

THE TAX EXECUTIVE

Volume 48, Number 2

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FEATURE ARTICLES

**Corporate Procurement Card Programs:
Are They Paperless Chaos?
Sales/Use Tax Considerations**
By Mark D. Loftis

**The Effect of the IRS District Office Reorganization
on Corporate Taxpayers**
By George A. O'Hanlon and Michael A. Urban

**Proposed Section 3121(v) Regulations: Application of
Employment Taxes to Nonqualified Deferred Compensation**
By Paul T. Shultz and Ian A. Herbert

TECHNICAL SUBMISSIONS

Notice 96-7: Request for Comments on Further Capitalization Guidance

**Application of Small Business Regulatory
Enforcement Fairness Act to Tax Regulations**

TEI Urges Treasury To Permit Companies to "Check the Box" (Notice 95-14)

Limiting Retroactive Legislation in Canada

TEI Opposes Virginia Legislation to Permit Contingency Fee Audits

National Tax Association
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Also in this Issue...

**Saul Kass Examines the Role of the TEI Member
TEI's 1996-1997 Leadership Team**

Spring Fling: Highlights of TEI's 46th Midyear Conference

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"Every man owes some of his time to the upbuilding of the profession to which he belongs."
Theodore Roosevelt

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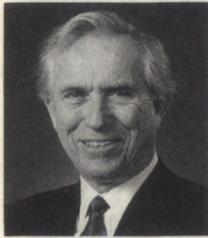
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PRESIDENT'S CORNER



This year's Midyear Conference was bittersweet for me. The conference itself was excellent. Our technical sessions featured one outstanding speaker after another, and I was honored to introduce a fine cadre of government leaders and to present the Institute's Distinguished Service Award to Lloyd Bentsen, who served the country so well as Secretary of the Treasury and Chairman of the Senate Finance Committee. Senator Bentsen's eloquent remarks at the Tuesday banquet reminded us all of the tax community's debt to him and reinforced the importance of being active in organizations like TEI: The system cannot be improved unless men and women of common purpose come together and act in concert.

The conference was also a lot of fun. Lee and I had a chance to renew old acquaintances and to make new friends at the reception on Sunday and the Tuesday night banquet. I say this, moreover, even though the reaction to Mike Murphy's and my singing-and-dancing efforts with The Capitol Steps will cause me to keep my day job. Seriously, the musical comedy troupe picked up everybody's spirits and demonstrated once again that they are indeed funnier than Congress.

Given these positive comments on the Midyear Conference, why was the conference bittersweet? Because it was the beginning of the end of my term. At Wednesday's farewell luncheon, I had the pleasure of introducing Jim Murray, TEI's 1996-1997 President-elect, and the Institute's other incoming officers. I also had the honor, for the last time, of addressing a TEI conference as President. I shall save my good-byes for the next issue's column, but did not want this occasion to pass without saying how much I enjoy being your President and how much, I am sure, I will miss it when my term ends.

Between now and then, I pledge my continuing efforts to serve the Institute. The contents of this issue demonstrate TEI's depth and strength. TEI's Federal Tax Committee has responded so quickly and comprehensively to the Treasury and IRS's request for comments on the aftermath of the *INDOPCO* decision. I also commend the efforts of the State and Local Tax Committee to defeat bounty hunter legislation in Virginia and to participate meaningfully in the Federation of Tax Administrators' electronic data interchange project. Our International, Canadian, and IRS Administrative Affairs Committees have also been busy. Whether the subject is the newest "regulatory reform" bill, the Treasury's "check-the-box" initiative for entity classification purposes, or Canada's trend toward retroactive legislation, TEI has ably served the membership. And our activities promise to pick up steam in the coming weeks, when we file comments on the IRS's research tax credit audit plans, digital imaging, and global interest netting, as well as a plethora of other subjects.

I would be remiss if I did not note two changes in our leadership team. Phil Bergquist, who has served as chair of the International Tax Committee, has accepted a position with a public accounting firm, and consequently tendered his resignation. We are fortunate that Joe Tann of the Chicago Chapter has agreed to assume the helm. We are also fortunate that Dave Klausman of the Pittsburgh Chapter has agreed to become chair of the Federal Tax Committee. Dave steps in for Bruce Barnett of the Minnesota Chapter, who resigned his TEI post after assuming additional duties at his company. Phil and Bruce have done tremendous jobs of leading their committees, and I thank them.

Last but not least, please be on the look out for two mailings: your dues statement and a survey concerning TEI's educational activities. The dues statement itself will be self-explanatory, but I encourage you to double check your roster listing. I also encourage you to pay your dues quickly, to eliminate the need for follow-up mailings and hence to minimize the overall costs to the membership.

The questionnaire was prepared by the Institute's Continuing Education Task Force, and is designed to elicit information about the educational wants and wishes of TEI members. How is TEI doing in delivering good quality programs to the membership? What is optimal length of TEI conferences and seminars? Who are the Institute's competitors — our local chapters, other membership organizations, or various for-profit groups — and how can TEI best meet the competition? Please help TEI remain competitive by completing the survey.

Jack R. Skinner

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CALENDAR OF EVENTS

Listed below are the dates, locations, and registration fees for Tax Executives Institute's and TEI Education Fund's educational programs through November 1996. Dates, locations, subjects, and fees are subject to change. Members may register in advance for any program for which the fee has been set, but the check or credit card form must be accompanied by a registration form. If you are interested in registering for any of these programs, please call 202/638-5601.

1996

April	18-19	IRS Audits and Appeals Seminar (Stouffer Renaissance Harborplace Hotel — Baltimore, Maryland)	\$545
	28-May 3	Federal Tax Course — Level I* (Michigan State University, East Lansing, Michigan)	\$1,400
June	6-7	Corporate Tax Management Seminar (Renaissance Los Angeles — Los Angeles, California)	\$545
	16-18	Leadership Seminar (New officers and Chapter Presidents) (Quebec City, Quebec)	
	16-21	Federal Tax Course — Level II* (Michigan State University, East Lansing, Michigan)	\$1,400
July	14-19	State and Local Tax Course* (Houstonian Conference Center, Houston, Texas)	\$1,400
August	11-13	Annual Meeting of Members and Board of Directors Meeting (Jackson Hole, Wyoming)	
	18-23	International Tax Course — Level II* (UCLA — Los Angeles, California)	\$1,400
October	19-23	51st Annual Conference (Sheraton Chicago Hotel, Chicago, Illinois)	Member: \$675 Associate Member: \$300 Business Guest: \$595 Spouse: \$125
November	17-22	International Tax Course — Level I* (Arthur Andersen Center for Professional Education, St. Charles, Illinois)	\$1,400

CPE/CLE Accreditation: Boards of Accountancy. TEI is registered with the National Association of State Boards of Accountancy (Sponsor No. 91-00116-97, Exp. 12/31/96). TEI is also registered with the following Boards of Accountancy: **Illinois** (#158-000651); **Indiana** (#CE92000119, Exp. 12/96); **New Jersey** (#160, Exp. 6/30/97); **New York** (E93-253, 9/1/93-8/31/96); **Ohio** (P0087); **Pennsylvania** (PX613L); and **Texas** (#3512).

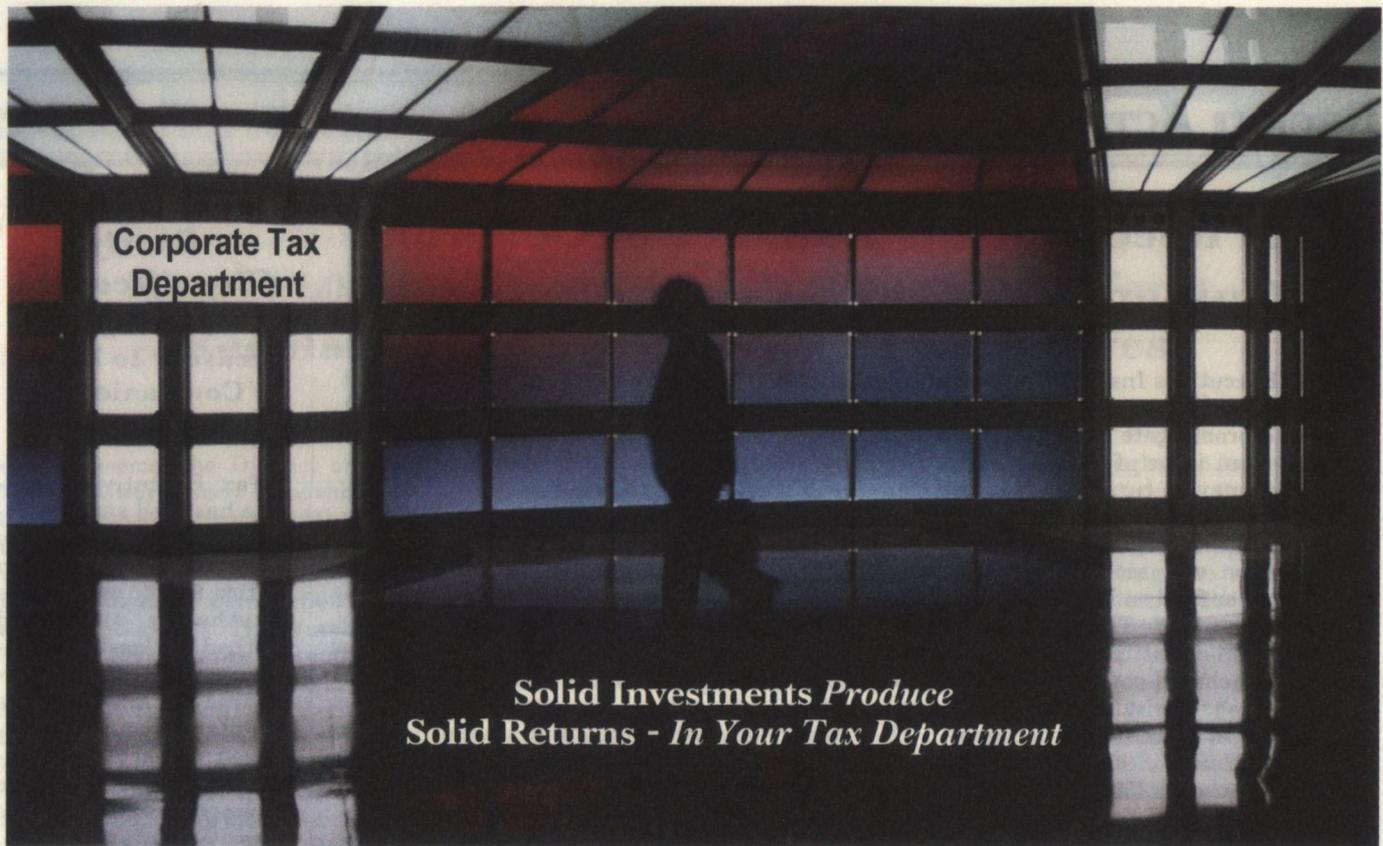
Continuing Legal Education. The Institute is registered in the following states as a sponsor of continuing legal education programs: **California** (Approved Provider status from September 1, 1995, to August 31, 1996); **Iowa**; **Kentucky** (1996 46th Midyear Conference — 24.5 credit hours [Ethics credits are included], 1995 50th Annual Conference — 25 credit hours [Program Number 36198]); **Minnesota** (1996 46th Midyear Conference — 20.5 credit hours, 1995 50th Annual Conference — 19.50 credit hours); **Ohio** (1996 46th Midyear Conference — 26.25 credit hours, 1995 50th Annual Conference — 27.25 credit hours), 1996 International Tax Seminar: Section 482 Compliance — 11.5 credit hours); **Oklahoma** (1996 46th Midyear Conference — 31.5 credit hours, 1995 50th Annual Conference — 25.0 credit hours); **Pennsylvania** (1995 50th Annual Conference — 20.5 substantive); **Wisconsin** (1996 46th Midyear Conference — 26.0 hours; 1995 50th Annual Conference — 31.50 hours). The Institute is also an accredited sponsor of educational programs for enrolled agents.

Note. Several states, such as Wisconsin and Georgia, require the individual to submit conference materials directly to the CLE board. TEI provides a continuing professional education form for each registrant at its conferences, courses, and seminars, which should be completed at the end conclusion of the program and returned to the TEI Registration Desk for verification and signature. A copy of the form is retained and filed at TEI headquarters.

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TEI Recommends Issuance of General Guidance on Capitalization Issues

Tax Executives Institute has urged the Treasury Department and Internal Revenue Service to promulgate general guidance on the important issue of whether certain expenditures may be currently deducted ("expensed") by taxpayers or, rather, must be capitalized. The corporate tax group's recommendation was set forth in a detailed position paper filed on March 20 in response to IRS Notice 96-7. That notice requested assistance in identifying approaches the government should consider to address the expense-versus-capitalization issue, particularly in light of the 1992 decision in *INDOPCO v. United States*, which held that certain expenses related to an acquisition must be capitalized because they produced an enduring long-term benefit.

TEI's submission observes that, "since the inception of the income tax, a recurring source of friction between the government and taxpayers has been the need to draw proper distinctions between capital expenditures and deductible ordinary and necessary business expenses." The Supreme Court decision in *INDOPCO*, "with its expansive and amorphous language applied to a narrowly circumscribed set of facts, has sparked another cycle of controversy," TEI explained. It pointed to revenue rulings concerning advertising, repairs, environmental clean-up costs, and other matters upon which guidance has been issued since the *INDOPCO* decision and urged the IRS to continue issuing similar general guidance.

"Rather than permit the legacy of *INDOPCO* to evolve slowly through private letter rulings, technical advice memoranda, or litigation," TEI urged the Treasury and IRS "to publish general guidance clarifying the tests for capitalization or deduction of expenditures." In addition, in response to the statement in Notice 96-7 that taxpayers may seek private letter rulings to resolve capitalization issues, TEI said that "the limitations on the private letter ruling process suggest that private rulings are no substitute for published guidance."

After commenting on the limitations of the private ruling process and the record-keeping and examination burdens placed upon companies undergoing scrutiny for

matters loosely referred to as "*INDOPCO* issues," the comments discuss the general principles of tax law that are helpful in resolving the deductibility/capitalization issue. The comments next focus on two principal areas where TEI believes guidance would be most useful: expenditures for self-created intangibles and post-acquisition operating expenses.

For self-created intangibles, the comments address expenditures for training and other costs related to adoption of just-in-time manufacturing and total quality management programs, business expansion costs (including customer service contract costs and costs of developing new services), and recurring expenses (including cellular telephone commission expenses and product or process certification costs). For post-acquisition operating expenses, the comments address expenditures for severance payments, system integration costs, contract termination expenses, and decommissioning costs to eliminate redundant assets.

Finally, the Institute addressed the need for the IRS to instruct its agents to ensure that, where a cost is capitalized, it is properly associated with an identifiable asset to permit its recovery as a deduction in a reasonable amount of time. "Creating new assets or associating expenditures with exiting assets with indefinite or excessively long lives will ensure protracted and continuing controversies between taxpayers and the government," TEI concluded.

TEI's comments, which are reprinted in this issue beginning on page 111, were prepared under the aegis of its Federal Tax Committee, whose chair is Bruce H. Barnett of Cargill, Inc. The following members contributed materially to the development of TEI's comments: Roger D. Wheeler of General Motors Corporation, Richard N. Kappler, MCI Incorporated, and the 1994-1995 chair of TEI's Federal Tax Committee, Michael A. DeLuca of Household International, Inc. Also contributing to the development of the comments were Joseph Migas of MCI Incorporated and Margaret Satko and Neil Miller of General Motors Corporation.

Entity Classification TEI Urges Treasury to Permit Companies to "Check the Box"

Tax Executives Institute has filed supplemental comments with the Treasury Department on Notice 95-14, which asks whether a simplified method of classifying unincorporated business organizations should be adopted (commonly referred to as the "check-the-box" procedure). The comments, which took the form of a January 23, 1996, letter from TEI President Jack R. Skinner to Deputy Tax Legislative Counsel Michael D. Thomson, follow up on a November 1995 meeting between Mr. Thomson and TEI representatives. TEI's initial comments on Notice 95-14 are reprinted in the July-August 1995 issue of *THE TAX EXECUTIVE*.

TEI's comments addressed three issues relating to the international aspects of the procedure: (i) the feasibility of using a list of *per se* corporations; (ii) the designation of "default" corporate status for entities that fail to make an election; and (iii) the mechanics of making the election.

The letter was prepared under the aegis of TEI's International Tax Committee, whose chair is Philip J. Bergquist of Apple Computer Co. The Institute's comments are reprinted on page 123.

TEI's Spring Fling**Nearly 800 Tax Executives Discuss Tax Reform,
Regulatory Developments, CEP Initiatives**

Spring in Washington, D.C. is cherry blossoms, the District of Columbia's answer to snow removal, and Tax Executives Institute's 46th Mid-year Conference. This year's conference, held on the cusp of the vernal equinox, attracted nearly 800 TEI members and guests. The March 16-20 program featured the presentation of the Institute's Distinguished Service Award to former Treasury Secretary and Senator Lloyd Bentsen and addresses by Senator Orrin Hatch, Congressman Bill Archer, Canada's Associate Deputy Minister of Revenue Ian Bennett, Assistant Treasury Secretary Leslie Samuels, and IRS Commissioner Margaret Richardson. In addition, an outstanding array of TEI members and private practitioners gave technical presentations on issues ranging from the use of accounting methods, to dividend planning to the development of a tax department's best practices, from the use of the Internet to digital imaging developments, from hot state and local topics to...well, you get the idea.

The congressional speakers focused on the prospects for fundamental tax reform. In his keynote address on Tuesday morning, Senate Finance Committee member Orrin Hatch observed that there will be "winners and losers" in any reform legislation. He added that taxpayers are searching for the "tax nirvana" that they believe is out there — if only Congress could get its act together. Noting that some good ideas are "on the table," Senator Hatch urged TEI's members to get involved in the debate. We have not heard anything about the effect of tax reform on industries, he said.

The next morning, the Chairman of the House Ways and Means Committee, Bill Archer, defended his call to "pull the income tax out by its roots" as "not so radical" an idea. Noting that 68 percent of the American people believe the income tax

should be abolished, Congressman Archer referred to the hearings to begin later that day on the functioning of the income tax system. He suggested that the country would benefit if tax collectors and tax practitioners were "out producing wealth rather than shifting it around."

Assistant Treasury Secretary Samuels also commented the prospect for tax reform, noting that "as we go down that yellow brick road," more issues will arise. Don't be lured by the rhetoric, he cautioned, that may be fool's gold — not a pot of gold — at the end. He expressed concern about the effect of "radical" reform proposals such as Congressman Arme's flat tax on health insurance coverage and pension savings. The losers will be stable businesses with a low ratio of current investment to existing assets, he predicted.

In his remarks, Senator Hatch also addressed several issues involving the current Code including the likelihood of an extension of the expired tax provisions. If the provisions are not made permanent, he said, they should be dropped. He lamented that very little concern has been expressed about the expiration of section 127 and expressed pessimism over the prospect of a retroactive extension of the deduction for educational assistance. The research tax credit may also be a casualty of the failure to reach a budget agreement, he stated. Finally, calling the failure to repeal section 956A "really tragic," the Senator said that the provision works as an incentive to invest abroad.

IRS Commissioner Richardson's comments on Monday afternoon focused on the need to improve the current tax system for taxpayers. She stated that the IRS's recent restructuring can have only a positive impact on taxpayers in the Coordinated

Examination Program (CEP). We want your thoughts on how the reorganization is working, she remarked. The Commissioner also discussed several improvements to the CEP program, announcing the signing of a revised delegation order to give the Examination division more authority to settle cases and addressing the prospects for three or four year examination cycles. Many of the ideas to improve the currency of audits have come from TEI, she said. She commended two TEI members — Ralph J. Weiland and D. Daniel Porras, who currently serve on the Commissioner's Advisory Group — for their work to improve the CEP program.

On Tuesday afternoon, Ian Bennett, Associate Deputy Minister for Revenue Canada - Customs, Excise & Taxation, commented on Canada's federal budget and the establishment of the Canada Revenue Commission. Billy Hamilton, President of the Federation of Tax Administrators and Deputy Comptroller of Texas, closed the four-day program on Wednesday afternoon with a discussion of current developments in Texas and the FTA's priorities.

Other government speakers included Barry LaCombe, Revenue Canada's Assistant Deputy Minister, on audit initiatives for large corporate taxpayers; Lindy L. Paull, Majority Staff Director and Chief Counsel of the Senate Committee on Finance, on legislative developments; Michael Danilack, IRS Associate Chief Counsel (International), Thomas J. Smith, IRS Deputy Assistant Commissioner (International), and Jacqueline J. Wong, Senior Advisor with the Treasury Department, on developments in the international tax area; Samy Watson, General Director of the Tax Policy Branch of the Canadian Department of Finance, on VAT develop-

(continued on next page)

TEI's Spring Fling:

(continued from previous page)

ments; Jacob Feldman, Attorney Advisor with the IRS's Office of Chief Counsel (International), on section 936 developments; and Dennis McCarthy, an IRS CEP Branch Chief, on taxpayer involvement in the audit planning process. Former Delaware Governor Pete du Pont, a member of the National Commission on Economic Growth and Tax Reform, spoke on the recommendations of the Kemp Commission.

A lighter moment during the conference was the performance by the Capitol Steps at the Tuesday night banquet.

Photo highlights of the conference will be included in the next issue of *THE TAX EXECUTIVE*.



Bounty Hunters and Fool's Gold

TEI Opposes State Contract Audits

As the Virginia legislature raced toward adjournment of its 1996 session, Tax Executives Institute filed comments opposing proposed legislation to permit localities to hire accounting firms to conduct audits of local taxes. The Institute's January 31 comments argued that the proposal, which would authorize the hiring of contract auditors on a contingency fee basis, would seriously undermine the integrity of, and public confidence in, local tax administration.

TEI explained that the determination of tax liability is a core governmental function — similar to the provision of police protection — that the legislature should be loath to outsource. The Institute continued that although the privatization of the government's audit function might be appealing at first blush, the proposal's allure resembles "fool's gold":

"Contract audits violate public policy. They threaten taxpayer privacy and, where the auditor

is paid on a contingency basis, deprive taxpayers of due process and subject them to abuse. No longer would a taxpayer's liability be determined by a public employee, but by a 'bounty hunter' whose compensation is directly linked to the amount he or she can extract from the taxpayer. Contract auditors would gain access to the most important personal, financial, market, and customer data that businesses and other taxpayers possess. Since contract auditors at best would be providing their services to a locality on a part-time basis, they would be in a perpetual conflict of interest vis-à-vis their private clients."

The legislature adjourned for the year without taking formal action on the legislation.

TEI's comments are reprinted on page 127.



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Canadian Liaison Follow-Up: Eschewing Retroactive Legislation

Tax Executives Institute has submitted comments to the Canadian Minister of Finance, Paul Martin lamenting certain trends affecting the development of Canadian tax policy and legislation.

The comments, which took the form of a February 16, 1996, letter from Institute President Jack R. Skinner, followed up on matters issues discussed at TEI's liaison meeting on December 5, 1995, with representatives from the Department of Finance. At the meeting, TEI expressed concern about (i) the increasing tendency to introduce major policy changes in the guise of technical amendments bills, (ii) the introduction of legislative amendments retrospectively changing the tax treatment of completed transactions, and (iii) the use of hypertechnical changes to extend

taxing jurisdiction to non-residents of Canada.

In the letter, TEI noted that technical amendment bills have traditionally been used to implement limited and narrow changes in order to correct anomalies, clarify the meaning or intent of statutory provisions, and provide legislative support for assessing practices that are fair and beneficial. TEI expressed concern that significant policy changes are being included in technical amendment bills, thereby eluding the public scrutiny and debate that such policy changes might deserve.

The comments address three specific instances where the retroactive change seems particularly unwarranted, the proposed amendments regarding the treatment of inducement payments as refunds, the proposed amendment to paragraph

62(3)(f) to exclude amounts paid on account of GST from the definition of moving expenses, and the proposed amendments to subsections 13(4), 13(4.1), 14(6), 14(7), 44(1), and 44(5) adding an intention test to the replacement property rules. Finally, TEI commented on the use of the April 26, 1995, technical amendment bill to expand the definition of "taxable Canadian property."

The Institute's comments were prepared under the aegis of its Canadian Income Tax Committee, whose chair is J. A. (Drew) Glennie of Shell Canada Limited. The Institute's comments are reprinted on page 125. The response from the Department of Finance appears immediately below.

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Retroactive Legislation Deemed Sometimes Necessary

Canadian Department of Finance Responds to TEI's Effective Date Concerns

On March 13, 1996, the Canadian Department of Finance responded to Tax Executives Institute's letter dated February 26 concerning the effective date of tax legislation. (TEI's letter is reprinted elsewhere in this issue.) The text of the letter, which was addressed to TEI President Jack Skinner and signed by Paul Martin, the Minister of Finance, follows:

Thank you for your letter of February 16, 1996, further to the meeting between members of the Tax Executives Institute, Inc. and my officials on December 5, 1995. In your letter you raise concerns with the policy content of so called "technical bills" and the effective date for new tax legislation.

