TAX FUNDAMENTALS FOR MBA STUDENTS

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For large corporations, over 35% of their net income is spent on federal and state income taxes. In addition, there are payroll, property, excise and other taxes imposed on businesses. Tax planning (or tax minimization) is an important activity for businesses. While the details of tax planning and reporting is best left with the tax experts, anyone involved with the finances of a business should have some basic understanding of tax concepts so that they can be conversant on the topic, able to participate in strategic planning and able to help to identify potential tax issues and planning opportunities. To provide an overview to income taxes, the first part of this paper describes 10 policies underlying the income tax system. The second part of the paper focuses on a current hot tax topic – taxation of e-commerce and focuses on the reasons why e-commerce raises tax issues. This topic is included in this tax introduction because these issues will be an important discussion item for governments and businesses over the next several years.

POLICIES UNDERLYING THE FEDERAL INCOME TAX LAWS

The first part of this paper discusses ten policies (as identified by the author) that underlie the federal income tax rules. The policies provide a foundation to better understanding of tax rules. In addition, awareness of the policies can assist you in dealing with the tax implications of various business transactions because that awareness will help make you more alert to potential tax issues and planning opportunities.

Ten Policies Underlying the Federal Income Tax System

1. The definition of income is influenced by the need to raise revenue.
2. The income tax law can serve as a mechanism to influence certain types of activities and to discourage others.
3. Income should be measured on a worldwide basis.
4. Recognition of gain and/or loss should be deferred in certain types of transactions.
5. Design of the tax law must consider administrative convenience and certain equitable principles.
6. In some situations it may be appropriate to use the time value of money concept to measure taxable income.
7. Changes in financial and other types of transactions may lead to changes in the tax law.
8. The federal tax law should distinguish between capital and ordinary income and losses.
9. To administer the income tax certain types of information are needed in addition to the details of taxable income.
10. Procedures and penalties are needed to ensure proper compliance.

A matrix is used to present the examples of the rules that illustrate the ten policies. Within each policy, the illustrative rules are categorized into the following areas of the income tax law:

* Measuring taxable income.
* Business structure, acquisition, and restructuring.
* Other taxes and tax credits.

* International transactions.

Policy #1 - The definition of income is influenced by the need to raise revenue

The need to raise revenue is a key policy underlying every tax. How much tax revenues are raised under the income tax is a function of several factors, particularly, a) how taxable income is defined, and b) the tax rates. A predominant policy underlying the definition of taxable income is that the definition is based more on the need to raise revenue than on using generally accepted accounting principles (GAAP) to define income. That is, the need to raise revenue results in rules defining "taxable income" that are different from GAAP.

The goal of GAAP is to fairly reflect income and not to overstate assets or income. The primary goal of the tax law is to raise revenue. Under GAAP the principle of conservatism demands that income not be overstated. Congress usually has just the opposite goal: income should be reported as early as possible. Another key principle under GAAP is the matching principle. The matching principle is not always followed in the tax rules because of the differing purposes of the income tax rules and GAAP.

Some of the examples of Policy #1 explained below illustrate how a tax provision can be changed in order to raise revenue without changing tax rates. Note that some of these provisions are timing changes in that they only postpone a deduction, rather than permanently deny a deduction. However, when Congress is looking, for example, at a five-year budget projection in determining the revenue effect of a tax bill, a revenue increase during this time period is sufficient to allow for a new rule that results in less tax revenue for the government during that same time period.

Examples of Policy #1

MEASURING TAXABLE INCOME	
A	Accounting for Inventory There are several differences between how inventory is treated for financial reporting purposes and for income tax purposes. For example, under GAAP, writedowns of obsolete, damaged, and discontinued inventory are required so that assets and revenues are not overstated. However, for tax purposes, such inventory may not be written down unless the taxpayer has proof of actual offerings or sales at the lower price for each type of item in the inventory. Forecasts and estimates of future demand that are usable for GAAP purposes are not sufficient to write down inventory for tax purposes.[1] If a taxpayer does not have the proper data, no tax benefit is recognized until the inventory is actually sold. In 1986 the *UNICAP* (uniform capitalization) rules were added to the Code.[2] These rules are an example of the revenue that can be generated without increasing tax rates even though the additional costs included in inventory will be offset against future income when the goods are eventually sold (referred to as a timing difference). The UNICAP rules were projected to raise $4.3 billion in 1987, $7.6 in 1988, $8.2 in 1989, $8.6 in 1990 and $6.8 in 1991.[3] For most companies with inventory, the UNICAP rules require more types of costs to be included in inventory than is required for GAAP purposes.
B	Prepaid Income Generally Required to be Reported Using the Cash Method Revenue recognition rules in the federal income tax law do not always follow the GAAP rules. For example, most prepaid income, such as prepaid rent, must be included in taxable income when received by an accrual basis taxpayer, rather than when earned.[4]

C	Restrictions on Deductions Business meals and entertainment: A business may generally only deduct 50% of what it incurs for meals and entertainment expenses. The reason for this limitation is that meals and entertainment expenditures "also convey substantial personal benefits to the recipient."[5] This limitation raises revenue for the government relative to allowing a full deduction for meals and entertainment expenses. Bad debt deduction: The bad debt reserve method is not allowed for tax purposes because it allows taxpayers to take a deduction prior to its actual occurrence. Instead, a bad debt is only treated as a tax deduction in the year the debt become uncollectible. [6] This is a good example that the tax law does not follow the matching principle of GAAP. Charitable contribution deduction: Corporations may not deduct charitable contributions that exceed 10% of their adjusted taxable income. Any excess contribution amount will carry forward for 5 years, subject to the 10% limitation each year. Limitations also exist for individual taxpayers.[7]
BUSINESS STRUCTURE, ACQUISITION, AND RESTRUCTURING	
D	Restrictions on the Use of Acquired Losses In certain reorganizations, such as a corporate merger, the tax law imposes limitations on the acquiring corporation's ability to use losses of the acquired corporation (typically referred to as the *target* corporation).[8] Example - Amper Corporation merged into Target Corporation. At the time Target had a net operating loss from prior years (in prior years, Target's expenses exceeded its income and the tax law allows Target to use this loss against income in other years). Amper might not be able to fully use Target's net operating loss carryover. Congress was concerned that Amper might merge with Target in order to obtain use of Target's loss (as opposed to merging solely for non-tax reasons).
OTHER TAXES AND TAX CREDITS	
E	Alternative Minimum Tax (AMT) The income tax rules include an AMT system to ensure that taxpayers pay some minimum level of tax when optimal use of allowable deductions and tax credits reduces their regular tax liability to a small amount.[9]

Policy #2 - The income tax law can serve as a mechanism to influence certain types of activities and to discourage others

As mentioned earlier, the tax law is often viewed as a useful tool to help reach other goals of Congress (goals other than raising revenue). For example, to help distressed areas in the U.S., in 1993 Congress enacted various tax incentives designed to improve economic conditions in specified *empowerment zones*, *enterprise communities*, and *rural development investment areas*.[10]

Sources of ideas. Suggestions for changes to the tax law to encourage or discourage particular behavior come from a variety of sources. The Administrative branch of the government (the President and his cabinet) make suggestions to Congress, members of Congress introduce a variety of bills, and industry and lobbying groups make suggestions as well. When Congress considers a particular proposal it typically schedules a hearing at which interested parties may testify on the pros and cons of the proposal and make suggestions for improvements. Individuals and industry groups may also meet with members of Congress and their staff, as well as employees of the Treasury Department.

