our model compares how much various proto-typical firms would pay in each state if they are a new firm or a mature firm. I believe this will be the first study of its kind anywhere. Stay tuned.
The 112th Congress held over 20 hearings in 2011 on tax reform. Both California and the federal government have significant budget issues, that will likely require changes to both revenues and spending to adequately address the problems. What did Congress learn from the tax reform hearings? What types of changes are needed at the federal and state levels? What can be learned from other countries and states? What are the prospects for major tax changes?

Conference speakers will answer these questions and attendees will have an opportunity to share their ideas on tax reform. The conference offers an opportunity to stay up to date on tax policy and reform issues that affect individuals and businesses. Presentations will focus on high technology businesses.
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, 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.

Three 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. Repeal of the Federal Telephone Excise Tax
2. Repeal of the IRC §199 Domestic Production Deduction
3. Applicability of VAT in the United States

---


23 Information on this MST course (BUS 225R) can be found at http://www.cob.sjsu.edu/nellen_a/bus225R_reading.html.
Repeal of Federal Telephone Excise Tax

By: Sandra Peters, MST Student

The federal excise tax on telephone use (IRC Section 4251) began in 1898 as one of many excise taxes enacted to raise revenue for the Spanish-American War. The tax has been repealed, reinstated, expired, extended and changed. It was made permanent in 1990. It has outlived its original intent yet has stayed to provide revenue for the general fund.

Many sessions of Congress have looked at its repeal in the last decade. The current proposal in the 112th Congress is H.R. 428 which again attempts to repeal the tax. 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. Each of the ten principles is considered in respect to the existing law.

For additional information on the telephone excise tax and its application and economic effects, see The Telephone Excise Tax: An Economic Analysis, by Steven Maguire and Brent W. Mast, Congressional Research Service, June 2006; available at http://www.policyarchive.org/handle/10207/bitstreams/2810.pdf.

Principles of Good Tax Policy Evaluation

<table>
<thead>
<tr>
<th>Principle</th>
<th>Application</th>
<th>Rating</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity and Fairness</td>
<td>The telephone excise tax does treat similar taxpayers equally.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>The tax would be roughly the same for two taxpayers with similar income and</td>
<td>Vertical –</td>
</tr>
<tr>
<td></td>
<td>consumption. The consumption or variation in local calls for similar</td>
<td>Horizontal +</td>
</tr>
<tr>
<td></td>
<td>taxpayers would be the same. Before the exclusion of long distance calls</td>
<td></td>
</tr>
<tr>
<td></td>
<td>from the tax, the horizontal equity may have been less. Taxpayers in the</td>
<td></td>
</tr>
<tr>
<td></td>
<td>same income bracket could be taxed differently based on need for long</td>
<td></td>
</tr>
<tr>
<td></td>
<td>distance calling. Vertical equity is not achieved since taxpayers of all</td>
<td></td>
</tr>
<tr>
<td></td>
<td>income levels are taxed at the same rate. The tax is regressive as it does</td>
<td></td>
</tr>
<tr>
<td></td>
<td>not take into account an ability to pay and the percent of income used to</td>
<td></td>
</tr>
<tr>
<td></td>
<td>pay this tax is greater for the lower income taxpayers. Changes in</td>
<td></td>
</tr>
<tr>
<td></td>
<td>technology can create inequity in that some types of Internet based</td>
<td></td>
</tr>
<tr>
<td></td>
<td>calling may not meet the definition of communications services subject to</td>
<td></td>
</tr>
<tr>
<td></td>
<td>the excise tax.</td>
<td></td>
</tr>
<tr>
<td><strong>Certainty</strong></td>
<td>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.</td>
<td>-</td>
</tr>
<tr>
<td>---</td>
<td>---</td>
<td>---</td>
</tr>
<tr>
<td><strong>Convenience of Payment</strong></td>
<td>The telephone excise tax is conveniently paid by the taxpayer when making payment for the communication service. It requires no special forms or calculations for the consumer. The communication provider however, must properly calculate and pay at a minimum every quarter by filing an excise tax return. There is convenience to the taxpayer but not necessarily to the remitter of the tax. The tax is in effect collected by a third party, similar to a retailer’s collection of sales tax.</td>
<td>+</td>
</tr>
<tr>
<td><strong>Economy in Collection</strong></td>
<td>The cost to collect this tax is minimal because it is collected by the service provider rather than by all users. The provider may have costs to properly identify and assess the amount due but from the government’s perspective, costs are minimal. Collection costs are minimal for the service provider as customers are motivated to pay their bills to avoid service interruption. Any IRS collection costs to collect from the provider would be minimal since there are few remitters of the tax.</td>
<td>+</td>
</tr>
</tbody>
</table>
### Simplicity

