Tax Reform:
Status, Needs & Realities

A conference sponsored by the Tax Executive Institute, Inc., SJSU Lucas Graduate School of Business – College of Business, and The State Bar of California; The Taxation Section, Tax Policy, Practice and Legislation Committee
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By: Kenny Cai Ng, *MST Student*

Introduction

The tax policy conference, "Tax Reform: Status, Needs, and Realities," was held on February 3, 2012 at Techmart in Santa Clara. During this all day conference, tax practitioners and government employees gathered to find out the latest on federal and state levels tax reform from the speakers and to share their ideas with each other. Because the conference was held in Silicon Valley, the emphasis was on the impact of tax reform on the high tech industries; however, individual tax reform proposals were also covered.

Ms. Annette Nellen, director of the *San José State University MST Program* and the conference, commenced the proceedings by introducing the representatives of the conference sponsors: Ms. Lorraine McIntire, President of the *Santa Clara Valley TEI Chapter*, and Ms. Cynthia Catalino, Chair of the *California Bar Tax Section's Taxation Policy Committee*. Ms. Nellen then conducted an initial polling, using clickers and instant polling software, to understand the demographics of the attendees, and gauge the audience's self-perceived understanding of the tax law. We learned that most of the attendees were natives of California; and about half were employed in corporate tax departments and most were lawyers or CPAs. When asked to rate their level of understanding of the federal tax law, 10% of the attendees said they understood it very well. A majority of the attendees also considered themselves as having a medium level of understanding of California's tax and fiscal system. The consensus coming from the attendees was that California's fiscal policy was "quite bad."

After the initial polling questions, Ms. Nellen overviewed the sessions of the conference. Highlights from these sessions are summarized in this section of the journal:

1. Tax Policy and Issues of Complexity.
2. Federal Tax Reform: Relevance for High Tech Industries.
3. Chairman Camp Proposal:Territorial, 25% and More.
4. California Tax Reform Proposals and Their Prospects.
5. Looking Forward.

Editor's note:

The 2012 Tax Policy Conference also included remarks of Assemblymember Jim Beall (now Senator), as well as a panel on considerations on the effect of federal tax reform on California. That program was presented by Mr. J. Pat Powers, Partner with Baker & McKenzie; Mr. Oksana Jaffe, Chief Consultant with the California Assembly Revenue & Taxation Committee; and Mr. Gregory Turner, Senior Tax Counsel with the Council on State Taxation (COST). The agenda and presenter materials from the conference can be found at the "history" link at http://www.tax-institute.com.

Tax Policy and Issues of Complexity

By: Lindsay Wilkinson, *MST Student*

One of the biggest challenges facing taxpayers today is the complexity of the Internal Revenue Code and related regulations. With tax reform as the over-arching theme of the day, Ms. Annette Nellen, director of *San José State University's MST Program*, set the tone as the first keynote speaker with her presentation on "Tax Policy and Issues of Complexity."

Ms. Nellen reiterated that "The tax law should be simple so that taxpayers understand the rules and can comply with them correctly and in a cost-efficient manner." Although altering the tax law to make it more simple, transparent, and administrable is no small task, there are principles of good tax policy that can be used to evaluate new tax proposals as well as the design of the system as a whole.

Of these ten principles, Ms. Nellen focused her presentation on the principle of simplicity. In addition to making it easier and less costly to comply with the law, a simple tax system reduces errors and builds respect for the laws and those who administer it. It is easy to get frustrated with the current tax system when the instructions for the 1040EZ alone are 40 pages long.

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So why is our tax system so complex and what can be done about it? Ms. Nellen suggested that first, politicians should stop using the tax law to remedy all problems and phase-out unnecessary special rules that either serve no purpose or can be addressed outside of the tax law. Next, Congress should stop enacting complicated provisions or multiple provisions with similar purposes. This includes overly complicated approaches to prevent possible abuses such as the kiddie tax and AMT. Lastly, lawmakers should always ask, "Is there a simpler way to accomplish what we are trying to do? Did we ask tax practitioners for their advice?"

