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.

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Santa Clara Valley Chapter
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31st Annual TEI-SJSU High Tech Tax Institute

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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 adverting 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.

Return	Current due dates	Proposed due date	Proposed extended due date
1065	April 15/ Sept 15	March 15	Sept 15
1120S	March 15/ Sept 15	March 15	Sept 30
1120	March 15/ Sept 15	April 15	October 15
FBAR	June 30	April 15	October 15

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 deprecation 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]

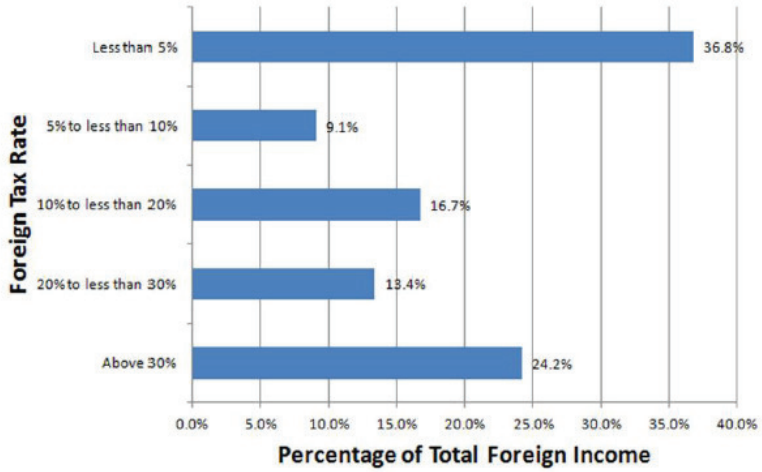
To circumvent the prohibitively high US corporate income tax rate, US multinational corporations have developed elaborate tax strategies and structures to reduce their US tax bill. In terms of revenues and profits, US multinationals pay the highest tax rate on US sources, but through sophisticated tax 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.

Figure 1. Distribution of Effective Foreign Tax Rate of US 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)[5]. 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[6]. 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.

1 Ryan, E. (2014, Feb 28). International Taxation Reform - Camp versus Baucus versus OECD. San Jose State University, Annual Tax Policy Conference on Federal Tax Reform: Dealing with the Known and Unknown, Santa Clara, CA. [Graph Source: OECD Tax Database (2012) as presented in Unpublished PowerPoint Slides].

2 Territorial vs. Worldwide Taxation, September 19, 2012 http://www.rpc.senate.gov/policy-papers/territorial-vs-worldwide-taxation

3 Martin Sullivan, (2013, Apr 22), Economic Analysis: Designing Anti-Base-Erosion Rules. Taxanalysts Featured News, [Figure 2 Source: Harry Grubert and Rosanne Altshuler, "Fixing the System: An Analysis of Alternate Proposals for the Reform of International Tax," Table 3 (2013)]. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2245128

4 Ryan, E. (2014, Feb 28). International Taxation Reform - Camp versus Baucus versus OECD. San Jose State University, Annual Tax Policy Conference on Federal Tax Reform: Dealing with the Known and Unknown, Santa Clara, CA. [Chart Source: Slide 14 as presented in Unpublished PowerPoint Slides].

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

6 OECD (2013). Action Plan on Base Erosion and Profit Shifting, OECD Publishing, http://www.oecd.org/ctp/BEPSActionPlan.pdf

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.