

Tax Talk

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Crisis, Compromise, and the Code

During my first year of marriage, one of the many places where my husband and I had to reach a compromise concerned how much money to give to our church. My husband assumed that we would tithe 10 percent of our joint income. He applied that amount to our gross salaries and proposed a pledge in the tens of thousands of dollars. After realizing he was serious, I stopped laughing and pointed out that such a generous figure would be nearly impossible given our other obligations like income taxes, rent, food, student loan payments, and, if anything was left, retirement savings. I suggested subtracting these obligations from our gross income and applying the 10 percent to a much lower figure (which I argued was our discretionary income and the amount any higher power clearly intended for us to start with). Eventually we both gave a little and agreed to apply 10 percent to a number somewhere in between.



Congress could benefit from our example. The failure of Congress to compromise on budgetary cuts, revenue increases, and tax reform cost our nation an extra \$1.3 billion in 2011¹ and set us up for Tax Armageddon 2013 (a.k.a. the Fiscal Cliff).² In addition to the usual expiring tax provisions that Congress only sees fit to extend annually, such as the AMT fix, the research and experimentation (R&E) tax credit and accelerated depreciation, on Jan. 1, 2013, both the Bush tax cuts and the payroll tax reduction expire. If no Congressional agreement on deficit reduction is reached, the automatic spending cuts adopted in 2011 will go into effect in 2013. Known as sequestration, these cuts will total \$1.2 trillion over time and are split between defense and domestic spending. The stage is set for some tough decisions in the coming months, and tax policy is sure to play a central role.

Against this looming fiscal crisis, our country is having a conversation about the influence of corporations in America. The government bailouts following the 2008 financial downturn, paid for with rising deficit spending while corporate America gave out millions of dollars in bonuses, made some people question whether corporations have too much influence over public policy. The Supreme Court's *Citizens United* decision invigorated the debate by ruling that the First Amendment prohibited the government from restricting corporations (and unions) from making independent political expenditures.³ The Occupy Wall Street movement kept the discus-

sion alive, fueled by campaign statements asserting that corporations are people.

The tax code, however, does not consider corporations to be people and differences exist between how we tax individuals and corporations.⁴ Though some differences are justified, others may be inadvertent. Whether the code properly balances the tax burden between individuals and corporations is a topic with strong views and tough rhetoric on each side. By looking at some of the differences between corporate and individual taxation, we may identify opportunities for compromise that can help our country avoid going over the fiscal cliff.

Gross Income becomes Taxable Income

Gross income is broadly defined for both individuals and corporations as income from whatever source derived.⁵ Both corporations and individuals have graduated income tax rates, with differing percentages and dollar thresholds.⁶ But gross income is not the critical figure for tax purposes. For both corporations and individuals, taxes are calculated on the taxable income figure. Just as in my tithing example I deducted many expenses from our income before multiplying by ten percent, the tax code allows both corporations and individuals to deduct many expenses from their gross income before applying the appropriate income tax rate.

Exemptions and Deductions for Individuals

Case law provides that deductions are a matter of legislative grace, and a taxpayer seeking a deduction must point to an applicable statute and show that he comes within its terms.⁷ For individuals, this principle is further enumerated by the tax code itself. Section 262 provides that no deduction shall be allowed for personal, living, or family expenses "[e]xcept as otherwise expressly provided. ..."⁸ The personal exemption was historically designed to allow taxpayers to set aside money used for personal living expenses and thereby only be taxed on an amount akin to the discretionary income term I used in my opening example. The value of this exemption has drastically eroded over time.

After passage of the 16th Amendment, which authorized a federal income tax without apportionment among the states, Congress passed the Revenue Act of 1913. This Act included a personal exemption, the purpose of which was to establish a tax-free amount "for an American family to live upon, with a proper standard of living. ..." In 1913, the personal

exemption was set at \$3,000 for a single individual (in 2012 dollars, the \$3,000 figure from 1913 would equal about \$69,000). The personal exemption has not kept up with inflation: for 2012, the personal exemption is set at \$3,800, just \$800 more than it was nearly 100 years ago.¹⁰

Rather than increase the personal exemption, Congress has chosen to give individuals various deductions from income. These deductions are for expenses such as alimony, contributions to health savings accounts and IRAs, certain educational and medical expenses, home mortgage interest, and charitable contributions, among others. By designating specific deductions rather than granting a large personal exemption, Congress can reward desired taxpayer behavior in order to achieve policy goals. Many of the deductions favored by Congress are only allowed to those who itemize (which is generally only one-third of all taxpayers). To provide some tax relief for those who do not itemize, the Code provides a standard deduction (set for 2012 at \$5,950 for individuals). The standard deduction has been around since 1944. Unlike the personal exemption, the standard deduction has risen significantly over time, more than quadrupling in the past 40 years.¹¹

Corporate Deductions

Corporations are not entitled to a corporate exemption in the same way that individuals get a personal exemption. To reach taxable income, corporate returns first calculate profits by subtracting the cost of goods sold from sales and receipts. The code section authorizing corporate deductions allows corporations to deduct all “ordinary and necessary” business expenses before their income is calculated for tax purposes.¹² This broad language encompasses most corporate expenses, including salaries not included in the cost of goods sold, repairs, bad debts, rent, advertising, and charitable contributions. In a more limited manner, individuals who are engaged in a profit-making activity may deduct expenses related to that activity (to the extent they exceed two percent of adjusted gross income).¹³ In addition, some corporate expenses must be capitalized, meaning they cannot be deducted in the year incurred, but instead must be spread out over time.

