

# *The Contemporary Tax Journal*

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## **Letter from the Editor**

I would like to congratulate and thank everyone who contributed to the Fall/Winter 2015 volume of *The Contemporary Tax Journal*, a publication of the SJSU MST program. I joined the SJSU MST program with little knowledge about taxation. The time I spent in the program helped me discover my passion for taxation and broaden my tax knowledge. It gives me immense pleasure to be part of this prestigious program and publication. To share tax knowledge through an interesting style meaningful to both tax professionals and taxpayers, we bring to you the newest edition of the journal.

We begin this issue with two tax enlightenment articles. The first article is about tax issues related to changes in method of accounting. The author addresses the issue of misinterpreting section 446(e) and distinguishing between the correction of an error and changes in methods of accounting with a help of a Tax Court case. The second tax enlightenment article on prize and awards provides an overview of the tax issues surrounding this income in context of an employee and an employer.

Summaries of selected sessions of the TEI-SJSU Annual High Tech Tax Institute have always been an important part of this MST journal. In this issue, summaries from the 31st annual institute held in November 2015 focus on IRS developments and examination strategies, cloud computing activities and issues, the *Altera* transfer pricing case, and recent developments in state tax reform. In our Focus on Tax Policy section, you will find four new additions to our library of tax proposals analyzed using the AICPA's ten principles of good tax policy. These contributions are from students of the MST program's tax policy capstone course.

Our "Tax Maven" section profiles leading individuals in the field of tax. For this issue I had an opportunity to interview Eli J. Dicker, Executive Director of the Tax Executives Institute, Inc. It was great to learn of his experiences in the tax field and his passion for baseball. I and the other student authors hope you find this issue of the journal both educational and enjoyable.

Finally, I would like to thank Professors Annette Nellen and Joel Busch for their guidance, support and tireless efforts for putting this all together. I applaud all the students who made time to support this edition. Thank you for your contribution and making this journal a success. Stay tuned as we now enter our sixth year of *The Contemporary Tax Journal*!

**Shruti Raja**

Student Editor

## Tax Issues Related To Change In Method of Accounting

By: Prasanti Mishra, MST Student

Internal Revenue Code section 446 and related Treasury regulations govern general rules for defining methods of accounting and changes in methods of accounting. However, many taxpayers do not follow this tax statute properly, and as a result, they may have to pay penalties-sometimes substantial. The recent court case of *James H. Hawse, et ux v. Commissioner*, T.C Memo 2015-99, is an example of this issue. Here, the United States Tax Court addressed the issue of misinterpreting section 446(e) and distinguishing between the correction of an error and changes in methods of accounting. The court upheld a \$5.4 million tax deficiency judgment against a married couple, James and Cynthia Hawse, based on Mr. Hawse's sole ownership of a California auto dealership, JHH Motor Cars Inc. (a subchapter S corporation) and denied their claim for a refund. The decision of the court was based on IRC section 446, related regulations, IRS administrative procedures and court cases.

Therefore, the taxpayer wanted to change from the LIFO method of accounting to the specific identification accounting method for the inventory of JHH. JHH filed form 3115 with the IRS to seek its consent for the change in method of accounting. It complied with the Form 3115 except for attaching a statement explaining how its proposed new method of identifying and valuing its vehicle inventory was consistent with the requirement of Treasury Reg. §1.472-6.

The sale did not occur in 2001, and JHH continued to use the specific identification method for its inventory from 2001 to 2007. However later it amended the tax returns for the corresponding years to correct what the taxpayer claimed was an error of using the specific identification method and attempted to revert back to the LIFO inventory method and requested a refund. After JHH claimed refunds on its 2002 and 2003 amended returns, there was an examination/audit of the client for 2002 and 2003.

The IRS sent a notice of deficiency for the years covered under amended returns. JHH filed a petition with the Tax Court.

The case involved three issues:

- Whether JHH received an automatic consent from the IRS to change its method of accounting for its vehicle inventory from the LIFO to specific identification method for the tax years in issue,
- If not, whether JHH changed its method of accounting to the specific identification method from 2001 to 2007, and
- If so, whether there was a second change in its method of accounting when JHH attempted to revert to the LIFO method of accounting for its vehicle inventory by filing amended tax returns for 2002 and 2003.

Section 446(a) states that "the taxable income of a taxpayer shall be computed on the basis of the accounting method under which he/she computes his/her income regularly for keeping his/her books." Under section 446(e), if a taxpayer plans to change his/her method of accounting, he/she must obtain the consent of the IRS before computing his/her taxable income under the new method.

In analyzing the first issue, the court relied on Rev. Proc. 99-49 and determined whether JHH met all the terms and conditions. According to Rev Proc.99-49, secs.1, 4.01, if a taxpayer wants to change from an accounting method described in the appendix of the Rev. Proc. to a new method of accounting described in that appendix, he/she must seek consent from the IRS. If the taxpayer has non-LIFO inventory for which he/she already uses one of the permitted methods, i.e. FIFO or specific identification method, that method would be the only permitted method to which the taxpayer may seek to change its LIFO inventory under Rev. Proc. 99-49, sec.10.01 (1)(b)(i)(A).

To obtain automatic consent from the IRS, a taxpayer must submit Form 3115 signed by an

individual with authority to bind the taxpayer before or with his/her timely filed income tax return for the year of change and file a copy of the same 3115 form with the IRS national office no later than the date on which the original tax return is filed. The taxpayer must then cite the applicable section of the revenue procedure appendix on the form and attach a statement to the form identifying the taxpayer's new method of identifying his/her inventory and valuing his/her inventory and describing in detail how the new method of accounting conforms to the requirement of Rev. Proc. 99-49. Finally, if a section 481(a) adjustment is required, the taxpayer has to make the adjustment over a four-year period beginning with the year of election.

JHH did not comply with all the requirement of Rev. Proc. 99-49. It did not cite the applicable section of the Revenue procedure's appendix on Form 3115 and did not attach a separate statement describing how its proposed new method of identifying and valuing its inventory conformed to the requirements of Rev. Proc.99-49. Therefore, the US Tax Court held that because JHH did not comply with all the terms of Rev. Proc. 99-49, its application for automatic consent failed.

However, if a taxpayer changes his/her method of accounting without requesting the consent of the commissioner, the commissioner would have two choices:<sup>1</sup>

- Require the taxpayer to abandon the new method of accounting and compute taxable income using the old method by complying with section 446(e).
- Accept the change in method of accounting and require the taxpayer to make necessary section 481(a) adjustments to avoid amounts being duplicated or omitted.

In this case, the IRS chose the second option.

On the issue of change in method of accounting, the taxpayer contended that there was no change in method of accounting because it failed to

obtain the consent of the IRS. However, under Treasury Reg. 1.446-1(e) (2)(ii)(a), a change in method of accounting includes either a change in the overall plan of accounting for calculating gross income or a change in the treatment of any material item used in the overall plan. A change in the treatment of a material item will not change the lifetime income of the taxpayer, but instead will accelerate or postpone the reporting income of the taxpayer. The same rule applies to valuing inventory.

In *Johnson v. Commissioner*,<sup>2</sup> the court reported that if the change in reporting method affects the amount of taxable income for two or more taxable years without altering the taxpayer's lifetime taxable income, it constitutes a change in method of accounting. In the JHH case, the court held that because the taxpayer followed the specific identification method for seven consecutive years, it established a new method, i.e. the specific identification method for valuing its inventory, notwithstanding its failure to secure consent of the IRS.

On the issue regarding reverting to the LIFO method of accounting, the taxpayer argued that attempting to revert to the LIFO method reflects a correction of error and no consent of the IRS is required. According to the opinion of the court, JHH changed the treatment of vehicle inventory to adhere to its previous LIFO method on its amended returns, and this change constitutes a change in method of accounting. In addition, a change from the specific identification to LIFO method constitutes a change in the overall plan of identifying and valuing items and, therefore, a change in method of accounting. Finally, the two changes JHH proposed to make in its amended returns involve material items. The first change was to reverse the section 481(a) adjustments for recapture of the LIFO reserve that was made for 2001, 2002, and 2003 income tax returns. The second change was for deducting the LIFO reserve amounts for tax years 2001 through 2003. JHH's reversal of section 481 adjustments and deduction of the LIFO reserve retroactively

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<sup>1</sup> Sunoco, Inc., T.C. Memo. 2004-29

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<sup>2</sup> Johnson, 108 T.C. 448,(1997)

postponed its recognition of the LIFO reserve. Therefore, these two changes relate to timing of reporting income and change in treatment of material items. Therefore, the US Tax Court held that the changes JHH made on its amended returns constitute a retroactive change in method of accounting for which IRS consent is needed.<sup>3</sup>

As a result, the IRS was entitled to reject the amended returns of JHH and JHH was not entitled to its claimed refunds.

This case provides an important message to taxpayers and tax practitioners on various facts related to change in method of accounting. If we go deep into this case, the taxpayer took tax advice from the advisor, its accounting service provider and the advisor consulted an auto dealership industry professional, to examine whether there was a change in method of accounting in 2001 after the failure of the taxpayer for obtaining consent of the IRS. The taxpayer and his tax advisors misinterpreted section 446(e), which generally states that a taxpayer must secure consent before changing its accounting method. Therefore, taxpayers as well as the tax practitioners should understand the language of the statute clearly before deciding upon tax matters.

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<sup>3</sup> Huffman, 126 T.C. 322 (2006)



## To Win or Not to Win!

### Article on Prize and Awards

By: Shilpa Balnadu, MST Student

#### Background

The law on 'prize and awards' took incipience much before the codification of the Internal Revenue Code of 1986.<sup>4</sup> However, the passage of the Tax Reform Act of 1986 ("Act") brought along with it certain amendments that aimed at making the existing law more tax neutral and economically fair. While the original congressional intent on prizes and awards continues to hold true post the Act, a few revisions were made to bring about more clarity and uniformity in treatment of the taxpayers. The following are the highlight of the provisions of the law as it stands today and how it may impact taxpayers.

#### Introduction

The statute has always required taxpayers to include in their gross income amounts received as prizes and awards by default. These may range from contest winnings, door prizes, radio and television giveaway prizes to awards received during the course of employment.<sup>5</sup> The law, however, allows for tax relief in two situations: payments transferred to charity and to certain employee achievement awards.

- Payments Transferred to Charity

<sup>4</sup> IRC § 74

<sup>5</sup> Reg 1.74-1(a)(1)

One of the exceptions to the general rule of taxability of prize award money is if the award money is diverted at the source to a governmental unit or charitable organization. The prerequisite to qualify for the exclusion is that, it is in recognition of past religious, charitable, scientific, educational, artistic, literary, or civic achievement and

- The recipient did not undertake any action to be a part of the contest;
- The payment is not contingent on any subsequent performance by the recipient.<sup>6</sup>
- Decline of Award

Another instance where prize money is tax-exempt is where the awardee refuses or rejects the award altogether. This doctrine emerged more from Rev. Rul. 57-374, 1957-2 CB 69 rulings rather than the Statute.

- Employee Achievement Awards

Another exception to the general rule is when an item of

tangible personal property is presented to an employee in appreciation of either length of service or safety achievement<sup>7</sup>, provided it is awarded as part of a meaningful presentation and is not merely disguised compensation.<sup>8</sup> If deemed to be disguised compensation, the employment-productivity related awards, performance excellence awards, etc. are includible as wages and consequently subject to withholding of tax.



<sup>6</sup> IRC §74(b)

<sup>7</sup>Length of service award: should not be made in employee's first five years of employment or should not have already been presented in the current or any of the preceding four years. Safety achievement: Must be offered to eligible employees (employees other than those in positions not engaged in work involving significant safety) or must not be made to more than 10 percent of the employer's eligible employees.

<sup>8</sup> Reg .1.274-8(c) (3) Meaningful presentation: Whether an award is presented as part of a meaningful presentation is determined by a facts and circumstances test A ceremonious observance emphasizing the recipient's achievement may suffice. 1.274-8(c)(4) Disguised compensation : An award will be considered disguised compensation, if the conditions and circumstances surrounding the award create a significant likelihood that it is payment of compensation

Moreover, the exception applies only to tangible awards and not to cash, gift certificates and other items akin in nature to these.

Not all of the qualified receipts are disregarded from gross income. The law limits the amount that can be excludable from income. In case of employment achievement awards, this has been interlinked with the amount an employer can claim as a deduction<sup>9</sup> or prize and awards, which is prescribed at \$400 and increases to \$1,600 if the award is disbursed under a “qualified plan”.<sup>10</sup> The deductibility treatment differs when the cost of the award is less or more than the ceiling limits, both of which are examined in the following paragraph:

- Cost Less than FMV

If the cost of the award is below the ceiling limits, the award is excludible irrespective of the FMV of the award. However, taxpayer must note that Fair Market Value (“FMV”) that is disproportionate vis-a vis the cost will be designated as ‘disguised compensation’ and hence taxed.

**Illustration:** An employer makes a length of service achievement award (other than a qualified plan award) to an employee in the form of a watch, and all other conditions of IRC §274(j) are met. Assume further that the cost of the watch to the employer is \$375, and that the FMV of the watch is \$415. The full FMV value of \$415 is excludable from the employee's gross income. If on the other hand, the FMV was \$1,000, the same would be perceived as disguised compensation and the full amount of \$1,000 would be subject to tax.

- Cost Exceeds FMV

In a situation, where the cost of the award to the employer exceeds the dollar limitations, the gross amount must include greater of-

- Excess cost over threshold, limited to FMV

- Excess of FMV over the threshold

**Illustration:** Employer C pays \$500 (FMV of \$475) for a watch (not a qualified plan) that goes as a safety award to B, an eligible employee. C's deduction is limited to \$400. Therefore, B must include as income the greater of (1) \$100, which is the difference between the watch's cost (\$500) and C's \$400 deduction limit (Limited to FMV=\$475), or (2) the excess of the watch's FMV over C's \$400 deduction. B includes \$100. Instead, if FMV is \$600, B includes \$200 [Greater of \$100 or \$200(\$600-\$400)].

### *Certain Disqualifying Charitable Contributions*

Another closely related issue is when purported charitable contributions are



made in connection to fund-raising events such as purchase of raffle tickets for the benefit of the charitable organization.<sup>11</sup> In such cases, the courts have held that the presence of a chance of receiving *something in return* results in a lack of a full deduction for the entire donation.

