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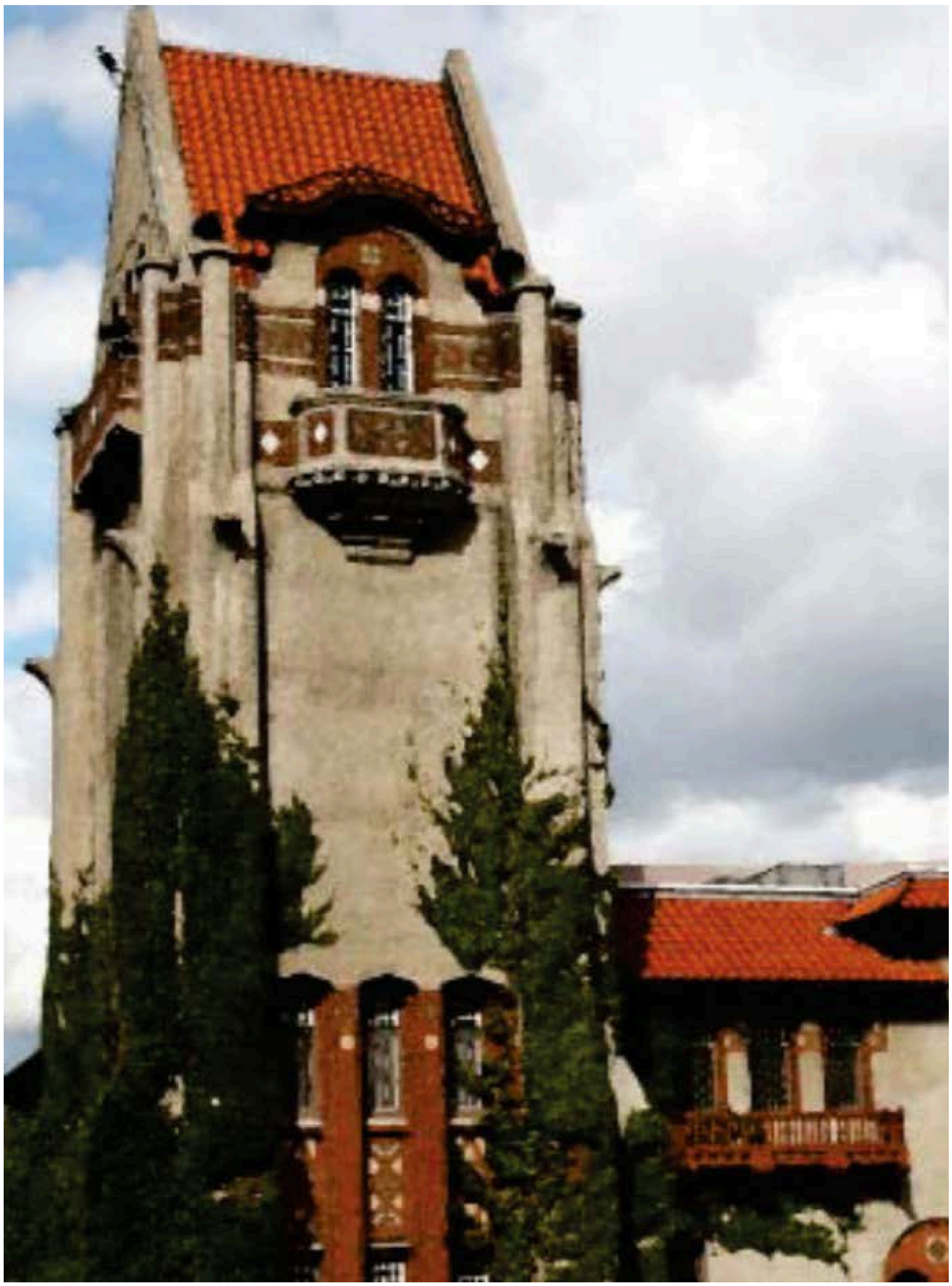

The Contemporary Tax Journal Winter 2018

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Letter from the Editor

Our Winter 2018 Issue of The Contemporary Tax Journal features articles that were written before the Tax Act.

We are proud and grateful in our seventh year of this journal to provide you with the following interesting articles:

In *Featured Contributors,* **Dr. David Randall Jenkins** helps us understand the argument of why Section 179(b)(3)(A)'s business income limitation does not apply to partnerships and S corporations. **Dr. Paul D. Hutchison, Dr. C. Elizabeth Plummer, and Dr. Benjamin George** discuss the latent semantic analysis (LSA) and its application and research opportunities for tax research, which will be a key to understanding 'big data', an increasingly trendy topic.

June Hostetter and **Sara Sun** examine start-up costs and R&D credits pertaining to high-tech companies, and **Stephen Wildt** explores the mortgage interest deduction policy in *Tax Enlightenment*.

In *Tax Feature*, you will enjoy summaries written by my fellow MST students for the 2017 IRS-SJSU Small Business Tax Institute, where analysts and staff from the IRS, the California FTB Taxpayers' Rights Advocate Office, and experts from CPA firms and IT companies addressed various issues in our current digital economy concerning small businesses and their tax advisers.

Our *Tax Maven* of this issue of the journal is **Mr. Jim Fuller**, a tax partner at Fenwick at West LLP. I am honored to have interviewed him and learned about his illustrious career and opinions. It was a treasured and fascinating experience for me personally, and I hope his words will inspire you as well. Mr. Fuller shared that his key to success is to "stay current," genuine advice that requires a tremendous amount of diligence, and that I will always take to heart.

Finally, *A Focus on Tax Policy* presents the analyses of various tax bills by our MST students in the Summer 2017 *Tax Policy Capstone* class using the Guiding Principles of Good Tax Policy outlined in the AICPA Tax Policy Concept Statement No. 1.[1] In the midst of understanding the new tax reform, I sincerely encourage you to assess and understand these new tax policies with professionalism, objectivity, and context, with the articles in this section serving as examples.

2017 has been an eventful year for our U.S. tax system. It's been 32 years since the Tax Reform Act of 1986, and now we finally have another tax reform: The Tax Cuts and Jobs Act of 2017.[2] I just graduated in December 2017, and I am excited to start my career in this historic moment in tax. I vividly remember during my MST program in 2015, my mentor and personal hero, the MST

[1] American Institute of Certified Public Accountants (AICPA) Tax Division. (January 2017). *Tax Policy Concept Statement 1 - Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals.* Retrieved from: https://www.aicpa.org/ADVOCACY/TAX/downloadabledocuments/tax-policy-concept-statement-no-1-global.pdf

[2] The full title of the 2017 Tax Act is: An Act to Provide for Reconciliation Pursuant to Titles II and V of The Concurrent Resolution on The Budget for Fiscal Year 2018 (Public Law No. 115-97).

Program Director Professor Annette Nellen told us our friends and family might ask us why we are getting a master's degree in taxation as tax laws change all the time. She ensured us what we will be learning are the fundamental skills to understand the changes no matter what they are, as long as we stay abreast of the new developments. Clearly, that's never been more real than right now.

At this point, I want to thank all the contributors to this issue, as well as Catherine Dougherty, our MST coordinator and journal webmaster, and Sara Sun, our assistant student editor. Their insights and hard work made this issue of the journal possible.

I also want to give an enormous 'THANK YOU' to **Professor Annette Nellen and Professor Joel Busch,** the advisors for this Journal. They have deftly guided me through editing and learning journey. As I reflect upon my now-concluded MST experience, I can say that enrolling in the program is one of the best decisions I've made in my life. I am prepared for the professional world in every possible way. Starting a new career in tax can be daunting and overwhelming. I work through my daily projects drawing upon the knowledge and skills I am equipped with from my classes and my work on the Journal, and I couldn't be more grateful for the program. As my lifelong journey in tax continues, I hope this Journal will serve as a good reminder for me to "stay current" in this ever-changing tax world.

As always, we invite your comments and hope you will consider contributing to our upcoming issues.

I now present to you, the Winter 2018 issue of *The Contemporary Tax Journal.*

Enjoy,
Ophelia Ding, *MST*
Student Editor

Why Section 179(b)(3)(A)'s Business Income Limitation Does Not Apply to Partnerships and S Corporations

by
David Randall Jenkins, Ph.D.*

Abstract

This article breathes new life into the argument Section 179(b)(3)(A)'s business income limitation does not apply to partnerships and S corporations. On the other side of the debate sits the Tax Court's 1999 *Hayden* decision affirmed by the Seventh Circuit in early 2000. Those authorities buttress Treasury's Section 1.179-2(c)(2) promulgation as valid. While the odds appear to be formidable to otherwise construe the business income limitation, this article challenges the court decisions and regulatory promulgation as inconsistent with the plain meaning of the statute and Congress's underpinning policy objectives.

I
Introduction

The Tax Court's 1999 *Hayden* decision was the first time the judicial department addressed the issue whether Section 179(b)(3)(A)'s business income limitation applies to partnerships.[1] The Tax Court's affirmation that the business income limitation did indeed apply to partnerships was upheld on appeal to the Seventh Circuit.[2] In the process, both courts sustained the validity of Treasury Regulation 1.179-2(c)(2) against the taxpayer's challenge.[3]

This article supplants the *Hayden* taxpayers' validity argument by challenging Treasury Regulation 1.179-2(c)(1) as an impermissible expansion of the statute's language by including this sentence in paragraph (1):[4]

> For purposes of section 179(b)(3) and this paragraph (c), the aggregate amount of taxable income derived from the active conduct by an *individual, a partnership, or an S corporation* of any trade or business is computed by aggregating the *net income (or loss)* from all of the trades or businesses actively conducted by the individual, partnership, or S corporation during the taxable year.

The emphasized language bears witness to an appearance Treasury foresaw the partnership taxable income issue the *Hayden* courts eventually decided in its favor.

This article condemns the *Hayden* decisions as problematic and Treasury Regulation Section 1.179-2(c)(1) and (2) as impermissible expansions of the statute's plain and obvious language on two inextricable fronts. First, taxable income of a partnership is not qualitatively equal to taxable income of individuals or C corporations. The *Hayden* court decisions failed to properly characterize this distinction. The *Hayden* courts should have counseled that while the notion of a "taxpayer" applies equally to partnerships and individuals for Section 179(b)(1) and

[1] See *Hayden v. Commissioner*, 112 T.C. 115 (1999) ("*Hayden* TC").
[2] See *Hayden v. Commissioner*, 204 F.3d 772 (7th Cir. 2000), *aff'g*, 112 T.C. 115 ("*Hayden* 7th Cir."). Note, the Seventh Circuit's geographic jurisdiction embraces the Central, Northern, and Southern Districts of Illinois, the Northern and Southern Districts of Indiana, and the Eastern and Western Districts of Wisconsin.
[3] See *Hayden* TC at 121; also see *Hayden* 7th Cir. at 774-75.
[4] See Treasury Regulation Section 1.179(c)(1) (*emphasis added*).

(2) purposes, the Section 179(b)(3)(A) notions of "taxpayer" and "taxable income" do not. Had they done so, both decisions would have invalidated Treasury Regulation Sections 1.179-2(c)(1) and (2).

Second, the *Hayden* taxpayer failed to raise the inextricable issue involving Section 179(b)(3)(A)'s requirement that taxable income "derived from the active conduct by the taxpayer of any trade or business" is contextually qualified by Section 469's passive activity loss rules, particularly the Section 469(c)(1)(B) participation conclusive presumption.[5] Within the Section 469 context, partnerships do not engage in the *active* conduct of a trade or business because active conduct implicates only the aforementioned participation conclusive presumption.[6] It can only be said partnerships engage in the conduct of a trade or business, which implicates the Section 469(c)(1)(A) activity conclusive presumption.[7] Moreover and for underpinning policy reasons, this article concludes while Section 179(d)(8) extends the Section 179(b)(1) and (2) dollar limitation to partnerships and partners alike, it only extends Section 179(b)(3)(A)'s business income limitation to partners but not to partnerships.[8]

II
The Hayden *Decisions*

Let us begin substantive discussion by reviewing the *Hayden* decisions. Dennis and Sharon Hayden were the sole members in a Frankfort, Indiana limited liability company ("LLC") treated as

[5] For a discussion regarding the Section 469(c)(1)(B) participation conclusive presumption see D. R. Jenkins, "Section 469 Activity and Participation Conclusive Presumptions," *Journal of Taxation*, 125(4), October 2016, pp. 168-179 (Section 469 Paper).
[6] *Ibid.*
[7] *Ibid.*
[8] Some commentators may consider that Section 168(k), as modified by the Tax Cuts and Jobs Act of 2017, now overrides the importance of Section 179. One important difference between Sections 179 and 168(k), even after the recent changes, is the Section 179(d)(5)(B) noncorporate lessor conclusive presumption. Section 469(c)(2) provides that all rental activity is *per se* passive activity. The Section 469(c)(2) rental real property trade or business activity conclusive presumption is one exception to this mandate. See Section 469 Paper. The other exception to the Section 469(c)(2) mandate is the Section 179(d)(5)(B) noncorporate lessor rental activity conclusive presumption. Section 168(k) does not have such a preemptive conclusive presumption. Conclusive presumptions are an affirmative defense to an IRS equitable challenge. See, D. R. Jenkins, "A Note on the Noncorporate Lessor Activity Conclusive Presumption," *Journal of Taxation*, 128(2) February 2018. (expected). Therefore, taxpayers relying on the noncorporate lessor conclusive presumption will prefer Section 179 expensing over Section 168(k) bonus depreciation notwithstanding changes wrought by the Tax Cuts and Jobs Act of 2017.

a partnership for federal income tax purposes.[9] The LLC commenced operations on September 1, 1994 and purchased Section 179 property, placing same in service during the 1994 calendar-based taxable year.[10] The partnership's Form 1065 showed an operating loss, pre-Section 179 depreciation.[11] The partnership's Form 4562 claimed a Section 179 deduction in the amount of $17,500, which passed through to the Haydens' Form 1040, Schedule E.[12] On audit, the IRS disallowed the Section 179 deduction.[13] The Haydens filed a timely Petition for Redetermination in the United States Tax Court.[14]

The Tax Court recognized the partnership's 1994 Section 179 depreciation deduction did not exceed the Section 179(b)(1) and (2) dollar limitation.[15] Rather the Tax Court focused its decision on whether the partnership's Section 179 $17,500 expense was limited by Section 179(b)(3)(A)'s business income limitation.[16]

In the first instance, the *Hayden* Tax Court noted Section 179(d)(8) provided in material part "[i]n the case of a partnership, the limitations of subsection (b) shall apply with respect to the partnership and with respect to each partner."[17] Without further analysis, the *Hayden* Tax Court cited Treasury Regulation Section 1.179(c)(2):[18]9

> The taxable income limitation * * * applies to the partnership as well as to each partner. Thus, the partnership may not allocate to its partners as a section 179 expense deduction for any taxable year more than the partnership's taxable income limitation for that taxable year, and a partner may not deduct as a section 179 expense deduction for any taxable year more than the partner's taxable income limitation for that taxable year.

[9] *Hayden* TC at 116. Dennis Hayden was a Certified Public Accountant. The Haydens represented themselves, *pro se*, in both the Tax Court and Seventh Circuit proceedings.
[10] *Ibid*.
[11] *Ibid*.
[12] *Ibid*.
[13] *Ibid*.
[14] *Ibid*.
[15] See *Hayden* TC at 117.
[16] *Ibid*.
[17] *Ibid quoting* Section 179(d)(8).
[18] *Ibid* at 117-18, *quoting* Treasury Regulation Section 1.179(c)(2).

The Tax Court noted the taxpayers acknowledged that under the foregoing regulation the partnership's Section 179 $17,500 deduction is not allowable; and, further acknowledged their sole responsive argument was that Section 1.179(c)(2) was invalid.[19] Thereupon, the Tax Court set the stage for rebuking the taxpayers' invalid regulation argument.

First, the *Hayden* Tax Court reviewed a select few guidelines in considering whether a Treasury Regulation should be sustained. The Tax Court noted the primary consideration is that a Treasury Regulation must be sustained if it implements the congressional mandate in some reasonable manner.[20] The tax tribunal counseled that courts refuse to displace the Commissioner's regulation with a judicial construction when the former is reasonably based.[21] The Tax Court's valid Treasury Regulation soliloquy concluded by noting regulations must be sustained unless unreasonable and plainly inconsistent with the revenue statutes.[22]

Indulge noting a few relevant weaknesses in the *Hayden* Tax Court's valid regulation legal analysis. In the first instance, it appears to be well settled that when the judicial department is able to measure executive interpretation against a specific provision of the tax code the executive interpretation is owed less deference than a regulation issued under a specific grant of authority to define a statutory term or prescribe a method of executing a statutory provision.[23] While Section 179's plain language empowered the executive specific grants of legislative regulatory authority, Congress did not empower Treasury to 1) conclude Section 179(d)(8) imposed the Section 179(b)(3)(A) business income limitation at the partnership level, 2) define Section 179(b)(3)(A)'s "taxable income" notion, and as well be relevant later in this article, 3) define

[19] *Ibid* at 118.
[20] *Ibid citing United States v. Vogel Fertilizer*, 455 U.S. 16, 24 (internal citations omitted). Also see *Rowan Cos., Inc. v. United States*, 452 U.S. 247, *citing United States v. Correll*, 389 U.S. 299, 307 (1967) (the same decision cited by the Court in *Vogel Fertilizer*, *supra*).
[21] *Ibid citing Schaefer v. Commissioner*, 105 T.C. 227, 230 (1995) (internal citations omitted).
[22] *Ibid citing Commissioner v. South Texas Lumber Co.*, 333 U.S. 496, 501 (1948).
[23] See *Rowan*, *supra*, at 253 (internal citations omitted).

"active conduct by the taxpayer of any trade or business" as that term is used in Section 179(b)(3)(A). As a result of these enumerated matters, it can be said the judicial department owes Treasury's regulatory interpretations less deference on these three points.[24]

Two other infirmities in the Tax Court's valid regulation analysis are relevant in this article's discourse. First, the Supreme Court has expounded the meaning of "implementing the Congressional mandate in some reasonable manner." It has held courts should look to see whether the regulation harmonizes with 1) the plain language of the statute, 2) the statute's origin, and 3) the statute's purpose.[25] It is plain and obvious Section 179's policy objective is to provide an impetus to small business capital formation. This article demonstrates the *Hayden* courts failed to counsel that policy objective and Treasury likewise ignored it when it promulgated Section 1.179-2(c)(1) and (2).

The Supreme Court has further held the judicial department must inquire whether an executive regulation is a substantially contemporaneous construction of the statute by those presumed to have been aware of congressional intent.[26] This article demonstrates the *Hayden* Tax Court failed to harmonize the statute's contemporaneous construction. Specifically, the *Hayden* Tax Court failed to consider Section 179(b)(3)(A)'s business income limitation and Section 469's passive activity loss rules were both enacted in the Tax Reform Act of 1986 (TRA86). The harmony is wanting because, as this article demonstrates, the latter statute contextually qualifies the meaning of the former statute's term "active conduct by the taxpayer of any trade or business" to limit the taxpayer reference therein to those taxpayers described in Section 469(a)(2).

[24] *Ibid*.
[25] *Ibid citing National Muffler Dealers Association v. United States*, 440 U.S. 472, 477 (1979).
[26] *Ibid*.

Let us follow the *Hayden* Tax Court's nominal review of Section 179's legislative history. It began by noting Section 179 first became a part of the tax code in the passage of the Small Business Tax Revision Act of 1958.[27] At the time of this initial enactment, Section 179(b) had only a dollar limitation: 20% of the amount of Section 179 property placed in service up to a maximum of $10,000. In this initial legislation, the dollar limitation was not reduced dependent on the total amount of Section 179 property placed in service.[28] Moreover, in the 1958 enactment of Section 179, the provision's reference to "taxpayer" was unqualified.

The *Hayden* Tax Court further noted Section 179(d)(8) was first enacted in the Tax Reform Act of 1976 (TRA76).[29] At that time, Section 179(d)(8) provided:

> (8) Dollar limitation in case of partnerships and S corporations. In the case of a partnership, the dollar limitation contained in subsection (b)(1) shall apply with respect to the partnership and with respect to each partner. A similar rule shall apply in the case of an S corporation and its shareholders.

As can be seen, the foregoing 1976 provision only applied to the dollar limitation contained in Section 179(b)(1). The original incorporation of Section 179(d)(8) necessarily meant the dollar limitation applied both at the partnership and the partner levels. The business income limitation wouldn't become a part of the tax code for another ten years.

The *Hayden* Tax Court concluded that in order to sustain the taxpayer's position it would "have to read the Section 179(b)(3)(A) limitation out of Section 179(d)(8)."[30] The tribunal concluded it could not do so.[31] Rather, the *Hayden* Tax Court, citing a Tax Court Memorandum

[27] See *Hayden* TC at 118, *citing* Pub. L. 85-866, 72 Stat. 1606, 1676.
[28] See Small Business Tax Revision Act of 1958, Section 204. At the inception, Section 179 was considered a form of depreciation. It would not be transformed to an "expense" until the Economic Recovery Tax Act of 1981 (ERTA), Pub. L. 97-34, Section 202(a), 95 Stat. 172. See *Hayden* TC at 118-19. In TRA86, it was transformed back to a depreciation deduction. See Staff of Joint Comm. on Taxation, General Explanation of the Tax Reform Act of 1986 (Jt. Comm. Print 1987), at 110. As a result, and in this article, I interchangeably refer to the Section 179 deduction as an expense or depreciation.
[29] See Pub. L. 94-455, Section 213(a), 90 Stat. 1525, 1547.
[30] See *Hayden* TC at 121.
[31] *Ibid*.

Opinion,[32] substantively construed Section 179(d)(8) as requiring that its terms apply to all subsection (b) limitations regardless of any subsection (b) paragraph's express language or unique underpinning policy objective.[33] The *Hayden* Seventh Circuit's decision likewise takes the substantive position Section 179(d)(8) requires that its terms apply to each and every subsection (b) limitation without regard to any respective limitation's express language or underpinning policy objective.[34]

Neither the *Hayden* taxpayer nor the IRS disputed the Section 179(b)(1) dollar limitation applied both at the partnership level and at the partner level. The $17,500 limitation amount at bar in the *Hayden* decision was introduced by the Small Business Job Protection Act of 1996.[35] Accordingly, the amount of the Section 179 expense subject to the dollar limitation in *Hayden* was $17,500.

The taxpayers made two contentions to support their argument Treasury Regulation Section 1.179-2(c)(2) was invalid. First, they argued a partnership is not a taxpayer within the meaning of Section 7701(14). Their argument pleaded that since, pursuant to Section 701, a partnership did not pay taxes it could not be a taxpayer.[36] Accordingly, Section 179(b)(3)(A) could not apply to a partnership.[37] Second, the *Hayden* taxpayers argued that a partnership's trade or

[32] *Ibid citing Green v. Commissioner*, T.C. Memo 1998-356 (applying Section 179(b)(3)(A) to an S corporation). In citing *Green* the *Hayden* Tax Court ignored its own policy not to consider Tax Court Memorandum Opinions as controlling precedent. See *Nico v. Commissioner*, 67 T.C. 647, 654 (1977).
[33] The *Hayden* Tax Court recognized Section 179(d)(8) "does not say that only subsection (b)(1) and (2) shall apply." *Ibid*. Later in this article, I demonstrate underpinning policy considerations distinguish that while Section 179(d)(8) applies to partnerships for dollar limitation purposes, it does not apply to partnerships for business income limitation purposes. In the latter setting, it becomes clear when Congress changed the language of Section 179(d)(8) in TRA86 it generalized the TRA76 language to apply to partnerships for any current or prospective subsection (b) limitation as a particular limitation's express language so demands but not when it does not. Such statutory construction flexibility allows Congress to add further subsection (b) limitations without changing Section 179(d)(8)'s language.
[34] See *Hayden* Seventh Circuit at 775.
[35] See Pub. L. 104-188, Section 111(a).
[36] See *Hayden* TC at 119-120.
[37] See *Hayden* TC at 119.

business activity should be measured by its gross income and not its bottom line ordinary business income.[38] The *Hayden* Tax Court rejected both arguments.[39]

The *Hayden* Tax Court's taxpayer-adverse reasoning began by recognizing the Section 179(b)(3)(A) business income limitation was first introduced in the TRA86.[40] It proves interesting the Tax Court noted an important difference in the underpinning Senate Finance Committee Report, the House Conference Report, and the Staff of the Joint Committee on Taxation Report.[41] The Tax Court recognized that while the Senate Report would impose the Section 179(b)(3)(A) business income limitation on each of the taxpayer's trades or businesses, the House Conference and Joint Committee reports finalized the condition in terms of taxable income from *any* of the taxpayer's trades or businesses. The distinction becomes important when Section 469's contextual qualification of the Section 179(b)(3)(A) business income limitation is understood because "any of the taxpayer's trades or businesses" is Section 469(c)(1)(B) participation conclusive presumption incident.[42] That is, the business income limitation's "taxable income" aggregates all trade or business ordinary income in which the taxpayer materially participates.

The *Hayden* Tax Court correctly rejected the petitioners' argument partnerships are not taxpayers.[43] The Tax Court pointed to Section 7701(14)'s definition of a taxpayer as any person subject to internal revenue taxes.[44] While partnerships are not subject to subtitle A income taxes, they are subject to subtitle C employment taxes.[45] Accordingly and as the *Hayden* Tax Court concluded, partnerships are taxpayers for subtitle A purposes unless there is a qualification that

[38] *Ibid*.
[39] *Ibid*.
[40] See Pub. L. 99-514, Section 202(a).
[41] See *Hayden* TC at 119 *citing* S. Rept. 99-313 at 106 (1986), 1986-3 C.B. (Vol. 3), p. 106; H. Conf. Rept. 99-841, at II-49 (1986), 1986-3 C.B. (Vol. 4) 1, 49; and, Staff of Joint Comm. on Taxation, General Explanation of the Tax Reform Act of 1986 (Jt. Comm. Print 1987), at 109.
[42] See Section 469 Paper, *supra*.
[43] *Ibid* at 119-20.
[44] *Ibid*.
[45] *Ibid*.

limits the scope of relevant taxpayers. This article acquiesces only to the extent that Section 179(a)'s reference to taxpayers is unqualified and, as a result, partnerships are properly and generally considered Section 179(a) taxpayers.

Spuriously, the *Hayden* taxpayer next argued Section 179(b)(3)(A) required measuring its business income limitation at the level of a partnership's gross receipts and not its ordinary business income.[46] The Tax Court rejected this frivolous argument.[47] The *Hayden* taxpayer did not raise the issue that Section 469 contextually qualified Section 179's business income limitation as applicable only to Section 469(a)(2) taxpayers.[48]

The *Hayden* taxpayer also did not raise the issue that applying the dollar limitation to partnerships furthered Congress's underpinning policy objectives while applying the business income limitation to partnerships was contrary to Congress's underpinning policy objectives. The *Hayden* taxpayer failed to argue this important statutory construction tenet in the Tax Court proceeding. Such incomplete argument impairs the quality of important legal precedent affecting small business capital formation.

The *Hayden* taxpayers appealed the Tax Court's adverse decision to the United States Court of Appeals for the Seventh Circuit.[49] The Seventh Circuit's reported decision did not remark any legal analysis that would supplant, amend, or otherwise be distinguished from the Tax Court's legal analysis. Notably, the Seventh Circuit also did not reason its legal conclusions grounded in the statute's underpinning intent, nor did it consider Section 469's contextual qualification of Section 179's business income limitation.

[46] *Id* at 121.
[47] *Ibid*.
[48] The commonality of Section 469(a)(2) taxpayers is that they're all subject to subtitle A income taxes and a requirement of actively conducting (*i.e.*, materially participating in) a trade or business. Notably, neither partnerships nor S corporations are among the set of Section 469(a)(2) taxpayers.
[49] See *Hayden* 7th Cir., *supra*.

