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Business or Pleasure? The Red Flag Deductions of the Entertainment Industry

In our [previous issue of For the Record](), we briefly discussed tax planning issues for individuals in the entertainment industry.

This issue will focus on the areas of audit exposure that such individuals face—the areas that raise red flags to Internal Revenue Service (IRS)—namely, the attempts at claiming excessive deductions and expenses. Due to the complexity and uniqueness surrounding these attempts, IRS' Market Segment Specialization Program (MSSP) has issued guidelines to assist IRS examiners in scrutinizing and denying deductions unless they meet stringent requirements.

As Per the Code

The Internal Revenue Code allows for a deduction of all "ordinary and necessary expenses paid or incurred in carrying on any trade or business," which creates much opportunity for abuse. However, Congress tries to minimize abuse by creating limitations. For example, deductions are not allowed for expenses that have been reimbursed or are reimbursable by the entertainer's employer, even if the entertainer failed to ask for reimbursement. Generally, union contracts require that producers pay for their employees' expenses provided that they are connected with the job.

The law bars deductions for “personal, living or family expenses.” These types of expenses include home furnishings, personal credit card interest or everyday meals with no business purpose. Actor Nicolas Cage learned about this the hard way. He and his production company were slapped with $1.8 million in taxes, interest, and penalties after his attempts to write off millions of dollars of limos, meals, gifts, travel and use of his Gulfstream 1159A turbojet were challenged by IRS. IRS deemed these expenses personal in nature. While his business manager claimed the expenses were "customary in the industry," IRS disagreed. The actor ultimately settled, but many of his expenses were disallowed. When challenged, an entertainer must affirmatively prove that any such deductions are not, in fact, personal.

Common “Red Flag” Expenses

Maintaining Skills, Status and Image

Entertainers, particularly high profile individuals, incur many expenses while trying to maintain their skills, status and image. Whether it be wardrobe, cosmetic improvements, physical fitness, education/training, public persona or even personal security, entertainers spend a significant amount on their upkeep. But how much of these expenses really are connected with their jobs?

Though many entertainers argue that the aforementioned expenses are essential to their image and thus, their livelihood, it turns out that the majority of these expenses are, in fact, too personal to be considered business related. Unless the entertainer can affirmatively prove a business purpose for such expenses with substantiation and detail, they will be nondeductible. For example, one can only deduct the cost of clothing if it is required by the employer and not adaptable to general use. On the other hand, costumes are usually deductible. The cost of physical fitness (trainers, gym memberships, etc.) is nondeductible. If physical conditioning is required by an employer, the expense is usually reimbursed. Also, the cost of hiring a bodyguard is nondeductible unless it is clearly related to the entertainer’s business (e.g., protecting the entertainer from fans and paparazzi during a performance or paid appearance).

Alternatively, fees paid to representatives of the entertainers (e.g., agent fees) are deductible. Similarly, the cost of publicity managers, public relations firms, and the like are considered business expenditures but require statements and specific examples of services performed. Further, special training, education or coaching, if required for a job, are also deductible expenses. For example, if an entertainer is required to learn a certain dialect for an acting role, the cost of hiring a coach for such would be considered a business-related expense. Finally, ongoing training to “keep up” one’s skill can be deducted so long as it is a skill that is ordinarily and necessarily used in the entertainer’s business.

Travel

Traveling is an essential part of the livelihood of many entertainers as they may be on the road performing, job searching or maintaining skills. Travel expense—the expense incurred while being away from home overnight—is distinguished from transportation expense which is considered the commute within the general area of the entertainer’s regular place of business and is generally nondeductible.

Generally, an entertainer who incurs expenses when traveling away from home for a primarily business-related purpose, will be entitled to a deduction for airfare or other travel related expenses, so long as the expense is not reimbursable by his employer. Meals and lodging can also be deducted for business-related days and for any additional stops that are made so long as they, too, are for business-related purposes.

Alternatively, commuting costs are not deductible and therefore, entertainers need to understand what falls into this category. Driving from home to the studio and back is nondeductible commuting. If the entertainer's home is his place of business, transportation to and from his home for business purposes is deductible. Further, the expenses of going from one job location to another (e.g., auto mileage, taxi, subway) are also deductible, as is searching for employment, promoting oneself or even auditioning.