With regard to the policy ramifications of "technical bills," it can be difficult to distinguish between a technical change and a policy change. Any change to the Income Tax Act, even a very technical one, is likely to affect some taxpayers. Unfortunately, the complexity of tax law requires that amendments be facilitated more frequently than just once a year in the budget. Technical bills are legiti-

mate pieces of legislation and should be reviewed by all practitioners; there is no attempt to hide proposed changes. Indeed, the period between the announcement of changes and their introduction in Parliament as a Bill is intended as an opportunity for commentary on the new proposals.

With respect to your suggestion that the government delay the effective date of tax legislation until the date of Royal Assent, I am sure you will understand that such a practice would give tax advantages to sophisticated taxpayers, who would be able to respond to announced changes before they became effective, while ordinary taxpayers would be likely to be unable to plan in advance for tax changes. This would not only pre-

dice the treasury, but would also increase the fiscal demands on the populace as a whole. Further, most instances of retroactivity in legislation introduced through technical bills result from requests for accommodation from the tax community with regard to the structure of specific transactions which have already occurred. Such accommodation would not be possible if all legislation were stated to come into force only on Royal Assent.

Other instances of retroactivity occur to correct anomalies or inconsistencies, or in response to an unexpected outcome in a court case. The usual policy of this Department is for

(continued on next page)

RECENT ACTIVITIES

(continued from previous page)

changes to the tax laws to be prospective in application. Decisions to include an element of retroactivity in the application of legislation are not made lightly. For example, the amendments to paragraph 12(1)(x) of the Income Tax Act to which you refer provide, in general, that a refund of an amount that was previously deducted must be included in computing income unless it is applied to reduce the related expenditure for tax purposes. This amendment, which reinstates the practice that was generally accepted by both Revenue Canada and tax practitioners before being called into question as a result of the *Johnson & Johnson* case to which you also refer, is effective in respect of amounts received after 1990. In this regard, it is difficult to accept the proposition that a refund of a previously deducted amount should have no tax result. Faced with the choice of delivering an unexpected windfall benefit to a small group of taxpayers,

at a cost to all other taxpayers who have been called upon to pay increasing levels of taxes over the last few years of very serious fiscal restraint, or correcting the situation for open taxation years, I chose the latter.

You also mention the amendment to paragraph 62(3)(f) of the Act to specifically exclude GST on a new home as a qualifying moving expense. As you know, subsection 62(3) of the Income Tax Act provides for a very limited number of expenses involved in the acquisition of a new house to qualify as moving expenses. When the provisions of paragraph 62(3)(f) were initially proposed in the 1976 Budget, it was envisioned that no expense associated with acquiring a new house would qualify. However, the position was modified to allow certain expenses associated with the acquisition of a new house to be eligible as moving expenses. In its current state, this position may be seen to favour individuals whose move involves the sale of an old house and

the acquisition of a new one over individuals who rent before a move and either buy or rent after their move. It would be difficult to justify enriching this bias by further allowing GST on a new house (an amount that may be quite significant on expensive houses) to be a deductible moving expense in such situations.

As well, one must keep in mind that GST on house transfers, as on other transactions, was intended to replace the hidden manufacturer's sales tax inherent in such transactions. As there was no income tax relief provided for the manufacturer's sales tax, there is little rationale to extend tax assistance to its substitute.

It is my understanding that the Department of National Revenue, based on the current provisions of paragraph 62(3)(f), has taken the position that the reimbursement of GST payable on the cost of relocating an employee's new home would be a taxable benefit to the employee and not a deductible moving expense. In line with this position, and with the underlying rationale that I have explained, I would find it difficult to support a suggestion that the effective date of the proposed amendment to clarify this matter be changed.

With respect to the replacement property rules, the amendments simply clarify that the replacement property must have been acquired to replace the former property. This clarification is consistent with the previously existing law and Revenue Canada's Interpretation Bulletin, neither of which have been judicially challenged.

While you may not agree with the policy underlying these specific legislative amendments, I cannot agree that the implementation of these amendments is inappropriate, although I do understand that others may weigh the difficult balancing of interests that these issues entail in a different manner.

Thank you for bringing your concerns to my attention.

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Reg-Flex Redux

Application of Regulatory Reform Proposals to Tax Rules

Tax Executives Institute recently renewed its opposition to the application of self-described regulatory reform legislation to tax rules and regulations. In comments filed with the Senate's Small Business Committee on March 5, the Institute urged that the Internal Revenue Service be exempted from the provisions of S. 942, the Small Business Regulatory Enforcement Fairness Act. An amendment before the committee would require agencies — such as the Internal Revenue Service — that publish a "notice of interpretive rulemaking of general applicability" to comply with the Regulatory Flexibility Act by preparing an analysis that the final rule minimizes significant economic effect on "small entities" to the maximum extent possible. The amendment would also permit an adversely affected small entity to seek judicial review of the agency's action.

In its comments, TEI reiterated the concerns it voiced last summer in

connection with certain regulatory reform measures championed by proponents of the "Contract with America." (The Institute's prior submissions were reprinted in the July-August 1995 and September-October 1995 issues of *THE TAX EXECUTIVE*.) Specifically, TEI said that subjecting IRS regulations to the Regulatory Flexibility Act could delay the issuance of important guidance. The Institute explained:

Tax obligations arise not under IRS regulations but under specific statutes that are enacted by Congress. Taxpayers are dependent upon regulations and other guidance to fill in the gaps, to explain the ambiguities, to finish the job often left undone by the statutory language. Taxpayers — and taxpayer groups — continually press the IRS and Treasury for more, not less, guidance.

TEI predicted that if IRS is forced to review every interpretative regulation for its effect on small businesses, the backlog of regulatory projects will undoubtedly grow. "Rather than relieving taxpayer burden," the Institute concluded, "subjecting tax rules to the Regulatory Flexibility Act may actually exacerbate it."

Notwithstanding the Institute's comments, the Senate unanimously passed a bill that would apply the enhanced regulatory flexibility standards to all federal regulations, including those issued by the Internal Revenue Service.

TEI's comments were prepared under the aegis of its IRS Administrative Affairs Committee whose chair is Robert L. Ashby of Northern Telecom Inc. The Institute's submission is reprinted on page 122.



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RECENT ACTIVITIES

Additional Projects on the Horizon

TEI Assists FTA on EDI Project

Since October 1994, members of TEI have been participating in a task force sponsored by the Federation of Tax Administrators (FTA) concerning legal and audit issues surrounding the use of electronic data interchange (EDI) by business. The task has been meeting regularly in working groups to develop a model recordkeeping and record retention regulation, as well as a summary of the audit approaches that the States might employ to ensure that taxpayers' electronic and paper records support their reported state tax liabilities. Representatives of other business associations, including the Committee on State Taxation and the Institute of Property Taxation, also participated in the task force.

On February 29, 1996, the Institute submitted a letter to the FTA commenting on the draft report of the Task Force Steering Committee on the Model Recordkeeping Regulation. The TEI letter commends the FTA for undertaking the project, saying that the "Model Recordkeeping Regulation is superior in its approach to recordkeeping requirements, especially for those in electronic format, to that adopted by the IRS in Rev. Proc. 91-59." Moreover, TEI urged the FTA to forward its Model Recordkeeping Regulation and report to the IRS Office of Chief Counsel so that the IRS might consider it in its revision of Rev. Proc. 91-59. "It is in the best interests of taxpayers and state tax administrators alike that federal and state recordkeeping requirements be harmonized," the letter commented, concluding that TEI "would prefer to see the IRS move closer to the FTA's model regulation."

In addition, a draft report from the Audit Issues workgroup has been circulated among the participants. When final, the Audit Issues workgroup report and the Model Recordkeeping Regulation workgroup reports will be combined in a single report to be published by the FTA.

TEI's representatives on the various working groups included Barbara Barton of EDS Inc., Manny Davila and Barbara Timek of AT&T Corp., Bill Zornes of Western Auto Supply Co., Marc V. Beshears of Sprint Corp. and Jeffery P. Rasmussen of the Institute's legal staff.

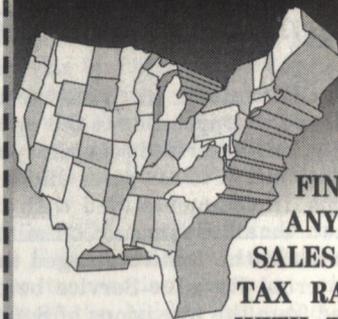
As the initial project of the Task Force nears its completion, the Steering Committee is studying additional business tax issues that the members believe could be addressed through a similar cooperative Task Force approach. Among the issues to be discussed at a May 2, 1996, meeting in Washington, D.C., are:

- streamlining of refund procedures and exemption certificate requirements for sales and use taxes;
- the implications of evaluated receipts transactions;
- procurement (or purchasing) card issues;
- direct pay permits;
- prepaid calling cards; and
- issues related to electronic filing of returns and electronic payment of taxes.

TEI members with an interest in participating in a golden opportunity to influence the development of state tax policy through the Task Force working groups should contact Christopher W. Baldwin of Gannett Co., Inc., chair of TEI's State and Local Tax Committee, at (703) 284-6801; Bill Zornes of Western Auto Supply Co., chair of TEI's Tax Information Systems Committee at (816) 346-4073; or Jeffery P. Rasmussen of the Institute's legal staff at (202) 638-5601.



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TEI Announces 1996-1997 Leadership Team

Tax Executives Institute has announced the election of its 1996-1997 officers, the composition of its Executive Committee, and the impending appointment of committee chairs for the fiscal year beginning July 1, 1996. The announcement was made by James R. Murray of PacifiCorp, who will begin a one-year term as TEI's International President next summer. TEI is the professional association of in-house tax practitioners; its 5,000 members work for the leading 2,700 companies in North America; the organization has 48 local chapters, and submits comments on proposed tax legislation and regulations, sponsors educational programs, and provides its members a forum to meet with government officials, share ideas, and educate themselves about the latest developments in federal, international, and state and local taxation.

Mr. Murray announced that the following TEI members have been elected to serve as officers of the Institute:

President	James R. Murray of PacifiCorp (Portland Chapter)
Senior Vice President	Sandy J. Navin of General Mills, Inc. (Minnesota Chapter)
Secretary	Paul Cherecwich, Jr. of Thiokol Corporation (Salt Lake City Chapter)
Treasurer	Lester D. Ezrati of Hewlett-Packard Company (Santa Clara Valley Chapter)
Region I Vice President	J.A. (Drew) Glennie of Shell Canada, Limited (Calgary Chapter)
Region II Vice President	Linda A. Klang of Time Warner Inc. (New York Chapter)
Region III Vice President	Natu T. Patel of John Wiley & Sons, Inc. (Westchester-Fairfield Chapter)
Region IV Vice President	Charles E. Miller of Lenox, Incorporated (Philadelphia Chapter)
Region V Vice President	Preston B. Barnett of Cox Enterprises, Inc. (Atlanta Chapter)
Region VI Vice President	Donna Lee Walker of PPG Industries, Inc. (Pittsburgh Chapter)
Region VII Vice President	David L. Bernard of Kimberly-Clark Corp. (Wisconsin Chapter)
Region VIII Vice President	Robert D. Adams of Halliburton Company (Dallas Chapter)
Region IX Vice President	Raymond G. Rossi of Intel Corporation (Santa Clara Valley Chapter)

In addition, Mr. Murray reported that the following individuals will be appointed to the Institute's Executive Committee, which will be responsible for overseeing the day-to-day operations of the Institute and for developing and implementing the Institute policies in respect of technical submissions, continuing education programs, and member services.

Executive Committee Members

James R. Murray of PacifiCorp (Portland Chapter), <i>Chair</i>
Sandy J. Navin of General Mills, Inc. (Minnesota Chapter), <i>Vice Chair</i>
Paul Cherecwich, Jr. of Thiokol Corporation (Salt Lake City Chapter)
Lester D. Ezrati of Hewlett-Packard Company (Santa Clara Valley Chapter)
J.A. (Drew) Glennie of Shell Canada Limited (Calgary Chapter)
Susan M. Murray of ENRON Oil and Gas Company (Houston Chapter)
Raymond G. Rossi of Intel Corporation (Santa Clara Valley Chapter)
Donna L. Walker of PPG Industries, Inc. (Pittsburgh Chapter)
Roger M. Wheeler of General Motors Corporation (Detroit Chapter)

Finally, Mr. Murray announced whom he will appoint to chair the Institute's committees during the coming year. In making the announcement, Mr. Murray said that, to foster communication between TEI's Executive Committee and its committees, he will continue the practice of designating specific members of the Executive Committee, as well as staff representatives, to serve as liaisons to the Institute's committee chairs. Under the program, each committee has a direct link to the Executive Committee and the staff (through its designated liaisons). There follows a list of the Institute's 1996-1997 committee chairs and liaisons:

- Advisory Comm. to the President** — Linda B. Burke of Aluminum Company of America (Pittsburgh Chapter)
Liaisons: James R. Murray — Michael J. Murphy
- Alternative Tax Systems** — Gareth E. Glaser of Alcon Laboratories, Inc. (Dallas Chapter)
Liaisons: Susan M. Murray — Mary L. Fahey

TEI's 1996-1997 Leadership Team

- Awards** — Robert D. Adams of Halliburton Company (Dallas Chapter)
Liaisons: James R. Murray — Thomas J. Plutz*
- Canadian Commodity Tax** — Pierre M. Bocti of Hewlett-Packard (Canada) Ltd. (Toronto Chapter)
Liaisons: J.A. (Drew) Glennie — Jeffery P. Rasmussen
- Canadian Income Tax** — Alan Wheable of Canada Trust (Toronto Chapter)
Liaisons: J.A. (Drew) Glennie — Jeffery P. Rasmussen
- Communications** — Vincent Alicandri of Xerox Canada Ltd. (Toronto Chapter)
Liaisons: Paul Cherecwich, Jr. — Timothy J. McCormally
- Continuing Education** — Sandy J. Navin of General Mills, Inc. (Minnesota Chapter)
Liaisons: James R. Murray — Deborah K. Gaffney
- Corporate Tax Management** — Raymond F. Douglas of Dean Witter, Discover & Company (San Francisco Chapter)
Liaisons: Paul Cherecwich, Jr. — Mary L. Fahey
- Federal Tax** — David L. Klausman of Westinghouse Electric Corp. (Pittsburgh Chapter)
Liaisons: Lester D. Ezrati — Jeffery P. Rasmussen
- Internal Affairs** — Jack R. Skinner of Halliburton Company (Dallas Chapter)
Liaisons: James R. Murray — Michael J. Murphy
- International Tax**** — Joseph S. Tann, Jr. of Ameritech Corporation (Chicago Chapter)
Liaisons: Donna L. Walker — Mary L. Fahey
- IRS Administrative Affairs** — Robert L. Ashby of Northern Telecom Inc. (Nashville Chapter)
Liaisons: Roger D. Wheeler — Timothy J. McCormally
- Membership** — Paul J. Schaffhausen of McDonald's Corporation (Chicago Chapter)
Liaisons: Lester D. Ezrati — Thomas J. Plutz*
- Nominating** — Jack R. Skinner of Halliburton Company (Dallas Chapter)
Liaisons: James R. Murray — Michael J. Murphy
- State and Local Tax** — Christopher W. Baldwin of Gannett Company Inc. (Baltimore/Washington Chapter)
Liaisons: Raymond G. Rossi — Timothy J. McCormally
- Tax Information Systems** — Bill Zornes of Western Auto Supply Company (Kansas City Chapter)
Liaisons: Paul Cherecwich, Jr. — Jeffery P. Rasmussen

* Deborah C. Giesey has been named interim staff liaison until Mr. Plutz returns from his medical leave of absence.

** In previous years, the Institute has had a separate committee on Puerto Rico and U.S. possession tax matters. For the coming year, those matters will be the responsibility of a subcommittee of the International Tax Committee.

Region IX 1996 Annual Conference — May 19-22, Incline Village, Nevada

The Region IX 1996 Annual Conference will be held May 19-22 at the Hyatt Regency in Incline Village, Nevada. The conference will open on Sunday with an all-day session on Negotiation Strategy led by David Starr, who is a consultant to numerous Fortune 500 companies.

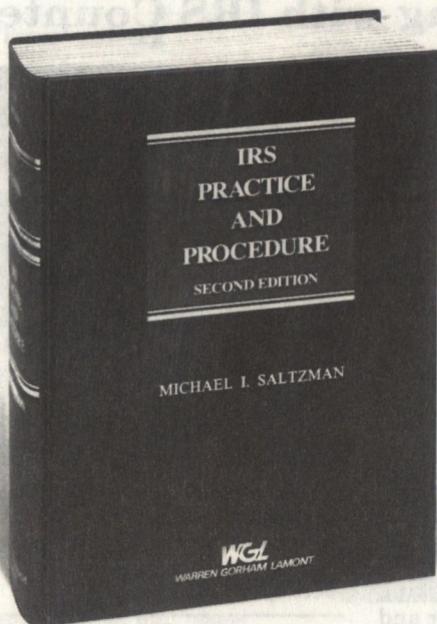
This event will be followed by another two-and-one-half days of continuing education and special events. Monday's schedule includes a panel discussion of *INDOPCO* issues led by Roy Strowd of Price Waterhouse's Portland office and an afternoon session on International Tax developments led by John Peterson of Baker & McKenzie. The IRS Western Region Branch Chiefs will open Tuesday's session, and will be followed by a presentation on Tax reform and Alternative Tax Systems by Pamela Pecarich, Director of Tax Policy for Coopers & Lybrand L.L.P. The conference will close with a National Overview of Recent State Income, Franchise, Sales, and Use Tax Developments and Issues led by Bruce Daigh and Alan Floria of Price Waterhouse's Los Angeles Office.

Don Alexander, former IRS Commissioner and currently a partner in the Washington, D.C., law firm of Akin, Gump, Strauss, Hauer & Feld, will be Monday's luncheon keynote speaker. Mike Murphy, TEI Executive Director, will review the state of the Institute as Tuesday's luncheon speaker. Wednesday's luncheon will mark the conclusion of the conference and feature Robert Huber of Price Waterhouse's Orange County office, who will discuss Tax Departments as Profit Centers.

Evening events include a Murder Mystery Dinner on Monday and a 1950s-1960s theme dinner on Tuesday. A special spouse program will include a brunch featuring "Tales of an Old Showgirl" and a tour of North Tahoe. Registrations are limited and will be accepted on a first-come, first-served basis.

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- how refunds are obtained, and how carrybacks, credits and abatements operate
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Los Angeles Chapter Addresses Streamlining the Audit Process via Education and Working with IRS Counterparts

By Dan Laksfoss

The Los Angeles Chapter recently implemented some changes with an eye toward making its meeting more convenient for members. Because the federal and state tax calendars have due dates that predominantly fall on the 15th of the month, the chapter's monthly dinner meetings have been changed from the second to the third Thursday of the month. The dinner meetings feature a roundtable discussion by members on current tax topics of interest followed by dinner and a presentation by an outside expert on technical tax subjects. The monthly dinner meetings qualify for two hours of continuing education credit for CPAs and attorneys.

The major educational program of the Los Angeles Chapter comprises six full-day training classes each fiscal year. These classes provide the opportunity for in-depth coverage of complex tax subjects and are a great value to members and their staffs. The attendance at each seminar, which ranges from 80 to 130 tax professionals, speaks to their popularity.

In October of 1995, the Los Angeles and Orange County Chapters jointly held a full-day seminar entitled "Planning and Developments in Foreign Jurisdictions." Also in October, Rod Hare, Assistant Chief, Examination Division in the IRS's Los Angeles District, discussed the Large Case Audit Program at the monthly dinner meeting.

The January seminar was entitled "Streamlining the Tax Process: Compliance in the 21st Century," and in February a seminar on property tax issues was held. March's seminar was entitled "Advanced Electronic Tax Research."

On February 8, the chapter officers and Board members participated in their annual liaison meeting with the Los Angeles and Laguna Niguel

Districts of the IRS. The meeting was chaired by Paul Thompson, Chapter President. Los Angeles District Director Richard Orosco and Laguna Niguel District Director Jesse Cota both made presentations on IRS matters of importance to their districts. They voiced concern over the reduced IRS budget for fiscal 1996, its effect on operations, and the IRS reorganization effort, and stressed that the Coordinated Examination Program would be least affected by budget restrictions because of its importance as a revenue source. Bob Wenzel, Fresno Service Center Director, spoke on changes taking place at the Service Center and on changes affecting IRS service centers in general.

Chapter Director Pat Ellingsworth then reviewed the results of a "best practices" survey which had been mailed to Los Angeles Chapter CEP taxpayers in December 1995. The survey is the product of an IRS/TEI Working Group, which consists of IRS CEP staff and chapter Board members representing CEP taxpayers. The Working Group is concerned with improving the audit administration and currency, initially for CEP taxpayers; it is hoped that what is learned can subsequently benefit other taxpayers. To this end, the Working Group had its initial joint session last October with 25 IRS CEP case managers, case coordinators, and specialists, and 25 tax professionals representing CEP taxpayers for the purpose of addressing currency and the IDR process.

The December survey was a follow-up to the initial effort and was designed to elicit responses about best practices in the administration and completion of IRS examinations. Rob



Paul Thompson, Los Angeles Chapter President (left) and Jesse Cota, Laguna Niguel District Director. Mr. Cota attended the chapter's February meeting, where he discussed the IRS's reduced budget and how it might affect operations.



Richard Orosco, Los Angeles District Director (left), and Bob Wenzel, Fresno Service Center Director. At the Los Angeles Chapter's February meeting, Messrs. Orosco and Wenzel updated chapter members on recent activities in their jurisdictions.

Hare and Pat Ellingsworth then discussed how the Working Group intends to build on its previous meeting and the survey responses for its next meeting, planned for April. At the April meeting, the group will discuss two case studies of recent IRS audits that went well administratively and

(continued on next page)

Chicago Chapter's CE Program Off to Strong Start in '96

By Neil D. Traubenberg

The 1996 calendar year got off to a big start for the Chicago Chapter with its initial meeting of the year on January 16. Robert J. Cunningham, a partner in the Chicago office of Baker & McKenzie, opened the meeting with a presentation entitled "The International Audit Process and Current Issues." Mr. Cunningham emphasized the need to be creative in the resolution of audits and audit issues. We certainly work hard at the creativity angle in transactional analysis, so applying those energies to dispute resolution should come naturally. The presentation provided an excellent overview of administrative and judicial review related to tax controversies.

For the second half of our meeting, Michael Knighton and Brian Morris of Coopers & Lybrand transported us all into the 21st century for a view of the paperless tax department. It was acknowledged that some of our member companies are certainly much further along in this task than others, but it was also noted that

the cost of getting there is not insignificant and more than just the tax department will have to benefit for the outlay to be justified. Mr. Knighton cited examples of best practices among companies in this technology wave, all of which are represented within TEI.

On February 13, the monthly meeting attracted 100 attendees, and

contrast to the process within the federal bailiwick.

After the panel, Mark Ely, a partner in the Washington office of KPMG Peat Marwick, gave an excellent presentation on "Alternative Dispute Resolution Techniques/Investigatory Issues Within the IRS." Besides providing background and citations for the techniques now being tried, Mr.

Chicago Chapter Calendar

- April 16 Half-day Workshop on Foreign Tax Credit Planning
- April 18 Federal Tax Litigation Workshop with Mayer, Brown and Platt
- April 23 Intercompany Regulations/Consolidated Returns Workshop with Ernst & Young
- June 21 Annual Meeting at Arlington International Race Course

was kicked off with a panel discussion on "How to Get a Fair State Tax Hearing." The panel's moderator was Pat Toal of The Quaker Oats Company. Mr. Toal was joined by Rick Hanson of McDermott, Will & Emery and Marilyn Wethekam of Horwood, Marcus & Braun. The session provided a

Ely did a superb job of identifying specific opportunities that can exist within the Service's new initiatives. Adding meaningful value to his presentation, Mark annotated his outline with specific references to Mid State Region activity in these areas. ♦ ♦ ♦

Los Angeles Chapter

(continued from previous page)

were completed expeditiously, in order to learn from them and apply their lessons to other audits. IRS case managers and coordinators and tax professionals representing Los Angeles area CEP and other taxpayers will have breakout sessions to discuss and recommend best practices.

The fiscal year has not been all work. On the first Saturday in December, the chapter held its Annual Holiday Dinner Dance. The venue was the Beverly Hills Hotel, which has been splendidly redone during the past three years. The soiree was attended by more than 100 people and started with refreshments and hors d'oeuvres, followed by a four-course dinner and dancing until midnight to the tunes of the Bob Gaile Orchestra. It was a very festive evening for continuing and renewing friendships, as well as a great beginning to the holiday season. ♦ ♦ ♦

Cleveland Chapter's Seminar Explores Federal, State and Local Issues

The Cleveland Chapter of Tax Executives Institute will hold its annual day-long tax seminar on April 16 at the Hilton Hotel in Independence, Ohio. This year the meeting will feature concurrent federal and state and local sessions with such outstanding speakers as Rick Grafmeyer of Ernst & Young's Washington office and Maureen Pechacek of Arthur Andersen's Minneapolis office. Also featured will be presentations by Ohio tax administrators and our own "hot issues" panel.

