The Contemporary Tax Journal
A publication of the SJSU MST Program

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Letter from the Editor

“The hardest thing in the world to understand is the income tax.” — Albert Einstein

The US tax law is complex. However, with a solid foundation in the form of the SJSU MST program, I now wonder if Einstein’s quote is accurate. It is with this confidence that we bring to you the sixth issue of The Contemporary Tax Journal, a publication of the SJSU MST program. It gives me immense pleasure to be a part of this prestigious university and this publication. As we embark on our new journey as tax professionals, it is imperative that we stay tuned to new developments in the tax laws.

We begin this issue with a tax enlightenment article about ‘bitcoin’. The author attempts to explore the virtual currency and its impact on the current tax law.

Next, we have two significant articles from distinguished tax experts. The first paper is from Dr. David R. Jenkins, Algorithm LLC. Dr. Jenkins’s article focuses on the present administration of Section 530 of The Revenue Act of 1978 and the outlook of the states with respect to worker classification. The next paper, ‘An Examination of Tax Incentives for Child Support’ is contributed by Dr. Gary M. Fleischman, Dr. Paul D. Hutchison, and Dr. Zafar Dad Khan. We are truly grateful for these contributions.

The annual joint Tax Executives Institute-SJSU High Tech Tax Institute has always been an important part of the MST journal. In this issue, the summaries from the 29th High Tech Tax Institute focus on international tax developments and the Tax Policy Conference highlights the tax reform proposal put forward by Congressman Camp. In the ‘Tax Maven’ section, we have Mr. Dean Andal, Director at PwC, share his experiences in the public sector.

Finally, I would like to thank Professors Annette Nellen, Bobbi Makani and Joel Busch for their continued guidance and invaluable support for the journal. In addition, I would like to give a big shout-out to all my MST colleagues for pitching in and making the journal a grand success. Thank you!

Asmita Bedekar
Student Editor
‘Coin’ing the Tax ‘Bit’
By: Asmita Bedekar, MST Student

In June 2014, King’s College, a Christian liberal arts school in New York City, became the first accredited college in the United States to accept bitcoin for tuition, other expenses, and donations. Retailers like Overstock.com have started accepting bitcoin as a mode of payment. Other retailers like Whole Foods, Lowe’s, and Sports Authority are allowing customers to pay with gift cards, purchased by using bitcoins. With the bitcoin entering the financial routine, we make an attempt to understand this crypto currency and its impact on the regulatory framework.

What is Bitcoin?

In 2009, a software developer, under the alias Satoshi Nakamoto created ‘bitcoin.’ Bitcoin is a form of digital currency, created and held electronically. Bitcoins are not printed like dollars or euros. They are not created by any central bank. Bitcoins are created by people all around the world, using software that solves mathematical problems.

In simpler terms, bitcoin network is just a digital file that lists accounts and money like a ledger. Just like a bank maintains an account ledger for every customer, the bitcoin network maintains a copy of the digital file on every computer in the Bitcoin network, as illustrated by Fig. 1. This means that everyone can see everyone else’s transactions.

Figure 1: Sample of a Bitcoin digital file

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1 USA Today, Patrick Foster, June 14, 2014
http://college.usatoday.com/2014/06/14/new-york-college-becomes-first-in-u-s-to-accept-bitcoin-for-tuition/

2 http://newsbtc.com/2014/09/02/users-can-now-spend-bitcoin-whole-foods-products-via-egifter/
Suppose Alice wants to transfer 5 bitcoins to Bob (Refer to Fig. 2).

Figure 2: Bitcoin transaction messages:

<table>
<thead>
<tr>
<th>Transaction Messages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alice → Bob 5.0 BTC 04323784...</td>
</tr>
<tr>
<td>Alice → Dave 12 BTC 88432738...</td>
</tr>
<tr>
<td>Alice → Juan 2000 BTC 00328434...</td>
</tr>
<tr>
<td>Alice → Bob 14 BTC 19382637...</td>
</tr>
</tbody>
</table>

She broadcasts this message to the entire bitcoin network. Upon receiving this message, every computer in the network updates their copy of the ledger with this information.

In the bitcoin world, the names of Alice and Bob are replaced by numbers. Each account has a specific identity represented by digits. The true identity of the owner is thus protected. Simply put, one deals with complete strangers.

To verify that the request is genuine, bitcoin network uses a ‘digital signature.’ A digital signature is a password which authenticates the bitcoin transaction. Each bitcoin transaction has a unique digital signature. The digital signature works by utilizing two different but connected keys: a “private key” to create a signature and a “public key” to verify the transaction.

This is a simple explanation of how bitcoins work. In truth, instead of ledger balances, ownership of bitcoins is verified through links to previous transactions.

To send 5 bitcoins to Bob, Alice must reference the previous transactions through which she received 5 or more bitcoins. Other computers, verifying the Alice and Bob transaction will check the referenced transactions to make sure that Alice was in fact the recipient and also that the inputs add up to 5 or more bitcoins. Through these referenced links, ownership of bitcoins is passed along in a kind of chain, where the validity of each transaction is dependent on previous transactions. Once a transaction has been used, it is considered spent and cannot be used again. Otherwise, someone could double-spend an input by referencing it in multiple transactions. Therefore, when verifying a transaction, in addition to the other checks, computers also make sure that the inputs have not been spent already. Thus, instead of a ledger of balances, bitcoin nodes keep track of a giant list of transactions.

**Bitcoin ‘Mining’**

Bitcoin is a peer to peer network: everyone who creates bitcoin is a fraction of the entire bitcoin network. With paper money, a government decides when to print and distribute money. Bitcoin does not have a central government, so how are bitcoins created? With bitcoin, people use specialized software to solve math problems, and in exchange they are

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issued a certain number of bitcoins as commission. By solving the algorithms, they are verifying the transactions in the network, such as the Alice and Bob transaction mentioned previously. More miners means more verification and, therefore, a more secure network. The bitcoin network changes the difficulty of the math problems depending upon how fast they are being solved.

In early days, miners were able to solve these problems with computers and processors. As bitcoin grew, miners moved on to graphic cards, used for gaming purposes, for solving algorithms. Graphic cards are faster but use a lot of power. Today, bitcoins are mined with the help of Application Specific Integrated Circuit-chips (ASICs). ASIC technology has made bitcoin mining faster with comparatively less power.

Bitcoin mining needs ample resources in terms of hardware, software, and electricity. As more miners join the network, it becomes more difficult for a single individual to mine bitcoins. Hence, the miners form a pool, solve the algorithms together, and share the proceeds according to the work performed.

**Bitcoin Trade and ATM**

Bitcoin mining creates bitcoins. The bitcoins reach the consumers by way of open trade, just like the stock exchange, but bitcoins are bought and sold on an unregulated exchange. Another way of distributing bitcoins is through the ‘Bitcoin ATM.’ Bitcoin ATMs enable the bitcoin owners to exchange the digital currency for cash and vice versa. The world’s first bitcoin ATM opened in Vancouver, Canada in October 2013.4

**Why did the Bitcoin become so Popular?**

Bitcoin gained popularity due to its unique features:

1) **Privacy:** A person’s real-world identity can be separated from his pseudonym within the bitcoin system. Although privacy is sometimes associated with illicit transactions, there may be legitimate reasons for wanting to maintain one’s own privacy.

2) **Accessibility:** Anyone in the world can transact using bitcoin so long as they have access to the internet. Such easy access might not work for other forms of transactions.

3) **Transaction costs:** The cost to validate a bitcoin transaction is insignificant when compared to a credit card transaction fee. With bitcoin, the person initiating the transfer sets a proposed fee appropriate enough to provide an incentive for a bitcoin miner to validate the transaction. At the same time, it is not much extra effort for a miner to add one more transaction to the block on which they are working.

4) **Decentralization:** No central parties are involved in a bitcoin transaction (example, a bank). No one can "freeze" your bitcoin account or try to seize your assets. All transactions are public, and the transaction block chain is a publicly verifiable trail that you own the bitcoins you do.

5) **Irreversibility**: Once a transaction happens, it cannot be undone, which might be advantageous or even necessary for some merchants.

**Proposed Regulations for Bitcoin in New York:**

On July 17, 2014, the New York State Department of Financial Services (DFS) issued a draft of its “BitLicense” regulatory framework for New York virtual currency businesses. The proposed regulatory framework contains rules for consumer protection, anti-money laundering compliance, and cyber security.  

The following is a summary of the proposed legislation:

1) DFS BitLicenses will be required for firms engaged in the following virtual currency businesses: receiving or transmitting virtual currency on behalf of consumers; securing, storing, or maintaining custody or control of such virtual currency on the behalf of customers; performing retail conversion services; buying and selling virtual currency as a customer business or controlling, administering, or issuing a virtual currency. The license will not be required for merchants or consumers that utilize virtual currency solely for the purchase or sale of goods or services.

2) Each firm will hold virtual currency of the same type and amount as any virtual currency owed or obligated to a third party. The licensee would be required to maintain a bond or trust account in United States dollars in such form and

amount, as is acceptable to the DFS, for the protection of the licensee’s customers.

3) Upon completion of any transaction, each firm shall provide to a customer a receipt containing the following information: the name and contact information of the firm, including a telephone number established by the licensee to answer questions and register complaints; the type, value, date, and precise time of the transaction; the fee charged; the exchange rate, if applicable; a statement of the liability of the licensee for non-delivery or delayed delivery; and a statement of the refund policy of the licensee.

4) When opening accounts for customers, firms would have to verify their identity to the extent reasonable and practicable and maintain records of the information used to verify such identity, including name and physical address.

5) Each licensee would have to maintain a cyber-security program designed to perform a set of core functions: identifying internal and external cyber risks; protecting systems from unauthorized access or malicious acts; detecting system intrusions and data breaches; and responding and recovering from any breaches, disruptions, or unauthorized use of systems.

Additional requirements for books and records, reporting, auditing, compliance measures, disaster recovery, and transitional periods have been proposed in the draft.

Having these rules in place would certainly help in monitoring the virtual currency. The draft was followed by a 45-day public comment period. Further action on this draft is awaited.

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Present Guidance from the IRS


The notice discusses issues like information reporting requirements and determining FMV of currency and whether certain transactions generate ordinary income or capital gains.

Per the IRS notice, virtual currency that has an equivalent value in real currency, or that acts as a substitute for real currency, is referred to as “convertible” virtual currency. Bitcoin is one example of a convertible virtual currency. Bitcoin can be digitally traded between users and can be purchased for, or exchanged into, U.S. dollars, Euros, and other real or virtual currencies. The most important aspect of the IRS notice is that the IRS will treat bitcoin as property—not currency—for U.S. federal tax purposes. As such, general tax principles that apply to property transactions will apply to transactions using bitcoins. Bitcoin will be not treated as currency that could generate foreign currency gain or loss. Generally, any taxpayer who receives virtual currency as a payment for goods and services shall include in his/her gross income the fair market value of the currency on the date of receipt. For U.S. tax purposes, transactions using virtual currency must be reported in U.S. dollars. If a virtual currency is listed on an exchange, the fair market value of the virtual currency will be determined by converting the virtual currency into U.S. dollars at the exchange rate, in a reasonable manner.

Furthermore, a taxpayer will recognize a gain if the fair market value of property received in exchange for virtual currency exceeds the taxpayer's adjusted basis of the virtual currency. If the fair market value of the property received is less than the adjusted basis of the virtual currency, the taxpayer has a loss. Upon mining, a bitcoin miner will include the fair market value of the virtual currency as of the date of receipt as gross income. Wages paid in bitcoin would be subject FICA, FUTA, and federal income tax withholding. If bitcoin mining is undertaken as trade or business, the net earnings from self-employment will constitute self-employment income and will be subject to self-employment tax. For 1099 purposes, payment of fixed and determinable income using virtual currency with a value of $600 or more to a U.S. non-exempt recipient in a taxable year will be required to be reported to the IRS and the payee. Failure to timely or correctly report virtual currency transactions will attract penalty under sections 6721 and 6722.

The IRS notice throws light on the federal tax treatment of bitcoin transactions. However, there are a few open tax issues which have not been yet addressed.

Open Tax Issues:

- Reporting for FBAR and Form 8938:
  Under present law, the instructions for the FinCEN Form 114 (FBAR) and Form 8938 - Statement of Specified Foreign Financial Assets - do not specifically address the reporting of virtual currency. If the bitcoins are held on behalf of the taxpayer by any entity, reporting may be...
required. However, the current guidance is silent on this issue.

- **State Taxation:**
  Presently, few states have any kind of guidance for bitcoin transactions. In California, the State Board of Equalization clarified that sales and use tax would apply to virtual currency transactions like bitcoin in the same manner as traditional payment methods, such as cash or credit card. For example, a restaurant sells a taxable meal to a customer with an advertised menu price of $50. The customer pays the restaurant 0.065 Bitcoin for the meal. The measure of tax from the sale of the meal is $50, which is the amount allowed by the retailer for the 0.065 Bitcoin at the time of the sale. The restaurant should retain a copy of the menu in its records to document the measure of tax from its virtual currency transactions.

- **Tracking The Basis In Bitcoins:**
  Every bitcoin used in the system can be tracked by the algorithms. Hence, the specific identification method of inventory seems appropriate for bitcoin transactions. For simplicity, should the FIFO inventory method be allowed to track basis? Presently, the FIFO is used for tracking the basis of securities only.

- **Impact On Estate Tax and Gift Tax:**
  Simply put, federal estate tax is normally due when a taxpayer dies and if the total value of his estate (which essentially includes everything—property of all types) exceeds a certain amount after taking deductions. Gift tax is due when a taxpayer gifts something in excess of the specified amount to a single person. In both cases, the issue is valuation of bitcoin. At what value should the bitcoins be included as property? Bitcoins are not recognized on any national stock exchanges, so various platforms that issue bitcoins use different values for bitcoins. In such a situation, the valuation of bitcoin is not uniform.

- **Cautions:**
  - **Loss of Bitcoins:**
    If a person loses his credit card, the credit card company may reimburse him for his loss depending on his contract with the company. In the U.S., bank accounts are protected up to a certain amount by the FDIC (Federal Deposit Insurance Corporation). If a taxpayer loses his bitcoins, either by theft or any other reason, no protection is available to the taxpayer.

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7 For bitcoin picture, see en.bitcoin.it, For Figures 1 and 2, see Imponderable Things (Scott Driscoll's Blog)
Illegal Activities:
Recently, law enforcement officials shut down Silk Road, a black market website which sold drugs for bitcoins. Bitcoin became popular due to the anonymity factor. How will laws ensure that the bitcoin transactions are for legitimate purposes?

Will the popularity of the bitcoin have any effect on the world currencies?
When compared to a currency, bitcoin falls short of certain important qualities. Presently, the bitcoin is relatively nascent. Unlike a currency, bitcoin lacks ample liquidity and controlled volatility. A currency is backed by confidence, created through sound monetary policy and regulation. Bitcoin is backed by the expectation that the encryptions behind the virtual currency cannot be hacked. A country with limited investment options of bank deposits and real estate may flock to bitcoin for diversity. More investment options might undermine the value of bitcoin, and not the currencies.

As the bitcoin is growing, so is its legislation. It would be interesting to see a form 1098-T with a small box specifying the tuition paid in bitcoins. It has become imperative for tax professionals to keep track of the bitcoin developments. Going forward, a relevant question for every client could be, ‘do you have any bitcoin transactions?’

And you never know, the next time you file your tax return, your tax advisor may accept his fees in bitcoin!

Asmita Bedekar would like to thank Professors Annette Nellen and Joel Busch for their guidance on this article.