III
Section 179's Taxpayer and Taxable Income Notions

Section 7701(14) defines the term "taxpayer" as any person subject to any internal revenue tax. Generally, the set of internal revenue taxes are defined in the first five subtitles of Title 26, U.S.C., to wit:

a. Subtitle A-Income Taxes,
b. Subtitle B-Estate and Gift Taxes,
c. Subtitle C-Employment Taxes,
d. Subtitle D-Miscellaneous Excise Taxes, and
e. Subtitle E-Alcohol, Tobacco, and Other Excise Taxes.

Unless otherwise specifically qualified in a given statute, the term "taxpayer" equally describes an individual, a partnership, an S corporation, a C corporation, a personal service corporation, a trust, or an estate notwithstanding the person's subtitle origin of internal revenue tax incidence.

Section 179(a) reads:[50]

> A taxpayer may elect to treat the cost of any section 179 property as an expense which is not chargeable to capital account. Any cost so treated shall be allowed as a deduction for the taxable year in which the section 179 property is placed in service.

Note, the term "taxpayer" as used in Section 179(a) is not qualified. As a result, Section 179 taxpayers potentially include any Section 7701(14) taxpayer. However, estates and trusts are specifically excluded from Section 179 expensing.[51] Moreover, personal service corporations are not involved in active trades or businesses. Accordingly, Section 179(a) taxpayers only include individuals, partnerships, S corporations, and C corporations.

[50] Section 179(a) converts a cost chargeable to a capital account to an expense. As a result, and to the extent of this conversion, Section 179 expensed capital is not subject to Section 167 depreciation.
[51] See Section 179((d)(4).

Familiarly, the two limitations found in Section 179(b) that apply to all Section 179 taxpayers and to all Section 179 property include paragraph (1) and (2)'s dollar limitation and paragraph (3)'s business income limitation. Specifically, paragraph (1) presently provides:[52]

> (1)DOLLAR LIMITATION. The aggregate cost which may be taken into account under subsection (a) for any taxable year shall not exceed $500,000.

Also presently, paragraph (2) provides:[53]

> (2)REDUCTION IN LIMITATION. The limitation under paragraph (1) for any taxable year shall be reduced (but not below zero) by the amount by which the cost of section 179 property placed in service during such taxable year exceeds $2,000,000.

Reading paragraphs (1) and (2) within the context of subsection (a) means an individual, partnership, C corporation, or S corporation may expense up to $500,000 of Section 179 property and that the expense is reduced dollar for dollar once the amount of Section 179 property placed in service in the taxable year exceeds $2,000,000. Moreover, Section 179(d)(8) causes the Section 179 dollar limitation to apply both at the partnership level and at the partner level since the notions of a Section 179(b)(1) partnership taxpayer and a Section 179(b)(1) partner taxpayer are equal without distinction.

Poignantly, all Section 7701(14) taxpayers are equal in definition of the term "taxpayer" anywhere throughout Title 26, U.S.C., unless specifically indicated otherwise. That is, with respect to Section 7701(14) taxpayers, there is no (endogenous subtitle, exogenous subtitle) distinction. This subtitle-distinction-less quality means all Section 7701(14) taxpayers are equal for purposes of the Section179(b)(1) and (2) dollar limitation. On the other hand, Congress did not define the term "taxable income" among the terms it chose to define in Section 7701.

[52] See Section 179(b)(1).
[53] See Section 179(b)(2).

It appears Congress did not define the term “taxable income” in Section 7701 because of the complexities of confounded (Internal Revenue Tax, Section 7701(14) Taxpayer) interrelationships. Construing the meaning of “taxable income” in a given statute becomes confusing when court decisions and administrative rules and regulations fail to distill [(endogenous subtitle internal revenue tax), (endogenous subtitle taxpayer, exogenous subtitle taxpayer)] combination significance.

Here, the term “Exogenous Taxable Income” refers to the combination of an endogenous subtitle internal revenue tax and a person who is defined as a taxpayer solely because of the imposition of an exogenous subtitle internal revenue tax. That is, Exogenous Taxable Income = f(Endogenous Subtitle Internal Revenue Tax, Exogenous Subtitle Taxpayer).

For purposes of this article, the term “Endogenous Taxable Income” implicates the combination of endogenous subtitle internal revenue tax and a person who is defined as a taxpayer, *inter alia*, because of the imposition of an endogenous subtitle internal revenue tax. That is, Endogenous Taxable Income = f(Endogenous Subtitle Internal Revenue Tax, Endogenous Subtitle Taxpayer). Importantly, Endogenous Taxable Income ≠ Exogenous Taxable Income because of the fineness of the subtitle taxpayer distinction.

It can be said that Endogenous Taxable Income is meaningful because it has actual internal revenue tax consequences while, at the same time, it can be said Exogenous Taxable Income is not meaningful because it has illusory internal revenue tax consequences. Endogenous Taxable Income has actual internal revenue tax consequences because the incidence of the Endogenous Subtitle Internal Revenue Tax befalls the Endogenous Subtitle Taxpayer. Exogenous Taxable Income has illusory internal revenue tax consequences because the incidence of the Endogenous Subtitle Internal Revenue Tax is not the Exogenous Subtitle Taxpayer. Accordingly, (Endogenous, Exogenous) distinctions are valid when construing Section 179(b)(3) as contextually qualified by Section 179(d)(8), if only because of this distinction.

First, since the definition of a taxpayer within the meaning of the Section 179(b)(1) and (2) dollar limitation is without "taxable income" distinction, then Section 179(d)(8)'s contextual qualification of that provision with respect to partnerships and partners is likewise without distinction. This lack of taxable income distinction means Section 179(b)(1) and (2)'s dollar limitation should be construed to properly apply at both the partnership and partner levels.[54]

On the other hand and because Exogenous Taxable Income is endowed with illusory internal revenue tax consequences, Section 179(d)(8)'s contextual qualification of Section 179(b)(3)(A) means the business income limitation does not apply at the partnership level.[55] Likewise and because Endogenous Taxable Income is endowed with actual internal revenue tax consequences, Section 179(d)(8)'s contextual qualification of Section 179(b)(3)(A) means the business income limitation does apply at the partner level.[56]

In construing any statute throughout Title 26, U.S.C., the foregoing taxpayer and taxable income distinctions should be adopted as the authoritative guide unless Congress clearly speaks otherwise. Else, the inherent confusion materially, significantly, and adversely affects risk-return combinations and the allocation of scarce resources.[57] This is so because such confusion results in widening the expected outcome's variance, concomitantly lowering its expected return. As

[54] Later in this article I explain Congress's substantive underlying policy objective in applying the dollar limitation at the partnership level is to increase or sustain contributions to America's productivity through ordinal diversification or Section 704(b) special allocations.
[55] Later in this article I explain applying the business income limitation at the partnership level frustrates Congress's aforedescribed policy objective.
[56] Later in this article I explain by contextually qualifying the business income limitation with the Section 469(c)(1)(B) participation conclusive presumption Congress adds to its policy objectives. However, any attempt to contextually qualify the business income limitation with the Section 469(c)(1)(A) activity conclusive presumption simply doesn't make any productivity contribution policy sense.
[57] See D. R. Jenkins, "Section 469(c)(7) Procedure, Practice, and Regulatory Implications," *Journal of Taxation*, 125(6), December 2016, pp. 270-278; D. R. Jenkins, "Treasury's Contract Harvesting Farming Business Definition Executive Fiat," *Drake Journal of Agricultural Law*, 22(2), Summer 2017, forthcoming (Contract Harvesting Paper); and D. R. Jenkins, "Treasury's Passive Activity Interest Abuse of Power," *Journal of Taxation of Investments*, 34(3), Spring 2017, pp. 51-69 (Treasury's Abuse of Power Paper).

demonstrated later in this article, such a confused outcome undermines the articulated policy objective.[58]

When provisions like Section 703 refer to the "taxable income of a partnership" it should be construed to implicate the (Exogenous: Endogenous) Taxable Income transition.[59] That is and under such circumstances, statutory construction must always transition illusory internal revenue tax consequences into actual internal revenue tax consequences. Inherently, Section 703 does speak in terms of the (Exogenous: Endogenous) Taxable Income transition because it declares the taxable income of a partnership shall be computed in the same manner as in the case of and individual with certain exceptions.[60]

Therefore, it can be said when the *Hayden* Tax Court compared Section 703's (Exogenous: Endogenous) Taxable Income transition to Section 179(b)(3)(A)'s Endogenous Taxable Income, it was comparing "apples to oranges." To this extent, then, the *Hayden* Tax Court's decision is clearly erroneous. Likewise and to the same extent, the *Hayden* Seventh Circuit's decision is clearly erroneous.

The (Endogenous, Exogenous) Taxable Income issue is inextricably intertwined with the issue that Section 469 contextually qualifies Section 179(b)(3)(A)'s business income limitation. That means the Section 179(b)(3)(A) taxpayer reference is limited to Section 469(a)(2) taxpayers. Since all Section 469(a)(2) taxpayers are subject to subtitle A internal revenue taxes, such contemporaneous statutory construction concomitantly limits the meaning of Section

[58] *Ibid*.
[59] The Fifth Circuit's decision in *Williams v. Commissioner*, 637 Fed. Appx. 799, 803 (5th Cir. 2016), captures the essence of the (Exogenous: Endogenous) Taxpayer transition (Thus, in a real sense an S corporation is not a taxpayer; rather, its shareholders are taxpayers. Because S corporations do not pay taxes directly, there was no need for Section 469 to include S corporations in its list of potential "taxpayers"). TRA86 committee reports support the *Williams* analysis and this article's notion of the (Exogenous: Endogenous) Taxpayer transition. See S.Rpt. 99-313, *supra*, at 740 (Rather, the activity rules generally are applied by disregarding the scope of passthrough entities such as partnerships and S corporations).
[60] See Section 703.

179(b)(3)(A)'s reference to taxable income to Endogenous Taxable Income. Accordingly, it can be said both the *Hayden* Tax Court and *Hayden* Seventh Circuit committed plain and obvious error by holding Section 179(b)(3)(A)'s reference to taxable income properly includes a reference to partnership taxable income. Moreover, by the measure of the foregoing analysis, Treasury's promulgation of Sections 1.179-2(c)(1) and (2) is an impermissible executive fiat.

III
Section 469's Contextual Qualification of Section 179

My article published in The Journal's Fall 2014 issue, "Why Section 530 of the Revenue Act of 1978 Applies to the States," gave birth to characterizing one statute construing the meaning of similar words or terms in other statutes as "contextual qualification."[61] Substantively, the *Rowan* Supreme Court's statutory construction technique underpins the meaning of the term.[62] A review of that decision's facts and holding makes the notion plain and obvious.

The *Rowan* taxpayer employed personnel on off-shore drilling rigs.[63] The employees were accommodated meals and lodging for the convenience of the employer within the meaning of Section 119.[64] Then prevailing Treasury Regulations recognized the authority of the Section 119 exclusion for Section 3402 income tax withholding purposes.[65] However, Treasury's regulations under Section 3101 (FICA tax) and Section 3301 (FUTA tax) required inclusion of the value of the Section 119 excluded meals and lodging.[66]

As explained in my 2014 article, the Supreme Court substantively held that when Congress enacted Section 119 it contextually qualified the meaning of wages for both subtitle A and subtitle

[61] See D. R. Jenkins, "Why Section 530 of the Revenue Act of 1978 Applies to the States," *The Contemporary Tax Journal*, 4(1), Fall 2014, pp. 9-20 (Section 530 Paper).
[62] See Section 530 Paper *citing Rowan*, *supra*.
[63] *Ibid*.
[64] *Ibid*.
[65] *Ibid*.
[66] *Ibid*.

C purposes.[67] Accordingly, the Court held Treasury's Sections 3101 and 3301 regulations to be invalid.[68] As a result, it can be said my Section 530 Paper recognizes contextual qualification may be a function of relative juxtaposition in the United States Code.[69] Importantly and since Section 530 of the Revenue Act of 1978 sits outside the entire United States Code, it contextually qualifies the term employee for purposes of the entire United States Code.[70]

In a *Journal of Taxation* article I explained that by properly invoking a plan asset rule exception a conclusive presumption results that the Section 4975 impounded investment risk diversification standard is contextually qualified to be on a par with investment risk diversification for a public security portfolio and, therefore, policy compliant.[71] In a *Journal of Pension Planning & Compliance* article I explained Section 4975 contextually qualifies ERISA's[72] policy provisions by impounding Section 4975 management and investment risk diversification policy requirements. In the same article I explained the tax code's enforcement provisions contextually qualify its policy empowering provisions because the former reveals the breadth and scope of the latter.[73]

To this end, it can be said Section 469 contextually qualifies Section 179. Section 469's passive activity rules operate similar to an enforcement provision because that section defines boundaries for determining when a taxpayer actively conducts a trade or business for purposes of taking loss deductions generated by any other tax code provision. While Section 469's statutory language does not expressly say as much, the underpinning committee reports do say as much.[74]

[67] *Ibid*.
[68] *Ibid*.
[69] See Section 530 Paper, *supra*.
[70] *Ibid*.
[71] See D. R. Jenkins, "Building Prohibited Transaction Chinese Walls for Retirement Plan Investment Structures," *Journal of Taxation*, 123(5), November 2015, pp. 218-30 (Jenkins' PTCW Paper). Also see D. R. Jenkins, "Got Your Assets Covered?," *Journal of Pension Planning & Compliance*, 42(2), Summer 2016, pp. 1-25, at 9.
[72] ERISA refers to the Employee Retirement Income Security Act of 1974, Pub.L, 93-406, 88 Stat. 829 (September 2, 1974).
[73] *Ibid* at 11.
[74] See General Explanation of the Tax Reform Act of 1986, Pub. L. 99-514, at 218 (1987) (The passive loss rule applies to all deductions that are

Section 469 provides losses from passive activities are disallowed.[75] Importantly, Section 469(a)(2) limits the provisions application to individuals, estates, trusts, closely held C corporations, and any personal service corporation. It notably does not apply to partnerships or S corporations.[76]

A passive activity is defined as any activity which involves a trade or business in which the taxpayer does not materially participate.[77] It is plain and obvious that the complement of "does not materially participate" is "actively conducts." This is the heart of the Section 469(c)(1)(B) participation conclusive presumption.[78] Thus, it can be said that a taxpayer who materially participates in a trade or business actively conducts such trade or business.

Because partnerships and S corporations are not Section 469(a)(2) taxpayers, the Section 469(c)(1)(B) participation conclusive presumption does not apply to those entities.[79] Thus, while it can be said a partnership or S corporation may conduct a trade or business, it cannot be said, within the meaning of Section 469, that a partnership or S corporation can be conclusively presumed to *actively* conduct a trade or business.[80]

Had the *Hayden* taxpayer raised the issue that Section 469 contextually qualifies Section 179's business income limitation, both the *Hayden* Tax Court and *Hayden* Seventh Circuit decisions would have had a different outcome. The Supreme Court made it clear that courts are required to

from passive activities.) Also see, Conference Report, Tax Reform Act of 1986 (H.R. 3838), at II-139 (1986) (It is clarified that the passive loss rule applies to all deductions that are from passive activities . . .).

[75] See Section 469(a)(1).

[76] However, either a partnership or an S corporation can be a Section 469(c)(7) taxpayer for purposes of a rental real property Section 469(c)(1)(A) activity conclusive presumption. But, they are not taxpayers for purposes of the Section 469(c)(1)(B) participation conclusive presumption as defined by Section 469(h)(1). See Section 469 Paper, *supra*.

[77] See Section 469(c)(1).

[78] See Section 469 Paper, *supra*.

[79] *Ibid*. Also see *Williams*, *supra*.

[80] *Cf.* J. W. Lee, "'Active Conduct' Distinguished from "Conduct" of a Rental Real Estate Business," *Faculty Publications*, *William & Mary Law School Scholarship Repository*, (1972) available at: http://scholarship.law.wm.edu/facpubs/610/.

consider contemporaneous statutory construction in determining Treasury Regulation validity.[81] In TRA86, Congress concomitantly—

1. Changed Section 179(d)(8) to its present reading,[82]
2. Introduced the Section 179(b)(3)(A) business income limitation, *and*
3. Introduced Section 469's passive activity loss rules.

Accordingly, the Supreme Court's mandate to give a contemporaneous construction to Section 179(b)(3)(A)'s business income limitation involves all three provisions, one in relation to the other.

It is plain and obvious multiple references to a "taxpayer" within the same tax code section can mean different things. For example, we know Section 469(c)(1)(B)'s participation conclusive presumption only applies to Section 469(a)(2) taxpayers meeting the Section 469(h)(1) material participation requirements.[83] At the same time, Section 469(c)(7) taxpayers are Section 7701(14) taxpayers (any subtitle taxpayers), a larger set of taxpayers than the set of Section 469(a)(2) taxpayers (subtitle A taxpayers).[84] This means that any taxpayer among the larger set of Section 7701(14) taxpayers can establish the Section 469(c)(1)(A) activity conclusive presumption for rental real property trades or businesses.[85]

Since only Section 469(a)(2) taxpayers can be conclusively presumed to *actively* conduct a trade or business, then the Section 179(b)(3)(A) requirement that the taxable income be "derived from the *active conduct by the taxpayer* of any trade or business" limits the taxpayer definition for

[81] See *Rowan*, *supra*, at 253 *citing National Muffler Dealers Association v. United States*, 440 U.S. 472, 477 (1979).
[82] Prior to TRA86, Section 179(d)(8)'s scope was limited to Section 179(b)(1)'s dollar limitation. The generalized wording of Section 179(d)(8) imposes a requirement to consider whether any subsection (b) limitation, present or future, applies at both the partnership and partner levels. As in the case of Section 179(b)(3)(A), it does not apply at both the partnership and partner level because of the express wording of that paragraph.
[83] See Section 469 Paper, *supra*.
[84] *Ibid*.
[85] *Ibid citing Aragona Trust v. Commissioner*, 142 T.C. 165 (March 27, 2014).

that subparagraph (A) purpose to Section 469(a)(2) taxpayers.[86] Moreover and since the commonality of Section 469(a)(2) taxpayers is that they are all subject to subtitle A internal revenue taxes, the Section 179(b)(3)(A) term "taxable income" points solely to the notion of Endogenous Taxable Income explained in an earlier section in this article. Since neither partnerships nor S corporations are taxpayers characterized by Endogenous Taxable Income,[87] it can be concluded the *Hayden* Tax Court and *Hayden* Seventh Circuit committed plan and obvious error by ascribing Section 179(b)(3)(A) taxable income to partnerships (or S corporations).[88]

[86] *Emphasis added*.
[87] It does not point to either Exogenous Taxable Income or the (Exogenous: Endogenous) Taxable Income transition either.
[88] See *Rowan*, *supra citing Nat'l Muffler Dealers Ass'n*, *supra.*

IV
Why the Hayden *Decisions and Sections 1.179-2(c)(1) and (2) are Inconsistent with Congressional Intent*

The other lesson derived from Supreme Court statutory construction jurisprudence is that the judicial department should consider a statute's underpinning Congressional intent.[89] This statutory construction tenet is made more important when considering the legislative history of Section 179(d)(8). Recall Section 179(d)(8) was first made a part of the expensing provision by TRA76. There, however, the paragraph was limited to expressly providing Section 179's dollar limitation applied to both partnerships and partners.[90]

When Congress transitioned Section 179(d)(8) in TRA86 to its general subsection (b) application, as it reads today, it didn't explain any underpinning policy objective or provide guidance as to how the changed provision should be construed. As a result, executive and judicial department authorities are required to consider both a particular subsection (b) limitation's express language and underpinning policy objectives in determining the scope of Section 179(d)(8)'s relative application at both or either the partner and partnership levels.[91]

It was made clear by TRA76 that Congress intended Section 179's dollar limitation to be applied to both partnerships and partners. Understanding the economic consequences of applying the dollar limitation at both the partnership and partner levels reveals Congress's underpinning policy objective. Realizing how that policy objective is fulfilled supports a conclusion Congress intended TRA86's revised Section 179(d)(8) continue the dollar limitation's application at both the partnership and partner levels.

[89] See *Rowan*, *supra citing Correll*, *supra.*
[90] Similarly, TRA76's Section 179(d)(8) equally applied to S corporations and S corporation shareholders.
[91] See *Rowan*, *supra*, and *Correll*, *supra*.

Earlier in this article it was declared the plain and obvious Section 179 policy objective is to provide an impetus to small business capital formation. By accelerating the expensing of Section 179 property, Congress is trading off current tax revenues for increased investment in trade or business activities that contribute to or sustain America's productivity.[92]

Counseling practical constraints makes the realization of this policy objective achievable. Many upstart entrepreneurial ventures, the kind that crystallize the Section 179 policy objective, involve operating partners who lack sufficient cash equity and credit worthiness to get proper funding to commence a small business venture.[93] The partnership tax laws favor such operating partners finding a capital partner to buttress the venture's financial shortcomings.[94] Such operating and capital partner marriages increase or sustain contributions to America's productivity at the margin, Congress's Section 179 inception policy objective.

Section 179's dollar limitation, when applied to partnerships, is a weak form of policy imposed diversification. If the dollar limitation applied only at the partner level a capital partner could absorb his or her total Section 179 dollar limitation expensing benefit from a single partnership. Because the Section 179 dollar limitation also applies at the partnership level, then the operating partner's participation in the Section 179 expensing benefit means the capital partner must become a capital partner in more than one partnership to gain maximum Section 179 expensing benefits in a given taxable year. Thus, from the perspective of the Section 179 expensing benefit, the capital partner must invest in more than one activity and not put all his or her eggs in one trade or business basket.[95]

[92] Congress doesn't take this empowerment lightly. It invests today's tax benefits to ensure continued contribution to America's productivity.
[93] See D. R. Jenkins, "Simple Substantial Economic Effect Regulatory Compliance," *The EA Journal*, 33(5), September/October 2015, pp. 14-19 (Jenkins *EA Journal* Article).
[94] *Ibid*.
[95] In order for a capital partner to benefit from Section 179 expensing, the capital partner must establish the Section 469(c)(1)(B) participation conclusive presumption. In other words, material participation is a form of "know-how" succession planning affecting all sectors of society. That is, the capital partner is empowering the operating partner with business acumen. See Treasury's Abuse of Power Paper, *supra*.

I refer to this weak form policy-based diversification requirement as "ordinal diversification."[96] The imposed diversification requirement is considered weak because the policy merely distills the maxim of not putting all of one's eggs in one basket. That is, there is no required policy compliant diversification degree, *per se*. Therefore, Section 179's dollar limitation impounds an ordinal diversification policy requirement. The transparent policy goal is to create more certainty in contributing to or sustaining contributions to America's productivity through such ordinal diversification.[97]

Based on the implicit ordinal diversification policy requirement, Section 179's dollar limitation does not impair America's productivity, but improves it by improving the certainty of the contribution. Therefore, notwithstanding Section 179(d)(8)'s (TRA76: TRA86) transition, Section 179's dollar limitation has positive consequences for upstart trade or business capital formation. Accordingly, underpinning policy objectives support construing post-TRA86 Section 179(d)(8) as implicating the dollar limitation at both the partnership and partner levels.

An alternative dollar limitation strategy is to specially allocate Section 179 expensing to one partner, usually the capital partner.[98] Congress's policies support special allocations in furtherance of increasing or sustaining contributions to America's productivity.[99] Special allocations ensure business venture startups, at the margin, don't go unfunded.[100] Substantiality's

[96] Congress typically characterizes cardinal diversification policy requirements by and through employing a disqualified person criterion. The Section 4975(e)(2)(G) fifty percent or more disqualified person criterion impounds a policy requirement majority investee entity decision-making manifest at least any two out of three capital equity interest holding combinations or greater diversification. Such management risk diversification policy compliance enables access to plan asset rule exceptions. This threshold cardinal diversification policy empowers the plan participant to transform self-dealing activities into incidental benefits. Prohibited transaction determinations are thereby avoided. See Jenkins' PTCW Paper, *supra*. Here, the investee operating company is usually a taxable C corporation to avoid adverse Section 512 unrelated business taxable income.
[97] Congress characterized the Section 409(p) disqualified person criterion at ten percent or more. When deemed share ownership manifests a majority through at least any six out of eleven plan participants or greater diversification, the incremental benefit is that the Employee Stock Ownership Plan (ESOP) can own S corporation stock without disqualification. Thus, S corporation ESOP earnings accumulate tax-free. See D. R. Jenkins, "Section 409(p)'s Economically Substantive Succession Planning Policy Implications," *Employee Benefit Plan Review*, 71(4), October 2016, pp. 24-28; D. R. Jenkins, "Management Company ESOP Structures and the Insurable Interest Doctrine," *Employee Benefit Plan Review*, 71(5), November 2016, pp. 5-12; and, D. R. Jenkins, "Management Company ESOP Structures, the Transfer for Value Doctrine, and the 3-Year Pull-Back Rule, " *Employee Benefit Plan Review*, 71(9), March/April 2017, pp. 11-17.
[98] See Jenkins *EA Journal* Article, *supra*.
[99] *Ibid*.
[100] *Ibid*.

conclusive presumption usually translates the capital partner's commitment to assuring the venture is a going concern for a period of no less than ten years.[101] In the competition for the allocation of scarce resources, such special allocations reduce a venture's cost of capital and improves its economies of scale.[102]

Whether ordinal diversification or special allocations manifest the capital partner's Section 179 depreciation deduction, Congress's action to impose the dollar limitation at the partnership level assures its policy objective to increase or sustain contributions to America's productivity. That is, the application of Section 179(d)(8) at both the partnership and partner levels for purposes of the Section 179 dollar limitation is consonant with Congress's policy objective underpinning the initial 1958 enactment of the expensing deduction. The same cannot be said for applying the business income limitation at the partnership level.

The prior discussion concerning Section 469's contextual qualification sufficiently demonstrates Section 179's business income limitation does not apply to partnerships or S corporations. Nonetheless, underlying policy considerations make it more clear that Congress intended TRA86 Section 179(d)(8)'s purview is subject to any subsection (b) limitation's plain language to determine whether a given limitation applies to just partners or to partners and partnerships alike.

It is beyond the pale this article establishes that considering the expensing provision's dollar limitation at the partnership level is grounded in 1958's objective to improve small business capital formation and assure increased or sustained contributions to America's productivity. It is not unusual for small business startups to incur losses for one or more periods.

[101] *Ibid*.
[102] See Contract Harvesting Paper, *supra*. Also see Treasury's Abuse of Power Paper, *supra*.

Therefore, if the business income limitation applies at the partnership or S corporation level, as it did in *Hayden*, then the expensing benefit may not be fully realized for one or more periods beyond commencement. The benefit delay and uncertainty as to taxable income realization translates impaired economies of scale and higher costs of capital. Capital partners are less likely to bring needed equity and credit worthiness to the table and, as a result, many upstart business ventures will go unfunded.

Nothing could be more contrary to the provision's 1958 policy objective to encourage small business capital formation with an eye toward increasing or sustaining contributions to America's productivity. That is, applying the business income limitation at the partnership level, *prima facie*, is inconsistent with Congress's underlying policy objectives. Moreover, it is also clear Section 1.179-2(c)(1) and (2)'s impermissible promulgation truncates this underpinning policy objective.

The *Hayden*-esque emphasis on applying the business income limitation at the partnership level masks the real incremental policy objective. The relation between capital partner active and passive income manifests the importance of the Supreme Court's contemporaneous construction mandate. As discussed, Section 179's business income limitation and Section 469's passive activity rules were concomitantly enacted in TRA86.

Congress's underpinning objective in enacting the passive activity rules was to stop the drain of economic resources allocated to activities having the sole objective of producing tax avoidance.[103] Similarly, Section 179's business income limitation forecloses the ability to apply Section 179 expensing to passive income. That is, by and through the business income limitation, Congress was making it clear it was not empowering the use of the Section 179 depreciation

[103] See Section 469 Paper, *supra*.

deductions to enlarge trade or business losses as a means to shelter capital partner passive income.

Congress did not want the capital partner to merely invest in a trade or business activity to benefit from Section 179 expensing. The business income limitation's active conduct of a trade or business requirement coalesces Section 469(c)(1)(B)'s participation conclusive presumption fulfilled through the Section 469(h)(1) material participation requirements.