Dan Porras, Chapter President, also announced that selected students enrolled in the masters degree in taxation programs at Case Western Reserve and Akron University will be guests of the chapter for the seminar.

The program enrollment fee is \$125, which includes lunch and refreshments. Anyone interested should contact Peggy Maltrich at (216) 668-7667 or Pat Ripple at (216) 252-7300, extension 1703. ♦ ♦ ♦

Neither Snow, Nor Rain, Nor Heat, Nor All that Stuff... Ohio District Director Takes Herodutus's Oath to Heart

By Gerald L. Steltenkamp

"Man bites dog" was the story at the Cleveland Chapter's first meeting of 1996. If we reported that the January meeting was disrupted by snow, no one who knows anything about Cleveland would blink an eye. After all, snow in Cleveland is like stadium mustard on a hot dog. It's part of our life, like the Browns...well, forget that part.

The snow that caused Ohio District Director Ashley Bullard (he officially took over the position April 1) to be two hours late was in *Cincinnati*, of all places. (The airport is really in northern Kentucky, but, then again, so is the Cincinnati Service Center.) Much to his credit, Mr. Bullard arrived in time for dinner, only to be told that both Jerry Reese, Cincinnati Branch Chief, and Jim Mehan, Cleveland Branch Chief, had filled in admirably in his place. We northeastern Ohioans want to thank Mr. Bullard for his "above and beyond the call of duty" effort to attend the meeting. After all, how many public servants



Ashley Bullard, Ohio District Director (center), discussed the finer points of winter travel with Harry Jackson and Kathy Wanner at the Cleveland Chapter's January meeting.

would sit on a plane for more than three hours, waiting to take off, being periodically de-iced (he hoped), to give a speech to a bunch of tax people?

While it is the U.S. Postal Service which has Herodotus's motto, "Neither snow, nor rain, nor heat, nor gloom of night stays these couriers from the swift completion of their appointed rounds," carved into its building façade, it seems the Internal Revenue Service has been taking those words to heart.

It is this sort of extra effort that motivated the Cleveland Chapter to issue its first Distinguished Service Award to retiring Branch Chief Jim Mehan. Les Rachocki, 1993-1994 Chapter President and a charter member of the Cleveland TEI-IRS Work Group, presented Mr. Mehan with a plaque thanking and recognizing him for his efforts with the Work Group. Mr. Mehan retired February 2 and all of us with TEI wish him the best of luck.

Jerry Reese, Cincinnati Branch Chief, announced that he would be the new Ohio District Branch Chief and that Dwight Davis would be replacing Jim Mehan in Cleveland. Mr. Reese's presentation at the January meeting focused on IRS efforts to make to keep all large case audits current and asked for our assistance in making the audit process work better.

Harry Jackson, the Cleveland Chapter's First Vice President, pinch hitting for Dan Porras (vacationing in sunny Spain), announced that the February meeting would be the popular State and Federal Audit Issues night and that the Corporate Tax Management meeting in March would be entitled "Ethics in the Tax Department."



At the Cleveland Chapter's January meeting, Les Rachocki, 1993-1994 Chapter President (left), presented retiring IRS Cleveland Branch Chief Jim Mehan with the chapter's first Distinguished Service Award.



CHAPTER NEWS

Region V Annual Conference: June 6-8, 1996

The Baltimore-Washington Chapter will sponsor Region V's 1996 Annual Conference June 6-8, 1996, at the Harbor Court Hotel in Baltimore's Inner Harbor. The program will begin with a welcoming address from Maryland Governor Parris N. Glendening. This address will be followed by a distinguished group of speakers consisting of: former IRS Commissioner, Assistant Secretary for Tax Policy, and IRS Chief Counsel Fred T. Goldberg, Jr., now

What: Region V Annual Conference

When: June 6-8, 1996

Where: Harbor Court Hotel
Baltimore, Maryland

For more information, contact
Jeff Fasick at (301) 897-6375 or
Arnold Chiet at (301) 897-6063.

of Skadden, Arps, Slate, Meagher & Flom; and Kenneth J. Kies, Chief of Staff, Joint Committee on Taxation. The speakers will share their views on proposed tax legislation.

Stuart L. Brown, Chief Counsel, Internal Revenue Service, has agreed to speak at the conference about current developments within the Chief Counsel's office.

There will also be another very distinguished panel of speakers on hand to discuss the topic, "Regulations, Rulings, and Current Developments." Scheduled to participate in this session are: Glen A. Kohl, Tax Legislative Counsel, Treasury Department; Judith C. Dunn, IRS Associate Chief Counsel (Domestic); former IRS Chief Counsel Abraham (Hap) N.M. Shashy, Jr., now of King & Spalding; and former Special Counsel to the IRS Chief Counsel Thomas F. Wessel, now of King & Spalding.

In addition to these topics, the conference program will cover partnerships and joint ventures, non-qualified plans, state and local tax developments, opportunities for IRS interest refunds, tax department automation, and international tax developments.

The registration fee for the conference is \$275 for members and business guests. For further information, contact Jeff Fasick at (301) 897-6375 or Arnold Chiet at (301) 897-6063.

Santa Clara Valley Chapter Plans Two Full-Day Seminars

All Members Invited

In 1996, the Santa Clara Valley Chapter will sponsor two separate full-day seminars. The chapter invites TEI members from across the country and in Canada to attend one or both of these seminars. Non-members are also welcome. A summary of key information is provided below:

Topic: Tax Issues Involving Software

Speakers (all from Baker & McKenzie): John Peterson, John McKenzie, Gary Sprague, Pat Powers, Karen Kuenster, Klaus Bermeister, Bart Bayer, Kent Wisner, and Robin Chesler

Date: Tuesday, May 7

Location: Westin Hotel, Santa Clara, California

Fee: \$90 (includes lunch)

For information about specific issues that will be covered during this full-day seminar on software taxation, contact Deborah Lange of Oracle Corporation at (415) 506-4107.

Topic: International Day

This seminar will focus on recent tax developments from around the world and the U.S. tax planning strategies that relate to these developments.

Speakers: A large group of international tax partners from Baker & McKenzie foreign offices, as well as prominent tax partners from some of the firm's U.S. offices.

Date: Thursday, October 3

Location: Westin Hotel, Santa Clara, California

Fee: \$90 (includes lunch and a reception following seminar)

For information about this international tax seminar, contact Eileen Landauer of 3COM Corporation at (408) 764-6506.

To receive an announcement and registration form for each seminar, which normally is available between four and six weeks prior to each event, please contact chapter meeting coordinator Debbie Wittick at (408) 654-8601.

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ATI

THE AMERICAN TAX INSTITUTE IN EUROPE

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Wednesday, June 19 Germany
Thursday, June 20 Italy
Friday, June 21 United Kingdom

New York • June 17-21, 1996

Monday, June 17 Germany
Tuesday, June 18 Italy
Wednesday, June 19 United Kingdom
Thursday, June 20 France
Friday, June 21 Netherlands

Instructors from the following prominent European firms will teach these programs:

- ◆ **France:** Bureau Francis Lefebvre ◆ **Germany:** Oppenhoff & Raedler
- ◆ **Italy:** Maisto & Miscali ◆ **Netherlands:** Loyens & Volkmaars
- ◆ **Spain:** Cuatrecasas ◆ **United Kingdom:** RSMi/Robson Rhodes (New York)
 - ◆ **United Kingdom:** Linklaters & Paines (Chicago)
 - ◆ **United Kingdom:** Linklaters & Paines and David Wheatley, U.K./Int'l Tax Consultant (San Francisco)

TEI Members will receive a \$50 discount.

For complete program and registration information contact:

The American Tax Institute in Europe
1 Falmer Court, London Road
GB-UCKFIELD, TN22 1HN, United Kingdom
Phone: 011-44-1825-760-901 Fax: 011-44-1825-760-903
E-Mail: 101471.2237@compuserve.com

How I See the Role of a Tax Executives Institute Member

By

Saul D. Kass
Kansas City Chapter

Editor's Note: The following article is adapted from a presentation by the author to TEI's Kansas City Chapter. Saul D. Kass is Vice President-Finance for House of Lloyd Inc. and was a charter member of the Kansas City Chapter. Mr. Kass was graduated from the University of Kansas in 1937, worked as a revenue agent for 10 years, and joined TEI in 1950. Mr. Kass, who joined House of Lloyd in 1981, is 81 years old. In 1995, the Kansas City Chapter honored Mr. Kass for his more than four decades of service to TEI.

I wish to begin by discussing why I feel that it is important for every corporation to have a tax executive. In making this statement, I am not knocking the Big 6 accounting firms or any other accounting firm for that matter.

Each of our businesses is different. This means that our tax problems are different as well. I feel strongly that only an in-house tax executive can be a watchdog for his or her corporation on how to best utilize the Internal Revenue Code. An accounting firm has many clients and as a result, can only think of them in general terms. They just do not have the time to get into the specific needs, nor do they know the needs of each of our businesses. Yes, we still need our accounting firms, but primarily in the role of adviser. As we research an income tax problem, we may need advice to check on what we have come up with. This is where we can take advantage of an accounting firm. Many TEI members do not have the tax reference facilities that accounting firms have. Thus, an accounting firm is in a position to do research that most of us are unable to do.

What should true TEI members be doing on behalf of their companies? First of all, they should do a lot of reading on a daily or weekly basis to keep up with what is coming out. You never know when you might get an idea from something you read.

Be active in your TEI chapter. Do not sit around and let "the other guy" do the job.

Make every effort to meet other members of your chapter at the meetings, particularly during the reception or hospitality period. Do not always sit at the same table for dinner. Mix it up. That way you get to know more people. This is how you can expand your resource list and improve your networking.

Volunteer to serve on the various committees of your chapter. Each member has skills and abilities and should be willing to share them. Each chapter needs your help. You will be surprised with what you get back in return for an effort of this type.

At your chapter meetings, do not hesitate to ask questions. And certainly do not be afraid that your question might be "dumb." There is no such thing as a dumb question. By participating in meetings, you not only broaden your knowledge but you are able to impart knowledge to other members as well.

TEI furnishes each member with an Institute-wide directory. When you have a question that pertains to your industry and there is not anyone in your chapter in that industry, use the Membership Roster to identify someone that you can call. Do not be afraid to make the call, for I am sure you will be amazed and pleased at how TEI members respond to questions from their peers around the country. I have used this technique on many occasions throughout my career and have developed many friendships as a consequence of my "cold calls" to TEI members. Most important is the knowledge that I gain from calling a fellow TEI member who is willing to share with me his knowledge. Keep in mind what I have just said: The knowledge that exists in the heads of the members of TEI is unmatched by any other organization in taxes. You should take advantage of it.

Members should make every effort to attend every meeting of their chapter. There is nothing more important to you as a TEI member representing your corporation than attending the meetings. Do not seek refuge in the old cliché "This meeting doesn't have anything in it for me." Every meeting has something in it for each of our members. Do not close your mind to what is going on around you. I am disappointed in the attendance that we have at our meetings. These are good meetings and have good topics, and they should have 100-percent attendance.

In addition to attending the meetings of your chapter, you should attend meetings that are sponsored by the Internal Revenue Service or state and local tax authorities. Most states have advisory councils. These councils were started many years ago through the efforts of TEI and represent a valuable source of information. It is important

(continued on page 91)

EVERY YEAR
TAX AUTHORITIES
SPEND HUNDREDS
OF MILLIONS ON
THE SURVEILLANCE
OF AMERICAN
BUSINESS.



FOR A MERE
\$50 PER MONTH,
YOU CAN RETURN
THE FAVOR.

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NOT JUST KNOWLEDGE. KNOW HOW.

Receipts Threshold: Did Notice 95-50 Reduce Taxpayer Burden?

During Tax Executives Institute's 46th Midyear Conference, TEI members heard from Margaret M. Richardson, Commissioner of Internal Revenue. During her remarks, the Commissioner addressed a number of subjects, including the business community's response to IRS Notice 95-50, which raised the threshold for travel and entertainment receipts from \$25 to \$75. (Additional coverage of the Commissioner's speech, and the entire conference, will be included in the May-June issue of The Tax Executive.) TEI President Jack Skinner sent the following letter to the Commissioner on whether the IRS notice reduced taxpayer burden.

On behalf of TEI, thank you for addressing our Mid-year Conference yesterday. We know you are exceptionally busy and appreciate your willingness to bring our 800 conference participants up to date on the IRS's recent initiatives, including the new delegation order on settlement authority.

During your remarks, you commented on the business community's response to Notice 95-50, which raised the threshold for travel and entertainment receipts from \$25 to \$75. You wondered whether — since few companies have raised their internal receipts threshold — the IRS had misread the burden-reducing potential of the policy change. Absolutely not: The IRS's action *has* reduced taxpayer burden, and TEI commends the agency for its action.

It cannot be denied that many companies, for valid (non-tax) business reasons, have chosen not to follow the

IRS's lead and raise their internal receipts threshold to \$75. Even those companies, however, will enjoy the benefits of Notice 95-50. This is because even companies that maintain a lower-than-\$75 threshold for internal purposes will not be required to *retain* the voluminous receipts for tax purposes; once the company's internal controls are satisfied (say, when an employee's supervisor reviews the employee's expense report), the receipts can be discarded. In other words, even if companies do not raise their internal receipts threshold, they likely *will* change their behavior. The burden reduction associated with Notice 95-50 should not be minimized, and we encourage the IRS to pursue similar burden reduction initiatives.

Once again, TEI appreciates your participation in its 1996 Midyear Conference.

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How I See the Role of a Tax Executives Institute Member

(continued from page 89)

that you go to these meetings, even if they are not in your city. For example, at a recent semi-annual meeting of the Missouri Director of Revenue's advisory council in Jefferson City — 250 miles from Kansas City — only three members of the Kansas City Chapter attended. I went to the meeting just because I never know what I may learn. Sure enough, the Director of Revenue had a handout that covered several items I would not have otherwise been aware of.

I was pleased when the Director of Revenue sat down next to me during the lunch period. I talked to the Director about a matter in which I needed to get some information, and she immediately brought the head of the department to me and asked that he take care of the situation. The department head considered the matter and said he would have information for me in 45 minutes. When our lunch

ended, he took me to his department. I went over our problem and during the discussion that took place, I learned why the problem existed. I explained it to the three revenue officials and they said they understood. Two weeks later I received a letter from the department indicating that I was receiving a credit for my company of more than \$5,000. This is not a lot of money, but it certainly paid for that trip and more. And I now have more contacts in my state network.

In conclusion, I hope that you have not just read this and passed over the words. If you really take this to heart, and do even more than I have suggested, then you will become a valuable asset, not only to your company, but to yourself and to your fellow TEI members.

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Calgary Chapter Celebrates 25th Anniversary

TEI's Calgary Chapter observed its twenty-fifth anniversary on March 14, 1996. Although unable to attend the chapter's celebration, TEI President Jack Skinner sent the following letter of congratulations to Dale E. Coburn of Sceptre Resources Limited, the chapter's president. A full report on the celebration will be published in a future issue of THE TAX EXECUTIVE.

As TEI's International President, I get to do a lot of enjoyable things. Two of those things are to preside over the Institute's conferences and to extend congratulations to our chapters when they reach certain milestones. Regrettably, these two functions will be in conflict next week. Hence, the need for me to prepare for TEI's 46th Midyear Conference in Washington (which will begin on March 16) will prevent me from being in Calgary on March 14 when the Calgary Chapter celebrates its silver anniversary. Having spent considerable time in Alberta early in my career, I am truly sorry that I will not be able to join you, John Hopkins, Max Phillips, and the other members of the chapter in lifting a glass to TEI.

The members of the Calgary Chapter have much to be proud of. During the last quarter century, the chapter has become an integral part not only of Region I but of the Institute as a whole. The chapter has served as a vital link between tax executives in Alberta and throughout Canada, and chapter members have served both as members and the chairs of Institute-level committees and as TEI officers. The Institute's records identify three members as being especially influential in the char-

tering of the Calgary Chapter: Bela Berci, who worked for Mobil Oil Canada and stoked the home fires; Ron Theriault of the Montreal Chapter, who was in charge of charter development in Canada; and Mac McKie, who served as Institute President (the first Canadian to do so) when the charter request came before the Board of Directors in 1971. I understand that Bela may be with you for your celebration, and I thank him and the other charter members for their dedication to the Institute. It is with sadness that I note that both Ron and Mac died this past year, but I am sure they are with you in spirit.

When men and women turn twenty-five, they are full of fire, driven by enthusiasm, and rich with potential. At the same age, the Calgary Chapter has already proven its worth, but equally important it has demonstrated that the fire, enthusiasm, and potential remain unabated. Congratulations on a job well done. Please accept my thanks for a quarter century of service and professional growth to the tax community, and my best wishes for the next 25 years.

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12th Annual High Technology Tax Institute

Sponsors: San Jose State University and TEI's Santa Clara Chapter

Dates: November 11-12, 1996

Location: Sunnyvale Hilton

Cost: \$400 for TEI members (\$450 for nonmembers)

CE Credits: Recommended for 16 hours CPE/CLE credit

For information contact Stu Karlinski, Director, San Jose State University
Graduate Tax Institute, at (408) 924-3482.

What's Missing from This Tax Ditty?

To tax or not to tax
That is an inquiry I wish to think about
I think: Ah, what do I tax, and how
Do I flat tax
Do I VAT tax

Ah, I think, how do I tax
(A random thought I think
Not too bad, it would not stink:
Malcolm, Jr. was no sap
His campaign put flat tax on a map
And though his campaign, alas, did stop
His thoughts go on, rising to G.O.P.'s top)

But wait: It is an inquiry I had
For bad or good or good or bad
It is a hard thing to construct a tax
A fair, not foul or funny, tax
It is hard to craft a law or build a boat
To tax fairly, poor and non-poor both
To amass coins from all who work
But not to tax too much worth
To do God's work but not impair
Ambitions, visions: oh, what a pair

Of goals. Now, how to support our U.S.A.
Without an I.R.S., you say?
You actually think you could go forth
Without tax cops to do cops' work
Do you think that folks would actually pay
Without an I.R.S. to goad away

Ah, many taxing thoughts to think:
Should I.R.S. swim or should it sink
How to tax both work and play
Should capital gains just slip away
Without a claim

Without a claim should auditors fall
Can U.S. go forth without it all
Think calm, think smart, do not think small
Thing long, my pals, and think of all
Things to think about our tax
Do you tax flat, do you tax VAT
Do you tax with all alacrity
Or do you wait till autumn, pals
To find out if Bill and Al
Or Bob and who Bob brings aboard
Has a plan to tax our hoard

Taxing north, taxing south
'Tis taxing work to think about
But if you don't think hard and long
You might just tax it all all wrong.

* * *

Did you finish without knowing
What's missing from this lyric
Did you quit without thinking
Ah, that's what's not around?
It not so hard, now boys and girls
It's not so difficult, my pals
You say you wish to know why I say, boys and girls
I shall inform you, thus:
I say it inasmuch as I wish to avoid
Using a non-first, non-third, non-fourth,
non-fifth (and occasionally non-sixth)
Non-consonant
Ah, to avoid using not a, not i, not o, not u,
and occasionally, not y
But a non-consonant not said.

Editor's Note: The foregoing verse was slipped under the door of Tax Executives Institute shortly after Timothy McCormally acquired a copy of Georges Perec's novel *A Void*. Published in France in 1969, *A Void* is characterized by a total absence of the letter E. Indeed, this attribute was carried over from the original French to the 1994 English translation of *A Void* by Gilbert Adair. Interestingly, after completing *A Void*, Perec took all the unused E's and produced a short work, *Les Revenentes*, in which the only vowel is E. To date, no English translation of that work has appeared.



JOHN J. MARCZYBSKI, a former member of the Toronto Chapter, has been appointed Deputy Director General - Audit Programs for Revenue Canada's Verification, Enforcement, and Compliance Research Branch. He will be responsible for directing the department's initiatives to improve its tax audit programs for large businesses. From 1991, Mr. Marczybski has been Director of Taxation for Abitibi-Price Inc., a Tor-

onto-based paper manufacturer. His principal duties included ongoing work on a major U.S./Canada transfer pricing dispute, negotiating with U.S. and Canadian tax officials, and tax planning for corporate reorganizations and divestitures. Mr. Marczybski joined TEI in 1984, and was very active within his chapter and at the national level. He was a long standing member of both the Institute's and Toronto Chapter's Canadian Income Tax and Commodity Tax Committees. He served as chair of TEI's Canadian Income Tax Committee in 1994-1995 and was also the Toronto Chapter's 1994-1995 President. Mr. Marczybski holds a bachelor's degree in commerce from the University of McMaster, and he is a chartered accountant. Mr. Marczybski's professional activities include: Chairman, Ontario Tax Committee, and Vice Chairman, National Tax Committee, for the Canadian Manufacturers Association; Chairman, Finance and Tax Committee, for the Canadian Steel Producers Association; and Taxation Committee member for the Canadian Pulp and Paper Association. He has also chaired and been a speaker at numerous transfer pricing/taxation seminars and conferences.

PHILLIP PACEY, a member of the Kansas City Chapter, has been promoted to Treasurer of O'Sullivan Industries Holdings, Incorporated. The Lamar, Missouri-based company is a leading manufacturer of ready-to-assemble furniture. In his new position, Mr. Pacey, a TEI member since 1994, will be responsible for all treasury functions, cash management, and tax planning and compliance for the company's operations. Prior to his promotion, Mr. Pacey was Manager of Treasury and Tax. Before joining O'Sullivan in 1995, he was Corporate Tax Manager at Sa-

vannah Foods & Industries. Mr. Pacey holds a bachelor of science degree in business administration and a masters degree in accounting and taxation, both from the University of Florida.



MUNIR A. SULEMAN, a member of the Toronto Chapter, has been seconded to the Canadian Department of Finance for one year. He will be on leave from his current position of Vice President - Domestic Taxation at The Bank of Nova Scotia. Mr. Suleman will serve as Special Advisor on the Taxation of Financial Institutions, reporting to the Assistant Deputy Minister, Tax Policy Branch. In his

new role, Mr. Suleman will review the goods and services tax (GST) as it applies to financial institutions, consider GST replacement options, study how a harmonized or national sales tax would apply to financial institutions, review the various other types of taxes to which financial institutions are subject, and consider the effect all these taxes have on the competitiveness of Canada's financial institutions compared to those in other countries. Mr. Suleman joined TEI in 1988, and was elected 1995-1996 treasurer of the Toronto Chapter and vice chair of the Institute's Canadian Commodity Tax Committee. He holds a bachelor of arts degree from the University of Toronto, and is a chartered accountant.



IN MEMORIAM

AUGUST W. FRISCH, 55, a member of TEI's Pittsburgh Chapter since 1974, died of lung cancer on February 16. He was Vice President and General Tax Counsel for Westinghouse Electric Corporation. Mr. Frisch joined Westinghouse in 1967, having previously worked for Peat, Marwick, Mitchell & Co. and the Union National Bank of Pittsburgh. He was appointed General Tax Counsel for Westinghouse in 1976 and was elected Vice President in 1979. He also served as Treasurer from 1990 to 1992 and as Vice President, Taxes and Pension Investments from 1992 through 1994. In September of 1988, Mr. Frisch received Westinghouse's highest honor, the Order of Merit. In TEI, Mr. Frisch was extremely active on the Institute's Commonwealth of Puerto Rico and U.S. Possessions Committee; he served as the committee's chair in 1982-1983. Mr. Frisch earned his bachelor of science degree in accounting from Pennsylvania State University and his law degree from the Duquesne School of Law. He was a member of the American Bar Association, the AICPA, and the Financial Executives Institute. Mr. Frisch is survived by his wife, Carole, six children, and two grandchildren.



My dear friends at TEI:

I have heard from so many of Matt's friends at TEI and want to thank you for the beautiful flowers you sent. The many expressions of sympathy and the prayers offered for him were very consoling. I will always remember the wonderful times Matt and I had with all our TEI friends.

Mary Lynn Kennedy
January 27th

Value-Added Taxes — A Comparative Analysis

Prepared by Tax Executives Institute's Consumption Tax Committee

“[T]he publication of this book...could not have come at a better time.”

— Robert J. Wells in *Tax Notes*

SPECIAL OFFER

Value-Added Taxes — A Comparative Analysis

Price: \$20 (discounts available for orders of more than five books).

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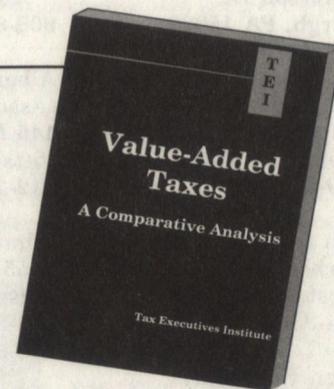
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Value-Added Taxes — A Comparative Analysis



A presidential election year always brings with it a renewed focus on taxes. Whether it's a pledge for "no new taxes," a promised tax cut for the middle class, or a platform based almost entirely on a flat tax, the United States tax system usually finds itself under assault by the time the campaign advertisements start airing in Iowa and New Hampshire — at least when the candidates aren't assaulting one another.