Although the Tax Reform Act of 1986 was enacted to simplify the tax law by broadening the base and lowering rates, numerous new complicated provisions have convoluted the tax law in the last 25 years. However, by implementing the suggestions mentioned when creating or changing laws,Congress could have a lasting impact on the simplicity of the tax code. As a result, the amount of time and money taxpayers spend just to comply with the law could be reduced.

Federal Tax Reform: Relevance for High Tech Industries

By: Shadi Mahdinia, *MST Student*

Mr. Joshua Odintz, a partner with the law firm of *Baker & McKenzie*, and Mr. Michael Hauswirth, a tax counsel with the *House Ways and Means Committee* addressed the impact of federal tax reforms on high tech industries. Mr. Odintz's presentation covered the issues that are fueling momentum for tax reform and how the reform could improve the corporate tax system.

Mr. Odintz explained that high U.S. statutory and effective tax rates, the lockout effect of the worldwide system, complexity and uncertainty of the current system, and the perception that the U.S. system is an outlier are all factors that encourage tax reform. Together, these factors hamper U.S. competitiveness in the global market and reduce business income.

Past reforms brought major changes to U.S. corporate tax structure. For example, the "Economic Recovery Tax Act of 1981" (P.L. 97-34, 8/13/1981) and the "Tax Reform Act of 1986" (P.L. 99-514, 10/22/1986) reduced the corporate tax rates, accelerated the deduction for depreciation, and broadened the tax base. However, no major changes to corporate tax have been introduced since these laws were passed, and the top corporate statutory rate has remained at 35% since 1993. Meanwhile, other countries have reduced their rates so that the U.S. statutory rate is now higher than the average rate of the OECD countries, while the U.S. effective marginal and average rates are at or below the OECD average. Mr. Odintz emphasized that the high U.S. rate is a key driving force for corporate tax reform.

On business income, Mr. Odintz explained that the contribution of corporate tax receipts to total federal receipts has declined because business income has "moved out of corporations." Increasing number of U.S. businesses are structured as LLCs and other pass-through entities because they provide limited liabilities, a single layer of tax, and better tax incentives. Mr. Odintz added that, compared with other OECD countries, the U.S. has significantly greater number of pass-through entities with taxable income in excess of $1 million, thus creating the largest unincorporated business sector within the OECD.

Mr. Odintz noted that key reform proponents want corporate tax reform to be revenue neutral, simple, and separate from individual tax reform. It should change tax treatment of debt-finance investment, improve efficiency, and change incentives for investing overseas. As reform will potentially create winning and losing industries, he stressed that any reform must take these industries into consideration.