Congress intended capital partners materially participate in the conduct of a trade or business activity to enjoy the benefits of Section 179 expensing. The "active conduct" or "material participation" requirement is a form of policy-driven exogenous succession planning.[104] That is, Congress is allowing capital partners to enjoy Section 179 expensing benefits provided they materially participate, which necessarily translates sharing their business acumen with operating partners. That is, the overriding business income limitation policy objective at the partner level is to assure exogenous succession planning as a means for increasing or sustaining contributions to America's productivity.

Therefore, it has been demonstrated applying the business income limitation at the partnership level is undermines the small business capital formation policy while applying it at the partner level furthers the policy of assuring contributions to America's productivity. Beyond Section 469's contextual qualification of the plain language of Section 179(b)(3)(A)'s business income limitation, Congress's underpinning policies likewise favor applying Section 179(d)(8) at the partner level but not the partnership level for this particular subsection (b) limitation.

By erroneously imposing Section 179(b)(3)(A)'s business income limitation at the partnership level, the *Hayden* Tax Court, the *Hayden* Seventh Circuit, and Treasury Regulations

[104] See Treasury's Abuse of Power Paper, *supra*.

1.179-2(c)(1) and (2) undermine Congress's forgoing important policy objectives. Therefore, the United States Tax Court should reconsider its *Hayden* decision in a future case. Moreover, absent intervening Treasury action to correct its own impermissible regulations, the judicial department should hold Section 1.179-2(c)(1) and (2) to be invalid regulations because the regulatory provisions—

1. Do not correctly construe the plain meaning of the terms "taxpayer" and "taxable income" as used in Section 179(b)(3)(A),
2. Do not counsel that Section 179(b)(3)(A)'s business income limitation is contemporaneously and contextually qualified by Section 469's passive activity loss rules, and
3. Do not coalesce Congress's intent to give impetus to small business capital formation while assuring continued contributions to America's productivity.

V
Conclusion

This article breathes new life into the notion Section 179(b)(3)(A)'s business income limitation does not apply to partnerships and S corporations. Congress never intended Section 179(b)(3)(A)'s "taxpayer" include partnerships or S corporations, but only Section 469(a)(2) taxpayers not otherwise excluded by Section 179(d)(4). As a result, Section 179(b)(3)(A)'s reference to taxable income can only be a reference to Endogenous Taxable Income as that term has been defined in this article. Therefore, Section 179(b)(3)(A)'s business income limitation does not apply to partnerships or S corporations. Policy considerations demand the judicial department correct *Hayden's* authority on point and that Treasury Regulation Sections 1.179-2(c)(1) and (2) be adjudged invalid as an impermissible executive fiat.

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Latent Semantic Analysis: A Big Data Opportunity for Tax Research

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ABSTRACT

The underlying purpose of this article is to discuss latent semantic analysis (LSA) and its application and research opportunities in tax research. LSA is a Big Data research methodology that can assist researchers in identifying the underlying themes/topics in data. To illustrate, the authors apply LSA to almost 2,300 abstracts of articles in *Advances in Taxation*, *The Journal of the American Taxation Association*, and *National Tax Journal* to identify the major topics in academic tax research over the period 1979-2015 and examine differences across journals and across time. The authors also discuss how researchers can apply LSA methodology to specific tax and accounting topics, providing research opportunities that heretofore may have previously been impractical.

INTRODUCTION

Over the past several decades, more and more data from company websites, electronic databases, court cases, regulatory filings, accounting standard-setting processes, blogs, and even tweets are made readily available for public perusal and research analyses. Current computer technology has evolved to the point that data manipulation and analysis can be easily accomplished using created computer programs or packaged software programs (e.g., Tableau). Due to the magnitude of Big Data available and the potential research questions that can be addressed using these resources, researchers from various academic fields have begun applying Big Data methodologies to determine meaning and understanding from patterns or signals in available data.

The purpose of the current article is to discuss a specific research methodology, latent semantic analysis (LSA), and its application and research opportunities within tax research for Big Data applications. To illustrate LSA's ability to analyze large amounts of textual data and extract patterns and themes, this study applies LSA to the abstracts of 2,293 articles from three tax journals over the time period of 1979 through 2015.[1] The primary 12 tax topical areas are identified, which are addressed by 84.4% of these articles. These tax topics are examined for

[1] In LSA research, the terms "topics" and "themes" are used interchangeably.

differences both across journals and across time. The study then discusses a number of research opportunities for LSA application in tax and accounting research.

The remainder of this article is organized as follows. The next section discusses prior research that analyzes unstructured (textual) data, and describes LSA in particular. Then, results from applying LSA to tax journal abstracts are presented. Finally, the article concludes with suggestions for future tax research opportunities.

LITERATURE REVIEW

Data content can be disseminated in many forms: words, phrases, sentences, or narratives; numbers; and visuals, yet its meaning is left for the reader to interpret and understand based upon their own knowledge and contextual reference points. Over the years, content analysis is one of many approaches that has been used to examine data. Abbott & Monsen (1979, p. 504) define this form of analysis as:

> a technique for gathering data that consists of codifying qualitative information in anecdotal and literary form into categories in order to derive quantitative scales of varying levels of complexity.

With content analysis, a principal characteristic of the data is that they are objective, systematic, and reliable (Krippendorf, 1980). The goal of content analysis, as applied to textual data, is to analyze message content by systematically enumerating, coding, and classifying words and phrases (McConnell, Haslem, & Gibson, 1986). This research approach can have varying levels of complexity from a simple counting methodology (Hutchison, White, & Daigle, 2004; Hutchison & White 2004; Hutchison & White, 2003) to more sophisticated statistical approaches. It can also be used to determine meaning/understanding from the amount of content or actual space occupied on a printed page (Gray, Kouhy, & Lavers, 1995).

Qualitative content analysis is one method used to analyze textual data, which focuses on language as communication with attention to the content and contextual meaning of the text (Hsieh & Shannon, 2005). It seeks to go beyond merely counting words, to closely examining language for the purpose of classifying large amounts of text into categories which represent similar meanings, and can represent either explicit or inferred communication (Weber, 1990).

Financial and accounting researchers have utilized qualitative content analysis methodology with accounting data to ascertain associations between narrative content and firm performance, valuation, or stock returns. For example, this approach has been applied to the president's letter in the annual report (McConnell et al., 1986; Kohut & Segars, 1992), earnings announcement press releases (Hoskin, Hughes, & Ricks, 1986; Frances, Schipper, & Vincent, 2002), and MD&A (Tennyson, Ingram, & Dugan, 1990; Callahan & Smith, 2004). Results based upon numerous research studies suggest that narrative disclosures do have information relevance.

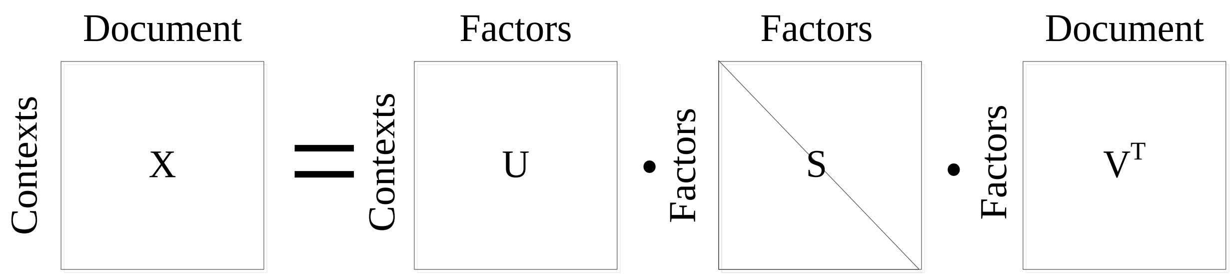
Latent Semantic Analysis

Within the area of content analysis, semantic analysis seeks to examine the linguistic or semantic elements of narrative data by relating syntactic structures. This approach reviews the words and/or linguistic structure of the disclosure narratives rather than the subject matter of the data. Specifically, it relates "syntactic structures, from the levels of phrases, clauses, sentences, and paragraphs to the level of the writing as a whole, to their language-independent meanings" (Goddard, 2013).

Using semantic analysis, Henry (2005) examined earnings press releases using linguistic tone and other stylistic attributes and found that they affect the market reaction to earnings announcements. Extending Henry (2005), Davis, Piger, & Sedor (2007) further examined earnings announcements and determined that managers use optimistic and pessimistic linguistic tone to provide useful information to the reader. Using a semantic approach, Yuthas, Rogers, & Dillard (2002) examined management disclosures in the annual report (both the President's Letter and MD&A) and determined managers communicated something about their own credibility to investors along with information about the firm. Cho, Roberts, & Patten (2010) applied semantic analysis to environmental reports, and results suggest that language and verbal tone are used to manage stakeholder impressions.

Currently, researchers are seeking to extend semantic analysis research by examining words and their context for underlying meaning by using LSA. From a research perspective, LSA can be viewed as a statistical model of word usage that allows the researcher to draw comparisons of semantic similarity between pieces of textual information (Foltz, 1996). This methodology assumes "there is some underlying, or 'latent' structure in the pattern of word usage across documents, and that statistical techniques can be used to estimate and define this latent structure" (Foltz, 1996). Specifically, LSA initially generates a matrix of occurrences of each word in each document under study and then uses singular-value decomposition (SVD), a technique closely related to eigenvector decomposition and factor analysis (see Figure 1). A key advantage of LSA methodology is that it can match two pieces of textual information even if they have no words in common (Foltz, 1996). (A detailed discussion of LSA can be examined in the Appendix of this article.)

Figure 1: Singular Value Decomposition (SVD)[2]



LSA was pioneered by researchers in psychology, information retrieval, and bibliometrics and has only recently been applied in the business discipline. One study used LSA to identify the intellectual core of the information systems discipline and identified five core research areas (Sidorova, Evangelopoulos, Valacich, & Ramakrishnan, 2008). Similarly, LSA has also been used to identify the intellectual core of real estate research (Winson-Geideman & Evangelopoulos, 2013b) and operations management research (Kulkarni, Apte, & Evangelopoulos, 2014), and to provide a comprehensive overview of the business processes literature and suggest directions for future research (Sidorova & Isik, 2010). Based upon article citations, LSA has also been utilized to chart the intellectual body of scholarly works based upon a specific author (F.W. Taylor) and textbook (*The Principles of Scientific Management*) (Evangelopoulos, 2011).

Quantitative Techniques and Journal Analysis

Recent research studies have used quantitative techniques to identify the top research themes across journals in accounting information systems (AIS) (Moffitt, Richardson, Snow, Weisner, & Wood, 2016) and real estate (Winson-Geideman & Evangelopoulos, 2013a). Moffitt et

[2] Adapted from Ashton, Evangelopoulos, and Prybutok 2014.

al. (2016) used text-mining techniques applied to AIS article abstracts for the period 1986-2014, to identify and examine the top research themes across three leading AIS journals (*Journal of Information Systems*, *International Journal of Accounting Information Systems*, and *Journal of Emerging Technologies in Accounting*) over this time period. Their text-mining techniques included part-of-speech tagging, pattern matching, term weighting, and search engine querying. Winson-Geideman & Evangelopoulos (2013a) used LSA applied to article abstracts from three leading real estate journals (*Real Estate Economics*, *Journal of Real Estate Finance and Economics*, and *Journal of Real Estate Research*) to determine and compare each journal's intellectual contribution to the real estate discipline.

LSA APPLIED TO TAX JOURNAL ABSTRACTS

Descriptive Statistics

LSA was selected as an appropriate method for the current research study's analysis to illustrate its application as a Big Data research methodology. This study applies LSA to article abstracts from three academic tax journals (*Advances in Taxatio*n (AIT), *The Journal of the American Taxation Association* (JATA), and *National Tax Journal* (NTJ) over the period 1979-2015, and then uses the results to provide insights into the most significant topical areas during the period examined. LSA provides an efficient method for content analysis that combines rigorous statistical techniques and scholarly judgement to categorize a large amount of unstructured, textual data (Kulkarni, Apte, & Evangelopoulos, 2014).

The current study's data are abstracts of tax research articles, as the abstract can be considered the best representation of the articles' research topic (Winson-Geideman &

Evangelopoulos, 2013b). To allow comparisons among journals, the authors chose June 1979, the release date of the first edition of JATA, as the start date for this study, and December 2015 as the end date. This research utilized article abstracts from AIT for the period 1987 to 2015; JATA for the period 1979 to 2015; and NTJ for the period 1979 to 2015. Accordingly, the abstracts cover a 37-year period, although AIT was only published during 29 of the 37 years examined. Abstracts were obtained electronically for JATA and NTJ from the EBSCO Host Business Source Complete database and hand-collected from published editions for AIT and then digitized.

The quantities of abstracts in each tax journal vary due to the number of volumes, issues, and articles published annually (see Table 1, Panel A). AIT typically publishes one edition per year. However, during the years under study, there were eight years in which no editions were published.[3] JATA published two editions per year during the study period, yet there were also supplements published in 11years.[4] NTJ regularly published four editions per year during the period examined.

[3] AIT did not publish editions in 1988, 1991, 1995, 2005, 2007, 2009, 2011, and 2013.
[4] JATA Supplements were issued for the years 1995 through 2005.

Table 1

Panel A
Journals, Volumes, and Issues Examined
1979-2015

Journal	**Volumes**		**Issues**	
	Number	*Percent*	Number	*Percent*
Advances in Taxation	22	*23.0%*	22	*8.7%*
The Journal of the American Taxation Association	37	*38.5%*	84	*33.2%*
National Tax Journal	37	*38.5%*	147	*58.1%*
TOTAL	96	*100.0%*	253	*100.0%*

Panel B
Journal Abstracts[5]
1979-2015

Journal	**Initial Sample**	**Deleted Abstracts**	**Final Sample**	***Final percent***
Advances in Taxation	188	1	187	*8.2%*
The Journal of the American Taxation Association	1,149	695	454	*19.8%*
National Tax Journal	2,007	355	1,652	*72.0%*
TOTAL	3,344	1,051	2,293	*100.0%*

Table 1, Panel A provides a summary of the volumes and issues examined. Overall, there were 96 total volumes published from 1979 through 2015: 22 for AIT (23.0%), 37 for JATA (38.5%), and 37 for NTJ (38.5%). There were also 253 issues related to these journal volumes: 22 for AIT (8.7%), 84 for JATA (33.2%) and 147 for NTJ (58.1%). Thus, NTJ published more total issues than AIT and JATA combined.

Panel B of Table 1 provides information on the sample selection. For all three tax journals

[5] Abstracts for book reviews, committee reports, doctoral research summaries, tax software reviews, editor reports, awards, discussions, replies, comments, remarks, corrections, introductions, and article summaries were not included in this study. Each abstract used in this study represents one article.

combined, there were 3,344 article abstracts initially collected: 188 for AIT (5.6%); 1,149 for JATA (34.4%); and 2,007 (60.0%) for NTJ. Because this study's goal is to examine tax topics in academic articles, the authors chose to limit the journal abstracts to those that focused primarily upon academic research. Accordingly, certain abstracts were deleted and removed from the sample. These included book reviews, committee reports, doctoral research summaries, tax software reviews, editor reports, awards, discussions, replies, comments, remarks, corrections, introductions, and article summaries. Deletions were 1 for AIT (0.1%), 695 for JATA (66.1%), and 355 for NTJ (33.8%). Please note that JATA and NTJ typically publish summaries of papers in the journal's issue, and JATA publishes a larger variety of items other than academic articles when compared to AIT and NTJ. The final sample for this study includes 2,293 abstracts: 187 for AIT (8.2%); 454 for JATA (19.8%); and 1,652 for NTJ (72.0%).

Results and Analysis

For this study, the authors applied LSA to the full sample of abstracts to identify the major topics in academic tax research over the past 37 years (1979 to 2015). SAS Enterprise Miner 14.2 and SAS Text Miner 14.2 were used to segregate text topics through a series of steps. Initially, the data file containing the full-length text abstracts were imported into SAS Enterprise Miner 14.2 from an Excel spreadsheet and then were converted from ASCII text format into a SAS table and SAS data file. This SAS dataset was then used for the natural language processing and textual analysis with SAS Text Miner 14.2 to generate the subsequent results (see Figure 2).

The horizontal axis of Figure 2 corresponds to the number of tax research topics extracted using the LSA methodology, while the vertical axis indicates the percentage of abstracts represented by those topics. Figure 2 shows that LSA identified nine tax research topics that are addressed by 78.89% of the journal abstracts, while 22 topics are addressed in 93.94% of the abstracts. For tractability, the authors chose to limit the current study's analysis to the 12 strongest tax research topics identified, since these primary topics are addressed by 84.39% of the 2,293 journal abstracts examined.

Figure 2

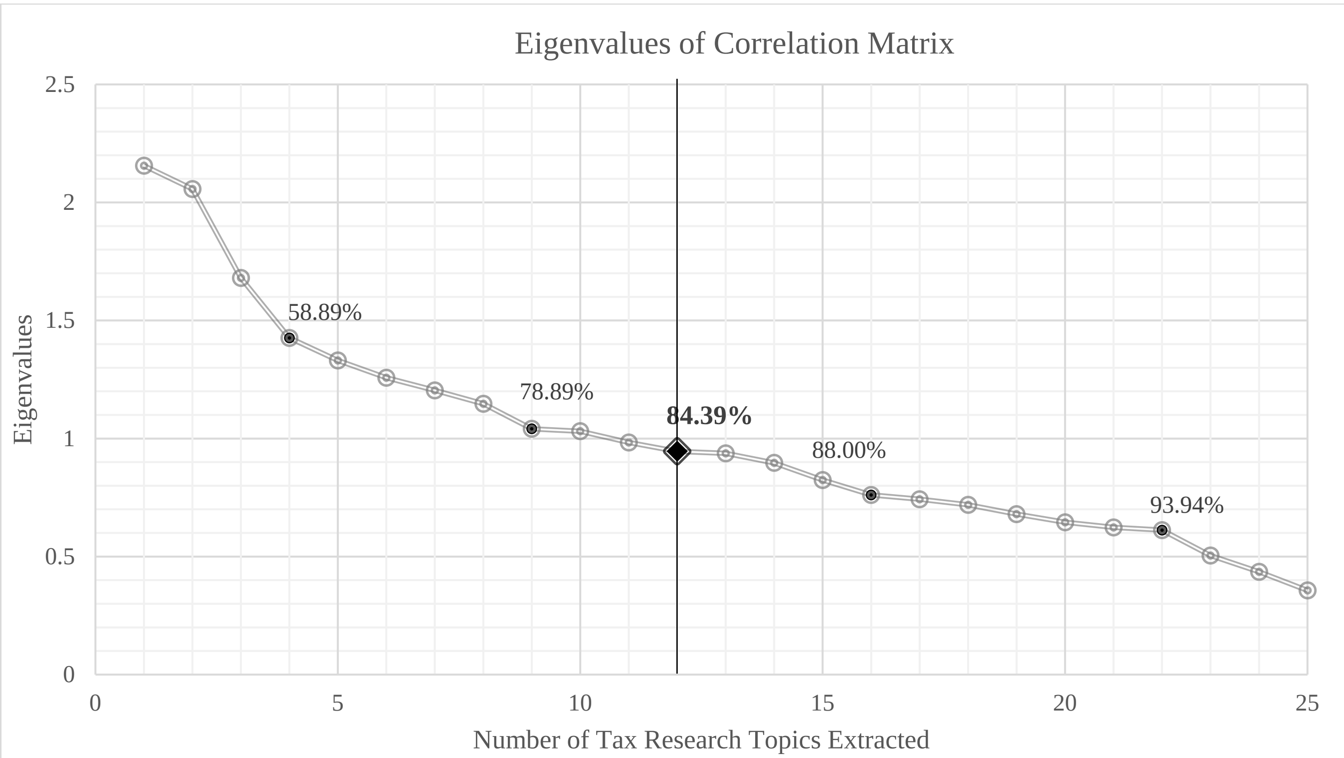


Table 2 presents a list of the strongest 12 Tax Research Topics identified from analyzing the full sample of abstracts.[6] Topics are ranked in order of the number of published papers related to a topic. It is important to remember that the number of published papers does not necessarily indicate the relative importance of that topic to a discipline. Articles are, in part, a function of data availability and preferences of journal editors, as well as other factors

[6] For each set of Terms identified, two of the authors independently determined a Tax Topic. Then they reconciled their differences after multiple passes to determine an agreed upon Tax Topic for each set of Terms.

(Winson-Geideman & Evangelopoulos, 2013a). In addition, this research examines abstracts, which do not capture article length, complexity, or incremental contribution to the literature (e.g., a paper's innovativeness). Nevertheless, this study's focus is to identify the major topics in academic tax research over the time period studied, and the number of published articles related to a tax topic provides a reasonable proxy of research effort and focus.

Table 2 indicates that there are 3,286 articles associated with the 12 Tax Research Topics identified. The LSA heuristic used in this study allows each article abstract to be associated with more than one topic, which results in more total documents associated with the 12 topics (N=3,286) than the source number of documents (N=2,293). Approximately half of the paper abstracts (49.2%) loaded on only one topic, while 35.8% loaded on two topics. The remaining 15% loaded on more than two topics. The most common reason for a two-factor loading was that a paper was associated with "Tax policy and tax reform," and also one of the other topics. Examination of these articles shows a paper that discusses "Tax policy and reform" in the context of (for example) the "Taxation of capital gains." There was also significant two-factor loading for "State and local taxes" and "Property taxes," which shared about one-third of the papers in common.

Table 2

Tax Research Topics: 12-Factor Solution for Full Sample[1] 1979-2015

	Terms	Tax Research Topics	No. of Articles
1	+policy,+system,+taxation,+reform,economic	Tax policy and tax reform	359
2	+elasticity,+estimate,+model,+price,+rate	Price elasticity	318
3	+firm,foreign,earnings,corporate,+corporation	Corporations and foreign earnings	317
4	+bond,+asset,+interest,+deduction,+tax-exempt	Effect of taxes on investment and financing	317
5	+income,+credit,+family,+taxpayer,+system	Income taxation of individuals	314
6	+state,local,+government,federal,fiscal	State and local taxes	299
7	+taxpayer,+compliance,+professional,+client,+audit	Taxpayer compliance	273
8	capital gains, +stock,+investor,+capital gain tax,+rate	Taxation of capital gains	261
9	+property,+school,property tax,+property tax,local	Property taxes	253
10	+sale,+sale tax,+state,+revenue,+business	State taxation of sales revenues and business income	229
11	+security,+retirement,+plan,social,+pension	Retirement plans, including social security	192
12	+health,insurance,care,+cost,+price	Health insurance	154
	Total Articles		3,286

[1] Ranked by number of articles.

Table 2 shows that "Tax policy and tax reform" is associated with the greatest number of articles (N=359 articles). This means that 15.7% of the 2,293 articles published in the three tax journals examined during 1979-2015 focused on tax policy and tax reform. This is not surprising for two reasons. First, as discussed above, tax policy and reform provides a broad research area which encompasses more specific topics. Second, tax legislation (both proposed and enacted) provides researchers with interesting questions and opportunities for impactful research. The next five topics identified in Table 2 are each associated with approximately 300 or more academic tax articles, which means that each topic is associated with more than 13% of the articles published in the three journals during 1979-2015. These topics are (in order): "Price elasticity," "Corporations and foreign earnings," "Effect of taxes on investment and financing," "Income taxation of individuals," and "State and local taxes."

Table 3 presents a list of the top 12 Tax Research Topics, but ranks each of the topics according to the number of published articles within shorter time periods (i.e., 7 to 10 years). This table thus shows how the relative importance of the topics has changed over time. The trend is consistent with proposed and enacted tax legislation during this period. The earliest time period (1979-1985) shows that state and local tax research topics were dominant, ranking first (State and local taxes) and third (Property taxes) in number of published articles. This reflects state-level reforms and legislation occurring prior to and during this period. For example, in 1978, California voters passed the highly-controversial Proposition 13 with a 64.8% voter majority, which initiated sweeping changes to the

California property tax system.[1] Although a single-state referendum, Proposition 13 drew national attention—Howard Jarvis (who co-sponsored the bill) made the cover of *Time* magazine after its passage. The "tax revolt" in California reflected taxpayer sentiments across the nation and was followed by tax relief initiatives in other states (e.g., Oregon, Washington, Colorado, and Massachusetts). Some people speculate that Proposition 13 was the prelude to the Reagan income tax cuts in 1981 (Moore, 1998).

[1] Among other changes, Proposition 13 generally caps tax rates at 1% of a property's assessed value, and limits real property tax assessment increases to 2% per year unless a property is sold.

Table 3

Decade-wise Analysis of Tax Research Topics[1]

	1979-1985 (7 years)	1986-1995 (10 years)	1996-2005 (10 years)	2006-2015 (10 years)
1	State and local taxes	Tax policy and tax reform	Tax policy and tax reform	Corporations and foreign earnings
2	Effect of taxes on investment and financing	Effect of taxes on investment and financing	Income taxation of individuals	Price elasticity
3	Property taxes	Price elasticity	Corporations and foreign earnings	Tax policy and tax reform
4	Income taxation of individuals	Taxpayer compliance	Taxpayer compliance	Income taxation of individuals
5	Tax policy and tax reform	Taxation of capital gains	Effect of taxes on investment and financing	Taxpayer compliance
6	Price elasticity	Income taxation of individuals	Taxation of capital gains	Taxation of capital gains
7	State taxation of sales revenues and business income	State and local taxes	Price elasticity	State taxation of sales revenues and business income
8	Corporations and foreign earnings	Property taxes	Retirement plans, including social security	Property taxes
9	Retirement plans, including social security	State taxation of sales revenues and business income	State and local taxes	State and local taxes
10	Taxation of capital gains	Corporations and foreign earnings	State taxation of sales revenues and business income	Health insurance
11	Taxpayer compliance	Retirement plans, including social security	Property taxes	Effect of taxes on investment and financing
12	Health insurance	Health insurance	Health insurance	Retirement plans, including social security

[1] Ranked by number of articles within the time period examined.

In each of the next two-time periods examined (1986-1995 and 1996-2005), "Tax policy and tax reform" was the dominant topic, with differences in the rankings of more specific topical areas. Most notably, "Income taxation of individuals" and "Corporations and foreign earnings" increased in their ranking during 1996-2005 period, while research related to state taxation dropped in the rankings. These relative changes in research focus reflect significant federal tax legislation occurring before and during this period, with the most notable being the Tax Reform Act of 1986 (TRA86). TRA86 made significant changes to the *Internal Revenue Code*, including lowering the top individual marginal tax rate from 50% to 28%.[1] Individual income tax rates were further changed by both increases (1990 and 1993) and decreases (2001 and 2003) in subsequent tax legislation.[2] Importantly, TRA86 also increased attention on the ability of multinational corporations to avoid or defer tax by transferring intangible property. Specifically, the Conference Committee Report on TRA86 recommended that the U.S. Treasury make a comprehensive study of the §482 regulations, with specific attention as to whether the regulations should be modified (these are commonly referred to as the transfer pricing regulations).[3] The U.S. Treasury and Internal Revenue Service (IRS) released their study in 1988. Then again in 1990, Congress directed the IRS to examine recent legislation aimed at increasing §482 compliance and to recommend further modifications (OBRA90, Committee Report 4821: Study of IRC §482). The IRS released that report in 1992.[4]

[1] Other significant tax legislation in the 1980's included the Economic Recovery Tax Act of 1981, Tax Equity and Fiscal Responsibility Act of 1982, and the Deficit Reduction Act of 1984. See http://www.taxpolicycenter.org/laws-proposals/ for a summary of major federal tax legislation from 1940 through the current year.
[2] Most notably, these include the Omnibus Budget Reconciliation Act (OBRA) of 1990, OBRA 1993, the Economic Growth and Tax Relief Reconciliation Act of 2001, and the Jobs and Growth Tax Relief Reconciliation Act of 2003.
[3] IRC §482 authorizes the U.S. Treasury Secretary to allocate income and deductions among commonly controlled businesses "in order to prevent evasion of taxes or clearly to reflect the income" of the businesses, and the §482 regulations provide the applicable standards and methodologies for determining transfer prices.
[4] See Green (1993) for a more detailed discussion.