Examples of industry and public policy groups that develop proposals and/or testify before and submit comments to Congress on various proposals include:

* Members of the President's cabinet and their assistants.

* Representatives of various government agencies, including the Treasury Department, the General Accounting Office (GAO), the Small Business Administration (SBA), and state

governments or associations, such as the National Conference of State Legislatures or the National League of Cities.

* Industry and public policy groups, such as the National Association of Realtors, the American Electronics Association, the Software Publisher's Association, the American Petroleum Association, the Independent Insurance Agents of America, the National Association of Manufacturers, and Citizens for Tax Justice.

* Various accountant and attorney groups such as the American Institute of Certified Public Accountants (AICPA), the American Bar Association (ABA), the National Association of Enrolled Agents (NAEA), and Tax Executives Institute (TEI).

* Interested law firms and CPA firms, often on behalf of their clients.

* Environmental groups, such as Friends of the Earth, and the Sierra Club.

* CEOs, CFOs, and tax directors of various companies.

Obviously, many different types of groups have an interest in the tax law and how it can be changed. While the comments of interested groups are considered, Congress and the groups may have conflicting goals. Congress must reach a consensus among its members on any tax bill, and Representatives and Senators have ideas of their own and promises made to constituents to deal with. Congress must also consider the view of the President because of the possibility of a veto.

Example - In July 1996 the Subcommittee on Oversight of the House Ways and Means Committee held a hearing on the effect of the tax law on land use. Congresswoman Johnson, who called the hearing, noted that the tax laws have intended and unintended consequences for land use. She noted as an example of intended tax consequences that specific tax rules exist to enable owners of historic property to preserve the property as such, even after their death. With respect to unintended tax consequences she noted that the current tax depreciation rules might discourage businesses from investing in urban areas. One of her purposes in calling the hearing was to determine if the tax law was discouraging businesses from investing in cities.

Preferential rules directed towards certain industries or businesses. In addition to influencing certain types of behavior the tax laws are also used to provide special relief to particular industries. Such rules often recognize special operational peculiarities of the particular industry relative to other industries that warrant a different tax treatment. In other cases, the special rules represent incentives for the particular industry. Examples of these special rules and industries includes:

* Oil and gas - owners may take depletion deductions greater than property basis.[11]

* Farming - some farming businesses are exempted from the rules that require additional costs to be capitalized into inventory (UNICAP rules).[12]

* Magazine publishers - generally an accrual basis taxpayer must report income when received, regardless of when earned. However, a special elective rule allows prepaid subscription income to be included in income when earned rather than when received.[13] In addition, a special elective rule allows income from magazines, paperbacks, and records returned within 2 1/2 months after year end (4 1/2 months for records and paperbacks) to be excluded from income in the earlier year.[14]

The tax laws are also used to provide specific benefits to certain types of taxpayers regardless of their specific business. One such benefited group of taxpayers are small businesses. For example, in 1958 Congress added some benefits for small businesses that are still in the tax law today. These rules include treatment of up to $100,000 of the loss from the sale of small business stock as an ordinary loss rather than as a less favorable capital loss.[15] Many small businesses may also accelerate depreciation deductions into the first year a business asset is placed in service.[16] Other favorable tax rules for small businesses include

allowing certain small corporations to elect to be treated as S corporations that are subject to a single layer of tax at the shareholder level, rather than double taxation at both the shareholder and corporate levels.[17] Congress added these rules to encourage taxpayers to invest in small businesses, provide tax breaks to such businesses, increase the amount of internal funds available, and prevent the breakup of small established businesses by their consolidation into larger businesses.[18]

Examples of Policy #2

MEASURING TAXABLE INCOME	
A	R & E (Research and Experimental) Expenditures To encourage R & E activities, the following provisions exist: 1. Taxpayers may expense R & E expenditures as incurred even though they may generate a long-lived asset. Alternatively, a taxpayer may elect to capitalize and later amortize the expenditures.[19] 2. Taxpayers may claim a tax credit for increasing research expenditures over what they were during a base period.[20] This example also illustrates that taxable income is not computed similarly to financial statement income. Financial Accounting Standard No. 2, *Accounting for Research and Development Costs*, requires R&D expenditures to be treated as deductions when incurred. There is no option to instead capitalize R&D expenditures for GAAP purposes. Also, under FAS No. 2, legal expenses of patenting technology is not an R&D expenditure while it is treated as such for tax purposes.
B	Ordinary and Necessary and Public Policy The tax law allows a business to deduct expenses provided they are ordinary and necessary.[21] However, certain expenses that may be viewed as ordinary and necessary in that they are incurred by many businesses, are specifically disallowed by the tax law because they violate public policy. For example, no deduction is allowed for fines and penalties paid for violation of a law.[22] Without such a rule, the government would, in effect, be paying part of the penalty because the taxpayer's tax liability would be reduced if the penalty were deductible. Similarly, another tax rule denies a deduction for illegal bribes and kickbacks.[23]
C	Social Provisions There are several beneficial rules in the tax law that do not raise revenue for the government, but serve some social need that Congress views as important. Common examples include various deductions individuals are allowed, such as personal exemptions, medical expenses, state income and property taxes, home mortgage interest, charitable contributions, and work-related moving expenses (to encourage the mobility of the workforce). In addition, special rules allow employers to deduct the cost of certain retirement and fringe benefits provided to employees, although such benefits are not currently taxable to the employees (pension benefits are taxable to the employee when received at a later date). The fringe benefit provisions are designed to encourage employers to provide certain items, such as health insurance, and retirement savings, that in the long run may save the government money. Likewise, allowing taxpayers a deduction for charitable contributions helps to ensure that charitable organizations that provide benefits to society will continue and the federal government will not have to provide their function and cover their costs.
BUSINESS STRUCTURE, ACQUISITION, AND RESTRUCTURING	

D	Disincentives With Respect to Certain Merger and Acquisition Activity If the principal purpose of the acquisition of control of a corporation or its property is to evade or avoid federal income tax, the IRS may disallow the deduction, credit, or other benefit of the transaction.[24] In the 1980's, as investors merged and acquired companies using leveraged buyouts and high-interest rate junk bonds, Congress viewed some of the transactions as oriented more towards advantageous use of tax benefits, such as interest deductions, rather than increases in business productivity. To address this concern Congress added various rules to prevent the use of acquired losses and tax credits,[25] and limitations on the deductibility of interest expense on certain corporate equity-reducing transactions (CERTs).[26]
OTHER TAXES AND TAX CREDITS	
E	Excise Taxes Some excise taxes are viewed as taxing "unnecessary" or "bad" activities, such as the purchase of alcohol and tobacco products. In the past few years, Congress has used excise taxes to influence environmental behavior, such as with an excise tax on ozone-depleting chemicals (CFCs). Excise taxes are also justified by Policy #1 because they are good sources of revenue. For example, in 1993 the federal excise tax on transportation fuels was increased 4.3 cents per gallon with the revenues designated to go towards reducing the budget deficit.

Policy #3 - Income should be measured on a worldwide basis

A tax system may be either worldwide-based or territorial. Under a *territorial tax system* a country only taxes income earned within its borders. Under a *worldwide-based tax system* a taxpayer or resident must report not only income earned within the home country, but also income earned outside the home country. The U.S. income tax system is a worldwide-based one.

> Example - Hover Corporation is a U.S. corporation that does business both in the U.S. and France. Hover must pay income tax to France on the income it earns in that country. In addition, under the U.S. tax system Hover must include income earned in France on its U.S. tax return along with its income earned in the U.S.