This was clarified in Rev. Rul. 67-246, 1967-2 CB 104. In explaining the principles of qualifying charitable contribution, the IRS maintained that the basic rule for a deductible charitable contribution is making of a gift without “adequate consideration”. Thus, when a raffle ticket is bought, the presumption is the purchaser receives a value in return, i.e., a chance to win. Any excess payment may however, be claimed as a deduction, if the following is proven:

- Evidence that the payment exceeds value of consideration received;
- That the excess payment was intended to be a gift.

<sup>9</sup> IRC § 274(j)

<sup>10</sup> An established written plan or program of the taxpayer that doesn't discriminate in favor of highly compensated employees as to eligibility or benefits.

<sup>11</sup> Charitable contributions are dealt under § 170. However, due to the nexus of charitable fundraising events with prizes and awards the issue has been discussed to throw light on the tax implications to donors



The above principle was explained in example 5 of the ruling, where a \$5 raffle to win an automobile was held as non-qualifying contribution. The court theorized that

“Amounts paid for chances to participate in raffles, lotteries, or similar drawings or to participate in puzzle or other contests for valuable prizes are not gifts in such circumstances, and therefore, do not qualify as deductible charitable contributions.”

*What This Means To You?*

### Implications to an Individual



The law covers all prizes and awards unless exclusion applies. Winnings from participation in contests which are held as marketing gimmicks,

such as free car, TV etc., are all taxable. There are certain crucial compliance issues, the adherence to which may mitigate an unwarranted tax exposure-

- In case of non-taxable awards (civic, religious etc.), timing of the designation to charity by the recipient is important. This is fulfilled by the recipient furnishing a written form to the payer indicating the intent before an impermissible<sup>12</sup> use of the award occurs.<sup>13</sup>
- Furthermore, with regard to awards received as an employee, the income exclusion rules must be met. Awards having a direct relationship with employment-related bonuses, awards for outstanding service, highest productivity or job performance are generally taxable. Cash or cash equivalent awards, such as savings bonds or general

merchandise gift certificates by an employer are always taxable.

- Tax must normally be withheld on taxable employer awards. A failure to do so may cause undue tax burden at the time of tax filing for the employee.
- The provisions of this law would not apply to any de-minimis fringe benefits, which continue to be tax free.<sup>14</sup>

### Implications to Businesses and Employers

Some key pointers for an employer are:

- The law specifically precludes any achievement awards by a sole proprietorship to the sole proprietor from the purview of this code section.<sup>15</sup>
- Employers generally have to adhere to the dollar limits set by the law in claiming a deduction. For partnerships, the limit is applied separately to the partnership and individual partners.<sup>16</sup> Deduct payroll taxes on all prizes and awards includable in employees' income.
- Prizes and awards are distinct from gifts and therefore, the two cannot be clubbed or interchanged for tax purposes.<sup>17</sup>
- If you are a tax-exempt business, the exclusion limitation is based on the deduction that would be allowed if the employer were subject to tax.<sup>18</sup>

### Conclusion

The forgoing paragraphs provide an overview of the tax issues surrounding prizes and awards in context of an employee and an employer. With the intricacies, rules and regulations surrounding each case, it is imperative that the taxpayer makes a

<sup>12</sup>Impermissible uses include spending, investing depositing or use of property with recipient's permission.

<sup>13</sup> The IRS has issued Rev Proc Rev. Proc. 87-54, 1987-2 CB 669, containing guidelines on how to assign the award to a donee and states that the designation should be made before the prize or award is actually presented by the payor to the recipient. If it's not possible to do so (as in an unexpected presentation) the recipient must return the prize or award to the payor before the item is used and certify in the designation document that he or she made no use of it before its return.

<sup>14</sup>The term means any property or service the value of which is (after taking into account the frequency with which similar fringes are provided by the employer to the employer's employees) so small as to make accounting for it unreasonable or administratively impracticable (IRC§ 132(e))

<sup>15</sup> Prop Reg § 1.74-2(d)(1)

<sup>16</sup> IRC§ 274(j) and 274(j)(4)(A)

<sup>17</sup> Under section 274(b), gifts have a separate deductible limit of \$25 per recipient employee.

<sup>18</sup> IRC§ 74(c)(3)

closer examination of the receipt and how it must be treated. In addition, donations must be rechecked to ensure that they have no element of return consideration. Also, for an employer, characterization of the income is crucial - including the withholding requirements. Although, the tax net is far and wide, it is evident that with some planning, a taxpayer can avoid the imposition of taxes in many circumstances.



## When Should Bitcoin be Subject to FBAR?

Submitted by: Arash Kiadeh, MST Student

### Introduction

The IRS has not issued official guidance on whether or not bitcoin held in a foreign online account (known as a Bitcoin wallet)<sup>19</sup> is to be reported on the Report of Foreign Bank and Financial Accounts (FBAR). The most recent statement from the IRS was during a webinar on June 4, 2014 in which Rod Lundquist, a Senior Program Analyst for the Small Business/Self-Employed Division stated, “At this time, FinCEN has said bitcoin is not reportable on the FBAR, at least for this filing season.”<sup>20</sup> This begs two questions: *should* bitcoin in a foreign online account be reportable on the FBAR and should bitcoin in a paper wallet or hard drive *located* in a foreign country be reported on the FBAR?

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<sup>19</sup> Coindesk. (2014, Dec. 22). How to Store Your Bitcoins. Retrieved from <http://www.coindesk.com/information/how-to-store-your-bitcoins/>

<sup>20</sup> Erb, K. (2014, June. 30). IRS Says Bitcoin Not Reportable on FBAR (For Now). Forbes. Retrieved from <http://www.forbes.com/sites/kellyphillipserb/2014/06/30/irs-says-bitcoin-not-reportable-on-fbar-for-now/>

## History of the Tax Rule

By 1970, the Mafia was a hot topic and Congress was looking to provide tools to law enforcement to help take them down. Two key laws came into effect in 1970: 1) the Racketeer Influenced Corrupt Organization Act (RICO) which essentially made it illegal to be a part of a criminal organization and whereby mafia bosses could more easily be prosecuted for the crimes committed by their underlings<sup>21</sup> and 2) the Bank Secrecy Act (BSA) which “requires businesses to keep records and file reports that are determined to have a high degree of usefulness in criminal, tax, and regulatory matters.”<sup>22</sup>

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<sup>21</sup> Schneider, S. (2015, May. 3). RICO Act. Encyclopedia Britannica. Retrieved from <http://www.britannica.com/topic/Racketeer-Influenced-and-Corrupt-Organizations-Act>

<sup>22</sup> IRS Website. (n.d.). Bank Secrecy Act. Retrieved from <http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Bank-Secrecy-Act>

The name “Bank Secrecy Act” stems from the fact that the law was intended to target those who used bank accounts in foreign secrecy havens to evade taxes and launder money.<sup>23</sup>

The BSA requires individuals to report financial accounts maintained outside of the U.S. This is codified in 31 USC § 5314, which is titled Records and Reports on Foreign Financial Agency Transactions. The regulations are in 31 CFR § 1010.350 and state that all U.S. persons who maintain foreign financial account(s) that have a combined total of more than \$10,000 at any time during the year must file a Report of Foreign Bank and Financial Accounts (FBAR).

Since the FBAR laws were originally enacted a number of different financial instruments and products have been categorized as falling within the definition of financial account. Specifically, in addition to traditional bank accounts, accounts for the following are also considered financial accounts reportable on FBARs: securities, commodity futures,

insurance policies with cash value, and mutual funds.<sup>24</sup>

### Potential Precedent Setting Case

Reading into the initial intent of Congress in passing the Bank Secrecy Act (to stop foreign bank accounts from being used by criminals to evade tax and commit crime) suggests that the FBAR requirement would apply to bitcoin maintained in a foreign online account. Figuring out exactly where it fits into the law and regulations proves more challenging. A recent court case, *U.S. vs. John C. Hom* is a potential precedence setting case.<sup>25</sup>

Hom played online poker at two different sites both located outside the U.S., PartyPoker and PokerStars.<sup>26</sup> Both sites allow users to deposit and withdraw real money and to maintain a balance.

The IRS brought suit against Hom because his poker accounts had a balance of more than \$10,000 in 2006 and 2007, which triggered the requirement to file an FBAR.<sup>27</sup> Per the regulations, “each United States person having

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<sup>23</sup> American Banker’s Association. (n.d.). History of the Bank Secrecy Act. pg-1. Retrieved from <http://www.aba.com/Compliance/Documents/07cbe87f05f94aa8b84faa573c790ba5AppendixC.pdf>

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<sup>24</sup> IRS Website. (2011, Feb. 24). IRS FBAR Reference Guide. Retrieved from [http://www.irs.gov/pub/irs-utl/IRS\\_FBAR\\_Reference\\_Guide.pdf](http://www.irs.gov/pub/irs-utl/IRS_FBAR_Reference_Guide.pdf)

<sup>25</sup> *U.S. vs. John C. Hom*, 45 F. Supp. 3d 175 (N.D. Cal. Jun. 4, 2014)

<sup>26</sup> *Id.*

<sup>27</sup> *U.S. vs. John C. Hom*, 45 F. Supp. 3d 175 (N.D. Cal. Jun. 4, 2014)

a financial interest in, or signature or other authority over, a bank, securities, or other financial account in a foreign country shall report such relationship.”<sup>28</sup>

The courts’ analysis found that the accounts maintained at the online poker services met the definition of a bank, and therefore, an FBAR was required. Specifically, the reasoning flowed as follows: under § 1010.350 (c)(3)(i) “other financial account” is defined as “an account with a person that is in the business of accepting deposits as a financial agency.” The Poker accounts were clearly accepting deposits, but did the service provided by PartyPoker and PokerStars make them a “financial agency”?

Under 31 U.S. Code § 5312 (a)(1) a financial agency is a “person acting for a person” as a “financial institution” or a person who is “acting in a similar way related to money.”<sup>29</sup> Consequently, if the accounts and related services provided by the poker companies met the definition of financial institution, then they met the definition of financial agency. The definition of a “financial institution” in § 5312 (a)(2) lists 26 different types of entities that are considered financial institutions. An online

poker account was not one of them. However, the court cited *United States v. Dela Espriella*, 781 F.2d 1432, 1436 (9th Cir. 1986), which stated that “the term ‘financial institution’ is to be given a broad definition.”

Also, the court cited *Clines*, 958 F.2d at 582, which stated that “by holding funds for third parties and disbursing them at their direction, [the organization at issue] *functioned as a bank.*”

Online poker and Bitcoin accounts have many similarities. In both instances a person can deposit, withdraw, and maintain a balance. Some of the differences are that a bitcoin account is funded with bitcoins vs. a poker account must be funded with currency. Also, a bitcoin account can be used to purchase real goods and services from anyone that accepts bitcoin. Differences aside, based on the broad interpretation of the term financial institution, the analysis in the Hom case can be used to make a compelling argument that the services provided by foreign online

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<sup>28</sup> 31 CFR 1010.350

<sup>29</sup> *Id.*

bitcoin account providers should be considered financial institutions subject to FBAR reporting.

### **What about Bitcoin Stored on Paper Wallets and Hard Drives Located in a Foreign Country?**

The IRS does not require antiques, jewels, cars, art, foreign currency, and real property that is held outside the country *directly* to be reported on an FBAR.<sup>30</sup> For instance, \$20,000 worth of pesos held in a safe deposit box in Mexico is not reportable because a safe deposit box is not considered a financial account. Thirty-thousand dollars in gold bars sitting in a Canadian vacation home is also not reportable. Bitcoin has characteristics of currency and jewels (they are both “mined” and often held for investment.<sup>31</sup> Neither foreign currency nor jewels are required to be reported on an FBAR if held directly, and therefore, bitcoin should not be either.

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<sup>30</sup> IRS Website: Comparison of Form 8938 and FBAR Requirements (2/2/2015 ver.): <http://www.irs.gov/Businesses/Comparison-of-Form-8938-and-FBAR-Requirements>

<sup>31</sup> See: <http://www.coindesk.com/information/how-bitcoin-mining-works/>

## **Principles of Good Tax Policy**

### ***Equity and Fairness***

Requiring bitcoin held in a foreign online account to be reported on an FBAR increases horizontal equity. The IRS has stated that virtual currencies such as Bitcoin should be treated as property.<sup>32</sup> However, bitcoin undeniably has characteristics of real currency (such as functioning as a medium of exchange), which is required to be reported on an FBAR if it meets the threshold and is kept in an offshore financial account. If two individuals both maintain foreign accounts with more than \$10,000 in currency (virtual or real), they should both be subject to FBAR reporting.

While horizontal equity is increased, vertical equity may be decreased if FBARs are required. Requiring FBARs will increase the cost of maintaining and transacting with bitcoin. Lower income taxpayers are likely to have smaller bitcoin account balances than higher income taxpayers. Therefore, in proportion to their account balances, lower income taxpayers would in theory bear a larger compliance burden. This theory is balanced against the fact that in many, if not most cases, the amount of bitcoin held by

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<sup>32</sup> IRS Notice 2014-21

lower income tax payers would not meet the filing threshold. Additionally, higher income taxpayers are more likely to already have offshore accounts that require an FBAR. Adding one additional account to their existing FBAR will not pose a significant increase in costs for these particular taxpayers.

### ***Certainty***

Providing an IRS Notice or amending the regulations to definitively require bitcoin held in a foreign online account to be reported on an FBAR would increase certainty for taxpayers. The most recent guidance from the IRS came on a June 4, 2014 webinar in which Rod Lundquist a Senior Program Analyst for the Small Business/Self-Employed Division, stated that virtual currencies are not required to be reported.<sup>33</sup> The guidance also stated that this may change. In the meantime, searching for Internet advice about Bitcoin and FBAR produces articles written by several tax experts stating that as an abundance of caution virtual currencies should be reported on an FBAR.<sup>34</sup> This uncertainty creates confusion

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<sup>33</sup> Erb, K. (2014, June 30). IRS Says Bitcoin Not Reportable on FBAR (For Now). Forbes. Retrieved from <http://www.forbes.com/sites/kellyphillipserb/2014/06/30/irs-says-bitcoin-not-reportable-on-fbar-for-now/>

<sup>34</sup> Id., Also see Beyoud, L. (2014, June. 10). Bitcoin Exchange Accounts Should Be

for people who currently hold bitcoin and may be holding others back from purchasing bitcoin.