As evidenced by the last column in Table 3, the topic of "Corporations and foreign earnings" continues to increase in importance. There have been more papers published during 2006-2015 on this topic than any other topic identified.[5] It is also worth noting that the ranking of "Health insurance" increased slightly during the last decade. Given the passage of healthcare reform in 2010 (Patient Protection and Affordable Care Act), and the Trump administration's efforts to repeal and/or replace significant portions of this act, health insurance will likely continue to increase in research importance.[6]

Because each of the tax journals used in the current study has a different audience, Table 4 presents a list of the top 12 Tax Research Topics separately for each journal, ranked according to the number of articles in each journal for the full time period (1979-2015). Differences among the rankings demonstrate the topical preferences of each journal. AIT's most highly-ranked topic is "Taxpayer compliance," followed by "Corporations and foreign earnings." Articles related to state and local taxation are ranked in the bottom half of the 12 identified tax research topics. In contrast, JATA's most highly-ranked topic is "Corporations and foreign earnings," followed by several federal tax topics. Articles regarding "Price elasticity" are ranked sixth, while topics involving state and local tax articles are among the bottom four (9, 10, 11). NTJ has the most diverse audience, including "academic, private sector, and government economists, accountants and attorneys, as well as business and governmental tax practitioners," and the broadest editorial policy—to publish "research on government tax and expenditure policies."[7] NTJ's audience and editorial policy is evident from the article rankings using LSA. Tax research topics involving state

[5] In 2004, Congress directed the U.S. Treasury to conduct three studies dealing with foreign-related earnings: the effectiveness of the §482 transfer pricing rules, with an emphasis on transactions involving intangible property; income tax treaties; and inversion transactions (e.g., American Jobs Creation Act of 2004, Committee Report 4821.099).
[6] Specifically, the Patient Protection and Affordable Care Act of 2010 and Health Care and Education Reconciliation Act of 2010.
[7] See NTJ's editorial policy (NTJ 2016).

and local taxation are highly-ranked among the topics identified (1, 5, 6), as well as "Tax policy and tax reform" (2) and "Price elasticity" (3)—this last topic being a research area more commonly pursued by economists than accountants.

Table 4

Tax Research Topics by Journal[8]
1979-2015

	AIT	*JATA*	*NTJ*
1	Taxpayer compliance	Corporations and foreign earnings	State and local taxes
2	Corporations and foreign earnings	Taxpayer compliance	Tax policy and tax reform
3	Effect of taxes on investment and financing	Effect of taxes on investment and financing	Price elasticity
4	Tax policy and tax reform	Taxation of capital gains	Income taxation of individuals
5	Income taxation of individuals	Income taxation of individuals	Property taxes
6	Taxation of capital gains	Price elasticity	State taxation of sales revenues and business income
7	Price elasticity	Tax policy and tax reform	Effect of taxes on investment and financing
8	Property taxes	Retirement plans, including social security	Retirement plans, including social security
9	Retirement plans, including social security	State taxation of sales revenues and business income	Taxation of capital gains
10	State taxation of sales revenues and business income	Property taxes	Health insurance
11	Health insurance	State and local taxes	Corporations and foreign earnings
12	State and local taxes	Health insurance	Taxpayer compliance
Total Articles	302 *(9.2%)*	683 *(20.8%)*	2,301 *(70.0%)*

Focusing upon the most recent time period in the study (2000-2015), Table 5 provides a ranking of the Tax Research Topics separately for each academic tax journal. The rankings for AIT and JATA are quite similar to their rankings for the full time period, while NTJ's rankings show the

[8] Ranked by number of articles in each journal.

most movement. Most notably, articles focused on "Corporations and foreign earnings" moved from a ranking of 11th (1979-2015) to 6th (2000-2015). The topics of "Tax policy and tax reform" remains a main focus of NTJ's articles, and "Price elasticity" is ranked first in this time period.

Table 5

Tax Research Topics[9]
2000-2015

	AIT	*JATA*	*NTJ*
1	Taxpayer compliance	Corporations and foreign earnings	Price elasticity
2	Corporations and foreign earnings	Taxpayer compliance	Tax policy and tax reform
3	Income taxation of individuals	Taxation of capital gains	Income taxation of individuals
4	Tax policy and tax reform	Effect of taxes on investment and financing	State and local taxes
5	Taxation of capital gains	Income taxation of individuals	State taxation of sales revenues and business income
6	Effect of taxes on investment and financing	Price elasticity	Corporations and foreign earnings
7	Price elasticity	Tax policy and tax reform	Retirement plans, including social security
8	Retirement plans, including social security	Retirement plans, including social security	Health insurance
9	State taxation of sales revenues and business income	State taxation of sales revenues and business income	Property taxes
10	Property taxes	Property taxes	Effect of taxes on investment and financing
11	Health insurance	State and local taxes	Taxation of capital gains
12	State and local taxes	Health insurance	Taxpayer compliance

TAX RESEARCH OPPORTUNITIES AND CONCLUSIONS

As illustrated in this article, LSA is a powerful text analysis methodology that can be used in tax and accounting research, providing research opportunities that may have previously been deemed impractical. Essentially, LSA can be applied to any textual data—including verbal, print,

[9] Ranked by number of articles in each journal.

or electronic, as well as textual data obtained from narrative responses, open-ended survey questions, interviews, and focus groups (Kondracki & Wellman, 2002). There are widely available technologies now to convert verbal data into textual data, making the application of LSA almost unlimited.

For tax researchers specifically, LSA can be applied to judicial decisions to determine (for example) differences and commonalities in reasoning used by different courts on the same issue, or by the same court across different issues. Transcripts of Congressional debates regarding tax legislation are now generally available and can be analyzed across political affiliation, geographic representation, or person-specific characteristics. Similar analysis could be contemplated with IRS rulings and notices, and Congressional committee reports. Further, most of these opportunities for textual analysis apply equally at the state level as well.[10]

For tax and accounting researchers more generally, LSA can be applied to firms' annual reports and SEC filings to examine (for example) the narrative in the firm's tax footnote, or transcripts of earnings conference calls to determine when and in what context tax issues are discussed. State and local governments also issue their own annual reports—a *Comprehensive Annual Financial Report* (CAFR), or a *Popular Annual Financial Report* (PAFR), to which LSA could be applied. CAFR's closely resemble a firm's annual report—including an MD&A section, auditor's report, financial statements, and detailed footnotes. As one would expect, taxation is a theme that permeates these CAFR's. Opportunities for analysis also applies to comment letters, which are available from both the Financial Accounting Standards Board (FASB) and Governmental Accounting Standards Board (GASB). These letters can be examined across entity type and issue, and it is worth noting that several significant statements have been issued recently that deal with

[10] For example, transcripts from the Illinois General Assembly are available at: http://www.ilga.gov/senate/transcripts/default.asp.

tax issues. For example, GASB Statement No. 77 requires state and local governments to disclose in their CAFRs any tax abatements affecting their revenue-raising abilities, effective 2016 or 2017, depending on the government's fiscal year-end. The GASB received 298 comment letters related to this statement (Francis, 2015). Thus, both comment letters and CAFRs provide textual information for analysis.

This research study has sought to discuss LSA, provide an application of LSA in tax research by using article abstracts from three academic tax journals (*Advances in Taxation, The Journal of the American Taxation Association,* and *National Tax Journal*), discuss those results, and suggest research opportunities for LSA application in tax research. While a counting methodology can be used for textual analysis, LSA extends that methodology by providing theory with an underpinning of statistics to reach its results. And importantly, LSA allows data to be assigned to multiple topics/themes. Because LSA can be applied to voluminous amounts of unstructured data (Big Data), it provides significant and interesting research opportunities that may not previously have been practical.

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Appendix

LATENT SEMANTIC ANALYSIS (LSA)

LSA is a natural language processing technique that extracts concepts from a matrix of terms to construct a pattern of words (Deerwester, Dumais, & Landauer, 1990; Kulkarni et al. 2014) and is bounded by the fundamental assumption that words that are similar in meaning will occur in similar sections of text. A collection of contexts, identified as either individual words or a collection of terms, is extracted from the data under investigation. Due to the central assumption of LSA, contexts with similar meaning will therefore occur in similar meaning documents. Through a process similar to traditional factor analysis, utilizing singular-value decomposition (SVD), LSA then establishes the common factors that represent the underlying concepts exhibited within the data and then are compiled in a term frequency matrix, which contains counts per terms.

A matrix containing counts of contexts per individual textual data segment (i.e., document, paragraph, or other designation of granularity) is constructed from the data. SVD is used to reduce the number of rows that represent contexts within the documents while preserving the similarity structure among columns representing each separate document (see Figure 1).

In an approach similar to principal component analysis, SVD generates simultaneous principal components for two sets of variables, the contexts (U) and the documents (V^T). These results produce two separate sets of factor loadings, one for each set of matrices, with each latent semantic factor associated with a set of corresponding high-loading terms and a set of high-loading documents. These can be interpreted to develop a fundamental word usage and association pattern, which are termed Factors or Themes. In a similar manner to traditional factor analysis, the researcher can dictate the number of factors to be extracted within LSA and therefore determine the level of granularity topics/themes that are identified.

The resulting LSA analysis approximates the influence of a word on the meaning of passages and vice versa. The similarity of the effects the words have on the passage is the interpretation of the derived relation between individual words, not the frequency of words in a passage. LSA allows for a word vector to represent a mixture of senses in comparison to contextual usage and not disambiguity in passage meaning formation. Due to the similarities to traditional factor analysis, cross-loadings and thus overlapping of topics can occur, and should be expected due to the nature of the utilized data source, academic tax journal abstracts.

Dimension Reduction for Topic Extraction

Due to the complexity of high dimensional data, the determination of the specific number of topics to extract that will provide meaningful context to the compiled collection of documents is a complex exercise. The extant literature provides several methods for the investigation and reduction of dimensionality of component matrices. Many of the current techniques rely upon various facets of the dimension reduction technique, principal component analysis (PCA). The three primary methods in use are: *percent variance*, *scree plot analysis*, and *sequential testing* (Jolliffe, 2002). Each method is contingent upon the eigenvectors generated by the sample variance–covariance matrix of the data during PCA with the ordered eigenvalues determining the rank of each extracted context. The percent variance approach attempts to simplify the selection process to a heuristic that defines a cutoff value for which a predetermined percentage of documents within the corpus are included by the addition of each subsequent ranked context. In comparison, scree plot analysis is a visual interpretation of gaps or "elbows" within the plotted magnitudes of each eigenvector to determine natural breaks within the extracted topics. Finally, the sequential testing approach attempts to repeatedly test the difference between the ordered eigenvalues in an attempt to locate statistically significant differences. Each of these three methods have their own benefits and shortcomings, which complicates the selection of an individual methodology.

The fundamental advantage of each of the three approaches is tied to the relative simplicity of analysis. As the approaches digress from a simple heuristic, to comparative visual analysis, to statistical tests, the ease in both application and interpretation declines. The primary detraction for both the percent variance approach and scree plot analysis is tied to the subjective nature of the determination of threshold or gaps. In addition, Zhu & Ghodsi (2006) highlight a problematic flaw concerning the validity of the sequential test approach as it relies on the assumption that the underlying data follow a multivariate normal distribution. Additionally Jolliffe expounds on this issue to surmise that "it's difficult to get even an approximate idea of the overall significance level because of the number of tests done is not fixed but random, and the tests are not independent of each other"(Jolliffe, 2002, sec. 6.1.4). Due to the variety of approaches available with no clear discernible predominant methodology and the heavy criticism for the parametric option, this study employed both an analysis of scree plots in conjunction with percentage of abstracts identified to determine the final number of topics extracted. Owing to the iterative nature of this methodology, this study includes the individual scree plot as well as the corresponding coverage values for reader perusal (see Figure 2).

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Tax Treatment of High-Tech Start-Up Costs

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Introduction

Due to the recent success of high-tech start-ups like Instagram, more and more people are looking into the possibility of being the next success story. The successful start-ups usually began with a few founders who got together with simple ideas to develop apps that are distributed via different platforms. Popular apps like Facebook, Box, and Snapchat were developed and their companies founded by college students. Many colleges now provide entrepreneurship-related programs to assist future start-up founders and innovators. For example, San Jose State University has the *Silicon Valley Center for Entrepreneurship* program to promote entrepreneurship among students by collaborating with investors and entrepreneurs.
[1] The University of California, Berkeley offers accelerator programs for the start-ups which stemmed from the school.[2]

Owning a business requires tax planning. Companies that are fortunate enough to make a profit must pay taxes on their generated income. On the other hand, businesses that are incurring expenses without generating any income may need to find a better way to utilize the tax benefits from their business activities. The purpose of this paper is to discuss tax treatment of high-tech start-ups by analyzing some of the relevant Internal Revenue Code Sections including §162 (trade or business expenses), §195 (start-up expenditures), and §174 (research and experimental expenditures).

<u>§162 Trade or Business Expenses</u>

§162 is pervasive in corporate taxation as it generally allows a deduction for business-related expenses. Although §162 does not clearly define what constitutes a trade or business, it provides

[1] San Jose State University (2017). *14th Annual Silicon Valley Innovation Challenge*. Retrieved from: http://www.sjsu.edu/svic/index.html
[2] University of California, Berkeley (2017). Skydeck is a program of the University of California, Berkeley. Available at: http://skydeck.berkeley.edu/

guidance to determine trade or business expenses and deductions. The question is whether or not start-ups that have not yet produced any income can be considered carrying on a trade or business.

In the 2017 U.S. Tax Court case, *Samuel J. Carrick v. Commissioner*, the taxpayer was denied deductions on the business expenses he claimed on his tax return because the court did not find that he was engaged in a trade or business.[3] Taxpayer Mr. Carrick had a bachelor's degree in electrical engineering and was employed full-time in San Diego. While still employed, he started two business ventures with other individuals. In 2013, he created a website similar to Angie's List, Yelp, and eBay. He spent time collecting data and developing software. He also traveled weekly from San Diego to Los Angeles to meet with his web developer. However, the venture fell apart, and the other members left. He ended the website business before the end of 2013. In 2014, he started another venture and planned to research and develop a device that would prevent swimmers and surfers from being bitten by stingrays. He researched at the beach by interviewing swimmers and surfers, but never actually developed any devices. The IRS disallowed the claimed deductions for meals and entertainment, travel, and car and truck expenses, which were roughly 35% for 2013, and 42% for 2014, of the expenses he claimed, because the taxpayer, according to the IRS, failed to carry on a trade or business. Even if the taxpayer might have carried on a trade or business, any traveling expenses, including meals and entertainment-related activities, must be substantiated to support the deduction.[4] The IRS's decision was based on the premise that the taxpayer's activities were merely preparatory to the beginning of an active trade/business and therefore considered start-up work because true business activity never commenced. The court held that preparatory expenses are not qualified for ordinary and necessary expenses in a trade or business and subsequently denied the claimed §162 deductions.

Two primary requirements must be met in order to claim deductions on business expenses: the expenses must be incurred in a trade or business, and they must be ordinary and necessary.[5] In the U.S. Supreme Court case of *Welch v. Helvering* in 1933, the Court ruled that the business

[3] T.C. Summary Opinion 2017-56.
[4] IRC §274(d)(1) and (2).
[5] IRC §162

expenses must be ordinary and necessary to be deductible.[6] The taxpayer in the case filed for bankruptcy and was discharged from his debts, but later on paid the discharged debts and deducted these payments as ordinary and necessary business expenses. His reasoning was to re-establish his business relations with customers. There was no doubt that the taxpayer, who was the Secretary of the E. L. Welch Company and worked as a commission agent for the company, carried on a trade or business. However, the question was whether or not paying off the discharged debts to restore his customer relations could be considered ordinary and necessary business expenses. The IRS asserted that the payments were capital expenditures rather than qualified expenses because the taxpayer's purposes were to rebuild his reputation and goodwill. The Court agreed with the IRS.

Another often-cited Tax Court case, *Frank v. Commissioner,* showed that it might be difficult to prove that the expenses were ordinary and necessary without carrying on a trade or business.[7] In this case the taxpayers, husband and wife, incurred travel and legal expenses in searching for a new business and claimed the deductions on the expenses. The court denied the deductions by addressing that the taxpayers were not engaged in any trade or business. The expenses of investigating and looking for a new business were preparatory works that could not be deductible as business expenses because there was no trade or business at that time. In 2017, the Tax Court in Mr. Carrick's case made the same argument. Preparatory works were not carrying on a trade or business, so they could not be qualified as ordinary and necessary expenses.

The tax code that the taxpayers in these cases intended to apply to was §162. Per §162(a), all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business are generally allowed as a deduction. However, it may be difficult for taxpayers who do not offer products or services and who do not have customers to prove that they are actually carrying on a trade or business. In spite of these rules, taxpayers can still potentially take advantage of start-up expenditures under §195 and research and experimental expenditures under §174.

[6] *Welch v. Helvering*, 290 U.S. 111, 115 (1933).
[7] *Frank v. Commissioner*, 20 T.C. 511, 513-514 (1953).

§195 Start-Up Expenditures

Tax planning in the first year of a business is very critical. Some of the tax incentives available for a newly-created business must be adopted in the first taxable year. If the start-up misses the first-year window, it may lose some tax benefits unless it files an amended return and requests permission from the IRS. §195 is a good example.

The purpose of §195 is to give a favorable tax treatment to start-ups since start-up costs are not eligible for a deduction under §162. Start-up costs are, by definition, any amount paid or incurred "before the day on which the active trade or business begins."[8] In 1980 Congress enacted §195 as part of Public Law 96-605 to allow taxpayers to amortize start-up costs.[9] Under the original §195 tax law, taxpayers could elect to defer and amortize all start-up expenditures over a 60-month period. The current §195(b), amended by Public Law 108-357, enacted on October 22, 2004, allows taxpayers to elect to potentially deduct some startup business expenses immediately without having to amortize them. Taxpayers may elect to deduct the allowable amount in the year in which the business commences. The limit for the immediately deductible start-up expenses for the taxable year is $5,000, reduced by the amount exceeding $50,000. The remaining start-up expenditures can then be amortized over 180 months, beginning with the month when an active trade or business commences. For example, if a taxpayer starts a business on July 1st and incurs $51,000 of start-up expenditures, the taxpayer can elect to deduct a total of $5,566 ($4,000 for the first-year maximum immediate deduction allowance plus $1,566 (the $261 monthly amortization amount times six months in the first year).

Other qualified start-up business expenses include the investigation cost for looking for an opportunity and the creation cost of establishing a business. It could be difficult for taxpayers to understand what start-up costs consist of and how the costs are treated. It is recommended that taxpayers create a timeline and divide start-up expenditures into two parts:[10]

[8] IRC §195(c)(1)(iii).
[9] U.S. 96th Congress (1979-1980). H.R.7956 - *Miscellaneous Revenue Act of 1980*. Retrieved from: https://www.congress.gov/bill/96th-congress/house-bill/7956/committees
[10] Maples, Larry and Earles, Melanie James. October 31, 2000. *How to Scale the Deduction Barriers*. Journal of Accountancy. Retrieved from: http://www.journalofaccountancy.com/issues/2000/nov/howtoscalethedeductionbarriers.html.

1. Investigation costs – costs incurred before decision to start a business.
2. Creation costs – costs incurred after the decision to start the business but before commencing a business.

In the early stages of a business it is important to distinguish start-up expenses[11] from organizational expenditures.[12] Businesses can potentially currently deduct organizational expenditures up to $5,000 (depending on the total amount of organizational expenditures) and amortize the remainder over a 60-month period beginning with the month when an active trade or business commences if the costs are incidental to the creation of the business and chargeable to the capital account. Start-up expenditures are deducted in the same manner as organizational expenditures, but pertain to expenses incurred after the company has been formed but before it opens up for business.

In the earlier discussed *Carrick* case, although the IRS denied Mr. Carrick's business deductions under §162, the IRS allowed his §195 deductions. As long as start-up expenditures are reasonable, taxpayers should be allowed to use §195 once the active business begins. Taxpayers should keep all documents to support their claim of start-up expenses and deductions.

<u>§174 Research and Experimental Expenditures</u>

High-tech entrepreneurs may be eligible for §174 treatment. The purpose of enacting §174 was to provide an incentive for promoting research and development activities. Taxpayers can either currently deduct or amortize research and experimental expenditures if the expenditures incurred are in connection with a trade or business. If the taxpayer elects to amortize, the amortization period is over a period of not less than 60 months beginning when the expenditures result in a benefit to the taxpayer.

The recently finalized Treas. Reg. §1.174-2 intended to clarify the definitions and eligibilities of expenditures under §174. By definition, research and experimental expenditures are the costs for

[11] IRC §195
[12] IRC §248

research and development in an experimental or laboratory sense. The costs are in connection with a trade or business and include pilot models, which include any model or representation of a product under evaluation or in the process of resolving uncertainty in a product.[13] The success or failure of a product is not a factor in determining the eligibility.[14] Thus, the 2014 final regulation broadens the description of research and experimental expenditures.

Some research and development activities are excluded, such as the ordinary testing or inspections for the quality control, the surveys, management studies, advertising, and research related to literacy or historical projects.[15] Exploration expenditures of natural resources are typically excluded.

An important factor concerning research and development costs is that the expenditures must be reasonable. §174(e) holds that even if the activities are generally qualified as research or experimental expenditures, only reasonable research expenditures are includible. Here is an example: a taxpayer was the CEO and patent holder of the S Corporation called Estech Sytems, Inc. (ESI). He started the company in 1987 and turned it into gross revenues of $38.5 million by 2004.[16] During 2004 to 2007, he claimed flow-through research tax credits due to his company's increasing research activities under §41 (credit for increasing research activities). §41 covers the R&D tax credit, which is a general tax credit available to companies with qualified research and development costs. Per §41, taxpayers may claim a credit equal to 20% of the amount by which taxpayers' qualified research expenses for the taxable year exceed the base amount of the year.[17] The IRS denied his R&D tax credits because his wages were not reasonable under 174(e). Although the taxpayer intended to use §41, the IRS and the court used §174(e) to determine the eligibility of §41. It is worth noting that if a business is eligible to claim the R&D deduction for qualified R&D expenditures, the R&D credit (under §41) can be claimed as well (with a reduction in the normal R&D deduction). Therefore, reasonableness is always an important consideration in determining the qualification of research or experimental expenditures.

[13] Treas. Reg. §1.174-2(a).
[14] *Ibid.*
[15] *Ibid.*
[16] Eric G. Suder, et al. v. Commissioner, T.C. Memo 2014-201.
[17] IRC §41(a)(1).

The use of §174 may be limited because the R&D expenditures must be in connection with a trade or business. Although eligible expenditures include pilot models, the requirement for §174 treatment is to have an active trade or business. Mr. Carrick's ventures in the above-mentioned 2017 U.S. Tax Court case may have qualified as pilot models, but the Court did not conclude that his ventures constituted a trade or business. Even if his ventures were heavily involved in new, innovative product research and development, it was unlikely that he would be qualified under §174 treatment. To seek §174 treatment, the start-ups need to meet the minimum requirement, which is carrying on a trade or business.

Conclusion

A business incurs expenses. Unfortunately, not all expenses are qualified business costs for tax deductions. Also, it is hard to define what constitutes a trade or business. For the high-tech start-ups that do not have sufficient grounds to claim a trade or business deduction under IRC §162, finding other relevant tax codes to provide potential tax benefits can be a challenge. For tax planning purposes, it is recommended to make a timeline and record what expenses will be qualified under what potential tax provisions. Assuming you are starting up a technology business, you may need time to investigate whether your business is a good idea and conduct some market research before officially starting the business. All incurring expenses will be qualified for investigation costs under §195. After you decide to start a business but before business activity takes off, the costs incurred including traveling expenses, wages, and advertising would be qualified for creation costs under §195. If you want to utilize the $5,000 maximum deduction limit, please make sure that organization and start-up expenditures each not to go over $50,000. If your business is involved in research and experimental activities, you may seek §174 treatment and claim a research credit and/or deduction once business status begins, unless your activities are excluded in the code or regulations. Even if you never develop or launch a product, you may be still qualified for the R&D credit and/or deduction as long as your research and development activity is experimental or laboratory in nature.

For owners of single-member follow-through entities or sole proprietorship, start-up entrepreneurs report income and expenses on Schedule C of Form 1040 of their individual returns. The taxpayers can elect to deduct §195 expenses and adopt §174 treatment in Part V ("Other Expenses") on Schedule C. The §195 election is available in the first year in which the taxpayers start a business.

If a start-up is a LLC and has multiple members, the entity is by default a domestic partnership and needs to file partnership tax return (Form 1065) unless the entity elects to file as a corporation. Regardless of the form of the entity you choose, the rules for what constitutes a trade generally remains the same. When you are ready to provide a service or product, or you have customers, you are entitled to §162 business cost deductions. However, not all expenses, even if carrying on a trade or business, are deductible. The expenses have to be ordinary and necessary.

R&D Credit Against Payroll Tax Liabilities - The Payroll Tax Credit

By: Sara Yaqin Sun, *MST student*

An Introduction to the R&D Credit

The Research & Development Tax Credit, or R&D Tax Credit, is a general business tax credit that enables companies to reduce their Federal tax liability based on the amount of eligible R&D costs for the year. The credit was initially introduced in 1981 as an incentive for economic growth and was later codified into Internal Revenue Code Section 41.
[1] The credit was made permanent by the *Protecting Americans from Tax Hikes Act* (the PATH Act) enacted as part of Pub. Law 114-113 in 2015, after going through a number of expirations and extensions over the years.[2]

Analysis of the R&D Credit Against FICA Tax (The Payroll Tax Credit Election)

The PATH Act contains significant changes to the use of R&D tax credit. Before the 2016 tax year businesses could only take the credit to offset their income tax liability. This old law was not fully effective in achieving its original intention to reduce burdens for small, startup businesses. Because most startup businesses accumulate NOLs during their research and development stage, many were not able to utilize the credits for many years, if at all, during the 20-year carryforward period. The new provisions allow *qualified small businesses* (QSBs) to make a Sec. 41(h) election to claim the R&D tax credit as a reduction against the Social Security portion of their FICA payroll tax liability ("payroll tax") under Sec. 3111(f).[3]

The Sec. 41(h) election, also referred to as the payroll tax credit election, allows certain small businesses that are entitled to the R&D credit to elect to use a portion of the credit to offset up to

[1] Legislative History of IRC §41 Credit for increasing research activities. Retrieved from: https://checkpoint.riag.com/app/find?begParm=y&appVer=17.09&dbName=TCODE&linkType=docloc&locId=41&ods=CODEHIST&permaId=idb0b54dd521ac7b7c66694228746e17e&permaType=doc&tagName=HIST&endParm=y
[2] 114th Congress (2015-2016). *Public Law No: 114-113: Protecting Americans from Tax Hike Act of 2015, Div. Q. 129*. Retrieved from: https://www.congress.gov/bill/114th-congress/house-bill/2029/text
[3]U.S. Congress Joint Committee on Taxation (JCT). 2015. *JCX-144-15: Technical Explanation Of The Protecting Americans From Tax Hikes Act Of 2015, House Amendment #2 To The Senate Amendment To H.R. 2029.*Retrieved from: https://www.jct.gov/publications.html?func=fileinfo&id=4861)

$250,000 of payroll taxes in tax years beginning after December 31, 2015. The election particularly helps QSBs in their early years during which they often do not yet generate sufficient taxable income to benefit from an income tax credit.

IRS Payroll Tax Credit Claiming Guidelines (Notice 2017-23)

The IRS released Notice 2017-23 to provide interim guidance with regard to the Sec. 41(h) payroll tax credit election. [4] The following aspects are covered in the guidance: definition of a qualified small business, determination of gross receipts, the aggregation rule, and the time and manner for making the election.

Qualified Small Businesses

A qualified small business (QSB) is a corporation (including S-corporation), partnership, or individual with less than $5 million of gross receipts in a taxable year after December 31, 2015.[5] The business must also not have any gross receipts for any taxable year preceding the five-year period ending with the taxable year.[6]

> Examples: Corporation A generated $3 million of gross receipts in 2016 and did not have any gross receipts prior to 2012. Corporation A is a QSB and is able to claim the credit on its 2016 tax return.