<table>
<thead>
<tr>
<th>The tax law should be simple so that taxpayers can understand the rules and comply with them correctly and in a cost-efficient manner.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxpayers may not understand the tax or rules but the compliance is cost-efficient since the tax is not self-assessed like an income tax. The calculation of amount owed is simple to the consumer but may be more complex to the service provider.</td>
</tr>
<tr>
<td>The complexity to the service provider is due to exceptions and definitional issues. Many years ago telephone companies were the only providers of telecommunications and phone services were limited to local and long distance voice calls. With the changes to technology, telecommunications may be provided by or bundled with other services such as Internet or cable. Broadband technology allows a phone line to be used for other than voice. As technology rapidly changes, the definitions of what is taxed and how it is separated out from other “line” uses will need constant re-evaluation. Some local voice calls may actually not even use a phone company at all, utilizing voice over Internet technology. Someday, local calls may also be eliminated as we move toward replacing calls with email, messaging and other forms of communication. There is concern that this will lead to an expansion of the tax to include other communication, not just local voice calls from phone companies.</td>
</tr>
<tr>
<td>Out of context, this tax appears simple yet it contributes to overall tax complexity. It is a layer of tax added to income taxes, sales tax and a multitude of “other taxes” which together form a web of complexity not always visible to the final consumer.</td>
</tr>
</tbody>
</table>

### Neutrality

<table>
<thead>
<tr>
<th>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.</th>
</tr>
</thead>
<tbody>
<tr>
<td>The telephone tax is based on local calls and some would argue that this type of communication is a necessity in today’s society. Access to emergency help and connection to the society is as necessary as electricity and plumbing.</td>
</tr>
<tr>
<td>In this regard, the demand is relatively inelastic in an economic sense, meaning an increased cost does not mean a decrease in demand. Consumers are somewhat limited in choices if the tax were too high; behavior is not likely to change, whether or not there is a tax. A tax on talking is not likely to limit talking.</td>
</tr>
<tr>
<td>Before the law change to exclude long distance calls, a consumer may have chosen a provider that used a flat rate for all calls. Business consumers may have more choices in structuring</td>
</tr>
</tbody>
</table>
communications to reduce the tax. The tax may not be neutral in its effect on the service provider. The provider may choose to find non-taxable communication services as an alternative to the defined local call for which more options are rapidly evolving. In today’s technology, not all communications are subject to the tax.

| Economic Growth and Efficiency | Taxes affect how resources are used. It affects the return on investment and contributes to barriers of entry in some markets. The fact that the tax increases the cost of service may affect the use of capital. Technology could be diverted to finding non-taxable alternatives. | - |

| Transparency and Visibility | It is not likely that most taxpayers know that the tax exists unless they carefully review their communications bill. Even when separately stated, it is not likely that it is understood or how it is calculated or how it could be avoided. One of the reasons the tax has eluded reform is that it is not very visible and thus, is hidden from scrutiny. It is not likely the average person even knows that it is paid to the IRS or funds the federal government. Some taxpayers might assume it is a fee paid to the phone company similar to a user fee. | - |

| Minimum Tax Gap | With the tax assessed upon the service providers rather than self-assessed by millions of users, the tax gap is likely minimal for the telephone excise tax. Yet, there may be a gap in compliance by communication providers due to complexities, exclusions, and misunderstood regulations. | + |

| Appropriate government revenues | The collection of this tax has been relatively stable and predictable over the last decade. Consumer behavior and economic turmoil will not likely significantly change the amount since it is based on an inelastic commodity. There would be some change based simply on population expansion. | + |
the government to determine how much tax revenue will likely be collected and when. Business expansion or additional phone lines may increase the tax. During down economies, the tax should still remain constant as consumers are not likely to change their behavior.

Conclusion

There is little argument that the existing telephone excise tax would qualify as good policy in regard to horizontal equity, convenience of payment, economy of collection, and minimum tax gap. These principles alone though do not qualify the tax as good policy.

The Institute for Research on the Economics of Taxation (IRET) stated in a 1999 paper: “Government revenues should be collected through broad, non-distorting taxes, not through selective excise taxes.” The current tax is one additional layer of tax that goes unnoticed yet contributes to the overall complexity of our tax system as a whole. The telephone excise tax should be repealed as part of tax reform to obtain simplicity, transparency, and visibility. In addition, the revenue the tax generates is minimal and its base and structure are based on 20th century ways of telecommunications and are thus outdated for today's economy and technology.

---

Repeal of the IRC §199 Domestic Production Deduction

By Jasmine Wu Ting, MST Student

Introduction

While the United States is slowly recovering from a prolonged recession, tax reform has been one of the most debated topics among lawmakers in Washington, D.C., particularly in 2011. In his State of the Union speech, President Obama called for reform of the corporate income tax system. He suggested the need to “get rid of the loopholes… to lower the corporate tax rate without adding to our deficit.”