This text provides a complete portrait of the various VATs in effect among out trading partners. Written with careful, thoughtful analysis and a willingness to consider bold alternatives, but not embrace them unthinkingly, *Value-Added Taxes — A Comparative Analysis* is an invaluable resource for the examination and potential application of the value-added tax.

Membership Roster Update

The following members had incomplete listings in the 1995-1996 Membership Roster Update, which was distributed as an insert in the January-February issue of *THE TAX EXECUTIVE*.

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Corporate Procurement Card Programs: Are They Paperless Chaos?*

Sales/Use Tax Considerations

By
Mark D. Loftis

Introduction

Many credit and bank card companies are aggressively marketing "corporate procurement card" programs under which cards are issued to a broad class of corporate employees for use in purchasing a wide range of goods and services. The procurement card programs offer the companies a streamlined procedure for making and documenting their purchases, saving both time and money. These programs, however, are not without significant tax implications. This article examines the sales and use tax considerations in respect of procurement card programs.

In today's environment of corporate downsizing and outsourcing, corporate procurement card programs have become an attractive way to reduce, or in some cases eliminate, the relatively high internal costs of the low dollar/high volume corporate purchasing process. It has been estimated that in most large to medium size companies 60 percent of all purchases are individually less than \$500 (30% less than \$100, which account for less than 5 percent of total purchasing expenditures. The internal cost of these transactions has been estimated at between \$120 and \$150 per transaction, and this cost is incurred whether the company is purchasing \$10 of paper clips or a \$1 million computer system.

From an overall business and efficiency perspective, the corporate credit card procurement programs offered by banks and credit card companies (such as VISA, MasterCard, and American Express) make imminent sense. There are, however, potential negative sales/use tax issues that must be addressed in evaluating these programs. There are also significant federal tax questions relating to the documentation of deductible business expenditures and information reporting requirements. Corporate tax professionals need to tactfully raise these issues in order to fully inform management of the potential implications without being perceived as impediments to progress. The only way to positively communicate the Tax Department's perspec-

tive is to ensure that tax professionals are part of the team on the front end.

If a company has not yet considered a procurement card program, the tax executive may wish to seize the opportunity to introduce his or her company to the overall benefits that these programs offer. Tax departments are not normally viewed as a source of innovation for the day-to-day business processes. By taking the initiative, the Tax Department is likely to be more positively viewed as an innovator. Equally important, by taking the lead the Tax Department can ensure that the sales/use tax issues are properly and expeditiously addressed.

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How the Programs Are Marketed

Corporate procurement card programs are marketed to corporations as the "greatest thing since sliced bread" and as *the* solution to the low dollar/high volume purchase cost issue. The card companies promise, and can deliver, a purchasing process that is greatly streamlined and simplified. Usually, the Accounts Payable and Purchasing Departments can reduce resources (headcount) while achieving overall improved process efficiency and lower costs.

Procurement card programs are relatively new (having developed in the last two to three years), and it is important to understand that the card companies are primarily in the retail (individual consumer) credit card business. With this "retail consumer credit card" background and mind set, the card company's approach to sales/use tax issues may not be fully developed and is rarely explored in the marketing process. What the card companies often fail to appreciate is that the corporate client is in a much different role regarding sales/use tax. In most jurisdic-

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* This article is adapted from a presentation made at Tax Executives Institute's 46th Midyear Conference in Washington, D.C., on March 19, 1996.



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tions, corporations are designated to be the agents of the taxing jurisdiction to collect and remit sales tax from consumers. They also are required to self assess use tax on their own taxable purchases (where tax was not charged) and to remit such tax to the appropriate taxing authorities. In contrast, individual consumers are not routinely audited regarding sales/use tax either because of logistics or, in some states, because the law places the incidence of the tax squarely on the corporate taxpayer.

The tax issues confronting the corporate taxpayer are usually glossed over in the card company's marketing presentation as "not a problem." Other responses are that "shortcuts and estimates can be used" to satisfy the taxing authorities who will be "likely to cooperate with the taxpayer" in an audit situation. They also interject that these tax issues are just "part of the price the company pays" in order to obtain the efficiencies these programs offer. The truth is that some degree of offset in the projected benefits/savings regarding resources and processes is likely to be required to properly address these tax issues. In other words, the great benefits of reduced internal resources and streamlined processes may not be quite as good as advertised.

Regardless, even if these savings are fully realized, the company must still comply with the laws in every state and local jurisdiction in which it does business. If a company does not comply, the states or localities can impose fines, penalties (which are not deductible for federal tax purposes), and interest, and (in cases of fraud or willful negligence) corporate officers can be held personally liable — and may even be subject to incarceration.

How the Programs Work

A company enters into a contract with a bank card company (usually a bank in the case of VISA/MasterCard) and authorizes certain company managers to make defined low-dollar purchases using the card. Most companies define low-dollar purchase maximums anywhere from \$500 to \$5000. The company also defines what types of purchases are to be made with the card, which may be modified from time to time.

These designated managers, which are issued the procurement cards, are authorized to make purchases directly from vendors without involving the Purchasing department or having to process the related paperwork. The vendors usually ship the purchased items immediately and directly to the cardholder. The bank card monthly statement is also sent directly to the cardholder, who is responsible for reviewing, reconciling, and approving each statement before it is sent to Accounts Payable for payment. The monthly statement is identical in format and content to statements provided to individual credit card customers. Each transaction is listed in summary-level detail. Most

card companies offer a customized account coding method to assist in the monthly posting of the credit card activity to internal general ledger accounts.

The Good News

The following are the obvious benefits of implementing this type of program:

Simplification. The purchasing process is greatly streamlined with little or no involvement by Purchasing and Accounts Payable personnel. Paper and paper trails are theoretically eliminated. The streamlining of the process allows resources to be redirected from tasks with little or no value to tasks with value added — especially in the Accounts Payable and Purchasing areas of a company.

Supply Base Reduction. Suppliers that receive numerous orders from various company purchasers are not required to issue separate invoices for each purchase. All monthly purchases using the card are summarized on the card statement, eliminating the issuance of multiple invoices by and multiple payments to the same vendor.

Interval Reduction. By using the corporate card, the purchaser obtains goods and services faster (usually in one or two days as opposed to weeks). The elimination of the usual Purchasing and Receiving processes cause greatly improved efficiency.

Internal Transaction Cost Reduction. Overall, the use of a procurement card can reduce internal cost per transaction by an estimated 35 to 40 percent. These internal costs — which include personnel and time costs in handling the paperwork in the Accounts Payable, Fixed Asset, Purchasing, and Receiving functions as well as cost of related supplies and overhead — are reduced significantly under such a program.

From an overall business perspective and especially from an Accounts Payable and Purchasing perspective, these programs offer many valuable benefits including greater efficiency and lower overall costs.

The Bad News

Detail Documentation Eliminated. The obvious concern with the streamlined approach offered by procurement card programs is that, by definition, there is less detail documentation available to the Tax Department to defend against increasingly aggressive sales/use tax auditors. In addition, the corporation (usually the Accounts Payable or Tax Department) has less information to make an informed decision regarding the proper monthly accrual and reporting of use tax on non-taxed purchases.

Point of Sale Tax Data Is Not a Required Input Field. Card companies cannot currently provide the corporate

Tax departments are not normally viewed as a source of innovation for the day-to-day business processes.

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taxpayer with an "automated" solution to provide the necessary sales/use tax detail. Hence, while the card companies have developed software and hardware to capture this data at the point of sale, individual vendors retain the "option" whether to use it. This apparently is a difficult problem for card companies which are reluctant to mandate the use of the software and hardware.

Monthly Summary Statement. The monthly card statement is in the same format of an individual credit card statement. It does not include the usual necessary detail information required for sales/use tax purposes such as:

- Detail description of item(s) purchased
- "Shipped to" location of the goods purchased
- Sales tax amount and jurisdiction charged by item

No Audit History (Track Record). Because these programs are relatively new, there has been very little significant state and local sales/use tax audit activity of taxpayers using this process. Therefore, the corporate users of these programs have not yet seen first hand how these issues can affect the corporation financially (assessment of tax, penalties, interest, etc.) in an audit situation.

State and Local Jurisdictions Are Becoming More Aggressive. State and local jurisdictions, and their sales/use tax auditors, are becoming increasingly more sophisticated and aggressive regarding corporate taxpayers. Corporate taxpayers are seen as easy targets in the never-ending search for revenue. As procurement card programs become more widespread and better understood by taxing jurisdictions, they will undoubtedly be seen as a point of vulnerability for companies that have poor alternative documentation procedures regarding credit card purchases.

Alternative Documentation Procedures Required. Because procurement card programs eliminate traditional documentation for purchases, a company must institute alternative processes and apply resources to ensure that card purchases are both properly analyzed for monthly use tax accrual and reporting purposes and properly documented for later review on audit. Usually, the responsibility for obtaining sufficient documentation rests with the cardholder, and the more cardholders a company has, the more difficult it is for a company to ensure that its documentation requirements are being satisfied. This process requires strict adherence to procedures and periodic internal review for non compliance and purchase pattern analysis.

Complex Purchasing Patterns Are Further Complicated. Large companies with operations in numerous jurisdictions can find that there are situations that will be quite complex and that the procurement card program can make them even more complex regarding sales/use tax.

Example: Cardholder located in State A is buying 100 widgets from a vendor in State B, having 50 widgets shipped to State A, and the rest drop shipped to five other States. Two of the other

States have no sales tax provisions, in one State (State C) the vendor is not registered to collect sales tax. The vendor charges the appropriate sales tax for State A and the other two States.

This already complicated transaction is made even more complex if a detailed invoice, purchase order, or other similar document is not obtained by the cardholder and properly archived by the company. Someone at the company must have the information available to analyze the transaction in order to determine that use tax must be accrued and paid on the widgets that were shipped to State C, and that the appropriate sales tax was charged by the vendor regarding the other components of the transaction.

On audit (typically, 3 to 5 years later), if detail documentation is not available, an auditor for State A could decide to assume, without proof to the contrary, that all 100 widgets were shipped to State A and that no tax was either accrued or charged. Hence, tax, penalty, and interest could be assessed, with the corporation having no recourse but to attempt to obtain the documentation well after the fact.

Current State of Corporations That Have Implemented Programs. Corporations with procurement card programs generally fall into one of the following categories regarding sales/use tax issues:

- **Oblivious:** They do not fully realize the potential implications of the procurement card program.
- **Reckless:** They realize the potential implications, but chose not to address them.
- **Paralyzed:** They realize the potential implications, but do not know what to do about them.
- **Prudent:** They realize the potential problems and have implemented interim solutions.

Solutions, Approaches, and Alternatives

Long-Term Solution. The obvious long-term solution is for corporations to insist that the card-issuing companies quickly move toward the automated solution. This would involve a significant change in their current mind set by requiring the capture of sales tax data at the point of sale by all vendors. Once captured, the bank card system could then automate the monthly use tax accrual process and provide clients with the needed data to assist the taxpayer in defending against outside auditors. Virginia has issued a recent ruling (P.D. 95-275) that verifies the state's acceptance of an automated tax reporting mechanism in place of paper invoices. Of course, the reporting process must contain the required data elements.

It is likely only a matter of time before corporations with less than perfect alternative documentation proce-

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dures begin being hit with large audit assessments (including penalty and interest). By necessity, these corporations will then put pressure on the credit card companies to provide an automated solution.

Interim Approaches/Alternatives. Until an automated solution emerges, there are a number of approaches and alternatives that corporations can implement to mitigate potential compliance problems and audit assessments. In the short term, the corporation must ensure that there are processes, strategies, and resources in place to:

- Accrue and report use tax on a monthly basis, and
- Ensure the monthly card statements and backup are properly archived for audit purposes.

Implement and Ensure Strict Adherence to Internal Procedures, and Provide Properly Resources for the Function(s) Responsible for Tax Reporting. The procedures for card usage and cardholder responsibilities (including specific requirements regarding sales/use tax documentation) should be implemented on the front end and strictly enforced. The process should be internally audited on a periodic basis to ensure compliance. Cards should be pulled from cardholders who do not provide the necessary tax information and documentation, as well as from those who otherwise abuse the company's procedures. The internal audit process should also include an analysis of cardholders for purchasing patterns that could assist in identifying either cardholders or departments with specific sales/use tax problems, or patterns that require less ongoing sales/use tax analysis (*i.e.*, all exempt purchases, etc.).

The Tax Department should ensure that the appropriate internal corporate personnel and senior management understand that purchases in the procurement card program still need to be analyzed for sales/use tax considerations. The appropriate corporate department (Accounts Payable, Purchasing, or the Tax Department) should have sufficient staff and resources to analyze these transactions to ensure compliance with use tax accrual procedures and the maintenance of proper documentation. Internal automation of processes should be initiated where possible to assist in this manual review and analysis process.

A systematic approach is required for large companies (many cardholders) with purchases in a large number of jurisdictions. Usually, such companies encounter extraordinarily complex situations (*e.g.*, a cardholder in one State may be buying goods, taxable and non-taxable, for multiple sites in other States). Documentation of these transactions and strict adherence to established procedures are essential.

Other Short-Term Approaches Not Requiring Extensive Resources

Direct Pay Permits. Securing direct pay permits can be a very effective means of controlling procurement card problems depending on the company's purchasing patterns and situation. In States that have provisions for direct pay, the

use of such permits simplifies the sales/use tax issues that arise out of the use of procurement cards because none of the corporation's purchases within that State will be taxed, and the corporation is responsible for self assessment of use tax on all purchases. This approach has limited application because fewer than 30 States currently have such provisions. Moreover, obviously each State has different rules on the application and granting of this treatment.

Shortcut/Estimated Approaches. This approach involves the implementation of shortcut processes using valid and reasonable assumptions in estimating use tax payments to taxing jurisdictions and negotiating the validity of those assumptions on audit. This approach may be somewhat dangerous in that negotiation in the audit process may not give the corporate taxpayer much leverage. However, if a corporation is present in relatively few jurisdictions, has a good working relationship with taxing authorities, and has a well thought out and documented methodology, this approach may be effective.

Another approach is to negotiate on the front end (prior to audit) with the taxing authorities about the propriety and acceptability of shortcut approaches, assumptions, and estimated payment methodology. Although there may be some risk in such an approach, the upfront negotiations may offer a good solution for corporate taxpayers with good relationships with the taxing authorities, especially when purchases occur in a limited number of jurisdictions and the company can document its methodology.

Examples of shortcut approaches are to perhaps limit the usage of the cards to only in-state vendors registered to collect sales tax, thereby eliminating any need to accrue and report use tax on card purchases. Another approach sometimes suggested by the card companies is to not restrict the purchases but simply to assume that all purchases from out of state vendors charged no tax, and that all in-state vendors did charge tax. In this scenario, the company would accrue and report use tax on all out of state vendor purchases without any analysis of each purchase. Depending on a company's situation, however, the prospects of either overpaying or underpaying are significant.

Reserve and Hope. This approach is generally to estimate the potential liabilities (including tax, penalty, and interest) and reserve for these liabilities while hoping either that the company will not be audited or that a reasonable settlement can be negotiated with a jurisdiction in the audit process. This is probably the least desirable approach in that a company that adopts an ostrich-type approach and refuses to address fundamental tax issues may find itself headless. There are also significant risks that a state or local jurisdiction could make a case for willful neglect, which would carry with it significant adverse consequences. Worse case, of course, is that the company's officers and management might be held personally liable and even subject to criminal penalties depending on the jurisdiction involved.

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The Effect of the IRS District Office Reorganization on Corporate Taxpayers

By

George A. O'Hanlon and Michael A. Urban

Introduction

Much has been said and written about the Internal Revenue Service reorganization since it was announced in May 1995. In 30 of the current 63 districts, the positions of District Director, Assistant District Director, and Division Chiefs, as well as some Branch Chief positions, will be eliminated. In some districts this has occurred already, but in all of the affected districts it must happen by no later than October 1, 1996. According to the Service, "these changes are intended to streamline the management and management support of field operations," reduce overhead, and "provide the flexibility to make better use of [the IRS's] resources and to better serve [its] customers and address non-compliance."

It will take initiative and effort on the part of professional organizations such as Tax Executives Institute to create new relationships with the district management in the reconfigured districts after their existing local management-level contacts are gone. Access to the District Director in the new districts may prove to be difficult. Distance and time become obstacles. Professional groups may find it difficult to make their voices heard at the high level within the IRS to which such organizations have become accustomed. It also seems clear that some TEI chapters will no longer align with IRS districts.

The reconfigured districts will, of course, have a District Director, but he or she may be located hundreds of miles farther away from a particular taxpayer than is currently the case. The District Director's attention can become spread thin over many new and, perhaps, unfamiliar problems. For example, the current Milwaukee, Des Moines, and Omaha districts will constitute the new Midwest District. The District Director will be located in Milwaukee, which is almost 400 miles from Des Moines and more than 500 miles from Omaha. Similarly, the St. Paul, Fargo (North Dakota), and Aberdeen (South Dakota) districts will be combined to form the North Central District, with its headquarters in St. Paul. The most glaring example is the new Rocky Mountain District, headquartered in Denver, which will encompass, in addition to the Denver District, the present-day Boise, Helena, Salt Lake City, and Cheyenne districts.

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The Roles of TEI and its Members

District Directors are continuously striving to improve communications and relationships between the IRS and tax professionals. With many districts doubling or even tripling in size, however, the Directors will have a difficult time maintaining existing levels of personal involvement, let alone forging new relationships. Taxpayers, however, should seek the same level of customer service they are currently receiving. Accordingly, professional groups such as TEI and their members must: (1) be watchful for any loss of top-level availability, (2) seek out and meet with the new district managers to establish new contacts and discuss expectations and areas of mutual concern early on, and (3) let the District Director know when problems arise.

The vigilance and involvement of professional organizations such as TEI are crucial, since their members deal with the IRS on a continuing basis and thus will be able to identify trends or repeated problems that individual taxpayers, who deal with the IRS only occasionally, will fail to notice.

Trouble Signs

The IRS has been, and still is, concerned about providing excellent service to all taxpayers. Nevertheless, because of the magnitude of the organizational changes that are already occurring, and will continue to occur over the next year or so, the potential for slippage in service and personal attention from top-level district management is very real. Three of the most important potential problem areas — access to management, communication, and attitude — are discussed below. Other signs of trouble that TEI members should be watchful for include:

- deviation from the IRS's goal of providing "one-stop service," evidenced by being transferred from place to place or person to person, and repeatedly having to explain your issue, question, or situation;
- an excessive amount of time being taken to resolve problems; and

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- lengthening response times, especially in the Problems Resolution Program area.

Access to Management

If TEI members are not able to meet or converse with district executive-level managers as often as in the past and feel it is hurting their working relationships with the IRS, they should bring it to the attention of the National Office. Once working relationships break down, communication, the spirit of cooperation, commitment to quality, timeliness, and customer service all generally suffer.

Communication

Establishing and maintaining good lines of communication is crucial. If TEI members notice any change in either their ability to get information from the IRS or the IRS's ability to distribute information in a timely manner, they should voice their concerns. Monitoring of the quality of communication should not be limited to case-related work, but should also include the IRS's ability and willingness to disseminate information on policy, tax law, and procedural issues, and its willingness to provide input to practitioner newsletters, provide speakers, and conduct educational seminars. TEI members should be alert for any delays in the release of information and any unresponsiveness to requests for advice or clarification regarding IRS or tax-related issues.

Attitude

The many changes that IRS employees are currently experiencing are perceived by many employees as involuntary or "forced" changes. Forced change is often the most difficult type of change for people to deal with, particularly when such change is coupled with budget cuts that affect both the working conditions of employees and the ability of management to support front-line workers. Any decline in taxpayer service or the quality of the IRS's work may first manifest itself in the attitudes of IRS employees or management. If employees become dissatisfied or encounter problems with their work environment or working conditions caused by the reorganization, the byproducts may be a decline in the quality of their work product or perhaps even a lack of concern for customer service.

Conclusion

A changing organization always needs both internal support and support from its outside stakeholders, particularly customers. As the IRS's customers, TEI members should support the reorganization of the IRS because it is happening right now, and will happen with or without TEI's involvement. Effective and responsible support on the part of TEI and its members, however, requires that they be watchful to ensure that one of the IRS's principal intentions of the reorganization — to better serve its customers — is met.



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Outsource Voucher Program Alternative. Several companies specializing in outsourcing have come to recognize both that corporate procurement card programs have shortcomings in respect of ensuring sales/use tax compliance and that a market niche might exist for them to fill. These companies have set up a service involving the usage and implementation of a voucher program in lieu of a procurement card program. The basic premise is that instead of issuing credit cards to your company personnel, they would develop vouchers that would be accepted by the vendors. Under such a program, the voucher company would be responsible for obtaining and providing the corporate client with all necessary sales/use tax data.

Conclusion

Even with their potential negative sales/use tax implications, corporate procurement card programs offer significant savings to the business community. Tax professionals obviously need to be aware of the various card programs, how they work, and the overall benefits they can provide. These programs are usually marketed in a way that makes it easy for a company to overlook the potential negative implications regarding sales/use taxes. The tax profession-

al must be involved on the front end to ensure that senior management is fully informed of these issues so that a true picture of the actual savings can be considered. Moreover, if a company has not yet considered such a program, the Tax Department may wish to consider introducing this concept — setting up itself as the "driver" of the process while ensuring the tax implications are properly addressed.

The long-term solution to the potential negative sales/use tax implications appears to be that the card companies need to provide automated solutions (point-of-sale data collection), which will permit corporate clients to fully realize the benefits of these imaginative programs. Corporate clients should, perhaps collectively, pressure the card companies to provide this solution sooner rather than later. Until this solution is implemented, there are a number of interim steps that can be taken to mitigate the potential negative impact of these issues. The only interim approach that seems to offers little or no risk regarding sales/use tax exposure is to properly staff the appropriate tax reporting functions to ensure that this data is properly captured and reported. This obviously means that proper sales/use tax reporting will likely offset, to some extent, the projected overall benefits (required resources etc.) of these programs.



Proposed Section 3121(v) Regulations: Application of Employment Taxes to Nonqualified Deferred Compensation

By

Paul T. Shultz and Ian A. Herbert

In January 1996, the Internal Revenue Service gave employers and practitioners a belated holiday gift in the form of long-awaited guidance on the Social Security tax treatment of amounts deferred under a nonqualified deferred compensation plan. Proposed regulations under section 3121(v) of the Internal Revenue Code clarify many of the concepts involved in the determination of the taxability of these amounts. Generally, the proposed regulations are reasonable and even generous; they provide employers with significant flexibility both in determining the timing and amount of the FICA liability and in withholding and paying the tax on any amounts deferred under a nonqualified plan. In addition, the proposed regulations are quite thorough. This article describes the rules governing the FICA taxation of nonqualified deferred compensation under the proposed regulations.

Background

In 1983, when Congress last made broad amendments to the Social Security system, one of its changes was to impose Social Security-related (FICA) taxes upon cash-or-deferred arrangements under section 401(k) of the Code and upon nonqualified deferred compensation by adding section 3121(v) to the Code. Generally, an employee's wages are subject to FICA taxes when they are paid. Employers and employees are equally liable for FICA taxes, which consist of Old-Age, Survivors and Disability Insurance (OASDI) tax (at a rate of 6.2 percent of wages) and Hospital Insurance (Medicare) tax (at a rate of 1.45 percent of wages). Thus, subject to a cap on the amount of wages subject to the OASDI portion of the tax, employers and employees each pay a total tax of 7.65 percent of wages. "Wages" are defined broadly in section 3121(a) to include almost all remuneration provided for services rendered. Amounts deferred under a nonqualified plan, however, are subject to a special rule under section 3121(v). Under this rule, these amounts are subject to FICA taxes on the date on which the services giving rise to the amounts are performed or, if later, the first date on which the employee's rights to the deferred amounts are not subject to a substantial risk of forfeiture. Once an amount is subjected to FICA taxes, it and the income it earns are not taxed again (*i.e.*, when actually paid).

Unfortunately, the statutory language says little more than this, leaving open a number of questions about the precise manner in which section 3121(v) is applied. Specifically, it has been unclear —

- What plans are subject to section 3121(v)
- What constitutes a "substantial risk of forfeiture"
- How to determine the amount that is required to be subject to FICA tax for any year.

Before publication of the proposed regulations, there was virtually no elaboration on the application of these rules. The only meaningful guidance was the relevant legislative history, very few letter rulings,¹ some language in the instructions to Form W-2 (unrelated to FICA taxation), and a single decision of the U.S. Claims Court.² And the guidance provided by these documents was limited indeed: Apart from statements in the legislative history and in the letter ruling to the effect that a "substantial risk of forfeiture" is to be determined in accordance with the principles of section 83, the available guidance addressed only the first of the three issues described above.

For much of the period since the enactment of section 3121(v) in 1983, guidance on its application was largely unnecessary.

Because nonqualified deferred compensation is typically paid to higher-paid employees, and because the inclusion of these amounts in the employee's wages subject to FICA tax frequently occurs while the employee is actively employed and typically earning wages in excess of the FICA taxable wage base, the rules of section 3121(v) had essen-

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¹ *E.g.*, PLR 9051003 (Sept. 18, 1990).