Under a worldwide-based tax system taxpayers are subject to double taxation because foreign income is taxed both in the country in which it was earned and in the U.S. A foreign tax credit exists (discussed later) to relieve taxpayers of this double taxation. A business must carefully consider the various U.S. and foreign tax rules in setting up international operations to minimize its overall tax liability.

While the worldwide income concept applies to a U.S. person (individual or business) with foreign income, a different concept applies to a foreign person (non-U.S. individual or business) with U.S. source income. These rules are fairly complicated.

As an introduction, international transactions can be broadly grouped into two categories: inbound and outbound. *Inbound transactions* are those where a foreign (non-U.S.) person is doing business in the U.S. or has investments in the U.S. *Outbound transactions* are those where a U.S. taxpayer is doing business outside of the U.S. or has investments outside the U.S.

The United States' authority to assess tax on inbound and outbound transactions can be summarized as follows:

Type of taxpayer	Income subject to U.S. tax
• U.S. citizen or resident alien individual • Domestic corporation or partnership (incorporated or formed in the U.S.)	• Worldwide income

• Non-resident alien (NRA) • Foreign corporation (non-U.S.)	• U.S. source investment income • U.S. source income and some foreign source income that is *effectively connected* with a U.S. business

Examples of Policy #3

MEASURING TAXABLE INCOME	
A	Use of Foreign Subsidiaries and Branches Generally, no matter how a U.S. corporation expands into foreign markets the foreign income will eventually be subject to U.S. tax. However, the form of the foreign operation will affect the timing of when the tax must be paid. Generally, if the foreign operation is through a foreign incorporated subsidiary the income will not be taxed in the U.S. until it is paid (*repatriated*) to the U.S. parent corporation (such as by a dividend paid by the subsidiary to the parent corporation). If the foreign operation is instead set up as a branch of the U.S. corporation, its income is subject to U.S. tax currently, regardless of repatriation.
B	Intercompany Transfer Pricing Rules[27] The IRS has the authority to reallocate income and deductions among entities under *common control* so as to prevent shifting of income to the taxpayer with the lower tax rate and shifting of expenses to the taxpayer with the higher tax rate. Example - Gary is the sole shareholder of Tyme Corporation and also operates another business as a sole proprietor (these businesses are considered to be under *common control*). Both businesses operate out of the same office and share two employees. Upon examination of the tax returns of these two businesses, the IRS examiner will carefully review how rental and wage expenses are split between them. The concern is that if the corporation is in a higher tax bracket than Gary, it may have been allocated more than its share of office and wage expenses. If this is the case, because the two businesses are under common control the IRS is allowed to reallocate the expenses to the appropriate business. In the international context this rule is referred to as the *transfer pricing rule* (also referred to as the §482 rules) and provides a mechanism for the IRS to remedy situations where a group may have allocated expenses to a member in a high-tax country that should have been allocated to a member in a low-tax country. Example - Parent Corporation (P) owns all of the stock of Subsidiary Corporation (S). P is a U.S. corporation while S is incorporated in Singapore. P has certain components of its widgets manufactured by S in Singapore, and shipped to the U.S. to be incorporated into P's widgets manufactured in the U.S. The patent on the components is owned by P. The U.S. tax rates are higher than those in Singapore. P and S must be sure that arm's length prices are paid by S to P for use of P's patent, and paid to S for purchase of the component parts. Detailed regulations exist to help P and S determine and prove the arm's length prices. The government's concern is that P might not charge S enough for use of its patent in order to keep P's income low. Similarly, there is a concern that S might charge P too much for the components in order to keep P's income low. If upon examination the IRS finds that the arm's length price was not charged, the IRS may reallocate the income and deductions of P and S to correct the situation. In addition, significant penalties may be assessed.[28]

C	Foreign Earned Income Exclusion To provide relief to U.S. citizens and residents working outside of the U.S., to better enable employers to entice such individuals to work outside the U.S., and to better equalize the tax treatment of U.S. persons working abroad with that of foreign workers, the tax law allows qualifying individuals to exclude up to $80,000 per year from their gross income. Various limitations and definitions apply in the operation of this income exclusion rule. Example - ABC Corporation is in the process of setting up a widget manufacturing plant in Germany to better serve its German customers. ABC would like employee Vernon, who is the production manager of ABC's St. Louis manufacturing plant, to relocate to Germany for three years to oversee the new production operations in Germany. ABC will pay Vernon $120,000 per year while he is in Germany. Because Vernon is a U.S. citizen he will be subject to tax on his worldwide income in the U.S., even though he will be living in Germany. In addition, Germany will most likely require Vernon to pay tax to the German government on his income earned in Germany. To alleviate the adverse tax consequences Vernon faces, in addition to possible increased living costs, and to assist ABC in enticing Vernon to move to Germany, the foreign earned income exclusion is a helpful benefit. Vernon will only have to report yearly U.S. income of $40,000 (the $120,000 wage income less the $80,000 exclusion).
D	Tax Treaties Tax treaties exist between the U.S. and many foreign countries to provide guidance on how certain types of income are taxed.
	OTHER TAXES AND TAX CREDITS
E	Foreign Tax Credit (FTC) To alleviate the double taxation problem noted earlier the federal tax law allows the U.S. taxpayer to reduce its U.S. tax liability by a credit for the foreign tax paid. Limitations on the amount of the credit and special rules exist that make the FTC a fairly complex provision. Because of the limitations and the complexities taxpayers can generally benefit from guidance from a tax adviser to help maximize the taxpayer's current use of the FTC.[29] Example - Faber Corporation has $200x of foreign source net income and $300x of U.S. source net income resulting in $500x of worldwide income. Faber's U.S. tax on the $500x is $175x (35% tax rate) and it paid $80x in tax to the foreign country. Faber's FTC is limited to $70x ($175x times $200x/$500x). The FTC may not exceed the equivalent U.S. tax on the foreign income ($200x times 35% = $70x). The $10x difference between the foreign tax actually paid ($80x) and the FTC generated ($70x) may be carried back two years and forward five years subject to the same foreign income to worldwide income limitation.

Policy #4 - Recognition of gain and/or loss should be deferred in certain types of transactions

When a taxpayer disposes of property a gain or loss is realized.

Example - Pi Corporation sold its warehouse for $500,000 at a time when its adjusted basis (concept similar to book value) was $200,000. Pi realized a $300,000 gain from this disposition ($500,000 less $200,000). The same calculation would be used for GAAP purposes, although the basis of the equipment would most likely be different because the tax and GAAP depreciation rules are different.

The manner in which property dispositions are reported is not always identical for tax and GAAP purposes. The tax law provides for certain types of *tax-deferred* transactions.

Example - Assume that instead of selling the warehouse Pi exchanged it for an office building owned by Triangle Corporation that was also worth $500,000. Under these circumstances Pi does not have to include the realized gain in its taxable income,

although it would report the gain on its financial statements. This transaction is referred to as a *like-kind exchange*.

The two major reasons that justify tax-deferred transactions are:

1. *Wherewithal to pay*: When certain transactions result in no cash remaining with which to pay the tax on any resulting gain, the tax law may allow the gain to be postponed.

Example - Box Company's warehouse was condemned by the state in order for the land to be used to construct a highway. Box used the proceeds it received from the state to purchase replacement property. Box had no funds remaining with which to pay the tax on the gain it realized from the condemnation.

A rule allowing a taxpayer, such as Box Company in the prior example, to defer recognition of a gain is justified when the transaction leaves the taxpayer with no wherewithal to pay the tax at the present time.