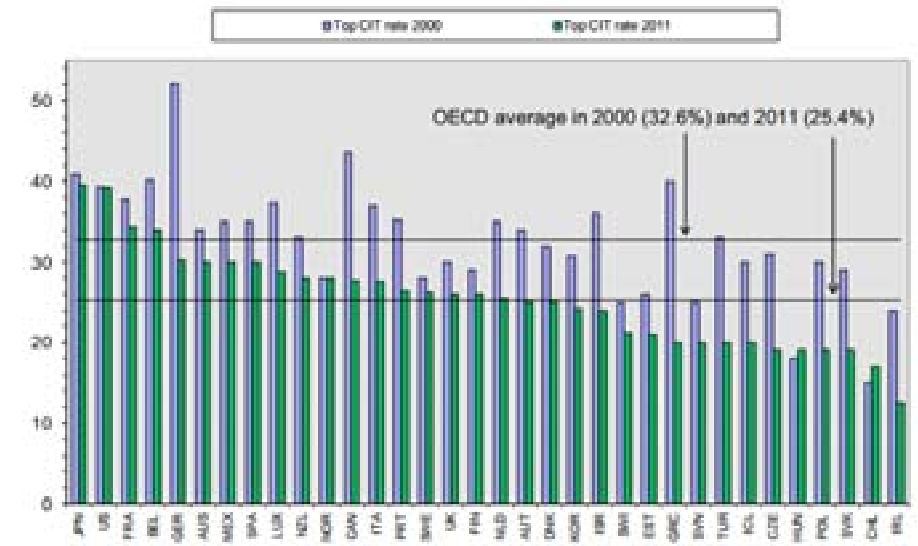

Figure 1 Statutory corporate income tax rates, 2000 and 2011 according to OECD. (2011, Jun. 30). Tax Reform Trends in OECD Countries. Paragraph 8. Retrieved from http://www.oecd.org/ctp/48193734.pdf

Another area Mr. Odintz discussed was Chairman Camp's discussion draft which outlines a 95% foreign dividend exemption, the provision of foreign tax credits for passive income, and retention of Subpart F. He also reviewed options to prevent base erosion such as taxing excess intellectual property returns as Subpart F income, taxing low tax cross-border income as Subpart F income, and combining U.S. patent box and Subpart F treatment of intangibles income.

As the final topic, Mr. Odintz explained key aspects of President Obama's insourcing proposals which are intended to reward companies that invest in or bring jobs into the U.S., and eliminate tax advantages for companies moving jobs overseas. If the proposals are enacted, there will be no deduction for outsourcing jobs, and multinationals will be required to pay a minimum level of tax.

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Chairman Camp Proposal: Territorial, 25% and More

By: Habiba Hussain, *MST Student*

In October 2011, the House Ways and Means Committee Chairman Dave Camp (R-MI) released an international tax reform discussion draft referred to here as the "Camp Proposal." In addition to presenting the highlights of the proposal, an expert panel overviewed the U.S. international tax policy framework and how it affects the behavior of U.S and foreign corporations. The panel was comprised of Mr. Mark Betker**,** Partner,*PwC LLP*; Mr**.** Christopher Haunschild, (then) Of Counsel, *DLA Piper*; and Mr. Mark Hoose**,** (then) Professor,*University of San Diego School of Law.*

The panel explained that the main tenets of tax policy are to tax income once as close to the source as possible, and that tax should be neutral – it should not influence decision making. These tenets are not currently present in the U.S corporate tax system.

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The Camp Proposal is intended to address some of these shortcomings. Highlights of the proposal include:

- Change from a worldwide to a territorial tax system in which all foreign source income is exempted from U.S. income tax. The U.S. is currently the only developed country with a worldwide tax system. In combination with the highest corporate tax rate, U.S. multinationals (MNCs) are at a disadvantage compared to their foreign competitors. The Camp Proposal offers an exemption from active foreign source income earned through controlled foreign corporations (CFC) and foreign branches.
- Reduce the corporate tax rate to 25%, which is important for companies that earn their income in the U.S.
- Introduce a dividend received deduction (DRD) where 95% for foreign-source dividends of a CFC received by domestic corporate shareholders is exempted provided the domestic shareholders satisfy a one year holding requirement of the CFC shares.
- Modify Subpart F by repealing IRC §§956 and 959 on previously taxed income (PTI). Instead, PTI dividends eligible for 95% DRD would be taxed at 1.25%.
- Implement transitional rules to tax accumulated deferred foreign earnings of CFCs at a 5.25% rate. U.S. shareholders would be allowed to pay any U.S. tax on its Subpart F income in equal annual installments over two to eight years with interest.
- Introduce a "Thin Capitalization Rule" that would deny U.S. shareholders a deduction for interest expenses if two tests are not met: the Relative Leverage Test (RLT) and the Percentage of Adjusted Taxable Income (ATI) Test. A taxpayer would fail the RLT when the debt percentage of the U.S. member is greater than the average debt percentage of the worldwide group. To pass the Percentage of ATI Test, the corporate taxpayer's equity ratio cannot exceed 1.5 to 1, as defined in IRC §163(j).