SEEKING ARTICLES

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

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

Submission deadlines:
Fall Issue: 1 February
Spring Issue: 1 August

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

Asmita Bedekar would like to thank Professors Annette Nellen and Joel Busch for their guidance on this article.
Abstract

This paper’s bold claim is Section 530 of the Revenue Act of 1978 applies to the states. The issue is topical given the Obama Administration’s current use of Memoranda of Understanding among the IRS, DOL, and several states to challenge independent contractor misclassification. The transparent MOU purpose is to circumvent employment tax constraints Congress imposed on IRS subtitle C determinations in furtherance of, *inter alia*, Affordable Care Act objectives. However and as the paper demonstrates, when Congress enacted section 530 it contextually qualified the subtitle C definitional infrastructure. Well settled dual federal-state employment tax jurisprudence imposes an obligation each state act must be coterminous, harmonious, and uniform with the federal progenitor. Since Congress has never impounded section 530 in the Internal Revenue Code, *per se*, it may well be the provision’s contextual qualification extends beyond title 26 boundaries.

Why Section 530 of the Revenue Act of 1978 Applies to the States

Beginning 2011, federal and state agencies undertook deliberate steps to become more aggressive in challenging worker misclassification. On September 19, 2011 the Internal Revenue Service entered into a Memorandum of

It may well be DOL’s challenge under the Fair Labor Standards Act is undertaken as a first instance worker misclassification challenge for the reason IRS Title 26, Subtitle C, Chapter 23 audits terminate once the IRS determines section 530 safe haven provisions have been met.\footnote{References to “section 530” are to Section 530 of the Revenue Act of 1978.} Indeed, the increased executive branch commitment undertaken to challenge worker misclassification appears to target reducing section 530 effectiveness. Eligibility for section 530 independent contractor status is tied to proper information reporting, consistent historical treatment of the contractor class of workers, and reasonable cause for the classification.

The administration’s increased worker misclassification challenges also extend to the states. On September 20, 2011, DOL and IRS signed a memorandum of understanding with Missouri and six other states (Connecticut, Maryland, Massachusetts, Minnesota, Utah and Washington) that will enable DOL to share information and coordinate enforcement activities with the IRS and participating states.\footnote{Retrieved from \url{http://www.martindale.com/labor-employment-law/article_Husch-Blackwell-LLP_1351352.htm}.} As discussed in this paper, Missouri is among the states leading the challenge to Congressional right, power, and authority to contextually qualify important employment tax infrastructure definitions such as employer, employment, and employee.

Current federal challenges to independent contractor status are undertaken, in large part, in furtherance of ACA interests. It remains unresolved whether Affordable Care Act worker classification is contextually bound by section 530 safe havens.\footnote{Weissman, W. H. (2009, February 28). Section 530: its history and application in light of the federal definition of the employer-employee relationship. \textit{BNA Insights: Labor and Employment Law}. Retrieved from \url{http://www.bna.com}.} Once an employer incurs an adverse DOL worker misclassification adjudication, the IRS will then be empowered to levy ACA penalties pursuant to 26 U.S.C. §4980H. ACA interests and undermining the reach of section 530 safe haven relief appears to be among the executive branch motives underpinning the DOL-IRS September 19, 2011 MOU and the September 20, 2011 MOU agreements with several states.

President Obama’s challenges to section 530 safe haven relief are not novel. When he was a member of the United States Senate he introduced S. 2044,\footnote{Boeskin, D. & Mort, K. (2011, December 6). Affordable care act may create hazards for employers that misclassify workers, especially those relying on section 530 relief. \textit{BNA Insights: Labor and Employment Law}. Retrieved from \url{http://www.bna.com}.}
“Independent Contractor Proper Classification Act of 2007.” The bill was among other bills introduced in Congress intended to limit or eliminate section 530. All such bills died in committee and never made it to the floor of either house.

While the President’s transparent section 530 disdain and ACA interests fuel the ongoing worker misclassification agenda commenced 2011, this paper’s focus explains why section 530 applies to the states. Briefly, dual federal-state taxation jurisprudence commands unemployment laws should be operationally uniform and harmonious among the states and coterminous with the federal progenitor. Moreover, extant decisional law holds relevant exogenous enactments contextually qualify the endogenous definitional infrastructure in the absence of express decoupling language. The paper concludes, accordingly, section 530 applies to the states.

Finally and as an example, the paper demonstrates incongruous operation of section 530’s contextual qualification of the coterminous unemployment tax definitional infrastructure among the states by comparing important provisions in the Indiana and Missouri economic security acts. Indiana’s economic security act respects section 530 contextual qualification while Missouri’s does not. Since uniform and harmonious operation of coterminous federal and state acts remains the public policy ideal, the Secretary of Labor’s involvement in approving state acts sets the stage for possible federal intervention.

Important Dual Federal-State Employment Tax Considerations

Federal unemployment tax laws were first enacted in 1935. The Supreme Court’s antedating Harmel decision expressed important tenets that have since become applicable to the unemployment tax schema. Harmel was an income tax case where the issue was whether certain oil and gas lease income should have been considered receipts from the sale of a capital asset, as treated under then prevailing state law, or ordinary income pursuant to the prevailing federal revenue act. The Harmel principle became a cornerstone embraced by both federal and state courts in the construction of dual federal-state unemployment taxing statutes. The Harmel principle recognizes the will of Congress controls in matters involving uniform nationwide taxation schemes and state law may control only when the federal taxing act, by express language or necessary implication, makes its own operation dependent upon state law.

This holding remains determinative today. Further, the Supreme Court extended such dual federal-state tax considerations to unemployment taxes in its 1939 Buckstaff...
Bath House Co. decision.\textsuperscript{15} There, the Court held the Act was an attempt to find a method by which the states and the federal government could ‘work together to a common end.’ The Court found prior thereto many states had “held back through alarm lest, in laying such a toll upon their industries, they would place themselves in a position of economic disadvantage as compared with neighbors or competitors.”

The Harmel principle, as substantively extended to employment taxes by the Buckstaff Bath House Co. Court, is generally recognized across the federal circuit courts of appeal and several state revisory courts.\textsuperscript{16} Such unmitigated authority commands the federal unemployment act and the economic security acts of the several states are to be uniform and harmonious in operation.

\textsuperscript{15} Buckstaff Bath House Co. v. McKinley, 308 U.S. 358, 363 (1939); citing, Steward Machine Co. v. Davis, 301 U.S. 548 (1937).

\textsuperscript{16} La Caisse Populaire Ste. Marie v. United States, 563 F.2d 505, 509 (1\textsuperscript{st} Cir. 1977); citing, Burnet v. Harmel, supra, at 110. Accord, Old Virginia Brick Company v. Commissioner of Internal Revenue, 367 F.2d 276 (4\textsuperscript{th} Cir. 1966); C. M. Thibodaux Co., LTD. v. United States, 915 F.2d 992 (5\textsuperscript{th} Cir. 1990); Slaughter v. Commissioner of Internal Revenue, 746 F.2d 1479 (6\textsuperscript{th} Cir. 1984); Scully v. United States, 840 F.2d 478 (7\textsuperscript{th} Cir. 1988); United States v. Myra Foundation, 382 F.2d 107 (8\textsuperscript{th} Cir. 1967); Kahn v. Immigration and Naturalization Service, 36 F.3d 1412 (9\textsuperscript{th} Cir. 1994); Matcovich v. Anglim, 134 F.2d 834 (9\textsuperscript{th} Cir. 1943); Ordway v. United States, 908 F.2d 890 (11\textsuperscript{th} Cir. 1990); Lewis v. Reagan, 516 F.Supp. 548 (USDC DC 1981); Goeller v. United States, 109 Fed.Cl. 534 (Fed.Clms. 2013); Kratz & Craig Surveying, Inc. v. Commissioner of Internal Revenue, 134 T.C. 167 (2010); Blanchard v. Blanchard, 261 Ga. 11 (1991); and, Albers v. Albers, 2013-Ohio-2352 (Cl.Apps. 2013).

Coterminous Federal and State Acts

Buckstaff Bath House Co. also crystallized the command state unemployment acts are to be coterminous with the federal unemployment act, to wit:

The Act was designed therefore to operate in a dual fashion—state laws were to be integrated with the federal Act; payments under state laws could be credited against liabilities under the other. That it was designed so as to bring the states into the cooperative venture is clear. The fact that it would operate though the states did not come in does not alter the fact that there were great practical inducements for the states to become components of a unitary plan for unemployment relief. It is this invitation by the Congress to the states which is of importance to the issue in this case. For certainly, under the coordinated scheme which the Act visualizes, when Congress brought within its scope various classes of employers it in practical effect invited the states to tax the same classes. Hence, if there were any doubt as to the jurisdiction of the states to tax any of those classes it might well be removed by that invitation, for in absence of a declaration to the contrary, it would seem to be a fair presumption for that purpose of Congress to have state law as closely coterminous as possible with its own. To the extent that it was not, the hopes
for a coordinated and integrated dual system would not materialize.\textsuperscript{17}

By the foregoing language, the decision created a first instance unemployment tax \textit{presumption} state law was to be as closely coterminous as possible with Congressional unemployment enactments. This important presumption translates section 530 is made applicable to the states on recognizing the safe harbor provision contextually qualifies Chapter 23’s definitional infrastructure.

Early on, state high courts embraced these tenets. For example, the California Supreme Court’s \textit{Butte County}\textsuperscript{18} decision counsels that state relied heavily on conformity to the federal act and uniform and harmonious operation among the several state acts as an inducement for that state to participate in the dual federal-state unemployment tax scheme. The \textit{Butte County} Court further counseled, “. . . heed must be given to the federal act as interpreted by the rules adopted thereunder . . .” California, accordingly, respects the fundamental requirement coterminous federal and state acts must operate on a uniform and harmonious basis.

\textbf{Exogenous Enactment Contextual Qualification}

Section 530 of the Revenue Act of 1978 was enacted in response to taxpayer complaints concerning IRS worker misclassification aggressiveness. The provision was originally intended as a temporary measure, but was made permanent by the Tax Equity and Fiscal Responsibility Act of 1982.\textsuperscript{19} It has since been amended by section 1706 of the Tax Reform Act of 1986 and section 1122 of the Small Business Job Protection Act of 1996.\textsuperscript{20}

Throughout its legislative history, section 530 has not been codified in Title 26, United States Code. The provision remains exogenous to the all titles of the United States Code. Its applicability to Title 26, subtitle C, however, is made clear by its opening statement: (a) Termination of Certain Employment Tax Liability. (1) In general. - If - (A) for purposes of employment taxes . . .” (Emphasis added). Unmistakably, Congress intended section 530 apply to employment taxes governed by Title 26, subtitle C. As a result, section 530 contextually qualifies Chapter 23’s definitional infrastructure, including terms like employment, employer, and employee.

Exogenous contextual qualification of the employment tax definitional infrastructure was first generalized by the Supreme Court’s in its \textit{Rowan} decision.\textsuperscript{21} \textit{Rowan} was decided in 1980, at a time after section 530’s initial enactment and before its provisions were made permanent by the Tax Equity and Fiscal Responsibility Act of 1982. The principles elucidated by \textit{Rowan}’s teaching still prove controlling today.

\begin{footnotes}
\footnotetext[17]{Buckstaff Bath House Co., supra, at p. 363.}
\footnotetext[18]{California Employment Commission v. Butte County Rice Growers Association, 25 Cal.2d 624, 643 (1944).}
\footnotetext[19]{Weissman, supra.}
\footnotetext[20]{Ibid.}
\footnotetext[21]{Rowan Cos., Inc. v. United States, 452 U.S. 247 (1981).}
\end{footnotes}
notwithstanding Congress's 1983 effort to "decouple" its holding.

First, Rowan makes clear Congress, by and through exogenous enactments (e.g., subtitle A's section 119 employee gross income exclusion), alters, modifies, or supplants the (intra-title, inter-subtitle) definitional infrastructure (e.g., subtitle C's definition of wages). Second, Rowan’s holding translates the executive branch of government lacks the right, power, and authority to promulgate regulations interpreting endogenous definitions in a manner inconsistent with Congress's contextual mandate. And, third, Rowan proves executive branch regulations so promulgated will be invalidated.

Rowan Companies, Inc. owned and operated offshore oil and gas rigs. For its convenience, Rowan provided meals and lodging without cost to its employees pursuant to 26 U.S.C. §119 during those times they worked on the rigs. The employer did not include the value of the meals and lodging in computing its employees' "wages" for the purpose of paying taxes under either FICA (Chapter 21) or FUTA (Chapter 23). Furthermore, it did not include the value of the meals and lodging in computing "wages" for the purpose of withholding its employees' federal income taxes (Chapter 24).

Upon audit, the Internal Revenue Service included the fair value of the meals and lodging in the employees' "wages" for the purpose of FICA and FUTA, but not for the purposes of income tax withholding. In so doing, the IRS acted consistently with then current Treasury regulations interpreting the definition of FICA and FUTA "wages" to include the value of such meals and lodging, whereas the substantially identical definition of "wages" in the statutory provision governing income tax withholding were then interpreted by Treasury regulations to exclude this value. The corporation paid the additional assessment and brought suit for a refund in the United States District Court for the Southern District of Texas.

The district court granted the government's motion for summary judgment. The United States Court of Appeals for the Fifth Circuit affirmed, expressing the view that the different interpretations of the definition of "wages" were justified by the different purposes of FICA and FUTA, on the one hand, and income tax withholding, on the other. The Supreme Court granted certiorari.

The Rowan Court reversed, holding meals and lodging for the convenience of the employer amounted to traditional notions of excludable wage income pursuant to 26 U.S.C. §119 and, by and through the enactment of that subtitle A section, Congress concomitantly excluded meals and lodging for the convenience of the employer from the definition of wages for


23 The Fifth Circuit’s Rowan decision is reported at 624 F.2d 701.
subtitle C, Chapters 21 (FICA) and 23 (FUTA), and Chapter 24 (federal income tax withholding) purposes. Distilled to a substantive generalization, the *Rowan* Court recognized (intra-title, inter-subtitle) contextual qualification and applied that contextual qualification to the term “wages.” It held when Congress qualified the definition of wages for subtitle A section 119 income exclusion purposes it concomitantly contextually qualified the definition of wages for subtitle C employment tax purposes. Accordingly, the Court’s *Rowan* holding recognized legislative branch exogenous contextual qualification in matters involving an endogenous definitional infrastructure.

The *Rowan* Court also held, in a 6 to 3 decision, since the then prevailing Treasury regulations recognized Section 119 income wage excludable only for federal income tax withholding purposes and includable for FICA and FUTA purposes the regulations were invalid on the grounds and for the reasons the Treasury failed to implement the statutory definition of “wages” in a consistent and reasonable manner. This aspect of the *Rowan* holding has important implications both when states enact employment tax legislation outside the coterminous and uniform and harmonious operation mandate and when the Secretary of Labor approves such facially infirm state economic security acts.

In 1983, Congress took two steps to countermand *Rowan’s* holding. First, it provided for an employment tax specific wage exclusion of section 119 meals and lodging for the convenience of the employer. Second, Congress enacted a provision “decoupling” federal income tax withholding wage definition from FICA and FUTA wage definition. The *Canisius College* Second Circuit considered Congress had, accordingly, overturned the general premise of *Rowan*. Here, it is suggested Congress did not overturn *Rowan’s* general premise by the 1983 modifications. *Rowan’s* (intra-title, inter-subtitle) contextual qualification holding was and remains the decision’s true general premise. Congress lacks the right, power, and authority to overturn the Court’s interpretation of the contextual qualification framework. Rather, it was the specific application of that framework to the definition of wages for Chapter 24 versus Chapters 21 and 23 that Congress “decoupled.”

The Second Circuit’s *Canisius College* decision elucidates the significance of *Rowan’s* (intra-title, inter-subtitle) contextual qualification mandate. Payments made by

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24 Affordable Care Act commentators have raised the issue whether section 530 applies to subtitle D ACA excise taxes. See, e.g., Boeskin and Mort, *supra*. However, at least in the case of the forgoing commentators, the analysis fails to properly countenance *Rowan’s* inter-subtitle contextual qualification mandate. If the Court consistently applies *Rowan’s* inter-subtitle contextual qualification holding, the inescapable conclusion is section 530 subtitle C contextual qualification concomitantly contextually qualifies subtitle D ACA excise tax provisions.


26 *Ibid*.