### ***Convenience of Payment.***

Requiring bitcoin to be reported on an FBAR will not impact the time or manner that the taxpayer will be required to pay tax on any income from bitcoin. This is because the FBAR is merely a foreign account reporting form and not an income tax form.

### ***Economy in Collection***

Requiring an FBAR will increase costs to taxpayers but may reduce overall costs to the government. Taxpayers will bear the cost of submitting an additional form and keeping track of account balances throughout the year. Currently, taxpayers must maintain records of purchases, sales and uses of bitcoin to be able to calculate taxable income.<sup>35</sup> If FBAR reporting were mandatory and taxpayers knew they faced steep FBAR penalties for incorrect calculations, their overall record keeping would likely improve. This improved record keeping would simplify the government's

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Reported on FBARs, Analysts Say. Daily Tax Report. Retrieved from <http://www.bna.com/bitcoin-exchange-accounts-n17179891170/>

<sup>35</sup> IRS Notice 2014-21



ability to audit a taxpayer and collect the correct amount of tax. However, this analysis is pure speculation, and the actual impact would be difficult if not impossible to measure since offshore bitcoin accounts are easily hidden.

FBAR is difficult for the average taxpayer. Couple this difficulty with the fact that a taxpayer must read laws and regulations and search for the most recent IRS guidance before deciding if an FBAR is required.

### ***Neutrality***

Under current IRS guidance, the principal of neutrality is not met. A foreign online bitcoin account has many characteristics of securities and currency held in a foreign account, both of which require the filing of an FBAR. Decisions whether to purchase bitcoin or a security will be skewed toward Bitcoin for individuals who do not want the additional cost of filing an FBAR. Mandating FBARs for Bitcoin would allow taxpayers to make their decisions without having to weigh the cost of compliance.

### ***Economic Growth and Efficiency.***

The effect mandating FBARs for Bitcoin will have on economic growth and efficiency has strong arguments on both sides of the coin (pun intended). Bitcoin has at least three

### ***Simplicity***

The regulations should be amended to provide a definite answer to a taxpayer's question of "does my virtual currency need to be reported on an FBAR?" As it is, complying with an characteristics which give it the power to potentially revolutionize the world economy. Those characteristics and how they interact with growth and efficiency are as follows.

1) Transaction costs are lower than other payment methods (think credit cards, Paypal and wire transfers) which increases purchasing power. This is particularly important for lower income individuals. Requiring FBARs will raise transaction costs, negatively impacting growth for lower income individuals.

2) Intermediaries such as banks are not required to conduct a transaction with bitcoin. Therefore, Bitcoin gives the unbanked population the ability to purchase items online just like others. This characteristic of Bitcoin will not be changed by reinterpreting the regulation.

3) Bitcoin is a global currency, not tied to any particular country. This feature has the potential to provide a currency with stability. Although no single country has the ability to control Bitcoin, each country can make their

own rules. Whether certain countries choose to ban Bitcoin or accept it has a yet to be determined impact.

On one hand, requiring FBARs may enhance the legitimacy of Bitcoin, which will lead to greater acceptance and increased opportunity for the poor and unbanked to benefit from it. On the other hand, the additional costs and time required to file an FBAR may drive people away from Bitcoin.

### ***Transparency and Visibility.***

The proposal will substantially enhance this principle. Currently, there exists a world of confusion about whether or not to file FBARs for bitcoin. Internet searches reveal a slew of analysis and opinions by CPAs and law firms, but no concrete guidance.

### ***Minimum Tax Gap.***

Requiring FBARs will undoubtedly minimize the tax gap. The first Voluntary Offshore Initiative was launched in 2003.<sup>36</sup> Taxpayers were given the option to come forward, declare their offshore accounts, and pay the

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<sup>36</sup> IRS Website. (1/14/2003) IR-2003-5, IRS Unveils Offshore Voluntary Compliance Initiative; Chance for ‘Credit-Card Abusers’ to Clear Up Their Tax Liabilities: <http://www.irs.gov/uac/IRS-Unveils-Offshore-Voluntary-Compliance-Initiative;-Chance-for-‘Credit-Card-Abusers’-to-Clear-Up-Their-Tax-Liabilities>

back taxes they owed. In return, the IRS would not criminally prosecute these taxpayers or assess them the stiff FBAR penalties. In conjunction with this initiative, the IRS ramped up enforcement and outreach about the need to file FBARs. As a result of these efforts, the number of FBARs filed in 2004 more than doubled by 2009, going from 217,699 to 534,043, respectively.<sup>37</sup> IRS news release 2012-5, released January 9, 2012, stated that the IRS had collected a total of \$4.4 Billion from its 2009 and 2011 offshore voluntary disclosure programs.

As the aforementioned research shows, the stiff penalties, outreach, and various offshore compliance initiatives have brought in over \$4 billion dollars and increased FBAR compliance. Mandating FBARs for foreign online bitcoin accounts will have a similar effect of increased compliance with the tax laws.

### ***Appropriate Government Revenues.***

Prior research on the number of unfiled FBARs found that it was nearly impossible to determine exactly how many people were not

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<sup>37</sup> 9/29/2010 TIGTA Report at: <http://www.treasury.gov/tigta/auditreports/2010reports/201030125fr.html>

compliant.<sup>38</sup> They did arrive at some broad estimates.<sup>39</sup> This will very likely be the case here. However, a few years after FBARs are mandated for bitcoin, the government will have new information to draw upon to analyze and assess the amount of Bitcoin related tax revenue it can expect.

## Conclusion

FBARs should be required for bitcoin held in a foreign online account. Implementing this requirement will not need an amendment to the laws or regulations. Existing laws and regulations are broad enough that they can be interpreted as already requiring FBARs for bitcoin. Hence, to implement the new requirement, the IRS only need issue a Notice explaining their position. This will undoubtedly be challenged and make its way to court. In court, the IRS will be able to leverage off of the analysis in the *Hom* decision.

Bitcoin accounts should be reportable because they meet the definition of “other financial accounts” under the current regulations. Here

is why. In *Hom*, the court reached the conclusion that poker accounts were reportable because the way they were being used fell within the definition of financial institution, which was within the definition of financial agency, which made them subject to reporting. To expand on that analysis, an online bitcoin account will fit in at least two places within the 26 different definitions of financial institution.

31 USC § 5312(a)(2)(H) defines a financial institution as a “broker or dealer in securities or commodities.” One definition of broker is as follows: An individual or firm employed by others to plan and organize sales or negotiate contracts for a commission.<sup>40</sup> Bitcoin exchanges that provide online bitcoin accounts function like brokers by charging a commission to organize sales of bitcoin. Dictionary.com defines commodity as “something of use, advantage or value.”<sup>41</sup> Bitcoin can be *used* to purchase goods and services, and it also has a readily available *value*. Based on these definitions, we can substitute exchange for broker and Bitcoin for commodity, and we arrive at the conclusion

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<sup>38</sup> Sheppard, H. (2006). Evolution of the FBAR: Where We Were, Where We Are, and Why it Matters. Houston Business and Tax Journal. Retrieved from <https://americansabroad.org/files/5413/6913/9189/sheppar2.pdf>

<sup>39</sup> Id.

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<sup>40</sup> The Free Dictionary.com. (n.d.). Retrieved from <http://legal-dictionary.thefreedictionary.com/broker>

<sup>41</sup> Dictionary.com. (n.d.). Retrieved from <http://dictionary.reference.com/browse/commodity>

that a Bitcoin exchange meets the definition of financial institution.

31 USC § 5312(a)(2)(R) defines financial institution as “... any other person who engages as a business in the transmission of funds, including any person who engages as a business in an informal money transfer system or any network of people who engage as a business in facilitating the transfer of money domestically or internationally outside of the conventional financial institutions system.” Because the IRS has characterized bitcoin as property not currency, the definition of “funds” must be interpreted broadly. An online dictionary defined funds as “A sum of money or other resources set aside for a specific purpose.”<sup>42</sup> Bitcoin can definitely be classified as other resources. Additionally, the second half of the definition suggests that the spirit of the law was to capture informal value transfer systems, not just “informal money transfer systems.”

To maintain simplicity, bitcoin accounts should be reported on the existing FBAR form. Most if not all of what is required on the existing form (maximum account balance, type of account, financial institution name,

and account number) is relevant to reporting an online bitcoin account. Minor adjustments to the FBAR instructions will be required such as what type of account to select for bitcoin: “Bank” or “other.”

Regardless of where and how Bitcoin fits into the regulation, the IRS should take the time to finalize its research on Bitcoin and other virtual currencies and issue official guidance. Mandating FBARs will enhance the majority of the 10 guiding principles of good tax policy, increase tax revenue, and produce records that will assist law enforcement, which is what the BSA originally intended.

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<sup>42</sup> Thefreedictionary.com. (n.d.). Retrieved from <http://www.thefreedictionary.com/funds>

## Repeal the Alternative Minimum Tax

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By: Branden Wilson, *MST Student*

### What is the AMT?

The alternative minimum tax, or AMT, can be described as a parallel tax system that operates on a different set of rules. The AMT is an income tax. It affects individuals, corporations, estates and trusts. When tax day comes around, taxpayers need to figure out how much tax they owe for the year under the regular tax rules, then again under the AMT rules, and pay whichever amount is higher. Also, it is necessary to consider possible AMT exposure throughout the year with additional record keeping and planning. The AMT was intended to make sure that certain high income individuals or businesses paid at least some tax.

The AMT applicability to individuals, works similarly to the regular income tax but it has different rules on how to calculate taxable income. It has two tax rates for ordinary income, 26 and 28 percent. Capital gains are taxed at the same rates under the AMT. Corporations are taxed at a flat 20% rate under the AMT. The individual AMT has exemptions with limits, so it does not impact the lowest earners. The exemption amounts are \$53,600 for taxpayers filing Single, \$83,400 for Married Filing Jointly, and \$41,700 for Married Filing Separately. The individual AMT phases out at \$119,200, \$158,900, and \$79,450 for taxpayers filing Single, Married Filing Jointly, and Married Filing Separately respectively. The AMT treats the exercise of incentive stock options as taxable gains upon exercise, even if the underlying securities have not been sold. The

major difference between the regular income tax and the AMT is that the AMT does not allow some of the deductions allowed under the normal tax rules. This makes it stealthy as it creeps up to surprise a taxpayer who is denied a large state tax deduction allowed under the regular tax rules and becomes a victim to a higher tax under the AMT.

The taxpayers most likely to get pulled into the AMT are middle-to-high income earners who live in high tax states and have children. Under the normal income tax rules a taxpayer may deduct state and local taxes paid on Schedule A of the Form 1040. This is not allowed when calculating AMT liability. Also there are no dependent deductions under the AMT, so people with kids or the ones who are taking care of others, could be surprised when these deductions disappear. Until recently, the exclusion amounts were not indexed for inflation and therefore, every year an increasing amount of taxpayers were subject to the AMT. The American Taxpayer Relief Act raised the exclusion limits permanently and indexed them for inflation so as to help prevent an increasing number of lower income individuals from being pulled into the AMT every year. Inflation indexing did help take the edge off of the AMT, but taxpayer advocate groups, politicians, and taxpayers alike plead for its complete repeal.

Even the IRS's own National Taxpayer Advocate cries out for the repeal of the AMT. In the NTA's 2013 Full Report to Congress, Legislative Proposal #1 was "Repeal the Alternative Minimum Tax" citing that it adds too much complexity to the tax system and it doesn't function like it was originally intended.<sup>43</sup> You know something is wrong

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<sup>43</sup> The Taxpayer Advocate 2013 Full Report to Congress, Legislative Recommendation #1

with a part of the system if even the IRS wants to get rid of it. The AMT adds unnecessary complexity to the tax system by not only making it difficult to figure out how much tax is owed, but it needs to be done twice. The report suggests that if Congress really wants the revenue generated by this rule, they should change the regular tax system to get the same result. Making taxpayers figure out their tax owed under two different sets of rules and rates is pointless and unnecessarily redundant. This report also points out that the AMT hits the wrong taxpayers, meaning it was originally intended for certain very wealthy taxpayers who sometimes legally avoided paying all Federal income tax under the regular tax rules, but now it seems to miss its target.

### **Who is affected by AMT?**

The AMT could affect every American taxpayer. It affects individuals when their income reaches a certain level and some deductions begin to disappear. It affects C corporations with special rules pertaining to calculating taxable income. All C corporations are exempt from AMT for the first year and could be exempt for future years based on gross receipts. To qualify as a small C corporation for AMT purposes average gross receipts must not exceed \$7.5 million for the three taxable years ending before the current tax year. However, for its first three years the average gross receipts must not exceed \$5 million.<sup>44</sup> If in any taxable year the C Corporation loses its small business corporation exemption it will be subject to the AMT in all future tax years even if gross

receipts decrease to small business levels in future years. The income that passes through S corporations, partnerships, and LLC's flows through to the owners and is potentially subject to the AMT. Estates and trusts are also subject to the AMT. All in all, almost every taxpayer and type of entity is a possible target for the AMT at some level.

### **A Brief History of the AMT**

The first version of the AMT was called the minimum tax and was enacted as part of the Tax Reform Act of 1969.<sup>45</sup> Congress was upset to learn via witness testimony that some 155 high income individuals were not paying any income tax at all. These individuals were making over \$200,000 at the time, which amounts to more than \$1.4 million after inflation today. They were utilizing rules allowed under the regular income tax to effectively reduce their tax liability to zero. When Congress learned about this phenomenon, they were upset that some of the individuals with the most means to pay were in fact not paying at all!

The minimum tax was then changed to something more like what we have today, in 1982 by the Tax Equity and Fiscal Responsibility Act of 1982.<sup>46</sup> This is when it became the parallel tax system where you calculate both and pay the higher one. Rates changed over the years. In 1999, a bill was passed by both houses that would have repealed the AMT, but it was vetoed by the President.<sup>47</sup> In 2003, a law was passed that taxed capital gains under the same rates as the regular income tax. As mentioned above, in 2012 the exemption limits were indexed for

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<http://www.taxpayeradvocate.irs.gov/userfiles/file/2013FullReport/Repeal-the-Alternative-Minimum-Tax.pdf>

<sup>44</sup> IRC §55(e)

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<sup>45</sup> Pub. L. 91-172, Dec. 30, 1969, 83 Stat. 487

<sup>46</sup> Pub. L. 97-248, Sep. 3, 1982, 96 Stat. 324

<sup>47</sup> Taxpayer Refund and Relief Act of 1999, H.R. 2488, 106th Cong. (1999)

inflation, which was a big step in the right direction.