However, this inclusive definition has greatly limited the eligibility for businesses that have existed for more than five years. For instance, if Corporation A in the example above sold just one unit of a product for a profit, or had small amounts of investment income prior to 2012, either activity would disqualify Corporation A from being a QSB for the 2016 tax year. Furthermore, tax-exempt organizations cannot be considered QSBs.[7]

[4] Internal Revenue Service (2017*). Notice 2017-23: Interim Guidance and Request for Comments; Election by Qualified Small Business to Claim Payroll Tax Credit for Increasing Research Activities.* Retrieved from: https://www.irs.gov/pub/irs-drop/n-17-23.pdf. [Hereinafter: IRS Notice 2017-23].
[5] IRC §41(h)(3)(A)(i)(I)
[6] IRC §41(h)(3)(A)(i)(II)
[7] IRC §41(h)(3)(B)

The Gross Receipts Definition

Gross receipts, for purposes of the payroll tax election, are defined under section 448(c)(3). Basically, gross receipts include total sales net of returns and allowances and income received for services, passive income (such as investment or interest income), as well as proceeds from selling properties that are used in the trade or business.

The Aggregation Rule

For purposes of the gross receipts measurement, all members of a controlled group, including both domestic and foreign related parties, are treated as a single taxpayer. Therefore, gross receipts of all members of a controlled group must be aggregated when determining whether the gross receipts requirement is met.[8]

Example: Corp X has 100% ownership of domestic subsidiary Corp Y and foreign subsidiary Corp Z. In taxable year 2016, Corps X, Y, and Z generated $2.5 million, $1.5 million, and $2 million of gross receipts respectively. Corp X, Corp Y, and Corp Z are not qualified small businesses for the payroll tax election purpose for taxable year 2016 because the aggregate gross receipts of the three (as a controlled group) exceed $5 million.

Time and Manner of Election

A QSB can claim the payroll tax credit by making an election in section D of Form 6765 and reporting the credit amount on a timely filed federal tax return with a Form 6765 attached to it.[9] The payroll tax offset is available on a quarterly basis after the QSB makes the election, starting in the first quarter of 2017. The credit is reported and claimed on the QSB's quarterly Federal payroll tax return (Form 941).[10]

[8] IRC §41(h)(5)
[9] Internal Revenue Service (2017*). Form 6765, Credit for Increasing Research Activities.* Retrieved from: https://www.irs.gov/forms-pubs/about-form-6765-credit-for-increasing-research-activities. [Hereinafter: Form 6765].
[10] *See* IRS Notice 2017-23, Pg.12-13. *Supra note 6.*

Example: Corp A filed its 2016 federal tax return Form 1120 on March 30, 2017 and attached a Form 6765 to the return to reflect the payroll tax credit election. It is eligible to claim the payroll tax credit on its quarterly payroll tax return (Form 941) for the second quarter, in July 2017.

If a QSB filed its original tax return reporting a R&D credit without electing the payroll tax credit for taxable year 2016, the IRS allows the filing of an amended return by the end of 2017 to elect the payroll tax credit.[11]

Credit Limitations and the Carryback/Carryforward Period

A QSB may claim the payroll tax credit for maximum five taxable years with the limitation of $250,000 each year, depending on the amount of its useable R&D credits and payroll tax liability.[12] Any amount not utilized in a taxable year follows the standard R&D credit carryback period (per the general business credit rules) of one year and carryforward period of 20 years.

Special Rules for Controlled Groups

Each member of a controlled group may separately elect to use the R&D credit against payroll tax at the entity level. The $250,000 amount is allocated to each member on a proportionate basis, and if a member does not make the election, its portion cannot be allocated to the other group members that made the election.[13]

Payroll Tax Credit Reporting Requirements

1) *Form 6765: Credit for Increasing Research Activities.*

   As mentioned previously, this form is used to make the payroll tax credit election, and it must be filed and attached to the timely-filed business income tax return (including extensions).[14] If

[11] IRC §41(h)(6)(C)
[12] IRC §41(h)(4)(b)
[13] Treas. Reg. § 1.41-6
[14] *See* IRS Form 6765. *Supra Note 12.*

an election is made for an amended return filed for 2016 tax year, a QSB must indicate on the top of Form 6765 or attach a statement to Form 6765 showing that the form is "FILED PURSUANT TO NOTICE 2017-23."[15]

2) *Form 8974: Qualified Small Business Payroll Tax Credit for Increasing Research Activities.*[16] The form is used to determine the amount of the payroll tax credit a QSB can claim on its Form 941, Employer's Quarterly Federal Tax Return. The quarter on the form must be the same as shown on the Form 941 to which it is attached.

Conclusion

It is extremely exciting news to the Bay Area's tech startups that the R&D credit was made permanent. Small businesses should take advantage in utilizing the credit against not only their income tax but also their AMT and payroll tax liabilities. However, even though startups might be able to use their accumulated R&D credits to offset up to $250,000 of their payroll taxes, very small amounts in gross receipts in prior tax years could potentially prohibit their eligibility. Taxpayers should pay close attention to the requirements of QSBs, especially the investment activities that may ultimately create passive income. In short, the payroll tax credit election is a great add-on to the R&D credit to help small businesses reduce their tax burdens, which also creates tax planning opportunities.

[15] *See* IRS Notice 2017-23, Pg. 9-10. *Supra note 6.*
[16] Internal Revenue Service (2017*). Form 8974, Qualified Small Business Payroll Tax Credit for Increasing Research Activities.* Retrieved from: https://www.irs.gov/forms-pubs/about-form-8974

Who Truly Benefits from the Mortgage Interest Deduction?

By Major Stephen Wildt, MBA, *MST Student*

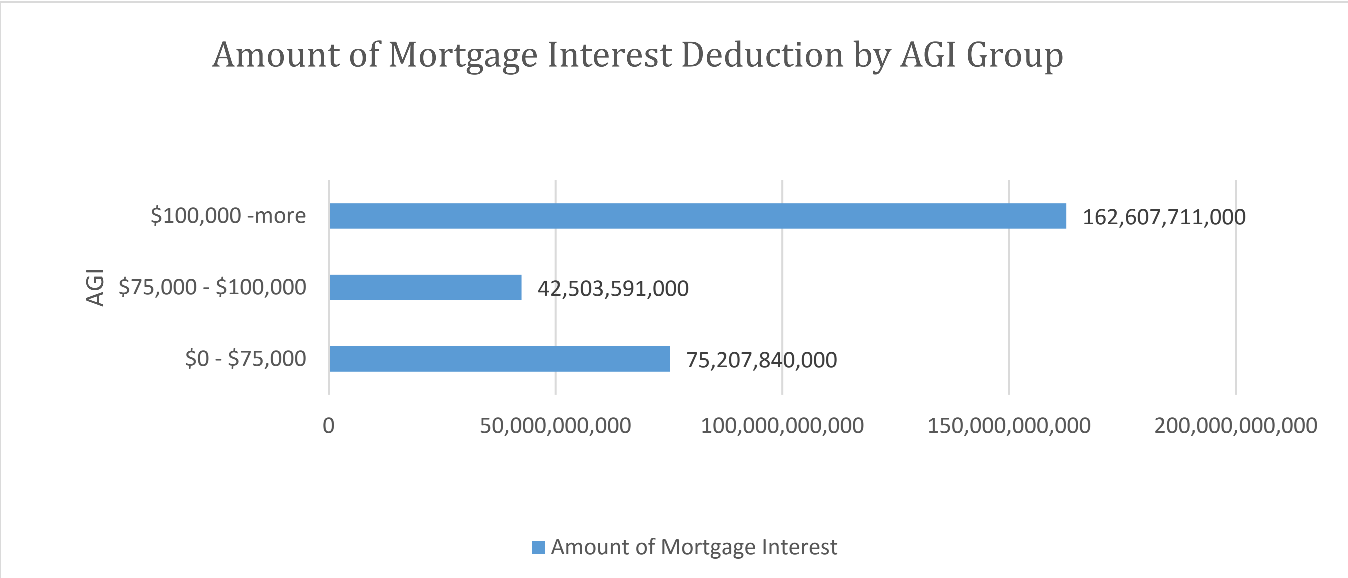
With the Trump Administration's proposal to simplify the Internal Revenue Code (IRC), there should be consideration to completely simplify the code because a partial simplification of the IRC only adds more confusion and complexity for the average taxpayer. One of the most important issues in the tax code is the mortgage interest deduction (MID) and it causes politicians and leaders great fear when considering the idea of removing the MID from tax policy. But should they feel fear? Well, there should be no fear because as we look at the actual statistics surrounding the deduction, we will be surprised by who benefits from it the most … and it is not the average taxpayer.

Let Us See Who is Impacted

For the mortgage interest deduction to be utilized, a taxpayer needs to itemize deductions on their individual tax return. In 2014, only 29 percent of taxpayers itemized their deductions (43.9 million taxpayers itemized[1] / 148.6 million taxpayers filed taxes[2]), therefore only up to 29 percent of taxpayers can qualify for the mortgage interest deduction the way it is currently structured because to receive the MID, one has to itemize deductions. Of the 29 percent of taxpayers who itemize, those with an Adjusted Gross Income (AGI) over $75,000 per year consume over 73 percent of the mortgage interest deducted or $205 billion of the $280 billion of mortgage interest claimed on itemized tax returns. Another way to view it is that 21 percent (29% x 73% or 32.2M of the 148.6M taxpayers claimed the MID) of all taxpayers receive a benefit of $205 billion of mortgage interest deductions (see figure 1).

[1] Internal Revenue Service (2017). *SOI Tax Stats, Individual Income Tax Returns with Exemptions and Itemized Deductions*, Table 2.1 (Used 2014 data). Retrieved from: https://www.irs.gov/uac/soi-tax-stats-individual-statistical-tables-by-size-of-adjusted-gross-income#_grp2.
[2] Internal Revenue Service (2017). *SOI Tax Stats, All Returns: Number of Returns*, Table 1.6 (Used 2014 data). Retrieved from: https://www.irs.gov/uac/soi-tax-stats-individual-statistical-tables-by-size-of-adjusted-gross-income#_grp2

Figure 1. Amount of Mortgage Interest Deduction by AGI Group[3]
(Note: all numbers shown in Figure 1 are IN U.S. DOLLARS)



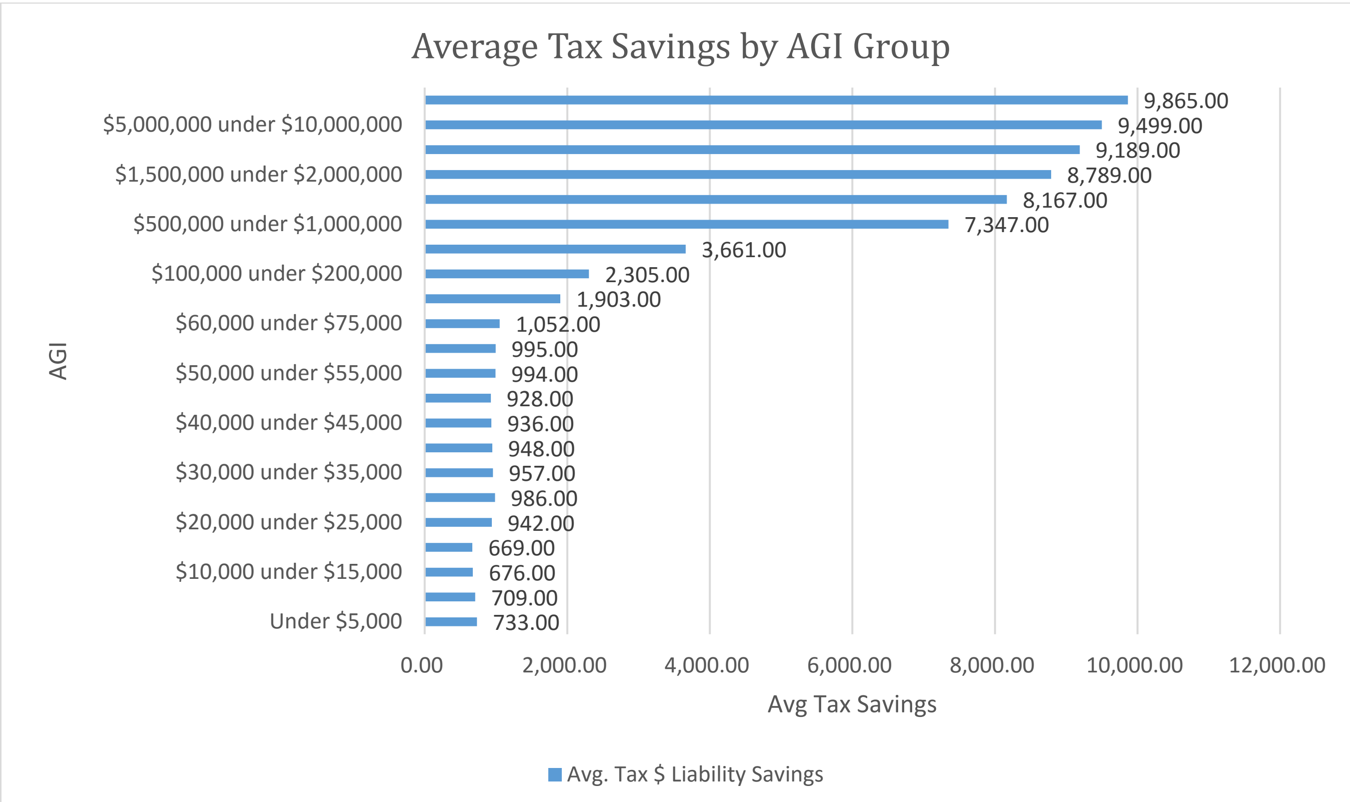
A tax credit, instead of a deduction, on mortgage interest will benefit most homeowners who have a tax liability, more so depending on if it is a refundable credit.[4] However, this may still not be the best option to increase homeownership rates as shown in research.[5] The proposal to replace the mortgage interest deduction with a 15 percent mortgage tax credit on a mortgage loan limit of $500,000 would distribute the mortgage tax subsidy more evenly across homeowners, which is approximately 74.1 million taxpayers. This proposal would increase the tax incentive for homeownership for lower and middle-class taxpayers, possibly leading to higher homeownership rates if it is designed correctly and specifically focuses on the taxpayers that actually need the assistance. Let us say that middle class taxpayers are those with $75,000 - $200,000 AGI and upper-class taxpayers are those with $200K AGI and above. My opinion is that the upper and upper-middle class taxpayers will buy homes regardless of the government subsidy. Figures 1 *(see above)* and 2 *(see below)* show that the majority of the MID goes to assisting the middle to upper class taxpayers. They are benefiting ten times more than the lower-income taxpayers, which

[3] Internal Revenue Service (2017). *SOI Tax Stats - Individual Statistical Tables by Size of Adjusted Gross Income.* Retrieved from: https://www.irs.gov/statistics/soi-tax-stats-individual-statistical-tables-by-size-of-adjusted-gross-income#_grp2 [Hereinafter: SOI Tax AGI Stats]
[4] *Ibid.*
[5] Katz, Bruce (November 2012). *Reform the Mortgage Interest Deduction to Invest in Innovation and Advanced Industries.* Brookings Institute. Retrieved from: https://www.brookings.edu/wp-content/uploads/2016/06/06-mortgage-interest-deduction.pdf.

runs counter to the equity and fairness principle *of AICPA's Guiding Principles of Good Tax Policy* and it could be argued that the neutrality principle is also violated because of the effect on purchasing decisions.[6]

Figure 2. Average Tax Savings by AGI Group[7]

(Note: all numbers shown in Figure 2 are IN U.S. DOLLARS)



Under the proposed legislation of the MIC, with the phasing out of the mortgage interest deduction, some home-owning taxpayers may rise into the next upper tax bracket and possibly be exposed to AMT. Additionally, they will owe additional tax on the nondeductible portion of their mortgage loan because it would add it back to the AGI. But some of these phase-out adjustments will be offset by the standard deduction or other itemized deductions taken on the return that, collectively, are larger than the standard deduction.

[6] Tax Division of the American Institute of CPAs (AICPA). January 2017 – update of March 2001 version. Tax Policy Concept Statement No. 1—Guiding Principles of Good Tax Policy: A Framework for Evaluation of Tax Proposals. *AICPA.* Retrieved from: http://www.aicpa.org/advocacy/tax/downloadabledocuments/tax-policy-concept-statement-no-1-global.pdf
[7] Internal Revenue Service, *supra* note 3.

If the politicians choose to partially simplify the tax code, they should consider the impact of changing from a mortgage interest deduction (MID) to a mortgage interest credit (MIC), which would impact income classes differently and benefit more homeowning taxpayers and possibly increase the homeownership rates. Those homeowners who do not itemize deductions would be able to benefit from a mortgage interest credit. Those who itemized deductions and took advantage of the mortgage interest deduction can now utilize itemized deductions or the standard deduction in addition to the MIC, which will be a minor negative impact from change in policy, but this change will make it fairer and more equitable to more taxpayers in a progressive tax system than the previous policy. As taxpayers move up in the tax brackets above 15 percent, the additional benefit of a MIC, versus a MID, will gradually decrease. Some taxpayers with AGI above $75,000 would receive less of a benefit under the proposed MIC than they currently receive under the MID. Those who do not itemize and own homes with mortgages will be impacted positively with a credit.

If there is a change in the policy to a 15 percent tax credit, only taxpayers who own and occupy a home would qualify for the credit. There would be approximately 74.1 million qualified homes, representing some portion of the 14 trillion dollar mortgage market at the end of 1st quarter of 2017.[8] If Congress applies the label of "owner-occupied" homes as only for primary residences, this will disallow the credit for second homes. However, rental properties will still be able to deduct mortgage interest as a rental interest expense on Schedule E, which may lead to lower rents to keep renters from moving out and buying a home. Either way, this proposal is still in violation of the neutrality principle of good tax policy, which is a guiding principle for lawmakers, that taxpayers' decisions to carry out a specific transaction should be minimally impactful. People who rent often do so because they are not able to obtain a mortgage loan, whether it be bad credit or affordability. However, many times renters are paying similar amounts in rent as a mortgage on the same home.

The value of the mortgage interest deduction is greater for higher income taxpayers, thereby benefitting those taxpayers more than the lower income taxpayers. Therefore, the MID may not

[8] Board of Governors of the Federal Reserve System. 2017. *Mortgage Debt Outstanding.* Retrieved from: https://www.federalreserve.gov/econresdata/releases/mortoutstand/current.htm.

negatively impact the higher-end housing market because the standard deduction (or other significant amounts of itemized deductions) combined with the MIC is still a significant tax liability deduction that will partially offset the new MIC proposal, which will also benefit the lower-end housing market.

The MIC proposal may negatively impact the RV and boat industries since the tax break on second mortgages and Home Equity Lines of Credit (HELOC) will no longer deductible. Lower income taxpayers are less likely to itemize due to a lack of deductions, so a credit works better for them.[9] So, now, with the MIC policy proposal, taxpayers will be able to take the standard deduction and also claim the MIC.

State and local governments are also impacted if the MIC becomes law depending on whether or not their state tax system incorporates the MID in their tax liability calculation of individual taxpayers.

Those indirectly impacted could potentially include every taxpayer by possible adjustments in the economy as a result of the enactment of the MIC. For example, increased (or decreased) demand in the economy for homes because of the MIC could lead to higher or lower tax revenues on real estate transactions. Additionally, there could be increased or decreased investment account values from the economic activity derived from the implementation of the MIC. Since state and local government revenues may be impacted by this MIC proposal, it affects schools and other services paid for by state tax revenues – including those used to teacher salaries, minimize class sizes and the effective teaching of our children. Other impacts include all suppliers to the impacted industries, to include RV, boat, builders, contractors, subcontractors, home improvement stores and even retail stores.

I believe that the current mortgage interest deduction policy needs to be changed. I would recommend a non-refundable homebuyer credit of 15 percent of mortgage interest paid on mortgage loans below $500,000, with a maximum $3,000 credit. According to the Congressional

[9] Congressional Budget Office (CBO). 2013. *Options to Reduce the Deficit: 2014-2023, Options 5, Convert the Mortgage Interest Deduction to a 15 Percent Tax Credit*. Retrieved from: https://www.cbo.gov/budget-options/2013/44798.

Budget Office (CBO), this plan is most beneficial for taxpayers, and it should provide up to $16.5 billion reduction in the mortgage interest tax expenditure, which can be allocated towards reducing the deficit.[10] Moreover, according to the *Tax Foundation*, getting rid of the mortgage interest deduction altogether would increase government tax revenues by $101 billion based purely on the elimination of the deduction (not including any potential impacts on a dynamic basis). However, it is important to note that eliminating the deduction may have some negative impacts on the economy and housing market.[11]

[10] *Ibid.*
[11] Tax Foundation (July 29, 2013). *Fiscal Fact No. 379, Case Study #1: Mortgage Interest Deduction for Owner-Occupied Housing dated*. Retrieved from: https://taxfoundation.org/case-study-1-mortgage-interest-deduction-owner-occupied-housing/

Summaries for the 2017 IRS-SJSU Small Business Tax Institute

Thriving in the Digital Economy-Best Practices for Small Businesses and Their Tax Advisers

Held on June 22, 2017 at the Biltmore Hotel, Santa Clara, California

Authors: Ruchi Chopra, Ophelia Ding, Surbhi Doshi, Nilesh Lad and Sara Sun

How to Successfully Deal with Correspondence Audits and IRS Notices

By: Ruchi Chopra, *CPA, MBA, MST Student*

The first topic discussed during the conference was on how to successfully deal with correspondence audits and IRS notices. The session speakers included various tax practitioners and IRS analysts: Ms. Torie Charvez, Enrolled Agent, Ms. Barbara Doherty, Tax Attorney, Ms. Gail Murphy and Ms. Susan Clark, Tax Policy Analysts from the IRS. The panel addressed the audit process, relevant Internal Revenue Manual (IRM) procedures, types of audit letters and notices, and ways to get help.

The panel started with correspondence audits, the most common type of audit the IRS conducts.[1] The taxpayer under the correspondence audit receives a letter from the IRS by mail, advising the taxpayer that his or her return has been selected for examination. This letter will also typically include a request of a list of additional documents and/or information to be provided to the IRS. Correspondence audit examinations, which cover a broad array of compliance areas, are highly automated, standardized and purportedly efficient.

Ms. Murphy commenced the discussion with an overview of the correspondence examination process and discussed the criteria the IRS uses to select the returns for an examination. As Ms. Murphy stated, the IRS typically uses a software program that compares returns against common norms and examines the selected returns that fall outside of these norms. Some of the common ways the IRS identifies returns for examination are based on results from prior year audits, third party information, entries on the return by the taxpayer, and referrals from criminal investigations or preparer actions. Correspondence audits typically have a defined scope and focus on documenting specific tax return entries. Some of the common issues discussed that trigger an examination audit are refundable tax credits claimed by the taxpayer such as the Earned Income Tax Credit,

[1] Internal Revenue Service. (2017). *IRS Audits.* Retrieved from: https://www.irs.gov/businesses/small-businesses-self-employed/irs-audits

Child Tax and American Opportunity Tax Credits. Other tax return entries with a high potential for an examination are employee business expenses, charitable contributions claimed on Schedule A, and business expenses claimed on Schedule C.

Ms. Clark from the IRS continued the discussion with types and uses of common initial letters and notices sent by the IRS. Notices such as the CP 75/75A for the Earned Income Tax Credit and the CP 06/06A for the Premium Tax Credit advise taxpayers that their returns are being audited and the IRS is requesting supporting documentation responding to the audited items. Some initial contact letters supplement a detailed examination report whereas others do not. For instance, Letter 1862 and Letter 2194 have forms and questionnaires enclosed that list the requested documentation. When a taxpayer fails to file a return, the IRS sends a Letter 1862 with a detailed examination report notifying the taxpayer that (1) a return is required to be filed and (2) a Federal tax liability has been calculated for the taxpayer by the IRS based on information the IRS has on the taxpayer. The IRS also sends some interim letters such as Acknowledgement Letter 3500 and Interim Letter 3501 to advise the taxpayer that they received the taxpayer's request and will be responding in 45 days. Other common follow-up letters that were discussed include Letter 525/692 which is sent with a computation report of the proposed adjustments to taxpayer's return outlining options for the taxpayer. Letter 525/692 are cover letters to Form 4549, a notice of deficiency used when the IRS determines that a taxpayer has unfiled returns and owes taxes. Form 4549 also gives a choice to the taxpayer of either submitting a return or filing a petition with the Tax Court within 90 days. The IRS also sends Form 886-A requesting information supporting documentation they propose to adjust during an audit.

Letter 3219, also termed as Statutory Notice of Deficiency or the "90 Day" Letter, is sent when the IRS receives information from third parties that is different from what is reported by a taxpayer on his return. The notice explains how the adjusted amount was calculated and how the taxpayer can challenge it in Tax Court should they not agree with the adjustments. Letter 555, a follow-up letter, is sent after the issuance of Letter 3219 if the information submitted by

Some key points about correspondence examinations that Ms. Clark highlighted were about the importance of responding timely to the notices and providing complete and organized responses, helping IRS to resolve issues efficiently. There was a brief mention of Publication 3498-A that gives an overview of the correspondence examination process for taxpayers and tax practitioners.[2]

The panel also discussed some of the current resources and future initiatives such as the Taxpayer Digital Communication (TDC) that the IRS is currently working on and the Practitioner Priority Service Hotline. The TDC is a pilot program launched in December 2016. The purpose of the program is to resolve correspondence examinations in a secure online environment where taxpayers are given an option to upload the requested documentation directly on an IRS portal instead of mailing it to them. The Practitioner Priority Service Hotline phone number (1-866-860-4259, prompt 6) is a service made available to practitioners for expedited access to a wide variety of client matters.
Ms. Doherty took over the next part of the session and shared some tips with practitioners on how to successfully deal with correspondence audits and protect themselves at the same time. Ms. Doherty advised that practitioners must disclose any potential conflict of interest and weigh the reliability of the underlying taxpayer data when dealing with IRS notices on behalf of their clients as there are potential preparer penalties. Tax practitioners must also consider if their continued representation violates any legal or ethical considerations. Practitioners must complete and file with the IRS Form 2848, Power of Attorney, after being engaged to represent taxpayers. The initial response made to the IRS in an examination should be in the form as indicated in the examination letter, and if the issue is beyond an accountant's competency or if there are potential criminal, practitioners should also consider the need to hire a tax or criminal tax attorney.

Ms. Doherty reiterated how important it is to respond timely to notices with clear and complete information printed and banded together with a detailed response. She also

[2] Internal Revenue Service. 2014. *The Examination Process (Audits by Mail).* Publication 3498-A. Retrieved from: https://www.irs.gov/pub/irs-pdf/p3498a.pdf

suggested that a practitioner or taxpayer must be prepared for several exchanges of information, as not all adjustments will be seen in a single IRS response. Often there is a need for second, third or more adjustments during the examination process. In addition, practitioners must conduct research ahead of time for any items that are requested to be included in the correspondence to the IRS to reduce the chances of being challenged by the IRS. Finally, it is also important to replicate and keep original return data in the records of the client by the practitioner.