27 The anti-*Rowan* wage definition decoupling provisions are included in Chapter 21 at section 3121(a) (following paragraph 23) and in Chapter 23 at section 3306(b) (following paragraph 20).
Canisius College pursuant to its salary reduction plan were excludable from its employees’ wages under section 403(b). However, Revenue Ruling 65-208 represented the notion such payments were nonetheless wages for FICA purposes notwithstanding they appeared to be excluded under 26 U.S.C. §3121(a)(2) as it then prevailed. The Second Circuit recognized Rowan essentially invalidated Revenue Ruling 65-208 on the same grounds and for the same reasons it had invalidated the regulations at issue in Rowan. However, the 1983 Congressional action intentionally made Revenue Ruling 65-208 retroactively valid, decoupling wage definition for Chapter 24 versus Chapters 21 and 23 purposes.

The foregoing series of events implicate Rowan’s contextual qualification mandate remains viable for purposes of recognizing exogenous legislation contextually qualifies the endogenous definitional infrastructure in the absence of decoupling. Accordingly, Rowan’s holding translates section 530 contextually qualifies the employment tax definitional infrastructure, including terms such as employment, employer, and employee. The confluence of Rowan, Harmel, and Buckstaff Bath House Co., requires state acts to be coterminous with their federal progenitor to enable uniform and harmonious operation of the dual federal-state unemployment tax schema engineered by Congress. Therefore, section 530 applies to the definitional infrastructure of the several state economic security acts. State acts facially inconsistent with this extant jurisprudence and approved by the Secretary of Labor, like Missouri’s, run the risk of federal intervention.28

Comparison of the Indiana and Missouri Economic Security Acts

Differences in respective key provisions included in the Indiana and Missouri economic security acts reveal Indiana’s compliance with the coterminous section 530 contextually qualified definitional infrastructure. The comparison also demonstrates Missouri’s disregard for such important employment tax public policy considerations by structuring its economic security act in a manner so as to evade Congress’s section 530 contextual qualifications, replacing it with its own standard. This one example of fundamental coterminous inconsistency destroys the uniform and harmonious operation of the dual federal-state unemployment tax schema recognized as the program’s most important characteristic by other states, like California.

The Indiana Department of State Revenue’s 2013 Section 530 Revenue Ruling

On March 19, 2013, the Indiana Department of State Revenue issued its Revenue Ruling #2013-02 ST. The ruling is interesting for the reason its dictum includes an anti-Section-530 diatribe while its holding conforms to Congress’s section 530 contextual qualification. In the ruling’s holding, the

Indiana Department of State Revenue concedes it will follow the IRS’s transparent Section 530 determination and, thereupon, forewarns once the IRS’s determination changes so will the state’s worker misclassification position.

Indiana has enacted an economic security act provision embracing this paper’s arguments: when Congress contextually qualifies definitions under 26 U.S.C. §§3301, et seq., (FUTA), it concomitantly imposes such contextual qualifications upon the states by and through well settled decisional law, including Harmel, Buckstaff Bath House Co. and Rowan. The Indiana Revised Statutes bear witness, to wit:

Section 22-4-37-1. Securing benefits of federal acts -- Rules to effectuate authorized.

It is declared to be the purpose of this article to secure to the state of Indiana and to employers and employees therein all the rights and benefits which are conferred under the provisions of 42 U.S.C. 501 through 504, 42 U.S.C. 1101 through 1109, 26 U.S.C. 3301 through 3311, and 29 U.S.C. 49 et seq., and the amendments thereto. Whenever the department shall find it necessary, it shall have power to formulate rules after public hearing and opportunity to be heard whereof due notice is given as is provided in this article for the adoption of rules pursuant to IC 4-22-2, and with the approval of the governor of Indiana, to adopt such rules as shall effectuate the declared purposes of this article.

As a result and by the express language of the foregoing provision, Indiana has embraced Congress’s contextual qualification of FUTA’s definitional infrastructure.

Missouri’s Non-Coterminous, Non-Uniform, Non-Harmonious Unemployment Tax Framework

By contrast, Missouri Revised Statutes Section 288.304 appears to challenge the weight of the foregoing authority and Congress’s sole right, power, and authority to contextually qualify FUTA definitions. Missouri’s definition of the term “employment” exhibits this authoritative indifference, to wit:

Employment defined.

288.034. 1. "Employment" means service, including service in interstate commerce, performed for wages or under any contract of hire, written or oral, express or implied, and notwithstanding any other provisions of this section, service with respect to which a tax is required to be paid under any federal unemployment tax law imposing a tax against which credit may be taken for contributions required to be paid into a state unemployment fund or which, as a condition for full tax credit against the tax imposed by the Federal Unemployment Tax Act, is required to be covered under this law.

By this provision, Missouri’s employment definition starting point references FUTA’s taxable obligation. While Indiana’s Act embraces the totality of Chapter 23, including section 3306’s definitions, Missouri’s Act begins with
Congress’s taxable FUTA base and then delineates its further inclusions and exclusions. That is, Missouri’s Act creates an illusory appearance of uniform and harmonious operation with the federal progenitor. Poignantly, Missouri adds back its own worker classification definition in section 288.034(5):

5. Service performed by an individual for remuneration shall be deemed to be employment subject to this law unless it is shown to the satisfaction of the division that such services were performed by an independent contractor. In determining the existence of the independent contractor relationship, the common law of agency right to control shall be applied. The common law of agency right to control test shall include but not be limited to: if the alleged employer retains the right to control the manner and means by which the results are to be accomplished, the individual who performs the service is an employee. If only the results are controlled, the individual performing the service is an independent contractor.

There is some evidence the state of Missouri recognizes it does not currently comply with Congressional section 530 contextual qualification of the unemployment tax definitional infrastructure. HB 1642 was introduced into the Missouri House of Representatives on January 29, 2014.

Among other things, the bill amends chapter 285, Missouri Revised Statutes. The bill introduces new section 285.517 which provides:

285.517. Notwithstanding any provision of sections 285.500 to 285.515 or any other provision of law to the contrary, for any taxpayer undergoing an audit conducted by the department of labor and industrial relations regarding classification of an individual as an independent contractor or employee, if the taxpayer has been granted relief from the imposition of federal employment taxes under Section 530 of the Revenue Act of 1978, as amended, for an individual, with the result that the taxpayer can continue to classify the individual as an independent contractor for purposes of federal employment taxes, the department of labor and industrial relations shall allow the taxpayer to classify the individual as an independent contractor for purposes of Missouri employment taxes.

HB 1642 passed the Missouri House of Representatives on March 27, 2014 by a vote of 87 to 53. The bill is now before the Missouri Senate. If the provision becomes law, it would bring Missouri closer to coterminous compliance with the federal act to the extent of a prior IRS determination.30

30 One case is currently pending before the Missouri Division of Economic Security wherein the employer has an Internal Revenue Service letter granting section 530 relief for the unemployment tax year ending December 31, 2011. The IRS recognizes the employer met the information reporting and consistent treatment requirements. The IRS recognized the employer had a reasonable basis for treating the workers as independent contractors pursuant to section 530(a)(2)(A). Compliance with that safe harbor
However, Missouri would not yet be in complete compliance with Congressional section 530 contextual qualification of the employment tax definitional infrastructure. That is, an original Missouri Division of Economic Security determination would not be bound by section 285.517.

In apparent response to the passage of HB 1642 by the Missouri House of Representatives, the U. S. Department of Labor (Administrator, Office of Unemployment Insurance) sent a letter to the Director of the Missouri Department of Labor and Industrial Relations on April 21, 2014. The letter’s first sentence reads, “We have reviewed Missouri House Bill (HB) 1642, as passed by the House, for conformity to Federal unemployment compensation (UC) law.” As a result, it is transparent the U.S. Department of Labor recognizes it has a duty to review the several states economic security acts to ensure such acts are coterminous and uniform and harmonious with the federal progenitor prior to approving same.

The DOL, on page three of the letter, objects to HB 1642 recognizing federal section 530 determinations as conclusive in Missouri Division of Economic Security audits. First, the letter claims Revenue Procedure 85-18 “does not
convert individuals from the status of employee to the status of self-employed.” However, the Ninth Circuit’s General Investment Corporation decision concludes compliance with section 530’s reporting, consistency, and section 530(a)(2)(c)’s reasonable basis requirements creates a conclusive presumption the workers are not to be treated as employees.

Second, DOL’s April 21, 2014 letter boldly declares, “Missouri UC law may not offer the same relief as provided in section 530.” This statement is in direct contravention to Rowan’s contextual qualification holding. Moreover, it is also in direct contravention to the Ninth Circuit’s General Investment Corporation conclusive presumption holding.

It appears the Obama administration attempted to influence the Missouri state government not to enact HB 1642. The Missouri House of Representatives passed HB 1642 on March 27, 2014 and the bill was reported to the Missouri Senate four days later. Before the Missouri Senate voted on the bill, the Department of Labor delivered its April 21, 2014 letter. The appearance the Obama administration’s DOL letter was written to influence the Missouri state government’s action not to enact HB 1642 is beyond the pale.

Taken together, the Harmel, Buckstaff Bath House Co., Rowan unemployment tax jurisprudence realizes section 530 applies to the economic security acts of the several states.

31 A copy of the April 21, 2014 DOL can be found at: https://www.academia.edu/8399054/Exhibit_A-
April_21_2014_DOL_Letter_to_MODES

32 General Investment Corporation v. United States, 823 F.2d 337 (9th Cir. 1987).
33 See note 23, supra.
Coterminous and uniform and harmonious operation of the dual federal-state unemployment tax schema was an important consideration for states subscribing to the program. When some states embrace Congress’ section 530 contextual qualification and others do not, the promise of uniformity and harmony is destroyed. It appears the Obama administration’s interference in the section 530 Congressional will to contextually qualify the unemployment tax definitional infrastructure implicates separated powers substantive due process. Federal intervention looms on the horizon.
An Examination Of Tax Incentives
For Child Support

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ABSTRACT

Approximately $13.2 billion of child support payments due to custodial parents in the United States goes uncollected each year. This failure in collection has a detrimental effect on all parties involved—child, custodial parent, non-custodial parent, and the legal system. The purpose of this study is to provide some insight as to the impact of two child support payment tax benefit alternatives (deduction “for” adjusted gross income and a tax credit) on tax progressivity and income inequality as compared to a baseline that reflects existing tax law. The data for this study is obtained from a sample of 100 child support payers gathered using a web-based survey. The study measures tax progressivity using the Suits and Kakwani indexes and investigates related income distributional effects using the Kiefer index. The results suggest that a tax incentive associated with child support payments would enhance tax progressivity and reduce income inequality while also enhancing non-custodial parent ability to pay their child support legal mandates.

INTRODUCTION

In the United States, there are 6.8 million custodial parents due $38 billion in child support annually, yet only $25 billion was actually collected—a shortfall of approximately $13.2 billion (approximately 35%) (U.S. Census, 2007). The underlying purpose of this study is to
suggest two possible federal tax incentives that would be beneficial to all parties involved (e.g., father, mother, child(ren), and society as a whole) and increase child support collection. To test their recommended tax incentives, the authors conducted a brief survey to collect data, and the results suggest that a federal tax credit would be more effective at increasing child support payments. While the idea of a national tax incentive to pay child support by non-custodial parents may seem to many without merit, it should be noted at the outset of this study that both the state of New York and District of Columbia implemented in 2006 an earned income tax credit (EITC) for low-income, noncustodial parents who work and fully pay their child support (Wheaton and Sorensen 2009). In New York, this credit is based upon a sliding income scale and phases out at income of approximately $37,870 (NY OTDA 2013). In 2011, 7,600 noncustodial parents in New York claimed $3.5 million using this credit and received an average refund of more than $460 (NY OTDA 2014). Additionally, New York has lauded this credit as one of the most effective tools at increasing labor force participation for low skilled workers, since it essentially supplements their wages (NY OTDA 2013). Both the New York and District of Columbia EITC suggest that a national tax incentive is both realistic and noteworthy from a public policy standpoint.

This study asserts that federal tax incentives will boost child support payment compliance based upon a public policy argument (supported by enhanced institutional legitimacy, fairness, and justice) and a theoretical economic argument. These two arguments are subsequently supported by illustrative empirical analysis based upon data collected from a web-based survey about taxpayers who pay child support. The empirics compare tax progressivity associated with two tax incentive proposals (i.e., deduction “for” adjusted gross income (AGI) and a tax credit) with a baseline containing no child support payment tax incentive using a sample of 100 child support payers. This research measures tax progressivity using the Suits and Kakwani Indices and associated income distributional effects using the Kiefer Index.

This article is organized as follows: first, a brief literature review that includes institutional theory and child support psychology literature is provided for study context; second, options for a child support payment tax benefit and three indices used to measure tax progressivity and income redistribution effects (i.e., Suits Index, Kakwani Index, and Kiefer Index) are presented; third, the illustrative empirics are discussed including data collection and survey methodology; fourth, empirical results are shown; and finally, a conclusion.

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34 Since single parents are 80 to 85 percent of the time mothers according to Tebo (2000) and Lin (2000), the authors use the personal pronoun “she” for the resident (custodial) parent and “he” for the non-custodial parent.

35 For Washington D.C., the authors performed multiple searches but were not able to find any statistics relative to the impact of the EITC for non-custodial parents.
BRIEF LITERATURE REVIEW

Institutional Theory

Simply stated, institutional theory holds that organizations (including the U.S. Congress (Congress) and Treasury Department’s Internal Revenue Service (IRS)) must conform to external institutional pressures as this behavior enhances societal perceptions of the organization’s credibility and legitimacy, and correspondingly promotes access to resources as well as organizational survival (Meyer and Rowan, 1977; DiMaggio and Powell, 1983; Fogarty, 1992). Since they ultimately are more important to these entities’ survival and success than actual organizational functioning, governmental entities must be sensitive to societal opinions and perceptions regarding legal processes and fairness, (Meyer, 1986; Covaleski and Dirsmith, 1991). Thus, Congress should be concerned that the laws they create and reform are consistent with societal norms of equity, so that they positively influence citizen perceptions and attitudes about process fairness (e.g., Lin, 2000; van den Bos, 2002; Fleischman et al., 2007), as well as procedural and retributive justice (Kray and Lind, 2002; Kirchler, 2007). In the context of the child support payment compliance, this is especially important issue. Payers of child support are not inclined to comply with system mandates if they believe that the legal system governing child support payments is not fair and equitable, because their perception is that this governmental public policy lacks societal legitimacy and fairness.

Thus, institutional theory (Meyer and Rowan, 1977; DiMaggio and Powell, 1983) is the underlying theory for the current study and helps to explain why the government should be motivated to revise the public policy on child support payments so that payer perceptions of justice and fairness are enhanced. This theory is appropriate for research that involves the United States (U.S.) government because it allows accounting research to assess institutional actions that, by necessity, involve both power and politics (Covaleski and Dirsmith, 1991). Other noteworthy accounting studies in the context of public policy issues have employed institutional theory (e.g., Covaleski and Dirsmith, 1991; Fogarty, 1992; Carruthers, 1995; Carpenter and Feroz, 2001).

Child Support Psychology Literature

In aggregate, psychology literature involving child support seems to suggest that the government has lost institutional legitimacy among most payers of child support due to low collection rate (approximately 65%). This determination helps to partially explain why child support payment compliance in the United States is still a deeply troubling public policy.

Two areas of justice that are relevant to child support payment compliance public policy issues are procedural justice and retributive justice. Procedural justice occurs when persons who are required by law to pay child support believe that the process that generated the payment mandate was fair and equitable, while retributive justice involves the perceived appropriateness and application of legal sanctions (Kirchler, 2007). This may evinced itself in the current study by how appropriate non-custodial fathers perceive their support payment mandate to be. Their perception of retributive
justice will be poor if they perceive that it exceeds their ability to pay. Also, if the non-custodial father becomes delinquent on his child support payments, is subsequently jailed or subject to onerous civil or criminal penalties, this too will seriously damage perceptions of retributive justice.