Complete repeal has been a tough sell for proponents because of how much tax revenue the AMT generates for the government.

### Application of the Ten Principles of Good Tax Policy

Whenever considering an addition, modification or repeal of tax policy, it is important to critique the proposal using the ten principles of good tax policy as provided by the AICPA. This is a well-balanced and objective way to really expose the strengths and weaknesses of any proposed tax change. Below is a comprehensive analysis of the AMT as it is currently.

#### Principles of Good Tax Policy Worksheet

Criteria	Does the proposal satisfy the criteria? (explain)	+/-
<p>Equity and Fairness – Are similarly situated taxpayers taxed similarly? Also consider any different effects based on an individual’s income level and where they live.</p>	<p><i>While the AMT could affect all taxpayers, it tends to affect some more than the others. The Alternative Minimum Tax does not meet the principle of equity and fairness because it is more likely to affect taxpayers with children, those living in high tax states, or those with high personal expenses. Under regular tax rules taxpayers with children get a dependency deduction, under the AMT they do not. Under the regular tax rules, taxpayers can deduct their state and local taxes while under AMT they cannot. Under AMT taxpayers need to add back certain expenses such as legal fees and employee business expenses that can be deducted under the regular tax rules above 2% of AGI. So the AMT is inequitable to those who have children, live in higher tax states or that have certain personal expenses.</i></p> <p><i>The AMT affects taxpayers with income levels higher than the exemptions amounts, so it will be more likely to affect higher income individuals. It definitely does not affect low income taxpayers. Although mortgage interest is still deductible under the AMT which is more beneficial to higher income taxpayers with large home loans. Also the capital gain rates being the same for both regular income tax and AMT is more beneficial to high income taxpayers who likely have more income from capital gains.</i></p> <p><i>The AMT does not meet the criteria for the principal of equity and fairness looked at from either the perspective of vertical or horizontal equity.</i></p>	<p>-</p>



<p>Certainty – Does the rule clearly specify when the tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined?</p>	<p><i>Because the AMT is due at the same time as the regular income tax, if in fact it is determined that the AMT is owed, it is certain. Although the way the AMT is calculated differs in terms of rates, allowable deductions, and exclusion amounts, they can be looked up just like rules under the regular tax system. So although burdensome to calculate the tax owed with two different sets of rules, the fact that one or the other is definitely due on tax day makes the AMT satisfy the principle of certainty. It is certain that one tax or the other will be due on tax day determinable by the rules set forth by the law.</i></p>	+
<p>Convenience of payment – is the tax due at a time that is convenient for the payer?</p>	<p><i>The AMT almost satisfies the principle of Convenience of Payment. Because some or most of the taxpayers which the AMT will apply are wage earners, they have withholding from their paychecks throughout the year based on their projected income calculated with the regular income tax regulations and rates. This makes paying the regular tax very convenient because it is pretty much done for them all year long. Sure the AMT is due on the same day as the regular tax if it is owed. The problem is that if the withholding has not been enough to satisfy the amount owed under the AMT rules, it will not be convenient for the taxpayer. So a taxpayer could be inconveniently surprised when they find out that they owe additional tax under the AMT rules and may not be able to pay on time triggering penalties. Unless a taxpayer has a good understanding of the tax rules under both tax systems or has a tax professional advising them, it is likely that a tentative minimum tax addition will come as an unwelcomed surprise.</i></p>	-
<p>Economy in collection – Are the costs to collect the tax at a minimum level for both the government and taxpayers? Also consider the time needed to implement this tax.</p>	<p><i>The AMT fails again to meet the criteria for the principle of economy in collection because it requires so many extra hours of preparation time to comply with. In order to comply with the AMT, taxpayers need to calculate their taxes in two different ways to see which one is higher. Millions of hours are spent recalculating taxable income under the AMT rules every tax year even if ultimately there is no additional tax owed. In addition to the taxpayers taking more time to compute potential AMT liability, the IRS revenue agents would also need to do calculations under both sets of rules to audit compliance. More hours spent on doing calculations and figuring out if everyone is complying with the law is very costly. The millions of hours spent on this AMT could instead be spent doing more productive</i></p>	+/-



	<p><i>activities.</i></p> <p><i>If the AMT were to be repealed, there would likely be additional administrative and compliance costs related to MTC carryovers. Credits accumulated by the taxpayers who have been subject to the AMT over the years, would need to be dealt with, if the AMT were no longer around. However, these amounts could likely be settled in one tax year and would not present an ongoing problem.</i></p>	
<p>Simplicity - can taxpayers understand the rules and comply with them correctly and in a cost-efficient manner?</p>	<p><i>One of the major issues with the AMT is that it is not simple. The AMT fails to meet the principle of simplicity because it takes what is owed under the regular income tax rules, throws it out, and makes taxpayers recalculate taxable income under a completely different set of rules. Most American taxpayers would probably say the tax system is complicated and I imagine they would be referring to the regular income tax. The AMT further adds complexity to an already complicated tax system by making taxpayers do extra record keeping and calculate their tax twice.</i></p>	-
<p>Neutrality - The effect of the tax law on a taxpayer's decisions as to how to carry out a particular transaction or whether to engage in a transaction should be kept to a minimum.</p>	<p><i>The AMT fails to meet the principle of neutrality because it can affect the business decisions of taxpayers. When an employee receives incentive stock options from their employer they may be subject to the AMT. This is because the AMT taxes the paper gain realized when an employee is granted and exercises stock options. The difference between the option contract value and the market value of the underlying security is a taxable event under the AMT, even if the shares are not sold. This can definitely have an effect on the economic decisions of taxpayers. If the gain is large enough the taxpayer payer may have to sell the securities against their will to come up with the money to pay for the tax on the gain. While under regular tax rules they could have held the stock and not been taxed until it is eventually sold, which could result in different economic results for better or worse.</i></p> <p><i>Also businesses may decide to use different depreciation methods or lease rather than buy property or equipment to simplify calculations under the two tax systems.</i></p>	-

<p>Economic growth and efficiency – will the tax unduly impede or reduce the productive capacity of the economy?</p>	<p><i>The AMT somewhat meets the criteria for the principle of economic growth and efficiency. Because it mainly affects the taxpayers in the \$100,000 to \$200,000 range, most taxpayers who are hit by this tax will be able to pay it. Occasionally a taxpayer near the lower bound of the exclusion amount under the right circumstances may be surprised by an AMT hit. However, a wage earning taxpayer can end up being subject to the AMT, who would have otherwise used the money to start a business, which would stimulate the economy by hiring employees or adding to the GDP. This is an example that has unduly impeded the economy. I would consider AMT a draw under the principle of economic growth and efficiency because it could go either way.</i></p>	<p>+/-</p>
<p>Transparency and Visibility – Will taxpayers know that the tax exists and how and when it is imposed upon them and others?</p>	<p><i>The AMT does not meet the criteria for the principle of transparency. This is because of its parallel nature that doesn't present itself until the conditions are just so that it is owed. Public education doesn't do much in the way of financial literacy and certainly doesn't try to explain our tax system. For most American's the first lesson in taxes is when a first paycheck is received and the recipient wonders where the rest of the money went. So the AMT is a tax you don't realize is there, until you have to pay it, unless you work with taxes for a living. The AMT is anything but transparent. The rules are out there but you have to find them. The AMT is a stealthy tax because it doesn't allow for certain tax deductions allowed under the regular tax rules and can catch a taxpayer off guard when it is time to file. Imagine a taxpayer is accustomed to receiving a large state tax deduction and one year when conditions are right they fall into AMT and are denied this deduction and become subject to additional tax. Uncertainty around whether a taxpayer will be in the AMT category or the regular tax category makes tax planning more difficult, which makes it less transparent. Only tax savvy individuals or businesses will see the signs that point to possible AMT exposure.</i></p>	<p>-</p>
<p>Minimum tax gap – is the likelihood of intentional and unintentional non-compliance likely to be low?</p>	<p><i>The AMT does not meet the criteria for the principle of minimum tax gap because individuals or businesses that are surprised by a larger than anticipated tax at the end of the year will be less likely to voluntarily comply. It is easy to comply with tax payments when the employer does the withholding for the taxpayer all year long based on the</i></p>	<p>-</p>

	<p><i>regular tax rates and rules. But after working hard all year paying property taxes and taking care of children, when a substantial under payment is due because of the AMT rules, a taxpayer is less likely to pay or be able to pay. The reason for automatic withholding is partly to increase voluntary compliance and when the automatic withholding is not enough to pay the bill, the taxpayer will likely feel cheated. Studies show that voluntary compliance suffers when a taxpayer receives a surprise tax due on their return. Although the IRS could easily compute and catch taxpayers who don't calculate or pay their AMT liability, because the potential to catch a taxpayer off guard, the AMT lowers voluntary compliance. For this reason, the AMT does not meet the minimum tax gap principle.</i></p>	
<p>Appropriate government revenues – will the government be able to determine how much tax revenue will likely be collected and when?</p>	<p><i>The AMT does meet the principle of appropriate government revenues because the ten year budget clearly reflects income from the AMT. Repealing the AMT, would lower revenues for the government unless it is done with comprehensive reform to offset the lost revenue from the AMT repeal. But the amount of revenue received from the AMT as a percentage of total income has steadily increased since its inception in 1969. The government has gotten comfortable with the increasing stream of income and is unwilling to part with it easily. However, the whole reason for enacting the AMT in the first place was to catch a handful of rich people avoiding tax by utilizing rules available to them under the regular income tax code. If Congress doesn't want people to avoid taxes by using these tax preference items, it should change the regular tax code, not use a parallel tax system to catch their legislative short comings.</i></p>	+

## Conclusion

In conclusion, it is clear that the AMT does not meet the guiding principles for good tax policy as provided by the AICPA. The matrix provided, shows many more minuses than pluses. Repealing the AMT would be a great step in the direction of simplifying our US tax system and increasing voluntary compliance. If a complete repeal is not possible by itself, elimination of the AMT with modification to the regular tax system to help recapture some lost government revenue might be a good second choice. The regular tax code could be modified by eliminating certain tax preferences, which were the reason, why the minimum tax was enacted in the first place. *Instead of having a minimum tax or alternative tax, we should minimize or eliminate the tax preference items that allow*

*taxpayers to avoid paying tax. The tax code should be as simple as possible to make it easier to follow and to increase voluntary compliance. If Congress wants the revenue from the taxpayers paying the AMT currently, they should write into law more straight forward rules that raise the same amount of funds more transparently without relying on a shady parallel tax system. Taxpayers should be able to easily understand how much they owe, understand why they owe it, and know how it is calculated. Simplicity helps everyone involved. It makes preparation, compliance, enforcement and audits easier. It would require less time to figure everything out, less government resources to administer and oversee, less computing power, and less internet bandwidth. I would even go as far as to say it would make taxpayers happier.*

**Focus on Tax Policy**  
**Consolidation of Educational Tax Credits**  
 By Michael Hynson, *MST Student*

**Background and Current Issues**

College students and families can take advantage of several programs to subsidize the costs of higher education. Two of the most utilized support systems are federal financial aid and the tax system. The tax system has provided various forms of relief since the 1940s, but tax credits for educational expenses only began in the 1990s.

President Bill Clinton believed an educational tax credit was necessary for low-income and middle-class taxpayers to alleviate the burden of rising tuition costs. In his second term as president, Clinton signed and passed the Taxpayer Relief Act of 1997, which introduced the Hope Scholarship Credit and the Lifetime Learning Credit (LLC). Within a decade, the tax system introduced a few more credits and incentives, such as the tuition and fee deduction, that subsidized the costs of attaining higher education and advanced training.

Following the Great Recession of 2007, Congress and President Barack Obama wanted more students and families to qualify for an educational tax credit. Obama signed and passed the American Recovery and Reinvestment Act of 2009, which introduced an improved and broader version of the Hope Credit, known as the American Opportunity Tax Credit (AOTC). The AOTC allows for a maximum tax credit of \$2,500 per eligible student based on the amount of qualified educational expenses. Up to \$1,000 of the total credit may be refundable. The AOTC can be claimed for the first four years of a degree-awarding program and will expire by the end of 2017.

However, taxpayers can only utilize one of these incentives per taxable year. For example, if the AOTC is claimed for the taxable year then the LLC and the tuition deduction cannot be claimed for the same year. Choosing the tax credit that offers the most benefit can be a complex situation that creates stress and burden on taxpayers, especially those without the resources to hire a tax practitioner. Each one has similarities but also differences in key definitions and eligibility rules. Taxpayers who appeared eligible for the LLC and the tuition deduction failed to minimize their federal tax liability in two ways.<sup>48</sup> Some failed to claim any credit at all while others selected the suboptimal choice. For example, about 40% of the 588,000 taxpayers who claimed the tuition deduction would have increased their tax benefit by an average of \$284 had they utilized the LLC instead of claiming the deduction.

**Proposal**

Congress has heard many ideas and proposals to consolidate the educational tax credits into a more simple and certain tax credit. In the 113th Congress, Representatives Diane Black and Danny K. Davis introduced H.R. 3393, which contained several changes to the existing educational tax credits. There are four key changes:

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<sup>48</sup> United States Government Accountability Office, *Higher Education - Improved Tax Information Could Help Families Pay for College*, May 2012, 32-38.  
<http://www.gao.gov/assets/600/590970.pdf#page32>.

- Consolidating the AOTC, LLC, tuition deduction, and Hope Credit into a broader version of the AOTC.
- Coordinating in conjunction with Pell Grants by excluding amounts received via Pell Grants from the taxpayer's gross income increasing the refundable portion of the AOTC to \$1,500.
- Making the AOTC permanent.

## Analysis

The consolidation into one tax credit would simplify the educational tax credits, because there is only one tax credit available to utilize. Less time would be spent researching which tax credit to use. Consequently, the chances of selecting the suboptimal choice would be eliminated, and everyone would be entitled to the same amount of tax benefit.