2. *Insufficient change in overall investment*: In some transactions the taxpayer's position really has not changed enough to warrant taxation. In the condemnation example provided above, Box used to own a warehouse and after the replacement property is purchased, similar property (a warehouse) is still owned. Because Box's investment has not changed, this transaction can be viewed as one that does not warrant current realization of the gain.

Note that the term used above is "tax-deferred" exchange rather than "tax-free" exchange. The realized gain or loss is typically just deferred until some future realization event where one or both of the factors allowing for tax-deferred transactions is not met.

Example - Assume that Box Company's basis in the condemned warehouse was $200,000 and it received $1,000,000 from the state when it was condemned. Within the time period specified in the tax provision on involuntary conversions Box acquired a new warehouse at a cost of $1,000,000. Box's basis in the new warehouse is $200,000 (rather than its cost of $1,000,000). If Box were to sell the new warehouse two years later for $1,100,000, it would recognize a gain of $900,000 ($1,100,000 less $200,000 (ignoring depreciation)). Thus, Box's original gain from the condemnation is merely deferred, it is not a tax-free transaction in the long-term.

Examples of Policy #4

MEASURING TAXABLE INCOME	
A	Tax-Deferred Dispositions As explained above, sometimes, when the taxpayer's position has not really changed, the tax law allows the disposition gain or loss to be deferred. For example, if a taxpayer exchanged an apartment building for an office building, the taxpayer still owns business real property. Also, if the taxpayer receives no cash in the transaction, there is no cash available to pay the tax on any realized gain (wherewithal to pay concept). These principles underlie the like-kind exchange rules and involuntary conversion rules (where property has been condemned, or destroyed by casualty). In both cases, as long as the taxpayer has no cash leftover after completing the transaction, the gain is deferred through adjustment to the basis of the new property (losses are also deferred under the like-kind exchange rules). Certain time limitations and elections may exist for these deferral rules to apply.

BUSINESS STRUCTURE, ACQUISITION, AND RESTRUCTURING	
B	Formation of Corporations and Partnerships[30] In forming a corporation (or partnership) the owners become owners by contributing cash or other property in exchange for corporate stock (or partnership interests). Because such an exchange is not considered a sufficient change in ownership to warrant current tax consequences, generally, any realized gain or loss is not reported by the shareholder (or partner) upon entity formation. Example - Sole proprietor Mr. Guiterrez has decided to incorporate his business. He forms ABC Corporation and contributes all of the assets of the sole proprietorship to ABC in exchange for 100% of the ABC stock. The assets had a combined adjusted basis of $500x and a fair market value of $1,500x. Thus, when Mr. Guiterrez received ABC stock worth $1,500x in exchange for the assets, he realized a $1,000x gain. However, the tax law allows Mr. Guiterrez to defer recognition of this gain. His basis in the ABC stock is $500x. In effect, Mr. Guiterrez still owns his original assets, he just owns them in a different form (corporate stock). Because this exchange of assets for stock is basically just a change in form of ownership of the assets, Congress allows the shareholder to defer any resulting gain or loss recognition.
C	Corporate Reorganizations In mergers, consolidations, and acquisitions where stock is the major consideration used to acquire the stock or assets of a target corporation, if certain requirements are met, the gains and losses will be tax-deferred.[31] That is, neither the corporations nor their shareholders will have a gain (or loss) to report currently provided stock is exchanged for stock (rather than for cash). The rationale for this treatment is that the entities involved continue to exist, but in modified form. Thus there is not enough of a realization event to require gain or loss recognition.

Policy #5 - Design of the tax law must consider administrative convenience and certain equitable principles

Some provisions of the tax law are probably best described as "fairness" provisions because they either allow for an equitable result or provide a simplified treatment for what would otherwise be a complex determination. The simplifying rules, referred to as rules of *administrative convenience* prescribe a specified treatment to avoid the need to make complicated calculations. For example, in 1993 Congress added a provision to the law to disallow a deduction for certain lobbying expenses. However, to eliminate the need for businesses with a small amount of such expenditures incurred by employees to have to calculate the exact amount of lobbying expenditures, Congress provided that the disallowance rule did not apply to de minimis in-house lobbying expenditures that did not exceed $2,000.[32]

> Example - Danver Company's CFO spent a few hours during 2000 to send letters and make calls to various members of Congress to try to get a bill passed that would benefit Danver's research and development activities. This was the only lobbying effort Danver made in 2000. The CFO estimates that the cost of her time, phone and postage costs were approximately $1,400. Because of the de minimis rule Congress provided for in-house lobbying expenditures, Danver will not have to make an exact determination of the CFO lobbying expenditures for 2000 in order to determine how much is not deductible.

Equitable provisions in the tax law are designed to avoid double or triple taxation of income and to minimize adverse effects caused by the need to account for taxable income or loss on an annual basis. For example, the tax law provides that a business that incurs expenditures greater than revenue, thus generating a loss, may use the loss in against taxable income generated in another tax year (see explanation below on NOLs).

Examples of Policy #5

MEASURING TAXABLE INCOME	
A	Installment Sales Method[33] Generally, when property is sold with payments to be made by the buyer over a period of years, the seller must recognize any gain as the installment payments are received. Example - ABC Partnership owns land that it has held for investment since it first purchased it six years ago for $60,000. During its current tax year ABC sold the land for $100,000. ABC's gain from this sale is $40,000 ($100,000 sales price less $60,000 basis). ABC's gross profit percentage on this sale is 40 percent ($40,000 ÷ $100,000). If ABC receives $10,000 from the buyer in the year of sale, ABC will report $4,000 of gain under the installment sale method ($10,000 x 40%). The installment method is an equitable provision because when applicable, it prevents the seller from having to report gain earlier than when payments are received from the buyer. Another rationale for the installment sale provision is the wherewithal to pay principle.
B	Dividends Received Deduction (DRD)[34] Corporate income taxation is a system of double taxation. A corporation pays tax on the income it earns. When that income is distributed to shareholders, tax is paid again (directly by the shareholders). Triple taxation occurs in situations where the shareholder is a corporation. Example - Assume that in 2000, Jasper Corporation (JC) had taxable income of $1,000,000. JC also paid a $100,000 dividend to its shareholders, including shareholder Baxter Corporation (BC) which owns 40% of the JC stock. BC must include the $40,000 dividend in its taxable income (double taxation) and BC's shareholders will pay tax again when BC pays a dividend to them (triple taxation). To lessen the burden of triple taxation, a corporation receiving dividends is allowed a dividends received deduction (DRD) equal to 70%, 80%, or 100% of the dividend received, depending on how much of the dividend paying corporation the corporate shareholder owns.
C	Carryovers The use of an annual reporting period can be disadvantageous to taxpayers in certain situations. For example, if a corporation had a loss in one taxable year (expenses greater than revenues), but income in all other years, it would not be able to use the loss, unless a special rule were provided. Congress has provided a special rule[35] that generally allows taxpayers with net operating losses (NOLs) to carry the losses back to offset taxable income in the prior two years.[i] If taxable income in the prior two years is less than the NOL, the remaining NOL is then carried forward and used to reduce taxable income in future years. If the NOL is not used up within a 20-year carryforward period, the NOL disappears. A taxpayer may elect to forego the 2-year carryback period. This would be advantageous if the immediate tax refund from the carryback would be less than the present value of the tax savings from carrying the NOL forward to apply against future taxable income. This might be the situation where the taxpayer expects to be in a higher tax bracket in future years than it was subject to in prior years.

[i] The Job Creation and Worker Assistance Act of 2002 (P.L. 107-147) changes the NOL carryback period to 5 years for NOLs in tax years ending during 2001 or 2002. This change was made to enable taxpayers to obtain refunds that can be used for capital investment and expenses that may then provide stimulus to the weak economy.