A number of provisions in the tax system narrow the tax base, distort the economic activity and increase the complexity of the tax code. President Obama’s National Commission on Fiscal Responsibility and Reform, estimated that tax expenditure total about $1.1 trillion. Eliminating these provisions could increase tax revenues significantly and improve efficiency of the system.

One of the above mentioned expenditures is the Domestic Production Deduction (IRC §199) which results in an estimated revenue loss of $210 billion over 10 years. The domestic production deduction was first introduced to the tax system in 2004 allowing businesses to deduct part of their earnings from certain kinds of domestic production from their taxable income. The purpose of this provision is to encourage manufacturing production in the U.S. The scope of the definition of “production” is quite broad. Many business sectors, from software development to food processing and filmmaking, benefit from the deduction.

Eliminating this provision would raise enough revenue to allow a 1.1% reduction in the corporate tax rate. Moreover, it would simplify the tax code because the definition of


qualifying production and other elements of the deduction are complex which increases compliance and administrative costs.

Understandably, organizations that benefit from this provision may fight to keep it in the Code. In early 2011, President Obama unveiled his fiscal year 2012 federal budget proposal which included repeal of the Section 199 deduction for oil and natural gas companies. The National Association of Manufacturers (NAM) responded by stating that such repeal would increase energy costs and hurt job creation.

On the other hand, full repeal of Section 199 has received support from some corporations. Some corporate executives testifying before lawmakers endorsed the concept of eliminating the domestic manufacturing deduction in exchange for simplifying the tax law and lowering the corporate tax rate. They stated that management could be more productive and increase hiring if it could spend less time and money on tax compliance. Walter Galvin, vice chairman of Emerson Electric, told lawmakers, “We as a country have been tinkering with credits and deductions that, while well-intentioned, have done little more than encourage complex tax planning.”

Principles of Good Tax Policy Evaluation

The following chart explains how the principles of good tax policy apply to the proposal to eliminate the Domestic Manufacture Deduction (Section 199). The analysis uses the ten principles of good tax policy outlined in the AICPA Statement #1, Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposal.

<table>
<thead>
<tr>
<th>Principle</th>
<th>Application</th>
<th>Rating</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Equity and Fairness</strong></td>
<td>Similarly situated taxpayers treated similarly. The manufacturing industry has benefited from the domestic production deduction. This deduction though discriminates against other business sectors and distorts economic decisions as it does not apply to all domestic production. Eliminating this provision will increase equity and fairness as business with similar characteristics will be treated similarly regardless of their industry sector.</td>
<td>+</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Certainty</th>
<th>Eliminating the domestic production deduction will increase certainty because the definition of qualifying production and other elements of calculating the deduction are complex. Taxpayers take great efforts to figure out what receipts and production can be considered in calculating the deduction. Eliminating this deduction would result in considerable tax simplification.</th>
<th>+</th>
</tr>
</thead>
<tbody>
<tr>
<td>Convenience of Payment</td>
<td>Eliminating the domestic production deduction will have no affect on the timing of payment by corporate taxpayers. Corporations will pay their taxes at the same manner whether the deduction exists or not.</td>
<td>n/a</td>
</tr>
<tr>
<td>Economy in Collection</td>
<td>Eliminating the Section 199 provision will improve economy in collection. The IRS will collect fewer forms and need less audit time to ensure that taxpayers who claim this deduction are in full compliance with the law. Elimination will also reduce the time taxpayers spend in producing and maintaining records needed to determine the deduction.</td>
<td>+</td>
</tr>
<tr>
<td>Simplicity</td>
<td>Eliminating the domestic production deduction will significantly simplify the tax code. Because the scope of the definition of “production” is broad, many business taxpayers spend considerable time and money on compliance and administration each year. Eliminating this provision will be cost-efficient for taxpayers.</td>
<td>+</td>
</tr>
<tr>
<td>Neutrality</td>
<td>Currently the domestic production deduction applies to both corporate and non-corporate business. If the deduction is repealed for corporate taxpayers only, businesses may be motivated to choose a non-corporate organizational form. However, if the deduction is repealed for all business taxpayers, there will be no effect on decisions of entity form. Repeal will also reduce any effect the deduction may have on businesses practices to engage in the types of activities and distribution practices that generate a deduction. If the deduction is eliminated and the corporate tax rate reduced below 35%, some businesses may be motivated to become corporations to benefit from the lower corporate rate (if double taxation is not a concern for them).</td>
<td></td>
</tr>
<tr>
<td>---</td>
<td>---</td>
<td></td>
</tr>
<tr>
<td>- If repealed for corporations only or only for specified industries. + If repealed for all taxpayers.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Economic Growth and Efficiency</td>
<td>Eliminating the domestic production deduction would broaden the tax base and therefore raise tax revenues. Increased revenue could allow a reduction in the corporate tax rate which, in return, may improve the competitiveness for US businesses. Removal will also reduce the incentive to invest in companies that generate this deduction.</td>
<td></td>
</tr>
<tr>
<td>Economic Growth and Efficiency</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td>Transparency and Visibility</td>
<td>Eliminating the Section 199 deduction should improve transparency and visibility. Taxpayers in all businesses would then know that no such deduction exists for a business in manufacturing. Tax reporting and calculations would be more transparent and visible for taxpayers in all business sectors. The Section 199 deduction could instead have been implemented as a tax rate reduction. Elimination with a rate reduction will be more transparent in knowing the effective tax rate of a business.</td>
<td></td>
</tr>
<tr>
<td>Transparency and Visibility</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td>Minimum Tax Gap</td>
<td>Eliminating the domestic production deduction will reduce the tax gap because the complexity of the provision may lead to inadvertent errors.</td>
<td></td>
</tr>
<tr>
<td>Minimum Tax Gap</td>
<td>+</td>
<td></td>
</tr>
</tbody>
</table>
### Appropriate Government Revenues

