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

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

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

An annual conference sponsored by the
Tax Executives Institute, Inc. and
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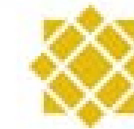
November 12 & 13, 2012

Introduction

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

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



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

By: Katelyn Truong, *MST Student*

Tax planning is essential in all corporations' structuring from the time of incorporation to the point of liquidation. An expert panel consisting of Ms. Rachel Kleinberg from *Davis Polk & Wardwell LLP,* Mr. Ivan Humphreys from *Wilson Sonsini,* Mr. David Hering from *KPMG,* and Mr. Paul Fahy from *A&L Goodbody* addressed tax consequences of organizational changes. This summary highlights two topics covered by the panel: spin-off and IRC §338(h)(10), and intangible transfer under IRC §367(d).

Spin-off and IRC §338(h)(10)

Ms. Kleinberg discussed how to recognize a loss in a spin-off. Such a transaction is usually tax free for the parent corporation, the spin-off corporation, and the shareholders.[1] If the spun-off corporation has built in loss; the loss, unfortunately, is not recognized. But with proper tax planning the parent corporation can recognize the loss and the shareholders can receive the stock of the spin-off corporation tax free. Ms. Kleinberg explained that the parent company has to plan a "busted 351" and then make an election under IRC §338(h)(10). IRC §351 states that "no gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control of the corporation." IRC §351 allows taxpayers to form a corporation tax free; thus a "busted 351" changes a tax-free transaction into a taxable one.

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

1 Fahy, P., Hering, D., Humphreys, I., & Kleinberg, R. (2012, Nov., 12). Acquisition Planning and Business Restructuring. [PowerPoint slides] Slide 4. Retrieved from http://www.cob.sjsu.edu/acct&fin/tax-institute/2012_HTI_Web_Copy/MON_Bus_Restructuring.pdf

Intangible transfers under IRC §367(d)

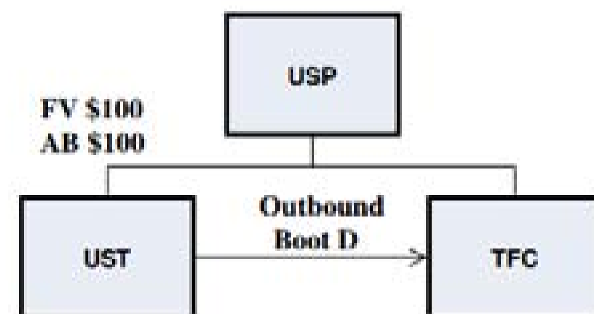
IRC §367(d) addresses transfer of intangibles. Many corporations are moving their intangibles around the world. The IRS is concerned about outbound reorganizations in which U.S. corporations transfer intangibles to controlled foreign corporations without income recognition. IRC §367(d)[2] applies to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

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

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

2 *Ibid.*, Slide26.

3 *Ibid.*, Slide 20.



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

Figure 1: Notice 2012-39[4]

- UST ceased to exist.

UST received $80 cash for the intangibles transferred. According to IRC §367(d), the transfer of intangibles would be treated as a transfer similar to sale of contingent payments (royalties). UST would recognize deemed royalty payments, commensurate with income attributed to the intangible, on an annual basis. When UST distributed the $20 worth of assets and $80 cash to USP, UST would recognize $15 (FV 20 – Basis 5) of gain from the U.S. Asset. UST would not be taxed on the $15 due to IRC §361(c). USP would not be taxed on the $80 cash due to boot-within-gain rule under IRC §356. The deemed royalty payments that UST would receive from TFC is transferred to USP. Since the deemed royalty payment was valued at $50, the net repatriation from this reorganization would be $130 ($80 cash + $50 royalties). USP would only be taxed on the $50 deemed royalty.

After the Notice is issued, given the same scenario, UST would not recognize deemed royalty payments, instead UST would recognize income based on the proportion of property transferred. In this scenario, since the full value of the goodwill and IP would be distributed to TFC, the $80 would be recognized by UST. UST would not recognize the gain from the $15. When UST distributed the U.S. asset and the $80 cash to USP, USP “steps in the shoes” of UST and would be taxed on the $80 cash.

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

4 *Ibid.*, Slide 10

From pg 20 of conference material http://www.cob.sjsu.edu/acct%26fin/tax-institute/2012_HTI_Web_Copy/MON_Bus_Restructuring.pdf

Indirect Taxes and Emerging Industries

By: Sandhya Dharani, *MST Student*

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

Sales and Use Tax

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

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

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

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

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

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

Value Added Tax

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

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

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

Section 199's Importance for Hardware and Software Companies

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

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

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

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

Alphabet Soup

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

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

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

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

Computer Software

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

Contract Manufacturing of Hardware

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

1. Contract Terms: What do the contractual terms of the manufacturing relationship say with respect to ownership and risk of loss of manufacturing work in process?
2. Production Activities: Did the taxpayer develop and oversee the manufacturing process?
3. Economic Risks: Did the taxpayer carry economic risk such as for raw material and other cost fluctuations that could affect the profitability of the manufacturing activity?