The details of all such expenses must be timely documented, for they will most likely be heavily scrutinized. In fact, keeping detailed and accurate records can be one of the best defenses if IRS decides to challenge any expenses as nondeductible. Entertainers undoubtedly incur many expenses in their industry, but the divide between personal and business motives is not always clear. Thus, professional advice should be sought so as to avoid raising red flags to IRS.

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Marketability Discounts Prove Critical Factors in Appraisal

When equity interests are transferred, appraisal reports are often required for tax purposes.

When the subject interest represents a minority interest in the underlying business or asset, the interest is typically valued at a discount from net asset value to reflect, among other factors, the lack of marketability. When such discounts are incorporated, it is critical that the appraisal report be prepared by a qualified appraiser and be prepared in such a way to withstand the scrutiny of Internal Revenue Service (IRS).

In August, 2011, a document was publicly released that has been used by IRS in reviewing appraisal reports, specifically, discounts for lack of marketability (DLOM). The report, titled *Discount for Lack of Marketability - Job Aid for IRS Valuation Professionals* (Job Aid), was prepared to provide a background and context for the DLOM, review past and existing practices, and provide insight into the strengths and weaknesses of the practices.

The report summarizes IRS' position regarding a number of weaknesses that examiners have seen as part of their review of submitted appraisal reports, including:

- inappropriate use of restricted stock studies;
- use of analytical models without market data support; and

- reliance on court case results to support appraisal conclusions.

Inappropriate Use of Restricted Stock Studies

Transactions involving restricted stock have been used for many years by members of the business valuation community to quantify DLOM, and numerous studies have been published over the years. The premise behind the restricted stock studies is that the effect of lack of marketability can be quantified by comparing the sale price of publicly traded shares to the sale price of restricted shares of the same company.

In the Job Aid, IRS provides an overview of a number of the restricted stock studies and highlights their respective weaknesses. For example, the Job Aid highlights the fair market value (FMV) restricted stock database of transactions. As described in the Job Aid, an IRS engineer completed an analysis of the 475 transactions in the database. The conclusions were: (i) the FMV model is flawed in explaining the DLOMs on restricted stock transactions; (ii) valuations cannot confidently rely on the FMV model; and (iii) neither the FMV model nor a regression analysis can be applied to FMV's database. These conclusions stress the importance of considering a variety of data sources rather than relying on one particular study.

Additionally, the Job Aid cautions against the following:

- *Using simple average or median indications from restricted stock studies.* The Job Aid states that one should not use measures of central tendency (e.g., averages or medians) without an examination of the underlying data and comparison to specific transaction or company data. It is important to stratify the underlying data from various restricted stock studies, and then select discounts after taking into consideration factors such as earnings, revenues, asset size, earnings volatility and asset price volatility.
- *Not analyzing transactions and reflecting other factors.* The Job Aid discusses adjusting a discount for factors not incorporated into the studies or methodologies to account for specific facts and circumstances around the subject interest. It is critical that the appraisal make qualitative adjustments for these factors (which are not considered in the restricted stock data), with the ones having the most impact on the concluded discount being dividend/distribution policy, amount of control associated with the subject interest, and restrictions on transferability or sale of the interest.
- *Not reflecting relative holding period.* When using a restricted stock analysis, the Job Aid states that it is imperative that the expected holding period of the subject company stock or interest be compared to the restricted stock study holding period being used.

Analytical Models

In addition to the studies mentioned above, a number of researchers have taken an analytical approach to quantifying DLOM. The Job Aid highlights a few based on option pricing theory. It is not uncommon to see many 409A valuations used for tax purposes to simply rely on an option model to calculate a discount for lack of marketability to apply to the common stock value. The Job Aid, however, clearly says that this methodology should be used as a proxy only and that this type of model cannot be used without consideration of other qualitative factors to arrive at a final conclusion.

The Job Aid notes that it is not uncommon for a valuation expert to propose a theoretical model as the basis for the determination of a DLOM. However, although the model seems conceptually sound, there is no attempt to validate the model using actual current market data and, for this reason, there is no way for the reviewer to perform a reality check. The DLOM must be firmly based on current market evidence, no matter how conceptually sound a model may appear.

Court Cases

Sometimes a valuation expert will base a decision as to the choice of DLOM on previous court decisions. The Job Aid notes, "... it must be remembered that judges are not valuators and are not constrained to the environment in which professional valuators operate." A judge can adopt any approach that is considered useful and can arrive at any result that seems reasonable in the court's view. The Job Aid goes on to say that court cases can be an excellent source of information when legal precedent is in question, but can be a very questionable source when valuation guidance is needed.