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

The Treasury Department has data from past tax returns demonstrating the lost revenue due to the provision. Thus, the government can easily determine how much tax revenue would be collected if this provision is no longer in existence.

### Conclusion

Repeal of the Section 199 domestic production deduction for all taxpayers meets all the principles of good tax policy. If the deduction is only repealed for corporations or certain industries (such as oil and gas), the neutrality principle is not met. Repeal has no effect on the convenience of payment principle.

To address the neutrality issue, Congress could apply the proposed elimination to all business/taxpayers, instead of only for corporate taxpayers or particular industries.
Applicability of the VAT in the United States

By: Lisa Lim, MST Student

Introduction

Value added tax (VAT), a consumption-based tax, is often considered as an alternative to reduce a government’s reliance on the income tax. Globally, over 140 countries have adopted the VAT to generate revenue and serve as a border-adjustable tax (unlike the income tax). The United States is the only OECD member nation without a VAT.

This analysis examines a proposal to implement a broad-based, low, single-rate credit-invoice VAT in the United States. The introduction of a federal-level VAT would be supplemented by a simplified federal income tax with fewer tax brackets, lower income tax rates and a scaled-down tax preference regime. The intent of such a proposal is to improve the overall tax regime in the United States.

Principles of Good Tax Policy Evaluation

The following chart explains how the principles of good tax policy apply to the proposal to impose a VAT along with a greatly simplified income tax in the United States. The analysis uses the ten principles of good tax policy outlined in the AICPA Statement #1, Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals.

<table>
<thead>
<tr>
<th>Principle</th>
<th>Application</th>
<th>Rating</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity and Fairness</td>
<td>VAT is generally regarded as a regressive tax. Under this proposal, a broad-based single-rate VAT that applies to all goods and services, without any compensating measures is the most regressive form of VAT. Vertical equity and the ability-to-pay principle are adversely affected by a broad-based VAT. This is because the total VAT paid represents a higher tax burden as a percentage of current income of a lower-income taxpayer than a higher-income taxpayer. Further, low income taxpayers are thought to be the hardest hit because they tend to spend a larger proportion of their income on basic necessities than any other group. However in an IMF publication, Ebrill et al. (2001), pointed out</td>
<td>+/-</td>
</tr>
</tbody>
</table>

32 OECD, Consumption Tax, available at http://www.oecd.org/department/0,3355,en_2649_33739_1_1_1_1_1,00.html
33 Ibid.
that the impact of VAT is highly regressive only when measured against current income, in isolation.\textsuperscript{35} The alternative view suggested is to assess the wider impact of the overall tax system. Ebrill et al. (2001) conclude that a broad-based VAT is neither regressive nor progressive, if other compensating direct government spending programs and a progressive income tax regime are taken into account.

Another alternative view considers ability-to-pay from a consumption standpoint, rather than from an income perspective. If one can afford to consume more goods, this directly indicates a higher ability-to-pay. Hence the VAT will impose a tax that is in proportion to a person’s ability-to-pay, resulting in vertical equity.

The 2005 Bush Tax Reform Panel report noted the regressive nature of VAT, but the Panel believed it was possible to achieve an “approximately distributionally neutral” VAT.\textsuperscript{36} To achieve this, some adjustments to the VAT proposal would be required, including changing the VAT rate structure and providing a refundable tax credit.