The current system penalizes Pell Grant receivers because of the lack of cohesion between the educational tax credits and Pell Grants. This group of students finds financial assistance more beneficial than those in the middle-class. Therefore, the proposal allows them to receive the same amount of tax benefit as any other taxpayer.

The higher refundable credit allows for more money in the taxpayers' pockets, which indirectly benefits state and local governments because this could incentivize using the refund towards purchases and investments. The permanence provides certainty to families and students with tax planning for the future. Families can feel assured that they can send their children to college and know that they will receive the same benefits as those who are receiving it today.

Many people admired the proposal, but others still had issues with it. Congressman Sander Levin showed concern for the students who

would no longer receive assistance from the LLC and the tuition deduction.<sup>49</sup> Because the bill consolidates everything to be under the AOTC, it generally takes on its current provisions. Only undergraduate students would have access to the credit. So graduate students and lifetime learners, though technically still seeking more education would no longer be eligible for an educational tax credit.

The concern from Congressman Rush D. Holt was in regards to the lack of means to fund the expanded tax credit.<sup>50</sup> The lack of funding would increase the nation's deficit. He suggested that better alternatives to assisting with secondary education exist and the focus should be on fixing student loan debt and Pell Grant funding.

Jeffrey A. Porter, Chair of the American Institute of Certified Public Accountants, thought the proposal had the right intentions but does not satisfy the goal of simplifying the educational tax credits.<sup>51</sup> Increasing the refundable tax credit does not simplify the incentive and does not guarantee more utilization of it. He makes a few suggestions

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<sup>49</sup> House of Representatives, 113th Congress 2nd Session, *Student and Family Tax Simplification Act*, July 17, 2014, 38-39.

<https://www.congress.gov/113/crpt/hrpt526/CRPT-113hrpt526.pdf>

<sup>50</sup> House of Representatives, *Congressional Records - Extension of Remarks*, July 24, 2014, 7.

<http://www.gpo.gov/fdsys/pkg/CREC-2014-07-24/pdf/CREC-2014-07-24-extensions.pdf>

<sup>51</sup> American Institute of Certified Public Accountants, *The Education Incentives Included in the Tax Reform Act of 2014 and the Student and Family Tax Simplification Act (H.R. 3393)*, March 27, 2014,

<https://www.aicpa.org/Advocacy/Tax/DownloadableDocuments/AICPA%20Comment%20Letter-%20Education%20HR%203393%20AOTC%203-27-14.pdf>.



to help ensure simplification, such as making the entire tax credit refundable, offering the credit on a per-student basis (as opposed to a per-taxpayer basis), and lengthening the credit to 6 years of any type of post-secondary schooling.

Although this proposal died in Congress, it took positive steps toward fixing the educational tax credits.

### Principles of Good Tax Policy Worksheet

Principle	Application	Rating
<p><b>Equity and Fairness</b> – Are similarly situated taxpayers taxed similarly? Also consider any different effects based on an individual’s income level and where they live.</p>	<p>Similarly situated taxpayers can be viewed in multiple ways. Taxpayers who are similar in being students would be seen as treated differently. An undergraduate student in his/her first year would be treated differently than an undergraduate student in their fifth year because they would no longer be able to claim the AOTC past the fourth year. They are both still students yet because one has attended college longer they are not eligible to claim the credit. Other groups of students, such as graduate students or lifetime learners, are ineligible for the AOTC despite sharing a common interest as an undergraduate student, which is to attain higher education.</p> <p>On an income level, taxpayers would all be treated equally. The main difference would be that Pell Grant receivers would perceive the educational tax credits as being fair. Currently, if a Pell Grant receiver has the same income level of a non-receiver, than the latter might receive more tax benefit than the former. The lack of coordination with Pell Grants has penalized those who receive it; their benefit would decrease either through a reduction of their qualified expenses or recognition of additional income. The proposal would entitle receivers to the same benefits as those who do not need financial aid.</p>	+/-
<p><b>Certainty</b> – Does the rule clearly specify when the tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined?</p>	<p>There is no change when the benefits of the tax credits would be received. In most cases, if the taxpayer is receiving a refund they can assume it would arrive to them within a few weeks of filing their tax return. The only change regarding the amount being paid is if the taxpayer is entitled to the full \$1,500 refundable credit. The same calculation would be done where the credits are first applied to the tax liability and any remaining amount, up to \$1,500, would be refunded. Because the AOTC has been in use since 2009 those who have been claiming it and are still eligible would continue to do the same process moving forward.</p>	+

<p><b>Convenience of payment</b> – is the tax due at a time that is convenient for the payer?</p>	<p>There is no change regarding when to claim the tax credit and when the refundable credit would be received. It would be claimed on the annual tax return and the refund should be received shortly after filing and any adjustments have been made. This creates convenience to the taxpayer because they do not need to do anything differently.</p>	+
<p><b>Economy in collection</b> – Are the costs to collect the tax at a minimum level for both the government and taxpayers? Also consider the time needed to implement this tax.</p>	<p>There are no additional costs to taxpayers because the changes do not create such burdens. Taxpayers can mimic the way they carried out transactions in previous years because it is essentially the same tax credit as before. The changes from the proposal are a minor cost to the government. The content of Form 8863, Education Credits would need to be updated to remove the LLC, which is not a difficult task.</p> <p>The AOTC has been in existence for a few years now so the tax credit has already been implemented. In the year of change, the differences from the proposal are only adjustments to certain numbers and changes in specific rules.</p>	+
<p><b>Simplicity</b> - can taxpayers understand the rules and comply with them correctly and in a cost-efficient manner?</p>	<p>A goal of the proposal is to simplify the existing educational tax credits and it does so in several ways. The consolidation of the educational tax credits leaves the public with one tax credit to choose from. Therefore, the proposal would remove overlapping tax credits with the same goal. It would also remove the complexity of defining the same word that have discrepancies in their meanings from one tax credit to another. The permanence of the AOTC would cease discussion and debate as to whether the credit should be extended. This could also reduce the frequency of how often the merits of the credit would change.</p> <p>Those who claimed nothing or incorrectly would not encounter the same confusion as they did before. Therefore, they could reasonably conclude that only one educational tax credit exists and if they are eligible they could utilize it. Additionally, the reporting requirement changes for qualified educational institutions would assist taxpayers in claiming the proper amount of tuition paid rather than tuition billed.</p> <p>Having all these changes limits the margin of error, thus enabling better decision making. The complexity of the current system can create a perception of unfairness. However, these changes toward simplicity ensures that taxpayers can have a better understanding of the single tax credit available and reduces any burdens.</p>	+



<p><b>Neutrality</b> - The effect of the tax law on a taxpayer's decisions as to how to carry out a particular transaction or whether to engage in a transaction should be kept to a minimum.</p>	<p>H.R. 3393 rewards taxpayers, via a tax credit, for attaining higher education. The tax credit may influence taxpayers to enroll in post-secondary school. Unlike some sort of additional tax, these changes offer incentives that influence taxpayers into an activity that should develop themselves and the economy. It is unlike proposals that might influence a taxpayer to buy one product over another, which could create unfairness for one business over another. Therefore, it could be called a positive-form of neutrality because it should lead to positive outcomes. The alternative to attending college is a missed opportunity to additional education. Not having the additional education may force the taxpayer to potentially settle for a lower wage in comparison to the earnings potential they could have with a college degree.</p> <p>A goal of educational tax credits is to increase college attendance. It can be concluded that the government would prefer taxpayers to obtain more education or, in other words, they want a certain activity to be carried out. Even though there are some taxpayers who attend college regardless of tax-based aid, there are others who may see these changes as an incentive to attaining higher knowledge.</p>	+/-
<p><b>Economic growth and efficiency</b> – will the tax unduly impede or reduce the productive capacity of the economy?</p>	<p>This proposal tries to fix the complexities of the currently available educational tax credits in hopes that simplification will influence taxpayers into attaining higher education and making the process of claiming an educational tax credit easier. Despite the negative effects on the nation's deficit, there are reasons to believe this could help the nation's economy in the long run. If more taxpayers attend college then it would have a positive effect on the economy through higher paying jobs. Additionally, the higher refundable credit means more money in the taxpayer's pocket, which they might use to make additional purchases or investments.</p> <p>However, if the student drops out or fails to complete a college degree the hope is that the individual has gained some benefit from college to enhance themselves and the economy, or else it could be seen as wasted resources on behalf of the government.</p>	+/-

<p><b>Transparency and Visibility</b> – Will taxpayers know that the tax exists and how and when it is imposed upon them and others?</p>	<p>Form 8863, Education Credits, would no longer contain provisions of the LLC and just those of the AOTC. Currently, taxpayers fill out a questionnaire that either leads to the AOTC, LLC, or no tax credit at all. The questionnaire would be updated to determine eligibility of merely the AOTC or no tax credit at all. Therefore, if someone receives a 1098-T then they would fill the form out and see if they qualify or not. Therefore, the consolidation and emergence of one tax credit would be visible on this tax form.</p> <p>The consolidation should also make it easier to understand what is available and how that affects your taxes and your costs of college.</p>	+
<p><b>Minimum tax gap</b> – is the likelihood of intentional and unintentional non-compliance likely to be low?</p>	<p>The changes from H.R. 3393 should help increase compliance both intentionally and unintentionally. On an intentional basis, the taxpayer could select only one educational tax credit and there are not ways to manipulate it to falsely claim the credit. Even if a taxpayer tried to manipulate the system, the revised reporting requirements would ensure that they could only claim what they paid. The information reports would provide the IRS proof as to whether an individual is correctly or incorrectly claiming the AOTC.</p> <p>The chances of unintentional compliance would be low because of the same reasons. The taxpayer would not accidentally pick the tuition billed for the credit because they would know it is the tuition paid that provides the tax credit. The margin for error is larger with multiple educational tax credits because the taxpayer might misunderstand the rules or apply a definition from one tax credit to another in an incorrect manner. Thus, one tax credit would help ensure people understand what they are claiming and doing so properly.</p>	+
<p><b>Appropriate government revenues</b> – will the government be able to determine how much tax revenue will likely be collected and when?</p>	<p>The government would be able to project how much tax revenue they would lose. This estimate can be done by reviewing the previous year's tax returns that have a 1098-T, whether it was utilized for a tax credit or not. The calculation could be made by taking the number of taxpayers with the information report and applying it to their tax liability. In doing so, they can make a reasonable estimate on the amount of the tax expenditure. Therefore, they have the necessary tools to make a projection.</p>	+

## **Conclusion**

The proposal was admirable because it would simplify the overlapping tax credits and reduce complexity. It meets most of the principles of good tax policy with an exception for fairness, for graduate students and lifetime learners would no longer be eligible. This exclusion violates the goals of financial assistance for educational expenses. The proposal has no argument or support as to why these two groups of currently eligible students would be excluded; they are essentially seeking the same goal as undergraduate students, which is to attain more education.

Although not adequate to be passed, aspects of this proposal and the suggestions of those against it should be taken into account for this issue to be resolved in the future. The biggest winners of this proposal would be Pell Grant receivers would not be penalized from having to include amounts received from Pell Grant

in their taxable income, which would have allowed them to receive the same amount of benefit as any other taxpayer. Moving forward, the Pell Grant suggestions from this proposal should be used as a framework or mimicked so that the receivers feel enabled by educational tax credits, as opposed to being limited by them. As Porter suggested, increasing the refundable credit does not necessarily simplify the tax credit. Although it makes it look more appealing, it pours into the argument that Congressman Holt made about increasing the nation's deficit.

There are three routes that could occur for the future of educational tax credits: no action could be taken; the AOTC could be extended for a few more years; or the provisions of educational tax credits could be entirely shaken up, such as through a proposal like this.

## ANALYSIS OF THE FEDERAL ESTATE TAX

By Rachita Kothari, MST student

### Introduction

The federal estate tax, in varying forms, has served as a source of funding the government of the United States for more than two centuries. The current federal tax system on the transfer of wealth has three major parts: the estate tax, gift tax and generation skipping transfer tax. Per section 2001(a) of the Internal Revenue Code, property transferred by a deceased person is subject to the estate tax. Normally it is the estate of the decedent that has to pay the tax and not the heirs who inherit the estate. As the estate tax, if applicable, is normally paid to the state prior to final distributions to the heirs, the estate tax indirectly reduces the amount of estate the heirs can inherit.

The estate tax is one of the most progressive taxes levied by the federal tax system because it taxes the wealthy taxpayers. Typically only the wealthy multi-millionaire and billionaire Americans pay estate tax on their property exceeding the exemption limits. For single individuals the exemption limits for 2015 are \$5.43 million.<sup>52</sup> In case of married couples the potential unused exemption amount of the deceased spouse may be passed to a surviving spouse under certain circumstances provided an election is made on the federal estate tax return filed by the deceased spouse. This is

known as exemption portability, according to which a surviving spouse is eligible for a total exemption amount of up to \$10.86 million. To elaborate, if a deceased spouse does not use the exemption amount at all and makes an election in the estate tax return filed, then the surviving spouse would have a total exemption limit of \$10.86 million, which would be \$5.43 million of the surviving spouse and \$5.43 million from the deceased spouse.<sup>53</sup>

While computing the estate tax, certain deductions and exemptions are available to compute the "Taxable Estate." One of the deductions is marital deduction, wherein any amount of estate transferred by a deceased to a spouse is normally exempt from estate tax.<sup>54</sup> Another deduction is bequests to charitable organizations – including religious and public use organizations.<sup>55</sup> Charitable contributions made by the estates are allowed as a deduction without any limits to compute the taxable estates, unlike in case of individual returns where the deduction may be limited

The estate tax rate is a progressive structure, with a maximum rate of 40 percent. A Federal Estate Tax Return (Form 706) has to be filed within nine months following the day of death, if the sum of the taxable estate and prior taxable gifts cumulatively exceed the exemption limits mentioned above. In 2015, gifts to individuals up to a total amount of \$14,000 (per recipient) are generally exempt

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<sup>52</sup> Internal Revenue Service, In 2015, Various Tax Benefit Increase Due to Inflation Adjustments, October 23, 2014; <http://www.irs.gov/uac/Newsroom/In-2015,-Various-Tax-Benefits-Increase-Due-to-Inflation-Adjustments>

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<sup>53</sup> Internal Revenue Code, § 2010(c)(4) - Deceased Spousal Unused Exclusion Amount

<sup>54</sup> Internal Revenue Code, § 2056(a) - Allowance of marital deduction

<sup>55</sup> Internal Revenue Code, § 2055 - Transfers to Public, Charitable, and Religious Uses

from gift tax.<sup>56</sup> Form 4768 is filed for an automatic extension of 6 months to file the federal estate tax return.