Section 262 on Individual Deductions

Corporations have no limitation on deducting discretionary expenses comparable to the way section 262 operates to restrict discretionary expenses incurred by an individual in order to earn a salary. As a result, section 262 prevents employed individuals from deducting expenses that corporations in similar situations may deduct.

For example, a corporation that chooses to locate its business in Jackson, Miss., even though its raw materials and customers are located in Mobile, Ala.,

can include the cost of shipping the raw materials and properly-documented business travel between Mississippi and Alabama as expenses deductible from taxable income. By contrast, an individual who lives in Mississippi but works in Alabama cannot deduct the commuting expense of getting to his job in Alabama or the cost of lodging in Alabama to avoid a long commute.¹⁴

Another example involves the ability to deduct the cost of having an employee. A corporation may deduct the cost of hiring a janitor to clean the business daily, even if the business could get by with a weekly cleaning or if existing employees could do the cleaning as a part of their duties. An individual taxpayer, however, who works a job with long hours and resorts to hiring a house cleaner once a week is not entitled to deduct the cost of the cleaner. Even though in most cases the house cleaner is considered by the tax law to be an employee of the individual taxpayer,¹⁵ and even if the need for the house cleaner is a direct result of the employee's long hours at work, the house cleaner would be viewed as a personal, living, or family expense and therefore not deductible.

Some will view this disparate treatment as fair: just as corporations are not people entitled to personal exemptions under the tax code, individuals are not businesses entitled to deduct commuting costs or employees under the tax code. Others may argue that the personal exemption is not sufficiently generous to make up the difference and that these examples demonstrate the imbalance of influence corporations hold over policymakers. The employment situation in this last example provides a good segue for comparing treatment of corporations and individuals under the federal employment tax.

Federal Employment Tax

Both individuals and corporations pay federal employment tax. Employment tax is comprised of two parts: FICA and FUTA.¹⁶ Individuals who work in exchange for a wage are classified as employees or as self-employed independent contractors. Setting aside the temporary payroll tax holidays, human labor is taxed with a 15.3 percent employment tax. Employees pay half of this amount (7.65 percent, with 6.2 percent attributed to FICA, and 1.45 percent to FUTA) and employers pay the other half. Self-employed individuals pay the full amount themselves. Employment tax is automatically withheld by the employer from an individual's wages, reducing the individual's take-home pay by that amount. So, for example, if an individual employee earns a salary of \$60,000, the employer will withhold 7.65 percent of those wages, or \$4,590, for employment tax and pay that amount to the federal government. That person's take-home pay will not exceed \$55,410

TAX TALK *continued on page 18*

(\$60,000 - \$4,590 = \$55,410).

Since corporations cannot act outside of their employees, they also pay an employment tax on their labor expense, in the form of the employer's share of the employment tax (7.65 percent). At first glance then, it appears that our tax code treats people and corporations equally with respect to employment tax issues. But the way the employment tax is deducted for income tax purposes is different for corporations versus individuals. A corporation may deduct the cost of the employee's salary, including the withheld employment tax and the employer's share of the employment tax, from its revenues.¹⁷ Stated another way, a corporation may reduce its taxable income by the entire amount of employment tax it pays the federal government (even though half of that amount came from withheld employee's wages).

The tax treatment is different for individuals: an individual reports his whole salary as income, including the amount withheld as employment tax, which he does not take home. Using the above example, the individual would report an income of \$60,000, even though that person only took home \$55,410. If individuals deducted employment taxes the same way corporations do, then an individual earning \$60,000 and paying \$4,590 in employment tax would subtract the employment tax from his income before calculating his income tax (and arguably would also subtract the employer's share of the employment tax). So instead of paying taxes on an income of \$60,000, the individual would have a taxable income of \$55,410 (or \$50,820, if the employer's share also were deducted).

The differences in employment tax treatment might be unintentional. Alternatively, they may reflect the fact that corporations tend to have lobbyists looking out for their interests, whereas individuals do not. Given the financial challenges our country faces, we should cast a critical eye on all parts of the tax code and make sure such differences are justified.

