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Focus on Tax Policy: An Introduction

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

One of the learning objectives of the SJSU MST Program is: To develop an appreciation for tax policy issues that underpin our tax laws. Students learn about principles of good tax policy starting in their first MST class - Tax Research and Decision-making. The AICPA's tax policy tool, issued in 2001,[1] which lays out ten principles of good tax policy, is used to analyze existing tax rules as well as proposals for change.

Beyond their initial tax course, SJSU MST students examine the principles and policies that underlie and shape tax systems and rules in the Tax Policy Capstone course. In other courses, such as taxation of business entities and accounting methods, students learn the policy underlying the rules and concepts of the technical subject matter in order to better understand the rules and to learn more about the structure and design theory of tax systems

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

1. Tax Credit for Qualified Plug-in Electric Drive Motor,
2. Tax Incentives to Move Jobs Back to The US

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

Tax Incentives to Move Jobs Back to the U.S.

By: Gamaliel Salazar, *MST Student*

Introduction

"Those jobs aren't coming back" is the response Apple CEO Steve Jobs gave President Barack Obama at a meeting in February of 2011.[1] The question the President asked was whether or not the U.S. could attract Apple manufacturing jobs back to the U.S. From 2001 to 2010, the U.S. lost approximately 2.8 million jobs due to its trade deficit with China; 1.9 million of those jobs were in manufacturing.[2] In 2012, the National Science Board reported that since 2000, the U.S. had lost 687,000 jobs in high-tech manufacturing sector.[3] The magnitude of these job losses is the main reason why the President has proposed tax changes to bring jobs back to the U.S.

This two-part tax policy analysis reviews the Treasury Department's proposal to "Provide Tax Incentives for Locating Jobs and Business Activities in the United States and Remove Tax Deductions for Shipping Jobs Overseas."[4] The proposal itself contains two different tax incentives: (1), to bring back jobs to the U.S. (insourcing); and (2) to prevent jobs from going overseas (outsourcing). First, non-tax factors in which corporations would be highly encouraged to insource jobs are discussed. The non-tax factors include economic risks that corporations routinely face. Second, this analysis examines the proposal within the framework of the AICPA's Tax Policy Concept Statement #1, Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals.

Non-Tax and Economic Incentives

In order for companies to insource jobs to the U.S., they need a combination of both economic and tax incentives. Tax incentives are created at the federal, state, and local levels; other incentives can be created by economic conditions. The U.S. automobile industry is an appropriate case study. This industry has seen an increase in insourcing and foreign direct investment (FDI), particularly in southern states. In January of 2012, Daimler AG and Nissan announced a partnership to build Mercedes-Benz engines at a Nissan plant in Tennessee.[5] The companies cited the savings that come with a partnership and the ability to reduce their exposure to foreign exchange rate risks as the main factors in the decision

Another example: In 2006, Kia received a tax incentive package of $410 million for building a $1.2 billion plant in West Point, Georgia that is near a Hyundai plant in Alabama.[6] Notable incentives included in the total package were land acquired by the State of Georgia and the development of a training operation for new employees. The same article mentioned that Toyota received a $14 million tax package from the state of Indiana for investing $230 million in a Subaru plant. While the tax incentives played an important role for both automakers, these were not the only reasons for expanding manufacturing in the U.S. For Kia, three non-tax factors also played important roles. Although Hyundai, the parent company of KIA, had manufacturing plants in the U.S. at the time, no KIA cars were manufactured in the U.S. This meant that KIA had to export all autos to the U.S. and thus expose itself to rising fuel costs for shipping, exchange rate risks, and delays in getting cars to the U.S. market. In order to be competitive, KIA invested in the Georgia plant to eliminate its international risk exposure and to shorten the time frame to get its cars to the U.S. market.[7] For Toyota, the main non-tax factor was to save money through a partnership with Subaru, which included renovating an existing Subaru plant to manufacture the Toyota Camry model destined for the U.S. market. The key for both companies was to reduce their international risks exposures and to get their products to the U.S. market faster.