OPTIONS FOR CHILD SUPPORT PAYMENT TAX BENEFIT

There is currently no Federal tax incentive for child support payments. Therefore, any tax benefit proposals that could be suggested are by definition arbitrary. However, based on tax deductions and credits that currently exist in the Internal Revenue Code, the authors wish to propose alternative tax breaks that would be potentially feasible. The suggested tax breaks should also be designed to target middle- and lower-income taxpayer groups, and thus, enhance tax progressivity (Seetharaman, 1994; Seetharaman and Iyer, 1995; Dunbar, 1996; Iyer and Seetharaman, 1997; Young, Nutter, and Wilkie, 1999), so they should probably contain phase-outs provisions to accomplish this purpose.

Based upon the current tax structure, the most logical and feasible child support tax incentives would be: a deduction “from” AGI (itemized deduction), a deduction “for” AGI, and a tax credit. Hutchison et al. (2007, p. 42) determined that a deduction “from” AGI (itemized deduction) was not a feasible alternative because only about 33% (based on 2003 Statistics of Income data) itemize, and 80% of itemizers have AGIs of over $50,000. “Thus, an itemized deduction for child support payments would likely only assist wealthier taxpayers who itemize, and who are more likely to meet their support obligations . . .” (Hutchison et al., 2007, p. 42). This authors concur with that determination and thus, only two tax incentives were developed for child support payments, a deduction “for” AGI and a tax credit, for the current study.

Deduction “for” AGI Option

To propose a child support deduction “for” AGI, the authors carefully reviewed all of the existing deductions to determine which specific deduction would be most appropriate to use as a model. While alimony payments are completely deductible, it was not thought that this would be an appropriate model for consideration due to progressivity and tax expenditure concerns. Additional review and consideration ultimately lead the authors to select the tuition and fees deduction since it purposes to target similar taxpayer income groups. Therefore, it was determined that the proposed deduction “for” AGI should be equal to a maximum of $4,000, limited by the amount of actual child support payments. Also, as mandated by the tuition and fees deduction, an AGI phase-out would be included in the proposal for single and head of household taxpayers with AGIs of $65,000 to $80,000 and for married filing joint taxpayers between $130,000 and $160,000.

Tax Credit Option

The authors also reviewed current tax credits in an effort to identify an existing tax credit that could be used as a model for a proposed credit yet focused on both low- and middle-income taxpayers. Over time, Congress has consistently focused on low- and middle-income-level groups of taxpayers as those most in need of tax relief (U. S. Congress, Joint Committee, 1981), and likely will do the same
in the future. After reviewing all of the current tax credits, the child and dependent care credit was selected to use a model for this study. Further review of the purpose and congressional intent of this credit showed that it was similar in ideology to a proposed child support credit. The child and dependent care credit limits for the 2001 tax year (the year of this study) were used as a guide for the present study. The maximum 2001 credit is 30 percent of up to $2,400 of qualifying child support costs associated with one child, or $720. This maximum credit doubles to 30 percent of up to $4,800 of qualifying costs (credit equals $1,440) for two or more children. The maximum allowed percentage is reduced from 30 percent as adjusted gross income increases, to a base of 20 percent for adjusted gross incomes of $28,000 or more.

**Tax Indices To Measure Tax Progressivity And Income Redistribution**

Because tax policy associated with the federal income tax system generally supports a progressive tax system due to equity concerns and the ability to pay criterion (e.g., Slemrod, 1994), people in the U.S. with higher taxable incomes not only pay a higher total amount of taxes as compared with persons with lesser incomes, but they also pay tax at a higher rate. Therefore, it is relevant to assess the impact of the two child support payment tax reduction proposals on tax progressivity and income redistribution.

The accounting literature that assesses tax progressivity of existing and proposed tax deductions and credits supports the use of multiple assessment measures (e.g., Seetharaman and Iyer, 1995; Dunbar, 1996). For purposes of this exploratory study, three measures are used as suggested by Dunbar (1996); two measures to evaluate tax progressivity (Suits, 1977 and Kakwani, 1976); and one measure to assess income redistribution (Kiefer, 1984). Seetharaman and Iyer (1995) provide a reference resource by discussing each of these indices in detail. The following briefly introduces each index that is used in the present study.

**Suits Index**

Suits (1977) created an index of tax progressivity which he labeled $S$. The index plots the accumulated percent of tax burden vertically against the accumulated percent of income, which is plotted horizontally. Suits (1977, p. 750) used mathematical notation where income is represented by the variable $y$ (which ranges from 0 to 100) and the total tax burden is labeled by the variable $x$, so that the “accumulated percent of the total tax burden for a given tax $x$, then becomes $T_x(y)$.” Equation (1) summarizes the calculation of the area that is to be calculated is denoted as $L_x$, (Suits, 1977, p. 750) where:

$$L_x = \sum_{i=1} \frac{1}{2} \left[ T_x(y_i) + T_x(y_{i-1}) \right](y_i - y_{i-1})$$

Furthermore, the progressivity $S_x$ of a tax $x$ is summarized in equation (2), where:

$$S_x = 1 - \left( \frac{L_x}{K} \right)$$
The variable $K$ is always equal to 5,000 because it represents the area of a triangle with both a base and a height of 100 (Suits, 1977, p. 750). If the tax in question is regressive, $L_x$ is larger than $K$, so $S_x$ will be negative. If the tax is proportional, $L_x$ equals $K$, so $S_x$ will equal 0. Finally, if the tax in question is progressive, $L_x$ will be less than $K$, so $S_x$ will be a positive number.

**Kakwani Index**

The Kakwani (1976) tax progressivity index is defined as twice the area between the Lorenz curve for pre-tax income and the concentration curve for tax liabilities for a given tax schedule $t = t(x)$. Here, $x_i$’s are the individual income levels for a particular tax system.

(1) $KK = C_t - G_x$

where $G_x$ is Gini index and is defined as

$$G_x = \left( \frac{1}{n(n-1)} \sum_{i \neq j} |x_i - x_j| \right) \frac{2}{\bar{x}}$$

and $C_t$ is concentration index and is defined as

$$C_t = \frac{1}{n(n-1)} \sum_{i \neq j} (t(x_i) - t(x_j)) I(x_i > x_j)$$

where

$$I(x_i > x_j) = \begin{cases} 
1 & \text{if } x_i > x_j \\
0 & \text{if } x_i = x_j \\
-1 & \text{if } x_i < x_j 
\end{cases}$$

This measure indicates progressivity in a tax system if the value of the index is positive, regressivity if the value is negative. The maximum value of Kakwani index is +1.0 and the minimum is -2.0 (Formby et al. 1984). This index is based on integration with respect to returns.

**Kiefer Index**

The Kiefer (1984) index is based on the notion of equally distributed equivalent (EDE) level of income that provides the equal level of public welfare if distributed properly. Kiefer’s index specifies the amount of increase in the level of EDE income relative to average income after a tax-system or tax law is enacted. The Kiefer index shows that as income inequality (measured before tax) changes, the tax progressivity index also changes. The Kiefer index increases if the proportional income increases. This implies that if the index is positive, the tax decreases income inequality (makes income more equal) and if the result is proportional, the index will be equal to zero. Kiefer’s index uses Atkinson’s (1970) social welfare function and assigns various weights to the various income transfers;

(1) **Kiefer’s Index:** $I_{eb} - I_{ea}$
where $I_{eb}$ and $I_{ea}$ are the measures of income inequality before-tax and after-tax, respectively. The income equality index is computed as follows:

\[
(2) \quad I_e = 1 - \left[ \sum_{i=1}^{n} \left( \frac{u_i}{u} \right)^{1-e} f(u_i) \right]^{1/(1-e)}
\]

where $u_i$ = mean income of the $i^{th}$ income class ($i=1,2,\ldots,n$); $u$ = mean income of all taxpayers; $f_i$ = probability density of the income distribution at $u_i$; or the proportion of taxpayers in the $i^{th}$ income class; and $e$ = inequality aversion parameter. $e$ measures the relative sensitivity to income transfers at different income levels. The value of $e$ depends on the society’s value judgment about society’s aversion to income inequality. Different authors have used different values but Kiefer used $e$ in the range of 0.5 to 2.5. (This study’s results are presented for these same two values of $e$.) Kiefer compares the EDE levels of before and after tax income and therefore, captures the effect of the tax system on income inequality. So, if the Kiefer index is $> 0$ ($< 0$), the income inequality has decreased (increased), and the higher the value of the Kiefer index is, the lesser the inequality. The Kiefer index interprets a tax system as progressive when $KF > 0$, proportional when $KF = 0$, and regressive when $KF < 0$. 

ILLUSTRATIVE EMPIRICS

Based on the foregoing, a key barrier that non-custodial fathers face regarding paying child support obligations in full is their limited ability to pay such obligations (e.g., Bartfeld and Meyer, 2003). The thesis of this exploratory public policy study is that a federal tax incentive would increase the after-tax income of non-custodial parents, thus enhancing their ability to pay child support, which should increase compliance and fairness perceptions. Unfortunately, this study is not able to directly measure changes in compliance attitudes and fairness perceptions associated with a proposed tax incentive because the authors’ experience with this delicate topic suggests that such questions would seriously damage any chances of obtaining reasonable number of respondents. Ideally, however, it is asserted that a child support payment tax incentive that would increase the ability to pay could also be viewed as a consensus-based approach to compliance based on Lin’s (2000) arguments, since this may be an effective means to transform the attitudes of the citizenry regarding the overall fairness (van den Bos, 2002; Fleischman et al., 2007) and justice (Kray and Lind, 2002; Kirchler, 2007) of the child support payment process. Institutional Theory (Meyer and Rowan, 1977; DiMaggio and Powell, 1983) suggests that strengthened child support payer fairness and justice perceptions associated with the child support payment process should also enhance perceptions of governmental legitimacy, which should theoretically further bolster payment compliance.

Data Collection

To both illustrate and assess the impact of a tax incentive on actual child support payers, including tax progressivity and income distribution issues, the authors collected detailed micro-level tax-oriented data about non-
custodial parents who paid child support. There is difficulty in general to collect any adequate data about non-custodial fathers, since most data is instead collected about custodial mothers (Cancian and Meyer, 2004; Hofferth et al., 1997).

Aggregate child support data exists from the U.S. Census Bureau’s Current Population Reports (2008), but this data is primarily demographic in nature and focuses on custodial parents, so it is of little help for the present study. The Panel Study of Income Dynamics also focused on female custodial parents (Case et al., 2003). Micro-level child support data is available at county courthouses, but associated demographic and economic data is not available.

The study’s micro-level data collection process was extremely difficult due to the exceptionally sensitive nature of the topic, so the authors essentially collected data in two stages. During stage one, a pilot study was created using a survey that was provided to participants in 2000 to collect 1999 tax return data. Participants were asked to agree in writing to allow us to obtain summary tax-related data about them directly from the IRS. Therefore, this study would not have to rely on subject self-reported information (that could result in transcription and/or estimation errors) except for actual child support payment and demographic data.

Unfortunately, the child support payers who were asked to participate in the study were very forthright in communicating that they wanted nothing to do with any legal or governmental entity (e.g., the IRS) because of the horrific and unfair (in their opinion) process that they endured to obtain their final child support payment obligation. The authors do not think that it is any exaggeration to state that the non-custodial payers interviewed were very angry and bitter about the child support legal process in general and were extremely hesitant and skeptical about making any disclosures about themselves personally or their child support payment obligations. It became obvious from this study that the authors would not be able to ask many opinion and perception questions about child support payments due to this sensitivity and hesitance.

In order to increase our study response rate by encouraging child support payers to fill out the survey, one of the authors made guest appearances at divorce recovery groups, church groups containing divorced singles, fathers’ advocacy groups, and a radio show. Further solicitations were made using newspaper articles and news releases, as well as a website. Unfortunately, these strategies were wholly unsuccessful in collecting the needed data. The sensitivity and privacy concerns seemed to restrict people from participating in this survey.

Sorensen (1997) highlights the monumental difficulty of obtaining meaningful and accurate demographic and economic data about non-custodial fathers, who generally are very hesitant to report any demographic and economic information about their situation. Most national surveys do not attempt to ask men if they are non-custodial fathers, and those that do have had extremely low response rates (e.g., Cherlin, Griffith and McCarthy, 1983; Seltzer and Brandreth, 1994; Sorensen, 1997). In fact, this non-custodial father information collection difficulty is so widespread that some well-known researchers in this area have attempted to
indirectly estimate non-custodial father income information based on the income characteristics of custodial mothers (e.g., Garfinkel and Oellerich, 1989). In summary, there are significant data limitations regarding economic and demographic information about child support payers (Hofferth et al., 1997; Sorensen, 1997; Bartfeld, 2003; Cancian and Meyer, 2004).

Therefore because of the need for a relevant child support payer micro-dataset for the study, in 2002 the authors initiated phase two of the data collection process, using lessons learned from the phase one pilot study as a guide. One of the authors hired a computer expert to design a professional website that contained no mention of any contact with the IRS other than self-reported tax data (from personal tax returns) for the 2001 tax year. Because this study necessitated micro-level tax-related data, respondents were asked to provide key tax data for the 2001 tax year, such as adjusted gross income (AGI), total exemptions, credits, and taxable income. Although such questions required subjects to physically access their tax return, that undoubtedly hurt the response rate, yet provided as accurate data as possible from the subject returns, as opposed to mere estimates which is likely the case with Current Population Reports information. (The survey instrument is provided in the Appendix.)

A clearly stated letter of purpose was posted and delineated the reason why the study was being initiated, as well as the motivation to conduct the study. Additionally, a list of answers was posted to frequently asked questions (FAQ) on the website. It was emphasized that subject responses were completely anonymous and that the study was for university academic research, and there was no connection with legal or governmental authorities. Again, even with these noticeable website enhancements, there was still difficulty collecting a reasonable number of usable surveys. In the end, there were 103 usable surveys collected for the 2001 tax year (filed in 2002). Because the data was collected in this manner, it was not possible to calculate response rate or non-response bias estimates36 (e.g., Armstrong and Overton, 1977).

[Note: over the intervening years, the authors have made additional attempts to obtain both child support and federal tax data from individuals, yet due to the extreme sensitivity of the data, they were not successful. Although the data used in this study may seem somewhat dated, they believe it is valid and a good proxy for testing their tax incentive proposals, since the elements extracted from the federal tax returns have changed very little over the years.]

With the foregoing in mind, the authors carefully screened the data and recalculated the self-reported data for accuracy using the individual income tax formula (e.g., Gross income less deductions “for” AGI = AGI, less deductions “from” AGI and exemptions = taxable income). This process led us to discard three observations. (Two observations were discarded because the subjects only entered the child support they paid but no other tax data. The third observation was discarded because it became clear that the tax data pertained to a year other than 2001 based on the standard deduction- and exemption-related calculations.) After these data integrity tests, the sample was left with 100 usable observations. Of the

36 This was not statistically feasible because of the small relative size of the sub-samples.
100 remaining observations, the authors utilized 2001 TurboTax software to make additional data integrity changes when needed to correct occasional subject typos and other issues, such as failure to properly calculate phase-outs, again using the individual tax formula. The authors concluded that a number of the subject tax returns were most likely prepared by hand.

RESULTS

Table 1 summarizes the demographic statistics pertaining to the study’s 100 web survey respondents. The average age of the sample was just over 37 years old, and the mean adjusted gross income level for the 2001 tax year was just under $57,000. The sample average taxable income was $40,334, with an associated average tax burden of $7,675, which suggests the average sample tax rate was approximately 19 percent. The average child support paid for the sample was $8,081 per year, or about 14 percent of the subjects’ average adjusted gross income. The average number of children that the sample non-custodial parents supported was just under two, so the average support paid per child was just over $4,600 per year. (This compares favorably with the $4,700 average child support received in 2005 (U.S. Census, 2007)).

Consistent with the literature (e.g., Lin, 2000 and Tebo, 2000), almost all of the non-custodial parents paying child support were men (95 percent). The majority of the respondents were married (66 percent) and almost half of the sample was from the southwestern United States. A little less than a third of the sample filed as single on their 2001 tax return, while just less than two-thirds were married filing jointly and 14 percent were head of household filers.