² *Buffalo Bills, Inc. v. United States*, 31 Fed. Cl. 794 (1994).

tially no effect. When the cap on the amount of wages taken into account for purposes of the Medicare portion of the FICA taxes was increased to \$125,000 in 1991 and then eliminated in 1994, however, clarification of section 3121(v) became critical to enable employers to determine, collect, and remit the taxes. Recognizing this fact, but nevertheless being unprepared to issue comprehensive instruction, the IRS published Internal Revenue Notice 94-96,³ which permitted taxpayers to adopt any reasonable good-faith interpretation of section 3121(v) until the issuance of regulations. Those regulations have now been issued, in proposed form.

The Proposed Regulations

Plans Subject to Section 3121(v). Generally, any plan that provides for the deferral of compensation from one year to another — even if only for a brief period — is subject to section 3121(v).⁴ The proposed regulations do, however, provide several exceptions to this rule.

First, amounts paid in accordance with an employer's ordinary payroll practice after the end of a calendar year and for the final pay period of the year or for a pay period that overlaps the year-end are not amounts deferred under a nonqualified plan. Hence, they are not subject to section 3121(v). (In other words, they are subject to FICA tax when paid.) Second, if amounts are paid within two-and-a-half months after the end of the calendar year in which the employee performed the services for which the payments are being made, the employer may elect to treat these amounts as not being subject to section 3121(v), if all employees and all similar plans are treated alike.⁵ Finally, the regulations specifically exclude stock options, stock appreciation rights, stock value rights, awards of restricted property, welfare benefits, benefits provided in connection with certain impending terminations of employment or under a plan established after termination, and excess parachute payments from the scope of section 3121(v). Phantom stock plans, however, are considered deferred compensation plans subject to this section. This rule is consistent with the approach reflected in the instructions to Form W-2.⁶

This purported bright-line test produces some inconsistencies and, therefore, some planning opportunities. In particular, phantom stock arrangements are specifically identified as deferred compensation plans, but stock value rights, which are defined as devices that give an employee the right to the difference between the value of a share of stock and a specified amount greater than zero (apparently to distinguish them from stock appreciation rights), are not. If a stock value right pays the difference between market value and some nominal amount, what is the difference between that arrangement (which is not deferred

compensation) and a phantom stock award (which is deferred compensation)?

Similarly, restricted property is specifically excluded from the definition of deferred compensation, but the proposed regulations state that an agreement to pay property in the future may give rise to deferred compensation. What is the difference between, for example, a current grant of restricted stock and an agreement to pay the same number of shares of unrestricted stock in the future coupled with a current grant of dividend equivalents and the ability to direct the vote of that number of shares? Because, depending upon the circumstances, it may be advantageous to treat an amount as deferred compensation rather than current compensation (or vice versa), careful planning may enable an employer to create an arrangement that both meets its desired objectives and produces the desired FICA tax treatment.

Substantial Risk of Forfeiture. Consistent with section 3121(v)'s legislative history and Private Letter Ruling 9051003, the proposed regulations provide that whether a substantial risk of forfeiture exists is to be determined in accordance with

the rules governing a substantial risk of forfeiture exists is to be determined in accordance with

³ 1994-2 C.B. 564.

⁴ In setting forth this rule, the IRS essentially acquiesced to the holding in the *Buffalo Bills* case, in which the Claims Court applied a literal definition of the term "deferred."

⁵ To a certain extent, the IRS has coordinated the FICA rules with the rules governing an employer's deduction for deferred compensation. Generally, an accrual basis taxpayer is entitled to deduct amounts paid as compensation for services rendered in the year in which the services are performed. If the compensation is paid pursuant to a nonqualified deferred compensation plan, however, the employer is entitled to the deduction, in accordance with section 404(a)(5), only in the year in which the employee treats the compensation as taxable income. For the purpose of this rule, an amount is presumed to be paid pursuant to a nonqualified deferred compensation plan if it is paid more than two-and-a-half months after the end of the year in which the services giving rise to the payment were performed; an amount paid within this period is generally considered current, rather than deferred, compensation. This approach reflects an accommodation of the holding in the *Buffalo Bills* case and the position the IRS took in PLR 9051003, in which the IRS concluded that amounts will not be considered deferred compensation for purposes of section 3121(v) if they are not deferred compensation for purposes of section 404(a)(5).

⁶ In completing Forms W-2, employers must indicate, in Box 11, the amount "that was distributed or became taxable because the substantial risk of forfeiture lapsed" under a nonqualified deferred compensation plan. The instructions further state:

Nonqualified plans include those arrangements traditionally viewed as deferring the receipt of current compensation. Accordingly, welfare benefit plans, stock option plans, and plans providing dismissal pay, termination pay, or early retirement pay are not nonqualified plans.

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principles applied under section 83. Thus, an employee's right to deferred amounts is generally subject to a substantial risk of forfeiture for as long as the employee is required to perform additional services to be entitled to payment of the amounts (*i.e.*, until the employee becomes substantially "vested" in his benefit under the plan).

Example 1. Company X maintains a nonqualified plan under which an amount equal to ten percent of a participant's compensation is deferred under the plan on the last day of each year. Under the terms of the plan, the participants vest in 20 percent of their interest in the plan on the third anniversary of their participation in the plan and in an additional 20 percent on each succeeding anniversary. A participant in the plan does not have wages as a result of participation in the plan until the third anniversary of the date on which he or she commenced participation. On that date, and on each anniversary of that date, a portion of the participant's interest in the plan ceases to be subject to a substantial risk of forfeiture and, therefore, the participant has wages that are required to be taken into account for FICA purposes as of each of these dates. In addition, the participant has FICA wages each year after becoming 100 percent vested in his or her plan interest. The amount treated as wages in each of these years is generally equal to the value of the participant's vested interest in the plan in each year, reduced by the total amount previously taken into account and by income attributable to that amount. Because the determination of what amount has been taken into account and what amount is interest on that amount can be fairly complicated, a detailed discussion of this issue, including examples, is set forth in the next section of this article.

Determining the Amount Subject to FICA Tax. The rules governing the timing and amount of FICA taxation distinguish between "account balance plans" and "nonaccount balance plans."

- **Account Balance Plans.** An "account balance plan" is essentially a defined contribution plan — one under which deferred amounts and additional amounts treated as income thereon are credited to a participant's account and the benefit payable from the plan is based solely on the participant's account balance.⁷ The section 3121(v) rules for account balance plans are rather straightforward. In a plan that provides for 100-percent vesting in the entire account balance, in the year in which an employee becomes vested in his benefit under such a plan, the amount included in wages subject to FICA tax for the year is the total amount credited to the employee's account at the time he becomes vested (including income on amounts previously deferred, if any). In subsequent years, the FICA wages the employee has for the year generally include only the additional amount deferred for that year. As previously noted, income on amounts previously treated as wages subject to FICA taxes are not subject to these taxes. In a plan that

⁷ Individual accounts, however, need not be maintained for individual participants for the plan to be an account balance plan. It is sufficient if individual participants are entitled to a specified portion of a pool of assets that is maintained for all plan participants.

provides for vesting in percentages of the account balance over a period of years, *e.g.*, 20 percent each year beginning on the third anniversary of participation, the same principle applies to each separately vested portion of the account balance.

Example 2. Jill Smith is a participant in the plan described in Example 1 and amounts deferred under the plan are credited with interest at an annual rate equal to the one-year Treasury bill rate (which, for the purpose of this example is assumed to be six percent per year). Jill Smith earns \$150,000 a year and becomes a participant in the plan January 1, 1996. On January 1, 1999, Jill becomes vested in 20 percent of her interest under the plan. At that time, \$47,754 (*i.e.*, $(\$15,000 \times 1.06^2) + (\$15,000 \times 1.06) + \$15,000$) is credited to her account under the plan. Consequently, as of January 1, 1999, Jill has wages for FICA tax purposes of \$9,550.80 (*i.e.*, $\$47,754 \times 20\%$). On January 1, 2000, Jill vests in another 20 percent of her account, which at that time has a balance of \$65,619.24 (*i.e.*, $(\$47,754 \times 1.06) + \$15,000$). Although the amount in which Jill has a vested interest is now \$26,247.70 (*i.e.*, $\$65,619.24 \times 40\%$), the FICA wages she has for the year do not equal the difference between that amount and the amount of wages she had as a result of participating in the plan in 1999. Rather, the income on the \$9,550.80 that were wages in 1999 is exempt from FICA taxation in 2000. Thus, the amount of wages that Jill has in 2000 is \$16,123.85 (*i.e.*, $(\$26,247.70 - \$9,550.80) - (\$9,550.80 \times .06)$).

The IRS was alert to potential abuse of the statutory exclusion from FICA taxes of income on amounts previously subject to the taxes through the use of excessive interest or other investment performance standards. Thus, the proposed regulations state that not all amounts denominated as "income" under the terms of a plan are treated as such and impose limitations on the extent to which additional amounts credited to an employee's account are in fact treated as income exempt from FICA taxes. Specifically, an amount credited to a participant's account may be "income" if it is determined by reference to the actual rate of return for the year on a predetermined actual investment (regardless of whether any assets are actually invested in the investment) or, if no predetermined actual investment is specified, a reasonable interest rate (as determined by the IRS). If the earnings credited to an employee's account exceed whichever of these amounts is applicable, the employee will be taxed on wages equal to the excess of the amount credited to the account over the amount that would be determined using the mid-term applicable federal rate (AFR) for January 1 of the year. Presumably, the IRS will issue guidance on what will constitute a "reasonable interest rate" (*e.g.*, Treasury bill rates, "GATT rates," *i.e.*, the rates used to calculate certain lump-sum distributions from qualified pension plans, etc.). Until that time, however, an employer can be certain that an amount intended to be income will not be treated as wages only if an investment is specified in the plan or if interest is credited at a rate equal to or less than the AFR. In addition, the regulations make it clear that if earnings are credited at a rate equal to the better of the rates on two investments, no investment will be considered "predetermined." In this case, the

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AFR will again determine the amount treated as income for FICA tax purposes, and any excess will be treated as wages. Similarly, although the proposed regulations do not specifically say so, officials from Treasury and the IRS have stated that the AFR will also be the measure of the amount of income where a plan provides for income to be credited at a rate earned by a specific investment or, if greater, a specified rate of interest (even if the rate is reasonable).

Further, even if additional credits to a participant's account under an account balance plan are denominated as income and do not exceed the permissible amount, they will not be treated as income exempt from FICA taxation if the amounts with respect to which they purport to be income have not actually been taken into account for FICA tax purposes. For an amount to be "taken into account," the employer must pay the applicable FICA tax. If the employer has not done that, any amounts that would be treated as income — along with the underlying deferral — are subject to FICA tax when paid.

• **Nonaccount Balance Plans.** A "nonaccount balance plan" is defined as any arrangement that is not an "account balance plan." Generally, nonaccount balance plans will be defined benefit arrangements under which an employee is promised a specified amount at a specified time. Not all nonaccount balance plans, however, will resemble usual defined benefit pension plans, under which a participant is promised an amount related to his service with and compensation from the employer. Although the point is not made explicit in the proposed regulations, government officials have said that a plan is not an account balance plan if the participant's benefit does not include an interest component. The typical long-term incentive plan, under which a participant will receive a specified amount if the participant or the employer attains predetermined performance goals, generally does not include an interest element and, therefore not being an account balance plan, is a nonaccount balance plan.

The amount includable as FICA wages as a result of an employee's participation in a nonaccount balance plan is generally equal to the increase in the present value of his benefit under the plan over any present value previously treated as FICA wages. Any reasonable actuarial assumptions can be used to determine the present value of a benefit; in addition, certain assumptions that reflect the probability that all or a portion of a benefit will not be paid can be taken into account. The regulations recognize, however, that a certain portion of the increase in the present value of a benefit is attributable solely to factors related to the passage of time. (Because of the shortening of the discount period and because an individual's life expectancy decreases each year by less than a full year, the present value of a specified sum at the end of any year is greater than the present value of that sum as of the end of the

previous year, assuming a constant interest rate assumption.) Consequently, the regulations treat this portion of the increase in the present value as income on amounts previously taken into account and, thus, as exempt from FICA taxation.

Example 3. Employer Y establishes in 1996 a nonaccount balance plan under which participants are entitled to receive, at age 65, a life annuity equal to two percent of "final average earnings" for each year of service. All participants are always fully vested in their benefits under the plan. Jane Jones is a participant in the plan who, as of December 31, 1996, is 60 years old and has 25 years of service and "final average earnings" of \$100,000. Consequently, she is entitled to receive a life annuity of \$50,000 which, using

reasonable actuarial assumptions, has a present value of \$375,000. Employer Y includes this \$375,000 in Jane's wages subject to FICA tax and, as of December 31, 1997, Jane has "final average earnings" of \$104,000, entitling her to a life annuity at age 65 of \$54,080. Even though this life annuity has a present value, using the actuarial assumptions used at the end of the previous year, of \$435,000, Jane does not have additional wages subject to FICA taxes of \$60,000 (i.e., \$435,000 - \$375,000). Rather, Jane has FICA wages equal to the present value (using the same actuarial assumptions) of a life annuity of \$4,080 (i.e., \$54,080 - \$50,000) beginning at age 65, or \$33,000. The \$27,000 difference between \$60,000 and \$33,000 is considered income on the \$375,000 previously taken into account and, therefore, is exempt from FICA taxation.

Although the present value of an employee's benefit under a nonaccount balance plan can be determined at any time, uncertainties relating to future benefits (e.g., the form in which the benefit will be paid, the possibility that the benefit when paid will include some sort of early retirement subsidy, the amount of any benefit payable from an underlying qualified plan, etc.) can make this determination especially complicated. Accordingly, the regulations do not require that any amount under a nonaccount balance plan be taken into account for FICA tax purposes until the date on which it becomes "reasonably ascertainable." (This date is referred to in the regulations as the "resolution date.") An amount is considered "reasonably ascertainable" only if the sole actuarial or other assumptions needed to determine the amount deferred are interest, mortality and cost-of-living assumptions.

It is important to note that the rule delaying the recognition of wages for FICA tax purposes until the resolution date is a doubled-edged sword. On the one hand, it reflects the most administratively practicable approach; on the other hand, it has the potential for requiring a tremendous amount of wages to be taken into account in the first year that deferred amounts become reasonably ascertainable. Accordingly, the regulations allow an employer to elect to

If the amount of the FICA wage inclusion cannot be readily calculated by the end of the year, an employer may use the "estimated method" or the "lag method" to make the calculation.

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include an amount in an employee's FICA wages as of an earlier date on or after the time at which the relevant services have been performed and the employee's rights to the deferred amounts are vested. (This date is referred to in the regulations as the "early inclusion date.") If it is determined at the resolution date that the aggregate value taken into account on all early inclusion dates (plus income on that value) is less than the value of the benefit at the resolution date, the difference must be made up at that later date. If the aggregate amount taken into account on all early inclusion dates is greater than the value determined as of the resolution date, the employer will be able to claim a refund of the amounts overpaid, but only as long as the refund is otherwise available. Thus, if the resolution date occurs after the statute of limitations has run for the year including the early inclusion date, the employer will not be permitted to claim a refund for any overpayments of FICA taxes.

As previously noted, where an employer treats amounts as wages as of an early inclusion date and is then required to treat additional amounts as wages as of the resolution date, income on amounts taken into account prior to the resolution date are not wages as of the resolution date. The regulations specify that the income on the amounts previously taken into account is determined using interest rate and, where applicable, mortality assumptions that are reasonable as of the early inclusion date. This rule is not necessary an intuitive one. Because much time can pass between the early inclusion date and the resolution date, "reasonable" actuarial assumptions may have changed considerably. Moreover, because all relevant information is known as of the resolution date, it seems proper to use assumptions that are reasonable in respect of the entire period between the two dates. Perhaps this rule will be modified when the regulations are finalized.

Perhaps the most significant choice an employer is required to make under the proposed regulations is between waiting until the resolution date to treat deferred amounts as wages or taking them into account as wages as of an early inclusion date. The advantages of taking amounts into account as of an early inclusion date are the following:

- The employee probably has other wages in excess of the OASDI wage base, so that no deferred amount will be subject to this portion of the tax.
- The exclusion from wages of income on amounts previously taken into account gives rise to "inside build-up" within the plan that is free from FICA tax.
- The amount taken into account in any one period may be minimized.

The disadvantages, relative to waiting until the resolution date, are that —

- Expensive actuarial calculations are needed more frequently.

- There is a potential for the employer and employees to make unrecoverable overpayments.

As previously noted, where the resolution date occurs after the statute of limitations has run for the year including the early inclusion date, the employer will not be permitted to claim a refund for any FICA taxes it overpaid. Although it is impossible to make any universal assertions about which approach is more beneficial, in many cases the cost savings from reducing the number of actuarial calculations (and waiting until most factors needed to make these calculations are known) will outweigh the benefits of treating amounts as subject to FICA taxes as of an early inclusion date.

Withholding and Paying FICA Taxes. Generally, FICA taxes must be withheld and paid at the time the deferred amounts are required to be taken into account. Nevertheless, the proposed regulations allow a good deal of flexibility on these timing issues. First, the regulations provide a "rule of administrative convenience" pursuant to which an employer may withhold and pay taxes at any time before the end of the calendar year in which the amounts are required to be treated as FICA wages. In addition, if the amount of the FICA wage inclusion cannot be readily calculated by the end of the year, an employer may use the "estimated method" or the "lag method" to make the calculation.

Under the estimated method, the employer may make a reasonable estimate of the amount required to be taken into account and withhold and pay FICA taxes on these amounts by the end of the year. If the employer underestimates the wage inclusion, the shortfall can be treated as wages (1) in the year in which the amounts were deferred (and the employer must correct the Forms W-2, W-2c, and 941 for that year), or (2) during the first calendar quarter of the following year. Income on the shortfall to the date of withholding and payment of FICA taxes is not treated as wages subject to FICA tax. If the employer overestimates the wage inclusion, it can claim a refund for the overpayment.

Under the lag method, the employer can calculate the deferred amount and make the payment by its first deposit date after the close of the first calendar quarter of the next year. Unlike under the estimated method, income earned on the deferred amount through the date on which the FICA taxes are withheld and paid is treated as additional wages under the lag method. The proposed regulations are not entirely clear, however, on the extent to which this "income" is treated as wages. Is the income to be calculated from the date on which the amount was required to be taken into account (*i.e.*, when the underlying services were performed or when any substantial risk of forfeiture lapsed), or is the income to be calculated from the last day of the calendar year? Technically, the "rule of administrative convenience" only requires that income from the last day of the calendar year be treated as wages. Moreover, this result is consistent with a rule that is intended to promote "administrative convenience"; if the rule were otherwise, the employer would be required to determine in-

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come from a date prior to the date as of which it is determining the amount of underlying wages.

While the regulations offer employers a number of choices (e.g., to treat an amount as wages as of the resolution date or as of an early inclusion date), it may be difficult for the employer to determine which option is preferable. With respect to the decision to use the estimated method or the lag method for withholding and paying FICA taxes, however, the choice for larger employers may be clear. Because employers that withhold and deposit more than \$50,000 of employment taxes per year are required to deposit these taxes daily, they will gain little additional time under the lag method, and the cost of treating income on the deferred amount earned during the lag period as FICA wages could be significant. As a practical matter, therefore, most employers in this category will want to opt for the estimated method.

Transition Rules. The proposed regulations are generally effective for amounts deferred and benefits paid on or after January 1, 1997. For periods before that date, the regulations provide flexible transition rules. First, consistent with the interim guidance provided in Notice 94-96, the regulations provide that any determination of FICA tax liability prior to the effective date of the regulations will satisfy section 3121(v) if it is made in accordance with a reasonable, good-faith interpretation of the statute. (Of course, a determination that is made consistently with the proposed regulations will be considered to be based on a reasonable, good-faith interpretation.) More significantly, for any year for which the statute of limitations has not run, an employer who — using a reasonable, good-faith interpretation of the statute — made a determination of FICA liability for an amount deferred under or paid from a nonqualified deferred compensation plan that is inconsistent with the proposed regulations is given the opportunity to adjust its determination for that year. Additional transition provisions address situations in which employers either treated plans that are not nonqualified deferred compensation plans as subject to section 3121(v) or failed to treat nonqualified deferred compensation plans as subject to section 3121(v).

Although a detailed discussion of the transition rules is beyond the scope of this article, these rules merit two general comments. First, there are situations in which, under the transition rules, it would be advantageous to treat amounts as having been deferred and taken into account for FICA tax purposes in previous years. The regulations make it clear that no amount can properly be

taken into account as wages subject to FICA taxes prior to the time that the relevant plan is established. Under the regulations, a plan will be treated as established only as of the latest of (1) the date on which it is adopted, (2) the date on which it becomes effective, or (3) the date on which the material terms of the plan are reduced to writing. Although a transition rule provides relief for plans that are adopted and effective, but as-yet unwritten, if benefits are to be paid from the plan after the effective date of the regulations, it is important that the plan's material terms be reduced to writing before the expiration of the transition period.

Second, an employer may generally revisit its determination of FICA liability for any year for which the statute of limitations has not run. 1993 is still an "open" year, and in 1993 there was still a cap on the amount of wages taken into account for purposes of the Medicare portion of the FICA taxes. Under this transition rule, then, it may be possible for employers to go back and treat as wages for that period amounts that were not previously so treated, thereby minimizing the extent to which amounts will be subject to the Medicare portion of the tax. To the extent that it is possible to do this, saving 2.9 percent of \$135,000 for each affected employee may make taking advantage of an early resolution date cost-effective where it otherwise might not be.

Federal Unemployment Taxes

Proposed regulations were also issued under section 3306(r) of the Code, which sets forth for FUTA (*i.e.*, federal unemployment tax) purposes the same rule as section 3121(v) does for FICA purposes. These regulations provide that the rules in the proposed regulations under section 3121(v) are applicable for the purposes of section 3306(r) as well.

Conclusion

The proposed regulations under section 3121(v) provide much-needed guidance on the application of employment taxes to nonqualified deferred compensation. Generally, the rules set forth in these proposed regulations are quite reasonable and accord employers significant flexibility. With careful analysis and planning, employers should be able to minimize the administrative burden, and perhaps the tax liability, in determining, collecting and remitting employment taxes with respect to nonqualified deferred compensation. ♦ ♦ ♦

The IRS has solicited comments on the section 3121(v) regulations. Written comments and requests for a public hearing must be made by April 24, 1996. IRS officials have expressed an intent to promulgate final regulations before or shortly after the end of 1996.

Notice 96-7: Request for Comments on Further Capitalization Guidance

March 20, 1996

On March 20, 1996, Tax Executives Institute submitted the following comments to the Treasury Department and Internal Revenue Service in response to IRS Notice 96-7, which requested assistance in identifying approaches the government should consider to address the expense-versus-capitalization issue, particularly in light of the 1992 decision in *INDOPCO v. United States*. TEI urged the IRS and Treasury to promulgate general guidance on the important issue of whether certain expenditures may be currently deducted by taxpayers or, rather, must be capitalized. TEI's comments were prepared under the aegis of its Federal Tax Committee, whose chair is Bruce H. Barnett of Cargill, Inc. The following members contributed materially to the development of TEI's comments: Roger D. Wheeler of General Motors Corporation, Richard N. Kappler of MCI Incorporated, and the 1994-1995 chair of TEI's Federal Tax Committee, Michael A. DeLuca of Household International, Inc. Also contributing to the development of the comments were Joseph Migas of MCI Incorporated and Margaret Satko and Neil Miller of General Motors Corporation.

Introduction

Proper matching of income and expense in order to clearly reflect income has been a source of contention between taxpayers and the government since the inception of the income tax. One recurring source of that friction is the requirement that proper distinctions be drawn between capital expenditures and deductible ordinary and necessary business expenses. The Supreme Court's decision in *INDOPCO v. United States*¹ — which employed expansive, amorphous language to adjudicate a narrowly circumscribed set of facts — has sparked another cycle of controversy.

Indeed, despite frequent public assurances from the IRS National Office that "*INDOPCO* did not change the law regarding capitalization,"² agents have seized upon that decision's reference to "future benefits" to support novel capitalization theories. In many cases, agents have distended the Supreme Court's decision, casting aside well-settled law and practice supporting the deduction of many business expenditures. In some instances, agents have sought to undo methods of accounting approved by the National Office for a specific taxpayer. Regardless of the authority cited — whether sections 263 or 263A or, more baldly, *INDOPCO* — the

same burdens are imposed on taxpayers: to produce reams of information replying to information document requests and to defend against unwarranted proposed adjustments.

Tax Executives Institute has monitored these developments and raised continuing concerns during annual liaison meetings with officials of the Department of the Treasury and Internal Revenue Service. In Notice 96-7,³ the IRS invited public comment on the approaches it should consider to address issues raised under sections 162 and 263 particularly in light of *INDOPCO*. In response to that invitation, TEI submits the following analysis and list of issues that should be addressed to clarify that expenses incurred are generally deductible. Without guidance on these and other issues not addressed herein (for example, the need for further clarification of the scope of deductible environmental remediation expenditures), there will likely be protracted and continuing disputes between taxpayers and the government. We shall be pleased to discuss these issues in greater detail.