In other areas of manufacturing, a report by The Boston Consulting Group (BCG) concluded that by 2015, American manufacturing will be as favorable as manufacturing in China for products destined for the U.S. market.[8] Three reasons that led to BCG's conclusion was the fast rise in the cost of labor in China, the steady cost of labor in the U.S., and the decrease in the ratio of labor costs to total manufacturing costs. The combination

1 Duhigg, C., & Bradsher, K. (2012, Jan 21) How the U.S. Lost Out on iPhone Work. The New York Times Online. Retrieved from http://www.nytimes.com/2012/01/22/business/apple-america-and-a-squeezed-middle-class.html?pagewanted=all.

2 Scott, R. (2011, Sep 20) Growing U.S. Trade Deficit with China Cost 2.8 million Jobs between 2001 and 2010. Economic Policy Institute, Briefing Paper #323, p.1. Retrieved from http://www.epi.org/files/2011/BriefingPaper323.pdf

3 National Science Board. (2012). Science and Engineering Indicators 2012. Overview p. 16. Retrieved from http://www.nsf.gov/statistics/seind12/.

4 Department of the Treasury (2012, Feb). General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals. pp.27-28. Retrieved from http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf

5 Manufacturing.Net. (2012, Jan. 9) Daimler, Nissan To Make Engines At U.S. Plant. Retrieved from http://www.manufacturing.net/news/2012/01/daimler-nissan-to-make-engines-at-us-plant; and
Reed, J. (2012, Jan. 8) Nissan and Daimler in U.S. engine venture. Financial Times. Retrieved from http://www.ft.com/cms/s/0/4ab9a014-3a0c-11e1-8707-00144feabdc0.html#axzz1tGncVU8G

6 Maynard, M. & Peters, J. (2006, Mar. 13) 2 Asian Auto makers Plan Venture in 2 States Left by U.S. Carmakers. New York Times. Retrieved from http://www.nytimes.com/2006/03/14/business/worldbusiness/14auto.html?pagewanted=print

7 There are two indirect benefits received by KIA and Hyundai in having plants nearby and across borders. First, logistics costs could be reduced if there are parts and service sharing between the two plants. Second, plants in Georgia and Alabama increase the consolidated group's political representation within the same region.

8 Hohner, D., Sirkin, H., & Zinser, M. (2011, Aug.) Made in America, Again: Why Manufacturing Will Return to the U.S. The Boston Consulting Group, p.3. http://www.bcg.com/documents/file84471.pdf

of the three has led to smaller savings from outsourcing to China in certain areas of manufacturing. In addition, automation in the U.S. has increased the productivity of the U.S. workforce which makes the U.S. labor market more attractive. At the same time, automation requires a smaller workforce which means a smaller job recovery. Automation in China will increase the productivity of the Chinese workforce but will defeat the purpose of outsourcing to China in the first place. An increase in automation in China will undercut its labor cost advantage.

Indirect factors have also improved the U.S. manufacturing environment. Due to an increase in income levels across Asia, the demand for goods within Asia has also increased. BCG believes that companies in Asia will devote more time producing goods sold to Asian markets than to U.S. or European markets. This is an opportunity for U.S. manufacturing to compensate for the loss in Asian manufacturing. Operational and intellectual property risks have also created manufacturing opportunities in the U.S., especially if the companies operate in countries that have weak intellectual property rights protection laws.[9] Boeing cited the loss of quality control and service of its outsourced manufacturers that lead to its 787 Dreamliner aircraft to be three years behind schedule.[10] Peerless Industries, a manufacturer of flat-panel TV mounts, decided to move its manufacturing back to the U.S. because Chinese companies kept copying their products.[11]

It can be concluded that non-tax factors play an equal, if not greater part in the decision making process when companies consider insourcing to the U.S. This is not to say that tax incentives do not play a part, because they do. Both the non-tax factors and tax factors must be considered in order to make a decision to insource and achieve maximum benefits.

Application of the Principles of Good Tax Policy

Background on the Proposals – In General

What is considered a moving expense related to insourcing and outsourcing? Based on the proposal and President Obama's 2012 State of the Union Address,[12] such moving expenses are defined as costs related to packing and shipping equipment to a new site, new employee training, and traveling expenses related to business development and finalizing agreements. Other moving expenses that could be included but need clarification are costs for services paid to intermediary organizations that assist U.S. companies to find business partners abroad, and the costs to close an old plant and open a new plant.