D	Small Business Exceptions A few tax provisions do not apply to small businesses. The rationale for such exceptions is not that Congress doesn't think the provisions are proper, but that it would be burdensome to subject small taxpayers to the particular treatment. Most C corporations are required to use the accrual method of accounting to compute taxable income (rather than the cash method). However, Congress realized that many small businesses find it simpler to use the cash method. Thus, Congress provided an exception under which small C corporations without inventory do not have to follow the rule requiring use of the accrual method.[36]

Policy #6 - In some situations it may be appropriate to use the time value of money concept to measure taxable income

The time value of money policy underlies tax rules requiring interest to be imputed if the stated interest in certain lending transactions is below the *applicable federal rate* (AFR). The AFR, published each month by the IRS in a revenue ruling, is based on the interest rate of certain government obligations and changes monthly. The time value of money policy has led to creation of terms such as *OID* which stands for *original interest discount*. Generally, the OID rules not only require imputation of interest in certain lending transactions with below market interest rates, but also require both the lender and the borrower to use the accrual method to account for the interest. Thus, if the borrower uses the accrual method and the lender uses the cash method and interest is not paid at least annually, the lender may be required to report the interest income each year as it accrues (even though it may not have been received yet).

The time value of money concept also underlies the rule concerning when an accrual method taxpayer may report a deduction. For example, if an accrual basis taxpayer offers warranties with the products it sells, it would estimate the warranty expense and report it on its GAAP financial statements. However, a tax deduction is not allowed until the warranty expense is actually incurred by the taxpayer, that is, not until the customer brings the product back for the repair work. The rationale for this treatment is that "allowing a taxpayer to take deductions currently for an amount to be paid in the future overstates the true cost of the expense to the extent that the time value of money is not taken into account; the deduction is overstated by the amount by which the face value exceeds the present value of the expense."[37] In addition, the government suffers a revenue loss by the overstated deduction. Congress believed that the theoretically correct approach would be to deduct just the present value of the later cash outlay. However, because present value calculations would create compliance problems, Congress decided instead to add an *economic performance* requirement to the rules for when an accrual method taxpayer may report a deduction. With respect to the warranty expense, economic performance occurs when the taxpayer performs the repair work. Thus, no tax deduction is allowed until the work is performed.

The economic performance rule, as well as expansion of the situations requiring imputation of interest, were added by the Deficit Reduction Act of 1984 which might be viewed as the outcome of Congress' discovery of the revenue benefits of applying present value concepts to the tax law.

Examples of Policy #6

MEASURING TAXABLE INCOME	
A	Bad Debts of Service Providers The tax law does not allow taxpayers to use the reserve method to determine bad debt expense. Instead, taxpayers must use the specific charge-off method (no deduction until a specific debt becomes worthless). However, there was concerned that service providers, such as accountants, using the accrual method might accrue amounts that would never be collected from the customer. Because of the time value of money, such a situation would cause a hardship for taxpayers that did not charge interest or late fees on their receivables. That is, the entire receivable would be included in income in year 1, and then deducted as a bad debt in a later year. This treatment would "overstate the taxpayer's income because the present value of the bad debt deduction [would] be less than the present value of the accrued income."[38] To provide relief, a provision referred to as the *non-accrual experience method* was created to allow accrual method service providers who do not charge interest or late fees on their receivables to estimate how much of each receivable might not be collected and exclude that amount from income in the year the receivable arises.[39] If the taxpayer later collects the entire amount the income that was previously not reported is included in income in the year collected. If the taxpayer ultimately does not collect the entire receivable the balance previously reported as income is deducted as a bad debt expense in that later year. The NAE only applies to services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, or to "small businesses" with average annual gross receipts in a prior 3-year period of $5 million or less.
B	Below-Market Loans As noted above, the tax law requires imputation of interest by applying present value concepts and the applicable federal rate to certain lending transactions that do not provide for an adequate rate of interest.

Policy #7 - Changes in financial and other types of transactions often lead to changes in the tax law

Factors that sometimes lead to a change in the tax law are the introduction of a new type of financial product into the marketplace and changes in business practices. For example, during the late 1980's Congress was concerned with the increase in the number of acquisitions and leveraged buyouts. Some members of Congress believed that such activity was perhaps being partly fueled by provisions in the tax law that were encouraging such activity. These members desired to make changes to the tax law to lessen the impact the tax law might have had on taxpayer decisions to engage in merger and takeover transactions.

Examples of Policy #7

MEASURING TAXABLE INCOME	
A	Tax Shelters A tax shelter is an investment that produces losses and/or tax credits that allow investors to offset other income and/or taxes on other income. The tax law includes some provisions to limit an investor's ability to deduct tax shelter losses against wages, business income, interest and dividend income. Under one of these rules, referred to as the ***at-risk rules***, tax shelter investors may only currently deduct losses to the extent of the amount they have at-risk (actual cash investment plus certain loans) in the investment.[40] Congress found that the at-risk rules were not adequate to stop the proliferation of tax shelters. "Extensive shelter activity contributed to public concerns that the tax system was unfair, and to the belief that tax is paid only by the naive and the unsophisticated. This, in turn, not only undermined compliance, but encouraged further expansion of the tax shelter market, in many cases diverting investment capital from productive activities to those principally or exclusively serving tax avoidance goals."[41] In response, Congress added a ***passive activity loss limitation rule***[42] in 1986 that seems to have been successful in ending the marketing of tax shelters. Under this rule, individuals, estates, trusts, closely-held corporations, and personal service corporations, may only use losses from passive activities against income from passive activities. A ***passive activity*** is any business in which the owner does not materially participate, such as by working over 500 hours per year in the business, and most rental activities. Example - Jane is a partner in a partnership that owns apartment buildings. The rental expenses from the apartments exceed the rental income resulting in a loss each year. Because this is a rental activity, it is most likely considered a passive activity (a few exceptions to this definition exist). Accordingly, Jane may only include her share of the rental loss on her tax return is she has income from other passive activities to offset the loss. Jane may not offset the rental loss against her wage and investment income (such as interest and dividend income). While the passive activity loss and credit limitation rules also apply to some corporations, their primary effect is on individual investors. In the past few years, reports of intricate schemes by some companies to reduce taxes, such as with Enron, have led Congress and the IRS and the states to take audit and legislative efforts to crack down on “abusive tax shelters” – a term with varying definitions. Rules on reporting certain transactions and prohibiting others have been enacted by Congress and some state legislatures to prevent the use of abusive tax shelters. In October 2003, California enacted legislation to crack down on abusive tax shelters by providing a brief amnesty program for certain taxpayers using shelters, and adding the judicial economic substance doctrine to the statute (an action must have economic substance to be respected for tax purposes as a legitimate transaction) (AB 1601 and SB 614).

BUSINESS STRUCTURE, ACQUISITION, AND RESTRUCTURING	
B	Mergers and Acquisitions In the 1980's, the proliferation of leveraged buyouts (LBOs) and the use of debt rather than equity financing for a large portion of these transactions caused Congress to resort to the tax laws to curb perceived abuses. Some of the rules Congress enacted included interest expense limitations on certain high-yield debt instruments and adverse tax treatment for *golden parachute* payments.[43] (A golden parachute is an arrangement that provides substantial payments to top executives and other key personnel of a corporation that has been taken over by another taxpayer.) In addition, the *General Utilities* doctrine was repealed in 1986 because it was viewed as "partly responsible for the dramatic increase in corporate mergers and acquisitions in recent years. Many legislators believed that the Code should not artificially encourage corporate liquidations and acquisitions."[44] Basically, the *General Utilities* doctrine[45] allowed corporations to structure certain property distributions and liquidating sales without any recognized gain or loss to the corporation. With the repeal of this doctrine, corporate distributions of appreciated property to shareholders became taxable to the corporation, and most corporate liquidations now result in taxable gains and losses to the corporation. To prevent taxpayers from attempting to avoid the repeal of the *General Utilities* doctrine, several anti-abuse rules were enacted, with a directive given to the Treasury Department to provide additional anti-abuse regulations as necessary.