On base erosion alternatives, the panel discussed three alternative SubpartF ideas included in the Camp Proposals. These alternatives offer three different ways to limit taxpayers' ability to shift income to low-tax authorities and provide different answers to these important questions in international tax policy design:

1. Does it matter if intellectual property ("IP") is developed partly in the U.S. or abroad?
2. Should low foreign effective tax rates be viewed as a standalone issue or should it be viewed with other factors?
3. Does it matter if a CFC's earned income is derived from serving its home country market rather than foreign markets?

The three base erosion alternatives included in the Camp Proposal are described next:

Option 1 - Obama's Excess Returns

When a U.S. person transfers intangibles to a related CFC and the intangible generates a high profit margin, the excess income earned by the CFC would be treated as a new category of Subpart F income – foreign base company excess intangible income. The panel's main concern with this option was that it would encourage taxpayers to relocate R&D activities outside the U.S. because the proposal does not apply to income generated by intangibles developed abroad. The panel prefers an approach that is neutral with respect to the location of the R&D development noting though that additional restrictions on income shifting can be implemented.

Option 2 - Low Taxed CFC Income

When the gross income from a CFC is subject to a foreign effective tax rate of 10% or less, the income would be treated as Subpart F income unless the same country exception applies. The same country exception applies when:

1. the income is earned from the conduct of a trade or business in the CFC's country of organization;
2. the CFC maintains a fixed place of business in such country; and
3. he income is derived in connection with property sold or services provided in such country.

The key concern expressed by the panel was that if a CFC operates in a home country with an effective tax rate of 10% or less and sells into its own homecountry, its income will be treated as Subpart F income irrespective of the other facts surrounding the CFC's earning of the income.

Option 3 – Carrot & Stick

In this option, all CFC income earned from IP related services or property is treated as Subpart F income, but U.S. shareholders can deduct 40% of income attributable to IP. The Subpart F high-tax exception would apply to this new category of Subpart F income, using 13.5% as the threshold. Unlike the excess returns option, this option limits its application to income attributable to IP, but does not explain how this attribution is to be done. The consensus from the members of the panel was that option 3 is complicated and would require further study. Their main concern is the IP attribution rule because it would create a new requirement for transfer-pricing-type analysis and valuation of IP.

Finally, the members of the panel laid out key criteria for the Camp Proposal to be successful. It should eliminate superfluous rules, such as IRC §§§909, 956 and 959; simplify the law; and help raise revenue. It is also important to ensure that U.S. shareholders who are not eligible to receive territorial dividend exemption do not suffer from double taxation on their Subpart F income when earnings are distributed. Overall, the panel believed that Chairman Camp's discussion draft is a significant development toward fundamental corporate tax reform.

California Tax Reform Proposals and Their Prospects

By: Shadi Mahdinia, *MST Student*

In this part of the conference, a panel of experts reviewed the key aspects of recent California State tax and fiscal reform proposals and assessed their prospects.The panelists included: Mr. Dean Andal, Director, *PwC* and a former member of the California State Assembly; Mr. David Ruff, Principal Consultant, *California Assembly Revenue & Taxation Committee;* Ms. Gina Rodriquez, Vice President of State Tax Policy, *CalTax;* and Mr. Fred Silva, Senior Fiscal Policy Advisor, *California Forward.*

The panel covered a number of recent reform proposals. Highlights of key proposals are summarized below:

Governor Brown Proposal

This proposal aims to improve fiscal balance by temporarily increasing income and sales tax rates to raise an estimated $4.8 to $6.9 million in General Fund revenue.

Advanced Project Proposal

This proposal is intended to increase funding for early childhood and K-14 education by making significant changes in income tax rates. It is projected to increase revenue by $10 billion.