Background

Tax Executives Institute (TEI) is the principal association of business tax executives in North America. The Institute's approximately 5,000 members represent more than 2,700 of the

largest companies in the United States and Canada. TEI represents a cross-section of the business community, and is dedicated to the development and effective implementation of sound tax policy, to promoting the uniform and equitable enforcement of the tax laws, and to reducing the cost and burden of administration and compliance to the benefit of taxpayers and the government alike. As a professional association, TEI is firmly committed to maintaining a tax system that works — one that is administrable and with which taxpayers can comply.

TEI members are responsible for managing the tax affairs of their companies and must contend daily with the provisions of the tax law relating to the operation of business enterprises. We believe that the diversity and training of our members enable us to bring an important, balanced, and practical perspective to the need for guidance on the deductibility or capitalization of expenditures in the aftermath of the *INDOPCO* decision.

Overview

A. The Need for General Guidance

Since *INDOPCO* was decided, the IRS has issued several helpful rulings limiting or explaining the application of this decision to certain expenses. For example, in Rev. Rul. 92-

* Footnotes appear on page 121.

80, the IRS held that advertising expenses are deductible notwithstanding the presence of some future effect on business activities.⁴ The future benefit of advertising in nearly every instance is subsumed by the current benefit. In Rev. Rul. 94-12, the IRS held that incidental repairs continue to be deductible because *INDOPCO* did not "change the fundamental legal principles for determining whether a particular expenditure can be deducted."⁵ Similarly in Rev. Rul. 94-38, the IRS held that soil remediation and groundwater treatment expenditures continue to be deductible.⁶

Nonetheless, emboldened by *INDOPCO*, revenue agents continue to raise capitalization issues outside the narrow scope of that decision. If the

TEI questions whether the IRS can or should modify the private ruling process in order to address capitalization issues separately from other forms of private rulings. The limitations of the private letter ruling process suggest that private rulings are no substitute for published guidance.

The first limitation is the lack of precedential value of private letter rulings under section 6110(j)(3). This limitation protects the government from having taxpayer-favorable private rulings cited against its interest by anyone other than the affected taxpayer. On the other hand, taxpayer-adverse private rulings, while not strictly precedential, often achieve the same result as a published ruling

such rulings and taxpayers may be compelled to litigate to achieve a result at variance with a published ruling.

The second limitation on the private letter ruling process is the diversion of resources — in terms of time and money — for both taxpayers and the government. Obtaining a private letter ruling generally requires months if not years, plus a significant commitment of taxpayer resources. As a result, taxpayers seek private letter rulings only (i) where a complex transaction is involved (and then only for those transactions for which consummation of the transaction may be deferred pending the receipt of a favorable ruling) or (ii) where the tax dollars at stake are significant but for which the timeliness of a ruling is not essential.

Matters loosely referred to as *INDOPCO* issues, however, frequently involve expenditures for items that are not attributable to discrete transactions, are generally not segregated for financial accounting purposes, and are not deferred (or deferrable) until a ruling is obtained. Increasingly, *INDOPCO* issues derive from expenditures pertaining to normal, day-to-day operating expenses that have been challenged and reclassified by revenue agents as capital expenditures. Typically, such day-to-day operating expenses are reviewed for proper tax treatment only during the course of the taxpayer's return-preparation process. Given the time necessary to develop the facts, research the legal issues, draft the ruling request, respond to government requests for additional information, and await a government ruling, the private ruling process will not be helpful or expedient in resolving issues; taxpayers often cannot even imagine that an issue exists until a revenue agent raises it because in many cases the expenditure has been routinely deducted and never challenged.

Hence, private rulings determining the deductibility or capitalization of expenditures are more likely to arise as technical advice memoranda. In that context, the issue that both revenue agents and taxpayers must assess before seeking guidance is whether the benefits obtained from invoking the ruling process outweigh

...[E]mboldened by INDOPCO, revenue agents continue to raise capitalization issues outside the narrow scope of that decision.

IRS does not limit through advance guidance the scope of the application of *INDOPCO*, the number of cases in controversy will flood all levels of issue resolution (Examination, Appeals, and litigation). Resolving these controversies will consume a significant amount of time and resources for taxpayers, the IRS, and the courts and likely will be counterproductive to the IRS's goal of audit currency. Indeed, a recent GAO report summarizing data from the IRS's CENTAUR issue tracking system documents that capital expenditure issues accounted for 42 percent of the disputes in Appeals as of September 1994.⁷ Those numbers are likely to increase, though, because of the continuing lag between examination cycles involving *INDOPCO* issues and their resolution, especially for large-case taxpayers.

B. Private Letter Ruling Process

Notice 96-7 reminds taxpayers that they may obtain private letter rulings concerning the deductibility or capitalization of specific expenditures. The IRS requests comments on whether that process may be improved to facilitate advance resolution of these issues.

since taxpayers must decide whether to comport themselves with the reasoning and result of the ruling, or — should the issue arise during the course of their own examination — challenge the ruling's analysis. Thus, the lack of precedential value in private rulings creates a perception (if not the reality) that the private ruling process is more calibrated in favor of the government than the public ruling process.

The rationale for limiting the precedential value of private rulings is plain: the review process for private letter rulings is attenuated compared with that for published guidance. Specifically, private rulings are reviewed and approved at the level of the Branch Chief of the Chief Counsel's Office, while public rulings are often reviewed at the highest policy levels within the IRS and the Treasury Department. Hence, under Treas. Reg. § 1.6662-4(d)(iii), published rulings are accorded greater weight for purposes of determining whether substantial authority exists to avoid the imposition of substantial understatement penalties. Moreover, published rulings are given greater deference by taxpayers — especially since the Appeals Branch of the IRS is bound by

the time and money required to resolving an issue. Although there will always be individual cases where the expenditures are of sufficient magnitude to justify resort to the technical advice process, the majority of cases do not rise to that threshold. Notwithstanding that the tax dollars at stake in individual cases may be nominal, the degree of controversy surrounding a particular issue may be great, especially where it is present in a large number of cases. Compelling numerous taxpayers to seek guidance on the same issue or injecting the National Office into the examination of the same issue in multiple cases is neither wise nor efficient.

Rather than permit the legacy of *INDOPCO* to evolve slowly through private letter rulings, technical advice memoranda, or litigation, TEI urges the IRS and Treasury to publish general guidance clarifying the tests for capitalization or deduction of particular types of expenditures. Specifically, we urge the government to continue to define the boundaries of the capitalization guideline articulated in the *INDOPCO* decision, including its application to the issues identified in parts V and VI below. The greatest benefit to the greatest number of taxpayers — and to the government — will be achieved through the issuance of general guid-

ance. Where ruling guidelines or principles are extant within the Chief Counsel's office (but unpublished), we suggest that such guidelines or principles be publicized in order that taxpayers may have more certainty in properly preparing their tax returns.

C. Recordkeeping Burdens

Increasingly, agents have taken the position that a particular project or expenditure results in some long-term future benefit — no matter how amorphous or attenuated that benefit might be. To develop a proposed adjustment under *INDOPCO*, agents seek records for associated costs — often employee compensation — that are routinely treated as period expenses and deducted in the year incurred. Since most companies do not require employees to maintain daily time sheets or records regarding time spent on specific projects or assignments, the salary, benefits, and associated costs often do not exist in a form that is retrievable or even recognizable as a "project" expenditure.⁸ Should the taxpayer fail to produce "records" in a form that an agent deems acceptable, the taxpayer may face an assertion that it has failed to keep "books and records" in accordance with Treas. Reg. § 1.6001-1(a) because, after all, "*INDOPCO* did not change the law of capitalization." To

avoid such a charge, taxpayers will be forced to devote significant time and effort to reconstruct an allocation or apportionment of time and related costs to a particular project or assignment to defend against such an adjustment.

In addition, the conclusory nature of the "future benefit" argument frustrates taxpayers because they are often compelled to undertake a futile search for records that are unlikely to be accepted as persuasive in any event. The *INDOPCO* argument frequently proffered by revenue agents is illustrated by the following composite of boilerplate language: (1) *INDOPCO* does not represent a change in law; (2) income tax deductions are a matter of legislative grace; (3) the burden to establish the right to the claimed deduction is on the taxpayer; (4) expenditures providing future benefits are capital in nature; and (5) since any expenditure *might* produce a future benefit (though not a "significant" one), an adjustment is hereby proposed for "X" — where "X" represents whatever expenditures the agent identified in the information document request and deems to provide a future benefit.

Since under "normal" tax and financial accounting rules, period expenses are deducted in the year in

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which they are incurred, taxpayers face an impossible task: they must provide books and records to establish the costs that relate to a newly contrived capital asset. As a result, even more disturbing than the increased burden of producing books and records is the specter of penalties on taxpayers for failing to provide documentation and proper support for recurring expenses that in the agent's view produce a future benefit. Adding further insult to injury, an agent's information document request or notice of proposed adjustment often invites the taxpayer to provide information to establish a useful life over which to amortize these newly contrived assets.

To defend against such adjustments, companies would be required to compel employees to complete daily time sheets and undertake other accounting procedures or system modifications to identify and properly allocate all such periodic expenses even though the proper treatment in nearly every case is that the expenditure should be deducted. Although it is theoretically possible to allocate wages, benefits, training expenses, and other costs that companies incurred on ordinary day-to-day business activities, the recordkeeping costs would be enormous and likely exceed the revenue to be collected. Hence, *the administrative costs of conceptual rigor are too great*. Asking companies to disprove a negative, *i.e.*, that there is no "significant future benefit" arising from an expenditure, is nearly impossible. More important, the recurring nature of periodic expenses, coupled with the incidental nature of the future benefit, compels the conclusion that income is more clearly reflected by permitting a current deduction.

Summary of Applicable Law

A. Ordinary and Necessary Expenses

Taxpayers are permitted deductions under section 162 for all ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. Although not defined in the Internal Revenue Code, courts have interpreted "ordinary" to mean any expenditure that is common and accepted in a particular industry or line of busi-

ness.⁹ The term "necessary" imposes only the minimal requirement that the expense be helpful or appropriate for the development of the taxpayer's business.¹⁰

B. Capitalization and the Matching Principle

Under section 263, taxpayers may not claim deductions for expenditures considered to be capital. Section 263(a)(1) provides that no deduction is permitted for any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. Under section 263(a)(2), no deduction is allowed for any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made for depreciation, amortization, or depletion. Treas. Reg. § 1.263(a)(1)-(b) explains that the cost of capital expenditures are added to the basis of the underlying property and "recovered through depreciation, amortization, cost of goods sold, or adjustments to basis...in accordance with applicable Code sections and regulations."

The purpose of these rules is to achieve a proper matching of income and expense in order to clearly reflect income.¹¹ The primary criteria for distinguishing whether a cost will be deductible under section 162 or capitalized under section 263 is whether the expenditure adds value, substantially prolongs the useful life of taxpayer property, or adapts property to a new use.¹² Where the expected future benefit is merely incidental¹³ or the benefit of an expenditure does not extend substantially beyond the taxable year, the expenditure is generally deductible in the taxable year in which it is incurred.¹⁴

C. Vague Scope of *INDOPCO's* Test Vitiates Its Value; Further Guidance Necessary

In *INDOPCO*, the Supreme Court supplied limited guidance regarding the distinction between capital expenditures and currently deductible expenses: the Court said the future benefit of an expenditure must be more than "incidental."¹⁵ Untethered by any

further defining principles, the concept of a "more-than-incidental future benefit" as the primary criterion threatens a degree of controversy that may overwhelm the tax system's ability to resolve disputes. The administrative costs of resolving the myriad issues that revenue agents are raising are too great — for the government and taxpayers alike. We recommend, therefore, that the IRS continue to issue general guidance clarifying the fundamental principles of capitalization. Before addressing specific issues on which such guidance would be appropriate, however, we wish to review other tenets of the tax "common law" of capitalization.

D. Regular and Recurring Expenses

Where an expenditure is regular and recurring, a deduction in the year the expense is incurred will more clearly reflect income since the expense will then be matched with the annual revenues produced by the expenditure. The court in *Encyclopaedia Britannica, Inc. v. Commissioner*,¹⁶ summarized the view thusly:

Most of the "ordinary," in the sense of recurring, expenses of a business are noncapital in nature and most of its capital expenditures are extraordinary in the sense of nonrecurring...The distinction between recurring and nonrecurring business expenses provides a very crude but perhaps serviceable demarcation between those capital expenditures that can feasibly be capitalized and those that cannot be.

Therefore, the recurring or non-recurring nature of an expenditure serves as a practical guideline to determine whether an expenditure is to be deducted or capitalized. Indeed, the court in *Encyclopaedia Britannica* further observed:

If one really takes seriously the concept of a capital expenditure as anything that yields income, actual or imputed, beyond the period...in which the expenditure is made, the result will be to force the capitalization of vir-

tually every business expense. It is a result courts naturally shy away from.... It would require capitalizing every salesman's salary, since his selling activities create goodwill for the company and goodwill is an asset yielding income beyond the year in which the salary expense is incurred. *The administrative costs of conceptual rigor are too great.*¹⁷

Indeed, the failure to take account of the administrative costs associated with capitalization of expenditures and the propensity of agents to ignore the current income produced by recurring expenditures are at the nub of *INDOPCO* controversies.

E. De Minimis Rule

Both the IRS and the courts have stated that expenditures that result in future benefits do not have to be capitalized if the amount is so small that permitting a deduction does not distort the clear reflection of income. For example, the Court of Claims in *Cincinnati, New Orleans & Texas Pacific Ry. v. United States*¹⁸ stated that:

where the burden on both taxpayers and Service to account for each item of property separately is great, and the likelihood of distortion of income is nil or minimal, the Code is not so rigid and so impracticable that it demands that nevertheless all items be accounted for individually, no matter what the trouble or the onus.¹⁹

In addition, the IRS has recognized that certain *de minimis* amounts should be permitted as deductions regardless of future benefits,²⁰ and as a matter of administrative convenience accepted taxpayers' use of reasonable thresholds.

F. Business Expansion Costs

Expenditures to start up a new business are not deductible currently.²¹ Expenditures to expand an existing business (e.g., promotional activities to increase sales²² or expenditures to develop a new sales territory²³), however, are deductible where the

expenditures are to expand an existing business;²⁴ the business activity contemplated is closely related to the existing business;²⁵ the expansion does not result in a new or separate entity being formed; and, finally, the expenditures are ordinary and necessary expenses and are not capital in nature.

The IRS has recognized that "recurring costs incurred by a going concern in expanding its business generally are deductible, but the costs of entering a new line of business are capital expenditures."²⁶ In addition, the Second Circuit's decision in *Briarcliff Candy Corp. v. Commissioner*²⁷ provides a welcome level of clarity and rationality for distinguishing expenditures that are deductible in the current year from those that may require capitalization. The Second Circuit agreed with the taxpayer and held that "the facts of this case bring it squarely within the long recognized principle that expenditures for the protection of an existing business . . . are ordinary and necessary within the meaning of section 162 and not capital in nature."²⁸ The court insightfully stated:

Every new idea and every change of method in making sales, even in promoting special sales or developing new sales territory, do not require that the expenses connected with the operation be non-deductible under § 162. While the quotation taken by the Commissioner from *Houston Natural Gas* that "an intensive campaign to get new customers at any time gives rise to capital expenditures" may be valid enough if confined to the facts of that case, *it is not acceptable as an unqualified general rule.* In fact, expenditures by an already established and going concern in developing a new sales territory are deductible under § 162. Rev. Rul. 56-181.²⁹

Briarcliff is merely one example of the well-settled principle of federal income tax law that ordinary expenses of an ongoing business are properly treated as expenses of the current period.³⁰ Thus, an already established

and going concern may deduct ordinary and necessary expenses incurred in the expansion of its existing normal business activity.³¹ Expenses that are deductible as costs incurred in the expansion of a business include expenditures by an existing company for the purposes of developing a new sales territory,³² increasing sales through promotional activities,³³ and developing foreign markets.³⁴

Moreover, the legislative history of section 195 confirms Congress's intention that business expansion costs continue to be deductible when incurred in the expansion of an existing business. In relevant part, the reports state:

In the case of an existing business, eligible startup expenditures do not include deductible ordinary and necessary business expenses paid or incurred in connection with an expansion of the business. *As under present law, these expenses will continue to be currently deductible.*³⁵

In its brief in *INDOPCO*, the government acknowledged that section 195 recognizes that "expenditures incurred in carrying on or expanding an existing business generally are deductible under Section 162(a), while expenditures incurred in creating a new business and expenditures incurred by a going concern in entering a new line of business are capital expenditures."³⁶

Expenditures for Self-Created Intangibles

In the course of its deliberations over the enactment of two separate statutory provisions modifying the treatment of certain expenditures, Congress has seemingly rejected the notion that expenditures incurred for self-created intangible property should be capitalized.

For example, in 1986 when Congress enacted the uniform capitalization provisions of section 263A, the Senate Finance Committee's report stated that the section was not designed to change the current determination of whether an expenditure creates a separate and distinct asset

with a useful life substantially longer than the current taxable year.³⁷ Accordingly, section 263A does not apply to the costs of creating an intangible item such as goodwill if such costs are currently deductible under present law.³⁸

Section 197 is similarly limited and does not extend to self-created intangibles. The legislative history of that 1993 legislation states, "it is also believed that there is no need at this time to change the Federal income tax treatment of self-created intangible assets, such as goodwill that is created through advertising and other similar expenditures."³⁹ During the legislative process leading to the enactment of section 197, it was stated that "some costs that are paid or incurred to create, maintain, or enhance the value of certain intangible assets may be deducted as ordinary and neces-

s income tax system are intended, they should result from congressional directives rather than unfettered administrative theorizing.

A. Training and Relocation Expenditures

1. Just-In-Time Manufacturing Expenditures

The just-in-time manufacturing technique may involve significant workforce training costs and consulting fees relating to training both management and the workforce in general. As we stated in our September 21, 1995, letter (copy attached), TEI believes that the workforce training and related consulting costs associated with the adoption of just-in-time manufacturing techniques are fully deductible, just as costs associated with

method for developing or improving the product.⁴⁷ The term generally includes all costs incident to the development or improvement of a product. The term "product" includes any pilot model, *process*, formula, invention, *technique*, patent, or similar property.⁴⁸ When manufacturers undertake to implement just-in-time *techniques* and *processes*, there is no certainty that their products or processes will be improved. As a result, the implementation costs for just-in-time manufacturing are experimental costs incurred to discover information that would eliminate the uncertainty concerning the development or improvement of a product.

2. Costs for Total Quality Management Programs

Many companies expend significant sums for consultants' fees, employee salaries, supplies, *etc.*, to maintain or improve the quality of their products or services. Some of the costs relate to wholly internal company programs designed to improve the efficiency and effectiveness of organizational or managerial processes, to translate concepts developed in manufacturing process environment to the office, to re-engineer and streamline office or manufacturing procedures, or to continuously improve the manner in which the company does business. Occasionally, these costs involve payments to employees or consultants to conduct formal classroom-type or on-the-job training. More often, the expenditures involve ordinary salary payments to employees for time spent engaged in mutual problem-solving sessions ("brainstorming" or "benchmarking" sessions). The beneficiaries of the total quality management (TQM) training include a company's internal and external customers.

Although company TQM programs have become both more popular and visible recently — owing in part to the need to respond to increased global competitive pressures and in part to publicity about business trends — TQM programs represent a sound business practice that has been employed for many years, albeit either as a less rigorously developed conceptual matter or under a different rubric such as quality control, process control, employee training, or, the employee suggestion pro-

[C]osts incurred to train employees generally may be deducted for the year such costs are paid or incurred even though the training results in a more knowledgeable or valuable workforce.

sary business expenses for the year that the costs are paid or incurred.⁴⁰ By way of example, the Joint Committee on Taxation cited Treasury regulations for the proposition that "advertising expenses generally may be deducted for the year paid or incurred."⁴¹ Likewise, costs incurred to train employees generally may be deducted for the year such costs are paid or incurred even though the training results in a more knowledgeable or valuable workforce.⁴² Finally, "although taxpayers generally must capitalize the costs of acquiring intangible assets from another person (such as the cost of acquiring a customer list or goodwill), taxpayers generally may deduct the costs incurred to develop or maintain such intangible assets."⁴³

Any attempt by revenue agents to require the capitalization of the costs of internally developed intangible assets is inconsistent with existing statutes, congressional intent, and case law. If broad sweeping changes in the administration of this country

training employees to perform their jobs within an existing business are fully deductible.⁴⁴ Just-in-time manufacturing involves ordinary and necessary training to implement efficient management and manufacturing practices, unlike the extraordinary training costs described in *Cleveland Electric Illuminating Co v. United States*,⁴⁵ where the costs were incurred to facilitate the issuance of governmental licenses.

Expenditures to implement just-in-time manufacturing techniques are also likely deductible as research and experimental expenditures under section 174. Under section 174, research or experimental expenditures means expenditures that represent research and development costs in the experimental or laboratory sense⁴⁶ — *i.e.*, if they are for activities intended to discover information that would eliminate the uncertainty concerning the development or improvement of a product. Uncertainty exists if the information available to the taxpayer does not establish the capability or

gram. In effect, TQM programs enable companies to capture the creative ideas generated by employees *while performing their day-to-day job duties*. Given the intense global competition that faces many businesses, and the resulting need for continuous improvement in efficiency and cost reduction, the TQM programs will persist in one form or another for many years. As important, the attendant training costs will be continuous or recurring.

TEI believes that costs incurred for TQM programs are ordinary and necessary business expenses and deductible currently under section 162 for several reasons. First, the primary purpose of the TQM training and program is to permit the employees to perform current duties in a more efficient fashion. In addition, the expenditures are recurring in nature. Moreover, any "future benefits" derived from the expenditures — to the extent particularized benefits can be isolated, quantified, and attributed — are inseparable from the current benefits derived from having a better-trained, better-informed, workforce *performing the same or similar tasks as before the TQM training*. Hence, the expenditures are deductible as ordinary and necessary educational expenses under Treas. Reg. § 1.162-5 and as recurring expenditures under the *Encyclopaedia Britannica* test.

3. Employee Relocation Expenses

Expenses incurred to relocate employees incident to a transfer have been deductible under section 162 for many years as ordinary and necessary business expenses. Under the uniform capitalization regulations, however, service costs that either (a) directly benefit or (b) are incurred by reason of the performance of production or resale activities of a taxpayer may be capitalized.⁴⁹ The uniform capitalization regulations are thus consistent with cases requiring capitalization of wages allocable to the construction of fixed assets.⁵⁰ Where relocation costs are unrelated to the construction of fixed assets, however, the costs are deductible recurring expenses.

Notwithstanding the lack of precedential value of private letter rul-

ings, some revenue agents have asserted that the reasoning in Private Letter Ruling 9426004 supports the capitalization of relocation costs incurred as part of a company-wide restructuring. Thus, although the relocation costs were not related to, or by reason of, the engineer's activities in the construction of fixed assets or production activities, agents have argued that the company's restructuring renders the costs nondeductible. Private Letter Ruling 9426004, which is concerned generally with proper treatment of construction workers' "unclassified time," however, is wholly unrelated to employee relocation costs. In other words, payments for relocation costs may in fact constitute taxable compensation to the employees, but such payments are *not* a fundamental component of the employee's compensation subject to capitalization or allocation to construction activity.⁵¹ Private Letter Ruling 9426004 notes that certain general and administrative expenses attributable to the performance of services that do not directly benefit, or are not incurred by reason of a particular production activity, are not required to be capitalized.⁵²

Treas. Reg. § 1.263A-1(e)(4)(ii)(B) permits the deduction of costs incurred by reason of the exercise of "overall management or policy guidance." Although expenses associated with relocation is listed in the examples of costs "generally allocated among production or resale activities," TEI submits that indirect expenses of relocation can be either deductible or capitalizable depending upon the reason for the relocation. Where the costs are unrelated to the construction of a particular fixed asset or construction or production activities generally, however, they are deductible recurring expenses.

B. Business Expansion

1. Customer Service Contract Costs

These expenditures, composed typically of employee salaries, benefits, legal expenses, and consultants' fees, are costs associated with the development and negotiation of service contracts with customers, the term of which may or may not exceed one year. When the costs are incurred to develop and negotiate an agree-

ment, the term of a particular customer's agreement is typically unknown until the execution of the agreement. Depending upon the type of agreement, the nature of the services provided, the relative bargaining power of the parties, the degree of standardization (or customization) of the services provided, and other factors, the time involved in negotiating and developing the contractual terms for specific customers may range from minutes to months. In all cases, however, the business purpose of these expenditures is to *maintain or expand* existing lines of business services.