Policy #8 - The federal tax law should distinguish between capital and ordinary income and losses

The U.S. tax law, as well as the tax law of some other countries, distinguishes between two primary types of income - ordinary and capital, with different tax treatment for each. Generally, capital gain income is taxed more favorably than ordinary income, while capital losses are treated less favorably than ordinary losses. Investment assets, such as corporate stock, is a common type of capital asset.

The tax law provides preferential tax treatment of gains from capital assets for a variety of reasons, including:

i) to encourage taxpayers to liquidate old investments to invest in "better" investments, thereby allowing for more efficient allocation of capital;

ii) to provide an incentive to taxpayers who have made investments, such as in corporate stock, that may have a high risk factor associated with them;

iii) to encourage savings activities; and

iv) to reduce the effect of inflation on the value of long-term investments such that all or part of the inflationary gain inherent in the capital asset is not taxed at normal tax rates.[46]

If a gain or a loss is not a capital gain or loss, it is ordinary income or an ordinary loss. Thus, the terms capital gain and capital loss must be defined. Capital gains and losses arise from the sale or exchange of *capital assets*. The Code employs an unusual technique to define capital assets. The tax law defines a capital asset by stating what is *not* a capital asset. Under this definition, a capital asset is any asset, whether or not used in a trade or business, that does not fall into one of the following 8 categories:[47]

1. Inventory and assets held primarily for sale to customers in the ordinary course of the taxpayer's trade or business.

2. Depreciable property and real property used in a trade or business.

3. A copyright, literary, musical, or artistic composition, letter or memorandum or similar property held by the taxpayer who created the asset by his personal efforts, or for whom the letter or memorandum or similar property was created.

4. Accounts or notes receivable acquired in a business for services rendered or from the sale of property described in (1) above.

5. U.S. government publications received from the government, but not by purchase at the public price. For example, a copy of the Congressional Record given to a Congressman is not a capital asset to him if he did not pay the public price.

6. Any commodities derivative financial instrument held by a commodities derivatives dealer (with some exceptions).

7. Any hedging transaction which is clearly identified as such before the close of the day on which it was acquired, originated, or entered into.

8. Supplies of a type regularly used or consumed by the taxpayer in the ordinary course of the taxpayer's trade or business.

Example - Tuan operates a sporting goods store as a sole proprietor. During 2003, Tuan sold the following assets:

* Inventory.

* Cash registers no longer needed because Tuan upgraded his sales equipment.

* 100 shares of ABC stock that Tuan purchased several years ago as an investment.

* A letter signed by President Reagan that Tuan received from the president in 1985 in response to a letter he sent to President Reagan.

To categorize the gain or loss from the sale of the above assets Tuan must determine whether or not they are capital assets. Based on the definition above, the inventory, cash registers (depreciable property used in Tuan's business) and letter from President Reagan (created for Tuan), fall into one of the five listed categories and thus, are not capital assets. However, the ABC stock does not fall within any of the five categories and is therefore a capital asset.

If Joe purchases the letter from Tuan and does not hold it for sale to customers, it will be a capital asset in Joe's hands because it was not created by or for Joe.

Examples of Policy #8

MEASURING TAXABLE INCOME	
A	Disposition of Assets To encourage investment in business assets, many years ago Congress added a rule that treats net gains on sale of certain types of business assets held for over one year as capital gains, while the net losses are treated as ordinary losses.[48] This is the best of both worlds because both capital and ordinary losses may be used against capital gain income, while ordinary losses may be applied against both capital and ordinary gains.

BUSINESS STRUCTURE, ACQUISITION, AND RESTRUCTURING	
B	Sale of an Entire Business When a taxpayer sells a business, it is treated as if each individual asset comprising that business, including its goodwill, was sold. Thus, gain or loss for each asset is calculated rather than a single gain or loss amount for the entire business. The treatment of a sale of a business as a sale of individual assets enables the seller to determine whether the gain or loss from each asset is properly characterized as capital or ordinary. Example - This year, Yates Corporation (YC) sold one of its divisions to Thunder Corporation (TC). The assets of the division consisted of inventory, three pieces of equipment, a building, land, a patent, and goodwill. The total sales price was $1,000,000. YC and TC must allocate the $1,000,000 among the assets of the division based on the fair market value of each asset. Assuming that the inventory has a value of $200,000 and a basis to YC of $170,000, YC will have a $30,000 ordinary gain from the sale of the inventory.

Policy #9 - To administer the income tax certain types of information are needed in addition to the details of taxable income

Over the past several years various reporting requirements for certain types of transactions have been added to the law. For example, some businesses handling certain transactions, such as real estate brokers responsible for processing paperwork related to the sale of a real estate, are required to issue a form (Form 1099) to the IRS and the seller of the property.[49] This form states the sales price and includes the seller's name, address and social security number. A similar rule applies to stockbrokers that requires them to issue a Form 1099 to both the IRS and the person they sold stock for during the year.

> Example - During 2001 Karen sold 100 shares of IBM stock at a price of $5,000. The brokerage firm that sold the stock for Karen is required to file a Form 1099-B with the IRS to report the amount of the sales proceeds. The broker must also provide a copy to Karen. Karen will use this information in preparing her 2000 tax return.

The primary reason for requiring more information to be reported to the IRS is to enable the IRS to use the information to determine if the transaction was properly reported on the taxpayer's return - a process referred to as *matching*. For example, the IRS can use the Form 1099-B filed for Karen to determine if the sale proceeds were properly reported on her tax return. In addition, Congress may use some of the information for statistical purposes, such as to support future proposals for tax law changes. For example, the Form 1099-B information can be used to indicate the number of stock sales and the dollar amount in a particular year.

In practice, it is important for brokers and others that are involved in transactions that result in income to an individual to check for reporting requirements because most of these rules impose a penalty for failure to comply.

Examples of Policy #9

MEASURING TAXABLE INCOME	
A	Reporting of Wage and Investment Income The tax law requires payers of various types of income to issue a reporting form to the recipient. For example, an employer must issue Form W-2 to employees (and to the IRS) that shows the employees wages and the amount of taxes that were withheld. Similarly, banks must issue Form 1099-INT to account holders (with a copy to the IRS) that reports the amount of interest earned during the year.