There is little written about moving expenses in professional and academic journals. Three possible reasons underlie this lack of attention. First, gathering the actual moving expenses is a tedious task. Even if these costs were identified separately on a project basis in public financial statements, it would be time consuming for any one individual to look through all statements to gather such data. In addition, access to information may be limited because financial reporting for tax purposes is private and unavailable to the public. Second, professional journals, academia, and newspaper articles often analyze insourcing and outsourcing based on cost savings, risk factors, timing, and financial incentives. The tax deduction of moving expenses is rarely mentioned in tax literature, perhaps because they are low and do not play an important role in the decision-making process. Lastly, companies that outsource may invest directly overseas, avoiding moving expenses altogether.

Proposals as Described by the Administration[13]

President Obama's FY2013 revenue proposal includes a few changes to expand manufacturing and insourcing of jobs in the U.S. This plan includes a tax credit equal to 20 percent of the eligible expenses paid or incurred in connection with insourcing a U.S. trade or business. For this purpose, insourcing a U.S. trade or business means reducing or eliminating a trade or business (or line of business) currently conducted outside the U.S. and starting up, expanding, or otherwise moving the same trade or business within the United States, to the extent that this action results in an increase in U.S. jobs. While the creditable costs may be incurred by the foreign subsidiary of the U.S.-based multinational company, the tax credit would be claimed by the U.S. parent company. A similar benefit would be extended to non-mirror code possessions (Puerto Rico and American Samoa) through compensating payments from the U.S. Treasury.

The Administration would also disallow expenses of outsourcing jobs. Per the FY2013 "Greenbook" description, this would apply to "deductions for expenses paid or incurred in connection with outsourcing a U.S. trade or business". For this purpose, outsourcing a U.S. trade or business means reducing or eliminating a trade or business or line of business

9 *Ibid*, p.11.

10 Malone, S. (2012, Feb. 13) After 'Lemming' Exodus, Manufacturers look to U.S. Reuters. Retrieved from http://www.reuters.com/article/2012/02/13/us-usa-manufacturing-onshoring-idUSTRE81C1B720120213

11 Cancino, A. (2012, Mar. 24) More Manufacturing Work Returns to U.S. Shores. The Chicago Tribune. Retrieved from http://articles.chicagotribune.com/2012-03-27/site/ct-biz-0326-reshoring-20120324_1_manufacturing-plant-china-wages

12 White House. (2012, Jan. 25) Remarks by the President in State of the Union Address. Retrieved from. http://www.white-house.gov/photos-and-video/video/2012/01/25/2012-state-union-address-enhanced-version#transcript

13 Department of Treasury, (2012, Feb) General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals ("Greenbook"), p.p. 27-28.

currently conducted inside the United States and starting up, expanding, or otherwise moving the same trade or business outside the United States, to the extent that this action results in a loss of U.S. jobs.

The tax policy analysis below addresses these two tax proposals: (1) a tax credit for insourcing, and (2) disallowance of deductions for outsourcing.

***Editor's Note**: the rating for the two tax proposals are displayed separately in the table below, (1) for the tax credit and (2) for the deduction disallowance.*

Equity and Fairness

Similarly situated taxpayers should be taxed similarly.

The tax credit would satisfy the Equity and Fairness principle for two reasons. First, the tax credit would apply to all corporations who insource jobs and would not be limited to a specific industry. This means that similarly situated corporations will benefit equally. Second, the tax credit is limited to insourcing expenses and not capital expenditures. This ensures that capital intensive industries do not benefit more than non-capital intensive industries. Capital expenditure benefits are more likely provided by states and local governments as discussed in the previous analysis section. The removal of the tax deduction would satisfy the Equity and Fairness principle for one main reason: the removal of this tax deduction would treat all U.S. corporations more equally with respect to this deduction. The removal would eliminate the tax liability reduction that corporations receive for moving expenses compared to corporations that do not incur such costs

Certainty

The tax rules should specify when the tax is to be paid, how it is to be paid and how the amount to be paid is to be determined.