In summary, it is critical to obtain a comprehensive appraisal prepared by a qualified appraiser when valuing fractional equity interests. As highlighted by the Job Aid, it is important that the appraiser utilize all available data and carefully consider the specific facts and circumstances.

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Standing Strong: Investing in Today's Volatile Market

Following the recent market pullback, uncertainty is a common concern shared among the majority of investors.

The second half of 2010 and the first half of 2011 saw a slow and steady climb in the S&P 500, and may have lulled some into a false sense of security. Borrowing costs remained low, many corporations increased (or regained) profitability, and the consumer confidence index gradually moved higher. It appeared to many that the days of bank failures and flash crashes were in the rearview mirror. However, following the considerable pullback in the major indices throughout July and the early part of August, it may be an especially prudent time to review the basics of asset allocation, dollar-cost-averaging and manager selection.

Most investors are aware of the importance of diversifying an investment portfolio, but may not understand just how meaningful it is. Seminal studies indicated that over 90% of investor returns are derived from strategic policy decisions (1986, *Brinson, Hood & Beebower*), highlighting the critical need to allocate your portfolio among an appropriate mix of asset classes based on your personal risk tolerance and time horizon. After developing an asset allocation strategy, it should be reviewed regularly to ensure it is well suited to your individual needs and preferences. It is essential to ensure that an asset allocation remains within a range of the assigned asset classes, which is achieved through a periodic rebalancing of the portfolio. Disciplined rebalancing during volatile markets can produce the favorable outcome of harvesting gains during times of relatively strong performance while mitigating losses during weaker periods.

While developing an asset allocation strategy, investors must consider the role of liquidity in their portfolio, with specific attention paid to the magnitude and timing of the liquidity requirements. While it is generally recommended that an asset allocation policy be managed within finite bounds to maintain objectivity within the investor’s constraints, it should also be flexible enough to accommodate changes in the “economic reality” of the time, often placing liquidity at the forefront of the investment process. Structuring liquidity into tiers, to facilitate current and future liquidity demands, distinguishes the amounts dedicated to capital-preservation from the yield-enhancing liquidity segments.

Attempts to time the market rarely work, and in many cases, fear and greed can often lead investors to rely upon instinctual judgment. A dollar-cost-averaging timetable is recommended for investors who strive to make the investing process less susceptible to timing risk and emotional reaction.

After determining an appropriate asset allocation and dollar-cost-averaging schedule, the next step is to implement the plan with appropriate investment vehicles. Selecting the right portfolio manager, mutual fund, or separately managed account is a much more detailed process than simply comparing the performances and choosing the fund with the highest return. Items such as expense ratios, manager tenure and turnover ratios should also be examined closely. An expense ratio is an embedded cost that can erode returns, and an investor should adequately review the prospectus to understand how it is calculated. Unlike most fees that are separately broken out, a mutual fund’s expense ratio is directly built into the performance, and some funds will have relatively higher expense ratios than others.

A manager’s tenure is also very important, because a manager that has been in place at a particular fund or company for a longer period of time tends not only to be more experienced, but also to have a track record that can be more accurately assessed. Manager tenure can be easily researched using an independent mutual fund evaluation service (e.g., Morningstar) or on the money manager’s own website.

Finally, an investment’s turnover ratio refers to the period of time in which investments are held in the portfolio, which can have a direct impact on an investment’s after-tax return. Today, long-term capital gains are taxed at a historically low rate of 15% or less. Conversely, securities bought and sold within a one-year period are treated as a short-term capital gain and taxed at the investor’s ordinary income tax rate. To put this into perspective, an investor in a 35% marginal tax bracket would need to earn over 13% in a portfolio with a 100% turnover ratio to earn the same after-tax rate of return as a portfolio that yields 10% with no turnover.

The highest quality equities and bonds should be at the core of one’s investment portfolio during periods of volatility. Companies with strong balance sheets, free cash flows, and top and bottom line earnings growth should lead their peers, since they should be able to expand earnings organically rather than being forced to rely on financing. Investors should be well served by retaining holdings of well capitalized, high dividend-yielding institutions in recession-resistant sectors that still offer relative value.

Properly diversifying a portfolio is not an easy accomplishment, and doing so in a volatile market is even more difficult. However, keeping the basics in mind while working with a knowledgeable advisor should help you protect your portfolio during volatile times, allowing you to accomplish your financial goals without losing (more) sleep.