Although lacking vertical equity, a broad-base single-rate VAT is favored because it adheres to several other principles (as noted below) such as simplicity, neutrality and certainty. In practice, the regressive nature of VAT is usually addressed by governments through a multi-rate structure. Goods are categorized and taxed at different rates, similar to the current sales tax regime in the US. But, the administrative cost of providing a VAT rate differential must be examined against the benefits of improving the distributional fairness of a VAT.\textsuperscript{37}

<table>
<thead>
<tr>
<th>Certainty</th>
</tr>
</thead>
<tbody>
<tr>
<td>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.</td>
</tr>
</tbody>
</table>

Generally, under the single-rate credit-invoice VAT, all businesses collect a uniform VAT calculated on the sales price. At the end of the reporting period, total VAT collected is reduced by total VAT paid on all purchases. Assuming a profitable business with receipts higher than input purchases, the excess VAT collected is then remitted to the authorities. If VAT paid is greater than what the business collected in VAT, a refund is issued. This is a relatively simple and straightforward procedure that aids certainty.


\textsuperscript{36} President’s Advisory Panel on Federal Tax Reform, “Simple, Fair and Pro-Growth: Proposals to Fix America’s Tax System”, November 2005, p 191; available at http://govinfo.library.unt.edu/taxreformpanel/.

### Convenience of Payment

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

The payment of a consumption tax, such as VAT is extremely straightforward and simple. From a consumer point of view, a VAT is no different from a sales tax. VAT is applied on the final purchase price and is paid at the point-of-sale. Under a broad-based VAT, most purchases of goods and services would have VAT added to the price.

On the business front, payment of VAT is also relatively convenient. The excess VAT collected at the end of the reporting period is remitted to the tax authority. Again, this process does not differ from the existing procedure with the income tax.

### Economy in Collection

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

In general, introducing a new VAT system in the US would increase the administrative burden and cost for the government. The main concern is the fixed cost to set up a new VAT administrative system within the IRS. These include training programs for IRS staff, implementation of a new IT system, issuance of forms, instructions and technical guidance, taxpayer awareness programs, and enforcement plans to ensure that all taxpayers can properly comply with the VAT.

In a 1993 report, the US Government Accountability Office (GAO) estimated that the cost of administering a broad-based VAT in 1995 would be between $1.22 billion and $1.83 billion annually.38 However, more recent studies showed that a broad-base single-rate VAT is in fact a more cost-efficient way to collect tax in the long run. The Bush Tax Reform Panel (2005) noted that in our current income tax system, the compliance cost is approximately 13 cents per dollar of tax paid, while the compliance cost of VAT in the EU countries range between 3 to 5 cents per dollar of tax paid.39

Accordingly, VAT is known as an extremely efficient revenue generator and hence the name, “money machine”. A 1% VAT in the US is estimated to generate approximately $37.8 billion in revenues.40 Assuming that there is no marginal cost of compliance, increasing the VAT rate to 10% can effectively raise revenues without triggering additional compliance burdens.

---


In other words, VAT produces a high revenue *yield* and supports a cost effective collection process.

<table>
<thead>
<tr>
<th><strong>Simplicity</strong></th>
<th>The tax law should be simple so that taxpayers can understand the rules and comply with them correctly and in a cost-efficient manner.</th>
</tr>
</thead>
<tbody>
<tr>
<td>In general, adding a VAT to the current income tax regime would not complicate matters for most individual taxpayers, who are consumers. There are no additional filing and reporting requirements for individuals who do not operate a business. And taxpayers stand to benefit from a simpler income tax regime that accompanies the proposal. However, adding on a VAT on top of the current corporate income tax regime could create another layer of complexity for businesses. But as mentioned under the principle of “certainty,” a broad-base single-rate credit-invoice VAT is relatively simple to administer. Businesses collect a uniform VAT on all their invoices and pay a uniform VAT on all purchases. Excess VAT collected is remitted to the authorities. Capital purchases qualify for input VAT refunds. And goods for export are not taxed. Without special exemptions and multiple rates, this form of single-rate VAT will be the easiest to comply with. Thus it is possible that VAT coupled with a simplified corporate tax regime could create a combined system that is potentially more business-friendly. The possibility of states replacing their sales tax systems with the federal VAT could yield further simplification.</td>
<td></td>
</tr>
<tr>
<td>+/-</td>
<td></td>
</tr>
</tbody>
</table>

| **Neutrality** | The effect of the tax law on a taxpayer’s decisions as to how to carry out a particular transaction or whether to engage in a transaction should be kept to a minimum. |
| In the current income tax regime, tax is imposed twice. Once on income earned and later again when the income saved earns interest. This is said to discourage savings and encourage current spending. However, as a consumption tax, VAT does not tax interest earned on savings or capital gains. Also, a broad-based single-rate VAT ensures uniformity and neutrality. The consumer choice is not distorted among various goods and services. This applies to businesses as well. There will be no economic incentive or disincentive to purchase or produce any one item. Thus, the neutrality of the tax system is better preserved. |
| + |

| **Economic Growth and Efficiency** | The tax system should not impede or reduce |
| Some analysts point to several negative effects on the broader US economy upon implementation of a VAT. One primary concern is the creation of an upward inflationary pressure causing an increase in consumer goods prices. In the 2005 CRS report by Bickley, it was noted that VAT would cause a “one-time” increase in consumer prices. Unlike other European… |
| + |

---

the productive capacity of the economy. countries which had an existing federal-level sales tax replaced with a VAT, the US does not currently have a federal-level sales tax. Thus a VAT introduction is expected to cause a one-time increase in prices. However, VAT cannot be said to cause sustained upward inflationary pressure.