California Federation of Teachers Proposal

The objective of this proposal is to increase funding for a variety of state and local programs. It will permanently increase income tax rates on taxpayers with income in excess of $1 million. The increased revenue, estimated to be between $5 and $6 billion, will be allocated to education, childhood and senior services, public safety, and infrastructure such as local roads and bridges.

Split Property Tax Assessment Roll Proposal

This proposal will bring non-residential property assessment closer to market value and is expected to generate an additional $4 billion in tax revenue per year for the state General Fund. It will place non-residential properties on a three year reassessment cycle, exempt property tax on personal properties up to $1 million, and double the homeowner exemption.

In addition to tax reform proposals, the panel also overviewed these fiscal reform proposals intended to revise California State's budget-making process, spending limit or voting requirements for certain fees and taxes.

California Forward's Proposal

The objectives of this proposal are to revise the state and local budget processes to focus on results, and to increase state and local governments' authority to integrate local services. Under this proposal, a budgeting system based on multi-year results would be established, and public programs would work collaboratively with a focus on performance.

Cal-Tax and the Howard Jarvis Taxpayers Association Proposal

This proposal would revise the state spending limit by resetting the spending limit base year to 2010-11, changing the allocation of money that is in excess of the limit, and clarifying the two-thirds legislative approval for tax increases.

Environmental Group's Proposal

If this proposal is enacted, the legislature would be able to raise fees with a majority vote for environmental and public health regulatory activities.

The last part of the panelists' presentation was focused on California's Sales and Use Tax (SUT) reform. The panelists addressed the benefits of reform, and explained how the government can use this tax source to generate more tax revenue.

Under current law, California's SUT imposes a sales tax on retailers for the privilege of selling tangible personal property (TPP). The tax is based upon the retailers' gross receipts from TTP sales in California. SUT receipts are the second largest contributor to the state's General Fund revenue behind personal income tax although it wasn't always this way. In the past 80 years, the revenue contribution from the SUT has dramatically decreased as the State transitioned from an agricultural and manufacturing dominated economy to a service and technology-oriented one.This reduction in SUT contribution created a need for the State to increasingly rely on revenue contributions from personal income tax.

The panel suggested that the SUT base could be expanded to cover more services to increase SUT revenue. California currently imposes SUT on only 21 services, while some states tax nearly all services. The panelists noted that imposing tax on services has benefits. It would promote fairness, stability, and economic neutrality; prevent cuts to vital services; provide funds to reform other areas of tax law; and prevent higher sales tax rates.

Finally, some panelists presented key tax policy principles that lawmakers must considered in expanding the sales tax to services:

- Administrative feasibility;
- Avoiding perverse incentives and pyramid effect from taxation of services by businesses;
- Promotion of progressivity; and
- Providing assistance for newly registered service providers.

Looking Forward

By: Kenny Cai Ng, *MST Student*

In the final session of the conference, Ms. Annette Nellen conducted a final poll to evaluate whether or not there was a change in the attendees' appreciation of tax reform after hearing the day's presentations. The attendees were asked to identify the most realistic federal tax reform. The majority of the attendees believed that letting the lower tax rates expire, and lowering the corporate tax rate are the solutions. However, a majority of the attendees believed that a higher tax rate on high income individuals is the more realistic approach to California tax reform. The last polling question confirmed that the attendees developed a better understanding of the tax law at the end of the conference. The audience had learned that California's largest tax revenue source is from personal income tax.

After the final polling, Ms. Kim Reeder, (then) Partner, Morgan, *Lewis & Bockius*, summarized the key issues that were discussed in the conference. She highlighted that every speaker addressed how interactions of federal and state tax affect tax policy. She summarized panelists' discussion about the difficulty for taxpayers to comprehend the tax code due to its complexity and the effect on tax planning. She stressed the importance to consider issues such as transparency and fairness in designing tax policy but overall, there must be a balance of sound tax policy. Finally, she reiterated the reality that there are always winners and losers in tax reforms, and that some industries wouldlikely fare better than others.