The vast majority of the respondents were Caucasian (86 percent), while 6 percent were black, and 5 percent Hispanic.

Panel A of Table 2 provides comparative descriptive statistics. As intended, both the for AGI and credit child support tax benefits reduce associated tax liabilities. The credit example reduces tax liability slightly more than the for AGI illustrative example. The table also documents that the mean for AGI total deduction was $3,267, while the mean credit was $686. Panel B of Table 2 documents that the reduction of tax liability for both tax incentive scenarios is significant based on the paired samples t test.

Table 3, Panel A provides the summary results for all taxpayers related to the tax progressivity and income distribution tests. Two different measures of tax progressivity (Suits and Kakwani indices) were utilized, and both corroborate that tax progressivity is enhanced by both tax breaks for child support payments. Consistent with the differences in tax liability noted in Table 2, the tax credit incentive proposal is slightly more progressive than the for AGI scenario.

The two measures (i.e., $e = 0.5$ and $e = 2.5$) of the Kiefer index also suggest that both tax incentive proposals reduce income inequality as compared to the original (baseline) scenario with no special tax incentive for child support payments. The credit proposal is slightly more effective as compared to the for AGI scenario where $e = 2.5$. 
Table 3, Panel B assesses these results by taxpayer status (married filing jointly versus all other filers).

Table 4 provides data input summaries for both the Suits and Kiefer indexes. Detailed calculations are also provided that support the final calculations contained in Table 3.

Figure 1 shows a Lorenz Curve based on tax liability that compares the three scenarios (original baseline, for AGI, tax credit). The for AGI and tax credit scenario curves drop below the curve representing the original scenario, which suggests that the two tax scenarios provide tax liabilities that are relatively more progressive. In sum, Figure 1 corroborates the findings presented in Table 3.

**CONCLUSION**

There are approximately 645,000 non-custodial parents in the United States who would receive an income increase of $500 to $1,900 per year from a federal tax incentive for child support (Wheaton and Sorensen 2009). Results from the present study suggest that Congress should create a tax incentive that would effectively enhance tax progressivity (based on the Suits and Kakwani indices), reduce income inequality (based on the Kiefer index), while also increasing child support payer ability to pay. The results imply that the proposed tax credit would be slightly more effective than the proposed deduction for AGI, but either option could be adjusted based on Congressional intent. Since both child support payment tax incentive options that are illustrated would increase payer ability to pay, institutional theory advocates that such a tax incentive would also likely enhance payer perceptions of IRS institutional legitimacy, as well as procedural and retributive justice, consistent with Kray and Lind (2002) and Kirchler (2007). Strengthened child support payer fairness and justice perceptions combined with an increased ability to pay should theoretically increase payer compliance, although this study could not corroborate this expectation with empirical analysis. The authors concluded that due to significant sensitivity issues, they could not ask respondents questions about future expected compliance patterns should a tax break be initiated. However all 100 respondents indicated that they favored a tax incentive of some kind to enhance their ability to pay child support.

While the child support tax incentive proposals presented in this study generally constitute tax expenditures, it should be noted that this public policy strategy is likely to also provide cost savings, if institutional theory is an accurate predictor and child support payers subsequently increase their compliance behavior. If this holds, then time and pecuniary outlays that society in general and the legal system in particular currently expend to enforce child support payment compliance may be diminished (e.g., costs associated with court deliberations, attorney fees, collection efforts, as well as incarceration costs, etc.) (Hutchison et al., 2007).

Overall, policymakers today may favor the tax credit option since the Obama administration seems to favor credits as part of their tax reform strategy. Further, it may be wise to structure the tax credit as a refundable credit, as opposed to a non-refundable credit, in order to ensure that lower income
child support payers actually receive a tax benefit from the credit.

REFERENCES


University of Michigan, Survey Research Center, Institute for Social Research.


Table 1
Sample Characteristics

<table>
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<tr>
<th>Variable</th>
<th>Category</th>
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<th>SD</th>
<th>Frequency</th>
<th>Percentage</th>
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<td></td>
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<td>$37,824</td>
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<td>(max = $179,000; min = $4,000)</td>
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<td><strong>Tax Filing Status (2001)</strong></td>
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<td>Single</td>
<td>28</td>
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<tr>
<td>Married Filing Jointly</td>
<td>58</td>
<td>58</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Head of Household</td>
<td>14</td>
<td>14</td>
<td></td>
<td></td>
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</tr>
<tr>
<td><strong>Ethnic Background</strong></td>
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<tr>
<td>Black</td>
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<td>Caucasian</td>
<td>86</td>
<td>86</td>
<td></td>
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<td>Other</td>
<td>1</td>
<td>1</td>
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Table 2
Panel A: Comparative Descriptive Statistics  

\( n = 100 \)

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<tr>
<th>Variable</th>
<th>( M )</th>
<th>( SD )</th>
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<tr>
<td>Taxable Income (Original)</td>
<td>$40,334</td>
<td>$33,603</td>
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<td>Tax Liability (Original)</td>
<td>$7,675</td>
<td>$8,061</td>
</tr>
<tr>
<td>Taxable Income (“For AGI”)</td>
<td>$37,066</td>
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<td>Tax Liability (“For AGI”)</td>
<td>$7,029</td>
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<td>“For AGI” Total Deduction</td>
<td>$3,267</td>
<td>$1,342</td>
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<tr>
<td>Taxable Income (Credit)</td>
<td>$40,334</td>
<td>$33,603</td>
</tr>
<tr>
<td>Tax Liability (Credit)</td>
<td>$6,988</td>
<td>$8,028</td>
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<tr>
<td>Total Credit Amount</td>
<td>$686</td>
<td>$295</td>
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Panel B: Paired Samples \( t \)-Test  

\( n = 100 \)

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<th>Pair</th>
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<th>( p )</th>
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<td>18.88</td>
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<td>Tax Liability (Credit)</td>
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### Table 3

#### Panel A: Progressivity and Income Inequality Summary

All Data

\(n = 100\)

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<tr>
<th>Index</th>
<th>Original Baseline</th>
<th>For AGI</th>
<th>Credit</th>
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<tr>
<td>Suits(^a)</td>
<td>0.160</td>
<td>0.199</td>
<td>0.206</td>
</tr>
<tr>
<td>Kakwani(^b)</td>
<td>0.164</td>
<td>0.199</td>
<td>0.209</td>
</tr>
<tr>
<td>Kiefer (e=0.5)(^a)</td>
<td>0.012</td>
<td>0.014</td>
<td>0.014</td>
</tr>
<tr>
<td>Kiefer (e=2.5)(^a)</td>
<td>0.122</td>
<td>0.131</td>
<td>0.138</td>
</tr>
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</table>

\(^a\) See detailed input data and calculations on TABLE 4.

\(^b\) \(G_x = 0.3520; \ C_{\text{original}} = 0.5155; \ C_{\text{For AGI}} = 0.5509; \ C_{\text{Credit}} = 0.5606\)

#### Panel B: Progressivity and Income Inequality Summary

Married Filing Jointly (MFJ) versus All Other Filers (AO)\(^a\)

\(n = 100\)

<table>
<thead>
<tr>
<th>Index</th>
<th>Original</th>
<th>For AGI</th>
<th>Credit</th>
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<tbody>
<tr>
<td>MFJ</td>
<td>AO</td>
<td>MFJ</td>
<td>AO</td>
</tr>
<tr>
<td>Suits</td>
<td>0.175</td>
<td>0.137</td>
<td>0.207</td>
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<tr>
<td>Kakwani</td>
<td>0.059</td>
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<tr>
<td>Kiefer (e=0.5)</td>
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<td>Kiefer (e=2.5)</td>
<td>0.136</td>
<td>0.093</td>
<td>0.139</td>
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\(^a\) MFJ = 48, AO = 42.
### Table 4
**Data Input Summary**
**Suits and Kiefer Indexes-Detailed Calculations**
**Panel A: Suits Index Tax Burdens and Calculations**

<table>
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<tr>
<th>Decile</th>
<th>$ Tax Original</th>
<th>Cum. (^a) Percent</th>
<th>$ Tax For AGI</th>
<th>Cum. (^a) Percent</th>
<th>$ Tax After Credit</th>
<th>Cum. (^a) Percent</th>
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<td>1</td>
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<tr>
<td><strong>Total</strong></td>
<td><strong>76,747</strong></td>
<td></td>
<td><strong>70,288</strong></td>
<td></td>
<td><strong>69,885</strong></td>
<td></td>
</tr>
</tbody>
</table>

\( L_x \) | \( L_x \) | \( L_x \) |
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>4,199.92</td>
<td>4,006.38</td>
<td>3,970.26</td>
</tr>
</tbody>
</table>
a Cumulative Percent

**Panel B: Kiefer Index Calculations**

<table>
<thead>
<tr>
<th>Decile</th>
<th>Mi Mean Income Before Tax ($)</th>
<th>MIAT&lt;sup&gt;b&lt;/sup&gt; Original ($)</th>
<th>MIAT&lt;sup&gt;b&lt;/sup&gt; “For AGI” ($)</th>
<th>MIAT&lt;sup&gt;b&lt;/sup&gt; Credit ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>14,462</td>
<td>13,808</td>
<td>14,017</td>
<td>14,090</td>
</tr>
<tr>
<td>2</td>
<td>24,759</td>
<td>22,942</td>
<td>23,470</td>
<td>23,789</td>
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<tr>
<td>3</td>
<td>30,008</td>
<td>27,257</td>
<td>27,824</td>
<td>27,873</td>
</tr>
<tr>
<td>4</td>
<td>34,293</td>
<td>30,718</td>
<td>31,314</td>
<td>31,463</td>
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<tr>
<td>5</td>
<td>43,472</td>
<td>39,248</td>
<td>39,938</td>
<td>40,016</td>
</tr>
<tr>
<td>6</td>
<td>49,678</td>
<td>43,970</td>
<td>44,656</td>
<td>44,704</td>
</tr>
<tr>
<td>7</td>
<td>60,271</td>
<td>52,806</td>
<td>53,688</td>
<td>53,490</td>
</tr>
<tr>
<td>8</td>
<td>73,617</td>
<td>65,034</td>
<td>65,980</td>
<td>65,754</td>
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<tr>
<td>9</td>
<td>94,182</td>
<td>79,292</td>
<td>80,095</td>
<td>80,036</td>
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<tr>
<td>10</td>
<td>143,768</td>
<td>116,691</td>
<td>117,240</td>
<td>117,411</td>
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</table>

<table>
<thead>
<tr>
<th>Mean (all)</th>
<th>$56,851</th>
<th>$49,176</th>
<th>$49,822</th>
<th>$49,863</th>
</tr>
</thead>
<tbody>
<tr>
<td>e = 0.5</td>
<td>-0.90433</td>
<td>-0.91662</td>
<td>-0.91794</td>
<td>-0.91850</td>
</tr>
<tr>
<td>e = 2.5</td>
<td>2.40318</td>
<td>2.28080</td>
<td>2.27242</td>
<td>2.26517</td>
</tr>
</tbody>
</table>

<sup>b</sup>MIAT = Mean Income After Tax
Figure 1

Lorenz Curve: Accumulated Percent of Tax Liability

Comparison of Original Scenario with \textit{for AGI} and Tax Credit Options

Lorenz Curve for Various Tax Situations
Appendix
2002 Web-Based Child Support Survey
(2001 Tax Year)

I. Participant Information

1. Sex: Male _____ Female______

2. Age: _____

3. Ethnic Background:
   Caucasian_____  
   Black_____  
   Hispanic_____  
   Asian/Pacific Islander_____  
   Native American Indian_____  
   Other_____  


II. Child Support Data

5. In what STATE was your child support order issued?  
   __________

6. How much child support did you pay in the year 2001?  
   $__________

7. How many months in year 2001 did you pay child support? ________

III. Federal Income Tax Information

9. Please select the 2001 Tax Form you completed:  
   Fill in for only ONE form!!!
   Form 1040:  
   Filing status: Single _____ Married _____  
   Head of household _____  
   Total Exemptions (line 6d) __________
   Adjusted Gross Income (line 33) $__________

   Total Deductions (line 36)  
   Standard __ Schedule A ___$__
   Taxable Income (line 39) $___________

   Total Credits (line 51) $__________

The Contemporary Tax Journal Fall 2014
Appendix (cont.)

Form 1040A: Filing status: Single ______ Married
___________ Head of household _______________
Total Exemptions (line 6d)____________________
Adjusted Gross Income (line 19) $________
Standard Deductions (line 22) $________
Taxable Income (line 25) $_______________
Total Credits (line 33) $___________________

Form 1040EZ: Filing status: Single _____ Married _______
Adjusted Gross Income (line 4) $________
Exemptions (line 5) $____________________
Taxable Income (line 6) $_________________
Total Credits:
Rate Reduction Credit (line 7) $____
Earned Income Credit (line 9a) $__

10. Do you think the Federal government should allow a
tax deduction or credit for child support payments?
Yes ____ No ____

Please verify that you entered ALL the information carefully before you submit the survey.
Summaries for the 29th Annual TEI-SJSU High Tech Tax Institute

An annual conference sponsored by the Tax Executives Institute, Inc. and SJSU Lucas Graduate School of Business
November 4 & 5, 2013

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 2013 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 2013 Institute, we hope this overview of the topics covered will encourage you to attend a future program.

Mark Your Calendars!!!

31st Annual TEI-SJSU High Tech Tax Institute

November 9-10, 2015
Crown Plaza Cabana, Palo Alto, CA
http://www.tax-institute.com/
IFRS: Steps Toward Convergence and Conversion in 2013

By Alexander Ciak, MST Student

Publicly traded companies in over 100 countries, including Brazil, Mexico, and Canada, require use of International Financial Reporting Standards (IFRS) for financial reporting. Both China and India have taken steps to fully adopt IFRS, but the U.S. has continued to rely on accounting principles generally accepted in the United States of America (U.S. GAAP). Since 2007, the U.S. Securities and Exchange Commission (SEC) and Financial Accounting Standards Board (FASB) have been taking steps towards both conversion to IFRS and convergence, the alignment of existing U.S. GAAP with IFRS. However, the steps have been slow and muddled in recent years.

In July 2012, the SEC completed the IFRS Work Plan, a document expected to give guidance on how the U.S. would approach convergence. Unfortunately, the document fell short of the public's expectations and failed to provide any insight about future steps. At the end of 2013, the 29th Annual High Tech Tax Institute received an IFRS update from Mr. Alan Jones, Partner, PwC and Mr. Eric D. Ryan, Partner, DLA Piper.

The presenters explained that the steps towards both conversion and convergence made limited progress during 2013. The lack of progress can be partially attributed to the partisan gridlock in Washington D.C. and busy agenda of the SEC. In the U.S., IFRS is generally supported by those in favor of free markets, often touted by the Republican Party, so under the Obama administration, convergence has been less of a priority.

Mr. Jones explained that the goal of IFRS is to have principle-based accounting standards, while U.S. GAAP focuses on a rule-based approach. Convergence is a tricky issue because U.S. GAAP is conceptually different than IFRS. For example, by converging with IFRS, the U.S. will be required to alter its accounting standards potentially to the detriment of U.S. companies in areas like inventory valuation.

Under U.S. GAAP, U.S. companies are allowed to use the Last-in-First-Out (LIFO) method to value their inventories. By converging with IFRS, U.S. companies would be required to use the First-in-First-Out (FIFO) method. The change from LIFO to FIFO, Mr. Jones explained, could trigger an increase in the amount of taxable income that U.S. companies pay and report.

Mr. Ryan explained that conversion could also impact the §41 R&D credit. Current U.S. tax law allows companies to immediately deduct qualified expenses related to research and development.
companies may deduct expenses related to research but must capitalize costs related to development. A company claiming the §41 R&D credit under conversion would have to keep its financial reporting in conformity with IFRS, while potentially maintaining a separate record of qualifying development costs for tax reporting.