The second concern points to the efficiency of a VAT to generate enormous amounts of revenues that ultimately fuels government spending. However, studies show that there is no conclusive evidence to link the revenue potential from VAT to government expansion. In fact, a case study of Canada shows that government spending gradually declined after the institution of a VAT in 1991. Subsequently, the Canadian VAT rate was reduced further shrinking government revenues and expenditures.

A third concern is the intrusion of VAT into the state’s sales and use tax (SUT) base. Opponents argue that combining a federal level VAT on top of a state SUT will lead to an excessive rise in prices that will curb public consumption. This concern was supported by a report prepared by Ernst & Young LLP for the National Retail Federation. The report found that introducing a VAT in the US will cause a significant decline in retail spending that will ultimately result in the loss of 850,000 jobs nationwide within the first year.

On the other hand, there is substantial support from commentators who believe that the state sales tax can be successfully integrated with the federal VAT. In the scenarios proposed, states could remove their existing SUT regime and “piggyback” on the federal VAT administration. States retain the autonomy to impose additional percentage points on top of the federal VAT, while a centralized administration program creates efficiency and economy in collection.

More importantly, the VAT is known to be administratively

| 46 | Ibid. |
superior over the SUT in many ways. VAT can help strengthen
taxation of interstate e-commerce, resolve the sales tax
pyramiding issues and create a stronger audit trail to support
enforcement efforts that ultimately reduces the state tax gap.

<table>
<thead>
<tr>
<th>Transparency and Visibility</th>
<th>VAT is highly transparent and visible. This is contrary to many public myths that VAT will be hidden between the convoluted production and distribution chain. In reality, under the current income taxation regime, many taxpayers are not fully aware of their effective tax rates. They are also unaware of how other taxes such as property tax and SUT interact to affect their overall tax burden. On the other hand, VAT is extremely visible. VAT can be printed on every invoice and receipt upon purchase. Taxpayers will know exactly how much VAT is paid on every transaction, at the checkout counter. The elimination of pyramiding under a VAT also helps transparency. For example, today, while food is exempt from sales tax in many states, there may indeed be some sales tax hidden in the price of food due to the sales tax grocery stores pay on equipment and other purchases. The other contention is that taxpayers would not know their total annual VAT liability, unless receipts are saved and tallied annually. But this is true of the current state sales tax regime as well. To be sure, the newly implemented VAT should be added on top of the prices of goods, instead of having the VAT imputed within the prices. This will ensure that the overall visibility of the VAT is not compromised.</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>Minimum Tax Gap</th>
<th>VAT has been praised for its superior administrative features. Key among them is the creation of a strong audit trail in the invoices between businesses and taxpayers. Under the credit invoice approach, every business in the supply chain imposes and collects a portion of the VAT on every sale made. There is an inherent incentive for businesses to collect VAT in order to report and offset the VAT paid from their purchases. Thus, VAT mitigates situations whereby end-retailers and customers collude to evade the sales tax completely. However, VAT is not an airtight process that is “evasion-free.” In the EU, several VAT fraud schemes have been identified. Among the most proliferated fraud techniques are the use of cash transaction in a “black economy,” non-reporting of VAT</th>
</tr>
</thead>
</table>

---

by insolvent companies, and the missing trader fraud also commonly known as the “carousel type fraud.”

| **Appropriate Government Revenues** | According to the Tax Policy Center, a 5% broad-based VAT would have generated approximately $200 billion in revenue in 2010. The aggregate revenue potential in a 10-year span beginning 2010 to 2019, is expected to reach $3.2 trillion. Further, a broad-based VAT promotes a more stable and durable revenue stream. There will be a baseline spending on necessities and basic services, which will maintain a certain amount of revenue. However, as with all consumption taxes, VAT revenues may eventually suffer from tightening wallets in the event of a prolonged economic downturn. |

Conclusion

A broad-based single rate VAT meets six principles of good tax policy. However, it did not fully meet the requirements for equity, simplicity, economy in collection and minimum tax gap. Therefore, the timing for implementation of a VAT (if considered) is crucial. Introducing a VAT in a fragile economic environment could cause unintended consequences beyond those examined in the Principles of Good Tax Policy framework.