In Closing

Compromise is at the heart of both good marriages and of good governments. Our elected leaders would do well to keep that in mind. Just as my husband and I each had to give up a little bit to find a pledge amount we could agree upon, our Congressional leaders need to be open to compromise. Reforming the tax code is one way to achieve this. Perhaps the consensus that has been built around corporate tax reform can be applied to individuals. By broadening the base and eliminating deductions, individual income tax rates can be lowered in a revenue-neutral manner. An increase in the personal exemption and adjusting employment tax rates can insure that the overall tax burden

on individuals remains progressive. The options are numerous, if only we would tone down the rhetoric long enough to find common ground. Whatever your position, and regardless of the outcome of November's elections, let us hope our nation's tax and spending policies are soon revised in a way that puts our fiscal house in order. **TFL**

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Endnotes

¹*Analysis of 2011-2102 Actions Taken and Effect of Delayed Increase on Borrowing Costs*, U.S. Government Accountability Office. GAO-12-701 (July 2012) available at www.gao.gov/assets/600/592832.pdf.

²The Committee for a Responsible Federal Budget has done an economic analysis of the impact on our country's economy of extending provisions or allowing them to expire as scheduled. See crfb.org/blogs/economics-fiscal-cliff.

³*Citizens United v. Federal Election Commission*, 558 U.S. 50 (2010) (striking down portions of section 203 of the 2002 Bipartisan Campaign Reform Act as a violation of the First Amendment).

⁴The differences discussed in this article may apply to businesses generally regardless of how they are organized, including corporations and individuals engaged in profit-making activities. For simplicity's sake, this article focuses on the corporate form only and assumes that the individual taxpayers discussed in this article are employees (not self-employed individuals).

⁵26 U.S.C. § 61(a).

⁶Individual rates vary from 10 to 35 percent for 2012, while corporate rates vary from 15 to 35 percent (with a 39 percent surtax rate) for 2012.

⁷See *New Colonial Ice Co. Inc. v. Helvering*, 292 U.S. 435, 440 (1934).

⁸26 U.S.C. § 262(a).

⁹Sen. John Sharp Williams, 50 Cong. Rec. 3851 (1913).

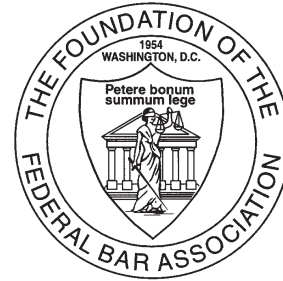
¹⁰The exemption will be subject to an income phase-out in 2013.

¹¹The Tax Policy Center has a chart showing the historic figures, available at www.taxpolicycenter.org/taxfacts/displayafact.cfm?Docid=171.

¹²26 U.S.C. § 162.

¹³See 26 U.S.C. § 212. Section 212 allows the deduction of ordinary and necessary expenses paid or incurred during the tax year for the production or collection of income.

¹⁴*Commissioner v. Flowers*, 326 U.S. 465 (1946).



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¹⁵For 2012, the wage threshold for classifying a cleaner as a household employee is \$1,800, or about \$35 per week, if the cleaner does not qualify as an independent contractor.

¹⁶FICA stands for the Federal Insurance Contributions Act (which funds social security and Medicare) found at 26 U.S.C. § 3101 *et seq.* FUTA stands for the Federal Unemployment Tax Act (which funds federal unemployment insurance) found at 26 U.S.C. § 3301 *et seq.*

¹⁷Employee compensation is a deduction or a component of costs of goods sold, depending upon the type of business.

IP INSIGHT *continued from page 15*

game developers, clones may have diminishing success in arguing that their wholesale copying is permissible because expression has merged with idea.

Already, the *Tetris v. XIO* decision is being cited to support similar attempts to crack down on clones. In another closely-watched case, *Spry Fox LLC v. LOLApps Inc. and 6Waves LLC, et al.*, 12-cv-00147-RAJ (W.D. Wash.), cloners LOLApps/6Waves moved to dismiss claims of copyright infringement, arguing that nothing copied from the original Spry Fox game was protectable. In opposing that motion, Spry Fox filed a notice of authority in June citing the *Tetris v. Xio* decision.

Finally, it is important to recognize another important concern of many game developers who worry that cracking down on clones might hurt innovation in gaming. One need not look very far to find examples of great games that were clearly inspired by their predecessors. But even to the extent *Tetris Holding* may tighten the screws on clones, its holding should not be overstated. The case does not extend copyright to cover ideas, nor does it minimize the exceptions to copyright protection provided by the merger or scènes à faire doctrines. However, for developers who have chosen to knock off, wholesale, the look and feel of a game, *Tetris Holding* gives warning: Clone at your own peril! **TFL**

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Endnotes

¹*Tetris Holding LLC v. XIO Interactive LLC*, 2012 WL 1949851 (D.N.J.).

²*Id.* at *13.

³*Id.* at *10.

⁴*Id.* at *15.

⁵*Id.* at *16.

⁶*Id.* at *18.

⁷*Id.* at *19.