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

The Bottom Line

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

IRS Examinations, Appeals and Litigation

By: Devon Lee, *MST Student*

A panel of tax experts with different backgrounds discussed IRS examinations, appeals, and litigation processes. Mr. Larry Langdon, a Partner with *Mayer Brown LLP* and former Commissioner of the *Large and Mid-Size Business Division of the Internal Revenue Service (IRS)* introduced Ms. Julia Kazaks, Partner at *Skadden Arps, LLP*; and two IRS experts: Ms. Cheryl Claybough, *Large Business & International (LB&I) Industry* Director for Communications, Technology & Media; and Ms. Laurel Robinson, *Area Counsel.*

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

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

Ms. Kazaks discussed IRC §7701(o) which codifies the economic substance doctrine. It was enacted by "The Health Care and Education Reconciliation Act of 2010" (P.L. 111-152, 3/30/2010). Under the new law, a transaction is considered to have economic substance if, other than federal income tax effects, the transaction changes the taxpayer's economic position in a meaningful way and if the taxpayer has a substantial purpose for entering into such transaction. Ms. Robinson said that the IRS's focus is ensuring the statutory economic substance doctrine is applied consistently and appropriately.

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

Ms. Claybough also gave an overview of the Pre-Filing Agreement (PFA) process, which allows a taxpayer to review with the IRS a transaction that is completed but the return of the relevant tax year is not yet due. Ms. Claybough emphasized that the PFA process puts the issue on the table so the taxpayer understands how IRS would deal with the issue before the taxpayer files the return.

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

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

Next, Ms. Kazaks covered issues in the appeals and litigation areas. She stressed that the Appeals Unit is independent, as required by the IRS Restructuring and Reform Act of 1998, from the IRS examiners who are organized under the Services and Enforcement Unit. The mission of the Appeals Unit is to resolve tax controversies fairly and impartially for both the government and the taxpayer. Ms. Kazaks and Ms. Robinson both agreed that taxpayers should try to avoid litigation because it is very expensive and time consuming. In the litigation area, Ms. Kazaks covered several topics including attorney-client privilege, the work product doctrine, and the use of the motion practice (submitting a case to the court without trial) to streamline litigation. She referred to the *PepsiCo*[1] case to illustrate that litigation takes time, and is unpredictable. The issue addressed by the Tax Court in *PepsiCo* was whether certain financial instruments of the taxpayer should be treated as debt or equity. The instruments had characteristics of both; thus, the taxpayer treated it as equity, while the IRS recast it as debt. The Tax Court ruled for the taxpayer after a lengthy review of the transaction.