The tax credit is currently ambiguous and needs better guidelines for taxpayers in order to improve the Certainty principle. Exact guidelines that improve on current definitions of what qualifies as an insource expense would be needed to provide certainty. For example, there is no IRC section dedicated to moving expenses for insourcing or outsourcing business operations. Instead, such expenses are spread across various IRC sections. If a new IRC section is created that specifically defines what is deductible and what is not deductible to support the proposal, then Certainty should be better met. As written, the proposal only provides a general definition of the tax credit, capital expenditure exclusion, and its overall intent.

The removal of the tax deduction also needs better guidelines for taxpayers in order to improve the Certainty principle. Exact guidelines and an IRC section that improve on current definitions of what qualifies as an outsource expense is needed to provide certainty. For example, would any general labor and overhead expenses of the company be allocated to the outsourcing activity or only direct expenses?

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 proposed credit and deduction disallowance should not affect the time when tax is due.

Economy of Collection

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

The tax credit and deduction disallowance would not meet the Economy in Collection principle because more guidelines regarding qualified expenses would be needed. Thus, the IRS would need to expend time issuing regulations and auditing these provisions. The specific guidelines, either in the form of a new IRC section or regulations, would give IRS agents and accountants a better interpretation of the tax credit resulting in faster implementation time. But time would be expended by both IRS agents and accountants to determine which expenditures qualify for the 20% credit and expense disallowance provision.

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.

Any proposal or tax law should not influence taxpayer decisions to engage in a transaction but the tax credit in this proposal serves as a small incentive for corporations to insource jobs - a contradiction. However, external factors explored in the previous section are long-term in nature and provide corporations with greater incentives to insource than the proposed 20% tax credit. Furthermore, capital expenditure tax incentives provided at the state and local levels have a larger impact on decisions to insource manufacturing jobs than the proposed tax incentive.

Taking the proposed tax credit for insourcing jobs would be part of short-term tax and business planning, whereas exposure to exchange rate risks, rising labor and shipping costs of overseas operations are ongoing business risks. Since the tax credit incentive, in combination with existing external factors and state and local tax incentives described in the previous section, would play only a small role in the decision-making process to insource jobs, the Neutrality principle would be satisfied.

The removal of the tax deduction for outsourcing would only eliminate one small incentive yet it still satisfies the Neutrality principle. Other more significant incentives such as low wage labor and capital expenditure incentives would still exist. The current tax deduction for outsourcing is at the full value of expenses paid or incurred. This means that the deduction violates the Neutrality principle by giving corporations a tax incentive to outsource.

Economic Growth and Efficiency

The tax rules should specify when the tax is to be paid, how it is to be paid and how the amount to be paid is to be determined.

The tax credit would satisfy the Economic Growth and Efficiency principle since the insource tax credit attempts the following: to improve the overall U.S. labor market; to avoid favoring one industry over another; to avoid impeding tax revenue collected by the government; to align federal and state economic goals to improve the international competitiveness of the U.S. corporations.

Although the tax credit would decrease the amount of tax revenue collected from corporations at the Federal level, the main benefit of the insource tax credit is the increase in the employment rate at the local level. An increase in employment rate means more growth in tax revenues collected at all government levels such as real property taxes, sales taxes, and individual income taxes. An increase in employment rate also means a decrease in unemployment benefits.

The removal of the tax deduction for outsourcing would satisfy the Economic Growth and Efficiency principle mainly because it would eliminate the current deduction of taxable income that corporations receive for outsourcing. Outsourcing jobs has a negative impact on employment rates in the U.S. and impedes economic growth. In addition, the tax deduction for moving jobs overseas reduces tax revenue collected by the U.S. since the deduction reduces corporations' taxable income. Since outsourcing increases the unemployment rate and the enrollment rate of unemployment benefits, the removal of the tax deduction would increase tax revenue slightly.

Simplicity

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

While the Simplicity principle should be better satisfied once specific guidelines are provided regarding qualified expenses for the insourcing tax credit. Once guidelines are improved and easier to interpret, taxpayers could better identify expenses for the tax credit. Currently, the proposal is ambiguous. Also, any special rule, such as the proposed credit requires special definitions and rules, thus adding complexity to the law.