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Form Over Substance: New York's Mechanical Approach to Residency

In the past few months, the Tax Appeals Tribunal (TAT), New York's administrative adjudicatory branch for tax cases, has issued two decisions that signal a shift in NY State Tax Department's approach to determining residency and the TAT's willingness to support it.

The department's shift to a "form over substance" approach for determining residency significantly increases the risk of being subject to tax on all income (no matter from what source) for non-residents that own a second home in New York.

Under New York law, an individual can be deemed a resident in one of two ways. First, because she is domiciled in New York, or second, because she is a non-domiciliary and maintains a permanent place of abode and is present in the State for more than 183 days in a calendar year. The latter is commonly referred to as statutory residency and it was originally enacted to prevent people who lived in New York from claiming residency in another state because they had a vacation home or other establishment that would give rise to an argument for domicile in the other state.

A permanent place of abode, although not defined by statute, has come to mean a dwelling that can be utilized year round. In other words, it has adequate heat, water, plumbing and other fixtures that make it habitable throughout the year. Maintenance can include ownership, rental, or in some cases, the mere payment of living expenses on behalf of another.

In one of the two cases recently decided, the adequacy of the abode and the level of use formed the core of the taxpayer's challenge. The case involved a very typical scenario: a Connecticut domiciliary who worked in the financial sector of New York City and owned a vacation home in the Hamptons. Since the taxpayer worked in the City throughout the year, he clearly was present in the state for more than 183 days.

As for the permanent place of abode, the taxpayer argued that the vacation home, while adequate for a few weekend visits in the summer, was inadequate for his family of five to live in year-round given its relative size. After spending a significant amount of the decision outlining how the taxpayer's home was suited for year-round habitation, the Administrative Law Judge (ALJ) in the case concluded that the law did not take into account whether an abode was "suitable" for a particular taxpayer. Instead, it focused on whether it was capable of year-round habitation. Further, the ALJ dismissed the taxpayer's claim that the vacation home was only used less than 2 weeks by the taxpayer during the years under audit and thus should not be deemed a permanent place of abode. On appeal, the Tax Appeals Tribunal affirmed the ALJ decision.

In the second case, the main point of contention was whether the mere ownership of an apartment, where the owner allowed his parents to live, could satisfy the permanent place of abode requirement. The facts involved a New Jersey domiciliary who owned and operated a business in New York City and also owned a small apartment building near his business. The taxpayer rented two of the three units in the building and allowed his parents to live in the third unit rent free. Further, the taxpayer paid for his parent's utility and other bills. Due to the requirements of his business, the taxpayer was present in the city for more than 183 days.[1] In the case, it was established that the apartment was the taxpayer's parents' permanent home and that the taxpayer did not have a bedroom or any personal effects (clothing, toiletries, etc.). In fact, it was proven that when the taxpayer would occasionally stay at his parents to assist them with their medical needs, he had to sleep on a couch in the living room.

Notwithstanding these facts, the ALJ decided in favor of the department. The ALJ's reasoning was that the taxpayer simply met the requirements under the statutory residency definition. That is, he maintained a permanent place of abode and spent more than 183 days in the city.

Initially, the TAT rejected the ALJ's reasoning and ruled in favor of the taxpayer. However, in a rare move, the Tribunal agreed to rehear the case and in doing so decided in favor of the department. The basis for the Tribunal's decision was similar to the ALJ's and amounts to a strict interpretation of the statutory residency rules—maintain a permanent place of abode and spend more than 183 days in the State or City and you will be deemed a resident.

Although these cases do not raise any novel legal arguments, they are important because of the precedent they set. Prior to these cases, taxpayers with similar fact patterns were able to resolve the residency issues favorably or at least had the ability to negotiate a settlement. Now, however, with the department's mechanical application of the residency rules being blessed by the Tribunal, auditors are unlikely to walk away or settle. Arguably, they are now required to look purely to the black letter of the law without considering the grey areas.

As a direct result of these cases, the tax practitioner community along with various other concerned parties (e.g., the real estate industry) has lobbied the Legislature to amend the tax law to provide relief. Their efforts have been fruitful; there is now a bill in the New York State Legislature that excludes from the definition of permanent place of abode any dwelling that is located more than 50 miles from the taxpayer's place of employment in New York provided that such taxpayer spends no more than 90 days at the dwelling during the taxable year.