Despite the problems related to conversion, the speakers emphasized that IFRS is already important for many U.S. companies. When a U.S. company has operations in another country, it most likely already utilizes a form of IFRS for its subsidiaries. Also, mergers and acquisitions related to foreign entities (both inbound and outbound) generally involve some form of conversion to or from IFRS. The presenters also mentioned that potential access to foreign capital markets often requires a U.S. company to submit financial statements prepared using IFRS. The presenters closed by reminding the audience that in a global economy it is important to be accounting bilingual. As U.S. capital markets continue to shrink and cross-border transactions increase, the importance of IFRS to U.S. companies will continue to grow. Thus, the road ahead for conversion is currently stagnant, but as a result of globalization, may pick up steam again sometime in the future.

Alexander Ciak would like to thank Mr. Alan Jones and Mr. Eric Ryan for their assistance in preparing this article.

Innovation Incentives for Renewable Energy

By Christen Brown, MST Student

Innovation incentives, as they are referred to in the accounting industry, are tax credits and refunds that businesses receive in exchange for research and development (R&D) expenditures. According to the Center for American Progress, “Investment in research and development is a significant driver of technological progress and economic growth, particularly in high-wage developed countries.”

During the 29th Annual High-Tech Tax Institute, an industry savvy panel comprising of Michael Locascio, Director, Deloitte Tax LLP, Emily Lam, Partner, Skadden, Arps, Slate, Meagher & Flom LLP, Tanya Erbe-German, Senior Director, BDO and Mark Andrus, Partner, Grant Thornton LLP, discussed the following areas of innovation incentives.

- Federal Research & Development credit
- Domestic Production Activities deduction
- State Incentives
- Patent or innovation boxes
- Renewable energy incentives

Since the Silicon Valley is a hotbed of solar and wind power generation, the topic of renewable energy incentives was of particular interest. President Obama’s Recovery Act, a plan to double renewable electricity generation by 2020, creates a greater opportunity for business growth. Companies, poised to take advantage of these new incentives, can not only gain tax credits, but also achieve public recognition for promoting the wellness of the environment. Some of the tax incentives currently available to businesses are mentioned below.

1) **Accelerated Depreciation**: Under Section 168(e)(3)(B)(vi), a 5-year recovery period for certain renewable energy property is created. If this method is used under the half-year convention, expenditures will incur a 20% depreciation in Year 1, 32% in Year 2, 19.2% in Year 3, 11.5% in Year 4 and 5.8% in Year 5.

2) **Bonus depreciation**: Under Section 168(k), a one-time depreciation deduction equal to 50% of the adjusted tax basis of certain renewable energy property placed in service before January 1, 2014 is also available. The remaining 50% is recovered through accelerated depreciation.

3) **Production Tax Credit (“PTC”)**: Under Section 45, based on the production and sale of electricity over a 10-year period for qualified facilities businesses will receive a credit for construction beginning prior to
January 1, 2014. These credits are:
• 2.3 cents/kWh in 2013 for wind, closed-loop biomass and geothermal construction or
• 1.1 cents/kWh in 2013 for open-loop biomass, hydropower, landfill gas, trash combustion, marine renewable and hydrokinetic construction.

4) **Investment Tax Credit (“ITC”)**: Under Section 48, a credit is available for investment in certain types of energy property. This credit is divided between a 30% and 10% credit:
• 30% for solar, qualified fuel cell (limited to $1,500 per 0.5 kW of capacity), and qualified small wind investments, and
• 10% for qualified micro turbine (limited to $200 per kW of capacity), combined heat and power, and geothermal investments.

5) **Election for ITC In Lieu of PTCs**: Under Section 1102, businesses are able to elect for an ITC in lieu of a PTC (production tax credit), if this returns them a better tax advantage. Businesses are able to claim an ITC for 30% of the adjusted tax basis of property that would otherwise be eligible for PTC.

According to a Recovery Act article, Promoting Clean, Renewable Energy: Investments in Wind and Solar boasts of the programs already in place to promote renewable energy. These measures have produced over $7 billion in tax credits, payments in lieu of credits, and loan guarantees. They have also produced 17,000 jobs across 44 states.\(^2\) Tax incentives for R&D are a critical tool to increase the amount of innovation needed to produce renewable energy. A good accountant will be aware of this fact; but a great accountant will be well apprised on the current tax incentives available for their clients.

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\(^1\) The Corporate R&D Tax Credit and U.S. Innovation and Competitiveness Gauging the Economic and Fiscal Effectiveness of the Credit, Tyson, Laura and Linden, Greg, Center for American Progress, January 2012, p. 1

Presentation of Unrecognized Tax Benefit (UTB) on Financial Statements

By Tejal Shah, CPA, MST Student

In July 2013, the Financial Accounting Standards Board (FASB) issued an update regarding the presentation of an Unrecognized Tax Benefit (UTB)\(^1\). As per the update, an unrecognized tax benefit, or a portion of an unrecognized tax benefit, shall be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss (NOL) carryforward, a similar tax loss, or a tax credit carryforward.

The first question that one can ask is the definition of an UTB. UTBs are defined as the different treatment of certain positions on tax returns and financial statements\(^2\). For example, the tax position of not filing a return in certain jurisdiction (multistate) or change in characterization of income, such as classification of certain income as tax exempt or claiming more credit on tax return than what was eligible. The UTB defers income taxes to future years. Therefore, it creates a deferred tax liability. Fin 48 provides guidance on accounting for these uncertain tax positions.

The main purpose of this article is the presentation of deferred tax liability due to UTB on financial statements, when there is a deferred tax asset created due to NOL carryforward or credit carryforward. Neither US GAAP nor IFRS have explicit guidance on the presentation of UTB. Thus, some entities presented the UTB as a liability, unless it directly resulted in the recognition of net operating loss or tax credit carryforward for that year. Other entities presented UTB as a reduction of a deferred tax asset for a NOL or credit carryforward. The objective of ASU 2013-11 is to eliminate the diversity in practice and streamline the presentation of UTB on financial statements.

Prior to this update, most of the entities used gross presentation: if an uncertain tax position is unrelated to NOL (i.e. does not create or increase a NOL carryforward), but will utilize NOL carryforward to satisfy such liability if due, then both the NOL carryforward and the UTB liability were presented gross in the balance sheet. The only time the UTB liability is reported net of NOL carryforward is the year when such NOL carryforward is utilized to satisfy such liability.

Per ASU 2013-11 update, the financial statement must present UTB, or a portion of UTB liability, as a reduction to a deferred tax asset for a NOL carryforward, a similar tax loss, or a tax credit carryforward\(^3\). However, if the NOL carryforward, a similar tax loss, or a tax credit
carryforward is not available at the reporting date under the tax law of the applicable jurisdiction to settle any additional income tax that would result from disallowance of a tax position, UTB shall be presented as a liability in the financial statements (i.e. gross method must be followed). Also, the UTB must be presented as a liability on a financial statement if the tax law of applicable jurisdiction does not require the entity to use the NOL, similar loss, or credit carryforward or the entity does not intend to use the deferred tax asset for such purpose.

The following examples might help in understanding the exceptions to net presentation of UTB liability:

a) Different jurisdiction – An entity has a NOL carryforward (deferred tax asset) for the state of CA but the uncertain tax position (UTB liability) pertains to the state of PA. In such cases, UTB liability and the deferred tax asset are presented gross on financial statements.

b) Limitation on use of NOL carryforward in a particular jurisdiction – CA suspended NOL carryover deduction with some exceptions for taxable years beginning 2008, 2009, 2010, and 2011. Thus, the tax position is disallowed and there is a limit on use of NOL carryforward in a particular year, the UTB liability and deferred tax asset must be presented gross on financial statements.

c) Elective treatment – An entity has an option either to use its existing deferred tax asset to settle the UTB liability or pay it off by cash, and the entity expects to cash settle the UTB liability. In such scenario, the UTB liability and the deferred tax assets must be presented gross on financial statements.

Conclusion:
ASU 2013-11 provides guidance on the presentation of unrecognized tax benefit when a NOL, similar tax loss, or credit carryover exists. Its objective is to eliminate diversity in presentation in such situations.

This update is effective for fiscal years and interim periods within those years beginning after December 15, 2013 for public companies and after December 15, 2014 for nonpublic companies. Early adoption is permitted.

This update should be applied prospectively to all UTBs that exist at the effective date. However, retrospective application is permitted.
ASU 2013-11

Fin 48, paragraph 17

ASC 740-10-45-10A, ASU 2013-11

ASC 740-10-45-10B, ASU 2013-11

Ibid


http://www.sjsu.edu/lucasschool/prospective-mst/index.html
Transfer Pricing: Developments, Surprises, and Challenges

By Ngan Pham, MST Student

At the 2013 TEI - SJSU High Tech Tax Institute, Rod Donnelly of Morgan Lewis, with Alpana Saksena of KPMG, Sam Maruca of the IRS and Craig Sharon of EY, discussed issues related to transfer pricing. They provided updates regarding the Organization for Economic Cooperation Development Base Erosion Profit Shifting (OECD BEPS) projects, US Transfer Pricing, and India. Base erosion and profit shifting (BEPS) refers to tax planning strategies that exploit gaps and mismatches in tax rules to make profits ‘disappear’ for tax purposes or to shift profits to locations where there is little or no real activity but the taxes are low resulting in little or no overall corporate tax being paid.¹

OECD BEPS

The Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (TPGs) are targeted for revision. The OECD plans to approve the revision of about 60% of TPGs’ chapters from 2014 through 2015. One of the issues they plan to develop and revise, that is pertinent to Silicon Valley, is Action 8 – Intangibles. The goal is to prevent BEPS by moving intangibles among multinational entities.

US Transfer Pricing

The transfer pricing landscape has changed after the IRS moved the former Advanced Pricing Agreement program to the Office of Transfer Pricing Operations, Large Business and International Division (TPO). The TPO has sought out to improve the Advance Pricing Agreement (APA) process and maintain a better relationship with treaty partners. Although optimistic, budget limitations and resources may restrict their progression. In addition, global tax enforcement has a more focused approach on higher-risk transaction related to reputational risk.

India Update

Furthermore, the Advance Pricing Agreement (APA) program with India became operational as of September 2012. India’s APA program allows for flexibility in the method for determining arm’s length pricing and a timeline of 1 to 3 years for approval. The focus of the India APA team is to agree on a Function Asset Risk (FAR) analysis during which ‘site visits’ are required. As of March 31, 2013, 158 formal pre-filing APA applications were received by the government and 90% of the pre-filings were converted to applications.
The panel concluded the presentation by reminding the audience that transfer pricing is an evolving subject. As tax practitioners, it is important to track and understand the new developments, so that the element of ‘surprise’ can be contained.

1 OECD website  http://www.oecd.org/ctp/beps-frequentlyaskedquestions.htm

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• 30-unit graduate
International Tax Implications for Businesses Operating in “The Cloud”

By Kara Virji-Gaidhar, MST Student

On November 4, 2013 at the TEI-SJSU High Tech Institute seminar held at Palo Alto, a panel of distinguished international tax experts included Gary Sprague, Managing Partner at Baker & McKenzie, LLP., Kent Wisner, Managing Director at Alvarez & Marsal Taxand LLC., Kimberly M. Reeder, Partner at Reeder Wilson LLP., and Malcolm Ellerbe, Partner at Armanino LLP.

Mr. Wisner began by asking the audience to consider: What is the Cloud?

The term generally refers to a lack of locally-owned infrastructure where data reside and electronic functions are performed. Instead, this activity takes place over the internet through remotely located servers and at high-speed connectivity. The original categories that comprise the cloud are SaaS (Software as a Service), PaaS (Platform as a Service) and IaaS (Infrastructure as a Service), as illustrated in the following Figure 1.¹

According to Mr. Ellerby, these categories have rapidly evolved and blended into an array of innovative business models where modern retail transactions occur instantaneously. In this modern paradigm, the instantaneous nature of e-commerce becomes problematic because it involves both the definition of logical moments in time where tax relevant events occur, and the determination of what permanent establishment for a taxable nexus means. In e-commerce transactions, determining a tax event is often challenging. Does the incidence of tax occur when a buyer places an order online or when the buyer’s credit card is charged? Does it occur when the seller receives the payment or when the seller delivers the product or when the customer
receives the product? Additionally, transactions that occur in "the cloud" involve complexity in pinpointing exactly where the taxable nexus occurs.

Mr. Sprague observed that on the subject of cloud computing, there is limited US tax guidance whereas there are extensive commentaries in Article 5 of the Organization for Economic Cooperation and Development (OECD) Model Convention. For purposes of Article 5, Permanent Establishment is defined as a fixed place of business through which some degree of business of a company occurs. Importantly, Article 7 of the OECD Model Convention sets forth that only profits attributed to a Permanent Establishment will be taxed.

The OECD commentaries provide that a website, by itself is not tangible property and does not give rise to Permanent Establishment. However, a server on which the website is stored, and through which the website is accessed can result in Permanent Establishment because the server constitutes a “fixed place of business”, yet the server location will not give rise to Permanent Establishment when the server functions performed are deemed preparatory or auxiliary to the business. Some activities that are preparatory and auxiliary include advertising of services or goods, gathering market data for the enterprise, and supplying information. To establish Permanent Establishment, a foreign enterprise must own, or lease, and operate the server or data center. Interestingly, a company’s Permanent Establishment may be established interpretively when the functions performed are deemed “essential”, “significant” or “core”. Examples of core functions include a data center hosting a website, holding user data, and engaging in transaction processing.

Mr. Sprague discussed an important ruling that provides guidance with respect to Permanent Establishment to US e-commerce companies doing business in Canada. He discussed the Canadian administrative ruling that involved a US parent company (USP) and its related party, a Canadian subsidiary with a data center. The Canadian ruling addressed the issues of ‘fixed place of business’ and ‘services permanent establishment’. The legal basis for their decision was the US/Canadian tax treaty. Although all server access could be made from the US by employees of the USP, the ruling held that the USP did not have a fixed place of business service Permanent Establishment in Canada because the assets were not owned by the USP, the premises was not at the disposal of the USP, and therefore, the USP did not have a tax nexus in Canada.

The OECD discussions address Permanent Establishment in the e-commerce context from a national or federal governmental view. Mr. Sprague noted that the OECD definition of virtual Permanent Establishment is paralleled in many US states’ tax codes as market-based
sourcing where selling into a state jurisdiction establishes tax nexus. For example, as it related to sales, California’s economic nexus standard is applied under market-based sourcing rules to any taxpayer doing business in California if the taxpayer’s sales for the applicable year in the state exceed the lesser of either $500,000, or 25% of the taxpayer’s total sales. According to Ms. Reeder, California taxpayers have generally used the Uniform Division of Income for Tax Purposes Act (UDITPA) section 17 cost-of-performance rule, to determine whether or not a sale of services is deemed a California sale for apportionment purposes.

There is currently an apparent fundamental US federal tax concept violation. The longstanding premise that income should be taxed where it is created is not being reflected in many state statutes that are allowing for market-based sourcing nexus. Absent sustaining federal tax authority, US states may encounter difficulty to jurisdictionally compel e-commerce companies with virtual Permanent Establishments to pay state taxes. It is critical for businesses and US state regulators to follow the US federal government’s response, or lack thereof, to the evolving OECD guidance on Permanent Establishment for taxable nexus in international e-commerce.

1 http://www.crmnext.com/learning/what-is-cloud-computing/


5 Cal. Rev. & Tax Code §23101(b)

6 Cal. Rev. & Tax Code §25136(b)(5) and Cal. Reg. §25136-2
Current International Tax Issues
By: Megan Park, MST Student

Globalization today, has made the tax world complex. As companies spread their wings internationally, the tax issues associated with their growth multiply. Current tax developments in the international arena were discussed at length, at the 29th TEI-SJSU High Tech Tax Institute, held on November 4, 2013, at Palo Alto. The esteemed panel comprising of David L. Forst and Adam S. Halpern of Fenwick & West LLP, opened the discussion by presenting the following court case.