The discussion concluded with a Q&A session, where the audience brought some questions for clarification on the discussed IRS letters and notices as well as the Service's latest digital initiatives. At the end of discussion, the panelists pointed out Part 25, Chapter 1, Section 2 of the Internal Revenue Manual (IRM 25.1.2.3) and a list of fraud indicators within the IRM.[3]

Overall, the session was informative and interactive. It was a great learning experience hearing the insights of the knowledgeable speakers on how to successfully deal with correspondence audits and IRS notices. As tax practitioners, we must be diligent and proactive, while thoroughly understanding the importance of timely and proper responses to IRS letters and notices with complete and accurate information

[3] Internal Revenue Service (2014). *Internal Revenue Manual.* Retrieved from: https://www.irs.gov/irm/part25/irm_25-001-002.html

FTB Taxpayer Advocate Update

By Ophelia Ding, *MST Student*

California's taxpayers' rights are protected through the California Taxpayer's Bill of Rights, which became law in 1988 and with it established the Taxpayers' Rights Advocate.[1] The Taxpayers' Rights Advocate services are independent of the California Franchise Tax Board's (FTB) audits and collection areas, they protect the rights of the taxpayers and help taxpayers with their tax issues that are unresolved through normal administrative channels. Taxpayers may contact the Taxpayers' Rights Advocate when they have any complaints, face any problems, or if they suffer an irreparable loss. The Taxpayers' Rights Advocate has the power to postpone the tax enforcement actions during the review of the taxpayer's case.[2]

Susan Maples, CPA, is the current Taxpayers' Rights Advocate of the California FTB. Ms. Maples has worked in the FTB for more than 20 years in both Sacramento and Southern California field offices. She started as a tax auditor in personal and corporate income tax before transitioning to the Tax Practitioner Liaison between the FTB and external stakeholders (i.e. the taxpayers and tax practitioners). Her main job function now as the Taxpayers' Rights Advocate is acting as an independent intermediary to resolve problems between taxpayers and the FTB to ensure that taxpayers' rights are protected. Ms. Maples focuses on education and outreach programs to provide information to taxpayers, tax practitioners, industry groups, and small business owners regarding the most common issues and problems faced by taxpayers while assisting them on how to avoid or resolve them.

Ms. Maples started her panel on FTB Taxpayers' Rights Advocate annual updates by providing some background information on identity theft and data security issues that the

[1] Cal. Rev. and Tax., §§ 21001 – 21028 and State of California, Franchise Tax Board. *California Taxpayers' Bill of Rights.* Retrieved from: https://www.ftb.ca.gov/forms/misc/4058.pdf
[2] State of California, Franchise Tax Board. *California Taxpayers' Bill of Right – An Overview.* R&TC Section 21004. Retrieved from: https://www.ftb.ca.gov/forms/misc/4058C.pdf

FTB has been recently dealing with after rolling out their MyFTB system. MyFTB is an online system that provides "tax account information and online services to individuals, business representatives, and tax preparers."[3] With MyFTB, taxpayers and tax practitioners can access their tax account information quickly and easily online as soon as it becomes available in the FTB computer systems. However, like everyone else in this digital age, the FTB faces prominent security issues challenges like never before. Hackers are relentlessly trying to access the sensitive and confidential information stored on MyFTB. While the FTB strives to provide easy access and communications to taxpayers and practitioners, it is difficult, like many organizations, for the FTB to find the desirable balance between data security and user convenience.

Fighting Tax Fraud

The FTB has launched a number of measures to combat identity thefts proactively. Taxpayers and practitioners might have noticed they are receiving more forms or notices from the FTB in the past few years, requesting verification of a taxpayer's identity or a return filing status. Ms. Maples highlighted FTB Form 4734D and Notice 3904 in her presentation, as described below.

Identify Verification with Form 4734D, Request for Information and Documents

Since 2016, the FTB started sending out FTB Form 4734D*, Request for Information and Documents*, to verify taxpayers' identities. The form specifically asks for more information from the taxpayer, such as physical copies of the taxpayer's identification cards (e.g., driver's license or social security card) for verification purposes, before approving their tax refund. The reason for this is because some identity thieves might have acquired electronic copies of taxpayers' identification through criminal activities and have filed for a fraudulent tax refunds through fake California tax returns on these victims. The FTB needs to verify the taxpayer's identity by asking for the physical identification cards directly from the taxpayer to help protect them (and the state) from tax-related identity theft.

[3] State of California, Franchise Tax Board. *MyFTB.* Retrieved from: https://www.ftb.ca.gov/online/myacct/index.asp

Return Verification with FTB Notice 3904, Request to Confirm Tax Return Filing

Practitioners often wanted to know why their clients were getting notices from FTB when nothing has changed since their last filing. For instance, clients who are still working for the same employer with the same W-2 and withholdings suddenly got notices from FTB. Tax practitioners need to note that FTB started sending out FTB Notice 3904*, Request to Confirm Tax Return Filing*, to taxpayers when they highly suspected the particular taxpayer has fallen victim to tax-related fraud. Taxpayers who received the notice should contact the FTB immediately to notify them if he or she had indeed filed a tax return with the FTB.

Phishing

An increasing number of companies reported that they were victims to phishing scams. Common scams in this area include the Human Resource Department receiving a fake email from the Company's CEO asking for valuable personal or financial information of the employees such as their social security numbers. The FTB advises that if you are victim to any phishing scams, it is <u>crucial</u> to inform the FTB <u>immediately</u>. Upon notification, the FTB will flag the accounts that have been compromised to closely monitor the tax activities on the account. Tax practitioners themselves are also prevailing targets of identity thefts because they possess a large amount of sensitive and confidential information on their clients. Therefore, tax practitioners must take the necessary measures to safeguard their clients' information. Criminals frequently try to deceive tax practitioners with fabricated emails from the "FTB." Tax practitioners should <u>never</u> undermine the importance of due diligence and take the extra step to confirm with the FTB if they are truly requesting specific information of a particular client. Tax practitioners can do so by using the FTB identification number on the notices, or by verifying the fax number or mailing address on the notice with the FTB. Furthermore, tax practitioners should always ask FTB for a Secure Email Service if they are sending taxpayers' information via email. Secure email will encrypt the confidential data sent between the FTB and the taxpayers with high security standards without installing any software.[4]

Small Businesses– Rights and Responsibilities

With the prevalence of shared economy businesses such as TaskRabbit, Uber, and Airbnb in our current digital economy, clients who used to receive just W-2s for their services as employees are now receiving 1099s that they have never dealt with before. Thus, both the FTB and tax practitioners should do more educational outreach. Taxpayers involved in this new business model need to understand the tax implications they are facing, including the compliance requirements such as recordkeeping, deadlines, and self-employment tax.

Preparation and Representation

The FTB has done a massive re-training of its staff in the past year as a response to many tax practitioners' comments about the *Implied Consent* not working as well as it should. Implied Consent is a process that enables FTB staff to interact with tax practitioners easily and quickly to resolve urgent issues for their clients without a processed of Power of Attorney (POA). It occurs when "a taxpayer's representative can provide enough information from a Franchise Tax Board (FTB) notice or a taxpayer's account to infer that the representative has authorization to discuss specific account information."[5] The FTB also had issues processing POA forms for the past year. It could take as long as 90 days for the FTB to process a POA form received by mail. They now prefer that taxpayers and practitioners use the POA Wizard on MyFTB to submit POA applications, which could shorten the processing days to 35 days. Tax practitioners should note that beginning January 1st, 2018, the FTB will only accept the California POA (Form 3520) and will not accept a modified copy of an IRS POA. In addition, the FTB will no longer revoke old POAs even after receiving a new POA from the same taxpayer. However, newly issued POA will now expire after six years. The FTB will send a letter to notify the taxpayer of the approval

[4] "Secure email must be initiated by an FTB employee sending a secure email message to the recipient. First time recipients will be prompted to register. Returning customers only need to enter their passwords to view secure email messages. If a customer responds to a secure email message, the response is also encrypted." State of California, Franchise Tax Board. *Tax Practitioner Services - Electronic communication and data transmission.* Retrieved from: https://www.ftb.ca.gov/professionals/taxnews/tn_tps.shtml
[5] State of California, Franchise Tax Board. *Tax News February 2017.*

of a recent POA. A list all other POAs associated with the taxpayer will also be provided. The taxpayer should contact the FTB to revoke any POA they no longer want to keep in effect.

Ms. Maples ended the presentation by stating that taxpayers and tax practitioners should always contact the Taxpayers' Rights Advocate Office with any issues they are facing using *FTB Form 914, Taxpayer Advocate Assistance Request.*[6]

Ms. Maple's contact information is:

Franchise Tax Board
Executive and Advocate Services MS A381
PO Box 157
Rancho Cordova, CA 95741-0157
Phone: 800.883.5910
Fax: 916.843.6022
Email: susan.maples@ftb.ca.gov

[6] State of California, Franchise Tax Board. FTB 914 - *Taxpayer Advocate Assistance Request.* Retrieved from: https://www.ftb.ca.gov/forms/misc/914.pdf

Crowdfunding

By: Surbhi Doshi, *MST Student*

The post lunch session of the Fifth Annual IRS/SJSU Small Business Tax Institute on June 22, 2017 began with the interesting topic of crowdfunding. A three-member panel from Moss Adams LLP consisting of Mr. Andy Mattson, CPA, partner; Mr. Curtis Miyaji, Senior Manager and Ms. Dawn Rhea, J.D., LL.M, National Tax Director, threw some light on crowdfunding and its tax implications.

Mr. Mattson commenced the session and broadly explained the concept of crowdfunding. In crowdfunding, there is a fundraising campaign and a campaign owner who selects a crowdfunding platform as a way to raise funds to kick-start a business or introduce a new product or service in the market. Crowdfunding is increasingly being used in various activities include raising funds for personal medical expenses or funeral expenses.

The Process

Crowdfunding starts by the campaign owner selecting a crowdfunding platform on which he would like to initiate a campaign. After selecting a platform, the campaign owner provides a Form W-8 or Form W-9 to the platform to disclose necessary tax information.

- **Form W-8BEN** is for non-US based campaign owners and it certifies that the funds received are not associated with a U.S. trade or business.
- **Form W-9** is for US based campaign owners. The platform requires information like the Taxpayer Identification Number, name and address of the campaign owner before sending out Form 1099-K.
- **Form 1099-K** is used by the platform owners to report amounts received from third party organizations. IRC §6050W requires third-party settlement organizations, also called the payment settlement entities, to file Form 1099-K. These settlement organizations have a contractual obligation to turn over the funds to the payee.

- **Form 1099-K Issuance Threshold:** The number of transactions for the calendar year must exceed 200 and the gross value of all transactions must exceed $20,000 in order for Form 1099-K to be required. If any one of the conditions is not satisfied, then the platform owner need not issue 1099-K to the campaign owner.

The campaign owner selects a platform to raise funds

Campaign owner provides W-8/W-9 to the platform company

Investors contribute funds through payment processors like PayPal or Credit Card company

Payment processors issue 1099-K on all processed payments to the platform

If the funds raised meet the tax reporting threshold, then the platform issues 1099-K along with the contributions to the campaign owner.

Importance

Ms. Rhea took over by giving an example of Mondelez International, Inc. who initiated the "Triscuit Maker Fund" and donated money to Food Maker Projects on the crowdfunding platform Indiegogo.com[1] This campaign gave a head start to many small food production businesses. She added that according to Forbes estimates, about $16B was raised in 2014, while about $34B in 2015 was raised through crowdfunding, and by 2020, raised funds are

[1] Watrous, Monica. April 26, 2016. *Small businesses get boost from Mondelez.* Retrieved from: http://www.foodbusinessnews.net/articles/news_home/Business_News/2016/04/Small_businesses_get_boost_fro.aspx?ID=%7B6CB531D6-4350-4175-A80B-5AC745FBC806%7D&cck=1

estimated to be $90B.[2] Crowdfunding is unique because it is widely used to raise money for diverse purposes and covers numerous industries and areas.

Why Should Tax Practitioners Care?

In this increasing popularity of crowdfunding, there is a huge probability that taxpayers may have initiated one or more campaigns or have donated to such campaigns. As tax practitioners, we need to be ready to answer taxpayers' questions and identify the tax implications involving their crowdfunding activities. Clients may have one or more of the following questions:

- Why did I receive a Form1099-K?
- Why did the platform ask me to provide tax information on Form W-8/W-9?
- Will the funds raised be included in my income?
- Will I get a deduction for the expenses of the campaign?

If the client has donated to some campaign, then the queries may be:

- Can I take a charitable deduction for the amount I contributed?
- Will the contribution be considered a gift? What about any filing requirements?
- Will I have to pay any gift tax?

IRS on Crowdfunding

On inquiry by the AICPA Task Force regarding any guidance on crowdfunding, the IRS responded that no guidance was forthcoming and general tax principles should be used to determine the effects of the transactions. Later in 2016, an Information Letter was issued by the Office of Chief Counsel in response to a taxpayer's request for guidance on tax consequences of crowdfunding.[3] In this letter, the IRS referred to IRC §61 wherein all receipts, in the form of cash or property, are included in gross income subject to certain

[2] Barnett, Chance (June 9, 2015). *Trends Show Crowdfunding to Surpass VC in 2016.* Retrieved from: https://www.forbes.com/sites/chancebarnett/2015/06/09/trends-show-crowdfunding-to-surpass-vc-in-2016/ - 75e801574547
[3] Internal Revenue Service. Office of The Chief Counsel (March 30, 2016). *Information Letter Number 2016-0036.* Retrieved from: http://www.iflr.com/pdfs/4Info20160036 .pdf

exceptions. That said, crowdfunding receipts are includible in gross income if they are not in the form of loans or gifts made out of generosity. However, if the receipts in crowdfunding are for services rendered or sale of products then those must be included in income.

The major issue arises when the campaign threshold is not met, i.e. the number of transactions do not exceed 200 or the gross value of the transactions do not exceed $20,000. Some platforms (e.g., Kickstarter.com) require that all the funds be returned to the contributors, while other platforms just deduct necessary fees and distribute the money to the campaign owner. To determine the nature of funds raised and expenses incurred, the IRS resorted to the basic IRC sections mentioned below:

- IRC §61, in addition to other sections of the IRC, generally provides that any money received is includible in gross income if one has dominion or control on the money, unless it is loan, a gift or a capital contribution to a business entity.
- IRC §451 provides for the timing of recognition of income. If the taxpayer follows the accrual method of accounting, income is recognized when the right to receive such income is established and the amount can be determined with reasonable accuracy.
- IRC §461 allows a deduction for expenses incurred in the taxable year in which the all events test is met by an accrual basis taxpayer. The all events test includes three prongs, which includes the occurrence of the event, ascertainment of the amount of expense with reasonable accuracy and if the performance has taken place with respect to the liability. Costs of any perks or gifts given to the contributors and other expenses related to the campaign are eligible for a deduction.
- The IRS also brought up IRC §162 to ascertain whether the expenses of a campaign would be deductible for business purposes. The factors to be considered include:
    - Is the campaign owner actively engaged in a trade or business?
    - Is it a startup or an established trade or business? (Startup costs like legal fees, employee training expenses, advertising costs can be either capitalized or amortized over a period of time. But the condition for deductibility is that the activity must be considered an active business)
    - Are there any expenses incurred which are deductible under IRC §162?

To illustrate deductibility of expenses under IRC 162, Ms. Rhea mentioned *Richmond Television Corp. v. United States*[4], wherein the IRS disallowed deductions claimed under IRC §162 for all training costs incurred by the taxpayer after obtaining a television broadcast license. The issue was whether the expenses incurred by the taxpayer were deductible as capital expenditures amortized over the life of the asset or as ordinary and necessary expenses under IRC §162. According to the IRS, to qualify for a deduction under §IRC 162, expenses must be ordinary and necessary which must be paid or incurred in carrying on a trade or business within any taxable year. It was laid out that taxpayer is said to be engaged in a trade or business when it has "begun to function as a going concern and performed those activities for which it was organized." *Richmond Television Corp. v. United States 345 F2d 901(1965)*

Ms. Rhea added that IRC §183 applies when the activity is not engaged in for profit. IRC §183 provides that if an activity is not engaged for profit, then no deduction would be allowed for expenses incurred in relation to such activity. IRC §183 further states that expenses incurred that would be otherwise allowable if the activity was engaged in for profit may be deducted provided the expenses do not exceed the gross income related to the hobby. Also, the law presumes that an activity is not engaged in for profit, if there are losses in three or more years out of five consecutive taxable years.

Reg §1.183-2(b) provides nine factors for determining whether a taxpayer engages in an activity for profit. Some of them are the time and effort invested in the activity, the level of expertise, taxpayer's history of income and losses with the activity, the relative amount of profit or loss, and the element of personal interest or recreation. Crowdfunding receipts may be treated as hobby revenues or income from trade or business depending on the time and effort invested or the frequency of transactions and the frequency of profit gained or loss suffered from the activity.

[4] Richmond Television Corp. v. United States, 345 F.2d 901 (4th Cir. 1965), vacated and remanded per curium on other grounds, 382 U.S. 68 (1965), original holding on this issue affirmed, 354 F.2d 410 (4th Cir. 1965), overruled on other grounds by NCNB Corp. v. United States, 684 F.2d 285 (4th Cir. 1982)

Donation to a Campaign - Is It a Gift or a Charitable Contribution?

The answer is … it may or may not be a charitable contribution. Contribution`s made to crowdfunding websites are generally considered gifts and not donations Crowdfunding websites like GoFundMe.com have Certified Charity campaigns which are considered as §501(c)(3) tax-exempt organizations. In such circumstances, the donated funds will be treated as a charitable contribution.

To determine whether the donation is a gift, the intent of the donor should be considered. To prove it is a gift, factors like generosity of the donor need to be considered. Any service or discount received by the donor in exchange for making the gift also impacts the nature of the donation. Also, if the amount of the gift exceeds the annual gift tax exclusion limit of $14,000, filing of Federal gift tax return is required.

6.0 Crowdfunding and Sales Tax

Sales tax is imposed by majority of states in the USA. For any state to levy sales tax on tangible property sold, there should be nexus between the state and the business. Nexus refers to a minimum connection or a rational relationship between the state and the activities of the business. Nexus for sales tax is triggered by presence of an employee, office, warehouse, etc. in the state. In Quill Corp. v. North Dakota, 504 U.S. 298, a landmark case in reference to sales and use tax, the Supreme Court ruled that physical presence is required in a state to levy sales tax.

Sales tax issues come up when campaign owners having nexus in a state give away perks or gifts to the contributors. The campaign owners, sometimes, give gifts of nominal value or rewards to the contributors in exchange for their contributions. Such gifts may be in the form of an event ticket, a discount card or a t-shirt with their logo on it, etc. If an item is sold at concessional prices to the contributors, then sales tax is normally due on the selling price. If the item is given away as a perk or a gift, then sales/use tax is normally due on the cost of the item to the campaign owner.

Conclusion

With the increasing popularity of crowdfunding, many taxpayers are being involved either in initiating a campaign or donating to one. As tax professionals, we should inform clients that crowdfunding has specific tax filing and reporting requirements. For campaign owners, things need to be considered include: income recognition, year of deduction for expenses, and sales tax issues on products sold or gifts given during the campaign. We should also educate them on tax implications for contributions made to a campaign and how the filing requirements differ when the donation is categorized as a gift versus as a charitable contribution.

Digital Security - Expanding Your Technical Awareness

By: Nilesh Lad, CPA, *MST Student*

During the panel on Thriving in the Digital Economy-Best Practices for Small Businesses and Their Tax Advisers, John Giodano and Neal McCarthy, both cyber-security experts with SecureWorks, and Sean McLean, PMP, an IT Director with Petrinovich Pugh & Company LLP, discussed today's challenges in safeguarding digital information and best practices to protect this information.

Threats Today

Digital security is an ever-increasing concern for businesses of all sizes, including CPA firms. The perpetrating thefts of digital information are motivated by financial gain as this information has tremendous value in criminal markets. Threats come from individuals, criminal groups, and nation states. They target individuals, businesses, governments, and other types of organizations that keep confidential information that can be used for financial gain. The most common tactic for gaining access to confidential information is "phishing." Phishing attacks come from emails that appear to be legitimate, but they have attachments or links that, when opened, will give the perpetrator access to the computer and other devices connected to the internal network. Often, the ultimate target of the attack is compromised indirectly by gaining access to the target via vendors and customers with which the target does business, such as CPA firms and their CPA websites.
Types of incidents include theft of banking information, other financial information, Personal Identifiable Information (PII), ransomware, and computing power via botnets.
Most threats are opportunistic (88%) rather than targeted to the specific victim (12%).
Opportunistic threats are volume attacks that usually use phishing emails in the hopes of someone opening an attachment or clicking on a link.

Network breaches and data losses of PII are significant risk areas for any organization that keeps confidential information. Organizations must be aware of the various federal and state laws that require specific industries like professional tax preparers to establish safeguards to protect taxpayer information. Organizations are also normally required to provide notifications and free credit monitoring for customers whose information may have been stolen.

Security Solutions

Organizations need to focus on three areas to protect against cyber threats: prevention, detection, and correction. Prevention is key as it requires proactive steps to stop the threats in the first place. Prevention is two-pronged: policy and technology. Policies ensure that the basics are in place to provide a solid security foundation. They include things such as robust password policies, computer usage policies, data retention and disposal policies, and user education. Policies are also critical as threats could come from insiders, like employees, and the loss of data paper sources. These issues are especially true for tax preparation businesses that have significant amounts of financial and PII information on printouts, so non-electronic data security is just as critical. Preventative technology includes keeping software and virus protection updated, reviewing security certificates, using a secure portal to share data with clients, implementing a firewall with the ability to filter content, keeping both offline and online backups, and applying proper user access privileges. Other options are available, but may not be viable for many small tax practices due to costs and technological expertise needed.

Threat detection is more challenging than prevention as solutions to detect existing security breaches are often costly and therefore not as viable for small businesses. Corrective actions are reactive and based on fixing the cause of breaches. Again, for small businesses, some corrective measures may not be viable.

The IRS has two publications that provide an excellent guide for protecting taxpayer data.1 These guides are especially useful to smaller tax practices as they provide guidelines and tools that can be implemented and utilized by businesses of all sizes. In addition, the guides cover both non-electronic and electronic threat preventions.

Conclusion

Threat prevention is critical for all organizations that have financial and PII information, but it is especially critical for professional tax practices. Professional tax practices also have higher exposure to non-electronic threats due to the high volume of paper documentation. Implementing a good foundation of basic policy and technology solutions will protect most professional tax practices from the most common types of electronic and non-electronic threat.

[1] Internal Revenue Service. *Publication 4524 (Rev. 9-2015): Security Awareness for Taxpayers,* retrieved from: https://www.irs.gov/pub/irs-pdf/p4524.pdf, and *Publication 4557 (Rev 10-2015): Safeguarding Taxpayer Data – A Guide for Your Business.* Retrieved from: https://www.irs.gov/pub/irs-pdf/p4557.pdf

IRS Future State

By: Sara Yaqin Sun, MST Student

The Fifth Annual IRS-SJSU Small Business Tax Institute was held to address tax-related topics faced by small business owners and tax practitioners in today's digital economy. By taking advantage of the digital age and the latest technology, the IRS has initiated a *Future State of Tax Administration* to promote a superior user experience for taxpayers and practitioners. A three-member panel, consisting of Vivienne Antal and Gerry Kelly-Brenner, both representing the IRS Stakeholder Liaison Office, and Claudia Hill, EA, MBA, President of Tax Mam Inc., focused on the IRS Future State at the conference.

Digital Security and the Role of Stakeholder Liaison

Ms. Hill is the Editor in Chief of Wolters Kluwer's *Journal of Tax Practice & Procedure* and served on the IRS Commissioner's Advisory Group to Larry Gibbs in the 1980s. As an active tax practitioner, she frequently speaks at seminars for EAs, CPAs, and tax organizations - including the IRS. Ms. Hill commented on the digital security issues discussed in the previous presentation of the conference and suggested when facing data theft and hacking, firms should talk to the IRS Stakeholder Liaison representatives and follow the available procedures to minimize the taxpayers' losses.

As part of the IRS Small Business/Self-Employed Division, the Stakeholder Liaison intends to establish relationships with small business owners and tax practitioners to provide them tax information and resources offered by the IRS.[1] As Senior Stakeholder Liaisons, both Ms. Antal and Ms. Kelly-Brenner represent the IRS at a variety of educational outreach events, conferences, seminars, and workshops on tax-related topics. Ms. Kelly-Brenner also commented that to avoid being negligent, tax practitioners should make the greatest efforts to safeguard their clients' information. More digital security issues were discussed throughout the panel as a primary component of the strategic plan of the Future State.

[1] Internal Revenue Service (2017). *Stakeholder Liaison Local Contacts.* Retrieved from: https://www.irs.gov/businesses/small-businesses-self-employed/stakeholder-liaison-local-contacts-1

IRS Future State

Ms. Antal commenced the official discussion on the IRS Future State. She explained that the purpose of the Future State is to improve taxpayer experiences by providing them with accurate information and timely services. Ms. Antal pointed out some of the key objectives they have been trying to achieve:

- Easy and correct access to information via different communication channels.
- Ability for taxpayers to self-adjust account information.
- Case-solving within the first year of filling of the returns.
- Higher rate of compliance.
- More satisfying interactions between the taxpayer and the IRS.

The Taxpayer Component

Ms. Kelly-Brenner continued the panel discussion and introduced the taxpayer component of the Future State. She specified that the IRS is working to serve the taxpayers effectively and efficiently by offering a complete online experience that is similar to what the taxpayers get at banks or retail businesses. The components of the full-cycle online operations are as follows:

- Access to an online account to get personalized guidance and notices.
- Strengthened security to protect taxpayer identification.
- Self-adjustments to taxpayer account information and self-correction of return errors.
- Secure messaging for taxpayers and IRS agents to interact online.
- Authorization for representatives to access client account information (specifically for business taxpayers).

Operational Efficiencies

Ms. Kelly-Brenner also illustrated the concept of providing the best taxpayer experience possible at all stages of return filling with more efficient operations. At the pre-filing stage, taxpayers would be able to get the information they need to file their return online, either from e-subscriptions or from speaking with an IRS agent. The IRS is expected to increase their educational outreach to keep taxpayers informed on the filing requirements as well. At the filing stage, the IRS would provide taxpayers with guidance with clear explanations in a plain language which would help them to understand the types of adjustment that will need to be made prior to filing. For the post-filling stage, the IRS would detect errors and promptly send an early notification to taxpayers. Certainly, these ideas would not be realized without more efficient operations.

The overall goal of these strategies is to be a model of efficient operations that is adoptable, adjustable, and flexible. As a part of the model, an efficient workforce would be able to identify highest priority activities early, and analytics-driven operations would help with the taxpayer outreach and deliver tailored information to taxpayers. Again, taxpayer files would be digitized over secure channels that are accessible online. The IRS hopes to build a solid foundation in the near future.

IRS Online Tools

Many taxpayers who have more complex compliance issues will need regular responses from the IRS. The very first and easiest step taxpayers can make is to look through the information and guidance available online at www.irs.gov. The IRS website has experienced technical updates and transformations and is now more user-friendly, interactive, and easier to navigate. According to Ms. Antal, the majority of online tools are accessible on one page. The most commonly used tools offered online to individuals and business taxpayers include requesting a copy of a tax transcript, making an electronic tax payment, and getting an Employer Identification Number (EIN).

Ms. Kelly-Brenner also pointed out there are numerous tools available for tax professionals as well. They can check the tax calendar, request or renew a Preparer Tax Identification Number (PTIN), and subscribe to the periodic e-News from the IRS.

Next Steps and Goals

The panel noted that besides combatting identify theft and improving taxpayer expectations, another goal of the Future State is to maximize the use of the Service's budget and resources. It was noted that 25% of the overall IRS workforce was eligible to retire in 2016, and the number will exceed 40% by 2019. The goal of these current and planned improvements is to continue to provide quality services to taxpayers.
It will require a lot of effort to realize the visions of Future State. The IRS will pursue priority initiative development with a continual focus on engaging its stakeholders. The IRS welcomes taxpayers and practitioners to track its performance towards the discussed goals and provide feedback as part of the process.

Tax Maven
The Contemporary Tax Journal's Interview with Mr. Jim Fuller

By: Ophelia Ding, *MST Student*

Mr. Jim Fuller is a partner in the Tax Group at Fenwick & West LLP in Mountain View, California. He was named seven times by *Euromoney* as one of the world's top 25 tax advisers and one of the U.S.'s top 30 transfer-pricing advisors.[1] He is the only U.S. tax adviser to receive a Chambers star performer rating (higher than the first tier) in Chambers USA (2017).[2] He also is one of the three "most highly regarded" U.S. tax practitioners according to Who's Who Legal (Law & Business Research Ltd 2016).[3] Mr. Fuller holds a B.S. degree from New York University, a J.D. degree from Fordham University, and an L.L.M. in Taxation from New York University.