The expenses associated with these selling activities, especially those incurred for wages and benefits for employees, are part of, and inseparable from, recurring day-to-day activities incurred to expand an existing business. Hence, such expenses should be deductible under the rationale set forth in *Briarcliff*. Capitalization of the expenses would not necessarily reflect income more clearly; requiring companies to account for these costs separately in respect of each potential customer service agreement would, however, impose a severe administrative burden especially where there are substantial numbers of customers. Concededly, service agreements with a term in excess of one year may occasionally be executed. At any one time, however, employees are likely to be involved in negotiation with a number of separate customers or potential customers and the terms of the contracts will vary by customer. TEI believes that this type of expense, as a routine and ongoing part of a company's marketing efforts, are made to expand an existing business and, hence, indistinguishable from deductible advertising expenses. Should companies be required to capitalize such expenses, the time spent in unsuccessful negotiations would have to be segregated and the related costs deducted when negotiations cease. In addition, the costs related to the time spent in successful negotiations would be required to be segregated on a contract-by-contract basis with the costs recovered over the period of each separate contract. We believe, however, that any "future benefit" arising from agreements with terms exceeding one year would likely be overwhelmed by the incremental administrative burden of account-

ing for such costs on an agreement-by-agreement basis. Any increased clarity in the reflection of income would be purely theoretical. In such a case, administrative convenience and common sense should prevail to permit continued deductions and obviate additional recordkeeping burdens.

2. New Service Development Costs

These expenses (typically, again, employee salaries, benefits, legal expenses, consultants' fees, and research and development expenses) relate to the development of new services. New services generally involve an expansion of an existing line of service and, hence, are not start-up costs for a new trade or business. The expenses are incurred for such activities as software development, feasibility studies, and marketing surveys. As such, they are deductible because they are either (1) research and experimentation expenses under section 174 or (2) are of a recurring nature and should be deducted under section 162 in order to reflect income more clearly. Feasibility and marketing studies, the costs of which are deductible under section 263A — the most stringent congressional standard for capitalization — should not be capitalized under *INDOPCO*. In addition, a substantial administrative burden would be placed on companies to account for these costs in relation to each new service that is not a new trade or business.

C. Recurring Expenses

1. Cellular Telephone Sales Commission Expense

The deductibility of commissions paid to employees and independent sales agents by cellular telephone companies for selling one-year (or shorter), renewable service contracts have been challenged under the nebulous future benefit standard of *INDOPCO*. The commissions at issue are routine, recurring business expenses that do not necessarily secure significant future benefits. In the typical case, a commissioned sales agent is required to refund commissions received where the customer terminates cellular telephone service within six months of inception of the service. Thus, the commissions are properly

viewed as being paid to agents to secure the opportunity for cellular telephone companies to serve a customer. Once the customer, whose agreement may or may not be renewed for additional terms, is secured, no further services are expected from or provid-

ity levels or reliability standards have been attained, customers increasingly require that a supplier's processes be inspected and certified by an independent, non-governmental body or agency. Companies subject to these certification requirements must show

TEI believes that the costs incurred to establish that a company's processes meet or exceed quality or reliability standards are ordinary and necessary business expenses and deductible currently.

ed by the selling agent. Revenue agents are asserting that the commission is paid to secure a customer relationship that has a future value beyond the current year and, as a result, the commission must be capitalized and amortized over the expected life of the customer relationship.

The commissions paid by cellular telephone companies are another example of a routine recurring operating expense that *might* lead to customers' continuing to do business on a long-term basis. The customers, however, are not *bound* or compelled to do so. Any future benefit from the commission is highly attenuated and indistinguishable from the current benefit and income produced. Under the matching principle, the costs should be deducted when incurred.

2. Product or Process Certification

Many companies have expended significant sums for salaries, supplies, rent, consultants' fees and other costs to meet product or process quality standards set directly or indirectly by the companies' customers. As a result of intense global competition and the consequent focus on product quality and reliability (or the quality and reliability of a certain business or manufacturing process that produces the product), customers have increasingly prescribed certain standards of quality or reliability that suppliers must meet to be deemed an acceptable supplier.⁵³ (Often these standards are established by original equipment makers for other manufacturers who supply component parts.)⁵⁴ To ensure that the qual-

ity levels or reliability standards have been attained, customers increasingly require that a supplier's processes be inspected and certified by an independent, non-governmental body or agency. Companies subject to these certification requirements must show

that they meet existing standards and have business processes to ensure continuous improvements in the quality and reliability of their products.

TEI believes that the costs incurred to establish that a company's processes meet or exceed quality or reliability standards are ordinary and necessary business expenses and deductible currently. The primary purpose of the expense is to permit current product or service sales, and hence the costs are deductible under section 162. Alternatively, many of the costs will be incurred "for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product" and, consequently, deductible as research and experimentation expenses under section 174.

Post-Acquisition Operating Expenses

The factors to be considered in determining whether post-acquisition expenses are deductible or capitalizable are the nature of an expense, the purpose for which it was incurred, and whether it is directly related to the assets acquired through the acquisition. Operating expenses, such as those described below, that are incurred post-acquisition do not produce significant future benefits and hence should remain deductible. Unlike outside investment banking, appraisal, legal, and accounting fees, certain printing costs, and payments to acquire the stock or assets of an acquired company, post-acquisition operating expenses are unrelated to the transaction in which the property (including stock) was acquired. Post-ac-

quisition operating expenses generally originate in management's drive to reduce operating costs of the combined businesses.

In most cases, no significant future benefit arises from a post-acquisition expenditure because the costs incurred relate to the termination of unnecessary business arrangements. Indeed, such costs often relate to terminating arrangements or contracts that, left unaltered, would produce otherwise deductible operating expenses. For example, the cost of early termination of a lease will reduce deductible rent expense.⁵⁵ Capitalization of costs that reduce operating expenses would be inconsistent with a number of rulings including the most recently published guidance that held that the installation of energy saving devices that avoided costs and reduced future operating costs were deemed not to produce significant "future benefits" that required capitalization.⁵⁶

A. Severance Payments

Severance payments based on services previously rendered are generally deductible under Revenue Ruling 94-77.⁵⁷ The ruling states that no inference should be drawn concerning severance payments made in connection with the acquisition of property (including a deemed acquisition of assets pursuant to section 338). The "no inference" statement was seemingly intended to preserve other issues for further study. Regrettably, some revenue agents have seized upon the "no inference" statement as an invitation to capitalize severance payments to terminated employees of an acquired or acquiring company where the terminations occur about the time of the acquisition.

TEI believes that severance payments related to services previously rendered (*e.g.*, a payment of one week of salary for every year of service) constitute deductible compensation payments when made. Since Rev. Rul. 94-77 holds correctly that severance pay is deductible notwithstanding the future benefit of reduced operating costs or increased operating efficiencies arising from a down-sizing, we see no basis for a distinction where the severance payments are incurred coincident with an acquisition.⁵⁸ As

explained in a recent technical advice memorandum,⁵⁹ a deductible expense is not converted into a capital expenditure solely because the expense is incurred as part of the terms of a corporate reorganization. Rather the important consideration in determining the nature of an expenditure for tax purposes is the origin and character of the claim for which the expenditure is incurred.⁶⁰ Under the "origin of the claim doctrine," the character of a particular expenditure is determined by the transaction or the activity from which the taxable event proximately resulted.⁶¹ The purpose, consequence, or result of the expenditure is irrelevant in determining the origin of the claim, and therefore, the character of the expenditure.⁶² The technical advice memorandum held that payments made to cancel stock options and stock appreciation rights to effectuate an acquisition did not originate in the acquisition but rather in the employment relationship between the taxpayer and the option holders.⁶³ Hence, the payments were deductible ordinary and necessary business expenses.

B. System Integration

System integration expenses — costs associated with the bridging and interconnection of computer or telecommunications network systems that neither materially increase the value of the systems nor prolong their useful life — should constitute deductible expenses. Typically the expense is incurred to integrate one computer or telecommunications system into another to achieve operational efficiency. For example, assume Company A is acquired by Company B. Company A has a billing system that interfaces directly with its general ledger to update accounts receivable, inventory, *etc.* Following the acquisition, Company B decides to continue using Company A's billing system but not the general ledger. Instead, Company B "integrates" Company A's billing system into B's general ledger system by developing the necessary system interfaces and software links to pass data from Company A's billing system into Company B's general ledger.

The expenses of integrating computer networks or software systems are indistinguishable from the ex-

pense of relocating assets, which the IRS has held to be deductible.⁶⁴ As was the case in Rev. Rul. 70-392, the integration of the systems does not materially change the system's characteristics, add to its value, or prolong its life. The fact that the integration occurs as a consequence of an acquisition is irrelevant; the cost is attendant to the company's day-to-day business operations. Notwithstanding any attenuated "future benefit" that may arise from operational efficiencies, these expenses should remain deductible.

C. Contract Terminations

In order to reduce future operating expenses and consolidate the number of physical locations following an acquisition, companies often incur fees and charges to terminate leases or contractual commitments. Expenses incurred in connection with the termination of facility and property leases or contracts in order to reduce future operating costs should be deductible, notwithstanding that these costs were incurred as part of integrating the operations of an acquired company. A determination of whether a payment to terminate a contract must be capitalized or deducted depends on the origin and character of the payment.⁶⁵ Where the payment is made solely for termination of a contract, not in exchange for a new or modified contract that will bring the company long-term benefit, the payment is deductible.⁶⁶ The fact that the contract is terminated as a consequence of an acquisition is irrelevant. If the terminated contract related to the company's business operations, the payment is deductible.⁶⁷

D. Decommissioning Costs

Decommissioning costs may be defined broadly as any expense incurred to eliminate duplicative trade or business operating assets, *e.g.*, duplicate mainframe computers, accounting systems, telephone systems, *etc.* The disposition of trade or business assets generally gives rise either to abandonment losses under section 165 or deductible losses under section 1231. For leased assets, a lease or contract termination payment is generally deductible under section 162. Often such costs may be incurred as part of a post-acquisition plan to re-

duce continued operating costs. No new asset or other future benefit is generally obtained as a result of the cost reduction. As a result, the origin of the expense is the drive to reduce operating costs. TEI believes that such costs are deductible under section 162.⁶⁸

Recovery of Capital Expenditures

Under the Code and regulations, expenditures must be properly classified as between capital and expense.⁶⁹ When an expenditure results in the creation of an asset having a useful life that extends substantially beyond the close of the taxable year, such an expenditure may not be deductible, or may be deductible only in part, for the taxable year in which made.⁷⁰ Capital expenditures are subsequently recovered through depreciation, amortization, cost of goods sold, as an adjustment to basis, or otherwise, at such time as the property to which the amount relates is used, sold, or otherwise disposed of by the taxpayer.⁷¹ Among the applicable Code sections is section 167, which permits "a depreciation deduction for the exhaustion, wear and tear . . . (1) of property used in the trade or business, or (2) of property held for the production of income."⁷² Except as provided by statute, depreciation deductions for tangible property are determined under section 168. Certain intangible assets acquired in connection with an acquisition of a trade or business are generally amortizable under section 197, and other intangible assets are amortizable under section 167.

The current degree of controversy concerning capitalization issues is as much about the period and method for recovering a capitalized cost as it is about whether a particular expenditure is capital in nature. All too often, revenue agents seek the most disadvantageous result to taxpayers. Hence, agents generally propose that the longest-lived property with the slightest transactional or business

connection to the expenditure is the property "improved" by a capitalized expenditure. Indeed, the quest seems to be to relate the expenditure to an intangible asset (or to create a new intangible asset) with an indefinite life for which no amortization will be permitted under Treas. Reg. § 1.167(a)-3.

In providing guidance, the National Office should instruct its revenue agents to consider what period or periods are most benefitted by a particular expenditure. Thus, where an expenditure relates to the production of current income (notwithstanding some incidental ensuing future benefit), the proper period for deducting an expenditure is the current period. Where an expenditure relates to income earned in the past (e.g., compensation for past services,⁷³ legal fees,⁷⁴ compensatory damages,⁷⁵ and environmental clean-up costs incurred in the ordinary course of business⁷⁶), the expenditure similarly should be deducted currently. Where the IRS determines that the future benefit of an expenditure is significant enough to warrant capitalization, the next step must be to provide guidance ensuring that the cost is properly associated with an identifiable asset and *recovered* in the proper period and within a reasonable time. The alternative — creating new assets or associating expenditures with assets possessing indefinite or excessively long lives — will ensure protracted and continuing controversies between taxpayers and the government.

Among the reasons that taxpayers welcomed Rev. Rul. 94-38 (concerning environmental clean-up costs) is that — not only did it provide guidance that the groundwater clean-up expenditures are deductible — it provided a reasonable and certain life over which to recover the cost of the capitalized groundwater treatment facilities. Similarly, if under extraordinary and unusual facts and circumstances an intangible item is determined to be capital — say, for exam-

ple, the employee training expenditures in *Cleveland Electric Illuminating Co. v. United States*,⁷⁷ which permitted the taxpayer to license its engineers to operate a nuclear power plant — the IRS should consider providing guidance that the expenditures relate solely to the existing workforce and are recoverable either (1) over a reasonably short amortization period of up to, say, 36 months or (2) as current employees retire or otherwise terminate their employment.⁷⁸ The circumscribed amortization period reflects the likelihood that the value of expenditures for intangibles such as this diminishes rapidly. At a minimum, the National Office should require that agents undertake an analysis to define the recovery period and method for every capitalized expenditure that purports to give rise to an intangible asset. Moreover, the guidelines for agents (and taxpayers as well) should point out that expenditures for such assets *rarely* give rise to an asset with an indefinite life.

Conclusion

While many of the expenditures illustrated in the foregoing examples are not novel, the conflict over whether the costs are currently deductible is. Consequently, TEI is concerned that revenue agents have seemingly taken it upon themselves to extend the decision in *INDOPCO* to expenditures long considered deductible. Hence, we urge the IRS and Treasury to continue issuing general guidance clarifying that the *INDOPCO* decision did not affect the current deductibility of many expenses. We shall be pleased to discuss our comments and examples in more detail.

TEI's comments were prepared under the aegis of its Federal Tax Committee, whose chair is Bruce H. Barnett of Cargill, Inc. If you have any questions concerning these comments, please call either Mr. Barnett at (612) 742-6778, or Jeffery P. Rasmussen of the Institute's professional tax staff at (202) 638-5601. ♦ ♦ ♦

dteinnnn@reach.com

Tax Executives Institute now has an office-wide e-mail address. If you have a question or comment, but aren't sure of the department or person to which it should be addressed, use the address listed above and your message or comment will be forwarded to the appropriate person.

Notes

- ¹ *INDOPCO v. United States*, 503 U.S. 79 (1992).
- ² See, e.g., Rev. Rul. 94-12, 1994-1 C.B. 36.
- ³ 1996-6 I.R.B. 22.
- ⁴ 1992-2 C.B. 57.
- ⁵ 1994-1 C.B. 36.
- ⁶ 1994-1 C.B. 35.
- ⁷ *Tax Administration: Recurring Issues in Tax Disputes Over Business Expense Deductions*, United States General Accounting Office (GAO/GGD-95-232, Sept. 26, 1995).
- ⁸ Even for those companies that do require time sheets, the recordkeeping is likely limited to (i) a few departments within the company (e.g., the legal department) and (ii) cursory descriptions of the work performed. Where extant, in-house time sheets are often not comparable to the more detailed descriptions maintained to support invoices from fee-based consultants.
- ⁹ An ordinary expense means one that is "normal, usual, or customary." *Deputy v. Dupont*, 308 U.S. 488, 495 (1940).
- ¹⁰ *Welch v. Helvering*, 290 U.S. 111, 113 (1933).
- ¹¹ "Through provisions such as these, the Code endeavors to match expenses with the revenues of the taxable period to which they are properly attributable, thereby resulting in a more accurate calculation of net income for tax purposes." *INDOPCO v. United States*, 503 U.S. 79, 84 (1992).
- ¹² Treas. Reg. § 1.263(a)-1(b).
- ¹³ Amounts paid or incurred for incidental repairs are generally deductible under section 162 even though they may have some future benefit. Rev. Rul. 94-12, 1994-1 C.B. 36.
- ¹⁴ *INDOPCO*, 503 U.S. at 87. See also *Central Texas Savings & Loan Ass'n v. United States*, 731 F.2d 1181, 1183 (5th Cir. 1984).
- ¹⁵ "Although the mere presence of an incidental future benefit — 'some future aspect' — may not warrant capitalization, a taxpayer's realization of a benefit beyond the year in which the expenditure is incurred is undeniably important in determining whether the appropriate tax treatment is immediate deduction or capitalization." *INDOPCO*, 503 U.S. at 87.
- ¹⁶ 685 F.2d 212, 217 (7th Cir. 1982), *reversing and remanding*, T.C. Memo 1982-255.
- ¹⁷ *Id.* (citations omitted and emphasis added).
- ¹⁸ 424 F.2d 563 (Ct. Cl. 1970).
- ¹⁹ *Id.* at 572.
- ²⁰ In General Counsel Memorandum 34959 (July 25, 1972), Chief Counsel's Office recommended that the IRS issue a revenue ruling to permit a taxpayer to deduct small capital expenditures that do not exceed \$100 in the year incurred.
- ²¹ See *Frank v. Commissioner*, 20 T.C. 511 (1953); *Madison Gas & Electricity Co. v. Commissioner*, 633 F.2d 512 (7th Cir. 1980) (expenses incurred to start a new or unrelated business are treated as start-up capital expenses); I.R.C. § 195 (start-up costs may not be deducted and the taxpayer may elect to amortize these costs).
- ²² Rev. Rul. 56-181, 1956-1 C.B. 96.
- ²³ *Briarcliff Candy Corp. v. Commissioner*, 475 F.2d 775 (2d Cir. 1973).
- ²⁴ *Id.*; Rev. Rul. 56-181, 1956-1 C.B. 96.
- ²⁵ *Mid-State Prod. Co. v. Commissioner*, 21 T.C. 696 (1954); *York v. Commissioner*, 261 F.2d 421 (4th Cir. 1958).
- ²⁶ Brief for the Respondent on Petition for a Writ of Certiorari in *INDOPCO v. Commissioner*, 503 U.S. 79 (1992) (No. 90-1278), at 14-15 n.6 (citing *Colorado Springs Nat'l Bank v. United States*, 505 F.2d 1185, 1190 (10th Cir. 1974); *Carl Reimers v. Commissioner*, 211 F.2d 66, 68 (2d Cir. 1954)). See also H.R. Rep. No. 1278, 96th Cong., 2d Sess. 11 (1980).
- ²⁷ 475 F.2d 775 (2d Cir. 1973).
- ²⁸ *Id.* at 787.
- ²⁹ *Id.* at 782 (emphasis added).
- ³⁰ I.R.C. § 162; Treas. Reg. § 1.162-1(a). See also *Allen v. Commissioner*, 283 F.2d 785, 790-91 (7th Cir. 1960); *Lutz v. Commissioner*, 282 F.2d 614, 617, 620 (5th Cir. 1960); *Van Iderstine Co. v. Commissioner*, 261 F.2d 211, 213 (2d Cir. 1958); *Commissioner v. Surface Combustion Corp.*, 181 F.2d 444, 447 (6th Cir. 1950); *United States v. E.L. Bruce Co.*, 180 F.2d 846, 848-49 (6th Cir. 1950).
- ³¹ *Briarcliff Candy Corp.*, 475 F.2d 775 (2d Cir. 1973); *York v. Commissioner*, 261 F.2d 421 (4th Cir. 1958); see I.R.C. § 162(a).
- ³² *Briarcliff Candy Corp.*, 475 F.2d 775 (2d Cir. 1973).
- ³³ Rev. Rul. 56-181, 1956-1 C.B. 96.
- ³⁴ Rev. Rul. 64-42, 1964-1 C.B. 86.
- ³⁵ H.R. Rep. No. 1278, 96th Cong., 2d Sess. 11 (1980); S. Rep. No. 1036, 96th Cong., 2d Sess. 12 (1980) (emphasis added).
- ³⁶ Brief for the Respondent, *INDOPCO*, at 37 n.21.
- ³⁷ S. Rep. No. 313, 99th Cong., 2d Sess. 141 (1986).
- ³⁸ *Id.*
- ³⁹ H. Rep. No. 11, 103d Cong., 1st Sess. at 323 (1993).
- ⁴⁰ Joint Committee on Taxation, 102d Cong., 1st Sess., *Description of H.R. 3035, H.R. 1456, and H.R. 563*, at 18 (Sept. 30, 1991).
- ⁴¹ *Id.*, citing Treas. Reg. § 1.162-20(a)(2).
- ⁴² Joint Committee on Taxation, *supra* note 40, at 18. See also *Knoxville Iron Co. v. Commissioner*, 18 T.C.M. 251 (1959) (training costs held to be deductible when incurred); and *Cleveland Electric Illuminating Co. v. Commissioner*, 7 Cl. Ct. 220 (1985) (certain training costs were deductible when incurred; other training costs required to be capitalized because the costs related to the start-up of a new business).
- ⁴³ Joint Committee on Taxation, *supra* note 40, at 18.
- ⁴⁴ See *Ithaca Industries v. Commissioner*, 97 T.C. 253 (1991), *aff'd*, 17 F.3d 684 (4th Cir.), *cert. denied*, 115 S. Ct. 83 (1994).
- ⁴⁵ 7 Cl. Ct. 220 (1985).
- ⁴⁶ Treas. Reg. § 1.174-2(a)-1.
- ⁴⁷ *Id.*
- ⁴⁸ Treas. Reg. § 1.174-2(a)-2 (emphasis added).
- ⁴⁹ Treas. Reg. § 1.263A-1(e)(4)(ii).
- ⁵⁰ *Commissioner v. Idaho Power*, 418 U.S. 1 (1974). See also Treas. Reg. § 1.266-1(e).
- ⁵¹ PLR 9426004 (Mar. 22, 1994).
- ⁵² PLR 9426004 (citing Temp. Reg. § 1.263A-1T(b)(2)(v)(C)).
- ⁵³ One example of such standards is the ISO 9000 series standards prescribed by the International Organization for Standardization.
- ⁵⁴ Occasionally, the certification standards relate, not to how well a product is made or how reliable it is, but rather to how quickly it is made or may be shipped (to meet a customer's just-in-time inventory requirements), or how readily adaptable and multifunctional a process is. For service providers, the standards relate to issues of speed, accuracy, and flexibility in place or manner of performance of the services; for raw material suppliers, the standards may relate to issues of purity, resilience, or durability.
- ⁵⁵ *Cleveland Allerton Hotel, Inc. v. Commissioner*, 166 F.2d 805 (6th Cir. 1948); *Cassatt v. Commissioner*, 137 F.2d 745 (3rd Cir. 1943); Rev. Rul. 69-511, 1969-2 C.B. 23.
- ⁵⁶ See Rev. Rul. 95-32, 1995-16 I.R.B. 5.
- ⁵⁷ 1994-2 C.B. 19.
- ⁵⁸ See PLR 9527005 (Mar. 15, 1995).
- ⁵⁹ PLR 9540003 (June 30, 1995).
- ⁶⁰ See *Woodward v. Commissioner*, 397 U.S. 572, 577 (1970); *United States v. Gilmore*, 372 U.S. 39, 47 (1963).
- ⁶¹ *Gilmore*, 372 U.S. at 47.
- ⁶² *McKeague v. United States*, 12 Cl. Ct. 671 (1987), *aff'd without opinion*, 852 F.2d 1294 (Fed. Cir. 1988).
- ⁶³ See Rev. Rul. 73-146, 1973-1 C.B. 61, as discussed in TAM 9540003.
- ⁶⁴ See Rev. Rul. 70-392, 1970-2 C.B. 33.
- ⁶⁵ See Rev. Rul. 79-208, 1979-2 C.B. 79.
- ⁶⁶ See *Cleveland Allerton Hotel, Inc. v. Commissioner*, 166 F.2d 805 (6th Cir. 1948); *Cassatt v. Commissioner*, 137 F.2d 745 (3rd Cir. 1943); Rev. Rul. 69-511, 1969-2 C.B. 23.
- ⁶⁷ See, e.g., PLR 9240005 (June 12, 1992).
- ⁶⁸ See, e.g., *T.J. Enterprises, Inc. v. Commissioner*, 101 T.C. No. 39 (1993); PLR 9240005 (June 12, 1992).
- ⁶⁹ Treas. Reg. § 1.446-1(a)(4)(ii).
- ⁷⁰ Treas. Reg. § 1.461-1(a)(1).
- ⁷¹ Treas. Reg. § 1.263(a)-1(a)(2)(b).
- ⁷² Section 167(a).
- ⁷³ *Lucas v. Ox Fibre Brush Co.*, 50 S. Ct. 273 (1930).
- ⁷⁴ *Kornhauser v. United States*, 276 U.S. 145 (1928); *Commissioner v. Tellier*, 383 U.S. 687 (1966).
- ⁷⁵ Treas. Reg. § 1.162-21(b)(2).
- ⁷⁶ Rev. Rul. 94-38, 1994-1 C.B. 38.
- ⁷⁷ 7 Cl. Ct. 220 (1985).
- ⁷⁸ As a matter of administrative convenience, employers with a large number of employees benefitting from the expenditure would likely prefer amortization in lieu of assigning such costs to employees and monitoring employee turnover to claim the proper deduction.