Of course, this proposal is not perfect and will not cure every unjust residency determination. In fact, it would not even provide any assistance to the taxpayer in the second case discussed above. For that, a much broader legislative fix is needed. Nevertheless, the bill, if passed, should protect non-residents who work in and maintain a vacation home in New York as long as that vacation home is 50 miles or farther from the taxpayer's work location.

The prevailing opinion is that the bill or some form of it will pass this year. However, until there is some legislative action, the likelihood of the department wielding its newly sharpened sword is high. However, all is not lost; there are still a number of proactive steps that can be implemented to prevent taxpayers from being ensnared in New York's tax net.

[1]This case was a New York City resident case. New York City residency cases apply the same principles of law as are applied in New York State residency cases.

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Stock Options or Restricted Stock?

As an employee of a corporation, what would you rather receive – stock options or restricted stock? The answer depends on many factors such as the potential change in the price of the company's stock and the number of stock options or restricted stock that may be granted.

An option is only worth a fraction of the value of the underlying stock. Thus, in general, an employer will grant more stock options than restricted stock. The value of an option is computed using either the Black-Scholes Pricing Model or a binomial pricing model. A traditional 10-year compensatory stock option to purchase stock in a corporation is generally valued at between 15% and 50% of the value of the stock assuming the exercise price of the stock option is equal to the full fair market value of the stock on the date of grant. The value of restricted stock is the fair market value of the stock on the date of grant. As a result, a corporation conveying a certain level of compensation to an employee in the form of equity will offer more stock options than restricted stock.

If an employer wanted to provide an employee with $50,000 of compensation in the form of equity when the fair market value of its stock is $10 and the fair value of a stock option to purchase the stock at $10 is $2.50, then the employer would be willing to grant 5,000 shares of restricted stock or 20,000 stock options. Of course, the stock options do not provide the employee with any economic value on the date of grant since the current value of the stock would be equal to the exercise price. On the other hand, on the date the restricted stock is granted, the restricted stock has an economic value before income taxes of $50,000. So which would you take?

The answer depends on where you think the price of the stock is heading. If the value of the stock were to increase by at least 34% between the time of grant and the time of exercising the stock option, you would be better off economically, before income tax considerations, by taking the stock options. If you took the 20,000 stock options and exercised them when the price of the stock was $13.40, then economically, you would have $68,000 ($13.40 less $10 times 20,000 stock options) before taxes. On the other hand, if you took the restricted stock, the gross value of the stock would be $67,000. If the fair market value of the stock were to increase to $25, then the 20,000 stock options would have a pretax value of $300,000, while the restricted stock would only have a value of $125,000.

If the value of the corporation's stock did not increase by at least 34% or decreased in value, then the restricted stock would have a greater value than the stock options. For example, if the value of the company stock fell to $8 from $10, then the stock options would have no value since the exercise price exceeds the stock's current fair market value and the stock options would not be exercised. However, the restricted stock would have a value of $40,000 ($8 times 5,000). If the stock only increased to $12 per share, the stock options would have a value of $40,000, but the restricted stock would have a value of $60,000.

In the analysis above, income taxes have been ignored but would have an impact on the net value received from restricted stock and stock options. Compensation income is recognized as the restricted stock vests (typically three to five years). On the other hand, compensation income with respect to stock options is recognized when the stock options are exercised. Compensation income is subject to ordinary income tax rates. However, any appreciation after vesting of restricted stock or the exercise of a stock option will be treated as capital gain income taxed at the capital gain rate (currently 15% for long-term gains). The employee controls the timing of when he or she has to pay income taxes on the compensation element with respect to stock options, while such control is not available with respect to restricted stock.

From the company's point of view, however, it may want to grant restricted stock instead of stock options. As already mentioned, to give an employee a fixed level of income in the form of equity would require the company to issue more stock options than restricted stock. By granting employees stock options, the company would be using more shares under the program and diluting the ownership interests of other shareholders. Also, the company may be required to request the shareholders to approve more shares for future grants. In the above example, the company would record the same expense for financial statement reporting purposes. However, for income tax purposes, the tax deduction is equal to the amount of compensation recognized by the employee. Therefore, with a stock option, as the price of the stock increases significantly, the income tax deduction with respect to the stock option becomes more valuable.

The choice between stock options and restricted stock is not a quick answer and requires a careful review of the facts and circumstances. It depends on the number of shares granted, the current value of the stock option, the potential increase in the value of the stock, and the timing of the vesting of the restricted stock/exercise of the stock options. In addition, the company needs to consider the other shareholders and the dilution impact of granting stock options and/or restricted stock.