**Possible Improvements:** To address the equity issue, the solution typically applied is to provide some type of annual credit relief that reduces the regressive impact of a VAT. Simplicity can be preserved by ensuring that the VAT system will not be fraught with special exemptions and multiple rates. The administration must be committed to a single VAT rate to avoid confusing taxpayers. Also, the current corporate income taxation regime must be truly simplified to account for the additional VAT burden. To address the economy in collection concern, the fixed start-up cost of establishing the VAT system cannot be underestimated. The start-up cost must be balanced with the long run expected efficiency of VAT collection. To address the minimum tax gap concern, the US must look to the experience of its counterparts in the OECD. The US stands to benefit from the various lessons derived from other governments that can improve VAT operations.

---

48 Tax Policy Center, Table T09-0442; available at [http://www.taxpolicycenter.org/numbers/Content/pdf/T09-0442.pdf](http://www.taxpolicycenter.org/numbers/Content/pdf/T09-0442.pdf)
Annette Nellen: Tax Reform Advocate

Testifying before Congress, Professor and Director of the SJSU MST Program, AICPA chair Individual Taxation Technical Reference Panel – All in a day’s work!

By: Evie Lee, MST Student

Annette Nellen is not your typical scholastic administrator. For those of you who have not been through the SJSU MST Program, Annette is the MST Program Director and is the main architect of the new co-curricular elements of the SJSU program. Well-respected by students and peers, Annette takes a very active role in the program, teaching three of the five core MST program courses and several of the current elective classes.

Annette is also not your typical tax professional. When I first met Annette, I was (to put it mildly) blown away by her enthusiasm and passion for tax. (Now, let’s all admit, these words are rarely evoked when anyone talks about tax.) Her fervor for tax and her eagerness to share her passion with all of us provides the encouragement that is needed to pursue an MST at SJSU. Because Annette is so unique, I have often wondered, who is the woman behind the smile?

First let us run down Annette’s credentials, which would make most overachievers green with envy. Annette has a BS in Accounting from CSU, Northridge, an MBA from Pepperdine, and a JD from Loyola Law School. Annette started her tax career at the Internal Revenue Service, followed by a stint at Ernst & Young, and finally coming to SJSU in 1990. She presently chairs the AICPA’s Individual Taxation Technical Resource Panel, is a frequent speaker and author on

Fun Fact 1:

Professor Nellen has taught over 3,000 students for the past 20+ years. That’s a lot of grading!
tax policy and reform, and is the faculty advisor for the newly launched SJSU Contemporary Tax Journal. Recently, I had the pleasure of asking Annette to share with us her experience testifying before Congress earlier this year, some insights on tax reform, and her thoughts on the SJSU MST Program.

SJSU CTJ: On April 13th of this year, you testified before the House Way & Means Committee. Tell us what that was like.

Nellen: I had the opportunity to testify on behalf of the AICPA. The hearing was on individuals and complexity, and I chair the AICPA's Individual Taxation Technical Resource Panel. I was fortunate to testify for the AICPA as they provided me with helpful advice, and we based the testimony on prior simplification proposals of the AICPA. The committee's meeting room is quite large, and there is tiered seating for the members and almost all were there. Three others also testified. We each had five minutes for our prepared statements, and I knew in advance it was extremely important to keep to that limit. There was a timing system with the green, yellow and red lights, and I finished before the red light (as practiced). After our prepared remarks, each member had five minutes to ask questions. Some of the questions addressed reasons for complexity, but some members used their time to make a point about tax cuts and the budget. It was an exciting opportunity. I was honored to be asked by the AICPA and to be part of the committee meeting.

SJSU CTJ: Was there anything about the hearings that caught you by surprise?

Nellen: I was surprised that some members did not take advantage of an opportunity to ask the four people testifying questions about complexity and how to address it.

SJSU CTJ: What would you recommend for anyone testifying for the first time in front of Congress?

Nellen: Get your key points in your oral testimony and leave the details for the written testimony. Practice to be sure you are under the time allotted to you. Be prepared for any question. Think a few seconds before answering.

SJSU CTJ: Having had time to reflect on the hearings, what would you change to improve the process?
Nellen: Provide a longer time for asking questions of those testifying and coordinate the questions in advance.

SJSU CTJ: What do you think are the top three ways to get Congress to enact tax reform?

Nellen: Well, first, our unsustainable budget practices and expiring tax cuts will require that something be done to address continued budget deficits, and tax changes will have to be part of the solution. Second, I think efforts to better educate the public about how our tax system works today and who benefits from the multitude of tax expenditures and how poorly structured many are, will get more individuals to support a simpler and more equitable system. Finally, I think the messages from everyone have to be, "stop studying and act," and work together. The Senate and House tax committees have been holding many hearings to understand today's tax problems and possible solutions, but they really are not bringing up anything new in this information gathering stage. Also, President Obama and Congress need to work together to improve the system. Unfortunately, the situation seems to be too partisan now to move forward constructively.

SJSU CTJ: As a leader in this area, what are the top tax issues that should be addressed in tax reform today?