FOREIGN TAX CREDITS - Bank of New York Mellon Corp. v. Commissioner

In the case of Bank of New York Mellon Corp. v. Comm., 140 T.C. 2 (2013), the Tax Court held that Bank of New York Mellon (BNY) was not entitled to deduct foreign tax credits and certain business expenses incurred from a Structured Trust Advantaged Repackaged Securities (STARS) transaction due to lack of economic substance. As a result, the taxpayer’s foreign partnership structured in a STARS scheme was also disregarded, and the partnership’s income was determined as U.S. source income, rather than foreign source income.

The Supreme Court holding in the landmark 1934 Helvering v. Gregory case established the "economic substance doctrine." The courts have applied the doctrine with two prongs: the "economic substance beyond tax benefits” (objective prong) and the “non-tax business purpose” (subjective prong). To evaluate the economic substance of transactions, some courts applied one of these prongs, or both, to determine whether or not a transaction has a lack of economic substance. The Tax Court applied both prongs to the STARS transaction following the legal precedence of Second Circuit, which could be used as the taxpayer’s appellate court.

The taxpayer arranged the STARS transaction with Barclays to utilize a "below-market loan" from the U.K. bank. Several entities including a U.K. trust (a partnership for federal tax purposes) complicatedly wove STARS. The taxpayer deducted foreign tax credits and business expenses and reported income generated from the trust, as a foreign source income through this cross-border tax scheme.

Economic substance beyond tax benefits (objective prong)

Despite the Fifth and Eighth Circuits' (appellate courts outside the jurisdiction of this court) determination
that foreign taxes should not be taken into account in evaluating pre-tax effects for purposes of the economic substance analysis, the Tax Court held that STARS transactions did not have objective economic substance (other than tax avoidance) because it reduced its economic profit due to significant professional service fees and foreign taxes. In other words, the Tax Court also considered foreign taxes in relation to transaction costs. The court also stated that unintended benefits from by-product of taxpayer's transactions should not be considered to determine economic substance and that the circulating cash flows among entities' transactions without any alteration, lacked economic substance.

Non-tax business purpose (subjective prong)

U.S. corporate taxpayers must report worldwide income regardless of paying foreign taxes. In the Goodyear Tire case, "Congress enacted the foreign tax credit to alleviate double taxation arising from foreign business operations." The Tax Court states: "The U.K. taxes at issue did not arise from any substantive foreign activity. Indeed, they were produced through pre-arranged circular flows from assets held, controlled and managed within the United States. We conclude that Congress did not intend to provide foreign tax credits for transactions such as STARS." The court further mentioned that "STARS structure lacked any reasonable relationship to the loan. And the loan was not 'low cost.' To the contrary, it was significantly overpriced and required BNY to incur substantially more transaction costs than a similar financing available in the marketplace." Therefore, the taxpayer's true motivation of transactions was tax avoidance, and the taxpayer was not eligible for foreign tax credits. The deductibility of transaction costs arising from the STARS transaction was also denied due to the lack of economic substance of the transactions themselves.


Article 23(3) of the U.S.-U.K. Tax Treaty of 1975 states that "... income or profits derived by a resident of a Contracting State which may be taxed in the other Contracting State in accordance with this Convention shall be deemed to arise from sources within that other Contracting State." Per Article 4(1)(a)(i), a partnership or trust is resident of the United Kingdom for the purposes of U.K. tax, only if its income (including partners' or beneficiaries' portion) is subject to U.K. tax as the income of a resident. Thus, income from the trust (partnership) was foreign source income according to the Treaty. However, the court held the income as U.S. source income and reasoned that "U.S. tax laws and treaties do not recognize sham transactions or transactions that have no economic substance as valid.
for tax purposes."

The partnership of the taxpayer passed this test because Barclays clearly had its own economic benefits and had not intended to solely avoid taxes. The court's opinion, however, was not clear regarding the other partner's involvement. Furthermore, the Tax Court did not even mention subchapter K rules regarding the partnership.

The court disregarded the partnership although the partnership was a resident of the U.K. within the meaning of the Treaty and paid U.K. taxes. There might be double taxation issues that are not intended by the income tax treaties.

**SUBPART F, Active Rents Exception: Software - FAA 20132702F**

The IRS held in FAA 20132702F that a CFC's rental income from the lease of software was foreign personal holding company income (FPHCI, subpart F) and was not qualified for the active leasing exception due to the insufficient marketing functions by the CFC's employees.

Despite limited disclosure of FAA 20132702F, the following facts can be summarized. The taxpayer, a software developer, entered into a cost-sharing agreement with CFC-1. CFC-1 granted CFC-2 rights to distribute copies of the Software to third parties, and CFC-2 was required to return all copies of the Software and all information and had no rights to retain any related materials upon termination.

Reg. §1.861-18(c) provides two classifications regarding transfers of computer programs: a transfer of a copyright and a transfer of a copyrighted article. Reg. §1.861-18(f)(2) further states if the transferee has sufficient benefits and burdens of ownership, the transfer of a copyrighted article constitutes sales or exchange otherwise considered as a lease generating rental income.

CFC-2 was merely given rights to distribute the Software to thirty party customers. The transfer did not constitute a sale or exchange due to insufficient rights transferred. The taxpayer and the IRS both agreed that CFC-2's income from the software license to customers would be classified as a lease generating rental income under Reg. §1.861-18. Thus, the rental income was FPHCI under section.
Sec. 954(c)(2)(A) provides exceptions of FPHCI for "rents and royalties derived in active business." Reg. §1.954-2 (b)(6) further states FPHCI "shall not include rents or royalties that are derived in the active conduct of a trade or business." According to Reg. §1.954-2 (c)(1)(iv), rents from property leased to a CFC for marketing functions to generate substantial income for the CFC from the leased property shall be excluded from FPHCI. The taxpayer seemed to qualify for this exception, but the IRS came to a different conclusion.

Reg. §1.954-2(c)(2)(ii) describes "substantiality of foreign organization" when active leasing expenses are 25% or more than the adjusted leasing profit. According to Reg. §1.954-2(c)(2)(iv), the active marketing exception also applies to rents from leases acquired by the CFC lessor, "if following the acquisition the lessor performs active and substantial management, operational, and remarketing functions with respect to the leased property."

A few employees (Executive director, Financial Controller, Software Media Production Assistant) who all had non-marketing backgrounds managed CFC-2. They merely managed CFC-2 regarding administrative (accounting or clerical) matters. The evidence (a few new customers, no time tracking for marketing activities, no bonuses or commissions based on successful marketing) was not enough to prove that CFC-2 actively and regularly engaged in business marketing. CFC-2 was merely a conduit for the payments from third parties. Therefore, the rental income was not eligible for the active marketing exception and classified as FPHCI.

In sum, the active marketing exception to subpart F was particularly applicable to the CFC's engagement in real and substantial marketing business and not for the foreign entity as a mere conduit of payments.

1 Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934), aff'd, 293 U.S. 465 (1935).

Summaries of the TEI-SJSU Tax Policy Conference (February 28, 2014)

The High Tech Tax Institute holds a high standard professional tax education conference annually. This year, the topic is “Federal Tax Reform: Dealing with the Known and Unknown”. Following articles summarize selected sessions from the February 28, 2014 Tax Policy Conference. We encourage you to read these summaries to get a quick update on issues related to the federal tax reform. You can also visit the High Tech Tax Institute website to view the materials in greater detail. We hope this overview of the topics will inspire you to attend a future program.

Mark Your Calendars!!!

31st Annual TEI-SJSU High Tech Tax Institute

November 9-10, 2015
Crown Plaza Cabana, Palo Alto, CA

http://www.tax-institute.com/
Domestic Tax Reform Proposals
By Di Zhu, MST Student

Ms. Annette Nellen, Director of San José State University’s MST Program, as the first keynote speaker of the 2014 joint Tax Executives Institute – San Jose State University Tax Policy Conference, started off by stating that the Conference, which has been held for four consecutive years, is a good chance for participants to get a sense about what is going on in the tax world. Understanding a tax policy well allows those to explain the law to clients or CFOs and be aware of their impact to the company.

The presentation focused on tax reforms proposed in the last two years. Almost all tax reforms aimed at lowering tax rates and broadening the base by cutting back tax deductions. The tax reforms covered appropriate tax incentives for the economy, some administrative issues, how we will deal with double taxation and whether to treat S corporations and partnerships differently.

Ms. Nellen then went over a number of reform proposals in detail. Highlights of key proposals are summarized below:

Congressman Camp’s Proposal
Representative David Camp, Chair of the House Ways and Means Committee, as promised, introduced a comprehensive proposal for tax reform (The Tax Reform Act of 2014) in 2014 before his retirement from the House that would lower tax rates for individuals and corporations while making the code simpler and fairer. The impacts of Camp’s proposal for individuals and corporations are as follows:

For individuals:
The current seven tax brackets would consolidate into three brackets: 10%, 25% and 35% for high income individuals. Besides that, the proposal also intends to increase the standard deduction. Under current tax law, 33% of filers
itemize their deductions. The Tax Reform Act of 2014 estimated that the rate would fall from 33% to 5%. Camp believed that the tax reform should be tax neutral. Therefore, he proposed to cut back some tax expenditures, such as repealing personal exemptions and most credits, creating a floor for deducting charitable contributions to the extent it exceeds 2% of Adjusted Gross Income, requiring that the only deductible state and local taxes must be tied to business or the production of income. Furthermore, the Act would eliminate the deducting of personal casualty and theft losses, medical expenses, moving expenses, and alimony. It would also phase-out the limitation for home mortgage interest from the interest paid on $1 million of debt under current law to $500,000 and it would eliminate the deduction on home equity loans. Furthermore, Camp’s proposal would expand the child and dependent tax credit: $1,500 for a dependent child who is under 18 and $500 for non-child dependents, a replacement of the repealed personal exemption. A change for the gain exclusion on the sale of a principal residence is mentioned as well. Today, you must have owned and lived in the principal residence for two of the five years prior to the sale to exclude $500,000 (for most filers) of the gain on sale. Camp proposed changing the exclusion to require those to own and use the house for five of eight years and they can claim the exemption once every five years (versus once every two years under current law). Also, the exclusion will be phased out for high income individuals. 

For corporations:

The corporate side of the proposal includes many measures aimed to stimulate economic growth. The corporate rates would drop from the current top 35% rate to an eventual fully phased-in flat 25% corporate tax rate for all levels of taxable income in 2019. The draft makes permanent section 179 expensing, which allows $250,000 of deduction, with the deduction phased out for investments exceeding $800,000 for the tax year. The draft also allows computer software and certain real property to qualify for section 179 expensing. The Net Operating Loss deduction is limited to 90% of taxable income. Self-employment tax will apply to income of partnerships, LLCs, and S corporations. R&D will be written off over five years, and specifically includes software development costs, which is vague under the current law, and will be phased in over a few years. The research credit will be modified, and a simplified credit at 15% will be made permanent. Supplies and computer software development will be not eligible for the credit. Camp also proposed to increase amortization of intangibles from 15 years to 20 years. Also, only 50% of advertising expenses will be deductible – with the balance to be written off over 10 years.

There is a long list of corporate tax repeals, including:

- Phase out the Section 199 deduction
- Repeal AMT
• Repeal modified accelerated cost recovery system (MACRS) and use system like the alternative depreciation system (ADS)
• Repeal like-kind exchange deferral
• Repeal Section 1202 QSBS exclusion
• Repeal Section 1235 on sale of patents
• Re-characterization of capital gains in carried interest of an investment partnership as ordinary income
• Cut back on the availability of the cash method of accounting
• Repeal LIFO and the Lower of Cost of Market inventory valuations
• Repeal the medical device excise tax

Moreover, some administrative reforms were proposed: review examination selection procedures and prohibit conferences until the Treasury Inspector General for Tax Administration (“TIGTA”) reviews them, restrict IRS employees’ use of personal emails for official business, and the prohibition of pre-populated returns by the IRS. Camp made some changes on return due dates, which are illustrated in the following chart.

<table>
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<th>Proposed due date</th>
<th>Proposed extended due date</th>
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<td>March 15</td>
<td>Sept 15</td>
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**Senator Baucus Discussion Draft**

Senator Baucus in November, 2013 released a cost recovery and accounting reform discussion draft, which aims to simplify the existing MACRS rules. The draft introduced a pooling system under which pooled property is divided into four depreciation pools and assets would no longer be individually tracked. Real property is outside of the pools and is depreciated on a straight-line basis over a 43-year life. The discussion draft also repeals the last-in, first-out (LIFO) inventory method of accounting, the lower of cost or market (LCM) method and the like-kind exchange rules.
Senator Wyden Proposal

Senator Wyden, the new Chair of the Senate Finance Committee, was sure to take Camp’s bill and produced a version of his own. Highlights of his proposal include

- Lowering the individual rate to 15, 25 and 35%, and a flat 24% for corporations.
- Enlarging the standard deduction and repealing some itemize deductions which would encourage more people to choose standard deduction.
- Repealing AMT.
- Exempting 35% of long-term capital gains and dividends from any taxation.
- Creating a system where the IRS can prepare returns of many individuals.

President Obama Proposal

President Obama is advising the Congress to enact tax reform that meets the following five principles: lower tax rates in a revenue neutral way, cut inefficient and unfair tax breaks, cut the deficit, increase job creation and growth in the United States, and observe the Buffett Rule, which requires households making over $1 million annually to pay at least 35% of income for income tax.

Ms. Nellen talked about the President’s elements of business tax reform, which include:

- Eliminating dozens of tax loopholes and subsidies, broaden the base, and cut the corporate tax rate (down to 28%) to spur growth in America.
- Strengthen American manufacturing and innovation.
- Strengthen the international tax system, including establishing a new minimum tax on foreign earnings, to encourage domestic investment.
- Simplify and cut taxes for America’s small businesses.
- Restore fiscal responsibility and not add a dime to the deficit.
Momentum is Toward International Tax Reform US

By Kara Virji-Gaidhar, MST Student

The Federal Tax Reform conference hosted by the Tax Executives Institute and SJSU was held on February 28, 2014 in Santa Clara, CA. The esteemed panel of tax experts comprised of Mr. Eric D. Ryan, Partner at DLA Piper, Ms. Grace Chu, Senior Tax Director at Brocade, Mr. Lance Martin, Partner at Baker & McKenzie LLP, and Mr. Sanford Millar of Millar Law.

The discussion commenced with Mr. Ryan exposing a compelling corporate tax rate disparity among the Organization for Economic Cooperation and Development (OECD) the member nations. The average corporate tax rate for the OECD member nation’s stands at 25.47%.¹ This includes developed countries like Canada, U.K, France and Switzerland. In contrast to that, the highest statutory corporate income tax rate for the U.S stands at 39.26%. Since 2000, the US corporate income tax rate has remained constant while the majority of OECD nations, who are our foreign competitors, have gradually reduced their national corporate income tax rates.

Another inequality exists in that the US is one of a few OECD members adhering to a ‘Worldwide Tax System’ as opposed to a ‘Territorial Tax System’. Under the worldwide tax system, a corporation headquartered in the U.S. must pay the corporate income tax on all its income, regardless of whether it is earned in the U.S. or overseas. The corporation pays this tax when the foreign earnings are “repatriated” by bringing the income back to the U.S. This is known as “deferral,” because the income tax owed can be deferred until a later date when the income is repatriated. Under a territorial tax system, the U.S. would tax only the U.S. income of a corporation and would exempt most or all foreign income.²

To circumvent the prohibitively high US corporate income tax rate, US multinational corporations have developed elaborate tax strategies and structures to reduce their US tax bill. In terms of revenues and profits, US multinationals pay the highest tax rate on US sources, but through sophisticated tax planning their revenues and profits from non-US sources are structured overseas in significantly lower rate tax havens, and the resulting blended entity structural approach reduces US corporate effective tax rates (ETR). The distribution of ETRs of US Controlled Foreign Corporations (CFCs) is presented in Figure 1.³

Notwithstanding, US multinationals are at the forefront of recent criticism. A series of investigations, several US legislative hearings and public hearings involving the
executives of companies like Microsoft, HP and Apple have made an attempt to better understand their corporate involvement in offshore profit shifting and to uncover their international corporate tax strategies. Apple executives testified at a 2013 hearing stating, “There is no shifting going on. We pay all the taxes we owe.”⁴

To better understand this position, Ms. Chu explained that a risk adjusted ETR contributes to a corporation’s optimal target earnings per share ratio, and in due course, the corporation’s international earnings are repatriated to become taxable in the US. The legislative hearings have resulted in several recommendations, including the strengthening of IRC §482 related to the allocation of income and deductions among taxpayers and the better enforcement of IRC §951 to §965 on Subpart F rules for CFCs.