BUSINESS STRUCTURE, ACQUISITION, AND RESTRUCTURING	
B	Information on Certain Large Acquisitions and Recapitalization Transactions Corporations are required to report information to the IRS about the terms of a liquidation, recapitalization or change in control.[50] Under this provision, a corporation must file the reporting form when a capital structure change occurs that involves either, i) acquisition of 50% or more of the corporation ("control"), or ii) a substantial change in capital structure, such as an exchange of stock for debt or vice versa. The penalty for failure to timely report the information is $500 per day for a maximum penalty of $100,000. The required information includes the identities of the parties to the transaction, the fees paid to bankers, attorneys, accountants, underwriters, appraisers and others who provided services in the transaction, the details of the change in capital structure, and the identity of any foreign or tax-exempt entity involved.
C	Information on Asset Acquisitions Both the buyer and seller of the assets constituting a business are required to file a special reporting form with the IRS. This form requires the parties to show how the purchase price was allocated among various categories of assets that were transferred in the sale.
INTERNATIONAL TRANSACTIONS	
D	Information Reporting and Recordkeeping on Certain Foreign Relationships and Transactions A domestic corporation that is 25% foreign-owned, as well as a foreign corporation engaged in business in the U.S., must provide certain information to the IRS including the name, country, type and place of business of related parties that had any transaction with the reporting corporation during the taxable year, and how the parties are related. Records must also be kept (generally in the U.S.) as needed, to determine the correct treatment of related party transactions. Penalties exist for failure to comply. The major purpose of these reporting requirements is to enable the IRS to obtain information on transactions where, for example, the foreign owners of a U.S. corporation may attempt to reduce U.S. tax liability by selling products to related parties at very high prices (see the intercompany transfer pricing issues discussed under Policy #3).[51]

Policy #10 - Procedures and penalties are needed to ensure proper compliance

The U.S. tax system is based on *voluntary compliance.* Voluntary compliance means that all taxpayers are expected to voluntarily fulfill their tax reporting and payment obligations specified in the law. Congress has devised several techniques to better ensure that voluntary compliance occurs. These techniques include authority for the IRS to examine returns, penalties for noncompliance, and provisions for interest to be assessed on delinquent taxes.

Voluntary compliance, even when bolstered by techniques to encourage it, is not perfect. Congress and the IRS have studied the *tax gap* and ways to deal with it. The *tax gap* is the term for the revenue the government loses because taxpayers do not fully comply with the tax laws. The IRS estimates that about 17% of taxes owed are not collected. With some voluntary payments and IRS enforcement efforts, the tax gap falls to about 13% (for an 87% overall compliance rate).[52]

In the past several years, changes have been made to the law to reduce the tax gap. For example, more information returns are required (see Policy #9) and some penalties have been increased. In addition, Congress has included funding for specific compliance initiatives in the budget for the IRS in past years, such as programs to improve the collection of delinquent taxes.[53]

Over the past several years, various protective measures have been added to the tax law to ensure that taxpayers are treated fairly under the tax law. These provisions have been enacted under the title of

"Taxpayer Bill of Rights." The protective measures include establishing guidelines for selecting a reasonable time and place for interviewing taxpayers whose returns are under examination, extending the notification period before a levy can be used to seize taxpayer property,[54] and allowing taxpayers to request a Taxpayer Assistance Order if the taxpayer is suffering or about to suffer a significant hardship as the result of an IRS administrative action (such as issuance of a levy).[55] Taxpayer Bill of Rights legislation was enacted in 1988 and 1996.

In reading the examples below of the techniques created by Congress and the IRS to encourage voluntary compliance, consider whether the effort represents a balance between, a) unnecessary intrusion into taxpayer affairs and increased complexity of the tax law, and b) the need to have a high compliance rate so that everyone is paying their "fair share" of taxes. As noted in a 1995 GAO report:

> [T]he bottom-line decision on whether to extend the reach of the tax system to recover additional revenues due the government under current law involves determining the right mix between (1) the acceptable level of compliance for each type of taxpayer and (2) the acceptable level of tax system intrusiveness to promote compliance within each category of taxpayer.[56]

Examples of Policy #10

	MISCELLANEOUS
A	Enforcement Tools of the IRS To enable the IRS to effectively examine taxpayer records to determine if the tax liability has been properly computed, Congress has given the IRS authority to take certain actions. For example, the IRS has authority to canvass each internal revenue district to identify all persons there who may be liable to pay any federal tax.[57] The IRS has been given authority under the tax law to examine any books and records relevant or material to a tax inquiry.[58] In addition, the IRS may issue a summons to compel a taxpayer or a third party who has the relevant records to present them to the IRS.
B	Payor Withholding Requirements • *Back-up withholding*: The tax law requires certain payors of income, such as banks paying interest income to depositors, to withhold tax at a rate of 20% from such payments for taxpayers who do not provide their social security number to the income payor.[59] This rule is designed to ensure that the IRS information return matching program will not be weakened by taxpayers bypassing the system by having Form 1099s issued to them that have no social security number on them. • *Non-compliance penalties*: Most information reporting requirements (such as filing of Forms W-2 and 1099) include a penalty for failure to file or failure to file a complete and accurate form.
C	Receipt of Cash Congress and the IRS are concerned with taxpayers who receive income in the form of cash, rather than by check. With a check, records exist to show that a payment was made and received. However, with cash, fewer, if any, records exist. To assist in finding taxpayers dealing with large sums of cash that might be unreported income, businesses are required to file a special reporting form when they receive cash of more than $10,000 in a single transaction, or related transactions.[60] The information to be reported includes the customer's name, address and taxpayer identification number (such as the individual's social security number), the amount of cash, and the date and nature of the transaction. The IRS can then use this information to compare to the customer's tax returns to determine if the return warrants a more detailed examination.

D	Penalties for Third Parties Some of the penalties created by Congress apply to persons other than the taxpayer. Often, third parties are unaware of the existence of penalties they may be subject to, and thus are very surprised when the penalties are assessed against them. One such penalty is imposed on a party that lends money to a taxpayer to pay employee wages if the lender knows that the employer does not intend to or is unable to make timely payments of employment taxes withheld from employee pay (§3505). Another penalty, known as the responsible officer penalty also relates to employment taxes. This penalty is equal to 100% of the employment taxes that were not paid over by the employer to the IRS. It can be assessed on an officer or employee who had a fiduciary responsibility to pay over the taxes to the government, but failed to do so (§6672). A responsible employee could include a company's controller who was aware that the tax was owed, but not paid.

WHY THE INTERNET AND E-COMMERCE RAISE TAX ISSUES

E-commerce represents a new business model. As such, it creates some challenges to tax systems that were designed with a different model in mind. Some of the key reasons why e-commerce raises tax issues are explained below.

1. Location: Existing tax systems tend to determine tax consequences based on where the taxpayer is physically located. The e-commerce model enables businesses to operate with very few physical locations. An online vendor can easily sell to customers throughout the world from a single physical location. The e-commerce business model also involves more customized inventories so storage needs (and thus the need for many physical locations) are reduced. Also, the model involves less vertical integration and more outsourcing – again, fewer physical locations are used by a vendor. Also, some business assets, such as servers, are not necessarily tied to a single physical location, but can easily be relocated without any interruption to business operations. That is, the location of the server is not relevant for business purposes and thus, may not be a logical taxing point.

   Location factors primarily raise tax issues at the international and state and local levels, rather than at the federal level. For example, the U.S. Supreme Court has ruled that a state may only require a vendor to collect sales and use tax if the vendor has a physical presence in the state.[61] Also, outsourcing raises issues as to the nature of the relationship between the company and the supplier to determine if the supplier is the company's agent creating a taxable presence (nexus) for the company in the state.

2. Nature of Products: E-commerce allows for some types of products, such as newspapers and music CDs, to be delivered in digitized (intangible) form, rather than in tangible form. Digitized products raise issues at the state level as to whether sales tax applies and in which state income is generated for state income tax purposes. Public Law 86-272, enacted in 1959 prohibits a state from taxing a foreign corporation's net income derived from activities within the state if those activities consist merely of solicitation of orders for the sale of tangible personal property that are approved, filled, and shipped from outside the state. This law is out-of-date today where the transfer of services and intangible items is a significant business activity. The nature of products can also raise income tax issues regarding the type of revenue generated and how it is to be reported, as well as whether digitized products are subject to traditional inventory accounting rules.