The estate tax applies to a small number of estates due to the high exemption limits and various deductions. According to the Joint Committee on Taxation, 99.8 percent of estates do not owe any estate tax.<sup>57</sup>

The revenue generated from the estate tax is a small fraction of the total federal tax revenues, but it is a consistent source of federal revenue. The estate tax is expected to raise approximately \$20 billion in the year 2015.<sup>58</sup> According to the Joint Committee of Taxation, under the current law, the estate tax will generate approximately \$270 billion over the next ten years.<sup>59</sup>

In April 2015, the proposal H.R. 1105 (114<sup>th</sup> Congress) passed in the House Ways and Means Committee and the full House to completely repeal the estate tax and generation skipping transfer tax for decedents dying after the date of enactment of the proposal.<sup>60</sup> The proposal is pending the Senate Finance Committee's review.

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<sup>56</sup> Internal Revenue Code, § 2503(b) - Exclusion from Gifts

<sup>57</sup> Committee for a Responsible Federal Budget, Ways & Means Committee Adds \$270 Billion to Deficits by Repealing Estate Tax, March 26, 2015; <http://eww.budgetreform.org/blogs/ways-means-committee-adds-270-billion-deficits-repealing-estate-tax>

<sup>58</sup> Office of Management and Budget, *Table 2.5, Composition of Other Receipts*; <http://www.whitehouse.gov/omb/budget/Historicals>.

<sup>59</sup> Joint Committee on Taxation, "Description of HR. 1105, The "Death Tax Repeal Act of 2015"," March 25, 2015, Pg 13; <https://www.jct.gov/publications.html?func=startdown&id=4760>

<sup>60</sup> Congress.Gov, H.R. 1105 - Death Tax Repeal Act of 2015, April 16, 2015;

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[https://www.congress.gov/bill/114th-congress/house-bill/1105?q={%22search%22%3A\[%22%22hr1105%22%22\]}&resultIndex=1](https://www.congress.gov/bill/114th-congress/house-bill/1105?q={%22search%22%3A[%22%22hr1105%22%22]}&resultIndex=1)

## Application of Principles of Good Tax Policy

The following section will briefly analyze the existing Estate Tax law using the ten principles of good tax policy outlined in the AICPA Tax Policy Concept Statement No. 1: Guiding Principles of Good Tax Policy: A Framework for Evaluating a Tax Proposal.<sup>61</sup>

Criteria	Does The Proposal Satisfy the Criteria?	+/-
<p>Equity and Fairness –</p> <p>Similarly situated taxpayers taxed similarly</p>	<p>There are two kinds of equity - horizontal equity and vertical equity. As per horizontal equity, similarly situated taxpayers should pay the same amount of tax. For vertical equity, taxpayers with greater ability to pay should pay more tax.</p> <p>Under the estate tax, two similarly situated taxpayers with the same amount of estate value would generally pay the same amount of the estate tax. Accordingly, the estate tax meets the principle of horizontal equity.</p> <p>With regards to vertical equity, the estate tax is one of the most progressive taxes in the federal tax system because of the high exemption limit and the graduated rate structure. It is based on the value of the taxable estate. The estate tax only affects the wealthy taxpayers and has no impact on middle income or low income taxpayers; if the estate of a taxpayer is of significant value, the taxpayer would have to pay higher amount of estate tax and vice-versa. Accordingly, the estate tax meets the principle of vertical equity. However, taxpayers may do a lot of planning, which can result in the reduction of the taxable estate of the decedent, thereby reducing the estate taxes. This violates the principle of vertical equity since large estate taxpayers, with the help of planning, will pay low or no estate taxes.</p>	<p>+ for horizontal equity</p> <p>+/- for vertical equity</p>
<p>Certainty –</p> <p>The tax rule should</p>	<p>The estate tax law clearly specifies the exemptions limits, slab rates, filing of return and payment of taxes within nine months after the date of death and all the relevant</p>	<p>+/-</p>

<sup>61</sup> Shaping a Better Tax System, AICPA's Tax Reform Center; <http://www.aicpa.org/Advocacy/Tax/Pages/TaxReform.aspx>

<p>clearly specify when the tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined</p>	<p>instructions. It also lists the amounts to be included and deductions to be claimed to compute the taxable estate. Thus, the estate tax is certain to this extent.</p> <p>However, a taxpayer may not know for certain that his estate would owe any taxes after his death, because the tax base for estate tax is typically the market value of the property left by the deceased person on the day of death. Additionally, the valuation of certain assets such as business interests, artwork and antiques would be challenging and not as simple as valuing cash or publicly traded securities. This increases the uncertainty in determining the total value of the estates.</p> <p>Moreover, the timing of the estate tax depends on the death of a taxpayer. The estate tax base also cannot be determined until death. Therefore, the estate tax is uncertain to that extent.</p>	
<p>Convenience of Payment –</p> <p>A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer</p>	<p>The estate tax is due after the death of a person. However, wealthy taxpayers subject to estate tax would owe a huge amount of tax. It might be inconvenient to pay such large amounts of tax at once. In some cases, the estate may need to liquidate the assets to facilitate the estate tax payment. This would make the tax payment inconvenient.</p> <p>There is an exception whereby small businesses and farmers can pay the estate tax over a period of 10 years.<sup>62</sup> This would make the estate tax payment convenient for small businesses and farmers who may not have enough liquid assets to easily pay any applicable estate tax.</p>	+/-
<p>Economy in Collection –</p> <p>The costs to collect a tax should be kept to</p>	<p>Every tax involves some amount of compliance cost, and the estate tax is no different. The tax administration and the taxpayer have to invest huge amount of time, effort and cost.</p>	-

<sup>62</sup> Internal Revenue Code, § 6166 - Extension of time for payment of estate tax where estate consists largely of interest in closely held business

<p>a minimum for both the government and taxpayers</p>	<p>The executor of the estate has to have the property valued, which involves time and cost. Additionally, taxpayers spend substantial amount of money towards estate tax planning. Lawyers and accountants spend a lot of time in developing tax minimization strategies. Further, some of the taxpayers might think that they will owe an estate tax, and hence they spend money on estate planning. Later, if they do not owe any estate tax, all the money spent is a waste. Accordingly, the cost to collect estate tax is not a small amount for the taxpayer and the tax administration.</p>	
<p>Simplicity -  Tax law should be simple so that taxpayers understand the rules and can comply with them correctly and in a cost-efficient manner</p>	<p>Computation of the estate tax is not a simple task for the executor of an estate. It is difficult for a taxpayer to understand and comply with it.</p> <p>Computing the estate tax involves complicated calculations, such as inclusion of gifts transferred during the lifetime of the deceased, determination of various deductions which could be claimed by the deceased, and valuation of the property left by the deceased person as on the date of death. The base estate tax return (Form 706) is 31 pages long (not including any potential attached schedules or forms). Due to its complexity, it is difficult for someone other than a tax accountant to prepare the estate tax return. Additionally, it involves a lot of record keeping by the decedent and the heir. In view of the above, the estate tax law is complicated for the taxpayers to understand and comply on their own; which might lead to calculation errors.</p>	-
<p>Neutrality -  The effect of the tax law on a taxpayer's decisions as to how to carry out a particular transaction or whether to engage in</p>	<p>The estate tax influences a taxpayer's decision in a couple of ways. It affects the taxpayer's decision regarding how much they should save, invest and donate to charity and when to sell the appreciated assets.</p> <p>Because a taxpayer gets a complete deduction for charitable contributions, they would be influenced to donate more to charity to reduce their taxable estate and</p>	-



<p>a transaction should be kept to a minimum</p>	<p>thereby fall in a lower estate tax bracket. Various studies have found that there is a correlation between the estate tax and the amount of charitable giving.<sup>63</sup></p> <p>The estate tax also encourages a person with large estates to make exempt gifts each year and reduce the amount of the estate tax liability on their death. For the year 2015, a gift of \$14,000 or less received per recipient from a single person is exempt from tax.<sup>64</sup> Certain gifts are completely exempt from gift tax such as gifts given to spouses who are US citizens; gifts paid directly to a medical provider towards another's medical expenses or gifts paid directly to a college or university towards tuition expenses for someone else.<sup>65</sup> All of the above would reduce the amount of estate tax owed on the death of the estate holder.</p> <p>Based on the above arguments the estate tax influences the decision of a taxpayer to great extent. Hence, the estate tax does not meet the principle of neutrality.</p>	
<p>Economic Growth and Efficiency –</p> <p>The tax rules should specify when the tax is to be paid, how it is to be paid and how the amount to be paid is to be determined</p>	<p>The estate tax has different impact on different types of taxpayers.</p> <p>Due to the estate tax, some taxpayers might save less and would not be willing to invest and grow their money. This might be the case with small farmers and businesses. Therefore, there would be less capital available in the economy. To this extent, the estate tax does not meet the principle of economic growth and efficiency.</p> <p>However, some taxpayers might not react similarly. Even if the estate tax is likely, they would try to grow their business and invest more money. They would want to earn more money to offset the taxes paid to the government. Consequently, estate tax promotes economic</p>	<p>+/-</p>

<sup>63</sup> Robert McClelland and Pamela Greene, "The Estate Tax and Charitable Giving," Congressional Budget Office, July 2004, <https://www.cbo.gov/publication/15823?index=5650>

<sup>64</sup> Internal Revenue Service, Frequently Asked Questions on Gift Tax, November 2, 2015; <https://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Frequently-Asked-Questions-on-Gift-Taxes>

<sup>65</sup> Internal Revenue Code, § 2503(e) - Exclusion for certain transfers for educational expenses or medical expenses

	<p>growth and efficiency.</p> <p>It is inconclusive whether the estate tax increases or reduces the productive capacity of the economy. A Congressional Service Report has also mentioned that it is unclear whether estate tax increases economic growth or impedes it.<sup>66</sup></p>	
<p>Transparency and Visibility –</p> <p>Taxpayers should know that the tax exists and how and when it is imposed upon them and others</p>	<p>Taxpayers are aware that the estate tax exists. The taxpayers know that on death if the estate value exceeds the exemption limits then they have to pay the estate tax. The taxpayers would not know the exact amount of the estate tax they will owe.</p> <p>The estate tax is one of the very important political and economic topics. Any changes that affect the estate tax liability would be known to the public. As a result, the estate tax is transparent and visible to the taxpayers.</p>	+
<p>Minimum Tax Gap –</p> <p>A tax should be structured to minimize non-compliance</p>	<p>As mentioned above the estate tax is complex because of which the taxpayers might make accidental or unintentional errors. Additionally, taxpayers hire lawyers or accountants to develop tax minimization strategies to evade the estate tax. This has led to significant loss of revenue.</p> <p>There would not be a situation where the taxpayer would fail to file an estate tax return. It is clear that the tax has to be paid after a person dies. Accordingly, every estate will file the estate tax return.</p>	+/-
<p>Appropriate Government Revenues –</p>	<p>The government would be able to determine how much estate tax revenue would be collected in the future years. The Joint Committee of Taxation Report has predicted</p>	+

<sup>66</sup> Jane G. Gravelle and Donald J. Marples, “Estate and Gift Taxes: Economic Issues,” Congressional Research Service, November 27, 2009

<p>The tax system should enable the government to determine how much tax revenue will likely be collected and when</p>	<p>the amount of estate tax revenue collected for next 10 years is \$270 billion.<sup>67</sup> It also provides break-up of tax collection for each year. Accordingly, the government is able to determine the amount of tax they can collect over a specific period of time.</p>	
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<sup>67</sup> Joint Committee on Taxation, "Description of HR. 1105, The "Death Tax Repeal Act of 2015"," March 25, 2015, Pg 13; <https://www.jct.gov/publications.html?func=startdown&id=4760>

## Conclusion

Based on the above analysis, the existing estate tax law does not completely meet all the principles of good tax policy. It satisfies one of the most important principles, that of equity. Additionally, the estate tax also meets the principles of transparency, visibility and appropriate government revenues. The estate tax partially meets the principle of certainty, convenience of payment, economic growth, and efficiency and minimum tax gap. The estate tax fails to meet the principle of economic collection, simplicity and neutrality.

Based on the above, there are certain shortcomings of the current estate tax law, and it should be reformed in the light of these principles. Two of the major principles which should be improved are the principle of simplicity and economy of collection. The revenue collected from estate tax is not justifiable to the amount of time, cost and effort spent by the tax administration and the taxpayer. The cost involved in estate planning is significant. As the collected amount is small, Congress should try to simplify the tax laws.

Congress should consider strengthening the estate tax because tax laws are being misused by the taxpayers to elude estate tax. The law related to the estate tax has been drafted very loosely, and leads to misuse and tax avoidance. Instead of proposing to repeal the estate tax under the H.R. 1105, Congress should consider making some major reforms to the existing estate tax law. In considering to completely repealing the estate tax law, Congress should make major changes in other related tax laws. It should also get rid of the stepped-value in the basis of a property when it is transferred by the deceased. The basis of the property to the heir should be the basis of the deceased. This could effectively serve the main purpose of the estate tax.

Taxes reduce a taxpayer's saving and consumption. At the same time, taxes are essential for a civilized society. With the increasing federal deficit, the government has to take measures to reduce the tax expenditures and increase the revenue raised. Estate tax is an important source of tax revenue for the government, and helps to maintain the equal distribution of wealth in the society.

## IRS Developments and Examination

### Strategies

by Aaron Grey

A panel of seven current and former IRS employees spoke about the state of the Internal Revenue Service today. This panel accumulated more than 100 years of combined experience with the IRS. The non-current IRS group consisted of Pat Chaback, Executive Director with Ernst & Young; Eli Dicker, Executive Director of Silicon Valley TEI; Larry Langdon, Partner with Mayer Brown, and Andy Mattson, Partner with Moss Adams. Tony Shabazz, Territory Manager; Gloria Sullivan, Assistant to the GHW Global High Wealth Director; and Nora Beltran, Large Business & International Territory Manager represented the IRS.