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Let's Make a Debt Deal!

On August 2, 2011, President Obama signed The Budget Control Act of 2011 (the Act) into law ending a political drama over an increase in the federal debt ceiling, at least for the moment.

While the so-called "debt deal" contained no tax increases, it set in motion a process by which some aspects of the tax reform debate may come into being. While some political observers may believe that Congress will not enact significant tax reforms just prior to or during an election year, provisions in the Act requiring mandatory across-the-board cuts will likely incentivize lawmakers to adopt some of the tax reform ideas as part of a deficit reduction package. This article will review the most significant recent tax reform proposals, including those contained in the "Gang of Six" report, after briefly reviewing key provisions of the Act that require deficit reduction.

The Act

Under the Act, the debt limit is increased by $400 billion immediately, and the President may obtain a further increase of $500 billion upon request. A subsequent increase of $1.2 to $1.5 trillion may be approved but only if Congress also approves net spending cuts of at least $1.2 trillion over the next 10 years. These cuts must take the form of a proposal developed by a "super committee" of lawmakers consisting of 12 members of Congress - 6 Democrats and 6 Republicans. The proposal must be passed into law by December 23, 2011, in order for increases to the debt ceiling beyond the initial $900 billion to occur. If the super committee fails to act in time, then the debt ceiling may be increased by another $1.2 trillion but “automatic” spending cuts of $1.2 trillion would be imposed and such cuts would fall equally on security and non-security programs (though Medicaid, Social Security, government employee pay and veterans programs would be spared).

The Prognosis

While the White House and several lawmakers hailed passage of the Act, many, including the President and a bipartisan group of six Senators (the Gang of Six), would have preferred to enact a more sweeping set of deficit reduction and tax reforms. The Gang of Six are: Dick Durbin (D-IL), Kent Conrad (D-ND), Mark Warner (D-VA), Tom Coburn (R-OK), Saxby Chambliss (R-GA) and Mike Crapo (R-ID). While this “grand bargain” could not be achieved it is likely that many of the tax reform elements of such a bargain will emerge again in the legislation to be proposed by the December 23, 2011 deadline imposed by the Act. For example, some of the key parts of the Gang of Six proposal may be resuscitated.

Under the Gang of Six proposal, tax rates for individuals would be lowered and existing tax brackets would be consolidated into three brackets with rates of 8-12%, 14-22% and 23-29%. The alternative minimum tax (AMT) would be eliminated, and a single corporate tax rate between 23-29% would be imposed, a significant reduction from the current tax rate of 35%. While these specific proposals would seem to decrease revenues, various significant tax expenditures would be curtailed. For example, the deduction for interest paid on debt incurred to purchase a home would likely be limited to interest paid on $500,000 of debt secured by a single residence. In addition, the deduction for charitable contributions would likely be reduced and deductions for tax-favored retirement vehicles would likely be reduced. Members of the super committee who seek a balanced approach to deficit reduction will probably resurrect some of the elements of the Gang of Six proposals.

But they will likely rely on other ideas as well. For example, a proposal to tax the so-called “carried interest” of private equity managers at ordinary rates will be part of the dialogue. As many observers have noted, the number one issue going into the 2012 election cycle continues to be job creation. As a result, we expect lawmakers to seriously consider a proposal to link a tax holiday on foreign-earned corporate profits to a fund for job training and creation. Other significant corporate tax proposals may form part of the debate including a proposal by business groups to change our approach to taxing foreign earnings to a territorial or “exemption” system. Under current law, U.S. corporations are subject to U.S. income tax on their worldwide profits and receive a credit for taxes paid to foreign governments on those earnings. Under an exemption regime, the U.S. would not tax foreign earnings at all (of course no credit would be available for foreign taxes under an exemption system). Business groups argue that an exemption system would put them on a level playing field as compared to their foreign competitors since many European countries have an exemption system (e.g., France, Germany and the Netherlands), and that this type of tax reform would enhance their ability to create domestic jobs by eliminating the incentive that exists under current U.S. law to keep foreign earnings offshore.

Given the current unemployment rate of 9.1%, a tax holiday for foreign earnings or even an exemption system may find their way into the super committee’s final work product in December along with one or more of the proposals discussed above. Taxpayers should follow the work of the committee very closely in the coming months because significant changes to the U.S. tax system may be right around the corner.