Since 2011, the House Ways and Means Committee Chairman, Mr. David Camp, and Senate Committee on Finance, former Chairman, Mr. Max Baucus, have championed US tax code reform proposals as a high priority for the US federal government. Salient discussion points of the Camp proposal include a reduction of the US corporate income tax rate to below 25%, and a US shift toward a territorial system. Significant discussion points of the Baucus proposal include the reduction of the US corporate income tax rate to below 30% and two anti-base erosion options Y and Z, with Y maintaining the current worldwide system and Z supporting a quasi-territorial system.
Both the Camp and Baucus proposals address the re-categorization of Subpart F. Under current rules, foreign subsidiaries owning intangible property in foreign jurisdictions may be able to allocate profits there and their U.S. parent may not include the related Subpart F income, thereby deferring US tax on related profits until they are distributed to the US parent. To address this base-erosion issue, the Camp proposal expands the scope of IRC §954, with a new category of Subpart F income, “Foreign Base Company Intangible Income” (FBCII), which is equal to a foreign subsidiary’s excess gross income over 10 percent of its adjusted basis in depreciable tangible property (excluding income and property related commodities). An ETR of 15% would be prospectively applied to FBCII of digital software and mobile intellectual property developers, other service based companies, and financial companies.

Option Y of the Baucus proposal expands the scope of Subpart F by adding two new categories of Subpart F income. First, the “US-Related Income” category would include income resulting from imported property and services. Second, the “Low-Taxed Income” category would include all income items of a CFC, except for CFC dividends, that are not subject to a foreign ETR of at least 80% of the US corporate tax rate. Because low-taxed income would be taxed, Option Y would repeal the current IRC §954(d) foreign base company rules, along with other Subpart F rules involving foreign personal holding company income and insurance income.

The Camp and Baucus proposals appear to be reactionary responses to the OECD anti-base erosion and profit shifting (BEPS) discussion. Specifically, the proposals of minimum tax on foreign-source income are aligned with the BEPS key discussion area covering availability of harmful preferential regimes. When the OECD issued its action plan in 2013 to address BEPS, it called for swift implementation of fifteen actions by Dec 2015. Action 15 is critical to the plan’s overall success as it requires the implementation of a multilateral instrument. Mr. Ryan explained that the action is based on anticipated member consensus on all fifteen dimensions, after which individual members are expected to enact national legislations consistent with the action plan consensus. In reality, many member nations are responding by preemptively and unilaterally implementing national tax reforms. The US response to BEPS is modest as evidenced by the Camp and Baucus proposals that address BEPS Action 3 on CFC rules, where the proposals fix the expansive and complex US federal code covering Subpart F. Mr. Martin noted that the dissimilar implementations of national tax reforms can lead to trade disputes, which are generally not effectively resolved under current dispute resolution mechanisms between nations because of ineffective competent authority and mutual agreement processes. On an encouraging note, he believes...
that Action 14 offers the potential of improving the international tax dispute resolution mechanisms for solving treaty-based disputes.

The OECD BEPS action plan and the US Camp and Baucus proposals create a serious impetus for international tax reform in the near future. Should US proposals be enacted, we should expect Subpart F provisions to be modified. Mr. Millar questioned if US corporations that have established elaborate blended entity structures that result in the reduction of ETR, have built exit strategies to mitigate for the adverse tax consequences of possible modifications to Subpart F. The panel concluded by responding to this question with action items for US companies to consider, such as considering “de-risking” the blended entity structure through simplification, educating corporate managements about projected overall ETRs under US and OECD proposals, and lobbying for favored US tax reforms. The US momentum is toward international tax reform.


5 See Section 4211 of the Camp Discussion Draft and IRC §954 of Tax Reform Act of 2014.

The Hidden Development State in U.S.

By Jun Xie, MST Student

Dr. Fred L. Block based his speech at the 2014 TEI/SJSU Tax Policy Conference on the research project he undertook over the past seven years where he looked at U.S. government activities in support of the commercialization of new technologies. His research found that these government programs are successful and widespread but “hidden” from the public because most of the programs operate in a decentralized fashion that makes it difficult to track their impacts. Unlike other speakers at the conference who focused directly on tax policy issues, Dr. Block addressed the topic of economy innovation. He talked about the change in innovation policy, a couple of major government programs that support the commercialization of new technologies, and current observations in the R&D area. Dr. Block challenged the attendees to consider what makes sense for any tax incentive for innovation.

Dr. Block began the speech by explaining the major shift in the U.S. innovation system. According to Dr. Block, for most of the 20th century, innovation primarily depended on research labs at large firms, with government focusing on the defense sector. However, dramatic changes have occurred over the past couple of decades. The U.S. innovation system we have now centers on small firms and public-private collaborations with government having a pervasive role. As you may have guessed, one major trigger of these changes was the invention of the Internet. The Internet encourages open innovation and makes resources accessible. Following such change in technology, Federal programs leveraged Federal investments to accelerate commercialization of new technology. Two of the best-known programs are Small Business Innovation Research (SBIR) and Small Business Technology Transfer (STTR). SBIR is for small business concerns to engage in federal R&D. STTR program facilitates cooperative R&D between small business concerns and U.S. research institutions.

Each year, the government spends about $2 billion on SBIR/STTR programs. The programs follow different phases with initial investment and further funding. SBIR/STTR differ from venture capital investments because venture capitalists rarely invest in early stage technology companies. From his interviews with venture capital managers, Dr. Block said that even venture capitals encourage IT startups to apply for SBIR first and then come back to seek venture capital investments in two to three years. SBIR/STTR and other similar government
programs are essential for today’s U.S. innovation system. Although the ideas back up by these Federal programs are small or at their early development stages, they form the foundations for major technology breakthroughs. For instance, everyone knows the iPhone, but not that Federal-private collaborations supported more than 20 programs that went into the creation of the iPhone.

Because the U.S. government spends tens of billions on R&D and commercialization programs, big corporations increasingly benefit from such open innovations. However, the yield on corporate income tax continues to decline with increasingly elaborate tax avoidance strategies. Some argue it is unfair when corporations take advantage of the federal R&D support but do not pay more taxes after the success. To potentially address this issue, Dr. Block thought of the idea of “National Innovation Foundation”. Under this proposal, all newly incorporated businesses would deposit a 2% stake in the new firms with the Foundation. The Foundation would be required to hold the shares for at least 10 years, and then it could sell the shares after the firms become profitable. The revenues collected from the shares would go into the expansion of government innovation programs. Dr. Block believes this is a good way for the government to raise revenue for R&D without taking away from other social benefit programs.
The Political Forecast for Tax Reform

By: Qianying Chen, MST Student

What will it take politically for tax reform to occur? This is the topic presented by Dan Kostenbauder, Vice President Tax Policy - Hewlett Packard Company.

Mr. Kostenbauder pointed out that the current United States statutory corporate tax rate is way higher than Organization for Economic Co-operation and Development (OECD) countries’ average level. Such international competitiveness enhanced the need for a tax reform to “broaden the base, and lower the rate.” He introduced the background of the 1986 U.S. tax reform, which was strongly led by the President, and also led by bi-cameral, bi-partisan intellectuals and politicians. The U.S. Treasury was actively involved in the tax reform starting from a revenue perspective using a revenue neutral approach. The reform cut taxes for most individuals.

Based on a macro political analysis, Mr. Kostenbauder addressed the political polarization phenomenon, indicating the difficulty of getting a bi-partisan compromise in agreement on current tax reform. The chart he cited from National Journal displayed a declining percentage of lawmakers rated as “moderate” as to promote a tax reform in both the House and Senate from 1982 to 2012.

Two issues of current tax reform were noted. First, the President and Democrats want to raise government revenue while Republicans stick to revenue neutrality or cuts. Second, the scope of tax reform is very broad, including individual, pass-through, business, and international entities. Mr. Kostenbauder overviewed current tax reform players and their roles and deeds regarding tax reform as follows:

- Dave Camp, Chairman of Ways & Means Committee, states that tax reform needs to be part of a Republican economic agenda
- Ron Wyden, new Chairman of Senate Finance Committee, introduces bi-partisan tax reform bills to lower the rate to 24% and broaden the base, but also repeals deferral.
• Orrin Hatch, next Chair of Senate Republican High-Tech Caucus in 2015 and Ranking Member of the Senate Finance Committee

• The Obama Administration, Jack Lew, Mark J. Mazur, John Koskinen – they do not take tax reform as a priority. They focused more on “messaging” than tax policy.

• Paul Ryan or Kevin Brady, likely new Chair of Ways & Means Committee in 2015. Ryan is a big proponent of comprehensive tax reform.

• The Senate Democratic leadership insists on raising revenue and concerns about “off-shoring” with territorial system.

• The House Republican leadership is concerned about tax reform votes being politicized in an election year and keeps the focus on Obama care.

Other forecasted factors concerned in tax reform include revenue estimating, potential impact of individual tax reform, and 2014 elections. In the last portion of the presentation, Mr. Kostenbauder explained more specifically several terms -- “tax extenders,” tax “vehicle,” and the OECD BEPs Project.

• “Tax Extenders” – Senate Democrats tried tax extenders in December 2013. The R&D tax credit, CFC look-through, and active finance provisions expired on calendar year end of 2013. However the final passage of tax extender is likely to be under the 2014 Lame Duck Congress because House Republicans are concerned that the package is too big, including special interest provisions. Chairman Wyden sees tax extenders as “a bridge to tax reform.”

• Tax “Vehicle” – The Medicare Sustainable Growth Rate (SGR) is a method currently used by the Centers for Medicare and Medicaid Services (CMS) in the United States. The SGR is the sustainable growth rate program that is supposed to deliver cuts to Medicare doctors, but Congress has routinely dodged those cuts in various "doc fix" bills.

• The OECD BEPS Project – The OECD does not view Base Erosion and Profit Shifting (BEPS) as a company problem; instead, it is a tax rule issue. Therefore, it is the government’s responsibility to revise the tax rule.
Wrap Up

By: Xiaoke Zhou, MST Student

To wrap up the conference, Kim Reeder provided a short summary of each topic discussed at the day’s conference. Ms. Reeder first emphasized that current domestic tax reforms under discussion today are focused on lower tax rates while maintaining revenue neutrality. In order to achieve this goal, Congress proposed to broaden tax bases by eliminating some tax expenditures. However, when choices are made among possible items of change, it is important to bear in mind that they both positively and negatively impact different types of taxpayers.

Ms. Reeder also highlighted Congressman Camp’s and Senator Baucus’s current international tax reforms. Due to substantially lower tax rates in other OECD member countries, they view it is necessary for the United States to minimize tax on taxpayer’s earnings. As for how companies should respond to the potential future tax changes, Ms. Reeder recommended that managers of companies identify key activities that may be impacted.

Mr. Reeder also reminded us of the non-tax information provided by Professor Fred Block (UC Davis) about how large companies innovate and how smaller companies might obtain funds for innovation.

Last but not least, Ms. Reeder reiterated how Federal tax reform impacts California. She pointed out how the proposed dividends received deduction work and that California may need new ways to generate tax revenue. Ms. Reeder mentioned that there is a lot more “unknown” than “known” in terms of today’s overall tax reform. The proposals may be more complicated than what we might initially think.
Mr. Dean Andal’s distinguished career in the tax field includes serving in the California State Assembly and working for a large CPA firm. Mr. Andal is currently Director at PwC, focusing on tax policy matters. Prior to this position at PwC, Mr. Andal was a member of the California State Assembly from 1991 to 1994. Then, for eight years, Mr. Andal served as an elected Member of the California Board of Equalization where he also served as Chairman for two terms. Mr. Andal’s public service also includes serving on the U.S. Advisory Commission on Electronic Commerce.

I had the pleasure of interviewing Mr. Andal on March 4, 2014 after we met at the 2014 TEI/SJSU Tax Policy Conference. In our follow-up conversation over the phone, Mr. Andal shared his experience in public sectors and advice for SJSU MST students. Below are questions I asked and a summary of Mr. Andal’s responses.

**SJSU CTJ: How did you get involved in the tax field?**

Mr. Andal began his tax career in 1991, when he won the election to become a California Assemblyman. He was the chief Republican budget negotiator and a member of the Revenue & Taxation and Ways & Means Committees. Over the four years in the Assembly with the above two committees, Mr. Andal heard all changes to tax bills. Then in 1994, he was elected to the California Board of Equalization. He was Chairman of this tax board twice. Serving on the Board of Equalization gave Mr. Andal the opportunity to hear thousands of tax bills, including both sales and income taxes - gaining a good understanding of various state tax issues. Over the years, he developed an expertise in California tax matters. In 1998, Mr. Andal was appointed by the speaker of the U.S. House of Representatives to the U.S. Advisory Commission on Electronic Commerce. He studied internet-related tax issues, and helped develop national policies regarding the taxation of e-commerce. After his career in public sectors, Mr. Andal joined PwC. Mr. Andal focuses on tax policies. Using his many years of experience in the government, he helps clients navigate through the ever-changing tax system.

**SJSU CTJ: What led you to get involved in running for the State Assembly and Board of Equalization?**

The answer to this question was interesting. Mr. Andal said, “I was young enough to run for the State Assembly” . He mentioned his campaign experience in college helped him get involved in a public career. He was young and brave. He ran door to door to get support when he was running for the State Assembly. In addition, Mr. Andal’s fundamental disagreement
with how much government should be involved in certain areas was also the drive behind his involvement in politics.

**SJSU CTJ:** What stands out as one or two of your most significant accomplishments working in the Assembly or the State Board of Equalization?

As a strong advocate for tax reform and taxpayer service, Mr. Andal received the Friend of Taxpayers award from the California Taxpayers Association. Also, he is the author of the majority report of the Advisory Commission on E-Commerce. The report is still widely used by the Congress to address e-commerce related sales tax issues. In addition to his accomplishments in the tax field, Mr. Andal spoke highly of his participation in many education reforms, which focused on increasing the performance of students from low-income families. Mr. Andal served on a local school board, and during his term, the literacy score for African-American students doubled from 30% to 60%. He is a co-author of the first charter school bill.

**SJSU CTJ:** What do you think is one area of our California tax system that could/should be improved and why?

More conformity with federal tax is the one area of California tax system that could be improved. If not, there will be more complication in the tax system and higher compliance costs. Mr. Andal believes that this change can happen with the government spending more time conforming the California code to the federal code.

**SJSU CTJ:** When e-commerce was in its infancy, you played a key role in serving on the Advisory Commission on E-Commerce. What ACEC recommendation do you think is most important today? Do you think there would be any new recommendations if the commission were to issue a report in 2014?

Mr. Andal commented that there may or may not be a report in 2014 depending on who would be appointed to the Commission. He thought the most important recommendation today would be to synchronize sales tax with income tax, thus encouraging economic activities across-states. Similar to the income tax, having economic activities in a State should not trigger the State’s sales tax.

**SJSU CTJ:** What advice do you have for tax students who want to be more involved in the tax policy area?

SJSU’s MST program is an outstanding tax program, and Professor Nellen is widely respected among Big 4 firms. Mr. Andal commented that getting an education from the MST program adds great value for tax students. He advised students to also gain some knowledge of the political process, for instance, to understand how a tax bill is passed. He recommended students attend the meetings of the Assembly’s Revenue &Taxation Committee and the Board of Equalization. He believes it is important to be on the other side of the table and to know how the government makes decisions.