Eli Dicker commenced the discussion illustrating the constraints and trends within the IRS. The IRS has reduced itself by over 3,000 employees in 2015 and 13,000 since 2010. “The biggest catalyst,” said Dicker, “is the budget.” The budget for 2015 in the IRS was \$10.9 billion, a 10% reduction since 2010’s \$12.1 billion figure. These cutbacks have led to reduced labor, forcing increased call center wait times, less manpower to facilitate audits, and a demand for automated processes. Pat Chaback commented, “the amount of work isn’t going away, but IRS employee resources are.” This was represented by a continuous increase of large business return filings inverted with a decrease of total IRS employees over the last five years. The workforce decrease includes “leaders with hundreds of years of experience moving on,” says Dicker, inhibiting the agency’s progress and knowledge transfer

capabilities. Not only are the budgetary issues leading to employee attrition, but the Service’s non-competitive salaries also make it difficult to recruit new talent to replace the old. Although new Silicon Valley agents are generally paid better than the ones in New York, the wages are still insufficient to attract replacements.

Another significant reduction within the budget was employee training, which has been cut by 74% since 2010. The IRS is presently implementing Lean Six Sigma and Just-In-Time training. These project management fundamentals allow employees to work more efficiently by minimizing wasteful or repetitive movements. The introduction of lean processes to the IRS workforce is crucial to alleviate the limited resources available for completing key tasks. But since “[the IRS] is so crunched in resources to roll out this vital training,” said Tony Shabazz, “[they] are forced to come up with innovative ways” to increase office productivity. As such, the Service is developing new technology and using data analytics to prioritize which companies to examine and to expedite the examination process itself.

The preceding issues yielded a necessary change to the IRS’s Large Business & International (LB&I) Division’s examination process. Nora Beltran claimed that these changes “place all taxpayers – big or middle-market companies—on the same level.” Significant changes to LB&I’s exam process include:

**Modification of Information Document Request (IDR) Enforcement process:** Covered under IRC §7602 (Examination of books and witnesses), IDRs allow the IRS to request financial and other information about the taxpayer, such as accrual forms, trial

balances, etc.<sup>68</sup> Previously, taxpayers who failed to comply with IDRs endured a series of deficiency notices and potentially summons to compel providing broadly-scoped information to the IRS. This previous enforcement process took an average of 140 days. With the modification, IRS experts are using data analytics and are narrowing the scopes of their summonsed information. Now, the IDR process time takes as little as 40 days.

**Piloting New Process for Coordinated Industry Cases (CIC):** CICs, as designated by the LB&I, are large business taxpayers that are generally more complex than other taxpaying entities. Qualifying as a CIC includes a certain level of gross assets, gross receipts, foreign assets, foreign taxes, and number of separate operating entities.<sup>69</sup> Those that do not qualify as CICs are ICs, or Industry Cases. Usually ICs take less than a year to examine, while CICs tend to be under continuous scrutiny.<sup>70</sup> The level of detail required by CIC examinations mandates large teams of revenue agents, which could otherwise be used examining smaller ICs and other taxpayers. Therefore, it became necessary to properly differentiate CICs from other cases. The CIC pilot, which occurred from April 2014 to October 2015, created an ongoing process to classify taxpayers as either CICs or ICs, compared to their static classification process in the past. The evolving classifications allow LB&I to prioritize their resources to the more frequent issues.

<sup>68</sup> <https://www.irs.gov/Businesses/Corporations/Large-Business-and-International-Directive-on-Information-Document-Request-Enforcement-Process>

<sup>69</sup> Internal Revenue Manual §4.46.2.5.

[https://www.irs.gov/irm/part4/irm\\_04-046-002.html](https://www.irs.gov/irm/part4/irm_04-046-002.html)

<sup>70</sup> The Tax Adviser.

<http://www.thetaxadviser.com/issues/2014/jun/clinic-story-04.html>

**Creation of Issue Practice Groups (IPGs) and International Practice Networks (IPNs):** Replacing Tiered Issue Process, which broadly addressed tax shelter issues, IPGs and IPNs are subject matter expert (SME) teams designated to handle specialized areas of tax.<sup>71</sup> A few examples of IPG and IPN experts include Business Credits, IRC Section 263A, Penalties, Accounting Methods, Offshore Arrangements, and Transfer Pricing. The scope of IPGs and IPNs are domestically-focused and internationally-focused, respectively. Rather than classifying an LB&I issue by severity (as done under the Tiered Issue regime), an issue would be classified to one of the IPG/IPN categories and managed by the team with expertise in that particular topic. By referring similar cases to the same panel of experts, “these SMEs gain consistent handling of cases,” said Gloria Sullivan.

The IRS and its LB&I Division must continuously implement these types of initiatives to reconcile their ever-decreasing budget and resources. For true progress to be made, talented individuals—those possessing both “project management skills and tax law expertise,” states Shabazz, need to heed the agency’s call. This niche group of talent, however, desires reasonable compensation for their capabilities. Unless Congress can meet in the middle with this talent pool, it may be difficult for the Internal Revenue Service to stay on track with their audit requirements.

<sup>71</sup> LB&I Memorandum.

<https://www.irs.gov/Businesses/Corporations/Tiered-Issues>

## **Cloud Activities and Issues under IRC Sections 41 and 199**

By Marina Pinato, *MST Student*

In a relatively short amount of time, cloud computing has seen substantial growth, and the demand for cloud services continues to increase, due to its convenience and low cost of operation. As more vendors and startups offer services on the cloud (also known as SaaS, Software as a Service), the more complex it is to understand where these services fit in the tax world.

At this year's 31<sup>st</sup> Annual High-Tech Tax Institute, Kevin Dangers, Partner at EY, and Rob Kovacev, Partner at Steptoe and Johnson, informed the attendants about issues that cloud companies are facing under Sections 41 and 199. The two presenters talked about updates in the two sections, proposed IUS (internal-use software) regulations, and IRS exam advice. These represent important topics for the tax directors of Silicon Valley companies.

### IRC §199 Issues

Software companies are eligible to claim IRC Sect. 199 deductions if its DPGR (Domestic Product Gross Receipts) are derived from the lease, rental, license, sale, exchange, or other disposition of computer software made in the US. Online services are explicitly not included in the Code which gives rise to the question whether or not SaaS is really a service. As of now, online software companies can claim a deduction if they can find an equivalent third-party tangible software product either in whole or by feature via the shrink back rule.

While industry is complaining about this artificial barrier between online services and other software products, the IRS, with its limited resources, is likely to take the path of least resistance in the new Software Guidance Project and perhaps exclude online services outright.

### Expiring Research Credit and Proposed IUS Regulations

In terms of the Research Credit, it expired at the end of 2014. Congress has a bad reputation for letting this credit expire and then extending retroactively many times over the years. This makes it difficult for tax directors to plan their estimated liabilities when they do not know whether this credit will be around. Currently there are talks of making the research credit permanent but no agreement has been reached. However, the expectation is that the credit will be extended as it has been in the past.

Earlier this year, the IRS issued proposed regulations relating to the eligibility of IUS to be included in the research credit. It defines IUS to include software that is developed in-house to be used for internal purposes only, and not for commercial or third-party purposes. It needs to meet the four-part test laid out in IRC Sect. 41 as well as the three-part High Threshold of Innovation. The effective date is not yet known but the proposed regulations are applied prospectively from January 16, 2015.

### IRS Exam Advice

The IRS is an important consideration when claiming Section 199 deductions and research credits. Research credits are a hot audit item and the IRC Sect. 199 deduction is being looked at more closely these days. It is positioning companies on the defensive when they are dealing with exam agents without sufficient knowledge regarding their operations and are receiving conflicting guidance from National Office and Field Counsel. The speakers' advice in dealing with R&D/199 cases is to get substantiation in order before the audit; arrange a presentation for the exam team regarding the nature of the business and potential issues they could focus on; and suggest simple techniques such as sampling to get around voluminous document requests. If taken to court it is more favorable to choose the district court as they will likely have greater software knowledge than the tax court.

In their conclusion, the speakers appeared cautiously optimistic for the future of deductions and credits on SaaS companies. There are bills in the House and Senate that

would allow a credit to offset the AMT (Alternative Minimum Tax); the research credit is likely to be extended in 2016 for 2015; and the OECD (Organization for Economic Cooperation and Development) is essentially blessing R&D credits and incentives in the U.S. which is a good thing for R&D.



## A Panel Discussion of Recent Developments in State Tax Reform

By: Leonel Renteria

There have been interesting current developments in the area of state tax reform. The presentation, “State Tax Reform—Tax Havens, Transfer Pricing, and More,” at the 31<sup>st</sup> Annual TEI-SJSU High Tech Tax Institute addressed recent state legislation on tax havens and transfer pricing. Brian Pederson, Managing Director with Alvarez & Marsal Tax; Rob Weyman, Senior Associate with Reed Smith; and Annette Nellen, Professor and Director of San José State University's graduate tax program led the panel discussion.

Brian Pederson began the presentation with a discussion on “tax haven” legislation. Several states and the District of Columbia have recently passed laws targeting corporations with tax haven affiliates.<sup>72</sup> These states are targeting after multi-national corporations by expanding the combined filing group requirements to include entities incorporated in jurisdictions with minimal or no taxes. By expanding the unitary group for tax filings purposes, these states are seeking to reach beyond the water’s edge and broaden the income base and apportionment factors. These new rules generally take two approaches: the “Blacklist” approach or the Multistate Tax Commission (MTC) approach.<sup>73</sup>

Under the “Blacklist” approach, states identify a list of “tax haven” jurisdictions. For example, Oregon includes 44 jurisdictions in its “Blacklist,” including favored tax planning jurisdictions such as the Cayman Islands and Bermuda. Generally, these rules will look to a multinational’s jurisdiction of incorporation and that of its affiliates and subsidiaries. A corporation deemed to be doing business in a “Blacklist” jurisdiction must include the income and apportionment factors of these affiliates or subsidiaries in its state consolidated water’s edge return.

Under the MTC approach, similar to that of the Blacklist regime, its purpose is to expand a unitary business combined group for state tax reporting, similar to that of the Blacklist regime. However, this method relies on the “tax haven” definition outlined in the Multistate Tax Compact rather than a list of jurisdictions. The MTC defines a “tax haven” as a jurisdiction that has no or nominal effective tax or relevant income *and*:

- I. has laws or practices that prevent effective exchange of information for tax purposes with other governments on taxpayers benefiting from the tax regime;
- II. has a tax regime which lacks transparency;
- III. facilitates the establishment of foreign-owned entities without the need for a local substantive presence or prohibits these entities from having any commercial impact on the local economy;

<sup>72</sup> Enacted legislation: AK, CT, MT, OR, RI, WV, DC; proposed legislation: AB, KY, MA, NH

<sup>73</sup> Pederson, Brian. “State Tax Reform—Tax Havens, Transfer Pricing, and More.” 31<sup>st</sup> Annual TEI-SJSU High

Tech Tax Institute. Crown Plaza Hotel, Palo Alto, CA. 10 Nov. 2015. Conference Presentation.

- IV. explicitly or implicitly excludes the jurisdiction's resident taxpayers from taking advantage of the tax regime benefits or prohibits enterprises that benefit from the regime from operating in the jurisdiction's domestic market; or
- V. has created a tax regime which is favorable for tax avoidance, based upon an overall assessment of relevant factors, including whether the jurisdiction has a significant untaxed offshore financial or services sector relative to its overall economy.<sup>74</sup>

A taxpayer who is a member of any unitary group doing business in a locality that meets the definition of tax haven jurisdiction will be subject to these statutes.

This category of legislation is not new; Montana passed similar laws about a decade ago. However, these laws have been receiving increased attention from multiple stakeholders due to their aggressive stance considered by many to be adverse tax treatment of multinational corporations. Whereas some view these laws necessary to recoup lost revenue due to corporations stashing profits in low tax jurisdictions, others see it as an attack on businesses and poor tax policy. As Mr. Peterson commented, many questions, for instance on the constitutionality and commerce clause implications, linger and might have to be addressed by the courts.

Some states have also shifted focus to transfer pricing taxation. Presenter Rob Weyman with law firm Reed Smith in

Philadelphia continued with a brief discussion on the transfer pricing (“TP”) environment. For multi-jurisdictional corporations and entities, transfer pricing is a settled tax issue at the federal level under I.R.C. §482. However, at the state level, the development and application of transfer pricing taxation appears to be in its rudimentary stage. As Mr. Weyman commented, states are looking for money without raising taxes. Since states have §482-like powers they are increasing scrutiny primarily by increasing the number of audits and expanding categories of transactions subject to examination. Nevertheless, states are challenged due to the difficulty in developing and implementing sound transfer pricing tax policy and lack of resources at the state level for this purpose.

To illustrate his point, Mr. Weyman provided several examples in state transfer pricing controversies that did not bode well for the states. In New Jersey, the Director of Taxation terminated a multi-million dollar contract that involved performing transfer pricing analysis citing taxpayer resistance. Kentucky’s Department of Revenue declined to renew its third-party contract for transfer pricing audit assistance even though no assessments were issued and no taxes had been collected. This was in great part due to the controversy and apparent conflict-of-interest of using third-party auditors contracted on contingency fee basis.

In the District of Columbia, the transfer pricing case *Microsoft Corp. v. Office of Tax and Revenue* is illustrative of the inherent problems with states adjudicating transfer pricing transactions absent sound policy.<sup>75</sup> In

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<sup>74</sup> *Ibid* pg. 4-10.

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<sup>75</sup> *Microsoft Corp. v. Office of Tax and Revenue*, District of Columbia Office of Administrative Hearings, No. 2010-OTR-00012, May 1, 2012.

this case, Microsoft's deficiency notice by the Office of Tax and Revenue ("OTR") was reversed. OTR contracted a third party, Chainbridge Software, to conduct a transfer pricing audit. The taxpayer filed for summary judgment arguing the Chainbridge method: (1) violated federal §482 regulations and (2) failed to properly reconcile tax accounting with financial accounting.<sup>76</sup> The District of Columbia Office of Administrative Hearings (OAH) found that the third party's transfer pricing study was arbitrary and wholly unreasonable. Given the overwhelming rejection of state's use of third-party contractors, it is not farfetched to think several transfer pricing cases on appeal with the D.C. OAH will be ruled on in the same manner.

Mr. Weyman emphasized that there are some inherent problems in states going after transfer pricing adjustments. Many, if not most, do not have the resources, the professional expertise or an assigned and dedicated staffed department for studying these specific types of transactions. The Microsoft case highlighted some of the challenges state tax authorities must grapple with when delving into a new tax territory.