I had the pleasure to meet and interview Mr. Fuller on November 13, 2017 during the two-day 33rd Annual TEI-SJSU High Technology Tax Institute where Mr. Fuller was a presenter. Beyond his exceptional reputation and professional achievements in the tax and legal communities, I found Mr. Fuller personable, approachable, and gregarious. Our encounter was a short, yet memorable and inspiring one. Mr. Fuller was kind enough to share his career experiences and thoughts with *The Contemporary Tax Journal.* Following are Mr. Fuller's answers to our questions.

How did you get involved in the tax field? Was that your plan when you started law school?

[1] *Euromoney* is a U.K. English-language monthly magazine focused on business and finance. For more information, see https://www.euromoney.com/.

[2] From the Chambers USA guide: the preeminent James Fuller remains a market leader in transfer pricing, an area in which he is regarded as an "all-star." Clients praise "his outstanding knowledge of the international and domestic sections of the internal revenue code." They also laud "his ability to communicate the analysis and jointly reach a conclusion." *Chambers and Partners* have been ranking the best lawyers since 1990, covering 185 jurisdictions. According to the *International In-house Counsel,* 51% of over 20,000 in-house counsel from around the world chose to use *Chambers and Partners* directories to identify law firms/individuals. For more information, see https://www.chambersandpartners.com/12059/49/editorial/5/1#profileEditorial_160258.

[3] Who's Who Legal identifies "the foremost legal practitioners in multiple areas of business law" per comprehensive, independent research. It features over 17,000 of the world's leading private practice lawyers from over 100 national jurisdictions. For more information, see http://whoswholegal.com/about/.

I had no plans to practice tax law. However, as an associate with a large NYC firm, it seemed to me that in litigation you worked hard to master a substantive area of law perhaps never again to use that substantive knowledge. The corporate work I did as a first-year associate wasn't especially exciting. I liked tax. It seemed as though there were substantive building blocks with each project and that those building blocks could and likely would be used again on future projects. I also liked the idea that in matters such as M&A, for example, the tax people had to be in the deal early to structure things. In tax, you also could be involved post-closing to help the client integrate the acquired business operations into its business.

What led you to Fenwick and West? What are your specialty areas?

I had decided as a fifth-year associate that I was going to change firms. I liked the work I had been doing (corporate international tax), but the partner for whom I did most of my work got "punished" as a result of certain partner-level law firm politics. His punishment in part was that he couldn't work with me anymore! That didn't seem so cool to me. I had not done anything wrong. After that, my work changed to having a more domestic focus. During this time, a group of former Cleary Gottlieb associates left New York to start their own firm in Palo Alto. I knew them while they were in New York. However, the idea of moving across the country didn't appeal to me. I had a typical New Yorker's parochial (narrow) view of the world. California didn't seem like a good place for a nice New York guy like me. Nonetheless, these Fenwick lawyers were unrelenting and kept their recruiting efforts going. They just wouldn't give up. I finally gave in.

I guess I really lucked out! I was lawyer #18 when I joined Fenwick. The Fenwick and Wilson firms were about the same size then (each barely took up one floor at Palo Alto Square), and there were no outsiders (firms based elsewhere but with offices here). Silicon Valley grew rapidly after I arrived and so did the Silicon Valley legal practice. It grew to become the envy of lawyers everywhere.

What stands out as a few of your most significant career accomplishments?

There have been many. Early in my practice (I had just made partner), I was involved in a huge deal in which my client, Chrysler, then one the U.S.'s so-called "Big Three" auto companies, was selling its European operation to Peugeot. We flew the Concorde New York to Paris and spent the next two weeks negotiating with Peugeot's lawyers and European bankers in Paris and Madrid. We flew the Chrysler company plane back and forth between the two cities. I had designed a structure that saved Chrysler hundreds of millions of dollars in tax in the transaction, and there I was the head tax person in charge of negotiating all of the parts necessary to make it work!

Working for young Apple Computer, in days long gone by, we represented the company in Tax Court on a U.S.-Singapore transfer-pricing matter and designed and participated in the first ever transfer-pricing arbitration matter under the Tax Court's arbitration rules. Working with a Silicon Valley client, we "invented" the first commissionaire structure for an American company to use in selling goods in Europe. Nobody had ever heard of such a thing at that time, not even the Europeans. It was for operational reasons -- it was a better way to operate, but it also produced nice tax benefits. As word about the structure spread (with the unasked-for assistance of the company's auditor), it quickly became the method-of-choice for American companies to use to sell goods in Europe, and it lasted as the preferred method for most American companies for the next thirty years.

In 1985, I was invited to Beijing by the Chinese government to discuss how China should change its tax laws to accommodate the country's planned transition to a more capitalist economy. There were four of us. I was the only American. It was exciting. Many of our recommendations were later adopted. To this day, I remain good friends with, and work with, one of the Chinese government representatives at those meetings. He's now a practicing tax lawyer in Shanghai.

We also have been involved in a number of the recent U.S. corporate inversion transactions. These transactions are both interesting and challenging for a tax practitioner. They typically involve both a large international M&A transaction and lots of interesting international structuring. The IRS also seems never to stop issuing regulations and notices under the inversion statute even though these pronouncements often seem unrelated to the purpose or language of the statute. The tax advisor needs be very current in handling these transactions.

How do you keep up to date with the changes in tax law and the ever-changing technology of the Silicon Valley tech companies?
This is one of the things that I like most about the tax law: it's an ever-changing area of law. You're always learning. It never gets boring. I read the tax services first thing each morning. On any given day, an IRS ruling or a court case can affect what you're working on, or affect advice that you gave last week or last month and which you will now need to update or revise. Such a development also can make something work that had problems before.

Since our practice is mostly in the international area, the chances of a relevant change such as this increases many-fold: it could be the change is in the French tax law, or a new Chinese regulation. You need to depend on foreign tax counsel to keep you current on that front. Good foreign tax advisors are necessary. You need them to be proactive and keep you current as necessary.

Changes in a client's technology or the development of new technologies simply makes the work more exciting and interesting. There is no way the tax law could ever keep up with the everyday, fast-moving changes we see in Silicon Valley. I wouldn't want to practice anywhere else in the country!

What do you think is one key area of our federal tax system that could/should be improved and why?
Our corporate tax rate has been way too high compared with corporate tax rates in the rest of the developed world. Our system of taxing foreign corporate earnings also is a dinosaur. Most other developed countries went to a territorial tax system (foreign operating earnings not taxed) long ago. Combined, these give foreign-based corporations a huge business advantage over U.S.-based corporations. I just don't understand why Washington doesn't

get it. And it's not just the Washington of today. This has been a problem for a couple of decades. While Congress plans to lower the corporate tax rate starting in 2018, its half-baked attempt at a so-called territorial system will only make things worse over time. No other developed country has such a strange system with all foreign earnings currently taxed, although at a lower rate. I thought the idea was to make American companies more competitive.

(Please note that this interview took place before the Tax Cuts and Jobs Act (TCJA) was signed into Public Law No. 115-97.)

What do you think is the biggest challenge facing tax professionals today?
Keeping current. Understanding clients' businesses and needs. Being both creative and practical.

What advice do you have for students preparing for a career in tax?
Stay current. Understand your clients' business and its needs. Be both creative and practical.

If you could have dinner with anyone, who would it be?
My Dad and my Mom, both of whom passed some years ago. They're the greatest people I ever knew. Jennifer (my wife) and I would love to have them at our house for dinner. Maybe we could convince them to stay for a while.

What is the most unusual item in your office or something in it that has special meaning to you?
A bar towel from a Fuller's pub in London. It's got a funny story attached. It was a client who took me there. I'd need a Fuller's London Pride (beer) to tell the story!

Ophelia Ding and Jim Fuller

Focus on Tax Policy

The following articles were written by students of the Tax Policy Capstone Summer 2017 Class of the MST Program at San Jose State University.

Please note that all bills were analyzed before the Tax Cuts and Jobs Act (TCJA) was signed into Public Law No. 115-97

H.R.2551 - 115th Congress (2017-2018) - Student Loan Debt Relief Act

By: Soon-Young Apple, Debanjana Banerjee, Nilesh Lad, Anna Li
MST Students

Introduction

H.R. 2551 (115th Cong.), the Student Loan Debt Relief Act, was introduced on May 19, 2017, by United States Congressman Steve Stivers (R-OH-15). If passed, the bill will modify IRC Section 127 (Educational Assistance Programs) and IRC Section 221 (Interest on Education Loans). The bill has three areas of focus. First, the bill will expand the non-taxable fringe benefits for educational assistance programs to include student loan repayment programs. Second, the bill will increase the maximum non-taxable fringe benefits amount from $5,250 to $10,000. Finally, the bill will increase the maximum deduction allowed under IRC Section221 for qualified student loan interest, from $2,500 to $5,000 with a new phase-out range.[1]

In his statement released on April 27, 2017, Congressman Stivers estimates that the current student loan debt of the nation is at $1.4 billion, affecting over 70 percent of college-going students and graduates. He stated that "over 15 percent of borrowers have either defaulted or been delinquent in repaying their loans."[2] Many citizens who pursue higher education are left with no option but to take on student loans that they must pay back with low paying entry level jobs. Also, according to a Gallup poll, one in five graduates is hesitant to start a new business because of their student debt, which in turn hinders our economy.[3]

H.R. 2551 intends to reduce the burden of student loans on students and graduates, who in many cases are starting their careers with lower-paying jobs and large debts. The bill enhances students' ability to repay their debt through tax-free employer-assisted programs and increased interest deductions. The bill will also help those graduates with higher paying jobs like doctors, lawyers, and high-tech professionals, who tend to have the highest student loan balances.

[1] 115th Congress (2017-2018). H.R.2551 - Student Loan Debt Relief Act. Retrieved from: https://www.congress.gov/bill/115th-congress/house-bill/2551
[2] Representative Steve Stivers (R-OH-15th Dist.). April 27, 2017. Opinion Piece – Repaying Loans, Relieving Student Stress. Retrieved from: https://stivers.house.gov/news/documentsingle.aspx?DocumentID=399231
[3] Brandon Busteed. (October 14, 2015). Gallup News - Student Loan Debt: Major Barrier to Entrepreneurship. Retrieved from: http://news.gallup.com/businessjournal/186179/student-loan-debt-major-barrier-entrepreneurship.aspx

Note: this analysis focuses on the changes H.R. 2551 proposes to make to IRC Section 127. A copy of the bill can be found at congress.gov.

IRC Section 127 was enacted as part of the Revenue Act of 1978. Since its enactment, it was scheduled to expire numerous times, but the American Taxpayer Relief Act of 2012 permanently extended this employer-provided education assistant program.[4] Under Section 127, an employer who maintains a qualified educational assistance program can offer tax-free educational assistance up to $5,250 annually to its employees. For an educational assistance program to be qualified under Section 127, it must be documented as a written plan that is nondiscriminatory (i.e., it should not be in favor or highly compensated employees). Also, the eligible employees should not have the option to choose between educational assistance benefits and other types of compensation. The Section 127 benefits can be used to cover employees' tuition, books, and supplies for both job or non-job related education. Currently, the employer-sponsored educational assistance program under Section 127 excludes employees who are covered by a collective bargaining agreement.[5]

Principles of Good Tax Policy

The following section will briefly analyze H.R. 2551 using the Guiding Principles of Good Tax Policy outlined in the AICPA Tax Policy Concept Statement No. 1.[6]

Criteria	**Does the proposal satisfy the criteria? (explain)**	**Result**
Equity and Fairness – Are similarly situated taxpayers taxed similarly? Consider the tax effect as a percentage of the taxpayer's income for	<u>*Horizontal equity:*</u> Horizontal equity requires similarly situated taxpayers to be taxed similarly. Tax incentives could cause similarly situated taxpayers to pay different amounts of tax. For instance, if two employees earn the same amount of wages, the one who has student loan debt and can take advantage of the employer-provided loan repayment program under H.R. 2551 will pay less tax compared to the one without student loan debt. Also, employees working for different	-

4 American Taxpayer Relief Act of 2012 (Public Law 112–240). Available at: https://www.congress.gov/112/plaws/publ240/PLAW-112publ240.pdf
[5] A collective bargaining agreement refers to a contract between an employer and a group (usually a union) bargaining on behalf of employees where educational assistance benefits were the subject of good faith bargaining.
[6] American Institute of Certified Public Accountants (AICPA) Tax Division. (January 2017). *Tax Policy Concept Statement 1 - Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals.* Retrieved from: https://www.aicpa.org/ADVOCACY/TAX/downloadabledocuments/tax-policy-concept-statement-no-1-global.pdf

different income levels of taxpayers.	employers where one offers educational assistance as defined in H.R. 2551, the employees will be taxed differently even if they have the same wage income and education expenses. Furthermore, the bill does not fix the eligibility issue noted in IRC Section 127(b)(2). Under Section 127(b)(2), employees who are covered by a collective bargaining agreement are excluded from the employer-provided educational assistance program. Collective bargaining agreements may provide a smaller amount of educational assistance. It would be unfair to union employees, who receive a smaller amount of benefits through a collective bargaining agreement, compared to employees who directly participate in employer-assisted programs and receive a higher amount of benefits. Although the bill would improve the inequity of the current Section 127 by expanding benefits to taxpayers who incurred student loans prior to employment, it remains unfair to employees without student loans (including those who never had them or paid them off prior to starting work) and employees under a collective bargaining agreement who might receive a smaller benefit amount. This undermines the horizontal equity principle. *<u>Vertical equity:</u>* The vertical equity principle is accomplished when taxpayers with a greater ability to pay should pay more tax than taxpayers with a lower income. H.R. 2551 will diminish the progressivity of the tax code as the tax benefit of the exclusion is greater for employees in higher tax brackets.	
Certainty – Does the rule clearly specify when the tax is owed and how the amount is	The qualified person under Section 127 who is eligible to receive the tax benefit per H.R. 2551 is not the same as under Section 221.	-

determined? Are taxpayers likely to have confidence that they have applied the rule correctly.	A taxpayer must first determine what constitutes as a "qualified education loan" under Section 221(d)(1). Per Section 221, qualified education loan is "incurred on behalf of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer as of the time the indebtedness was incurred." On the other hand, the rule that is related to Section 127 and Reg. 1.127-2(d) applies only to employees. To improve the principle of certainty, the bill should be modified to indicate it only applies to an education loan for the employee's education.	
Convenience of payment – Does the rule result in tax being paid at a time that is convenient for the payor?	The broader exclusion of modified Section 127 should not an effect on an employee's time of payment. An employer's payment of an employee's education debt will make it easier for the employee to have funds to pay his/her taxes.	+
Effective Tax Administration – Are the costs to administer and comply with this rule at minimum level for both the government and taxpayers?	Under the current law, as noted above, students are taxed on loan repayment assistance from employers on qualified education loans as fringe benefit income. Bill H.R. 2551 amends Section 127(c) by re-classifying such loan repayment assistance as a non-taxable benefit to employees. This may reduce the cost of auditing some income tax returns of student employees who receive education loan repayment assistance below $10,000 from their employers. In addition, it may reduce the compliance burden on employees as they do not need to keep track of any such assistance provided by employers. Thus, it appears that the bill may have some positive impact on effective tax administration though the extent would depend on the number of employees receiving the assistance below the threshold amount. Currently, the maximum exclusion of employer-provided educational assistance program is $5,250. Merely raising the	+/-

	limit from the current threshold to $10,000 would not impact employer's reporting or collection obligations. Lastly, the effect on time needed to implement the change might be positive. To promote such educational assistance programs, it would be imperative for employers, tax practitioners, educational institutions and lenders to undertake certain steps to market such programs. With the increase in the threshold of fringe benefit income exemption, it is likely that lenders would market student loans more actively. For instance, lenders might work with educational institutions to promote such loans among the student community. Further, employers may use this provision as a recruitment tool to hire talent at campus events because more students pursing courses are likely to incur student debt. A marketing practice followed by one firm may soon be adopted by others to compete for hiring the best talent. Therefore, awareness about the existence of this provision may increase. Based on our analysis, the government can easily administer this provision and induce compliance by taxpayers without incurring additional costs. It can be concluded that the overall impact of the bill on effective tax administration is neutral.	
Information Security – Will taxpayer information be protected from both unintended and improper disclosure?	The bill does not introduce any new information reporting or compliance requirements that could potentially expose more taxpayer information. Employers would continue to report their education benefits in excess of $10,000 as compensation on Forms W-2. In doing so, no additional taxpayer information is required by employers. In a situation where employers make principal or interest payments on qualified education loans directly to lenders, no additional sensitive tax information is required to be furnished by the employers in the process (employers already have employee tax	+ / -

	identification information). Therefore, employees would not be required to share additional information with employers related to the provisions in this bill. Also, there is no added complexity due to which lenders would require taxpayers to furnish additional information that could risk the unintentional or improper disclosure of taxpayer information. Thus, the bill does not impact the principle of Information Security.	
Simplicity - Can taxpayers understand the rule and comply with it correctly and in a cost-efficient manner?	H.R. 2551 raises the limit of maximum income exclusion from gross income from $5,250 to $10,000. It also expands the definition of educational assistance to include payments made by employers to employees or lenders of principal or interest on qualified education loans incurred by employees. In terms of simplicity, the rules are easy to understand without ambiguity. The changes can also be implemented without incurring additional costs. Also, the bill is easy to comply with as it does not require any additional forms. Therefore, in its current form, the bill achieves the principle of simplicity. However, it might cause unintended consequences if no process is in place to verify if the loan was truly for educational purposes.	+
Neutrality – Is the rule unlikely to change taxpayer behavior?	While this bill will have limited impact on taxpayer decisions to pursue undergraduate, graduate, or other educational opportunities, it will influence taxpayer decisions regarding how they fund their education. If employer student loan debt repayment programs are included in non-taxable income and the exclusion amount is increased to $10,000, students might prefer student loans over grants, scholarships, and other options because the	-

	application process for student loans is simpler and more certain. This could result in higher student loan debt as students take on more debt in lieu of free or cheaper funding options because they expect their future employer to offer a tax-free repayment program. The bill may also affect employers' decisions regarding employee compensation as they shift their recruiting resources to student loan repayment programs. Changes in compensation and benefit programs may negatively affect other employees who will receive no benefit from these changes. Additionally, the bill will most likely affect taxpayers' employment decision as those with student loans will prefer employers with a Section 127 program.	
Economic growth and efficiency – Will the rule not unduly impede or reduce the productive capacity of the economy?	The bill could have a positive impact on productivity as it may provide some additional benefits that would enable companies to recruit skilled labor at multiple education and experience levels that would improve efficiency and economic growth. Employees would have more disposable income as they would not have to use after-tax dollars to pay off loans, or include the student loan repayment paid by employers in their income. This could lead to more spending and increased economic activity. Student loan delinquency should also go down as more students are able to pay off loans. This will result in a stronger economic performance for both private student loan lenders and government lending programs.	+

Transparency and Visibility – Will taxpayers know that the tax exists and how and when it is imposed upon them and others?	As the bill increases benefits to taxpayers, employers and student loan lenders will likely promote these benefits to attract employees and students. In addition, the current legislation includes a provision Section 127(b)(6), that requires employers to notify employees of educational assistance programs and the terms of those programs. Thus, it is likely that students and employers will be aware of the Section 127 benefit and its tax effect.	+
Minimum tax gap – Is the likelihood of intentional and unintentional non-compliance likely to be low?	Section 127 allows an employee to exclude from gross income certain educational assistance provided by employer. Intentional non-compliance of the section is likely low because Section127 benefits the taxpayers by reducing the employee's taxable income. H.R. 2551 amends Section127 so that certain education loans paid by employers also qualify for income exclusion. As the proposed bill would broaden the tax-free fringe benefit provided to employees, intentional non-compliance is unlikely. Unintentional non-compliance could occur if employees are unaware of, or incorrectly interpret the new rule on educational loan assistance. Most taxpayers do not monitor the change in the tax code. Unless the employees are informed of this new bill (by their employer, school, or student loan agency), it is possible that they would report an incorrect amount of gross income on their tax returns. However, most employers do regularly monitor the change in tax rules on fringe benefits. Because employers, not employees, have the responsibility to issue correct form W-2s, and the impact of the new bill should be directly reflected on an employee's W-2, the risk of unintentional non-compliance is not significant. H.R. 2551 amends the annual income exclusion threshold from \$5,250 to \$10,000. Similar to the other amendments to Section 127, the risk of intentional non-compliance is low but	+

	the risk of unintentional non-compliance exists. Once the employees are aware of the changed rule, accurately reporting the taxable income should not be an issue because the language and guidance provided under Section 127 are clear and simple. It is important that a system exist to verify that any loan payment by the employer is for the employee's eligible student debt.	
Accountability to taxpayers – Will taxpayers know the purpose of the rule, why needed and whether alternatives were considered? Can lawmakers support a rationale for the rule?	Although most taxpayers do not pay close attention to the developments of tax laws, employees have several means to obtain information about H.R. 2551. For instance, the bill is published on the government website, and it is likely advertised to employees by their employers, schools, student loan creditors, and/or their tax accountants. Today, most employees who receive student loan assistance from their employers also hire a tax accountant, or use a tax software, to prepare their income tax returns. These qualified tax preparers are generally knowledgeable about the developments in tax laws, so the risks of employees not being aware of this new rule is low. It is noteworthy to mention that employers who provide educational assistance to its employees would likely advertise this new bill as a mean to attract future employees. This provides another layer of accountability to ensure taxpayers have the appropriate information and knowledge of the new bill.	+
Appropriate government revenues – Will the government be able to determine how much tax revenue	H.R. 2551 allows an employee to exclude up to $10,000 of employer provided educational assistance from his/her gross income each year. Compared to the current income exclusion limit of $5,250, the proposal will reduce government revenue. The taxing authority has access to certain data on existing education assistance programs and student loans, which will	-

will likely be collected and when?	help the government estimate how much revenue will decline due to the proposed bill. For instance, according to the *Society for Human Resource Management, (SHRM)* the number of people who received Section 127 benefits were about 913,100 in 2007.[7] Per SHRM, the average Section 127 benefit received in 2007 was $2,700 ($3,701 for graduate students and $1,940 for undergraduate students). However, it is difficult to forecast whether H.R. 2551 would significantly influence taxpayers and employers' behavior. For example, an employer that had not previously offered student loan assistance may now consider adding student loan payment as a fringe benefit to further attract future employees. Revenue loss due to changed behavior is difficult to estimate. Furthermore, the potential social and economic impact due to improved productivity of the workforce is not easily determined (see additional discussion in the neutrality section).	

Conclusion

Based on the above analysis, H.R. 2551 has a positive rating for the principles of convenience of payment, simplicity, economic growth and efficiency, transparency and visibility, minimum tax gap, and accountability to taxpayers. It has a neutral impact on the policies of effective tax administration and information security. However, several key principles, including equity, certainty, neutrality, and appropriate government revenues are violated.

The intent of H.R. 2551 is to alleviate the current student debt crisis, which was a result of inadequate government support for higher education, insufficient funds of college students, and

[7] National Association of Independent Colleges and Universities (NAICU) & Society for Human Resource Management (2010). *Who Benefits from Section 127? A Study of Employee Education Assistance Provided under Section 127 of the Internal Revenue Code.* Retrieved from: http://www.cpepea.com/wp-content/uploads/2017/05/10-0418-Coalition-Report-on-Public-Policy-Issue-E-P-E-A_FNL.pdf

rising college tuition. According to the Tax Policy Center, the outstanding student loan balance was $1.2 trillion in 2013 which exceeded other household debt (excluding mortgages). This mounting student loan debt has a long lasting and debilitating impact on a student's life. Student loans will likely impede people's ability to buy their homes and secure their financial stability including saving for retirement. As stated in the U.S. Treasury's Revenue Proposal for 2017, "accumulation of knowledge and skills contributes increased productivity of workers" and ultimately benefits the overall economy.

Higher education helps people to get a better paying job. That said, with other pressing reform goals (such as tax, healthcare, social security), the bill, if enacted, would put more pressure on the budget. As a result, the bill could be modified to include a limit on the number of times such education assistance can be received as tax-free by an employee in a lifetime. Furthermore, with the Consumer Financial Protection Bureau estimating that the U.S. will be facing a shortage in certain fields such as teachers, healthcare workers, police officers etc., the bill may increase the threshold of tax free fringe benefits for those students who pursue education in such fields. In addition, the bill in its present form is likely to motivate students to opt for employer sponsored student loans over other forms of funding. Hence anti-abuse provisions, such as making the loan assistance taxable for employees if the education program or coursework (for which the assistance is made) is not completed during their tenure of employment with the employer, might reduce any abuses and the costs to the fiscal budget.

Analysis of H.R. 2802 - 115th Congress (2017-2018) First-Time Homebuyer Savings Account Act of 2017

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Introduction

There are many financial pressures on individual and family budgets, such as rent, student loan payments, car payments, child care, healthcare, and other routine living expenses. With all those pressures, saving for a down-payment and closing costs for the purchase of a first home can be extremely challenging. As the American dream of homeownership is getting further away for many Americans, tax law changes have been proposed or passed at different levels of the government to help those trying to buy or build their first home.

Currently, some states allow a *First-Time Home Buyers Savings Account*. Minnesota is the latest state to adopt such a plan, joining a growing list of states: Colorado, Mississippi, Iowa, Missouri, and Oregon. Pennsylvania, New York, Oklahoma, Maryland, Utah, and Louisiana have also shown interest in enacting legislation on First-Time Home Buyer Savings Account. These state-level First-Time Home Buyers Savings Account allow individuals and families to save for their first home by putting a percentage of their income, or a capped amount of funds, into an account that is free from state income taxes.[1]

On June 7, 2017, Rep. Mike Coffman[R-CO] introduced the First-Time Homebuyer Savings Account Act of 2017 (H.R.2802, 115th Congress).[2] This bill is almost identical to a previous bill he introduced in the 114th Congress (H.R. 5575, - 114th Congress) with minor differences. H.R. 2802 would amend the federal tax code to create a 529-style savings account for first-time homebuyers. "The goal is to take the highly successful 529 plan model, which provides parents a tax-advantaged means to save for their children's college education, and apply it to another area where savings are equally important: buying a first home". This bill mirrors legislation that received bipartisan

[1] Realtor Mag (June 01, 2017). *More States OK First-Time Buyer Savings Accounts*, Daily Real Estate Retrieved from: http://realtormag.realtor.org/daily-news/2017/06/01/more-states-ok-first-time-buyer-savings-accounts
[2] 115th Congress (2017-2018). *H.R.2802 - First-Time Homebuyer Savings Account Act of 2017*. Retrieved from: https://www.congress.gov/bill/115th-congress/house-bill/2802

support which was signed into Colorado law in 2016 and is similar to state laws in Virginia and Montana.[3]

As Coffman stated that "the First-Time Homebuyer Savings Account Act is a straightforward and bipartisan solution to this problem. If we can help Millennials attain homeownership, this would not only be a wise financial move for them but would have a broader positive financial impact for our economy as a whole."[4]

Supporters of this legislation include the National Association of Realtors (NAR) and the Colorado Association of Realtors. After reviewing the bill, they commented that "home prices are rising around the country, and putting a down payment forward is no easy task…the First-Time Homebuyer Savings Account is an innovative tool that will encourage people to save while putting the dream of homeownership closer in reach."[5]

H.R. 2802 bill would allow individuals to make up to $14,000 per year in after-tax contributions to the account, subject to a $ 50,000 lifetime contribution limit, a $150,000 limit on the fair market value of the account, and adjustments for inflation after 2018.