3. New Marketing Techniques: The Internet has allowed for new ways of selling and buying goods and services. For example, individuals can offer their unwanted items to a worldwide group of potential buyers via auction sites, such as E-Bay. The Internet can also be used to easily link business buyers and sellers through exchange web sites where buyers post what they have to sell and sellers match up with them, or vice versa. Such sites can almost operate without human intervention for the matching function. In addition, the Internet has increased the use of bartering, most notably with respect to exchange of web banners that serve as advertisements. These new techniques raise various tax issues at all levels. For income tax purposes, issues include whether an exchange intermediary or broker should be accounting for inventory, and what amount of information reporting should be required for low-value bartering transactions, and how such transactions should be valued. At the international level, the source of the income generated (which country) might be uncertain. At the state and local level, issues exist as to when individuals have sold enough goods to be required to become sales tax collectors and how to enforce such rules. Another issue raised by changes or elimination of intermediaries is that some intermediaries collected excise tax, such as sellers of fishing equipment. When buyers interact directly with a foreign manufacturer, rather than a domestic retailer, the excise tax may go uncollected.

4. New Types of Assets: Some of the new assets created by commercial use of the Internet are domain names (URLs) and web sites. For income tax purposes, issues exist as to how to treat the costs of creating or acquiring such assets, as well as the characterization of any gain or loss generated upon disposition of the asset. Sellers of such assets may face uncertainty in the law as to how to characterize the gain or loss generated from the disposition (capital or ordinary).

5. Remote Workforce: The workforce of an Internet company may be scattered throughout a state or country, rather than working in a single work location together. This can raise issues as to whether the presence of the employee in a particular state creates tax obligations for the employer in that state. Also, cities may find that employers owe business license taxes due to the presence of an employee in the city or that if the worker is not an employee that the worker owes business license taxes.

6. Making Optimal Use of the Internet May Challenge Old Rules: One area where use of the Internet has potentially raised some tax issues involves how some tax-exempt organizations are using the Internet. For example, a tax-exempt organization might allow donors to be listed on the organization's Web site. This may cause the entity to face issues as to whether the listing is merely an acknowledgement or whether it is advertising that may result in unrelated business taxable income (UBTI) for the organization. Another issue may exist where an organization that primarily operates on the web, such as a non-profit information exchange, meets the tax definition of a tax-exempt organization. Also, the Internet may allow for more efficient interactions between a tax-exempt organization and its donors, yet existing rules were not written with such interactions in mind. For example, a receipt is required for certain donations in order for the donor to be entitled to a deduction. Will a receipt generated by and printable from a Web site constitute an appropriate acknowledgement for tax purposes? In October 2000, the Service issued Announcement 2000-84, 2000-42 I.R.B. 385, which lists various issues that tax-exempt organizations may face related to the Internet. The Service asked for input from interested parties as to whether additional guidance is needed for tax-exempt organizations.

7. Nature of Transactions: The Internet allows for paperless transactions and the potential for the use of electronic cash. This raises administrative concerns for the Internal Revenue Service as to whether transactions were properly reported, whether an audit trail exists, and whether new reporting rules are needed. In a speech entitled, "Tax Administration in a Global Era," (former) Treasury Secretary Summers stated:

> "The Internet provides new ways for tax administrations, such as the IRS, to improve the ease and transparency of tax collection. But new technology also raises certain problems. In a world where cyber-transactions are growing at a rapid pace, tax administrations face the challenge of adapting existing tax systems to an economy that increasingly ignores physical borders.
>
> In such a world, it will be easier for companies to avoid tax collectors by operating worldwide through web-sites based in jurisdictions that are unwilling to share taxpayer information."[62]

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[1] *Thor Power Tool Co., v. Commissioner*, 439 U.S. 522, 542 (1978), 79-1 USTC ¶9139, 43 AFTR2d 362 (USSC 1979), and *Tog Shop, Inc. v. U.S.*, 721 F.Supp. 300, 89-2 USTC ¶9554, 65 AFTR2d 390 (M.D. Ga), aff'd without opinion, 916 F.2d 720 (11th Cir. 1990).
[2] IRC §263A.
[3] *General Explanation of the Tax Reform Act of 1986*, prepared by the Joint Committee on Taxation, May 8, 1987, page 523.
[4] Reg. §1.61-8(b).
[5] *General Explanation of the Tax Reform Act of 1986*, *supra*, page 61.
[6] *General Explanation of the Tax Reform Act of 1986*, *supra*, page 531.
[7] IRC §170.
[8] IRC §382.
[9] IRC §§53 to 59.
[10] IRC §1391 to §1397D.

[11] IRC §613.
[12] IRC §263A(d).
[13] IRC §455.
[14] IRC §458.
[15] IRC §1244.
[16] IRC §179.
[17] IRC §1361.
[18] House Rpt No. 2198, 85th Cong. 2d Sess., H.R. 13382, July 1958.
[19] IRC §174.
[20] IRC §41.
[21] IRC §162.
[22] IRC §162(f).
[23] IRC §162(c).
[24] IRC §269.
[25] IRC §382 to §384.
[26] IRC §172(b).
[27] IRC §482.
[28] IRC §6662.
[29] IRC §27 and §901 to §904.
[30] IRC §351 applies to corporations and their shareholders, while IRC §721 applies to partnerships and partners.
[31] IRC §368.
[32] IRC §162(e)(5) and 103 House Report 213 (Part 4 of 7), Omnibus Budget Reconciliation Act of 1993.
[33] IRC §453.
[34] IRC §243 to §247.
[35] IRC §172.
[36] IRC §448.
[37] *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, prepared by the Staff of the Joint Committee on Taxation, 1984, page 260.
[38] *General Explanation to the Tax Reform Act of 1986*, *supra*, page 475.
[39] IRC §448(d)(5).
[40] IRC §465.
[41] *General Explanation to the Tax Reform Act of 1986*, *supra*, page 210.
[42] IRC §469.
[43] IRC §280G and §4999.
[44] *General Explanation to the Tax Reform Act of 1986*, *supra*, page 336.
[45] *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200, 36-1 USTC ¶9012, 16 AFTR 1126 (1935).
[46] See *Tax Treatment of Capital Gains and Losses*, prepared by the Staff of the Joint Committee on Taxation, JCS-4-97, March 12, 1997, pages 30 to 34.
[47] IRC §1221.
[48] IRC §1231.
[49] IRC §6045(e).
[50] IRC §6043 and §6652(l) and related regulations.
[51] *General Explanation to the Tax Reform Act of 1986*, *supra*, page 1053. The reporting requirements are at IRC §6038A, §6038B and §6038C.
[52] *Reducing The Tax Gap - Results of a GAO-Sponsored Symposium*, GAO/GGD-95-157, June 1995, pages 2 to 3. Also reported in *Journal of Accountancy*, September 1995, page 27.
[53] *Tax Gap - Many Actions Taken, But a Cohesive Compliance Strategy Needed*, GAO/GGD-94-123, May 1994, page 24.
[54] IRC §6331(d).
[55] IRC §7811.
[56] GAO/GGD-95-157, *supra*, pages 2 and 17.
[57] IRC §7602.
[58] IRC §7603.
[59] IRC §3406.
[60] IRC §6050I.
[61] *Quill*, 504 U.S. 298 (1992).
[62] From a speech to the 34th General Assembly of the Inter-American Center of Tax Administrators, released by Treasury on July 10, 2000, LS-759.