Application of Small Business Regulatory Enforcement Fairness Act to Tax Regulations

March 5, 1996

On March 5, 1996, Tax Executives Institute submitted the following comments to Senator Christopher Bond, Chairman of the Senate Small Business Committee, on S. 943, the Small Business Regulatory Enforcement Fairness Act to Tax Regulations. The Institute's comments, which took the form of a letter from TEI President Jack R. Skinner, were prepared under the aegis of the Institute's IRS Administrative Affairs Committee, whose chair is Robert L. Ashby of Northern Telecom Inc. The comments complement testimony filed with Congress in 1995 regarding certain regulatory reform provisions of the so-called Contract with America. Those prior submissions were reprinted in the July-August 1995 and September-October 1995 issues of The Tax Executive.

On behalf of Tax Executives Institute, I am writing to urge that the Internal Revenue Service be exempted from the provisions of S. 942, the Small Business Regulatory Enforcement Fairness Act. For the reasons set forth below, the Institute believes that including the IRS within the scope of any small business regulatory reform act would make government less responsive to the needs of the taxpaying public and hence be counterproductive.

Background

Tax Executives Institute is a volunteer association of nearly 5,000 professionals who are responsible for managing the tax affairs of their companies. TEI represents more than 2,700 companies — a cross-section of the business community. Our members must contend daily with business tax laws, from both tax planning and tax compliance perspectives. The Institute is firmly committed to maintaining a tax system that works — both for taxpayers and the IRS. We believe the diversity and training of our members enable us to bring a uniquely balanced and practical perspective to your attention.

Discussion

The Senate Committee on Small Business is considering legislation that would implement certain recommendations of the White House Conference on Small Business affecting the development and enforcement of government regulations. An amendment in the nature of a substitute offered by Representative Hyde would require agencies — such as the Inter-

nal Revenue Service — that publish a “notice of interpretive rulemaking of general applicability” to comply with the Regulatory Flexibility Act by pre-

tax rules to the Regulatory Flexibility Act may actually exacerbate it. Moreover, judicial review of regulations may impair the even-handed

Taxpayers are dependent upon regulations and other guidance to fill in the gaps, to explain the ambiguities, to finish the job often left undone by the statutory language. Taxpayers — and taxpayer groups such as TEI — continually press the IRS and Treasury for more, not less, guidance.

paring an analysis that the final rule minimizes significant economic impact on “small entities” to the maximum extent possible. The amendment would also permit an adversely affected small entity to seek judicial review of the agency's action.

TEI is concerned that subjecting interpretative rules of the IRS to the Regulatory Flexibility Act could delay the issuance of important guidance. Tax obligations arise not under IRS regulations but under specific statutes that are enacted by Congress. Taxpayers are dependent upon regulations and other guidance to fill in the gaps, to explain the ambiguities, to finish the job often left undone by the statutory language. Indeed, taxpayers — and taxpayer groups such as TEI — continually press the IRS and Treasury for more, not less, guidance. If the IRS is forced to review every interpretative regulation for its effect on small businesses, the backlog of regulatory projects will undoubtedly grow. Thus, rather than relieving taxpayer burden, subjecting

enforcement of the tax laws and impede the IRS from quickly responding to curb abusive transactions.

TEI and its members frequently take issue with particular IRS rules, or with specific provisions in regulations issued by the Treasury Department. Experience teaches, however, that instances of regulatory overreaching can be most effectively addressed on a case-by-case basis. Subjecting the IRS to the Regulatory Flexibility Act would, we believe, do substantially more harm than good.

Conclusion

TEI opposes the application of the Regulatory Flexibility Act to the Internal Revenue Service. We strongly urge that the Senate exempt the IRS from the reach of S. 942. If you have any questions, please do not hesitate to call either me at (214) 978-2675 or Timothy J. McCormally of the Institute's professional staff at (202) 638-5601.

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TEI Urges Treasury To Permit Companies to "Check the Box" (Notice 95-14)

January 23, 1996

On January 23, 1996, Tax Executives Institute filed the following comments with the Department of the Treasury on Notice 95-14, which asks whether a simplified method of classifying unincorporated business organizations should be adopted (commonly referred to as the "check-the-box" procedure). The comments, which took the form of a letter from TEI President Jack R. Skinner to Deputy Tax Legislative Counsel Michael D. Thomson, follows up on a November 1995 meeting between Mr. Thomson and TEI representatives. TEI's initial comments on Notice 95-14 are reprinted in the July-August 1995 issue of The Tax Executive. The letter was prepared under the aegis of TEI's International Tax Committee, whose chair is Philip J. Bergquist of Apple Computer, Inc.

This letter follows up on our recent meeting concerning Notice 95-14, which asks whether a simplified method of classifying unincorporated business organizations should be adopted (commonly referred to as the "check-the-box" procedure). During that meeting, you asked TEI to address three issues relating to the international aspects of the procedure: (i) the feasibility of using a list of *per se* corporations; (ii) the designation of "default" corporate status for entities that fail to make an election; and (iii) the mechanics of making the election.

The Institute wholeheartedly supports the expansion of the check-the-box procedure to the international area and is eager to assist the Treasury in ironing out the "nits" in the system. We have completed a survey of the members of our Executive Committee and International Tax Committee on this issue. The following comments are based on that survey.

Automatic Classification of Corporations

Under Notice 95-14, domestic, state-law corporations are automatically treated as corporations for federal tax purposes. You asked whether there are foreign entities that should be excluded from an elective check-the-box regime because they are always treated as corporations by U.S. taxpayers.

You specifically requested comments on the treatment of an *altien-*

gesellschaft (AG) in Germany, a *société anonyme* (SA) in France, and a *public limited company* (PLC) in the United Kingdom and Australia. Although the

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majority of our responding members treat these entities as corporations, the survey revealed that some members treat each of these enterprises as flow-through entities under the *Morrissey* regulations.

Given the IRS and Treasury's historical resistance to the use of lists in other areas (e.g., in respect of the high-tax country exceptions to Subpart F income inclusion), we are surprised that Treasury is considering designating certain enterprises unequivocally as corporations. The Government has also resisted having foreign law concepts drive U.S. tax consequences. See, e.g., *United States v. Goodyear Tire & Rubber Co.*, 493 U.S. 132 (1990) (foreign accumulated prof-

its computed under U.S., not British, law); *Procter & Gamble v. United States*, 961 F.2d 1255 (6th Cir. 1992) (Commissioner argued, albeit unsuccessfully, that the IRS had authority to reallocate royalty payments restricted by foreign law).

The use of a list of foreign entities that would constitute *per se* corporations raises several practical issues. First, what criteria are used in determining which entities should be placed on a list of *per se* corporations? Should the *Morrissey* factors remain the criteria or should other factors (such as a separate juridical person requirement) be used? In addition, what is the process by which the list will be developed? Will it be established only after a notice-and-comment period and will it be regularly updated?

More fundamentally, what happens if the foreign jurisdiction amends the governing statute (e.g., the United Kingdom changes the legal requirements for establishing a PLC) after the foreign entity is placed on the *per se* list? Presumably, good faith reliance on the list will not be upset. Thus, until the IRS issues a notice to modify the list (which could take months, perhaps even years), a taxpayer should be able to establish an entity with confidence that its initial and on-going treatment as a corporation will not be challenged. If the taxpayer did not enjoy such assurance — if it must worry that any change in the foreign stature could vitiate its

reliance – the certainty offered by the check-the-box regime would evaporate. Finally, an issue arises concerning the effect of the *per se* list on entities formed before the new procedure becomes effective.

Default Mechanism

Notice 95-14 provides that if an election is not made for a foreign entity, then that entity will be classified as a corporation. In contrast, the default mechanism in the domestic area is a partnership. You asked whether TEI members are comfortable with

for foreign tax credit purposes or requiring withholding on certain transfers.

Our responding members were evenly split in their responses to the alternative suggestion. A typical criticism was that the limited liability test is too mechanical and arbitrarily ignores the other three *Morrissey* criteria.

If the proposed regulations do provide for a default mechanism, then there is a critical need to provide for meaningful relief from the inadvert-

Moreover, there would be no detriment to the government in providing for the relief. We therefore recommend that the proposed regulations specifically provide that section 9100 relief will generally be available in such cases.¹

Election of Classification

One of the areas still open is how the taxpayer should effect the “check-the-box” election. You suggested several ways in which the election could be made: (i) on the Form SS-4 when the taxpayer applies for an identification number; (ii) on the quarterly estimated tax form; (iii) on the first return filed after the formation of the entity; or (iv) on a new, separate form.

Our responding members overwhelmingly endorsed making the election on the first return filed after the formation of the entity. For controlled foreign corporations, a line could easily be added to the Form 5471 or 5472; for foreign partnerships that file a Form 1065, a line could be added to that form. Indeed, the filing of a Form 5471, 5472, or 1065 could, in and of itself, act as the election of corporate or partnership status. Several members noted that many foreign entities do not file a Form SS-4 or make estimated tax payments. The use of a separate form only increases the paperwork burden for the taxpayer and the IRS.

Conclusion

TEI is pleased to be able to assist the Treasury Department in refining the check-the-box procedure. If you have any questions concerning the Institute’s comments, please feel free to contact Philip J. Bergquist, chair of the Institute’s International Tax Committee, at (408) 974-1531, or Mary L. Fahey of the Institute’s professional staff at (202) 638-5601.

Quite simply, taxpayers should not be penalized for procedural foot faults. Section 9100 relief should be available for taxpayers that inadvertently find themselves subject to the default treatment because they neglected to make an election under the new procedure.

such a bifurcated approach. Alternatively, you asked whether taxpayer concerns would be assuaged by a default mechanism that treats an entity as a corporation if all of the equity owners have limited liability.

There is no consensus among our members concerning the use of a default mechanism. Although the majority of our responding members would be satisfied with a corporate default, a sizeable minority expressed a preference for partnership or other flow-through status. Several members pointed out that imposing corporate classification for non-electing entities could upset taxpayers’ intent and spawn significant adverse tax consequences, for example, by adding tiers

ent effects of that default. Quite simply, taxpayers should not be penalized for procedural foot faults. Section 9100 relief should be available for taxpayers that inadvertently find themselves subject to the default treatment because they neglected to make an election under the new procedure. Thus, if the taxpayer completes its tax return and computes its tax liability on the basis of making the election, the failure to check the appropriate box or attach the right form should not preclude an election. In such a case, there can be no reasonable question that the taxpayer intended to treat the entity as a partnership or a corporation and no possibility that the decision to make the election came only with hindsight.

¹ This is an opportune time to broaden the scope of section 9100 relief. See Ann. 96-5 (issued Jan. 4, 1996) (describing administrative initiatives to enhance taxpayers rights, including the revision of the revenue procedure for obtaining section 9100 relief).

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Attention Members: 1996-1997 Dues Statements have been mailed. Please be sure to pay your dues quickly, since this eliminates the need for costly and time-consuming follow-up mailings. Also, be sure to double-check the information on your dues statement and provide your e-mail address, if you have one, in the appropriate space.

Limiting Retroactive Legislation in Canada

February 16, 1996

On February 16, 1995, Tax Executives Institute submitted the following comments to the Canadian Minister of Finance, Paul Martin, in respect of certain trends affecting the development and effective date of Canadian tax policy and legislation. The comments, which took the form of a letter from Institute President Jack R. Skinner, were prepared under the aegis of its Canadian Income Tax Committee, whose chair is J. A. (Drew) Glennie of Shell Canada Limited. Minister Martin's response is reprinted elsewhere in this issue.

On December 5, 1995, a delegation from Tax Executives Institute met with representatives from the Department of Finance to discuss a number of income tax issues. At the meeting, TEI expressed concern about certain trends in the development of Canadian income tax policy. Specifically, we commented on (i) the increasing tendency to introduce major policy changes in the guise of technical amendments bills, (ii) the introduction of legislative amendments retrospectively changing the tax treatment of completed transactions, and (iii) the use of hypertechnical changes to extend taxing jurisdiction to non-residents of Canada. We were invited to express our views and elaborate on our concerns through a separate submission.

I. Background

Tax Executives Institute (TEI) is an international organization of approximately 5,000 professionals who are responsible — in an executive, administrative, or managerial capacity — for the tax affairs of the corporations and the other businesses by which they are employed. TEI's members represent more than 2,800 of the leading corporations in Canada and the United States.

Canadians make up approximately 10 percent of TEI's membership, with our Canadian members belonging to chapters in Calgary, Montreal, Toronto, and Vancouver, which together make up one of our nine geographic regions. In addition, a substantial number of our U.S. members work for companies with significant Canadian operations. In sum, TEI's membership includes representatives from most major industries. The comments set forth in this submission reflect the views of the Institute as a whole, but

more particularly those of our Canadian constituency.

TEI has historically been concerned with issues of tax policy and administration and is dedicated to working with government agencies in Ottawa (and Washington), as well as in the provinces (and the states), to reduce the costs and burdens of tax compliance and administration to our common benefit. We are convinced that the administration of the tax laws in accordance with the highest standards of professional competence and integrity, as well as in an atmosphere of mutual trust and confidence between business and government, will promote the efficient and equitable operation of the tax system. In furtherance of this principle, TEI supports efforts to improve the tax laws and their administration at all levels of government.

Among TEI's principal objectives are the gathering and dissemination of information on tax issues of wide concern and the development of responsible positions that reflect not only the diversity and professional training of our members but also an appreciation for the practical aspects of tax administration and business decisions. In addition, we strongly believe that tax legislation should be fully consistent with the goals of economic growth, clarity and competitiveness.

II. Introduction of Substantive Changes in Technical Amendment Bills

On the whole, businesses and citizens in Canada are cognizant of, and take special interest in, the government's tax policy announcements. The government generally undertakes to ensure that taxpayers are informed

of policy changes sought by the government. In contrast, technical amendment bills have traditionally been used to implement limited and narrow changes in order to correct anomalies, clarify the meaning or intent of statutory provisions, and provide legislative support for assessing practices that are fair and beneficial. Such bills are not widely publicized. As a result, TEI is concerned that significant policy changes are being included in technical amendment bills, thereby eluding the public scrutiny and debate that such policy changes might deserve.

In particular, certain provisions in the draft legislation presented on April 26, 1995, go far beyond the scope of routine and non-political changes generally contained in technical tax bills. Two changes appear to overturn decisions of the courts retroactively. Specifically, the proposed amendment to paragraph 12(1)(x) of the Income Tax Act appears to be a reaction to the Federal Court of Appeal decision in *The Queen v. Johnson & Johnson Inc.*, 94 DTC 6125. In addition, the amendment to paragraph 62(3)(f) directly overrules an unpublished decision in *Randy Mann (Appellant) v. The Queen (Respondent)*, Tax Court of Canada. Such changes are not properly viewed as merely technical in nature. No one challenges the government's power to change the laws. We submit, however, that amending the law retroactively to override a court's reasonable interpretation of an ambiguous provision, and doing so without proper consultations about the proper scope and application of a provision engendering controversy — is both unfair and an abuse of the government's legislative power.

TEI is concerned about the trend toward introducing major policy

changes through technical amendment bills and urge the government to refrain from doing so. At a minimum, the government should inform the public of the policy changes contained in technical amendment bills and ensure that proper consultations and debate over those issues is not precluded.

III. Effective Date of Legislation Generally

Historically, legislative changes have been effective from the date of their announcement. For example, policy changes introduced in the Minister's Budget Message are generally effective as of the date of the Budget's release. For changes announced by way of Press Release, the effective date of the modified laws is generally the Press Release date. In recent years, the frequency and scope of changes to the Income Tax Act have increased substantially. One facet of the instability engendered by frequent law changes has been a greater level of taxpayer uncertainty about the effective date of the law. Moreover, the typical delay between the introduction and final passage of a proposal has increased and now extends to six to nine months. Such delays compound the difficulty of preparing a complex corporate tax return, which often requires several months, since taxpayers are uncertain whether to comply with the "old" or the "new" and modified laws for returns filed after legislation is introduced but before final assent. To avoid imposing unnecessary tax filing burdens upon taxpayers, we recommend that the government consider delaying the effective date of tax legislation to the date of Royal Assent.

IV. Retroactive Legislation Should Be Eschewed

For a tax system to be fair and, as important, to be perceived as fair, taxpayers must be able to rely on the extant legislation and regulations at the time that business transactions or other taxable events occur. Consequently then, legislation should be generally prospective in effect. Retroactive effective dates represent an extreme remedy for a defective legislative process. Retroactive legislation should, therefore, be reserved only for extreme cases. TEI believes that the

government bears a heavy burden to overcome the strong policy presumption against retroactive effective dates penalizing taxpayers. *Ex post facto* legislation significantly altering the tax treatment of good faith transactions will heighten public cynicism about the Canadian income tax system.

These policy concerns underlie our objection to the date of application of some of the technical amendments released on April 26, 1995, because the modified laws apply to transactions occurring before the legislation was released. We highlight three specific instances where the retroactive change seems particularly unwarranted.

A. Inducement Payments

The proposed amendment to paragraph 12(1)(x) will broaden its application to certain refunds. Although the Department has not explained the types of refunds to which the modified provision is directed (seemingly a deposit returned by a government or an income tax refund could now be taxable), the amended paragraph applies to all amounts received after 1990. TEI believes that a provision requiring an income inclusion should never be retroactive.

B. Moving Expenses

Paragraph 62(3)(f) currently provides that the definition of "moving expenses" includes, *inter alia*, "any taxes imposed on the transfer or registration of title to the new residence." In 1995, the Tax Court of Canada decided that the term "taxes" includes payments for Goods and Services Tax (GST). The proposed amendment to paragraph 62(3)(f) would exclude any amounts paid on account of GST. The proposal is to be applicable retroactively to taxation years after 1990. TEI recommends that the Department reconsider this retroactive proposal. We submit that the matter is not significant enough to overcome the general policy against retroactive legislation.

C. Replacement Properties

Proposed amendments to subsections 13(4), 13(4.1), 14(6), 14(7), 44(1), and 44(5) would add an intention test

to the replacement property rules. Consequently, in order for a property to qualify as "replacement property," the taxpayer must demonstrate that, as of the time the replacement property was acquired, it was with the intent to replace a former property. These changes are applicable for dispositions occurring after the 1993 taxation year. As a result, the change will adversely affect taxpayers who made substantial business decisions and filed valid tax elections based on the legislation as it existed when the properties were acquired. Again, TEI does not believe there is a compelling reason to justify a retroactive effective date.

V. Extending the Taxing Jurisdiction

Proposed amendments to subparagraph 115(1)(b)(v) set forth in the April 26, 1995, bill would expand the definition of "taxable Canadian property" to include shares of non-resident, non-Canadian corporations and interests in trusts where, at any time during the 12 months preceding a disposition of such shares or interests, more than 50 percent of the value of the assets of the corporation or trust consists of other taxable Canadian property. TEI has no comment regarding the propriety of the expanded definition. Nonetheless, we are concerned that the reach of the Income Tax Act has been extended by means of a Technical Amendment Bill rather than through a Budget or Tax Policy Act.

VI. Conclusion

TEI is pleased to have the opportunity to raise our concerns about the process for developing tax policy legislation in Canada. We stand ready to discuss how we can assist the government in resolving these matters to improve tax legislation in Canada. TEI's comments were prepared under the aegis of its Canadian Income Tax Committee, whose chair is J. A. (Drew) Glennie of Shell Canada Limited. If you should have any questions about TEI's comments, please contact either Mr. Glennie at (403) 691-4900 or Vincent Alicandri of Xerox Canada, Ltd., TEI's Vice President for Canadian Affairs, at (416) 733-6762.



TEI Opposes Virginia Legislation to Permit Contingency Fee Audits

January 31, 1996

On January 31, 1996, Tax Executives Institute filed the following comments with the Virginia legislature opposing proposed legislation to permit localities to hire accounting firms to conduct audits of local taxes. TEI's comments were prepared under the aegis of its State and Local Tax Committee whose chair is Christopher W. Baldwin of Gannett Co., Inc.

As President of Tax Executives Institute, I am writing to express the Institute's policy objections to House Bill No. 768, which would authorize localities to hire accounting firms to conduct audits of local taxes. TEI has fundamental concerns about such a proposal, which we believe would seriously undermine the integrity of, and public confidence in, local tax administration.

Background

Tax Executives Institute is a volunteer, professional association of nearly 5,000 accountants, lawyers, and other professionals who are responsible for managing the tax affairs of their companies. TEI members must contend daily with the interpretation, application, and enforcement of business tax laws. We represent a cross-section of the business community — in Virginia and across North America — and are dedicated to the development and effective implementation of sound tax policy. We are similarly committed to the uniform and equitable enforcement of the tax laws, and to reducing the cost and burden of administration and compliance to the benefit of taxpayers and government alike. TEI believes that the diversity, training, and experience of its members enable it to bring a unique and balanced perspective to the policy issues raised by House Bill No. 768.

Discussion

House Bill No. 768 would amend the Code of Virginia by adding section 58.1-3902.1, relating to the use of professional accounting firms for performing audits of local taxes. Specifically, the legislation would authorize the commissioner of the revenue or director of finance for any county

or city, or the tax-assessing officer of any town, to "employ, upon such terms as may be agreed upon, the services of professional accounting firms to

Tax Executives Institute strongly objects to the proposed legislation. We believe the use of so-called bounty hunters by local jurisdictions in Virginia could deprive taxpayers of due process and significantly undermine the public's perception of the tax system's fairness.

assist with the audit of any local taxes." Hence, the bill would authorize the hiring of contract auditors on a contingency fee basis.

Tax Executives Institute strongly objects to the proposed legislation. We believe the use of so-called bounty hunters by local jurisdictions in Virginia could deprive taxpayers of due process and significantly undermine the public's perception of the tax system's fairness. We also believe that the determination of tax liability is a core governmental function — similar to the provision of police protection — that the legislature should be loath to outsource.

At first blush, the privatization of the government's audit function is

appealing. The use of contract auditors seems to provide localities a way to secure revenues without spending a cent. Like other concepts that seem too good to be true, however, the use of contract auditors is fraught with risk and the potential for significant adverse consequences. Stated bluntly, the proffered justifications for contract, or contingency fee, audits are specious and the policy objections to them are overwhelming. Indeed, we submit that contingency fee audits are more inimical to the tax system's fairness than the use of quotas, which have been roundly and rightly condemned (and uniformly disavowed by Virginia and other States).

Contract audits violate public policy. They threaten taxpayer privacy and, where the auditor is paid on a contingency basis, deprive taxpayers of due process and subject them to abuse. No longer would a taxpayer's liability be determined by a public employee, but by a "bounty hunter" whose compensation is directly linked to the amount he or she can extract from the taxpayer. Contract auditors would gain access to the most important personal, financial, market, and customer data that businesses and other taxpayers possess. Since contract auditors at best would be providing their services to a locality on a part-time basis, they would be in a perpetual conflict of interest vis-à-vis their private clients. What safeguards would be — could be — imposed to prevent the unauthorized use or disclosure of taxpayer information — not only during the contract period but after it ends? What restrictions would be placed on where taxpayer information is stored or who at the contractor's firm would have access to it? What type of sanctions would be imposed for unauthorized use? Could

damages for unauthorized use be sought from both the locality and the contract auditor?

These questions underscore the difficulty of outsourcing core government functions to the private sector. They demonstrate the problems in-

Fairness and impartiality are threatened when a private organization has a financial stake in the amount of tax collected as a result of the assessment it recommends.

herent in asking contract auditors to attempt to serve two masters — the locality and their private clients. They make it impossible to believe that the public at large would support or benefit from this proposal.

The use of contract auditors has justifiably come under attack in the courts. The seminal case in this area was decided by the Supreme Court of Georgia in 1991. In that case, the court quickly dispatched a contract audit fee scheme whereby an outside firm would audit property tax returns

and receive 35 percent of any additional amount collected plus 100 percent of all first-year penalties collected. The court upheld Sears, Roebuck & Co.'s challenge to the system, stating:

The people's entitlement to fair and impartial tax assessments lies at the heart of our system. Fairness and impartiality are threatened when a private organization has a financial stake in the amount of tax collected as a result of the assessment it recommends.

TEI believes that it is wholly proper to focus on the deleterious effect that contract audit arrangements can have on the impartiality and fairness of state tax systems. Like the Justice of the Peace who gets to keep a percentage of the speeding fines he imposes, contract auditors who are compensated on a contingency fee basis will not be perceived as objective. This view is shared by the Federation of Tax Administrators (FTA), which is an association of tax administrators from across the United States. The FTA has stated that contract audit arrangements "are not healthy for the tax system." The FTA has also observed that contract audits "introduce extraneous issues such as motive,

work habits, and the like into the audit situation — all of which detract from the goal of objectively determining the appropriate amount of tax due."

TEI appreciates that localities are under tremendous pressure to reduce costs and increase the revenues flowing to their coffers. The urge to "privatize" the audit function may seem irresistible. We sincerely believe, however, that contract audits are nothing but fools' gold.

Conclusion

For the foregoing reasons, Tax Executives Institute urges the legislature to resist the hollow promise of contract audits and to reject House Bill No. 768.

If you should have any questions about the Institute's comments, please do not hesitate to contact Christopher W. Baldwin of the Gannett Co. in Arlington, who is chair of TEI's State and Local Tax Committee, or Timothy J. McCormally of the Institute's professional staff in Washington, D.C. Mr. Baldwin's telephone number is (703) 284-6801, and Mr. McCormally may be reached at (202) 638-5601.



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