According to the bill, "Distributions from the account that are used to pay the qualified principal residence purchase expenditures of the designated beneficiary are excluded from gross income. A "qualified principal residence purchase expenditure" is with respect to a designated beneficiary who is a first-time homebuyer, any amount: (1) paid toward the purchase price of a principal residence of the beneficiary, (2) required to be paid to settle the purchase of such residence, or (3) required to be paid by the beneficiary to obtain acquisition indebtedness with respect to the residence". The bill also states, "Excess contributions to the account, distributions that exceed the qualified principal residence purchase expenditures of the beneficiary, and distributions that are not used for first-time homebuyer purposes are subject to specified taxes."[6]

[3] Coffman, Mike (June 7, 2017). *The First-Time Homebuyer Savings Account Act.* Retrieved from: http://www.publicnow.com/view/6E38EB8909366134C96975E64764102DA12E39D0
[4] *Ibid.*
[5] *Ibid.*
[6] United States Congress (115th Congress 2017-2017). *First-Time Homebuyer Savings Account Act of 2017, H.R. 2802.* Retrieved from: https://www.congress.gov/bill/115th-congress/house-bill/2802

Principles of Good Tax Policy

The following section will briefly analyze H.R. 2802 using the Guiding Principles of Good Tax Policy outlined in the AICPA Tax Policy Concept Statement No. 1.[7]

Criteria	Does the proposal satisfy the criteria? (explain)	Result
Equity and Fairness – Are similarly situated taxpayers taxed similarly? Consider the tax effect as a percentage of the taxpayer's income for different income levels of taxpayers.	On its surface, the bill is fair. After all, nobody is excluded from making contributions for the benefit of the designated beneficiaries. Everyone is treated equally. But when considering the most likely taxpayers who would utilize the account, the bill appears not to be fair. Since the bill was modeled closely after section 529, the data for 529 plans sheds some light on the taxpayers who would likely utilize the First-Time Homebuyer Savings Account. In 2012, GAO studied the data from the Survey of Consumer Finance and reported to the chairman of Senate Finance Committee that less than three percent of families had a 529 plan in 2010, and those who did tend to be wealthier.[8] The study estimated that the median financial asset value for families with 529 plans was about twenty-five times the median financial asset value for families without 529 plans, and the median income of families with 529 plans was about three times the median income of families without these accounts. Similar to the taxpayers with 529 plans, high income or net worth taxpayers would more likely take advantage of the proposed First-Time Homebuyer Savings Account. They	-

[7] American Institute of Certified Public Accountants (AICPA) Tax Division (January 2017). *Tax Policy Concept Statement 1 - Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals.* Retrieved from: https://www.aicpa.org/ADVOCACY/TAX/downloadabledocuments/tax-policy-concept-statement-no-1-global.pdf

[8] U.S. Government Accountability Office (U.S. GAO). December 12, 2012. *High Education: A Small Percentage of Families Save in 529 Plans*. Retrieved from: http://www.gao.gov/assets/660/650759.pdf

	not only have the resources to fund the account but are also more motivated to choose the tax-preferred account due to bigger tax savings. The proposed account is per taxpayer, instead of per beneficiary. Hence, one beneficiary could have multiple tax-preferred saving accounts set up for him or her. In this sense, the first-time home buyers are not treated fairly. The beneficiaries from wealthy families with multiple tax-preferred saving accounts would have advantages over their lower-income peers. No doubt, this bill would help someone to purchase the first home, but it would help high net worth or income taxpayers the most. Besides, like the 529 plans, this account would become a vehicle for the high net worth taxpayers to pass their wealth to the next or even the third generation in a tax-preferred account.	
Certainty – Does the rule clearly specify when the tax is owed and how the amount is determined? Are taxpayers likely to have confidence that they have applied the rule correctly?	The bill was modeled after Section 529. It covers many grounds, and it is a long and complicated bill. Uncertainty comes with the many new definitions in the bill. The first uncertainty is the definition of "first-time homebuyer." The definition of "first-time homebuyer" is "any individual if such individual (and if married, such individual's spouse) has had no present ownership interest in a principal residence." "Present ownership interest" is not defined in the bill. If one sells the current principal residence, waits for a few months, then purchase another one, does it count as no "present ownership interest"? Or does it have to be the very first home a taxpayer ever purchased? What about a married couple? Do both have to be qualified as first-time homebuyers? If one of them is qualified, can he or she use the	-

	funds from his or her account to purchase the residence? And, if yes, how much? Another uncertainty is the language at proposed Section 530A(d)(1)(F): “no deduction, credit, or exclusion shall be allowed to the taxpayer under any other section for any qualified principal residence purchase expenditures to the extent taken into account in determining the amount of the exclusion under this paragraph.” It is unclear what the bill is trying to prevent. There are more questions. Will the basis of the property be reduced by the savings benefit? If there are multiple beneficiaries, can one own multiple accounts for different beneficiaries?	
Convenience of payment – Does the rule result in tax being paid at a time that is convenient for the payor?	This bill satisfies the Convenience of Payment principle. Even though it was not mentioned explicitly, one can reasonably assume the tax is due at the normal due date of an individual’s tax return. Or a taxpayer can make estimated tax payments like any other tax due on one’s tax return.	+
Effective Tax Administration – Are the costs to administer and comply with this rule at minimum level for both the government and taxpayers?	There will be additional compliance and administrative costs to both the government and taxpayers. The government will spend considerable time to verify all the information such as purchasing agreement and bank account, etc. Also, the IRS will need to issue guidance to help taxpayers better understand the tax treatments and improve compliance. Thus, additional time and money will be needed in order to implement the benefit provided by H.R. 2802. From taxpayers’ perspective, they also need to spend more time and money for tax compliance since the tax is not self-	-

	assessed. A taxpayer may need to consult with a tax adviser so that additional tax preparation cost will incur.	
Information Security – Will taxpayer information be protected from both unintended and improper disclosure?	The party who administers the First-Time Homebuyer Savings Account should be similar to 529 education saving account. Brokers who administer 529 education saving accounts usually have secure and private systems to protect taxpayers' data and personal information from theft. Many of the brokers have encryption and other security technologies with service providers specializing in security process to inspect their security procedures.	+
Simplicity - Can taxpayers understand the rule and comply with it correctly and in a cost-efficient manner?	Taxpayers may not understand the rules as the interpretation is not straightforward, and tax compliance cost could be more expensive compared to a simple tax return filing. Taxpayers may need to file the returns with the assistance of tax professionals. The complexity is due to variables and limitations in the rule. For example, if the taxpayer withdrew money from the account and did not use all of it to purchase a qualified house, the unused portion is subject to both income tax and excise tax (such as for excess contributions). Also, the definition of "first-time homebuyer" is complicated to understand as it refers to "no present ownership interest in a principal residence". This will cause confusion since it is unclear whether a taxpayer will be considered as a "first-time homebuyer" if he or she had a house before and does not have any house currently. The bill is also not clear if a taxpayer with partial ownership would be qualified as a "first-time homebuyer."	-

	Moreover, the bill does not specify the tax effect if the account's fair market value exceeds $150,000. Due to the complexity of the rules involving many variables in the bill, taxpayers need to spend more time or money to understand the tax effects arising from the tax-preferred account transactions.	
Neutrality – Is the rule unlikely to change taxpayer behavior?	The bill does not meet the principle of neutrality because it encourages taxpayers to save more and use such savings for a principal residence. One purpose of the bill is to relieve the burden of parents when they buy a house or provide the down payment for their children. However, the bill does not indicate whether an individual can be the beneficiary of multiple accounts. It is possible that grandparents or other relatives will also establish the accounts for one beneficiary. Therefore, many people might contribute to the account to gain the tax benefit. Furthermore, the price of the real property is always high in some places, which makes it unaffordable to many families in the United States. However, the existence of First-Time Homebuyer Savings Account will make the housing purchase easier for some people. Many young people will be able to buy a house after they start working because they do not have to worry about the down payments. In addition, since the bill does not specify if different accounts can have the same beneficiaries, an individual can be the beneficiary from the accounts established by their parents, their grandparents, and other relatives even non-relatives. As a result, one individual can have much more than $150,000 when buying a house. Therefore, individuals with the account will be able to buy a more expensive house for their first residence.	-

Economic growth and efficiency – Will the rule not unduly impede or reduce the productive capacity of the economy?	In the short term, H.R. 2802 impedes the development of the economy. First, the bill will increase the government's deficit because the tax revenue from individual income tax decreases. Secondly, the bill also discourages taxpayers' spending. In the situation that a taxpayer's income remains unchanged, the First-Time Homebuyer Savings Account will encourage the taxpayer to increase their savings and decrease their spending. Therefore, it will not benefit the development of the economy in a short period. In the long run, the bill can affect the economy in both positive and negative ways. The positive effect will be a spurring of the market of real property as the First-Time Homebuyer Savings Account may increase home purchases make. The demand for the houses will increase, which will increase the housing price. The hot market of the real property will attract more investments. As a result, the real estate investors will build more personal residences and hire more people. The government can also get more tax revenues. However, it will be even harder for low-income individuals to afford housing with the increase in prices. Low-income taxpayers may not have enough money to set up the First-Time Homebuyer Savings Account after spending on necessities. Furthermore, the housing price will be increased by the demand resulted from the enactment of First-Time Homebuyer Savings Account, making housing even less affordable for low-income taxpayers. While the demand for the housing in the future remains unknown, the price of the housing will likely increase, negatively affecting the economy.	-

Transparency and Visibility – Will taxpayers know that the tax exists and how and when it is imposed upon them and others?	Taxpayers will easily be informed of the existence of the new rule because the real estate industry will promote the policy to attract more buyers. Furthermore, IRS will also update the individual income tax return (Form 1040) to reflect the existence of the account, with instructions on qualified contribution, exclusion amount, and taxability of distributions. Taxpayers can follow the instructions to utilize the rule.	+
Minimum tax gap – Is the likelihood of intentional and unintentional non-compliance likely to be low?	Structuring tax laws to minimize non-compliance is essential. However, for this proposal, the likelihood of both intentional and unintentional non-compliance is likely to be high. *Intentional non-compliance* This proposal could lead to underreporting when funds are distributed from the account for nonqualified use. Some taxpayers may take the distributions for nonqualified use and not report the distribution as taxable income. *Unintentional non-compliance* The current proposal, as written, would create some confusion as to who qualifies as the first-time homebuyer. An individual how owned a home previously but "had no present ownership" may claim as the first-time homebuyer and enjoy the tax-free distribution on the purchase of a home. The First-Time Homebuyer Saving Account proposal will satisfy the Minimum Tax Gap principle if specific guidelines are provided – e.g., more detailed definitions and higher excise tax on nonqualified distributions or contributions. Also, there should be rules to improve compliance. When a distribution is made and reported on a taxpayer's income tax return, supporting documents, e.g., a properly executed HUD-1, Settlement Statement, should be required to minimize abuse.	-

Accountability to taxpayers – Will taxpayers know the purpose of the rule, why needed and whether alternatives were considered? Can lawmakers support a rationale for the rule?	This principle is not met. Few details are provided when this proposal was introduced. Although there are similar tax measures adopted by a few states, this bill is proposed at the federal level, and it is not well publicized to the targeted group of taxpayers. It is not clear if there was sufficient research to determine if this would help most first-time homebuyers.	-
Appropriate government revenues – Will the government be able to determine how much tax revenue will likely be collected and when?	Tax systems should have appropriate levels of predictability, stability, and reliability to enable the government to determine the timing and amount of tax collections. It is unclear if the proposal would satisfy the Appropriate Government Revenues principle. Although the Treasury Department and the IRS may obtain similar data from the 529 plan to estimate the costs of the proposal, the real cost is unknown, as taxpayers may have different attitudes towards saving for college and saving for a first home.[9] Also, before the funds are distributed from the First-Time Homebuyer Savings Account, there is no reporting of how much investment income was generated and accumulated (unless the account reaches the maximum amount of $150,000). Therefore, the government has no estimate of revenue loss due to this tax-free growth. There are many factors affecting the housing market. Therefore, the timing of home purchase varies among taxpayers. As a result, the lost revenue due to tax-free growth	-

[9] United States Treasury (September 9, 2009). *An Analysis of Section 529 College Savings and Prepaid Tuition Plans.* Retrieved from: https://www.treasury.gov/press-center/press-releases/Documents/529.pdf

	in these saving accounts and potential tax revenue from nonqualified distribution is difficult to measure at a given time.	

Conclusion

In summary, this bill is not equitable for taxpayers, as affluent families enjoy more benefit than lower income families. The bill ultimately helps the higher income taxpayers those with excess savings. Also, the complexity and the uncertainties within the bill increase the risk of abuse and noncompliance. The First-Time Homebuyer Savings Account Act violates most of the principles of good tax policy and therefore should not be passed as proposed.

Congress should consider allocating financial resources to homebuyer support programs that target low-income taxpayers.

Should the legislators choose to pursue this proposal, certain modifications should be made to reflect the goal of this bill better. The tax bill should be simplified to decrease taxpayers' compliance costs and the government's administrative resources, making preparation, compliance, enforcement, and audits easier. Taxpayers can easily understand how much they can save to purchase their first home.

Modification should also be made to set strict income limitations on both the account holders and the beneficiaries to focus the bill on providing help to middle-income and low-income families. The bill should also set a limit on how long the fund can be held in the savings account. This limit will prevent indefinite wealth accumulation.

In conclusion, the First-Time Homebuyer Savings Account Act of 2017 does not meet some important principles of good tax policy and may not help to promote the American dream of homeownership and affordable housing widely.

Analysis of S. 1352 - 115th Congress (2017-2018)

Apprenticeship and Jobs Training Act of 2017

By: Veena Hemachandran, Katrina Jodrey, George (Peixuan) Liu, and Leigh Ann Moore

MST Students

Introduction

A survey by the National Association of Manufacturers revealed that 67 percent of manufacturers reported a shortage in their workforce.[1] S.1352, *Apprenticeship and Jobs Training Act of 2017*, introduced by U.S. Senators Maria Cantwell (D-WA) and Susan Collins (R-ME) in June 2017, attempts to address this shortage by enacting a $5,000 tax credit for up to three years for qualified employers who add new apprentices to apprenticeship programs. Apprenticeship programs are registered programs approved by the U.S. Department of Labor and can be sponsored by an individual, joint employer and by employer associations. Employers, who are registered under the apprenticeship system, which satisfy the criteria stated in the bill will receive a tax benefit for up to three years and on a per employee basis, therefore encouraging employers to invest in employees' on-the-job skill development and a quality workforce. This tax credit will reimburse the employers' cost to provide the training.

The senators have chosen the apprenticeship programs as a vehicle for the credit because data from the Department of Labor shows that such programs benefit both the employer and employees who can continue working while upgrading their skills. Such workers purportedly average "$240,000 more in wages over a lifetime" than non-apprentice workers.[2] In addition, the Urban Institute, a Washington D.C.-based think tank, states that "more than 80 percent of U.S. companies that registered apprenticeship programs met their demand for skilled labor" and that 94 percent of employers would recommend apprenticeship programs as a strategy to increase skilled labor.[3]

[1] Senators Maria Cantwell and Susan Collins (2017). *Cantwell, Collins Introduce Bill to Kickstart American Apprenticeship Legislation would create $5,000 tax credit, hundreds of thousands of new apprenticeships.* Retrieved from: https://www.cantwell.senate.gov/news/press-releases/cantwell-collins-introduce-bill-to-kickstart-american-apprenticeship
[2] *Ibid.*
[3] *Ibid.*

Principles of Good Tax Policy

The following section will briefly analyze S.1352 using the *Guiding Principles of Good Tax Policy* outlined in the AICPA Tax Policy Concept Statement No. 1.[4]

Criteria	**Does the proposal satisfy the criteria? (explain)**	**Result**
Equity and Fairness – Are similarly situated taxpayers taxed similarly? Consider the tax effect as a percentage of the taxpayer's income for different income levels of taxpayers.	This proposal provides a tax credit to eligible employers for a qualified apprenticeship program with non-seasonal employees who are not highly compensated. This satisfies the standard for vertical equity, since the bill aims to increase the skills for average workers. In addition, this policy also satisfies the concept of horizontal equity presuming the workers benefiting from the bill are at a similar income levels. Other than the limitation of "highly-compensated" workers as defined under Section 414(q), the bill does not have further limitations. Overall, employers' out-of-pocket expense on training would decrease by the credit. Also, because the benefit is provided via a tax credit, the benefit is not greater for employers in higher tax brackets.	**+/-**
Certainty – Does the rule clearly specify when the tax is owed and how the amount is determined? Are taxpayers likely to have confidence that	The bill does not specify how a taxpayer can take the credit, leaving it to the Treasury to provide the appropriate regulations. The following criteria must be satisfied to be eligible for the credit:	**-**

[4] American Institute of Certified Public Accountants (AICPA) Tax Division (January 2017). *Tax Policy Concept Statement 1 - Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals.* Retrieved from: https://www.aicpa.org/ADVOCACY/TAX/downloadabledocuments/tax-policy-concept-statement-no-1-global.pdf

they have applied the rule correctly.	1. The employer must be eligible for the credit by being either a Qualified Apprenticeship Program (QAP) or Qualified Multi-Employer Apprenticeship Program (QMEAP); 2. The individual must be a Qualified Individual (QI); 3. The number of QIs should exceed the apprenticeship participation average (APA). The proposal appears to be straightforward. However, the use of multiple terms such as QAP, QMEAP, QI, APA, and the calculations used in determining the eligibility of the taxpayer negate the principle of certainty. The employee may not know whether he or she is truly an eligible QI. In addition, if the program fails to qualify for either a QAP or QMEAP, the bill states that the QI can be moved to another eligible program. In practice, this may be harder to achieve, and existing employers may be hindered by such revolving workers and increased education expenses. After determining eligibility, a calculation is implemented, being either the lesser of the $5,000 or another formula-derived amount. The use of such formulas can lead to computation errors, which make the proposal more ambiguous and violates the certainty principle.	
Convenience of payment – Does the rule result in tax being paid at a time that is convenient for the payor?	The credit is claimed on the employer's return. However, this principle also relates to the simplicity and certainty principles, which have not been fulfilled. The calculation of the credit, as previously stated under the certainty principle, is error-prone due to the ambiguities involved in the calculation. It would be inconvenient for employers to be registered and constantly keep track of their eligibility with the program in order to remain eligible for this credit. Companies may decide that the costs outweigh the benefits of the program. Additional time is	-

	needed to disseminate the information required to the qualifying apprenticeship programs, and this may lead to delays in return preparation, adding fees and liabilities to already overburdened taxpayers.	
Effective Tax Administration – Are the costs to administer and comply with this rule at minimum level for both the government and taxpayers?	Both finances and time value of money should be considered with respect to cost. The potential time taken to apply this credit to an employer's tax return could be costly. Calculations needed to determine the eligibility of the credit, and its associated calculations are, as previously stated, complicated and the additional time required to ascertain the calculation could outweigh the benefits of the credit. The cost is increased by the need to complete additional forms and hire eligible employees. In addition, any penalty that would be imposed on a taxpayer for improperly taking this credit should also be considered. Because this credit is difficult to compute, it is likely that there will be errors resulting in penalties. These will potentially increase the cost to both taxpayers and the IRS.	-
Information Security – Will taxpayer information be protected from both unintended and improper disclosure?	When it comes to information security, this proposal is neutral. The credit would be given to employers based on their current employees for whom they already have information. There should be no additional risk to taxpayer information security. In addition, individuals would claim the credit with additional tax forms along with their annual tax filing, and there would be no additional risk to their information either. The risk of having the security of personal information breached is not any different than it would be without this credit.	N/A
Simplicity - Can taxpayers understand the rule and comply	Much of the additional law that is built in with this proposal is fairly confusing, adding complexity to the current tax law. This proposal also has a lot of caveats as to how much the taxpayer	-

with it correctly and in a cost-efficient manner?	can claim. The legislative language makes it difficult to understand who is qualified to take the credit initially. A typical taxpayer without expert tax knowledge would not understand what this law means to them. Simplicity closely ties to the certainty principle, which is not met by this bill. If there is no certainty in how the tax policy affects taxpayers and how the credit is calculated and used, then simplicity is not achieved. The complex definitions in the bill already violate the simplicity rule. In addition, an employer must also register with the national apprenticeship program and make sure that the entity is subject to the correct agreements. Furthermore, employees will also need to follow a different set of rules to meet the qualifications, which can be complicated on its own. Finally, when it comes to claiming the credit, the employer must go through the steps necessary to calculate and appropriately categorize the credit on the tax return. Referencing the steps laid out in the evaluation of the certainty principle earlier, this proposal does not simplify the current code nor does it effectively follow the simplicity principle in making sure that taxpayers understand the code and are able to apply it correctly and effectively.	
Neutrality – Is the rule unlikely to change taxpayer behavior?	Professor Jason Furman of Harvard Universtiy once explained that "generally, the tax system should strive to be neutral so that decisions are made on their economic merits and not for tax reasons."[5] However, policymakers often depart from neutrality to achieve specific goals. This bill seeks to establish a tax credit for on-site apprenticeship programs in what	**-**

[5] Furman, Jason. April 15, 2008. Testimony Before the U.S. Senate Committee on Finance Hearing on "Tax: Fundamentals in Advance of Reform." *The Concept of Neutrality in Tax Policy*. Retrieved from: https://www.brookings.edu/wp-content/uploads/2016/06/0415_tax-_neutrality_furman-1.pdf

	appears to be an effort to favor and stimulate jobs in the skilled trades and similar sectors of the economy. Inherently, it is not tax-neutral. It is purposefully trying to incentivize a change in behavior to invest more in certain types of workers and industries.	
Economic growth and efficiency – Will the rule not unduly impede or reduce the productive capacity of the economy?	The tax would not likely impede or reduce the productive capacity of the economy since the maximum credit available per qualified individual is only $5,000 in a limited sector of the economy. In fact, the author of the legislation introduced it to stimulate employment in the skilled trades and apprenticeship programs, which are under-represented in the building and other service-provider sectors of the economy. The legislation also provides a veteran's preference to help provide job opportunities for returning veterans. The recordkeeping requirements include: the amount of wages paid to the individual, the total number of hours of work performed by the individual, the average of the total number of qualified individuals for the prior 3 years, potential overlap of the wages of this program with other Section 38 credits, whether or not the program is "qualified", whether or not the worker is seasonal, or whether or not the training is for a "qualified occupation", etc. Given the complexity, it seems unlikely that many taxpayers would want to take advantage of the credit for an annual benefit of $5,000 per worker for a maximum of 3 years. It might cost them that much to comply.	**+/-**
Transparency and Visibility – Will taxpayers know that	Without a publicity campaign, it is unlikely that taxpayers will know of the credit and how to participate in the program. The taxpayer(s) subject to the proposed Section 45S credit would	**-**

the tax exists and how and when it is imposed upon them and others?	be employers who participate in qualified apprenticeship programs. Most of these programs provide education to those interested in skilled trades such as carpentry, electrical, HVAC, machinist, painting, plumbing, and tile laying (for example per the State of California Department of Industrial Relations). According to the U.S. Department of Labor website, most of these taxpayers are small businesses in the building and improvement sector, or trade schools, training centers, or unions. These taxpayers are likely not sophisticated enough to maintain their own tax departments that would keep abreast of changes in tax law. More likely, a small to mid-size taxpayer like this would have their taxes prepared by their local CPA firm who may or may not be aware of this opportunity to inform the taxpayer of the tax benefit. Most importantly, the recordkeeping requirements to take the credit are substantial and must be communicated to the taxpayer well in advance of preparing their current year return, to educate them about the information needed. Furthermore, if the public wanted to gain an understanding of how the credit is calculated or carried out, it would be difficult to obtain this information.	
Minimum tax gap – Is the likelihood of intentional and unintentional non-compliance likely to be low?	The likelihood of intentional and unintentional non-compliance is likely to be low. First, the qualified credit is essentially capped at $15,000 maximum for each qualified individual claimable by the employer, and the credit is not allowed to be claimed for more than three taxable years with respect to any qualified individual. Second, the individual must (a) satisfy the rules laid out by the National Apprenticeship Act, (b) must have a qualified apprenticeship agreement with the qualified employer, and (c) the agreement must also be subject to the rules governed by the National Apprenticeship	+

	Act. For an employer to have a qualified apprenticeship program, it must be registered with the office of apprenticeship and training administration of labor or a state apprenticeship agency recognized by such office of apprenticeship. All of the programs must be registered, filed and maintained with proper authorities. These action items create extra layers of protection preventing intentional and unintentional non-compliances. Even though the rule allows an employee to transfer the completed training or educational credits to a separate apprenticeship agreement with a different employer, all the qualifications pertain to the individual; the separate apprenticeship program and the agreement must still be qualified under the rules of National Apprenticeship Act. The complexity of the rules is more likely to deter employers from claiming such credit than causing the likelihood of intentional or unintentional non-compliance in claiming such business tax credit.	
Accountability to taxpayers – Will taxpayers know the purpose of the rule, why needed and whether alternatives were considered? Can lawmakers support a rationale for the rule?	According to Section (e) of this proposed bill, the Controller General of the United States will need to conduct and submit evaluations to the Committees of Finance and Health, Education, Labor, and Pensions as well as to the Committees on Ways and Means. Although the bill did not specify in detail regarding the accountability of taxpayers, the responsibility of providing public awareness for this credit will be assumed by the agencies who are also collecting data for compliance purposes. Section (e) of this bill explains what needs to be included in the evaluation report. Some examples include: (1) whether qualified individuals or programs received credits, (2) whether qualified individuals who completed the	**+/-**

	apprenticeship program stayed in the same occupation, and (3) recommendation for improvement on legislative administrations all suggest that the burden of compliance and measurement for effectiveness falls on the government agencies rather than the taxpayers. On June 15, 2017, President Trump signed an executive order to create a task force to recommend ways to promote the apprenticeship programs and require all federal agencies to put in more efforts in evaluating and consolidating training programs.[6] Furthermore, President Trump wants the Department of Labor to allow companies to develop their own industry apprenticeship guidelines that are reviewed on a consistent basis.[7] This proposal happens to be one of the few that gained bipartisan support. The bill does not state in detail how taxpayers will be held accountable in complying with the requirements other than filing the required information for claiming the credit. The efficiency and effectiveness of the program will rely heavily upon the efforts of the government agencies for public awareness, reporting relevant data, and implementing and updating provisions on a yearly basis.	
Appropriate government revenues – Will the government be able to determine how much tax revenue will likely be collected and when?	The purpose of this bill is to induce economic growth by extending business credits to professional training programs. It will be hard to measure the indirect revenue that the government is hoping to collect by using this credit to induce business success because results might be due to factors other than the credit. However, it is easy to measure the tax expenditure the government will incur to sponsor this credit.	**+/-**

[6] Executive Order No. 13801 (June 15, 2017). 82 FR 28229, 2017-13012.
[7] Office of the Press Secretary (June 15, 2017). *Presidential Executive Order on Expanding Apprenticeships in America.* whitehouse.gov. Washington, D.C.: White House. Retrieved from: https://www.whitehouse.gov/pre sidential-actions/3245/

	Given the fact that both employers and sponsoring programs must comply with the specific rules laid out by the Apprenticeship Act and required proper filings, it is easy for the Department of Labor and IRS to compile data based on the number of taxpayers and employer programs registered with the authorities.	

Conclusion

Although the idea behind the proposal is positive with an attempt to stimulate economic and job growth, our evaluation shows that achieving these objectives through the tax code is unlikely to be successful. Results are mixed for principles such as economic growth, efficiency, equity, and fairness. Other principles such as certainty, transparency, visibility, and simplicity are violated. The only positive result is the minimum tax gap. The added complexities introduced into the tax code bring about more costs than incentives for businesses to hire and train their employees. Taxpayers and government agencies are burdened by additional recordkeeping requirements and potential penalties if the credit is not claimed correctly. This could lead to the credit being ignored or misused, thus failing to meet the stated objectives of the bill. Therefore, enacting this bill is not recommended.

Possible Improvements

The main problems identified relate to the violation of the simplicity, certainty, and transparency and visibility principles. A viable alternative would be to fund a grant through the Department of Labor that is similar to Pell Grants run through the Department of Education. The grants could be given to employees directly, allowing workers to apply for the grant on an individual basis. This not only bypasses the tax code but empowers the workers by incentivizing them to better their skills. The funds would operate on a first-come-first-serve basis, creating competition for workers. This would solve many of the issues identified, including simplicity and certainty. Another approach would be to encourage states to run trade schools or community colleges by offering grants and subsidies to students seeking certain high-level job training and education.