Professor and Director of San José State University's graduate tax program, Annette Nellen, finished the panel presentation with an update on other state tax reform topics. She listed and commented on several bills in Congress on state tax reform topics including: broadening the sales tax base, lowering income taxes and increasing sales tax, accountability measures and evaluating incentives, worker classification clarification and enforcement, getting ready

<sup>76</sup> Weyman, Rob. "State Tax Reform—Tax Havens, Transfer Pricing, and More." 31<sup>st</sup> Annual TEI-SJSU High Tech Tax Institute. Crown Plaza Hotel, Palo Alto, CA. 10 Nov. 2015. Conference Presentation.

for possible enactment of Marketplace Fairness, and taxing marijuana. Another state tax reform concern is whether the Supreme Court will revisit its decision in *Quill Corp. v. North Dakota*.<sup>77</sup> In this case, the Supreme Court ruled that a taxpayer must have a physical presence in a state in order to require collection of sales or use tax for purchases made by in-state customers.<sup>78</sup> Given the rise of technology, internet sales and ecommerce, it has been posited that the decision in *Quill* will be revisited soon. Certainly, in the arena of state tax policy the implications would be significant.

Many state legislatures are adopting more active and defensive tax policies against multi-national corporations. This will continue to have an effect on state tax planning and compliance issues. As highlighted in the presentation, "State Tax Reform—Tax Havens, Transfer Pricing, and More" tax policies at the state level will continue to enter new realms and will require further study and analysis. The High Tech Tax Institute offers the opportunity for professionals with expert knowledge in their respective areas to contribute to the understanding of the state tax realm.

<sup>77</sup> *Quill Corp. v. North Dakota* (91-0194), 504 U.S. 298 (1992)

<sup>78</sup> Atkins, Chris. "Important Tax Cases: Quill Corp. v. North Dakota and the Physical Presence Rule for Sales Tax Collection." Taxfoundation.org. Tax Foundation. 19 July 2005. Web. 21 Nov 2015.

## **The *Altera* Case: Tax Ramifications of Stock-Based Compensation**

By: Sandhya Dharani, MST Student

Stock-based compensation (SBC) serves as a popular tool to complement cash-based compensation by incentivizing entrepreneurs, executives, employees and independent contractors by aligning their interests towards corporate performance and goals. On the downside, corporations have to navigate the complex FASB guidance of Accounting Standards Codification (ASC) 718 (formerly SFAS No. 123(R)) to recognize, measure and disclose SBC in corporate financial reports – including implications on earnings per share and cash flow statements. Additionally, these rules have implications in income tax compliance, accounting for income taxes and transfer pricing. This was the subject of discussion in the Accounting for Incomes Taxes session at the 31<sup>st</sup> Annual TEI-SJSU High Technology Tax Institute. The esteemed speakers Tom Dong, Partner with Deloitte Tax LLP, Louis Gomes, Partner with BDO US, LLP and Dean Kamahale, Principal with KPMG LLP, underscored the tax complexities of SBC that resulted from FASB guidance and the IRS rules and regulations. This article mainly covers the recent developments of SBC of in the context of transfer pricing and its potential implication to corporate taxpayers.

### ***Altera* Vs. IRS: Highlights**

The focus of the session was the *Altera* case involving cost sharing of SBC between related parties, where *Altera* prevailed against the

IRS.<sup>79</sup> The Tax Court’s unanimous decision (15-0) invalidated the Service’s cost sharing regulations issued in 2003 that required corporations engaged in cost sharing agreements (CSA) with foreign affiliates to share SBC expenses among the parties.<sup>80</sup> In building its argument, *Altera* relied on a number of items of evidence, including those presented in the 2003 regulation’s rule-making process. The focus of *Altera*’s arguments was that unrelated parties would not share the costs of SBC with each other (i.e., essentially, the arm’s-length standard). This arm’s-length standard was not included in the creation of the 2003 regulations.

The arm’s-length standard is the foundation of Internal Revenue Code §482 and its underlying regulations, as well as in tax treaties. The IRS failed to take into account this third party comparable data in the enactment of the 2003 regulations and the Service argued that this standard should, theoretically, not be a determining factor for the inclusion of SBC in CSAs. In this regard, the Court dismissed the Service’s argument by pointing out that the preamble to the final rule did not justify the final rule to deviate from the arm’s length standard. Further, the Court determined that the 2003 regulation was a legislative rule because it has the force of law and thus it was subject to the “reasonable decision making” standard under §553 of the Administrative Procedures Act (APA).<sup>81</sup> The Tax Court held that the IRS violated the APA since the 2003 regulation was based on economic theories rather than on a factual basis and “was contrary to evidence presented to Treasury during the rulemaking process.” By disconnecting themselves from the facts found and ignoring significant comments

<sup>79</sup> *Altera Corp. v. Commissioner*, 145 T.C. 3 (2015)

<sup>80</sup> Treasury Regulation § 1.482-7(d)(2)

<sup>81</sup> §706(2)(A) APA

during the rulemaking process of the 2003 regulations, the Tax Court concluded that the IRS failed to satisfy the reasoned decision making standard under U.S.C. §706(2)(A) and Motor Vehicle Manufacturers' Association of the U.S. v. State Farm Mutual Auto Insurance Co., 463 U.S. 29 (1983).

Nevertheless, the decision to invalidate the 2003 regulation is not final until 90 days after the decision is entered. The IRS can acquiesce the Court decision or appeal the decision entered by the Tax Court during the 90-day period. If the IRS chooses to appeal, the decision is not final until the appellate court renders its final decision. The panel said, "The decision may take years to be resolved on appeal." As of the presentation the IRS extended the 90-day period and was negotiating for final settlement with *Altera*.

### Implications of the Case

Pre-*Altera*, most U.S. taxpayers with CSAs shared SBC costs to comply with the existing regulations and had Clawback clauses in their CSA contracts. Clawback clauses usually provide that the U.S. party to the CSA will repay prior SBC cost-sharing reimbursements if and when there is any relevant change in laws (i.e. IRS withdrawing the 2003 regulations or the U.S. Supreme Court invalidating the 2003 regulation). As of the date of the presentation the *Altera* decision was appealable and was not yet a final decision. All things considered, taxpayers must evaluate and take steps in considering the *Altera* opinion in the tax return and financial statement reporting purposes. There are three possible approaches that a taxpayer can undertake:

1. The U.S. participant to a CSA should consider the entire clawback payment in the current year tax return and not file the amended tax returns;

2. The U.S. participant to a CSA should file the amended tax return for the open years they received the recharge payment from their foreign affiliates; or
3. If there is a provision in the CSA, the U.S. participant to CSA can treat the overpaid portion of prior cost-sharing payments as advance credits for the current or future cost-sharing payments.

The first approach might cause taxpayers to incur an accuracy-related penalty for taking a tax position contrary to a regulation.<sup>82</sup> To avoid these penalties, the taxpayer should challenge the validity of the regulation in good faith, that the contrary position has a realistic possibility of being sustained on its merits and the position is disclosed on a Form 8275-R, Regulation Disclosure Statement (attached to federal tax return). The EPS and operating cash flows for the current year could produce abnormal results under this approach.

The second approach might not be possible since Treasury Regulation § 1.482-1(a)(3) prohibits any taxpayer-initiated transfer pricing adjustment for prior years that results in reduced U.S. taxable income. If this adjustment does not involve an "after-the-fact tax planning or fiscal evasion or is otherwise inconsistent with sound tax administration," then corporations might be able to circumvent the prohibition and self-initiate an adjustment on the basis of an invalidated regulation.<sup>83</sup> Taxpayers should consider the statute of limitations and any closing agreements in place with IRS in evaluating amendments of any open year tax returns. The approval of the Joint Committee on Taxation might be essential for amending past returns.

<sup>82</sup> Treasury Regulation §1.6662-3(b)(2) and §1.6662-3(c)(2)

<sup>83</sup> Notice 2013-78

Tom Dong illustrated the implication of the ruling on provisions for income tax with the following example: U.S. Parent (USP) historically received \$100 of income per year from charging out to its Controlled Foreign Corporation (CFC). Taking the *Altera* position, the USP should have \$100 less income, which could create a \$100 current year loss that can be carried forward to offset future taxable income. A deferred tax asset (DTA) account of \$40 (assuming a 40% statutory tax rate) and a full valuation allowance of \$40 would be created to offset the DTA. The DTA would vary depending on the method applied by the corporation and it should choose and consistently apply that one method. Uncertain tax positions should be recognized and measured based on FIN48 rules. The USP would have more foreign-sourced income and consequently the USP might be able to fully utilize its creditable foreign taxes paid from increased foreign tax credit limit.<sup>84</sup> Correspondingly, APB23 on Indefinite Reinvestment of Earnings is triggered upon the increase of offshore cash.

Absent a reversal on appeal, the *Altera* opinion has broader implications for matters involving the validity of the regulations issued by Treasury Department. Taxpayers may be more tempted to challenge regulations if they believe they do not reflect reasoned decision-making supported by empirical evidence. For instance, taxpayers could rely on the *Altera* decision to invalidate Treasury Regulation § 1.482-9(j) that requires a service provider to charge a portion of its SBC to a service recipient in intercompany transactions. Similarly, repercussions of the *Altera* case could have its reach in other areas of tax, such as in base erosion and profit shifting (BEPS)

initiatives by the Organization for Economic Cooperation and Development (OECD) where certain proposed rules were criticized by corporations for lacking empirical evidence.

To conclude, *Altera* has provided a landmark victory for taxpayers. Taxpayers should take decisions cognizant of future developments in the SBC area.

<sup>84</sup> §904 (a)

Foreign Source Taxable Income	x	Tentative U.S. Tax Liability	=	FTC Lin
Worldwide Taxable Income				

## Tax Maven

### *The Contemporary Tax Journal's Interview of Eli Dicker*

**By: Shruti Raja, MST student**

Eli J. Dicker is Executive Director of the Tax Executives Institute, Inc. He previously served as TEI's Chief Tax Counsel. Prior to joining TEI, Mr. Dicker led the Tax Accounting and Reporting function at Capital One Financial Corporation, overseeing federal and state tax accounting, reporting and compliance. Mr. Dicker's prior experience also includes service as a tax principal with KPMG LLP and as an attorney-adviser and trial attorney in the Office of the Associate Chief Counsel (International) and Miami District Counsel office of the Internal Revenue Service.

Mr. Dicker holds BA, magna cum laude, and MA degrees (political science) from Queens College, City University of New York, a JD from Northeastern University School of Law and an LL.M. (Taxation) from New York University School of Law.

I had the pleasure of interviewing Mr. Dicker on November 9, 2015 during the two-day 31st Annual TEI-SJSU High Technology Tax Institute. During our conversation, Mr. Dicker shared a few of his experiences in the tax field and offered advice for MST students. Below are the questions asked and a summary of Mr. Dicker's responses.

***1. SJSU CTI: How did you get involved in the tax field? Was that your plan when you started law school?***

My attraction to the tax field was a natural extension of my elementary and secondary religious school education where I was regularly challenged to study Biblical texts and commentaries and then build cogent reasoning and persuasive conclusions often grounded on incomplete and even ambiguous statements or principles. I learned very early to "grapple with the gray," and that exposure led me to the tax field.

***2. SJSU CTI: What led you to the IRS and then to KPMG? What were your specialty areas?***

I became interested in international tax while in the LLM program at NYU. What ultimately became the Tax Reform Act of 1986 and its emphasis on the new foreign tax rules appealed to me. Around this time, the IRS Office of Chief Counsel created a new division devoted exclusively to international tax matters (regulations, rulings, examination support and litigation). The timing for me was perfect and I was fortunate to be hired. Over time, my interest in international tax expanded to international tax-related litigation. Again, I was fortunate to have an opportunity to work for then-International Special Trial Attorney Cindy Mattson, who was based in Washington. Subsequently, when I recognized the need for more seasoning in the courtroom, I was fortunate to secure a transfer to the IRS's Miami District Counsel office, where I worked (under the tutelage of Ellen Freiberg and Dave Smith) to further develop my tax litigation skills.

My transition to KPMG (and back to Washington) came at a time when professional service firms (the major accounting firms, primarily), looking to expand their tax controversy-related capabilities, were seeking practitioners with experience in this area. I joined the tax controversy practice in KPMG's Washington National Tax practice.

**3. SJSU CTI: *How did you come to be Chief Tax Counsel and then Executive Director of TEI?***

I was looking for an opportunity to combine my public and private sector tax practice experiences in the service of clients. Serving as Chief Tax Counsel and now as Executive Director, provides me with a unique opportunity to serve in-house tax professionals and focus on tax policy and legislative developments.

**4. SJSU CTI: *What do you think is the biggest challenge facing tax professionals today?***

For in-house tax professionals, my current client base, the overriding challenge is keeping current with all of the compliance, reporting and disclosure obligations that are coming at them from all sides, while still keeping in mind why they became tax professionals in the first place: the intellectual challenge of interpreting and applying complex and ever-changing taxing regimes.

**5. SJSU CTI: *What advice do you have for students preparing for a career in the tax field?***

Aspiring tax professionals will have spent a great deal of time in their academic programs focusing on the “case, Code and reg.,” aspects of their tax educations. However, non-technical skills, such as communication (in writing and orally), leadership, facilitation, teaming, among others, often do not get the attention that they deserve in formal curricula. Young professionals should look for ways to develop and refine these skills, whether as part of or outside of their employment situations.

***Fun Questions:***

**6. SJSU CTI: *If you could have dinner with anyone, who would it be?***

Anyone who knows me knows how much I love baseball, both as a spectator sport as well as a window into our country's history. So, if I could, I would love to have dinner with Josh Gibson and Jackie Robinson. Gibson died on January 20, 1947, just three months before Robinson became the first black player in modern major league history. Historians consider Gibson to be among the very best power hitters in the history of any league, while Robinson, when he started at first base on April 15, 1947 for the Brooklyn Dodgers, ended racial segregation in major league baseball.

**7. SJSU CTI: *What is the most unusual item in your office or something in it that has special meaning to you?***



Again, I return to my passion for baseball; the baseball containing the autographs from the '69 Miracle Mets is especially meaningful to me, a kid from Flushing, Queens.



Shruti Raja and Eli Dicker