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

1 *PepsiCo Puerto Rico, Inc. v. Commissioner,* TC Memo 2012-269

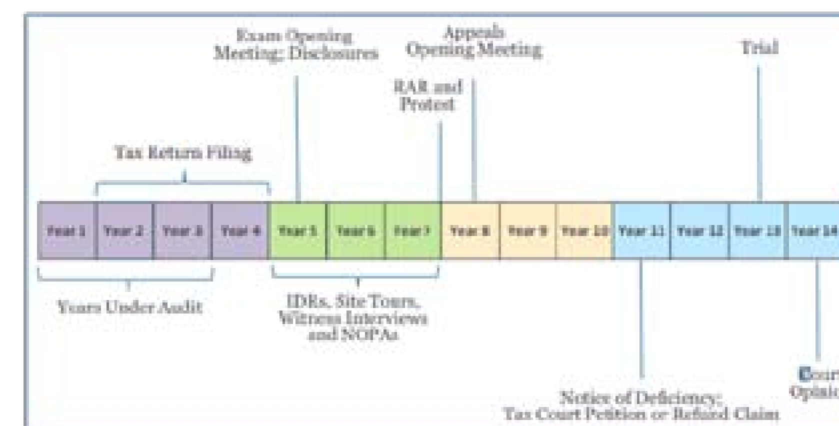


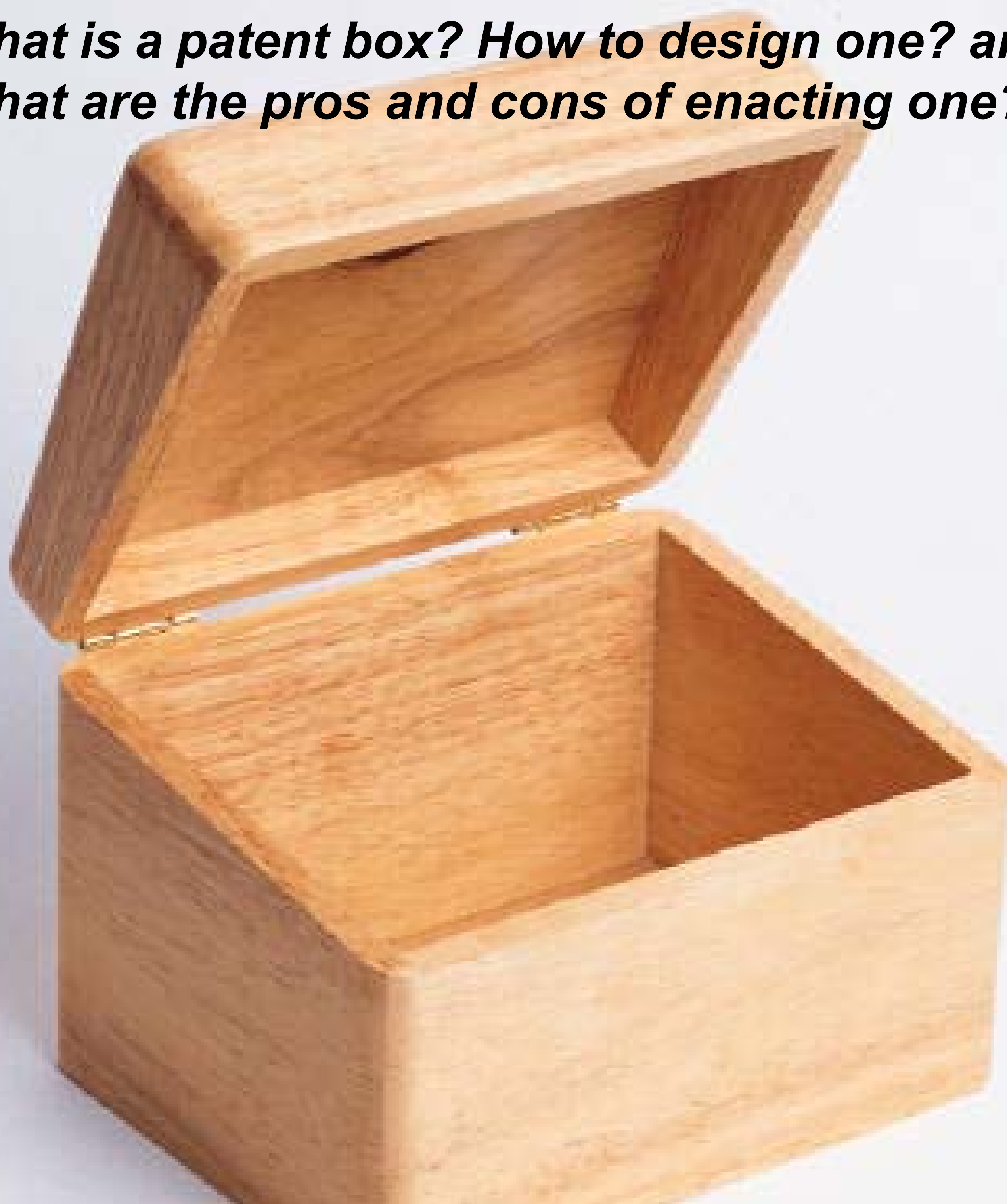
Figure 1: A typical timeline of an IRS examination

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

What is a Patent Box and Do We Want One?

By: Dana Ielceanu, *MST Student*

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



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

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

Another common question is "What types of IP should qualify for a tax incentive?" The panel explained that every country offering R&D tax incentives defines IP differently. Some countries restrict the scope to scientific discoveries while others, like the U.S., focus on the developmental aspect of R&D. Most countries offering tax incentives impose restrictions on the location of the qualifying R&D activities and location of the IP. Countries that require the R&D activities to be performed within its border include: Australia, Brazil, Canada, China, India, South Africa and the U.S. China and Japan require the IP resulting from the qualifying R&D activities to remain within the country to qualify for tax incentives. Generally, EU countries offering research credits do not impose development requirements.

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

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

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

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

consider:

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

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

Mark you calenders !!!

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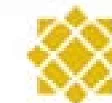

Federal Domestic and State Tax Updates

By: Dana Coroiu, *MST Student*

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

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

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

Other 2013 changes in healthcare include:

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

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

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

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

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

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

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