Nellen: The individual system needs to be simplified. There are too many special deductions, exemptions, rates and credits. These distort behavior, provide greater benefit to high-income taxpayers, and increase compliance costs and errors. Generally, a system with a broader base and lower rates is the way to go to best meet principles of good tax policy. I have more at my 21st Century Taxation website and blog - http://www.21stcenturytaxation.com.

SJSU CTJ: As a facilitator of learning, what is the best approach to engage taxpayers in tax reform?

Nellen: Provide information about how the current system works and its flaws. I think if more people really knew how the system worked, they would advocate for reform. The home mortgage interest deduction, one of the most expensive features of the federal and California individual income tax systems, is a good example. Most people don't know that it allows people to deduct interest on a mortgage on a second home. If the law is designed to help people buy a
Fun Fact 4:

Some favorite things that Professor Nellen keeps in her office:

- Her daughter Jalissa’s art work from when she was 5 (she is now in high school).
- A photo of her with Patricia Breivik, a former library dean at SJSU and one of her most favorite people.
- A life-size poster of one of SJSU’s most famous alums - Edwin Markham (class of 1872). The poster is used for the SJSU Legacy of Poetry Day which Professor Nellen started and helps coordinate annually.

home to live in, why a deduction for a second home? Also, that provision offers a tax break to higher income individuals who can afford a second home. Why not remove that deduction and use the savings for a higher standard deduction that would benefit more taxpayers. Also, why allow a deduction for interest on a home equity debt? That benefits homeowners only and encourages people to sometimes place too much debt on their home. If you borrow on a credit card to take a vacation or finance a car purchase, you can't deduct the interest. But if you borrow against the equity in your home to fund the same purchases, you get a deduction. That's unfair and a poor use of government funds. Of course, the government is everyone. The special deductions are really being paid for by everyone who doesn't claim them. Finally, why a maximum mortgage level of $1.1 million? I don't think the median home price in California has ever exceeded $600,000. Research shows that this high limit just helps higher income individuals to buy a more expensive home. This deduction could be reformed to just encourage ownership of your principal residence with the savings used to address the deficit and allow for lower rates or a higher standard deduction. So, more education on how our system works would likely be a good way to get taxpayers engaged in wanting reform.

SJSU CTJ: Do you have any recommendations for taxpayers on how to go about pursuing tax reform?

Nellen: Learn how the system works and tell your representatives in Congress and President Obama that you want a tax system that reflects principles of good tax policy.

SJSU CTJ: What do you like most about teaching?

Nellen: Finding ways to facilitate people’s understanding and perhaps heighten their interest in a subject matter. I enjoy discussing topics with students and learning from them. I also enjoy research and writing on topics that I teach.

SJSU CTJ: Over the years, what do you think has changed the most about the direction of the SJSU MST Program?

Nellen: I have been teaching in the program since I came to San Jose State in 1990. I think two significant changes are first that the subject matter just keeps on getting more and more complicated. Second, we have a trend of having more students who are getting their
MST as an entry into the tax field, rather than only people that have already been working in the tax field for a few years. I expect this trend to continue as California implements the requirement for 150 units to become a CPA. The program will continue to add or modify existing courses to have more courses (whether 1-unit or 3-unit classes) that are more foundational. That is, these courses devote more time to underlying rules, definitions and concepts in a variety of areas. Many of our courses cover more advanced topics. I hope that going forward, people who go right from undergrad to the MST program will come back after 3 to 7 years of practice and earn the Advanced Certificate in Taxation as a way to get a strong, broad and deep understanding of more advanced topics.

**Fun Fact 5:**

*Professor Nellen’s fantasy dinner is with Oprah Winfrey!*
Master of Science in Taxation Program

- Full-time or part-time programs of study
- Over 20 electives offered
- Courses taught by both full-time faculty and adjuncts from law and accounting firms
- Several co-curricular activities available to enhance your practical skills and knowledge

The Lucas Graduate School of Business at San José State University offers a high-value education with a global focus, innovative programs, and deep ties to Silicon Valley businesses and leaders.

Our distinguished faculty provide a relevant business education focusing on excellence in teaching and applied research, serving the needs of diverse students from the Silicon Valley and beyond.

Other Lucas School Programs:
- MS degrees in Accounting and Transportation Management
- Executive-Style Part-Time MBA program
- MBA/MS in Engineering joint degree, three-year evening program
- Full-time cohort programs: MBA-One, Conventional MBA, and MS in Accounting

To learn more, please visit: http://www.sjsu.edu/lucasschool/
Published by:
The SJSU MST Program
Lucas Graduate School of Business
San Jose State University
One Washington Square
San Jose, CA 95192-0066

Contact Information:
Student Editor - editor@sjsumstjournal.com
Journal Faculty Advisor - bobbi.makani@sjsu.edu
MST Program Director - annette.nellen@sjsu.edu

Copyright 2011, SJSU MST Program