The removal of the tax deduction might better satisfy the Simplicity principle once specific guidelines are provided regarding qualified expenses for outsourcing. Without specific guidelines, accountants could struggle to estimate which expenses should be excluded or included in the tax deduction, thus they would spend more time than necessary on calculating this amount than on other more important issues. In addition, as with the credit, a special rule for certain expenditures adds to the complexity of the tax law.

Transparency and Visibility

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

The insource tax credit would satisfy the Transparency principle since it specifically targets corporations with current overseas operations or plans to move jobs back to the U.S. These corporations are highly motivated to find tax benefits at all levels of government (Federal, state, local) in the U.S. and overseas. Therefore, corporations are aware of this entire proposal.

The removal of the tax deduction for outsourcing would satisfy the Transparency principle since it specifically targets corporations who are contemplating or planning to move some operations of their business overseas. Such corporations are highly motivated to find tax benefits at all levels of government (Federal, state, local) in the U.S. and overseas. They would be aware of this entire proposal.

Minimum Tax Gap

A tax should be structured to minimize noncompliance.

The insource tax credit would satisfy the Minimum Tax Gap principle after specific guidelines are provided. The specific guidelines would identify which expenses qualify for the tax credit. In addition, the tax credit targets corporations with overseas operations who either insource jobs to the U.S., are in the process of insourcing, or are contemplating insourcing after the effective date of the proposal. The credit would minimize noncompliance because it would eliminate any intentional or unintentional errors made by corporations without overseas operations and corporations who do not move jobs to the U.S. The current tax credit, as written, would create some confusion as to which expenses qualify for the tax credit. For example, calculating 20% of costs may sound simple, but without more specific guidelines, employees could mistakenly apply the tax credit to unqualified expenses.

The removal of the tax deduction for outsourcing would satisfy the Minimum Tax Gap principle after specific guidelines are provided. Unlike the 20% tax credit, the full amount of outsourced expenses would lead to less confusion in calculating the disqualified tax deductions. However, like the credit, the removal of the tax deduction for outsourcing requires specific guidelines regarding outsourced expenses. As written, the removal could lead to calculation errors.

Appropriate Government Revenues

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

The insource tax credit would satisfy the Appropriate Government Revenues principle since the Treasury Department and the IRS have sufficient data to estimate the costs of the proposed insource tax credit. Such data could be found from tax deductions taken by corporations that have moved jobs overseas; the corporations that have already moved jobs back to the U.S.; and the type of industries that have direct foreign investments in the U.S.

The tax deduction for outsourcing would satisfy the Appropriate Government Revenues since the Treasury Department and the IRS have sufficient data to estimate the costs of current overseas tax deductions. Such data could be found from tax deductions taken by corporations who have moved jobs overseas, and from the industries who have operations in the U.S. and overseas.

Ratings Summary

Equity and Fairness	(1) + (2) +
Certainty	(1) +/- (2) +/-
Convenience of Payment	(1) N/A (2) N/A
Economy in Collection	(1) - (2) -
Simplicity	(1) - (2) -
Neutrality	(1) - (2) -
Economic Growth and Efficiency	(1) + (2) +
Transparency and Visibility	(1) + (2) +
Minimum Tax Gap	(1) +/- (2) +/-
Appropriate Government Revenues	(1) +/- (2) +/-

Conclusion

The two-part proposal to provide a 20% tax credit for moving expenses related to insourcing jobs and the removal of the tax deduction for expenses related to outsourcing jobs would satisfy the 10 Principles of Good Tax Policy after specific guidelines are provided regarding qualified and unqualified expenses for both the tax credit and the tax deduction. The best guidelines would be for Congress to add an Internal Revenue Code section that is dedicated to specifics for both parts of the proposal. As currently proposed, the tax credit could only satisfy six of the ten and the removal of tax deduction for outsourcing would only satisfy seven of the ten. Based on the two-part analysis presented it appears that this particular proposal would provide only a small benefit to companies insourcing jobs to the U.S., and inversely slightly increase the tax liabilities to companies that outsource jobs.

It is important to note that this proposal is among seven proposals from the Administration to promote insourcing and manufacturing in the U.S. If these proposals are enacted, they would be added to the current tax incentives and included in the decision making process along with all the incentives created by economic conditions explored in the first part of this analysis. What this all means is that management must conduct a thorough analysis of the advantages and disadvantages to insource or to outsource.